

# CHAPTER 1

## The Small Business Challenge

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*Although competing in the same marketplace, there are inherent differences between small businesses and their larger counterparts. Knowing these differences creates a well-informed consumer of workers' compensation insurance and alerts small business owners and managers of the need to take action.*

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### **You're Not Alone**

It's probably safe to assume that most adult Americans have daydreamed about the prospect of going into business for themselves. It appears that more than ever before, many have taken the leap from fantasy to reality. Give some thought to the prevalence of small businesses within the United States, or even within the town in which you live. Simply attempt to count the small businesses (those that employ less than 100 employees) on your commute to or from work. For most of us, there are just too many to count. That is an incredible testament to the entrepreneurial spirit of the American people.

According to 2004 U.S. Census Bureau statistics, more than half of the people employed in the private sector are employed by businesses that have fewer than 100 employees. Even more revealing about the prevalence of small business is the fact that 98% of all private-sector business establishments in the U.S. employ fewer than 100 employees; 91% employing less than 20 workers. Incredibly, that's only 9% of private sector businesses that have 20 employees or more.

Despite the overwhelming prevalence of small businesses in the United States, success in a small business is not guaranteed. Many reliable statistics suggest that only half of small businesses remain in operation 5 years after their inception. However, an incredible number of small businesses not only survive, they thrive year after year.

Some of the reasons for the success of small businesses are the very characteristics that distinguish them from their larger counterparts. The ever-changing nature of business relationships, consumer needs, product marketing, delivery methods and virtually every other aspect of business is a reality that gives small businesses the advantage. The very nature of small businesses makes change quicker and easier than it is in larger companies. Simply put, it's much easier to turn around a small speedboat than it is to change the direction of a massive cruise ship. Furthermore, small businesses can typically be more responsive to customer needs and desires; can more aptly mirror the values of the local community; and can function more within the realm of customer loyalty.

### ***Maybe Size Does Matter***

Unfortunately, not all of the characteristics of small businesses are advantageous. In fact many of the very things that make small businesses unique also work to their detriment. Small businesses, with very few exceptions, must play by the same rules as the much larger companies. Small businesses must wade through the same governmental red-tape, adhere to the same restrictions, comply with the same laws as the larger companies, and they must do so with considerably fewer resources.

Regardless of whether or not there are blood-relatives working together, many small businesses function as a family. For that reason, there is typically an innate concern for protecting each employee from being injured at work. Despite that concern, small businesses typically do not employ individuals with specialized training and expertise in areas directly relating to injury prevention, claims management and insurance. In fact, few even have laypersons working within their ranks that are comfortable enough with their abilities to consider themselves competent in those disciplines. In short, large businesses frequently have the council of experts that small businesses lack. The result is that large businesses are in a better position to be more effective than small businesses at the things that influence workers' compensation premiums.

Not only do small businesses frequently lack the ability to hire individuals with specialized knowledge in safety, insurance and claims management, but much of time the owners and managers of small businesses are spread unbelievably thin. In fact, the owners and managers within small businesses typically perform such a wide range of duties that they often fail to afford due attention to addressing the aspects of business management that have the most profound impact upon workers' compensation premiums. Because small business owners are spread so thin, the squeaky wheel gets the grease. It's an unfortunate reality, until there's a workers' compensation claim, responsibilities such as sales, production, hiring, firing, billing, and appeasing customers, are the wheels that are squeaking much louder than the one labeled "workers' compensation."

Traditionally, small businesses have not been well served by the safety and health community. Most of the regulations to which all companies are obligated to comply have been written with the large employers, not small businesses, in mind. Likewise, the enforcement efforts have, by and large, sidestepped the small business community, and by default have sent the message that small businesses are on their own. Even some workers' compensation insurance companies focus their consultative loss control assistance on policyholders that pay the largest premiums.

## ***A Built-in Bias***

As presented so far, some of the very characteristics that set small businesses apart are the same characteristics that make it difficult for them to compete on a level playing field with their larger counterparts. To add insult to injury, some characteristics over which small business owners have little or no control also make it difficult for them to obtain reasonably priced workers' compensation coverage. In fact, workers' compensation insurance, in many ways, has a built-in bias against small businesses.

First, insurance carriers incorporate a premium discount when providing a quote for workers' compensation coverage. As the premium increases in size, so does the discount. This is done for at least two reasons.

One reason is that premiums paid by large companies are attractive to insurance carriers, thus making them more eager to offer a premium discount to attract their business. In this respect, insurance companies are no different than any other business. If you owned a doughnut shop and had one customer who ordered 1 doughnut to eat for breakfast and another who ordered 1,000 to feed the participants of a convention, you would be much more likely to provide a discount to the latter customer in an attempt to secure future large orders.

A second reason that workers' compensation carriers offer premium discounts to larger companies is that the administrative costs incurred by the insurance carrier do not increase proportionately with the number of employees. Although a company with 350 employees has 10 times the number of employees as a small business that only has 35 employees, the administrative costs incurred by the insurance company for the larger company are not ten times that of the smaller company. It doesn't take ten times longer to review the application, calculate a premium quote and to issue a policy for the larger company. Nor does it take ten times the resources for the insurance company to provide consultative loss control services to the 350-employee company.

