Economy

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Risk management for small and medium sized incoming tour operators

Shown at the example of Skylimit Travel S.A., Isla Margarita, Venezuela

Bachelor Thesis

Bibliographic information published by the German National Library:

The German National Library lists this publication in the National Bibliography; detailed bibliographic data are available on the Internet at http://dnb.dnb.de .

Imprint:

ISBN: 9783640561940

This book at GRIN:

https://www.grin.com/document/145466

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GRIN Verlag

BACHELOR THESIS

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Isla Margarita, Venezuela

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published 13 February 2009

Abstract

This paper introduces the reader to the concept of Enterprise Risk Management, its aims and utility. The goal of the paper is to encourage readers working in small- to medium sized enterprises in the tourism industry to be more conscious of risks faced by their organisation and to give those readers an example of how, with a comparatively low level of effort, Risk Management procedures might be implemented for their enterprise. To that end the attempt is made to develop a simplified risk management system for small- to medium sized enterprises in the tourism industry based on the Committee of Sponsoring Organizations' "Enterprise Risk Management – Integrated Framework".

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1 Introduction

"Take calculated risks. That is quite different from being rash."

George S. Patton, US-General (1885-1945)[1]

Every decision we make – be they our own, private, decision to buy a pair of shoes or our workplace decision to approve that multi-million dollar contract – carries consequences. These consequences can be positive or negative for us, but every decision will influence our life. Trying to foresee the consequences of our decisions is often difficult and frequently impossible, yet we must try to foresee them. The possibility that a decision has positive consequences we regard as an opportunity, while we regard the possibility of negative consequences as a risk. Only by balancing the possible consequences we can decide between alternatives. Thinking about the consequences of our actions is as old as humanity itself.

Similarly people conducting any kind of business had to think about the consequences of their decisions for their organisation since the dawn of times. The minimisation of the risk that a decision carries negative consequences has long been the goal of businesses and their leaders. In the early 14th century Italian merchants developed a system of bets that shared the risk that a ship would not return from a journey and the opportunity of high profit if the ship returned from its journey between a number of punters. From these roots grew the modern insurance industry (Bernstein, 1996). In modern times the view of risks faced by enterprises has expanded from looking solely at insurable risks via technical and financial risks to a holistic view of all risks faced by an enterprise in what has come to be called the "Risk Management" approach. The first known publication on Risk Management is the book "Die Unternehmensrisiken"[2] by Leitner, published 1915 in Berlin, Germany (Brühwiler, 2003, p. 19). The recent attention to Risk Management in both theory and practical application can be traced to two recent trends – the trend to recognise stakeholder value[3] and therefore Corporate Governance to be important and the trend to realise that risks do not only exist within the company but that developments that can not, or only minimally, be affected by the company can put the very existence of a company in jeopardy, leading to the holistic view of risks Risk Management entails nowadays.

In the wake of the ENRON and Worldcom scandals at the beginning of the 21st century Corporate Governance became a hot topic. The idea behind Corporate Governance that enterprises and their management should act in the interests of their stakeholders is old. As early as 1932 Berle and Means identified in their book "The Modern Corporation and Private Property" the potential for conflict between the interests of the owners of a company, who are interested in the sustainability and long-term profitability of the company, and the interests of the paid managers of the company, who might have different, short-term goals, which they called the Principal-

[1] in a letter to George S. Patton IV, 06 Jun 1944 (Morgan, 1996)
[2] Translatable as „Corporate Risks"
[3] Stakeholder value is a concept based on the recognition that a company and its management are not only responsible for returning a profit to its owners but can also be held responsible for the welfare of all its stakeholders, be they the owners, the employees, its suppliers, its customers, or anyone else affected by the activities of the company.

Agent-Conflict (Berle & Means, 1932). Since then, good Corporate Governance came to be mostly understood to mean that the managers of a company should act in the interest of the owners, mostly understood to be shareholders, of the company. This definition, however, has been recently extended vastly to include the interests of all stakeholders. The Organisation for Economic Co-Operation and Development (OECD) defines Corporate Governance as follows:

"Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. […] Corporate governance is only part of the larger economic context in which firms operate that includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can also have an impact on its reputation and its long-term success." (OECD, 2004, pp. 13 - 14)

The principles of Corporate Governance were first published by the OECD in 1999 and updated in 2004. The key principles of a Corporate Governance framework are, according to the OECD:

„The corporate governance framework:

- should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
- should protect and facilitate the exercise of shareholders' rights.
- should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders." (OECD, 2004, pp. 19-26)

As part of the principle of timely and adequate disclosure, the OECD advocates the disclosure of foreseeable risk factors:

“Users of financial information and market participants need information on reasonably foreseeable material risks that may include: risks that are specific to the industry or the geographical areas in which the company operates; dependence on commodities; financial market risks including interest rate or currency risk; risk related to derivatives and off-balance sheet transactions; and risks related to environmental liabilities.” (OECD, 2004, p. 55) The principles of Corporate Governance have been put into law and practice in numerous countries, for instance in Germany with the 1998 law “Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG)” and the German Corporate Governance Codex of 2006, in Switzerland with the “Swiss Code of Best Practice” of 2002 or in the United States of America with the Sarbanes-Oxley Act of 2002.

