

The assessment of loss of profits in the inspection report

Carlos Larrad Salgado

ITSEMAP Servicios Tecnológicos MAPFRE, S. A.

Inspection reports are of vital importance within the insurance sector in order to take correct decisions. They do not however always reflect the true situation regarding such risks as loss of profits resulting from fire, because they do not give sufficient information for the later analysis and assessment of the risk which is to be accepted.

The inspection report may be seen as a company's visiting card which it presents to the insurance sector. It should include not only the technical characteristics of the installations and processes which are carried out, but it should also identify the various risks which have been observed by the inspector, and thus any factors which may affect these risks. The inspector should give his subjective assessment of the risk through an evaluation of each of the risks which have been identified and which may be covered by the insurance.

Loss of profits is not always treated with sufficient rigour, despite the fact that, on many occasions, it is one of the covers which gives rise to the largest compensations. The determination of any possible loss of profits is perhaps the most difficult part within the risk inspection process, and the co-operation of the management of the inspected site with the inspector is very important in order to determine and assess the main factors which may influence the magnitude of loss of profits in case of an insured event.

As a guide, some factors which will affect loss of profits are given here and special note should be made of these in the inspection report in order to give the reader the maximum amount of information which will permit the risk to be assessed in an objective manner:

- Transport of raw materials or finished products may be of key importance to the activities of the company.

Let us take as an example a small island located somewhere in the world.

The companies on this island depend on sea transport for the delivery of raw materials and in order to send their finished products to their customers. Possible natural hazards could cut off the island and cause long periods of inactivity in the companies.

- Energy is essential for the company. How is it generated? What quantities are needed? Does the site have its own energy supply? Has the possibility for its own energy supply been considered? What capacity does the alternative supply have? These are some of the questions which are of great interest.

The possibility of diversifying supply sources and suppliers is a factor which will help to guarantee supplies which are necessary for the production process and the site's activities.

- Another of the most important aspects is the replacement or substitution of plant facilities and machinery.

In addition to the pure economic cost of reconstruction, the delay which is inherent in re-establishing normal activities may cause high extraordinary expenses and considerable loss of profits. It is advisable to note the source of the machinery and the estimated replacement time in case of loss.

The fixed salary costs of the employees may be the cause of serious financial difficulties for the company due to the fact that these costs will continue to be incurred even during periods when no sales are made as a result of forced inactivity, leading to a clear decrease in revenue.

The importance of certain installations which are vital to the func-

tioning of the plant, such as steam in a paper mill, or compressed air in a company whose activities are carried out using pneumatic systems, should not be forgotten. It should be ascertained as to whether there are alternative supplies on the site and whether their capacities are sufficient to meet the plant's needs.

- The independence or interdependence of the company in question with regard to other companies. An interdependent company is one which relies on others such as suppliers and/or clients. This company may not be an essential supplier, and other similar companies could step in to gain a share of the market, which may or may not be later recovered by the company which has been affected by the fire. At the same time, the company may form part of a group of companies and therefore have similar installations at its disposal. If however each of the group's companies is vital for the production of the final product, then large relative losses could be caused by the occurrence of a risk in a vital area, with catastrophic consequences for the group.

The following aspects should therefore be reviewed in the case of an interdependent company:

- a)** A description of its internal dependence within the group, whether this be with respect to the purchase of raw materials from other companies or sites, or with respect to the sale of the final product to these (chain production).

- b)** The possible alternatives within the group so that, in the case of interruption of the inspected company, other sites can take over its production. It is important to know both production capacity and any additional costs which may be incurred.

- c)** The relative position of the company within the group, giving an indication of the possibility of closure of other companies as a consequence of the closure of the inspected company.

Other aspects which may affect the magnitude of the loss of profits in the case of occurrence of an insured event, and which therefore should be reflected in the inspection report are:

- The existence of an efficient contingency plan with alternatives which have been economically quantified. This will speed up the company's recovery process.

- The number of work shifts (the fewer there are, the greater will be the losses in the case of interruption).

- The number of clients (the greater the dispersal and number of clients, the lower will be the losses).

- The level of dependence of the customers on the company. If this is high then the possibility of loss of clients will be lower.

- Large stocks of raw materials and finished products reduce possible losses of profits.

- In essential installations, the possibility of routing production through different fire sectors.

The characteristics of the company which is the object of the inspection will determine the aspects which should be dealt with in the inspection report with respect to loss of profits. The inspector should therefore have a comprehensive vision of the risks, and should not restrict himself exclusively to pre-defined check lists. Although these are necessary, if they are followed too strictly then one may run the risk of missing aspects which are important in assessing the risk of loss of profits.