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## Risk control methods in a hotel operation

**Abstract.** Risk is an immanent characteristic of all economic processes. Since a defensive approach to business and avoidance of risk at all costs may result in the loss of potential benefits and a waste of resources, companies should implement methods of professional diagnostics and active control of risk. The aim of the paper is to present in a systematic way the methods of risk control in a company and analyse their relevance to the hotel industry. After a brief introduction concerning objectives and stages of risk management procedure, physical and financial methods of risk control are presented. Given the attributes of tourism demand and the specific features of the lodging industry, techniques of demand risk control are analysed. Special attention is paid to such actions as joining a renowned hotel chain through franchising, outsourcing services, investing in weather derivatives, signing charter or quota contracts.

**Keywords:** risk management, risk control, tourism demand, hotel.

**JEL codes:** D81.

### 1. Introduction

The contemporary hospitality and tourism industry, like other economies today, is characterised by complexity and volatility. As a result, no business is able to fully understand and precisely foresee the processes taking place in the background, and predict future conditions for its operations and the consequences of decisions. The constant feature of economy is uncertainty, thus every business undertaking is burdened with risk. Risk in business is inescapable and objective. It is an immanent characteristic of all economic processes.

Ignoring risk and failing to account for it in the process of operational planning can result in business failure. On the other hand, an excessively prudent approach to business and avoidance of risk at all costs is not a recommended practice as it may result in the loss of potential benefits and a waste of resources. Since risk-taking in certain circumstances creates an opportunity for gaining benefits, it should be seen as a stimulant of entrepreneurship and innovation, and a factor of economic progress.

In view of the above, risk management becomes more and more important. With progressing globalisation and more and more intense competition in the tourism market, the need for professional diagnostics and active risk control in the hospitality industry is evident.

The aim of this paper is to introduce and present in a systematic way the methods of risk control in a company, and analyse their relevance to the hotel industry.

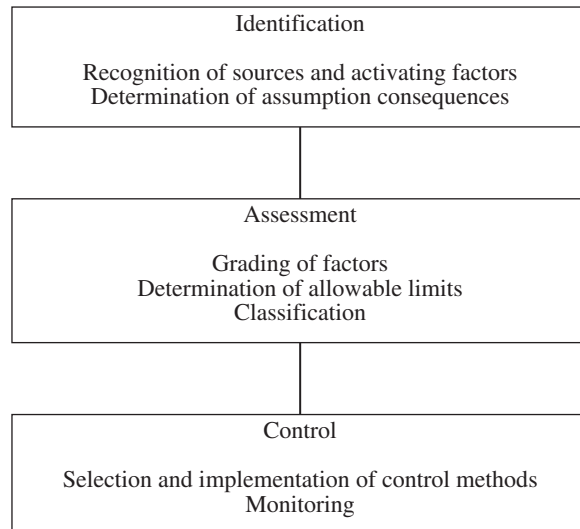
## 2. Risk management procedure

Risk control is an element of the risk management procedure. The fundamental objective of the process is to increase the level and stability of company value through the implementation of methods, techniques, and tools aimed at reducing negative consequences of events, and maximising potential benefits due to risk assumption.

Companies usually adopt a three-stage approach to risk management (Brigham and Gapenski 2000, vol. 2, p. 345):

1. Identification of all possible risks the company might face.
2. Assessment of the potential impact of specific risk factors on the company's performance.
3. Selection and implementation of risk control and monitoring tools.

The risk management procedure is illustrated in the diagram below:



**Figure 1. Stages of the risk management process**

Source: The author's own proposition based on the related literature

At the stage of risk identification, possible sources of risk are identified together with circumstances needed to activate these risk factors, and the direct and indirect consequences of risk assumption are determined. In practice, this is done by a systematic presentation of all threats that can endanger realisation of the objectives set, and of the opportunities that can facilitate achievement of those objectives.

A static presentation of potential threats and opportunities deprived of a metrics system is of little use to the company. So at the next stage of the risk management process specific risk factors are measured and allowable (critical) limits are determined. If a risk factor goes beyond the tolerable limit, its perception changes and a mitigating action is triggered. The outcome of the assessment procedure is the classification of risk factors which identifies (Jedynak 1999, p. 39):

- inconsequential risk that can be disregarded,
- material risk that requires application of control methods,
- risk under observation, inconsequential at the time of assessment, but for which there are reasons to believe that it might become material in the future.

Risk control is applied at the strategic level of a company. Of interest are only those risk factors that can be manipulated with the use of available company resources and in compliance with the company's objectives. The selection of control methods and their implementation must be supported by a continuous flow of information about events occurring within the company and in its surroundings with respect to the accepted risk limits.