The US-American Sarbanes-Oxley Act of 2002 demands in section 404 reporting on the responsibility of the management ”for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and […] an assessment […] of the effectiveness of the internal control structure“ of a company (107th US Congress, 2002). It is widely understood that following the rules set out in “Internal Control – Integrated Framework” by the Committee of Sponsoring Organizations (COSO)[4] of 1992 satisfies the demands of the Sarbanes-Oxley Act of 2002.

Applying COSO’s integrated framework for internal control “can help an entity achieve its performance and profitability targets, and prevent loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the enterprise complies with laws and regulations, avoiding damage to its reputation and other consequences“ (COSO, 1992). According to the executive summary the five major components of the “Internal Control – Integrated Framework” are (COSO, 1992):

- <u>Control Environment</u>
  Describes the way a company operates, the integrity, ethical values and competence of the entity's people and the management's philosophy and operating style.
- <u>Risk Assessment</u>
  Is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed.
- <u>Control Activities</u>
  Are the policies and procedures that help ensure management directives are carried out.
- <u>Information and Communication</u>
  Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities.
- <u>Monitoring</u>
  Is a process that assesses the quality of the system's performance over time.

[4] COSO is a voluntary private-sector organization comprising the professional associations American Accounting Association (AAA), American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), Institute of Management Accountants (IMA) and the Institute of Internal Auditors (IIA).

It is interesting to note that as early as 1992 the assessment, monitoring, reporting and management of risks was seen as an integral management task by a major professional body in the United States.
The framework was expanded by COSO considerably in 2004 to form the “Enterprise Risk Management – Integrated framework”, which provides a more robust and extensive focus on enterprise-wide risk management.

The debates on both Corporate Governance and its component Enterprise Risk Management have so far been focussed on publicly traded enterprises in developed economies (COSO, 1992; OECD, 2004, p. 13; OECD, 2006, p. 4). Brühwiler (2003, pp. 148-152) argues that effective Risk Management can lower the equity requirements of a company and raise the companies value and credit-worthiness as do COSO (1992; 2004, p. 7) and Chong & López-de-Silanes (2007, S. 3). The question therefore is how the lessons of good Corporate Governance and effective Risk Management can be applied to non-publicly traded companies and in particular to SMEs.

The tourism industry worldwide consists of a few large players that are publicly listed, such as large tour operators, cruise lines and air lines that are therefore subject to the relevant Corporate Governance laws and codices. Beside these main players a majority of small- to medium-sized enterprises provide the actual tourism services in the destinations such as ground-transport or accommodation to the end-user, which are typically privately-owned enterprises and as such not usually subject to Corporate Governance laws and codices. Hystad and Keller (2008, pp. 152, 161) as well as Pechlaner and Glaeßer (2005, p. 5) argue that there is only minimal proactive planning for and the management of risks in the tourism industry. This paper will use the example of the small incoming tour operator Skylimit Travel S.A. based in Venezuela to demonstrate how SMEs in the tourism industry can implement an effective Risk Management process in order to lower their equity requirements, raise the company value and increase their performance.

The paper is split into two distinctive parts. In the first two chapters following this introduction the stage is set by an explanation of the main statistics used throughout the paper, their data sources, setup and utility and by an introduction to Skylimit Travel S.A., its home country Venezuela and its home destination Nueva Esparta, Venezuela. In the second part of the paper, chapters 4 and 5, the theory and methodology of Risk Management is explained and its application to the specific circumstances faced by Skylimit Travel S.A. is demonstrated. Selected risks faced by Skylimit Travel S.A. and possible coping strategies for risks identified are discussed and conclusions are drawn.

The goal of the paper is to encourage readers working in small- to medium sized enterprises in the tourism industry to be more conscious of risks faced by their organisation and to give those readers an example of how, with a comparatively low level of effort, Risk Management procedures might be implemented for their enterprise. To that end the attempt is made to develop on the basis of COSO’s “ERM – Integrated Framework” (2004) a risk management system for SMEs.

