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POLICIES MANUAL - INSURANCE AND RISK MANAGEMENT

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**Synopsis**

- 1) Risk management is the process of planning, organizing, directing, and controlling an organization's resources and activities to minimize the effects of losses.
- 2) The first step in successful risk management is to identify the potential areas of risk, such as liability, property, personnel, or loss of income. Some of the methods used to identify these risks are questionnaires, the review of financial statements, interviews, and the analysis of loss data.
- 3) Once the unit has evaluated the identified risks, the next step is to decide how to handle that risk. Risk is handled through either risk control techniques, which minimize the losses faced by the unit, or risk financing techniques, which utilize various alternatives to provide funds for accidental losses that may occur despite risk control efforts.
- 4) Avoiding a risk may be preferable in some circumstances. However, avoidance is not always possible. Loss prevention or reduction is an effective method of risk control. Other loss exposures can be transferred to other entities by leasing assets or utilizing independent contractors.
- 5) Loss exposures are financed by either retaining some or all of the risk within the unit or by transferring that risk to other entities through insurance or other transfer methods.
- 6) A vital step to a risk management program's success is a risk management policy that is supported by the local government's top management.
- 7) If the unit has transferred the risk of loss to another entity, the expenditure/expense for the premium should be recorded in the period it is incurred and is measurable as an expenditure/expense and related liability of that period.

- 8) Risks of loss that have not been transferred to another entity should be reported in the financial statements of the local government as an expenditure/expense and as a liability if both of the following conditions are met:
  - a) Information available before the financial statements are issued indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and
  - b) The amount of the loss can be reasonably estimated.
- 9) If both conditions are not met but there is a reasonable possibility that a loss has occurred, then the risk of loss should be disclosed in the notes to the financial statements.
- 10) Local government units that account for risk financing in a single fund should do so in either the general fund or in an internal service fund.
- 11) However units account for risk, certain disclosure information is required in the notes to the financial statements. Several illustrated note disclosures are presented in Exhibit B.

### Introduction

Risk management is the process of planning, organizing, directing, and controlling the resources and activities of an organization in order to minimize the adverse effects of accidental losses at the least possible cost. The two main elements of risk management are risk control, which is minimizing any losses, and risk financing, which is using various techniques to provide funds for accidental losses which may occur despite risk control efforts. Risk management emphasizes pure risk, which is the risk that certain events will result in losses if they occur. Speculative risk, or the risk of gains and losses from investments or other such activities, is not considered. The ultimate objective of all risk management activity is to preserve the unit's assets as well as its ability to function.

To accomplish successful risk management, the local government must first identify the areas of risk for the unit by utilizing various identification tools. The government will then need to evaluate the risks it is facing to ascertain the best way to handle each one. Once a risk is evaluated, the unit can elect to avoid, reduce, retain, or transfer the risk, depending on the potential losses resulting from the risk and the financial condition of the unit involved.

### Risk Identification

The starting point for effective risk management is to identify the potential areas of risk. Failure to recognize a potential loss will inevitably lead to a failure to provide for the consequences. The risk manager should seek to identify both insurable and uninsurable risks and attempt to determine their financial impact on the unit. The most effective risk identification is accomplished by an individual who is knowledgeable about all areas of the organization. Local governments can experience losses through liability exposures, property exposures, personnel exposures, or the loss of income. All these exposures may potentially result in the impairment of assets. Numerous tools such as questionnaires, interviews, observations, and financial statement analysis will assist the manager in identifying the areas of risk.

**Note: The following material is for informational purposes only and is not intended to substitute for the advice of the local governmental unit's attorney. Units with specific legal questions should always contact their attorney.**

### **Types of Liability**

Contractual Liability - Contractual liability is the liability assumed under any contract or agreement. Purchasing agreements, leasing contracts, service contracts, and construction contracts all expose the unit to contract risk. Many contracts and licensing agreements contain a "hold harmless" clause in which one party agrees to hold the other harmless because certain liabilities are assumed by the first party. A unit that fails to recognize this potential liability to other entities may expose itself to significant, unexpected liabilities. Also, the failure by a local government to comply with contractual requirements exposes the unit to charges for breach of contract. To avoid potential contract liability, the risk manager should review all contracts for conditions, role clarity, and terminology before they are accepted by the unit. As an alternative, the unit can develop standard wording to use in all contracts that limits the risk assumed by the local government. Once the standard is developed, the risk manager will only need to review those contracts that vary from that standard wording. No governmental immunity exists for contract liability; regardless of the activity which a contract is associated with, the local government will be held to the same performance that a private organization would be. Governmental immunity in North Carolina is discussed under the heading "Civil Liability - North Carolina Law" in this section of the manual.

Civil Liability - Another area of potential risk is that of civil or tort liability. A tort is a civil wrong for which an individual who is injured in person or property can recover a monetary award from the alleged wrongdoer. Tort laws function to make the person who has injured another person pay for that injury and also to deter people from engaging in conduct that is likely to cause personal injury or property damage. To identify the potential liabilities facing local governments, liability under both North Carolina law and federal law must be explored. The following discussion is drawn from "Civil Liability of the County and County Officials" by Michael R. Smith, which can be found in County Government in North Carolina, Fleming A. Bell, II, Editor.

Civil Liability under North Carolina Law - Civil liability under North Carolina law arises from intentional acts or from negligence that causes personal injuries or property damage. Intentional acts are those that cause personal

injury or property damage without consent or legal excuse. Examples of intentional or wrongful acts are assault, battery, false imprisonment, false arrest, malicious prosecution, defamation, and trespassing.

Civil liability also can occur for a negligent act. The law imposes a duty on each person to exercise care in conducting his/her daily affairs. A person may be negligent if he/she fails to exercise reasonable care and causes personal injury or property damage to another as a result. If a person has a legal duty to act and fails to do so, then he/she can be held liable for negligent inaction. Before a person can be required to pay damages for negligence, it must be established that:

- (1) His/her failure to exercise reasonable care under the circumstances directly caused the injury, and
- (2) He/she should have predicted that his/her conduct would result in some injury.

The court will go through a predictable process of defining the duty which was owed to the injured party; determining that a breach of that duty actually occurred; deciding whether the breach resulted in damages; and reviewing any off-setting circumstances. Negligent civil wrongs occur more often than intentional wrongs and result in more lawsuits.

In North Carolina, two types of immunity have typically been granted to local governments. The Constitution of the State of North Carolina and the North Carolina General Statutes confer the power to make ordinances and policies upon the public officials of local governments. Under the doctrine of discretionary immunity, North Carolina courts will not review decisions that have been left to the sound discretion of a local legislative body. If a tort arises out of the passage or repeal of a local government ordinance, the State courts will not impose a liability on the local government for exercising this power. For example, in Hill versus the City of Charlotte, the city's board temporarily suspended a local ordinance against the use of fireworks inside the city limits. A building was destroyed when fireworks landed on the roof and caught fire. The owner of the building sued the city to recover damages, alleging that the board was negligent in suspending the ordinance that caused his loss. The State Supreme Court denied recovery on the grounds that

a municipality is not liable for the exercise or nonexercise of a discretionary power. The Court would not substitute its judgement for that of the local governing body. Note: the owner of the building may still have some recourse under federal statutes.

The second type of immunity provided to local governments in North Carolina is governmental immunity. Under governmental immunity, North Carolina local governments may not be sued in tort for the manner in which a governmental function is conducted. A governmental function is one that the government engages in for the benefit of the citizens as a whole. On the other hand, units will be held fully liable for torts that may occur in association with proprietary functions. A proprietary function is conducted primarily for the convenience of the citizens and bears a close resemblance to, or directly competes with, private enterprise. For some legally mandated activities such as street or sidewalk maintenance, immunity may still apply, depending upon the individual circumstances. There has been much confusion over how to classify certain activities. Typical governmental activities are the court system, law enforcement, and public building maintenance. Activities such as electric power plants, airports, water plants, and hospitals would be considered proprietary functions. Court decisions on governmental immunity are decided based more on case precedent than on any legal theory. Although the four-part test below cannot be used with certainty, it can be used to provide guidance about whether a particular activity is a governmental or proprietary one:

- 1) Whether the activity is undertaken for a public benefit.
- 2) Whether the activity has traditionally been performed by the government.
- 3) Whether a private company would engage in the activity.
- 4) Whether a fee is charged for the activity.

Once the question of immunity is decided against a local government, the State Court will apply general tort law to the case.

G.S. 160A-485 authorizes any municipality to waive its immunity from civil liability in tort by purchasing liability insurance or participating in a risk-sharing pool. G.S. 153A-435 allows a county the same powers. A municipality may decide to purchase liability insurance because having such insurance is good public policy in case

any citizen is injured or property is damaged by a governmental activity. In addition, immunity is such an inconsistently applied concept that a unit may not wish to depend on governmental immunity to provide a defense against tort liability. As discussed earlier, governmental immunity also will not apply to proprietary activities; therefore, some risk planning may be necessary to provide for potential claims against those activities. For governmental functions, the immunity is waived only to the extent of the insurance purchased. A judgement against a unit for damages on a tort claim that arises out of a governmental activity may not exceed the coverage of the local unit's liability insurance. However, a judgement against a city on a tort claim that arises out of a proprietary activity may very well exceed the coverage of the unit's primary liability insurance. For these types of claims, excess insurance coverage may be necessary.

Officials and employees of local governments are not absolved of the personal responsibility for any civil wrongs that they may commit because they work for a local government. Depending upon the circumstances at the time of the injury, the official may be granted either qualified immunity or no immunity. A policy-making official performing duties which require the exercise of judgement and discretion is not liable for damages caused by negligence in carrying out these duties, unless the official causes injury to another by actions taken for malicious or corrupt reasons. An officer may not be held personally liable for negligence in the exercise of discretionary governmental power. That same public official may be held personally liable for the negligent performance of a ministerial act. A ministerial act is one done in a prescribed manner or as an attendant or agent for another, such as receiving a fiduciary public bond from a unit employee in accordance with the General Statutes. (The question of the distinction between discretionary and ministerial acts of public officials parallels the problems with the governmental and proprietary distinctions. The distinction cannot be clearly defined and a court will rely more on case precedent than on any legal theory.) On the other hand, all public officers and employees will be held personally liable for damages caused by their intentional or wrongful acts. No public interest would be served by granting government employees immunity from liability for intentional torts.

In contrast, regular employees who work under the direction of a superior and exercise no discretion in performing their duties can be held personally liable for injuries caused by their negligence. Unlike officials whose tasks involve the

exercise of discretion, such employees perform mechanical tasks and are presumably not hesitant to act out of fear of liability. The process of legally defining a person as an official or as an employee can be difficult to do. Such decisions within a courtroom will be based as much on case precedent as on legal theory. Though a unit could consider sworn persons as officials and non-sworn persons as employees, this distinction may not hold up in court. In the case of *Miller v. Jones*, for example, governmental employees negligently drove a street sweeper past the open doors of a local store and much of the store's merchandise was ruined. The State Supreme Court held that the employees who operated the sweeper could be required to pay for the damages caused by their negligence. The State Court gave the following explanation:

A mere employee doing a mechanical job...must exercise some sort of judgement in plying his shovel or driving his truck...The mere fact that a person...is an employee of others...does not excuse him from liability for negligence in the manner in which his duties are performed.

G.S. 160A-167 authorizes any municipality, county or authority to purchase insurance to provide for the payment of claims for civil judgements against any present or former employee or officer. The unit also can provide for defense counsel and appropriate funds to pay any judgements entered, unless the employee or officer in question acted out of malice, fraud, or corruption. G.S. 160A-167(c) requires that the governing board of all municipalities, counties, and authorities adopt and make available for public inspection uniform standards under which claims made or judgements entered will be paid. The North Carolina League of Municipalities has developed a sample uniform standards resolution for units to consider when adopting an ordinance of this nature.

Civil Liability under Federal Law - A local government's liability under federal law is completely different from liability under State law. Federal statute 42 U.S.C. Section 1983 authorizes a person to sue and recover damages against a government or its officers for violations of federal constitutional or of statutory rights when the violations are caused by official conduct. A Section 1983 lawsuit may lead to an award of monetary damages; a declaratory judgement, a statement by the court; or injunctive relief, an order by the court requiring a person to act or refrain from acting in a certain manner. In 1978, the United States Supreme Court declared that under certain circumstances a local government may be held liable under Section 1983. Types of official conduct that can give rise

to federal civil liability under Section 1983 are the violation of constitutional rights such as wrongful search and seizure, the right of free speech and political affiliation, or the right to a due process of law. Additionally, Section 1983 authorizes a person, whose rights under a federal statute have been violated, to sue and recover damages. The variety of federal statutes that might be violated and become the subject of a Section 1983 lawsuit are very numerous and are not listed in this manual.

A governmental unit may be required to pay monetary damages in a lawsuit brought under Section 1983 only if the violation of federal rights is caused by official policy. (The distinction between governmental and proprietary functions does not determine whether a unit may be held liable under a Section 1983 lawsuit. Those distinctions only apply to suits brought under State law.) The unit may be held liable for damages under Section 1983 if a person's federal rights are violated as a result of the implementation of an ordinance, regulation, or decision that has been officially adopted by the governing board. Based on a recent landmark case, if a local governmental unit is judged by a court to have an implied "failure to train" policy in existence for employees, and damages are caused by this policy, then the unit may be held liable. A failure to train policy may be imposed upon a unit by the court if the unit's employees are so poorly trained that this failure is deemed to be an implied official unit policy. Insufficient training of jailers or other law enforcement personnel has been determined to be a "failure to train" policy and units of government were liable under Section 1983 as the result. The unit will not be required to pay damages if the violation of federal rights was caused by an independent, isolated act of an officer or employee who had no authority to set final policy for the unit. For example, a unit is probably not liable under Section 1983 if a police officer makes an illegal arrest in violation of someone's Fourth Amendment rights against wrongful search and seizure, as long as it is not the unit's policy to make such arrests. If the violation was the officer's independent, wrongful act, then he/she may be held personally responsible under federal law even though the officer may still be immune under State laws (based on governmental immunity).