A company strategy in the conditions of uncertainty falls within one of the following three risk- handling approaches (Bizon-Górecka 2001, p. 51):

- defensive,
- cautious,
- offensive.

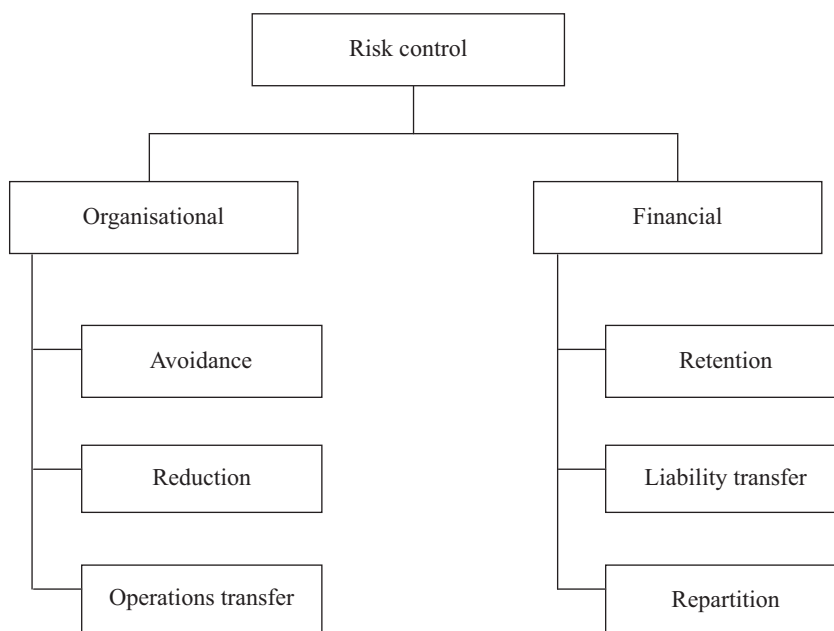
The **defensive** strategy is realised through the isolation and avoidance of trouble for as long as possible. A company adopting this approach is overly prudent, unwilling to take any risk. Instead, it concentrates on survival and failure-preventing actions. A company adopting this strategy is likely to miss the opportunities that come along and to waste its resources.

The **cautious** strategy manifests itself in a prudent undertaking of risk-generating activities. A risk-cautious company concentrates its efforts on identifying threats, applying measures mitigating the consequences of negative changes in the company surroundings and on insuring itself against potential losses.

A company pursuing an **offensive** strategy is willing to take risk in order to gain benefits. Such a company does not just anticipate an unfavourable turn of events and try to prevent it but, above all, identifies and takes advantage of the opportunities that come along, actively seeks information, and makes an effort to implement solutions best suited to the predicted business conditions.

### 3. Risk control methods

Within these general risk-handling strategies, companies use different control methods. These are shown in diagram 2:



**Figure 2. Risk control methods**

Source: The author's own proposition based on the related literature

Risk control actions can be divided into two groups: organisational (physical) and financial. The organisational methods consist in taking physical precautions to eliminate or reduce the possibility that a particular event will occur, or to limit the consequences of risk materialisation. The financial control consists in securing resources to cover the consequences of risk materialisation.

**Risk avoidance** is one of the so-called negative risk control methods. It means that a company will not undertake certain activities in fear of the risk consequences. In some circumstances this may prove beneficial and the decision-maker gains peace of mind that the company will not incur losses. At the same time, however, the company misses opportunities to gain profits, should the risk-bearing activity go ahead. For this reason the risk avoidance technique is seen as a curb on initiative and entrepreneurship.

**Risk reduction** is a more practical approach that includes **preventive** techniques whose aim is to prevent the occurrence of a negative event and **repressive** techni-

ques, where action is taken to limit the consequences of possible negative events. The central idea to prevention is to address the likelihood of risk materialisation *ex ante*, whereas the repressive methods are applied *ex post*. In practice there are three categories of risk reduction measures (Diacon and Carter 1995, p. 81): **physical safety precautions** (such as installation of fire alarms or burglar alarms, employment of security personnel), **staff training** (e.g. customer care training), and development of **security and indemnity procedures** (e.g. examining the credibility of business partners, inclusion of the necessary indemnity clauses in contracts, requiring guarantees of payment, contingency planning, and quality control).

**Transfer of operations** is similar to avoidance. Both methods use the technique of avoiding particular activities to eliminate risk. The difference is that in the case of transferring operations, the risk-burdened activity is undertaken by another business unit which assumes the risk – a relocation of risk takes place.