2 Statistics used throughout the paper

This paper utilizes three main sets of statistical data to describe the operating environment of the company. As these datasets are referred to throughout the paper, their data sources, setup and utility shall be described briefly here. In addition to these three main sets, some other statistical data, in particular demographical data of the main destination Venezuela is referred to in this paper, but not described in this chapter. Common to the three statistics is that they allow the analysis of patterns of demand over time, or, in other words, the patterns and strength of seasonality[5] experienced by both Skylimit Travel S.A. and their home destination Nueva Esparta, Venezuela.

The following may serve as a short overview of these three statistics:

- <u>Detailed Company Statistic Arrivals / Products / Departures April 2005 – March 2008 (CS-APD):</u>
  A highly detailed statistic for the period of three years, allowing an in-depth analysis with regards to arrival and departure point and time, purchased products and length of stay for reservations executed and passengers handled by Skylimit Travel S.A. for the period 01 April 2005 to 31 March 2008.
- <u>Company Statistic Passenger Totals by Source Market, Jan 2001 – Dec 2007 (CS-PSM)</u>
  A statistic of passenger numbers for a period of seven years, cumulated by passenger country of residence (source market), demonstrating the long-term development of passenger numbers handled by Skylimit Travel S.A. in respect to total numbers handled and to each individual source market.
- <u>Government Statistic Monthly Arrivals to Nueva Esparta by Transportation Type (Air/Sea)</u>
  <u>Jan 2001 – Dec 2006 (GS-ANE</u>)
  A statistic of passenger numbers for the period of six years; allowing a long-term view of the development of arrivals to the destination Nueva Esparta, home port of Skylimit Travel S.A., by arrival mode (sea / air) as well as analysis of the characteristics of seasonality of the destination as a whole

The chapter closes with an explanation of the common measure for the strength of seasonality used for all three statistics, the GINI Coefficient.

[5] See Chapter 3.4.3 for a definition of seasonality

2.1 Detailed Company Statistic Arrivals / Products / Departures April 2005 – March 2008 (CS-APD)

This set of statistical data was derived in April 2008 from reservation reports of the proprietary reservations system of Skylimit Travel S.A. (SKY). The reservation system is a dbase –based database with a purpose-built user interface. Due to the limitations of the database, no reliable data older than three years is contained within the reservations system. The precise structure of the database is unknown and it was therefore necessary to export all data in the form of system generated reports. These reports have a standard text (.txt) format and show the following information:

- Product
- Operator
- Booking number
- Number of Passengers
- Passenger Name(s)
- Date of arrival
- Date of departure
- Room type.

The information is sorted by operator. An example of the report format for the hotel "Hesperia Playa el Aqua", Isla Margarita, Venezuela follows:

```
RESERVACIONES HOTELES: -----> PL AGUA  PAX RES TODOS

OPERADOR ARKE  DESDE 01/04/99 HASTA 31/03/09

85974 ->   2 -> JACOBS       R.           20/06/07 -> 04/07/07  /  BUNGALOW
                DE JONG      S.
91557 ->   2 -> DE BRUYN     B.           28/11/07 -> 13/12/07  /  BUNGALOW
                SWART        E.
90539 ->   2 -> V/D BREUL    T.           30/01/08 -> 13/02/08  /  STANDARD
                BROERTJES    J.
93290 ->   4 -> DE KORT      R.           02/04/08 -> 16/04/08  /  BUNGALOW
                SCHIPPER     N.
                LAARHOVEN    R. *02y*
                LAARHOVEN    K. *04y*
93976 ->   2 -> KOOIJ        A.           07/05/08 -> 14/05/08  /  DBL
                DE HAAS      M.
94392 ->   1 -> DE KRUIJF    MR.M         11/06/08 -> 18/06/08  /  SGL STD

OPERADOR BLUE REE  DESDE 01/04/99 HASTA 31/03/09
       80649 ->   2 -> FRANQUELLI   EUGENIA      16/03/06 -> 25/03/06  /  DBL/AI
                BOSI         ANGELO
82693 ->   2 -> TOSEL        FILLIPO      22/09/06 -> 29/09/06  /  DBL STD
                FERRO        ANDREA
82893 ->   2 -> PERTILE      NICOLA       10/10/06 -> 20/10/06  /  DBL STD
                SARTORI      ENRICA
86868 ->   2 -> VINCIGUERRA  GIUSEPPE     06/03/07 -> 15/03/07  /  DBL STD
                SMEDILE      ALESSANDRA


OPERADOR BRAZIL  DESDE 01/04/99 HASTA 31/03/09
88700 ->   2 -> GULDEMONT    MR           20/06/07 -> 27/06/07  /  DBL STD
                VERELST      MRS

.....
```

Figure 1: Reservations Report; Source: own, SKY Reservations System