Members of governing boards are absolutely immune from personal liability when legislative actions of the board violate someone's federal rights. Absolute immunity means that a council member can never be held personally responsible in a Section 1983 lawsuit for a board action even if the action violates someone's federal constitutional or statutory rights. Such absolute immunity is considered

necessary to ensure that local legislators will perform their duties for the public good without fear of personal liability. This grant of absolute immunity extends only to acts taken within the scope of council members' legislative duties. For example, board members could not be held personally liable in a Section 1983 lawsuit if the board enacts a zoning ordinance that devalues someone's land so much that it is essentially an unconstitutional taking of property without just compensation. Even though the local government may be liable in this case, the board members involved could not be held personally responsible for the action.

Employees and officers who violate the federal rights of another person while performing their official duties are entitled to qualified - not absolute - immunity. Officers and employees are protected from liability if they acted in objective good faith. Objective good faith has been interpreted to mean that an official or employee may not be held liable in a Section 1983 lawsuit unless his/her conduct is clearly prohibited under existing federal law. No immunity would be granted for acts for personal gain, malice, or those outside the scope of authority.

Environmental Liabilities - Even though the environmental exposures of a governmental unit are somewhat less than those of a business in the private sector, environmental liability is still an area of potential loss exposure for local governments. The environmental exposures of a public entity can be divided into two categories: retrospective and prospective exposures.

Retrospective exposures are those arising from past operations. It is possible for units to have retrospective exposures of which they are not aware. Exposures would include landfills with toxic waste, leaking underground storage tanks, or contaminated water caused by the salting of roadways. Multi-user landfills by far have the most visible and expensive potential retrospective exposures. According to the Governmental Risk Management Report of August 1990, up to one-third of the sites on the Environmental Protection Agency's (EPA) priority list for immediate cleanup are multi-user landfills. The EPA conservatively estimates the cost to clean up each site on its priority list at \$29 million. Even though local governments may be responsible for only a small percentage of the total cleanup costs, any percentage of \$29 million can be catastrophic to a local government.

The Governmental Risk Management Report of August 1990 also sited leaking underground storage tanks as a potentially large risk. The EPA estimates that approximately 62,000 of the country's 1.3 million underground storage tanks belong to government entities and that up to 20% of those may be leaking. Any local government with underground tanks should consider inventory monitoring to help detect leakage. Technical equipment exists that will monitor the inventory levels in underground tanks and detect any leakage. Suspected leaks should be investigated immediately. EPA technical regulations are being phased in that will require all tanks to be monitored within the next few years.

Salt used to clear roads of ice and snow is a major contaminant in the water supplies. In the past, it was a common practice of some local governmental entities to store salt outside on the ground. As water infiltrated these salt piles, the runoff contaminated groundwater. For some entities, these storage and usage practices have led to significant levels of salt in the soil. High salt content kills vegetation and animals, rusts cars and bridges, and erodes the soil. Some wells that supply drinking water have been closed due to their high salt content. Contaminated areas will have to be cleared of the excess salt.

Other environmental exposures are prospective. The local unit also may face prospective, or future liability, for items such as above-ground storage tanks, multi-user landfills, waste incinerators, spraying operations, hazardous household waste, or sludge. Above-ground storage tanks can potentially cause many of the same problems as underground storage tanks. The local unit should regularly inspect any above-ground storage tanks for signs of decay or damage. Multi-user landfills also are a prospective environmental concern. Over time, environmental damage can occur from the leakage of landfills. While a landfill is still operating, the tipping fees should reflect not only the costs of securing the facility after it is permanently closed but also the risk of possible environmental damage in the future. Many landfills are now being replaced by waste incinerators. The risks from waste incinerators arise primarily from the heavy metal content of the fly ash and from unsafe ash disposal. Another potential liability exposure, herbicide and pesticide spraying, can cause crop damage or serious personal injury if an accidentally large release should occur. Local governments which collect household waste for disposal also face a liability of an accidental spillage during transport or leakage during storage. Lastly, waste water treatment often produces

sludge with a high heavy metal content that must be disposed of properly to avoid serious health risks to the general public. Environmental exposures are almost everywhere, and areas that are not even perceived as being risky today may prove to be very costly in the future.

Solid waste, hazardous waste, and toxic substances or petroleum products stored in underground tanks are regulated under federal law by the Resource and Conservation Recovery Act (RCRA). A companion federal law, The Comprehensive Environmental Response Compensation and Liability Act (CERCLA), commonly known as the "Superfund" law, works in conjunction with RCRA. Both laws are administered by the Environmental Protection Agency. The goals of RCRA regulations are to protect humans and the environment from the potential hazards of waste disposal, to conserve natural resources, to reduce the amounts of waste generated, and to ensure that those wastes are treated in an environmentally sound manner. Landfills, surface impoundments, land application facilities, and waste piles are some of the treatment methods covered in Subtitle D of RCRA. CERCLA attempts to deal with past waste mismanagement by cleaning up inactive and abandoned hazardous waste sites. Local units should be aware of the potential liability under these federal laws. Further information and publications concerning the RCRA program can be obtained by calling the EPA's toll-free RCRA/Superfund hotline at 1-800-424-3000.

### **Loss of Property**

Another potential loss exposure for local governments is property loss. Property losses may be either direct or indirect. A direct property loss occurs when an asset is damaged or destroyed as a result of a particular peril. An indirect property loss occurs when an asset loses its value because of damage to some other property. For example, an indirect loss would occur for the "going concern" value of the assets used for a specific function if a unit discontinues that function. Those assets, which must then be sold separately, may be sold at less than their aggregate value to the unit. Potential property losses are more easily identified than the other types of losses. Risk valuation is the major area of concern with property loss. Property loss covers the risk of damage to all property both real or personal, tangible or intangible, that is owned, maintained, or leased by the unit.

Real property, such as buildings, is carried at historical cost with no depreciation recorded, unless the asset is recorded in an enterprise fund. The value to consider regarding real property is the potential loss of the

structure based on the current replacement cost. In addition, the risk manager should be familiar with local building codes that may be applicable to partial damage. Building codes may require that the entire building be replaced in accordance with existing code if the building is determined to be more than 50% destroyed.

To properly assess the risk exposures relating to personal property, the risk manager will need to answer the following questions and many others. Inventory - How accurate are the inventory records and how well is the inventory valued? Electronic data processing (EDP)- Are the records safe from destruction and are regular back-ups made? What would be the cost to obtain replacement EDP services if there was major downtime? Cash items - How good are the internal controls and are deposits made daily and properly insured or collateralized? Are the automobiles of the local unit's fleet maintained in good repair? Is there a daily system for checking vehicles before placing them in service? Are the personnel who utilize various vehicles in their course of employment properly licensed to do so? The risk management questionnaire in Exhibit A of this section is devoted in large part to the identification and valuation of potential property losses.

### **Net Income Losses**

Another major area of risk faced by local governments is that of income loss. Net income losses are decreases in revenues or increases in expenses which occur when an organization's operations cease or are impaired because of a specific event. For example, the tax base of a local government will be severely impaired if a major taxpayer ceases operations. As a result, the unit's revenues may be adversely affected. Units whose activities are financed with grant funds face the risk that the funds will not be available in the future. For units financing facilities with revenue bonds, the debt service for the bonds will still be due even if the revenue source is lost. The governmental unit will only be able to continue functioning effectively and providing the same level of services if the revenue sources currently utilized and relied upon continue to be available.

### **Personnel Losses**

A local governmental unit cannot function effectively without key personnel. The loss of personnel may result from resignation, disability, retirement, or death. The effect of the loss on an organization depends upon such factors as the value of the person's services to the unit

and the costs associated with replacing that person. The personnel losses incurred by an organization include the costs to replace personnel and the additional health insurance, workers' compensation payments, unemployment benefits, pension or death benefits, or other benefits due to the former employee.

#### **Risk Identification Methods**

To help identify these various areas of potential risk, a risk management questionnaire can be an effective tool for risk identification. Such questionnaires are designed to elicit information on the structure, assets, liabilities, operations, and personnel within the organization to help identify areas of potential risk. Local governments can obtain sample questionnaires from several sources. Most insurance companies have questionnaires to help units identify risk, but these often focus on insurable risks only. There are numerous risks that units must be aware of and plan for that are not insurable. Trade associations or risk management literature also are excellent sources for questionnaires. A sample questionnaire is included in Exhibit A. It is important that a manager review the questionnaire closely and modify it as necessary to suit the unit's individual needs. Questionnaires should all address the following points:

- 1) owned and leased real and personal property,
- 2) income sources,
- 3) contractual obligations,
- 4) other liabilities besides contractual ones, and
- 5) personnel.

A unit's financial statements also are invaluable in identifying areas of risk. The current fiscal year's budget should be used by the risk manager in conjunction with the financial statements to locate potential losses of income or pending board plans which may expose the unit to excessive risk. The balance sheet can be a starting point for identifying risk; however, since assets are valued at historical cost, the financial statements may not be an effective tool for valuing risks. Other sources may need to be consulted to measure these risks. For example, asset entries for an equipment purchase could alert the risk manager to inquire further into the nature of the equipment, its importance to the unit's continuing operations, and the cost to replace the asset.

Inspections and interviews with employees are good methods to identify risk. The risk manager will need to talk to employees to ensure that existing safety procedures are being followed and that safety equipment is being used. The best way for the manager to become aware of unsafe activities is to observe them firsthand. Through observation, the risk manager will become familiar with the unit's operations and be aware of situations requiring management's attention. Employees should be questioned about their safety concerns since they are the most familiar with day to day operations.

If the risk manager has a good rapport with other managers, the managers will be more likely to ask for advice and to notify the risk manager of any pending activities or plans in their areas of responsibility. The risk manager should be advised of major changes in procedure, significant purchases, and other unit plans since these may all involve potential changes in risk. Strong management contacts will help facilitate this communication.

Well-maintained loss records can be invaluable to the risk manager in identifying potential areas of risk. If possible, the records should be maintained for insured as well as uninsured losses. The loss records of other local governmental units also can be helpful in identifying and evaluating risks.

### **Risk Evaluation**

After the risks facing a local government have been identified, the next step is to analyze the likelihood and potential severity of the identified loss. When valuing risk, it is important for the risk manager to remember that certain losses will cost the unit much more than the cost of property replacement. When measuring risks, the manager also should consider any loss of income as well as any costs to recreate the asset. If possible, the cost of maintaining services during the replacement or repair period should be considered. The purposes of risk evaluation are:

- 1) to determine the relative importance of each risk (saving money by not overinsuring),
- 2) to aid the manager in deciding the best methods to use for risk control, and
- 3) to establish insurable values (both to purchase insurance and to substantiate claims).

The two elements of risk are severity and frequency. Severity is the potential size of the loss of each exposure. In other words, severity is the dollar amount of the potential loss to the unit not only from a single event but also over a particular time period. Frequency is the number of times a loss of a given magnitude can be expected to occur. Exact risk evaluations are difficult to determine. For any given period, the average anticipated losses of a particular group can be estimated by multiplying the average frequency of the loss by the average dollar amount of the loss and then adjusting for variables such as inflation, and changes in risk, such as the purchase of several new automobiles for the unit's use. Certified actuaries have numerous tools to value risk and units may elect to use these professionals for such work. In addition, a unit may use professional judgement or experience to value risks. Probably some combination of these various methods will best suit most units.

### Risk Control

Once the risks of a local government have been identified and analyzed, the manager must then decide how to deal with those risks. Risk is handled through risk control or risk financing techniques. Risk control alternatives include:

risk avoidance - to completely eliminate the risk,

loss prevention - to reduce the chance of a given loss,

loss reduction - to reduce the severity of those losses which do occur, or

utilization of noninsurance transfer - to transfer the loss exposure to another entity by means other than insurance.

There is much overlap between the various alternatives to control risk. No category is mutually exclusive and, indeed, some risk control activities performed by a unit may fit into several of these categories.

### **Risk Avoidance**

One way to control risk is to completely eliminate the risk or the elements causing it. The risk manager should be consulted about acquisition of properties, new services provided by the unit, and major policy changes, etc. that may give rise to new risks so that those risks can be avoided if desired. If the risk manager is not included in

the original management decision to begin a certain activity and is informed only after the decision is made, then the opportunity for risk avoidance is lost and any risk management will have to be accomplished through other methods. Obviously, many operational decisions will be made without considering the risk exposures involved, so the risk manager needs to be prepared to use other risk methods of control as well.

### **Loss Prevention and Reduction**

Other risk control techniques are loss prevention and reduction. Reducing the risk can mean reducing the chance of a given loss or reducing the severity of those losses that do occur. A program of regularly scheduled inspections to find any potential loss exposures should be conducted by the safety director, or another knowledgeable employee or consultant. Safety measures such as safety glasses, steel-tipped shoes, or protective clothing can reduce the risk of employee accidents. Continual training of all employees and officials about existing safety policies and procedures also is necessary for successful risk reduction. Medical programs that supply employees with both pre-employment and annual physicals can provide employees with knowledge about potential problems. Employee health care, wellness programs, and emergency first aid help improve general employee health and also may reduce health claims in the long-run.

Safety programs usually work to combine loss prevention and reduction methods to accomplish risk control. For example, assume that a municipality operates a paint department for all city property. The risks associated with this activity are frequent and severe. The risk manager desired to avoid the risk by eliminating the department and contracting out for painting services. However, most of the jobs were so small that independent contractors would not be interested in them. Therefore, the risk manager was unable to avoid all of the risk, but several elements of the risk were eliminated as follows:

- 1) The paint used to repaint the metal trash cans owned by the city was highly flammable; therefore, the task represented a significant risk. The purchasing manager found attractive plastic trash cans to purchase at the same cost as new metal cans, eliminating the need for frequently repainting the metal trash cans.