In **risk retention** the company bears financial consequences of risk materialisation. Risk retention has two forms: passive and active. The former refers to unintentional retention of risk due to ignorance, indifference or negligence and it can hardly be called a technique of risk management. The latter is an intentional retention of risk, where the company is ready to cover the possible losses from its own financial resources. The losses may be covered by charging to the current operating costs (out of net profits), selling assets, building up a self-insurance fund, arranging loans.

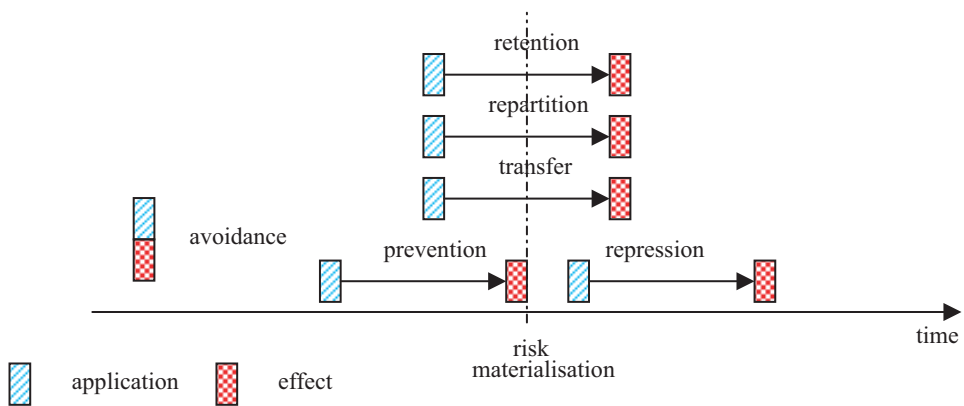
In **transferring financial liability** a business entity suffers the physical effects of risk materialisation, but another party bears the financial consequences of it, usually for a fee (premium). The risk transferor thus gains a guarantee of access to external resources to cover the possible losses.

**Repartition**, also referred to as risk distribution or atomisation, is an intermediate method between risk retention and risk transfer. Its aim is to spread the financial consequences of risk materialisation over a group of entities. An example of risk repartition is a corporation structure (parent company with subsidiaries).

Effects of individual risk control methods are differently distributed in time. These relationships are shown in Figure 3.

## 4. Risk control techniques in hospitality industry

In the process of risk management in a hotel operation special attention must be paid to sales-related factors. This is because in this market-oriented business profit improvement depends mainly on the sales growth (Kotaś and Sojak 1999, p. 20). Therefore, in the hotel industry the demand risk plays a significant role. This risk element is related to such inherent attributes of tourism demand as its strong de-



**Figure 3. Time distribution of risk control methods**

Source: The author's own proposition based on Jedynak 1999, p. 40

pendence on incidental factors, tendency to time and space concentration, and its remoteness from the place of delivery and consumption of services (Konieczna-Domańska 1999, p. 57).

The fact that tourism demand is uncertain has a great bearing on the planning process of a hotel operation, the more so that the hotel industry is specific because its service capacity is fixed, production and consumption of its services are inseparable, and it has an unfavourable cost structure (Harris 1995, pp. 15-22).

In the short term a hotel capacity is inflexible. Hotels, with a fixed number of rooms, face the problem of matching their supply to available demand. A sudden growth in demand means turning customers away and forfeiting potential profits. A fall in demand generates losses due to high costs of maintaining readiness to perform services and receive visitors.

In the lodging industry the act of production and consumption must be simultaneous. The performance of the service requires active participation of the producer and the consumer together, and it takes place on the premises of the producer. This temporal and spatial inseparability means that it is impossible for a hotel operator to create stocks and to distribute products physically – if service is unsold, the potential revenue it represents is lost and cannot be recovered.

A high ratio of fixed to variable costs is another important feature of the hospitality industry. As a result, the hotel occupancy rate has little bearing on its total costs, whereas the average cost of service production is strongly dependent on the room sales. In other words, the hotel business is vulnerable to the fluctuations in demand – even a small change in the volume of sales entails a significant change in the hotel's operating incomes. Hence, demand fluctuations strongly affect performance stability in the hotel industry. Given the specific features of the lodging industry, the risk identification efforts should focus on those risk factors which

have an impact on the size of demand and consequently affect the level of sales, in a word – they should concentrate on the demand risk and similar types of risk - such as weather or competition risk.