Regardless of the reasoning, the fact still remains that small businesses are placed at a financial disadvantage because their premium is likely not sufficient to warrant a significant premium discount, if any at all.

Premium discounts are not the only disadvantage to small businesses that is built into workers' compensation insurance. Although each state has unique rules relating to workers' compensation, most jurisdictions only permit companies with a workers' compensation premium in excess of a specified threshold to be "experience-rated." For example, state workers' compensation rules may dictate that only companies with an annual premium of \$5,000 or more for 3 consecutive years may be "experience-rated." The experience rating process is described in much greater detail in a later chapter of this book. For now, it will suffice to describe it as the process by which premiums are adjusted, based upon your company's past workers' compensation claims history. Put in practical terms, your small business may have gone 6 years without a workers' compensation claim and receive no automatic premium reduction as a result, simply because your company's insurance premium is too small. However, a larger company, even if only slightly over the "experience rating" threshold, may receive a substantial premium reduction for having the same workers' compensation claims record.

You may be screaming "foul" by now. But there is justification for excluding small businesses from the experience rating process. Think back to your high school or college years. Do you recall a statistical principal called Bernoulli's law, or the "law of large numbers?" The principal states that with a large enough number of trials, the experimental probability gets very close to the theoretical probability. On the surface this may appear to have absolutely nothing at all to do with workers' compensation premiums. However, consider the fact that workers' compensation premiums are based on the insurance company's prediction of what your company will cost them in claims during the policy year. One thing at which the insurance company looks to make that prediction is the number and cost of claims that your company submitted in the past. However, the law of large numbers implies that the more employees you have, the more accurate your company's past claims experience is going to be in predicting your future claims experience. Hence the fewer employees your company has, the less reliable your past claims will be in predicting the future. Since companies that have small premiums have relatively few employees, the past workers' compensation claims are less likely to be an accurate predictor of future claims. In that respect, insurance companies are taking more of a gamble when insuring small

companies. To offset that gamble, they are more apt to charge full fare for the ride.

Regardless of whether your premium is sufficient to allow your company to be experience rated, the insurance company will also take into consideration the "loss ratio" for the company. If you hated math in high school and now own a small business, you're going to like it even less. Basic math is the enemy to small businesses when considering the concept of a loss ratio. Quite simply, the loss ratio of a company is the ratio between the amount of money that the insurance company is holding in reserve to pay for the claim (medical costs, wage-replacement and other benefits), and the amount of money that has been paid to the insurance company in workers' compensation insurance premiums.

Consider a small business with an annual workers' compensation premium of \$4,500 in which an employee slipped and fell on the ice and broke his collarbone. In this example, the total incurred amount paid by the insurance company was \$9,000. If that were the only workers' compensation claim that the small business submitted during that year, the loss ratio would be 200% (\$9,000 divided by \$4,500). That's not too attractive to an insurance company that requires no more than a 70% loss ratio just to break even. However, that same claim incurred by a company with a \$90,000 premium would have a much less significant impact upon the loss ratio.

If you haven't already been thoroughly disgusted with the manner in which the system appears to penalize small businesses, consider the fact that some insurance companies who provide workers' compensation coverage have a self-imposed minimum premium threshold. For example, an insurance company may arbitrarily set their minimum premium threshold at \$10,000. If you operate a small business and have an annual workers' compensation premium of \$7,500, they will not insure your company. That automatically reduces the number of insurance companies from which you can seek quotes for coverage. Simply because of the size of your premium, you may not be able to find competitive workers' compensation coverage from any insurance company and thereby be relegated to your state's alternative.

### ***It's Just Not Fair***

Despite the overwhelming presence of small businesses in the United States, small business owners and the managers within them have an uphill battle to fight if they intend to come out on top.

First, as a person within a small business charged with the responsibility of securing workers' compensation coverage, you must recognize that there are inherent differences between your company and the medium and large sized companies. Some of these differences are to your advantage, such as the relative flexibility of small businesses. However other differences, such as not having specialized expertise on your staff to wade through the issues of insurance, injury prevention and claims management are to your detriment.

You must also be aware that your company is placed at a disadvantage to larger companies based almost exclusively on the amount of premium your company pays. It's somewhat of a catch 22 that the less you pay in premiums, the less favorably the workers' compensation system treats you when calculating your future premiums.

Seeking workers' compensation coverage for a small business is analogous to running in a marathon with hundreds of thousands of other business owners. Side-by-side you stand at the starting line beside owners of companies large and small, each waiting for the pop of the starting gun. However before the race, you and each small business owner running the race are required to place a ball and chain around your ankles. Don't be discouraged. You may not sprint into first place, but with persistence and a strategy to prevent and control loss, you can finish strong. In fact, you will finish ahead of your small business counterparts that leave workers' compensation and loss control to chance.