- 2) The shop manager eliminated the risk of an explosion by having employees use a water base paint instead of the flammable paints that were being used.
- 3) The fire hazard that was created by spray painting city vehicles was eliminated by contracting out such work.

The local government also may attempt to reduce the severity or loss exposure of the risk. For example, a unit installing a sprinkler system in a building is engaging in the reduction of loss severity. The system will not reduce the possibility that a loss by fire will occur, but it will reduce the financial impact if a fire should occur. Other examples of minimizing loss exposures would be the garaging of unit vehicles in several locations or the storing of backup computer tapes off-site.

The governing body should adopt a safety policy for the unit that addresses the scope of the safety program, the role of officials, and the accountability of the staff. Management should appoint a safety director to conduct the required safety studies, develop and monitor safety programs and establish procedures which assure compliance with any federal and State safety requirements. The first step to an effective safety management program is to identify and evaluate the areas of safety concerns facing the unit. Exhibit A contains a risk management questionnaire that will assist the unit in identifying safety risks. Next, the unit should develop and implement a safety plan to reduce any risks identified. To accomplish these goals, a safety policy will need to be developed and supported by the local unit's top management. The role of a safety director and risk manager are closely related, and the two functions should work together as much as possible to accomplish their similar goals.

#### **Noninsurance Transfer for Risk Control**

Another method that governments use to control risk is to transfer that risk to another entity. A noninsurance transfer is the contractual shifting of a financial burden and legal responsibility for a loss exposure to another entity which is not in the business of accepting such transfers, as an insurance company would be. The local government whose losses are transferred is known as the transferor; the entity to which the exposures are transferred is known as the transferee. If a local government does elect to transfer some of its risk to

another entity, the risk manager should be very sure that the transferee is financially capable of assuming that risk. Otherwise, the unit has accomplished nothing at all; no risk has actually been transferred. There are several methods that a unit can use to transfer risk to another entity.

Leasing - One way for a local government to transfer risk is to lease property rather than buy it. When property is leased from others, the lease contract can be written so that the risk of loss is borne by the owner. Through such an arrangement, the user has transferred the ultimate direct risk for property damage to the lessor. The cost of this risk will be passed along to the lessee in the form of slightly increased lease payments; however, these increases in the payments will be minimal and predictable. These types of low, predictable losses are good risks for local governments to retain. This transfer method is dependent on the proper execution of the lease contract between the local government and the property owner. Depending upon the situation, the unit may be able to get leasing contracts that are written according to its own terms. For contracts where the local government is the lessor, the unit should attempt to transfer the risk of loss or damage on the property to the lessee. A contract that includes a "hold harmless" agreement as part of the lease and is backed by a contract of insurance would accomplish this objective.

Whether the local unit is the lessor or the lessee, all executed leases should contain a provision that will waive any subrogation rights of an insurer. Subrogation is the substitution of the insurer for the insured. After a loss has been settled with the insured party, any rights that the insured may have had to collect on the loss from a third party will automatically transfer to the insurer. The insurance carrier "steps into the shoes" of the insured party and attempts to recover some of the losses from the third party. For example, in the event of an accidental loss on equipment in the possession of a local government lessee, the lessor's insurance carrier could try to recover the loss from the local government unless such a waiver was included in the contract between the two leasing parties. These provisions also can be written so that the lessee's insurance carrier cannot try to recover the loss from the lessor. A waiver of subrogation in a lease is typically mutual. When subrogation is waived, each party will then need to insure or self-insure its own property. Insurers will usually accept the mutual waiver of subrogation if it is effected before the loss.

Maintenance Agreements - Other methods that a local governmental unit can utilize to transfer risk are maintenance agreements and extended warranties. These agreements, which transfer some risks of loss to the seller, are offered for such items as computer equipment, heavy machinery, vehicles, or other expensive purchases. Units should review these agreements since they may be a cost effective way to transfer risk to another entity, especially for large mainframe computers which may be needed for accounting purposes. Often, a maintenance agreement or extended warranty will include the guarantee of loaner equipment until the unit's equipment is repaired. Since an annual maintenance contract for personal computers and small peripheral computer equipment may cost as much as 30% of the purchase price, a maintenance agreement for these types of equipment is not considered to be cost effective. For such equipment, units may be better off to buy extra parts or machines and stockpile them for later use.

Independent Contractor - A local governmental unit that is involved in an unusual activity which is not part of its normal operations can transfer any ultimate legal responsibility for property, liability, and personnel losses which are related to that activity by subcontracting with an independent contractor. The terms of the contract negotiated with the contractor should clearly indicate that the person is status as an independent contractor, and not an agent or an employee. In addition, the contract should include a "hold harmless" clause in which the independent contractor agrees to indemnify the local governmental unit for any legal liability losses which may befall the unit as a result of the activity. Hold harmless clauses are discussed more completely in the section "Transfer for Risk Financing" included in this section of the manual. The unit also should be careful to require all independent contractors to furnish certificates of insurance for workers' compensation and public liability insurance with reasonably adequate limits before beginning any work. As an alternative, the unit could be named as an additional insured party on the contractor's policy. With either of these options, the independent contractor will be assuming the risk of loss exposure, not the local governmental unit.

F.O.B. Destination Point/Shipping Point - When possible, the purchasing manager should have supply purchases delivered using the shipping terms F.O.B. destination point. With F.O.B. destination point, the risks of any loss or damage during transport are borne by the seller. Any items that are shipped out to others should be shipped F.O.B. shipping point or point of origin. For items sent F.O.B. shipping

point, risks of loss or damage during transport are borne by the party receiving the goods. Of course, shipping terms that favor the local government are not always possible to arrange, but they are an inexpensive way to transfer risks to other entities.

Exculpatory Clauses - Under an exculpatory clause or agreement, the transferee agrees to excuse the transferor from liability to the transferee when general liability may otherwise exist. These exculpatory agreements reduce the liability exposure which the transferor would normally have to the transferee. Units relying upon exculpatory clauses should be aware that if a contract containing such a clause is tested, the court may judge the clause to interfere unreasonably with the rights of others. Such "unconscionable" contracts are considered unfair to the transferee.

### Risk Financing

#### **Risk Retention**

One method of financing risk is risk retention. A unit retains risk when it uses unit funds to finance losses. Risk is retained through either passive or active retention. Passive retention occurs when risk is unknown or ignored. Thus, a unit passively assumes an unidentified risk. Passive risk retention is not a risk management tool; no risk management decision has been made. Active retention, commonly known as "self-insurance," is when the unit identifies the risk and consciously selects risk retention as the appropriate alternative to finance the risk. (Note: Self-insurance is a misnomer because insurance relates to the transfer of risk to another entity. Since a governmental entity is not actually transferring a risk, but is retaining some portion of the risk, active retention is often referred to as retention instead of self-insurance.) Rarely does the unit retain all of the risk. Usually, as much of the risk is retained as is economically feasible based on the financial situation of the unit at the time. The governing body, the finance officer, and the risk manager should work together to set a risk retention level that is appropriate for the unit's financial condition and risk retention policy. Depending upon the changing economic conditions and financial objectives of the government, the level of retention should be periodically evaluated. The unit may utilize excess insurance coverage or other risk transfer methods to cover losses occurring above the acceptable retention limit.

Determining When to Retain a Risk - Professional feasibility studies will assure that the decision to retain certain types of loss exposures is objective and also will reassure the governing board members who are making decisions about risk retention. When determining which risks to retain, or to transfer, a unit may consider the following guidelines based on the severity versus frequency concept.

High frequency/low severity - Retain. The amount of the losses will be low and predictable despite the large number of claims. An example of a high frequency/low severity loss is workers' compensation. For units with sufficient resources, workers' compensation losses can be retained and excess insurance purchased for high dollar losses.

Low frequency/low severity - Retain. Since the number of claims and the amounts associated with them will be small, the total amount of any loss also will be small. An example is the loss of inexpensive office equipment.

High frequency/high severity - Avoid. The unit may be forced to retain risk if the insurer is not willing to insure at a reasonable amount. The occurrence of claims may be frequent and the potential losses high. Examples of these risks may be civic centers or other recreation facilities operated by units. Risks should be carefully considered before a decision is made to engage in these types of activities. Safety measures can reduce the occurrence of these losses.

Low frequency/high severity - Transfer some or all of the risk to insurer. These losses are frequently insured. Examples are a fire loss in a public building or an explosion in a boiler owned by a local unit.

Methods of Retaining Risk - Active risk assumption can be accomplished in several ways. First, the unit can choose to do nothing. In this case, any loss that occurs would be charged to current period expense. Also called noninsurance, or "pay as you go", this method is not the same thing as passive retention. In the case of noninsurance, the unit has gone through the required risk management process and determined the risk to be so small or the cost of other choices so high, that the decision is made to "take their chances". Depending upon its size and financial condition, a unit also may decide to ignore all

property risks below a certain dollar amount and to absorb losses below that amount. In addition, losses of low-cost office equipment could easily be charged to the current operating budget of the appropriate department. Such losses are not large enough to insure.

Another method of retaining risk is for the unit to develop a reserve account from which retained losses will be paid. This reserve can be either funded or unfunded. A funded reserve creates a special account from which the losses can actually be paid. An unfunded reserve is merely a journal entry with no funding. If a loss does occur, it is written off against the reserve. If a unit plans to accumulate reserves to cover losses, then the reserved funds should be protected from other uses. Segregating the reserve funds from operating funds by utilizing a separate, internal service fund may accomplish this protection. Once reserved funds are borrowed for other uses, they may not be returned. Obviously, a reserve fund that has been depleted for other purposes will not benefit the unit if a loss should occur.

Local units that are developing a reserve for losses face the question of how much to reserve. An amount equivalent to the premiums saved by risk retention is not sufficient. The reserve amount should exceed the expected loss for a year. Local governmental units could use an independent, certified actuary to help determine the appropriate reserve amounts needed for their individual unit based on the loss histories of many similar units. Whatever amount the unit and its actuary select as appropriate, the amounts must be funded as originally planned or the unit is vulnerable to a loss exposure. These reserve funds should be invested in accordance with G.S. 159-30.

Another commonly utilized vehicle of risk retention is the insurance deductible. Deductibles are utilized when the risk retention policy is to retain some, but not all, of the risk. Losses above the acceptable retention level adopted by the unit are transferred to an insurance carrier. Local units that use deductibles to retain some portion of the risk should be aware that the insurer may have the right to decide whether a particular claim will be fought in court or settled. If the unit wishes to retain the right to make those decisions, then the use of insurance deductibles may not be the best retention option.

Straight Deductible - The simplest form of a deductible is the straight deductible. Regardless of the size of the loss, a fixed amount is deducted from it. Therefore, a local government with an insured loss of \$5,000 and a straight deductible of \$1,000 would recover \$4,000. The

insured party retains the risk of loss up to \$1,000. Beyond that level, the risk is transferred to the insurer. For property insurance, deductibles are generally available on a per-location or a per-occurrence basis. The per-location deductible is applied separately to each insured location. A location may be defined as a single building or as an area with several buildings. The per-occurrence deductible, which will be slightly more expensive, will apply only once to damages resulting from a single occurrence, regardless of the number of the unit's locations that are involved in the loss.

**Aggregate Deductible** - The aggregate deductible applies only once to all losses incurred during the policy period regardless of the number of events or the number of locations involved in the loss. With this deductible, the unit will not retain losses in excess of the stipulated amount in any given year. Once the accumulation of losses exceeds the amount stipulated in the policy, the insurer will cover 100% of all remaining losses. Because the aggregate deductible makes loss exposures very predictable during the policy period, this type of deductible is especially good for those units with limited financial resources.

#### **Noninsurance Transfer for Risk Financing**

The noninsurance transfer also can be used to finance risk. Commonly known as a "hold harmless" clause, a noninsurance transfer to finance risk refers to a contract clause in which the transferee agrees to indemnify the transferor, or to pay on the transferor's behalf, specified future losses befalling the transferor. The transferee is acting as the transferor's insurer. While such a transfer could apply to any property, net income, or liability loss, legal liability is usually the exposure addressed. Under a hold harmless clause, the transferee would agree to pay for the transferor's legal liability losses arising out of the transferor's liability. Therefore, a hold harmless agreement does not eliminate the legal liability of the transferor. A legally enforceable noninsurance transfer which eliminates the transferor's loss exposure through risk control provides the transferor with greater protection than a noninsurance transfer with the purpose of financing the transferor's loss.

According to G.S. 22B-1, a construction contract which attempts to hold harmless or indemnify the promisee, its independent contractors, agents, or employees against liability for damages caused by or resulting from the negligence of that promisee, its independent contractors,

agents, or employees is against public policy. This statute does not prohibit a contract whereby the promisor shall hold harmless or indemnify the promisee, its independent contractors, agents, or employees for the sole negligence of the promisor.

### **Insurance**

The most commonly used transfer method is insurance. Units should consider insurance only after the risks have been identified, evaluated, reduced, and, if beneficial, retained. Insurance transfers the risk of loss to another entity in exchange for an insurance premium. Local governments use insurance because all units have a finite limit beyond which they cannot expose themselves to losses. In other words, the local government can retain losses up to a certain dollar amount; however, it must transfer the risk of losses above that point. Insurance provides protection for catastrophic losses that are above this limit. Insurance should never be utilized by a local government to cover small losses or to serve as a prepayment program.

Another reason that a local government selects insurance as a risk management tool is because insurance may be required by a statute or contract. For example, a unit should attempt to execute all contracts so that the risk is transferred to another party. This is not always possible. Contracts executed by the unit may require certain levels of insurance. Also, according to G.S. 159-89(13), revenue bond orders and lease agreements may, and often do, contain covenants requiring insurance. These are just some examples of contractual and statutory requirements for insurance.