The simplest technique of risk control is avoidance. An example of the avoidance tactics is to abandon plans for opening a conference centre because of fear that demand for this type of services might not be satisfactory. As has been noted here, such an approach must not turn into a routine as it leads to a loss of potential benefits. Besides, there are situations where avoiding certain types of risk is simply impossible if the business is to continue, or if avoiding risks in one area will intensify them in another. For example, introducing a stringent credit policy towards institutional clients whereby a hotel demands instant payment for the service rendered to eliminate bad debts may turn clients away and result in a sales decline.

One of the techniques hotels use to reduce the demand risk is to join a renowned hotel chain through a franchising or management contract. This way a hotel can take advantage of a proven and successful business formula, gains the right to offer services under a recognised brand name, and can use images, emblems, and logos that in the eyes of the consumer symbolise excellence.

In order to limit the likelihood of a bad choice, consumers want to obtain the fullest possible information about a product they intend to purchase. The cost of obtaining information about a product depends to a large degree on the recognition of this product's properties. By this criterion products fall into two basic categories (Forlicz 2001, p. 118):

- products whose properties are recognised before purchase (e.g. appearance, softness, fragrance),
- products whose properties are revealed during consumption (e.g. comfort, reliability, quality).

From the consumer perspective, the cost (effort) of obtaining information about goods and services whose properties become apparent only during consumption, such as hotel services, is usually much higher than it is in the case of goods and services with properties recognised before purchase. For this reason the consumer, trying to avoid the trouble and cost of seeking information, prefers to buy a recognised product whose properties have so far been acceptable, rather than risk the purchase of an unknown product whose properties – for all he or she knows – might be better or worse than those of the product usually bought. This consumer behaviour pattern explains the growing role of brand awareness. The effect of brand name is what franchisees take advantage of.

The operations transfer techniques used by hotels to limit the demand risk include such actions as contracting out certain services (e.g. parking services), or renting premises to operators providing services or selling goods to hotel guests (e.g. barber shops, hairdresser and beauty salons, recreation and entertainment services, florists, souvenir shops, etc).

The best known technique of transferring responsibility is insurance. In the hotel industry insurance is voluntary and is applied mainly to property risk. The most frequently bought policies include insurance against losses due to fire and similar catastrophic events such as explosion, lightning strikes, flood, leakage from water and sewage systems, and losses due to theft. Another type of insurance cover, important to the hotel industry, is liability insurance whose purpose is to protect hotel operators from customer claims. This type of insurance is particularly useful because the civil code places on hotels a responsibility for loss or damage to the property carried onto the premises by guests on the principle of risk, not guilt. This means that a hotel is financially responsible for the loss or damage to the guest's property even if it cannot be blamed for the incident (Nestorowicz 1999, p. 105).

An interesting but not yet very common technique of risk transfer is investing in derivative financial instruments such as weather contracts. These derivatives, whose purpose is to cover contingent losses due to weather vagaries, relate both to atmospheric precipitation and temperature. Institutions dealing with weather contracts target their offerings at power generating companies and power distributors, ice-cream makers, breweries, and also amusement parks, pub chains, restaurants, and hotels. The advantage of derivatives over traditional insurance lies in the fact that insurance companies pay a compensation based on actual damages caused by weather, whereas the payout from a derivative is contingent on a weather factor index (precipitation or temperature) reaching a pre-defined value. The principles of payout from a derivative are set *ex ante*, hence they are clear to both contracting parties and eliminate the possibility of the so-called "moral hazard", whereby one party might manipulate the extent of damage to suit its interests.

A relatively popular risk transfer technique used in the hotel industry is a contract with tour operators. The most common forms of collaboration between hotels and tour operators are charter contracts and allotments (quota contracts). They totally or partially shift the risk of a hotel's unused capacity onto a tour operator in exchange for lower prices. By entering into formal co-operative arrangements with tour operators a hotel gains two major benefits, important for its pricing policy and profitability: the demand for its services increases, and the risk of unsold services declines (Konieczna-Domańska 1999, p. 109).

Another technique of risk spreading through distribution is external diversification based on industry consolidation (mergers and acquisitions) or cooperation (consortia, strategic alliances). The resulting unions or conglomerates enable the levelling out of the effects of downturns in specific markets.



## 5. Conclusion

By using a whole spectrum of risk control techniques a company can afford to accept risk in order to gain benefits. This way a company does not focus solely on contingent perils, but instead identifies and takes advantage of opportunities. Such an approach results in a more efficient use of resources and improved competitiveness of a hotel business. To follow this path, the decision maker must however realise that risk does not mean threats alone, and is not the flaw of a project to be avoided or reduced to minimum at all costs. In certain circumstances taking on risks affords opportunities for gaining advantages, so it should be perceived as a stimulant of creativity and an element of progress.

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