### Types of Insurance Coverage

#### Property Insurance

Local governments require a wide variety of real and personal property to perform day-to-day functions. The insurance industry provides insurance to cover these government properties. A discussion of standard property insurance policies supplied by most insurance carriers follows. Even though insurance policies will vary slightly for different insurers, most policies are fairly standard. However, local governments should not assume that all policies are standard. Each policy will contain different rates, deduction levels, and other terms. Insurance

coverage should be chosen with a view of the long-run financial objectives of the unit in mind. Different insurance policies will be appropriate for different units depending upon a particular unit's financial situation and management policies.

Fire Insurance and Extended Coverage Endorsement - Basic coverage for a property insurance program is fire insurance and the extended coverage endorsement. The basic fire insurance policy covers physical damage to the insured property by fire or lightening. Basic fire insurance also covers damages from the water used to extinguish a fire and smoke damage from a hostile fire. A hostile fire is one which is not in a furnace, fireplace, or other place that was intended to contain a fire. An extended coverage endorsement can be attached to the fire insurance policy to provide against the additional perils of windstorm, hail, explosion, riot and civil commotion, aircraft and vehicle damage, and smoke damage caused by a sudden malfunction of a heating or cooking device connected to a flue.

Units can extend the basic fire insurance policy to provide a broader "all risks" coverage. All risks coverage protects against all risks of physical loss except those that are specifically excluded. All risks coverage could be used to cover water damage, theft, or contamination. Wear and tear, vermin, or nuclear radiation are among the things that will be excluded from all risks coverage. The fire insurance policy and the extended coverage endorsement also will exclude coverage for certain specified property and perils that may instead be insured under other policies. Money and securities are excluded from the basic fire policy. Coverage of accounting records and files is often limited to the actual cost of the papers or the blank books, and the research required to recreate the records is not covered. The cost of research to recreate records, the loss of income, and the resulting inability to collect accounts receivable can be insured under a valuable papers policy or an accounts receivable policy. The fire and extended coverage endorsement policies also exclude losses caused by war, flood, nuclear radiation, or radioactive contamination. The extended coverage endorsement will probably exclude damages caused by explosions of steam boilers and steam pipes. Protection against damages caused by such explosions is available with other insurance policies. Such policies are discussed in another section of this manual.

There are basic concepts and provisions associated with standard fire insurance that are important. First, the standard fire insurance policy limits the amount payable on the loss to the actual cash value. The actual cash value is the cost to replace the insured property at the time of the loss less an allowance for depreciation, or any wear and tear on the property before the loss. The term actual cash value is usually not defined in the policy. Consequently, there may be a substantial difference between the insurance recovery based on the actual cash value and the actual cost of replacing the property. The risk manager should be aware that actual cash value coverage may be inadequate. For example, if a town hall with a current replacement cost of \$500,000 and total depreciation of \$350,000 is destroyed by fire, then the unit will be reimbursed for only \$150,000. Therefore, the local unit will need to raise an additional \$350,000 before the building can be rebuilt.

On the other hand, replacement cost insurance coverage does not deduct any depreciation in the loss adjustment. The full replacement cost of the property, regardless of any depreciation, is reimbursed by the insurer. Replacement cost coverage can be substituted for actual cash value coverage in exchange for an increase in premiums. The risk manager should be wary of replacement cost policies because there are several possible pitfalls. Some replacement cost insurance policies state that a destroyed building must be rebuilt on the same site. Because of population and demographic changes that occur over time, the unit may prefer to relocate the facilities rather than rebuild on the same site. In addition, replacement cost coverage may only indemnify the insured for replacement of the property as it was prior to the loss. If building codes have changed, the unit's needs are different, or if the building is obsolete, then the local government may elect to modify or update the structure. Local governmental units should be sure that any agreements with the insurer which allow modifications are in writing. When a loss does occur, that loss severity may be substantially increased by building modifications desired by the unit. Unless these modifications are part of a contractual agreement between the unit and its insurer, the changes may not be allowed under the insurance policy. When purchasing replacement cost insurance, the risk manager should be careful to select a policy that would not limit the unit's choices in the event of a loss.

A coinsurance clause is often written into an insurance contract to discourage an insuree from purchasing only minimum coverage. The coinsurance clause requires that an asset be insured for a certain minimum amount, usually a

stated percentage of the fair market value, if the loss is to be covered 100% by the insurer. Under a typical coinsurance agreement, the insured, in exchange for a reduction in the insurance premium, agrees to carry a certain stated percentage of the market value of the property. If a loss occurs and the insured party has failed to carry the required amount of insurance, the insurer will reduce the amount paid to cover losses. The coinsurance formula is as follows:

$$\frac{\text{Amount of insurance carried}}{\text{Coinsurance \% X Value at the time of loss X Loss}} = \text{Recovery}$$

The amount of insurance carried can be determined based on either the actual cash value or the replacement cost, depending on the terms in the insurance contract. The value at the time of the loss means that, regardless of the value when the property was purchased, the coinsurance percentage is applied to the market value at the time the loss actually occurred. For example, assume that a county has assets with a fair market value of \$1,250,000. Based on risk management techniques, the unit elects to obtain insurance coverage of only \$312,500. If the county's insurance policy contains an 80% coinsurance clause, the county would need total insurance coverage of 80% of the fair market value of the assets at the time of the loss (or \$1,000,000) to recover the full amount of any loss. If the county has an insurance policy with a face value of less than the 80% of the fair market value of the insured property at the time of the loss, then it will share the loss with the insurer. The recovery amount of an asset loss of \$100,000 is \$31,250, computed as follows:

$$\frac{\$312,500}{80\% \times \$1,250,000} \times \$100,000 = \$31,250$$

The unit has transferred 31.25% of the risk of loss to the insurer and retained 68.75% for itself. As shown in the example above, coinsurance clauses can be a legitimate tool for retaining part of the risk, but such clauses should be used cautiously. However, if a local government intends for losses to be fully covered, then the face value of the insurance policy will need to be at least equal to the product of the coinsurance percentage in the policy and the market value of the insured property. Therefore, a regular program of property appraisal should be established to be sure that the amount of insurance is adequate to meet any coinsurance requirements. In practice, units can avoid a

coinsurance clause in an insurance contract by valuing the property liberally enough so that the insurers are collecting a fair premium for the risk assumed. Any premium increase resulting from the slightly higher valuation should be compared with the costs of an appraisal program to determine which option is the less expensive.

Another standard term included with insurance policies is a subrogation clause. Subrogation is the substitution of the insurer for the insured. A subrogation clause requires that, after the loss has been settled with the insured party, any rights that the insured may have had to collect on the loss from a third party automatically transfer to the insurer. For example, a right of subrogation might arise if a public building was destroyed by a fire resulting from the negligence of a heating contractor who was repairing the building. The insurance carrier would settle the claim and then "step into the shoes" of the unit and attempt to recover some of the losses from the negligent contractor. The insured party may not be able to collect on the policy if it does anything, either before or after the loss, to damage the insurer's right to subrogation.

Difference in Conditions Policy - A difference in conditions policy is a broad contract that is written to provide coverage for risks of physical loss which are not normally included with fire policies and extended coverage endorsements. A difference in conditions policy provides for protection against the occurrence of perils such as floods or earthquakes that might not otherwise be available. A difference in conditions policy is an alternative to the previously mentioned "all risks" type coverage against additional perils that may be excluded from the basic policy. The policy provides for the difference between what is covered by the primary policy and what is specifically excluded. Each insurer will have an individualized form of the difference in conditions policy; however, the terms of these contracts are open to negotiations. There is no standard form of the difference in conditions contract, so it can be tailored to fit the specific needs of the insured unit.

Boiler and Machinery Insurance - As discussed earlier, the extended coverage endorsement specifically excludes coverage for damages caused by the explosion of a steam boiler. Losses from explosions, mechanical breakdowns, power surges, and various other accidents can be insured under a boiler and machinery policy. Electrical motors and apparatus, electrical panels, turbines, generators, hot water heaters, and air compressors also can be insured under this policy. If a local governmental unit has a boiler and machinery

policy in effect, the policy should be reviewed when a maintenance type problem occurs, since such a problem may be covered under the policy. Even though losses of hot water heaters and air compressors are covered under the extended coverage endorsement, some local governments also elect to purchase policy coverage in order to receive the loss prevention services and inspections that insurance carriers routinely supply.

Valuable Records Coverage - The fire insurance policy does not provide adequate amounts of coverage for accounts and records. Records that the unit might need to reconstruct following a loss include real estate title and transfer records, tax records, and accounting records. In addition, documents or books held by libraries may be quite valuable. Two special insurance policies, the valuable papers policy and the accounts receivable policy, are intended to cover these types of losses. A valuable papers policy covers the cost of research to reconstruct damaged records, as well as the cost of new paper and transcription. The accounts receivable policy covers the lesser of the expenses incurred to reconstruct the accounts receivable records, or the amount of loss due to the inability to collect accounts receivable as a result of the destruction of the records. The premiums of both these types of policies are discounted if duplicate records are maintained at a separate location. Moneys for valuable records insurance may be better spent on loss prevention such as a fireproof vault for valuable papers, frequent fire inspections, or routine computer back-ups and off-site record storage.

Electronic Data Processing Systems Insurance - Because of the high cost of computers and peripheral equipment, several insurers have designed policies for electronic data processing equipment. These types of policies usually insure against the following types of risks:

- 1) Physical damage to the computer and its peripheral equipment.
- 2) Damage to program materials and such media as disks and tape, including the cost of research to reconstruct programs and the data stored on damaged media.
- 3) Extra expenses incurred to maintain normal operations following damage to the computer, tapes, or media.
- 4) Loss of income resulting from damage to the computer, programs, or media.

The policy also may cover system breakdowns as they are defined within the policy; however, the accidental erasures of data stored on magnetic tape will not normally be covered.

Automobile Physical Damage Insurance - Since property insurance policies do not provide coverage for automotive equipment, the local government may need a separate policy. Basically, there are three types of automobile physical damage coverage available with a business auto policy.

- 1) Comprehensive coverage protects for virtually all risk of physical loss or damage to vehicles, except by collision and upset.
- 2) Specified perils coverage is available which covers a package of perils. Included in this coverage are the perils of fire and explosion; theft; windstorm, hail or earthquake; flood; mischief or vandalism; and the loss caused by the sinking, burning, collision, or derailment of any conveyance transporting a covered vehicle.
- 3) The collision or overturn of a vehicle.

Fires, floods, or explosions can cause substantial amounts of damage when there is a concentration of vehicles in one place, as in a motor pool or garage. Property insurance to provide for this risk may need to be considered. If necessary, the unit's fleet may be housed at several different locations overnight.

Inland Marine Policies - Fire insurance policies usually cover personal property only while it is located in or near specified buildings. Another type of policy, an inland marine policy, is available to cover property away from the insured's premises. Inland marine insurance is insurance against loss for items utilized for transportation other than on the ocean and also for certain types of stationary personal property, wherever that property may be located. The more commonly used inland marine policies are described below.

Construction equipment such as bulldozers, rollers, and graders can be insured under a type of inland marine policy known as the contractor's equipment floater policy. Large equipment usually is listed with a specified amount of insurance on each item. Smaller items, such as hand tools or low value items, may be included under a blanket of coverage.

Bridges, tunnels, and transmission lines are not movable, but can be insured under policies similar to those provided for movable equipment. Electric, gas and water transmission lines and equipment, and radio and television transmission equipment and towers also may be insured under this same type of policy. Water tanks and pumping equipment which constitute a part of the transportation system also may be covered under inland marine contracts.

Crime Insurance - This type of policy covers losses of money and securities inside the unit's premises due to theft, disappearance, or destruction. The loss of, and damage to, a locked safe, vault, or cash drawer resulting from theft or unlawful entry also is covered. In addition, money and securities outside the premises in the custody of a messenger or any damage to the premises caused in the course of a theft may be covered.

#### Liability Insurance

General Liability Insurance - The exposure to liability claims resulting from injuries to persons and damage to property is a serious risk facing local governments. General liability insurance covers exposures for bodily injury and property damage arising from the condition of the unit's premises; the ongoing operations of the unit; products manufactured, distributed, or sold by the unit; and completed operations of the unit. In addition, general liability policies cover personal injury, such as false arrest, malicious prosecution, wrongful entry, or oral or written publications that slander or libel another person or organization's goods or services or violate another's right to privacy. Finally, advertising injuries arising from oral and written publications which slander or libel a person or organization's goods or services, violate another's right to privacy, misappropriate advertising ideas, or infringe on copyrights, titles, or slogans also are covered under general liability insurance.

Numerous sponsored events such as concerts, fireworks displays, airplane rides and shows, or firing ranges are specifically excluded from most general liability policies.

If the unit engages in these or any of the following activities, additional coverage may have to be obtained by endorsement or with other policies:

Operation of hospitals, housing authorities, or vendor sites,

Operation of any facilities that generate or handle toxic waste or pollution,

Ownership and operation of automobiles,

Explosions and blasting,

Medical and professional services, including EMS services,

Activities that involve the care, custody, or custodianship of another's property,

Exercise of eminent domain,

Participation in any athletic events,

Serving of any alcoholic beverages, and

Liability under workers' compensation resulting from employee claims.

General liability protection is especially important for theaters, stadiums, and other places where large numbers of people would be injured if a fire, explosion, or a similar event occurred. Streets and sidewalk coverage can be included with commercial general liability coverage. Important contractual agreements such as construction contracts are not automatically covered. Liability arising from any act or omission by civil authorities in connection with mob action prevention or suppression is excluded but may be covered for an additional premium.

Frequently, general liability insurance covers damages only when an injury was caused by an accident, as opposed to an occurrence. An occurrence is an unexpected injury or damage resulting from a condition over a period of time which cannot be traced to a single, identifiable event or happening. In contrast, an accident is a single, identifiable event. Insurance coverage against an "occurrence" rather than an "accident" is broader coverage and local governments should insist on it. As an example, the consumption of excessively chlorinated water over time by a citizen which results in a chronic illness is not an

accident but an occurrence; therefore, a policy written for accidents would not cover such a situation. Some insurers will make this change in the policy without changing the premium, while others will increase the premium amount.

The premiums that insurers set for the general liability insurance for local governments are based on a rate per \$1,000 of net annual operating expenditures of the insured. Net operating expenditures are computed by subtracting the following from total expenditures:

Capital project expenditures,

Debt service,

Any amounts paid to independent contractors,

Any amounts paid in welfare benefits, and

Expenditures for operations that are separately insured.

This obtained base rate is then adjusted for loss and claims experience data and market conditions. Since the rates used by insurers are public information, risk managers can estimate their premiums and use such estimates to obtain lower rates. Annually, risk managers should obtain and evaluate the general liability base rates being used by their insurers.

Excess Insurance - Excess insurance provides coverage above the limits provided by the applicable underlying risk financing, which may be primary insurance, a lower layer of excess insurance, or some level of planned retention. Excess insurance covers only those portions of losses that exceed the upper limit of the underlying insurance or planned risk financing. Excess insurance does not offer broader coverage than underlying policies. Excess insurance policies that are written to overlay specific primary policies incorporate, by reference or physical attachment, the coverage provisions of that underlying policy and are said to "follow form."

Umbrella Liability Insurance - Umbrella liability insurance provides excess general liability and automobile liability above the limits set by other policies. In addition, umbrella liability insurance offers "drop-down" coverage for other specified losses to which other insurance may not apply. Thus, umbrella liability insurance protects the insured from the exclusions and gaps of primary liability policies. An umbrella policy provides coverage after the

limits of the primary insurance policy have been exhausted, or when a claim develops that is not covered by the primary insurance. Umbrella insurance provides protection that is broader than the underlying primary or lower layer of excessive insurance. The major advantages of umbrella liability insurance are the elimination of concern over catastrophic losses by means of high limit protection (at least up to the contractual limits set by the policy); broadened protection for blanket contractual liability coverage; coverage of the property of others that is in the care, custody and control of the insured; malpractice coverage; and non-owned aircraft and watercraft liability coverage. The umbrella liability insurance may overlap with general liability coverage, but the umbrella policy pays only after the limits of the comprehensive policy are exhausted. Umbrella liability insurance policies are typically very limited in coverage and contain many exclusions. Local governmental units considering such policies should be sure to read the terms of the policy carefully. If umbrella liability insurance is not available at a reasonable premium, then excess insurance may need to be relied upon to cover these types of high severity losses.

Automobile Liability Insurance - Automobile liability insurance coverage may extend to vehicles owned or leased by a local government or to those owned by employees that are used on government business. This coverage may be issued under individual policies, a schedule policy, or a fleet policy. Ownership of five or more vehicles qualifies a local government for a fleet policy. An advantage of a fleet policy is that the insurer need not be notified of the acquisition and disposal of vehicles. Coverage of new vehicles is automatic as long as the policy is in force. The automobile liability policy provides protection for the governmental body, any person authorized to operate the vehicle, and any other person liable for the use of the vehicle while it is being operated by an authorized person. This protection for employees is important because employees do not have immunity while operating government vehicles. The local unit's automobile policy stands above the employee's own automobile policy when the employee uses it for business reasons. Units should obtain insurance certificates verifying the existence of insurance from employees who routinely use their vehicles for business purposes. (Note: A slightly higher personal insurance premium will be incurred on the part of those employees, but the travel reimbursement for mileage should be set high enough to cover such additional expenses.) Normally, the basic automobile liability policy does not cover rented vehicles unless a "hired car" endorsement is attached.

Errors and Omissions Insurance - Errors and omissions liability is a general term for a wide variety of loss exposures covered under specialized policies known as public officials' liability; school leaders' error and omission liability; fire department, rescue squad and EMT error and omission; or law enforcement liability. Errors and omissions policies cover claims for which the insured is obligated to pay damages arising out of "wrongful acts". On the other hand, general liability policies cover bodily injury or property damage caused by an occurrence or accident. Wrongful acts are defined as:

Any actual or alleged error, omission, misstatement or misleading statement, act of neglect or breach of duty by an insured or insureds while acting within the scope of their duties as officials or employees of the covered organization.

Errors and omissions insurance commonly covers claims for which the insured parties are legally obligated to pay damages arising out of these wrongful acts. An example of an error and omission covered claim would be a decision by a governing board that results in a financial loss to a contractor who then sues the governing board members for damages. This type of coverage is designed to cover the liability arising out of the business decisions of public officials and employees. The administration of grants, assessment of taxes, or discrimination in hiring are just some potential sources of liability.

Numerous provisions and limitations are common to errors and omissions policies that affect the scope of coverage. First, all error and omissions policies should clearly define the insured party. Besides the local unit, the policy should cover past, present, and future employees, officials, departments, boards, commissions, and volunteers acting within the scope of their duties for the entity. Some error and omission policies exclude coverage for claims made by one insured party against another insured party. With such a policy, an entity sued by an employee who is also insured under the policy would be denied coverage. If possible, such exclusions should be deleted.

Errors and omissions suits often result from events that are difficult to pinpoint in time. Many errors and omissions policies are therefore written on a claims-made basis. That is, the policy will only cover claims first made during the policy period. Coverage also is dependent on a retroactive date. There is no coverage for claims arising from events occurring prior to the retroactive date, regardless of when

the claim is first made. The retroactive date is usually the policy inception date or the date the insured party places continuous coverage with the insurer. Sometimes earlier retroactive dates may be purchased by the insured party. If a claims-made policy is cancelled or not renewed, there can be a gap in coverage for claims made after the cancellation date arising out of events that occurred prior to that date. Because of this potential gap in coverage, most insurers provide an extended discovery period during which the former policyholder can purchase "tail" coverage to cover such claims.

Errors and omissions policies are not standard policies and the scope of coverage varies greatly between insurers. Risk managers should read these policy forms very carefully or have an expert read them and then relate the coverage offered to the actual exposures faced by the unit.

The broadest form of errors and omissions insurance coverage possible is a Public Officials Liability Policy. This policy typically covers the unit and all lawfully elected or appointed past, present, or future officials. Employees also should be covered under these policies. The unit should beware of operations that are not covered under the policy, such as utilities or districts. Special endorsements or separate policies may be needed to cover the operations of those units.

A special type of public officials coverage is written for school leaders. A School Leaders' Errors and Omissions Liability Policy covers the school system, the board of education for the system, any members of the board, the superintendent, and other equivalent positions. Extended coverage can be obtained to cover all employees acting within the scope of employment. When selecting public officials insurance coverage for a school system, the unit should be aware of exclusions for specific activities, such as athletic events. Additional coverage may need to be obtained if the unit engages in such excluded activities.

Fire Department, Rescue Squad, EMT, and Law Enforcement Liability Errors and Omissions Policies should be purchased when the coverage for the activity is excluded from the public officials coverage. Typically, the malpractice and bodily injury claims associated with EMT and law enforcement are excluded from public officials coverage so additional may be necessary for these individuals. Again, the entity, officials, and the individual members should be covered under the policies. Liability will only arise out of the operations specified in the policies.

### Workers' Compensation Coverage

The employees of all local governments in North Carolina are covered under the Workers' Compensation Act included in the North Carolina General Statutes. The purpose of this Act is to provide compensation benefits for workers who suffer disability as the result of an accident which arises out of and in the course of their employment. Besides supplying the injured employee with some portion of regular compensation during the period of disability, the Act requires the employer to provide medical, surgical, hospital, nursing services, medicines, sick travel, supplies, rehabilitation services, and other treatments as may reasonably be required to effect a cure or give relief. G.S. 97-31 includes a schedule of compensation rates that vary depending on the nature of the injury.

G.S. 97-93 requires employers who are covered under this Act to either insure their liability under the Act or provide proof to the Industrial Commission of financial ability to pay compensation when due. Local governments have not been held to this particular statute in the past. Generally, local governments can select self-insurance (or retention) by notifying the Industrial Commission that they intend to be self-insured. For units that do not choose to self-insure, the North Carolina League of Municipalities, the North Carolina Association of County Commissioners, and the North Carolina School Boards Association operate public entity risk pools which provide protection for workers' compensation claims. Some coverage also may be available from private insurance carriers. As with all risks the unit faces, the local government should consider all options before deciding how to handle these potential losses.

### Reinsurance

Reinsurance, or "insurance for insurers", is a contractual arrangement under which one insurer, the ceding company, transfers to another insurer, the reinsurer, some or all of the ceding company's obligations and premiums relating to primary and excess policies issued by the ceding company. Reinsurance exists as a risk management tool for insurers, helping to make their losses more predictable and their finances more stable. The insured party is not a party to the reinsurance arrangement and has no rights against the reinsurer. In the interest of sound risk financing, the local unit should take an interest in its insurer's reinsurance arrangements because they may ultimately affect the insurer's ability to meet its obligations if reinsurance is inadequate.

### Public Entity Risk Pools

Another method that local governments utilize to manage risk is to participate in a public entity risk pool. GASB Statement No. 10 defines a public entity risk pool as a cooperative group of entities joining to finance an exposure, liability, or risk.

A key question that is repeatedly asked regarding risk management and risk pools, and one that will determine the accounting method that a unit applies to risk financing, is whether the risk has been transferred to a third party or retained by the governmental entity. For example, a local government paid a premium to a third party (such as a risk pool) with the ultimate premium charge based on the unit's loss experience. If the pool can assess the unit additional amounts for any unit losses that exceed initial premiums and the governmental unit receives refunds for losses that are less than premiums, then risk has been retained and the pool is acting more as a claims-servicer. There are four types of public entity risk pools:

Risk-sharing pool - an arrangement by which governments pool risks and funds and share in the cost of losses.

Insurance-purchasing pool - an arrangement by which governments pool funds or resources to purchase commercial insurance products. This also is referred to as a risk-purchasing group.

Banking pool - an arrangement by which moneys are made available for pool members in the event of loss on a loan basis.

Claims-servicing or account pool - an arrangement by which a pool manages separate accounts for each pool member from which the losses of the member are paid.

A public entity risk pool can fulfill either one or several of these functions. Pools that act only as banking or claims-servicing pools are not assuming any of the unit's risk. In those cases, the pool member has retained all the risk.

There are numerous public entity risk pools that various local governments can join. For example, the North Carolina League of Municipalities operates a pool which provides workers' compensation coverage for municipalities and certain other public agencies. Premium rates are based on each participant's estimated payroll, the insurance rates approved by the rating bureau of North Carolina, and

adjustments based on the members' prior claims experience. Members pay a proportionate share of the funds' administrative costs and of the costs of claims made, plus a share of the excess insurance coverage purchased to protect the program from catastrophic losses. The North Carolina League of Municipalities, the North Carolina Association of County Commissioners, and the North Carolina School Boards Association all operate risk pools providing protection from property liability, workers' compensation liability, general or automobile liability, or life and health insurance for employees. The terms associated with each pool are quite different, so local governments should contact these associations for specific information concerning pool membership.

### Public Employee Bonds

Instead of standard insurance, there are several forms of surety and fidelity bonds available to cover the losses arising from the faithful performance of local government employees and officials. Bonds differ from insurance because there are three parties to these agreements; the local governmental unit, the surety company, and the public employee. Surety bond premiums are based on the applicants' financial exposures. Faithful performance bonds cover both honest and dishonest acts. The bonds transfer the risk of loss from the government to the public employee because any losses incurred by the surety company are recoverable. Under the principle of subrogation, the surety company paying a claim made under a surety bond may legally seek reimbursement from the public official or employee who originally caused the loss. The public official or employee may very well need to personally carry insurance to provide for such losses.

Two types of bonds are generally available: (a) dishonesty bonds (covering theft, embezzlement, and forgery); and (b) faithful performance of duty bonds (covering dishonest acts and nonfaithful, but not necessarily dishonest, performance). The risks existing with a particular office or position should be the criteria in determining whether faithful performance or dishonest coverage is to be written. For example, in finance departments, employees should be covered by dishonesty and faithful performance of duty bonds, while in other departments only dishonesty coverage may be necessary.

Surety bonds are required by numerous North Carolina General Statutes. According to G.S. 58-73-30, an elected or appointed official is required to provide a bond to make good any losses incurred because of the failure to perform the duties of his/her office. G.S. 105-349(c) requires that a tax collector furnish a bond conditioned on his honest and faithful performance before being allowed to begin his duties. The amount should be set by the governing body. G.S. 115C-442(a) requires the finance officer of a school board to furnish a bond for an amount not less than \$10,000 and not more than \$250,000. According to G.S. 161-4(a), the register of deeds for a county must be bonded. Sheriffs must furnish a bond payable to the State of North Carolina under G.S. 162-8. Finally, G.S. 159-29(a) requires that the finance officer of a local government or public authority furnish a faithful performance and true accounting bond with sufficient sureties in an amount to be fixed by the governing board for not less than \$10,000 nor greater than \$250,000.

According to G.S. 159-29(b), each officer, employee, or agent of a local government or public authority who handles or has in his/her custody more than \$100 of the unit's money or who handles or has access to the inventories of a unit is required to furnish a faithful performance bond. The governing body should determine the amount, and the unit will pay the premium. The local government or authority can adopt a blanket faithful performance bond as an alternative to individual bonds. Blanket bonds are often less expensive than individual bonds. In addition, the unit will not have to prove which employee caused the loss; all losses caused by employees are covered. Such a bond will meet the statutory requirements of individual bonds, except for finance officers, and tax collectors. An individual bond is required for the tax collector and finance officer, although such an officer may be included in the blanket coverage as well if the blanket bond protects against risks that are not covered under the individual bonds.

Within the statutory limits discussed above, the amount of bond coverage that a local government decides to purchase for its various employees is up to the unit. A review of the financial statements and a listing of all persons who exercise control over governmental funds are the first steps toward evaluating the unit's particular needs. A formula has been devised to help units estimate the amount of

coverage that is appropriate. To calculate the suggested amounts of coverage, the unit should first determine its exposure index. The exposure index is 10% of the sum of:

- a) The total annual receipts from all sources, and
- b) the market value of all negotiable securities for which physical possession is held.

The actual components of the exposure index may need to be modified by the unit depending upon the unit's activities and financial situation. The surety company's representative or an advisor can assist a unit in determining the exposure index and the appropriate type and amount of bond coverage. All surety bonds held by the unit should be purchased from the same entity to avoid responsible party conflicts between different sureties if a loss does arise. If there is a change or interruption in surety bond coverage, the unit should consider purchasing "tail" coverage. As with other types of insurance, an extended discovery period may be available to the unit under limited circumstances.

Finally, units must be able to prove that a loss actually occurred before a surety will pay any damages. If a unit lacks an internal control system that is sufficient to prove first that the unit "had" the claimed item and then "lost" it, the unit may not be able to recover a particular loss from a bond surety. Surety bond claims tend to be lengthy and complicated. A local government with a strong system of internal controls would be more likely to recover a claim.

#### **Establishing a Risk Management Policy**

Achieving a successful risk management program requires involvement by a local government's top decision-makers. A strong commitment from the governing body is vital to the risk management program. A successful risk management program may require that significant changes be made in existing procedures and practices. Depending upon the individual unit and the proposed program, officials and employees may have to add certain procedures and practices to the ones they are currently doing; they may have to stop performing other procedures and practices; funds may have to be spent and accounted for in different ways; and relationships among local government officials and employees may have to be altered. Without a strong commitment, such sweeping changes will be difficult to implement.

The support of the governing body should be expressed in a formally adopted risk management policy. The policy should express top management's support for risk management and provide overall guidelines for the implementation of the new practices. As soon as possible in this process, the unit should select an individual to be responsible for risk management. To formulate a risk management policy, the unit may select a committee to produce a draft statement for review by others or ask the risk manager to do so. Insurance agents and the policy statements of other local governments can help the unit develop a policy that will fit its own particular situation. The initial policy can be modified as the unit's management becomes more knowledgeable about risk management.

Matters that might be addressed in a policy are:

- 1) An overview of the objectives of the risk management policy and the methods to be used to achieve these goals.
- 2) The authority and responsibilities of the risk manager, department heads, officers, and other employees. The party or parties to whom the risk manager is responsible should be indicated.
- 3) Any important procedures and required records.
- 4) The unit's policy on insurance coverage (for example, the exposures that will be insured, levels of coverage and deductible limits, selection of insurers, or insuring property for the actual cash value or the replacement cost).
- 5) The types of risk assumption and the maximum amounts of those risks that the unit is willing to assume.

Implementing and administering a risk management program is not an easy task. Implementing a program is not like building a fire station; there is not necessarily a huge expenditure before the unit begins seeing benefits. Before any significant expenditures are made, a local government can benefit from risk management principles by identifying and addressing certain situations. For example, a local governmental unit might easily discover that it needs to increase the limits of coverage for catastrophic losses, obtain public officials' liability insurance, and require certificates of insurance from several contractors. These simple steps may significantly decrease the unit's loss exposures with minimal expenditures.

In conclusion, rather than being overwhelmed by the huge task of implementing a risk management program, local governments should first develop a policy that commits the unit's management and resources to a program. Next, they should identify an initial list of concerns and begin addressing those concerns. There will be time later to fine tune the program as local officials become more knowledgeable about risk management.

#### Accounting for Risk Financing

GASB Statement No. 10 establishes the accounting and financial reporting standards for risk financing and insurance related activities of states and local governments. Statement No. 10 covers both public entity risk pools and entities other than pools. Because the recognition of claims expenditures and expenses within Statement No. 10 is linked with the measurement focus proposed in GASB Statement No. 11, "Measurement Focus and Basis of Accounting - Governmental Fund Operating Statements", entities other than pools will be required to comply with GASB Statement No. 10 and GASB Statement No. 11 at the same effective date. The requirements of Statement No. 11 are effective for period beginning after June 15, 1994; therefore, the effective date for GASB Statement No. 10 implementation also is June 15, 1994. GASB intends for the two statements to be implemented at the same time; consequently, early application of Statement No. 10 is not permitted. For public entity risk pools, the requirements of GASB Statement No. 10 are effective for periods beginning after June 15, 1990. GASB Statement 10 and the reporting requirements for public entity risk pools are not addressed in this manual. For entities other than pools, the accounting for risk financing activities will vary, depending upon whether the risk of loss has been transferred or retained.

#### Accounting for Transferred Risk

Risk is considered to be transferred when the insurance premium that is collected by an insurer is estimated to cover all the claims for which the insurer is obligated. If a governmental unit's losses exceed its premiums, there is no additional supplemental assessment to the unit. On the other hand, if the entity's losses are low, it will not receive a refund. When risk is transferred, the insurer is viewing risk activities in the aggregate, rather than on an individual basis. The unit should be sure that the insurer

has a sufficient amount of assets available to pay any claims before assuming that risk has been transferred to the insurer. If the necessary assets are not available to pay claims, the entity remains liable for those claims and no transfer of risk has occurred.

If a local unit expects to transfer a risk and has purchased insurance to transfer such a risk, then the expenditure/expense for the premium should be recorded in the period that it is incurred and is measurable as an expenditure/expense and related liability of that period. According to the 1990 Codification, Section 1600.122, expenditures for insurance extending over more than one accounting period need not be allocated between or among accounting periods, but may be accounted for as expenditures of the period of acquisition.

#### Accounting for Retained Risk

When loss contingencies exist, the possibility that a future event will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. FASB Statement No. 5, which contains the loss contingency criteria utilized in Statement No. 10, uses the terms probable, reasonably possible, and remote to identify these ranges as follows:

- a) Probable - The future event is likely to occur.
- b) Reasonably possible - The chance of the future event occurring is more than remote but less than likely.
- c) Remote - The chance of the future event occurring is slight.

If the risk of loss has not been transferred to a third party, local governments should report the estimated or contingent loss as an expenditure/expense and as a liability if both of the following conditions are met:

- a) Information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
- b) The amount of the loss can be reasonably estimated.

When it is probable that an asset had been impaired or a liability incurred at the balance sheet date and the reasonable estimate of the loss is a range, then the amount within that range that is the better estimate should be

accrued. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range should be accrued. Even though this minimum amount is not the amount of the loss that will actually be realized, it is not likely that the ultimate loss will be less than the minimum amount.

When risk is retained, the expenditures accrued will consist of two elements:

- 1) Claims expenses, including loss adjustment expenses such as legal or adjuster's fees, and
- 2) Incurred but not reported claims (IBNR) for uninsured events that occurred at or before the balance sheet date but that have not been reported to the governmental entity as of the date of the financial statements.

IBNR claims include known loss events that are expected to later be presented as claims, unknown loss events that are expected to become claims, and expected future development on claims already reported. IBNR is an estimate of loss and claim adjustment expenses associated with estimated future claims activity based on historical actual results that establish a reliable pattern. The amount that the unit should accrue for claims losses and IBNR losses should be based on the estimated ultimate cost of settling claims (including the effects of inflation and other social and economic factors), using past experience adjusted for current trends. The appropriate accrual amounts for claims expenditures/expenses and the related liabilities may be estimated through a case-by-case review of all claims, the application of historical experience to the outstanding claims, or a combination of these two methods. Actuarial analysis also is permitted in some instances. IBNR losses should be estimated based on historical experience.

Even if an accrual is not made for a loss contingency because the event is either not probable or not estimable, then disclosure of the contingency in the notes to the financial statements may still be necessary. The disclosure of a loss contingency should be made when there is at least a reasonable possibility that a loss may have been incurred. The note disclosure should indicate the nature of the loss contingency and the amount or range of the expected loss or a statement that such an estimate cannot be made.

### Discounting of Claims Liabilities

Claims liabilities associated with structured settlements that represent contractual obligations set up to pay money on fixed dates should be discounted. Discounting is a method used to determine the present value of a future cash payment or a series of payments that takes into consideration the time value of money. Otherwise, the choice of whether or not to present claims liabilities at the discounted present value of estimated future cash payments or the face value is up to each unit. If claims are discounted, the unit should select the discount rate by considering such factors as the entity's settlement rate for the particular liability involved and the investment yield rate.

### Annuity Contracts

An annuity contract is a contract that provides either fixed or variable payments made from a certain date and continuing for a specified period of time. Such a contract may be purchased in exchange for a lump sum of money from an insurance company or other investor. If a local unit purchases an annuity contract in a claimant's name to satisfy a claim liability and the likelihood that the unit will have to make any future payments on the claim is remote, then the primary liability to the claimant has been satisfied. If this is the case, then the annuity and the related liability can be removed from the unit's balance sheet. The aggregate amount of such liabilities that are no longer carried on the balance sheet should be disclosed in the notes to the financial statements as long as the contingent loss is outstanding. However, if the claimant has signed an agreement releasing the unit from any further obligations and the likelihood of any further obligations is remote, then the claim will not have to be disclosed. If it is later determined that further obligations do indeed exist, then the annuity and related liability will need to be reinstated on the unit's balance sheet.

Because of the recent instability in the insurance industry relating to annuity contracts, local officials should carefully analyze the financial condition of the annuity provider and the provider's investments or securities underlying the annuity contract. The bankruptcy of an annuity provider could potentially result in the liability for payment returning to the unit of government.

Fund Types Used for Risk Management

Government units that account for risk financing activities in a single fund should do so in either the general fund or an internal service fund.

General Fund - The local government that accounts for all risk financing activity in the general fund will need to allocate any loss expenditures/expenses to other funds or to other departments within the general fund. The amount of the loss and the related liability should be accrued in accordance with the FASB Statement No. 5 guidelines for contingent losses, which are discussed above. The unit can use any reasonable method it chooses to allocate these losses. According to NCGA Statement No. 1, transactions that constitute reimbursements of a fund for expenditures/expenses initially made from it that are properly applicable to another fund should be reported as expenditures or expenses in the reimbursing fund and as a reduction of the expenditures or expenses in the fund that is reimbursed. Based on GASB Statement No. 10, if the total amount charged to the other funds or departments exceeds total loss expenditures and liabilities, then the excess amounts of expenditures should be reported as operating transfers out of the other funds or departments and operating transfers into the general fund.

Internal Service Fund - NCGA Statement No. 1 defines an internal service fund as a fund used to account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost-reimbursement basis. These funds are used to account for the total cost of each activity and to provide greater ease in costing and pricing internal services. Like enterprise funds, they are proprietary in nature. As such they are sometimes referred to as "commercial-type" funds and are used to account for a government's ongoing organizations and activities that are similar to those found in the private sector. The generally accepted accounting principles that are applicable in internal service funds are those applicable to similar businesses in the private sector; and the measurement focus is on the determination of net income, financial position, and changes in cash flows.

If a local government utilizes an internal service fund to account for risk financing activities, the fund should recognize claims expenses and the related liabilities according to the FASB Statement No. 5 guidelines for

contingent losses that are discussed above. The internal service fund can use any appropriate basis to charge other funds for their portion of the unit's risk financing, as long as the following conditions are met:

- a) The total charge by the internal service fund to the other funds for the period is calculated based on the estimated cost of settling the claims, using past experience adjusted for inflation, current trends, or other social and economic factors. Estimated losses and the related liabilities should be reported in the internal service fund if they are both probable and reasonably estimable, and
- b) The total charge by the internal service fund to the other funds is based on an actuarial method or historical cost information and is adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal. The total charge by the internal service fund to the other funds also may include a reasonable provision for expected future catastrophic losses.

The charges in the above discussion are revenues to the internal service fund and expenditures/expenses to the other funds. If the charges by the internal service funds to the other funds are greater than the amounts resulting from the application of the conditions above, then that excess should be reported in both the internal service fund and in the other funds as operating transfers. The charges made by the internal service fund to other funds may be greater than or less than the amounts resulting from the applications of the conditions above since both conditions are estimates to be applied over a reasonable period of time. If the internal service fund has a deficit resulting from the above application, the deficit will need to be recovered over a reasonable period of time by charging the deficit fund balance back to the other funds as an expenditure/expense of those funds. This will not need to be completed in any one year, as long as the adjustments are made over a reasonable period of time.

#### Disclosure Requirements

Whether or not the local unit accounts for risk financing activities in the general fund or in an internal service fund, there is certain information that should be disclosed in the notes to the financial statements. The disclosures required by GASB Statement No. 10 may be made by the entity

as a whole. However, there may be circumstances when aggregate disclosures are misleading and additional or separate presentation by fund or fund types may be necessary. The disclosures required are as follows:

- a) A description of the risks of loss to which the entity is exposed and the way(s) in which those risks of loss are handled (for example, purchase of commercial insurance, participation in a public entity risk pool, or risk retention).
- b) A description of significant reductions in insurance coverage from coverage in the prior year by major categories of risk. Also, an indication of whether the amounts of settlements exceeded insurance coverage for each of the past three fiscal years.
- c) If an entity participates in a risk pool, a description of the nature of the participation, including the rights and the responsibilities of both the entity and the pool.
- d) If an entity retains the risk of loss:
  - (1) The basis for estimating the liabilities for unpaid claims.
  - (2) The carrying amount of liabilities for unpaid claims that are presented at present value in the financial statements and the range of discount rates used to discount those liabilities.
  - (3) The aggregate outstanding amount of claims liabilities for which annuity contracts have been purchased in the claimant's names and for which the related liabilities have been removed from the balance sheet. If a claimant has signed an agreement releasing the entity from further obligation and the likelihood that the pool will be required to make further payments on the claim is remote, then those claims need not be included in the disclosure.
  - (4) A reconciliation of changes in the aggregate liabilities for claims for the current fiscal year and the prior fiscal year, in the following tabular format:
    - a) Amount of claims liabilities at the beginning of each fiscal year.
    - b) Incurred claims, representing the total of a provision for events of the current fiscal year and any change (increase or decrease) in the provision for events of prior fiscal years.

- c) Payments on claims attributable to events of both the current fiscal year and prior fiscal years.
- d) Other. (Provide an explanation of each item.)
- e) Amount of claims liabilities at the end of each fiscal year.

Illustrated risk disclosure notes for several local governments are presented in Exhibit B. The examples are reprinted from the Audit Manual for Governmental Auditors in North Carolina published by the Department of State Treasurer and also from GASB Statement No. 10.

**RISK MANAGEMENT/INSURANCE SPECIFICATION QUESTIONNAIRE**

General Management

1. List the names of each board member, whether the member is elected or appointed, and the length of the term of office.
2. List any appointed boards or committees, including the body's function and the number of its members.
3. List the names of the Manager, Clerk, Tax Collector, Sheriff, Personnel Director, Register of Deeds, Finance Director, Attorney, Risk Manager, and any other key personnel involved with the unit. Indicate the terms and amounts of any existing fidelity bonds. Provide copies of bonds.
4. What is the population of the unit? \_\_\_\_\_
5. What is the appraised valuation of property subject to unit taxation? \_\_\_\_\_
6. If applicable, what is the area in square miles of the unit? \_\_\_\_\_
7. Provide details on all bonded indebtedness. Show the types of bonds issued, the amounts issued, the amounts retired, the amounts due each year, and the year of retirement. Detail any insurance requirements included in the bond agreements or orders.
8. Provide a list of all other long-term indebtedness. Show the nature and amount of all liabilities listed.
9. Provide a list of contingent liabilities that are disclosed in the notes to the financial statements for the fiscal year just ended and any that may have arisen during the current fiscal year. Indicate the likelihood that the unit will incur a liability and the range of that liability, if estimable.
10. Briefly discuss the procedures for the selection of insurance agents and companies.
11. Provide a list of insurance companies or pools utilized by the unit. Include the agents' names and the policies provided by each.

Exhibit A  
(continued)

12. Obtain and attach copies of all policies currently held by the unit (automobile, property, general liability, umbrella liability, professional liability, boiler and machinery, inland marine, etc.).

Operations and Services

13. List any recreation programs operated on property not owned by the unit. Include the sites, annual fees, and the programs provided.
14. Describe the sponsored activities of the recreation department, i.e. swimming, basketball, crafts, etc.
15. Does the unit own or operate any swimming pools? If so, list the location of each, annual receipts, qualifications of lifeguards on duty, available first aid facilities, and the loss/accident history for each pool. Explain the maintenance and repair schedule for these pools and include a copy of the last inspection report for all pools, if applicable.
16. If the unit owns or operates a golf course, list the location and the annual receipts. Does the facility own any major assets such as golfcarts or trucks? If so, list the assets' description, replacement costs, and depreciable values.
17. Are concessions operated by the entity or another party at recreational events or at any other locations? If they are operated by an outside party, attach a copy of the contract. Also, list any annual fees or receipts.
18. Are alcoholic beverages sold at any unit location? Are alcoholic beverages expressly forbidden at unit locations?
19. Are fireworks exhibitions ever sponsored? If so, give the location and the event. If independent contractors are used, attach a copy of the contract and a certification of insurance.
20. Are fairs or festivals ever sponsored? If so, list the location of the event(s), the date(s), and a description of the event(s).

Exhibit A  
(continued)

21. Does the unit own or operate any libraries or museums? If so, give the location of the facilities and a description of the properties and services provided. Estimate the replacement costs of the books or exhibits at each location, listing separately any valuable documents, rare books, or major assets.
22. Does the unit operate a bookmobile? If so, estimate the value of the vehicle and its contents (books, generator, shelving, etc.)
23. Are any airports or aircraft operated? If so, supply the following information:

Airports

Location of facilities:

Is the facility operated by the insured?

If yes, give the dimensions of the airfield with a full description on an attached page.

Are there any underground or above-ground tanks on the site which are being used or have ever been used for the storage of fuel or any other potentially hazardous chemicals?

Do scheduled airlines regularly use the airfield? If so, explain who uses the field, how often, etc. Supply a copy of any contracts and of the certificate of insurance.

Are landings and take-offs controlled? If so, by whom?

Is radio or directional information given to aircraft navigating in the air and on the airfield? If so, by whom?

Which party bears responsibility for handling freight or passenger traffic on arriving and departing aircraft?

Are all required regulations complied with?

Number of hangars \_\_\_\_\_ Plane capacity of each \_\_\_\_\_

Are hangars utilized to store the property of other parties?

Exhibit A  
(continued)

If the airport is operated by another party for the unit, attach a copy of the existing contract and discuss the monitoring procedures and specific insurance requirements in the contract. Attach a set of the other party's audited financial statements for the previous three years.

Aircraft

Provide a description of all owned aircraft. Include the replacement cost, depreciable value, and the purpose for which the aircraft are utilized.

If aircraft are leased, is the unit responsible for any losses as the lessee? Attach a copy of the lease contract.

24. Does the unit construct or maintain any streets or roads? If so, give the number of paved and unpaved miles. If street work is contracted out, attach a copy of the standard contract used. Is the independent contractor required to hold the unit harmless and to carry adequate liability and workers' compensation insurance?
25. Does the unit construct and maintain any sidewalks? If so, give the number of miles of sidewalks maintained. If sidewalk work is contracted out, attach a copy of the standard contract used. Is the independent contractor required to hold the unit harmless and to carry adequate liability and workers compensation insurance?
26. Are traffic signs or signals maintained by the unit? If so, give the number of traffic signals by type.
27. Are any parking decks or lots maintained for public use? List the location and acreage of the lots and the annual receipts for usage. Is there any outstanding debt on the facilities?
28. If other parties operate the parking decks or lots for the unit, attach a copy of the contracts.
29. List the location, area, and percentage of spaces filled of any cemeteries or mausoleums owned and operated by the unit.

Exhibit A  
(continued)

30. Explain the arrangements for the perpetual trust fund set up by the unit for the maintenance of the filled plots (G.S. 160A-347).

31. Does the unit own any voting machines? If so, list:

Storage location \_\_\_\_\_  
Total number of machines \_\_\_\_\_  
Value (replacement cost) of machines \_\_\_\_\_  
Number of owned public precincts \_\_\_\_\_  
Number of non-owned public precincts \_\_\_\_\_  
Number of privately-owned precincts \_\_\_\_\_

If there is an agreement with non-owned precinct locations, attach a copy of the standard contract.

32. Does the unit provide law enforcement services? If so, is a jail owned and operated? If a jail is operated, provide the following information:

Location \_\_\_\_\_ Square footage \_\_\_\_\_  
Capacity \_\_\_\_\_ Average # of inmates \_\_\_\_\_

33. How are the food and other operating services provided at the jail? If food and various cleaning services are handled using independent contractors, attach copies of the contracts used.

34. Describe the unit's arrangements for fire services, if applicable.

Number of paid firemen \_\_\_\_\_

Number of volunteer firemen \_\_\_\_\_

Are volunteer departments franchised? If so, attach a copy of the franchise agreement.

Does the unit subsidize the volunteer fire department?

Has a first responder program been implemented? If so, describe the insurance protection available for first responders.

Exhibit A  
(continued)

35. Does the unit provide emergency medical services? If so, how many emergency medical technicians are on staff and what are their qualifications? What are annual fees or revenues? Are the services franchised? If so, attach a copy of the agreement and audited financial statements of the other entity for the past three years. What is the loss/accident history of the emergency medical services?

Do the EMS services have procedures to prevent the transmittal of Acquired Immune Deficiency Syndrome (AIDS)?

36. Is sewer service provided? If so, supply the following:

Gallon capacity of plant \_\_\_\_\_ Peak load \_\_\_\_\_

Number of customers \_\_\_\_\_ Annual revenue \_\_\_\_\_

Does the plant have an alternate power source \_\_\_\_\_

If so, describe the alternate source. \_\_\_\_\_

Attach a list of sewer lift stations showing construction type of building, location, and replacement value, and the number of pumps (note spare pumps).

Supply the total miles of sewer lines \_\_\_\_\_

Does the unit treat sewage from other entities? If so, what are the annual fees? Attach copies of any agreements.

37. Does the unit treat and distribute water? If so, provide the following information:

Miles of water main \_\_\_\_\_ Capacity of plant \_\_\_\_\_

Number of meters \_\_\_\_\_ Average distribution/day \_\_\_\_\_

Does the plant have an alternative power source? \_\_\_\_\_

If so, describe the alternate source \_\_\_\_\_

What are the location and capacity of the storage tanks and reservoirs? Describe the capacity and the type of dams, if applicable.

How many gallons are distributed residentially per year?  
Industrially?

Attach a list of water pump stations showing construction type of building, locations, replacement cost, use (finished or raw water), and the number of pumps (note spare pumps).

Exhibit A  
(continued)

38. Is water brought from or sold to other entities? If so, attach copies of any agreements.
39. Is any blasting done by the unit? If so, describe the storage facility for dynamite and blasting caps. If the unit has blasting done by an independent contractor, attach a copy of the agreement used and the certificates of insurance from the latest contractor.

40. Is garbage or refuse collected? If so, provide the following information:

Number and type of trucks \_\_\_\_\_  
Frequency and method of residential pickups \_\_\_\_\_  
Frequency and method of business pickups \_\_\_\_\_  
Method of disposals \_\_\_\_\_

If an independent contractor is used, attach a copy of the agreement and certificates of insurance. Are any private collectors required to obtain a franchise? If so, attach a copy of the agreement.

41. Is a landfill or other type of disposal plant owned and operated? If so, provide the following information:

Parties allowed to use \_\_\_\_\_  
Any transfer station (locations and descriptions) \_\_\_\_\_

Attach any contracts with other parties regarding the use or operation of the landfill. Supply total annual revenues of the landfill? \_\_\_\_\_

What is the status of any closed landfill? Does the unit have any potential liability for any closed landfill? \_\_\_\_\_

42. Does the unit operate an electrical service or system? If so, provide the following information:

What is the source of power? Describe the source. Is there an alternate source available?

Provide a list of electric substations showing location, replacement value, maximum probable loss, and safety features.

Gross annual receipts \_\_\_\_\_  
Location of power plant(s) \_\_\_\_\_  
Number of customers: residential \_\_\_\_\_ commercial \_\_\_\_\_

Exhibit A  
(continued)

43. Does the unit have a community development block grant? If so, describe the activities to be performed. Attach copies of agreements used for administration, construction, rehabilitation, etc.

44. Does the unit provide public housing? If so, how many units are provided? Attach a copy of the standard lease agreement.

45. Are any social service programs operated? If so, provide the following information:

Attach an organizational chart and copies of contracts or agreements with other agencies (day care, childrens' homes, etc.).

Provide a written narrative describing the services provided, including funding sources.

Estimate the additional expense (overtime, additional employees) that would be needed to replace valuable papers and records that may be destroyed in a fire.

46. Does the unit operate any health programs? If so, provide the following:

Attach an organizational chart and copies of any contracts or agreements with other agencies or individuals (physicians, nurses, etc.)

Provide a written narrative describing the services provided.

Does the unit have any procedures addressing prevention practices to avoid the transmission of the Acquired Immune Deficiency Syndrome (AIDS)? Does the procedure address the disposal of contaminated medical waste?

Estimate the additional expense that would be incurred to replace valuable papers and records that may be destroyed in a fire.

47. Is a hospital, nursing home, asylum, or sanitarium operated by the unit? If so, describe the facility and its operations fully.

Does the facility above employ doctors, nurses, and other medical professionals? If so, how many?

Exhibit A  
(continued)

48. Does the unit operate mental health programs or care facilities for the mentally ill or retarded? If so, describe fully.

Does the above facility employ physicians, nurses, or other medical professionals? If so, how many?

List any major assets that are associated with the facility. Include the replacement cost, depreciable value, location, and use.

49. Does the unit operate a transit system? If so, describe the system and its operations and disclose the following information:

Annual revenues \_\_\_\_\_ Operating expenses \_\_\_\_\_  
Number of buses \_\_\_\_\_ Amounts of other funding \_\_\_\_\_

Briefly discuss the repair and maintenance procedure for transit vehicles. What is the system of follow-up to verify that necessary repairs are made?

Are background checks completed on transportation employees prior to employment? What type of safety guidelines are in place and are employees trained in these procedures?

Are there any underground or above-ground storage tanks that are currently used or have ever been used for the storage of fuel or other potentially hazardous chemicals located on the site of the transit facility?

Describe and attach any contractual agreements relating to the transit system.

50. Does the unit operate a gas distribution system? If so, provide the following information:

Gross revenues \_\_\_\_\_ Operating expenses \_\_\_\_\_  
Number of commercial customers \_\_\_\_\_ Residential \_\_\_\_\_  
Miles of mains by size \_\_\_\_\_

Describe the operations of the gas distribution system and attach any contractual agreements.

51. Does the unit operate an animal shelter? Is there a leash law in effect?

Exhibit A  
(continued)

52. Does the unit ever hold an auction? If so, are buyers required to sign a hold harmless agreement? Does the unit have any contracts with the auctioneer? If so, attach a copy.
53. Discuss any operations conducted by the unit that have not been mentioned previously.
54. Has the unit granted a cablevision franchise? If so, attach a copy of the contract.

Property

55. Attach a list of all government-owned and leased buildings. Include the square footage and construction features of each. Include the replacement cost and actual cash value of all listed buildings. Indicate if significant changes in design or location would be necessary to make the building more useful in case of fire or other major loss. Also, list the approximate value of any major assets contained in each building. Attach copies of all available appraisals.
56. Attach a list of all vehicles owned by the unit. Show the year, make, use, serial number, original cost, actual cash value, and replacement cost for each vehicle (include any boats or other items owned with vehicles).
57. Attach a list of all heavy equipment owned by the unit. Show the size, description, serial number, use, actual cash value, and replacement cost of all equipment.
58. List any auditoriums, theaters, civic centers, or exhibition halls owned by the unit and provide the following information for each:

Location \_\_\_\_\_  
Seating capacity \_\_\_\_\_ Annual receipts \_\_\_\_\_  
Description of use \_\_\_\_\_

59. List any stadiums, ballfields, or grandstands owned by the unit and provide the following information for each:  
Location \_\_\_\_\_  
Seating capacity \_\_\_\_\_ Annual receipts \_\_\_\_\_  
Permanent or temporary \_\_\_\_\_  
Description of use \_\_\_\_\_

Exhibit A  
(continued)

60. Are there any additions, alterations, or demolitions to existing properties currently being contemplated or under construction? If so, give a description of the work to be done, the approximate cost, and the estimated date of completion.
61. Is any property of others kept for repair, processing, or other purposes (include the property of concessionaires or employees and property held for consignment)? If so, describe.

Is there any agreement concerning the unit's responsibilities for protecting the property of others? If so, attach a copy of the contract.

62. For all data processing equipment, provide the following information on a separate listing:

Description of equipment \_\_\_\_\_  
Location \_\_\_\_\_  
Serial number \_\_\_\_\_ Book value \_\_\_\_\_  
Replacement cost \_\_\_\_\_  
Owner of equipment \_\_\_\_\_  
If leased, who is responsible for damage or  
destruction? \_\_\_\_\_

What would be the approximate cost to replace data if equipment were destroyed (include any costs associated with reconstruction)?

If equipment were destroyed, what would be the approximate extra expense to continue operations or the cost to renew operations? (Include overtime costs, costs to rent replacement computer, or computer time on another system.)

Is there an established procedure for backing-up system programs and data? If so, describe the procedure.

Is there off-site storage of system back-up?

Is the system used by others? If so, who is liable for loss of data? Are the other parties adequately trained to avoid loss of data and the consequences?

Exhibit A  
(continued)

63. Attach a listing showing the location and number of all boilers. Indicate the use, manufacturer, and capacity of each unit. Describe the maintenance and inspection program and attach a copy of the last inspection report.

64. List the number and location of all air tanks and other pressure vessels owned by the unit or in the unit's possession.

Is alternate power available in case of breakdown or disruption?

65. List the number and location of all key machinery, motors, pumps, compressors, and electrical equipment and the approximate value of each that is not already listed elsewhere.

66. Are unit vehicles garaged overnight? If so, describe the location and procedure.

Does the garage contain an alarm system?

67. Are vehicles or equipment ever rented from other parties? If so, describe the type of vehicles and the reasons for the rentals.

68. Are valuable papers and records stored in a fire/burglary resistant vault on the premises or off-premises at a bank or another secure location? Describe the standard storage procedure.

Estimate the cost to research and reconstruct valuable records at each location.

69. Are there any fine arts or other valuables in the custody of the unit? If so, describe and supply an approximate value. Indicate the owner of the property and the loans terms if owned by another party.

70. Does the unit own any unusual scientific equipment, cameras, or valuable instruments? If so, indicate the location, approximate value, and use of the equipment.

71. Provide a description of the location of all elevators.

Describe the procedure for scheduling maintenance and repairs. Review a recent inspection report for follow through action.

Exhibit A  
(continued)

Are elevator maintenance contractors used for maintenance?  
If so, attach a copy of the contract.

72. Does the unit own any vacant land? If so, describe the location, the dimensions, and the usage.

#### Contracts

73. List any property leased to others. Attach a copy of each lease agreement.
74. List any property leased from others. Attach a copy of each lease agreement.
75. To determine the risk management responsibilities of the parties involved, is a careful review made of all pending contracts? If so, discuss the procedure for contract review.
76. Are all independent contractors required to furnish proof of general liability and workers' compensation insurance before work is begun? Is there a procedure for the maintenance and retention of the documents?
77. Attach copies of the standard purchase order form, sales agreement, and permit ordinances utilized by the unit.

#### Safety and Loss Control

78. Is an active safety and loss control program maintained? If so, answer the following questions:

Is there a safety committee? \_\_\_\_\_

List the titles of committee members. \_\_\_\_\_

How often does the committee meet? \_\_\_\_\_

Are employees informed about safety practices and procedures? \_\_\_\_\_

How are accidents reported? Investigated?

Who reports and investigates accidents?

Exhibit A  
(continued)

79. Do insurance companies provide periodic safety and loss prevention inspections and recommendations, as well as periodic loss runs that alert management to claims activities and sources of frequent claims? If so, who reviews and follows up on such recommendations?
80. Are records of losses, claims, and complaints kept? Is there a unit policy for maintenance and retention of these documents? Whose job is it to maintain such records?
81. Provide a three-to-five year loss history for each type of loss as well as the premiums paid for each year. (This information may be obtained from insurance carriers for insured losses.)
82. Are new employees given a pre-employment physical exam?
83. Does the unit have a policy establishing a drug-free workplace? Are new employees tested for drug use?
84. Are the driving records of new employees checked before they are allowed to operate vehicles?
85. Are regular drivers required to take a course in defensive driving?
86. Attach a list of buildings showing if the following are installed and maintained: fire extinguishers, smoke detectors, and sprinkler system.
87. Who is responsible for inspecting fire extinguishers and what is the inspection schedule? Attach copies of the last inspection report.
88. What are the safety precautions taken by the sanitation crews (brightly colored vests, flashing warning lights on vehicles, steel tipped shoes, or safety glasses)?
89. What safety precautions are taken by street crews?
90. Are sewer lines frequently inspected for blockages? Describe the policy for inspection and maintenance. Who maintains the inspection records and how long are the documents retained?
91. Do the police report on the condition of roads, cars, traffic signals, etc. at the end of each patrol?

Exhibit A  
(continued)

92. Are there any burglar alarms installed on property of the unit? If so, provide the following information from the Underwriters Laboratories certificate that can be found on each system:

Description of system \_\_\_\_\_  
Name of manufacturer \_\_\_\_\_  
Installation number (1, 2, or 3) \_\_\_\_\_  
Class (A or B) \_\_\_\_\_  
Certification number \_\_\_\_\_  
Expiration date \_\_\_\_\_

93. For all safes and vaults, provide the following information:

Location of item \_\_\_\_\_  
Manufacturer's name \_\_\_\_\_  
Serial number \_\_\_\_\_  
Fireproof or burglarproof \_\_\_\_\_  
Thickness of door lining \_\_\_\_\_  
Type of lock \_\_\_\_\_  
Name of relocking device \_\_\_\_\_  
Does safe contain a burglarproof chest \_\_\_\_\_  
Value and description of contents \_\_\_\_\_  
Description of alarm or protection device \_\_\_\_\_

94. Is there a safe deposit box? If so, what is kept there and what is its value? Who has access to the contents?
95. Is there a night depository? If so, describe.

#### Financial Organization

Obtain copies of the audited financial statements for the last fiscal year and of the current year's budget ordinance.

Exhibit A  
(continued)

Cash and Investments:

96. Supply the names and addresses of any banks utilized by the unit for any purpose.
97. How are moneys and checks taken to the bank, i.e. police escort, locked satchels?
98. Where are cash and other securities kept? Are custody agreements in compliance with the General Statutes? Are any securities held in the unit of government's name?
99. Are the employees who handle more than \$100 of the unit's cash bonded as required by State statute?
100. Are bank reconciliations completed regularly?

Inventory:

101. How often is a physical inventory made of stocks and supplies?
102. Are all employees who have access to the unit's inventory bonded as required by State statute?
103. If the unit maintains a warehouse, what type of inventory control system exists in that warehouse?

Accounts Receivable:

104. Are duplicate records maintained? If so, where are these records maintained?

Loss of Income:

105. If the unit conducts utility services that must be resumed immediately in the event of a fire or other catastrophe, have plans been made to arrange for substitute facilities or equipment?
106. Describe the arrangements made.

Exhibit A  
(continued)

107. What materials, parts, machines, or equipment will be particularly difficult to replace in the event of a catastrophe?
108. Is there a single source or a few sources of supply whose damage would affect the unit's services? If so, list them.
109. Are there any large customers (or taxpayers) whose closing due to fire, other catastrophe, or bankruptcy would seriously affect the financial status of the unit of government? If so, list them.

**Sample Financial Disclosure Notes**

As discussed in this manual, GASB Statement No. 10 requires local governments to make certain disclosures in the financial statements regarding a description of the risks that the unit is exposed to, and how the unit handles those risks. (A complete discussion of disclosure requirements is included in the section "Accounting for Risk" found in this manual.) Sample notes 1 through 3 are taken from the illustrated financial statements for Carolina County, City of Dogwood, and Carolina County Board of Education. All the notes are taken from the Audit Manual for Governmental Auditors in North Carolina, published by the Staff of the Local Government Commission. In the samples drawn from the Audit Manual, the local governments have all transferred their risks of loss to other entities. Sample note 4 is drawn from GASB Statement No. 10 and illustrates the financial note disclosure for a unit that elects to retain some portion of risk. The actual note disclosure that a specific unit presents in its financial statements will depend on the unit and its particular risk situation. The following sample notes are guidelines to assist local governments in the preparation of their financial disclosure notes.

1)

Carolina County

The County is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The County participates in two self-funded risk financing pools administered by the North Carolina Association of County Commissioners. Through these pools, the County obtains property insurance coverage of \$125.5 million per occurrence, general liability coverage of \$2 million per occurrence, and workers' compensation coverage up to statutory limits. The pools are reinsured through commercial insurance for single occurrence losses in excess of \$500,000 for property coverage, \$500,000 for general liability, and \$350,000 for workers' compensation.

The County carries commercial coverage for all other risks of loss. Claims have not exceeded coverage in any of the last three fiscal years.

Exhibit B  
(continued)

2)

City of Dogwood

The City is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The City participates in three self-funded risk financing pools administered by the North Carolina League of Municipalities. Through these pools the City has property, general liability, and auto liability coverage of \$10 million per occurrence, workers' compensation coverage of \$2 million per occurrence, and employee health coverage up to a \$1 million lifetime limit. The pools are reinsured through commercial companies for single occurrence claims against property, general liability, and auto liability in excess of \$300,000, and \$250,000 for workers' compensation. The pools are reinsured for annual employee health claims in excess of \$100,000.

The City carries commercial coverage for all other risks of loss. Claims have not exceeded coverage in any of the last three fiscal years.

3)

Carolina County Board of Education

The Board is exposed to various risks related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Board participates in the North Carolina School Boards Insurance Trust, a self-funded risk financing pool administered by the North Carolina School Boards Association. Through the trust, the Board maintains general liability and errors and omissions insurance coverage of \$1.25 million per occurrence. The Trust is reinsured through commercial insurance companies for losses in excess of \$250,000 per occurrence. The Board has workers' compensation coverage for employees paid from local and federal funds. The State of North Carolina provides workers' compensation coverage for employees paid from State funds. All workers' compensation coverage is subject to statutory limits. The Board participates in the Public School Insurance Fund, a voluntary, self-funded risk financing fund administered by the North Carolina Department of Public Instruction. The Fund provides property coverage up to \$22 million per location annually, and is reinsured for losses in excess of \$1 million per occurrence, and \$12 million in aggregate annually.

Exhibit B  
(continued)

The Board carries commercial coverage for all other risks of loss. Claims have not exceeded coverage in any of the last three fiscal years.

4)

City of ABC

The City is exposed to various risks related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. During fiscal year 19X6, the City established a Risk Management Fund (an internal service fund) to account for and finance its uninsured risks of loss. Under this program, the Risk Management Fund provides coverage for up to a maximum of \$250,000 for each workers' compensation claim, \$125,000 for each general liability claim, and \$10,000 for each property damage claim. In the fiscal year 19X7, the Fund provided coverage of up to \$50,000 for each workers' compensation claim and \$25,000 for each general liability claim.

The City purchases commercial insurance for claims in excess of coverage provided by the Fund and for all other risks of loss. Settled claims have not exceeded this commercial coverage in any of the last three fiscal years.

All funds of the City participate in the program and make payments to the Risk Management Fund based on actuarial estimates of the amounts needed to pay prior- and current-year claims and to establish a reserve for catastrophe losses. That reserve was \$23,000 at June 30, 19X8 and is reported as a designation of the fund balance in the Risk Management Fund. The claims liability of \$773,000 reported in the Fund at June 30, 19X8 is based on the requirements of Governmental Accounting Standards Board Statement 10, which requires that a liability for claims be reported if information prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated.

Exhibit B  
 (continued)

The City purchases annuity contracts from commercial insurers to satisfy certain liabilities under workers' compensation claims; accordingly, no liability is reported for these claims. At June 30, 19X8, \$176,000 of those covered liabilities were still outstanding. Changes in the Fund's claims liability amounts in fiscal 19X7 and 19X8 were:

	<u>Beginning of- Fiscal-Year Liability</u>	<u>Current-Year Claims and Changes in Estimates</u>	<u>Claim Payments</u>	<u>Balance at Fiscal Year-End</u>
19X6-19X7	\$675,000	\$110,000	\$(93,000)	\$692,000
19X7-19X8	\$692,000	\$149,000	\$(68,000)	\$773,000