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II



**UNIVERSITY OF KRAGUJEVAC
FACULTY OF HOTEL MANAGEMENT
AND TOURISM IN VRNJAČKA BANJA**



RISK MANAGEMENT IN HOTEL PROCUREMENT AND THE ROLE OF EXTERNAL AUDIT

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Abstract

Successful management should ensure stable condition of an entity, successful existence on the market and continuous development of business processes. This imposes the necessity that operations and development of the business entity should be managed appropriately. Procurement function in the hotel industry has been increasingly viewed not as an administrative function, but as the creator of profit, with a significant impact on very operations and operating results of the business entity. Because of specificity it represents, being it also an area of the increased risks, it must be managed appropriately. Therefore it is necessary to establish an effective procurement system, which involves the adoption of an appropriate risk management strategy. This means that procurement should be performed in a timely manner, with appropriate quality and in the best conditions. Effective system of risk management includes the active control and supervision of external audit. Seen in such a way, active risk management and external audit contribute to eliminate or minimize the risk, enable bad consequences on one side and enforce the chances of assuring continuous growth and development of the business entity on the other side.

Keywords: *business entity, development, acquisition management, risks, control.*

Introduction

Hotel industry, as an important service industry within tourism, has an essential role and is a source of important income in the Republic of

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Serbia. Special service in the hotel industry is primarily related to customer satisfaction in order to meet modern user demands for accommodation and meals, both domestic and foreign. Management in the hotel industry has to respond to specific users' habits, as well as high culture of accommodation and nutrition, and in this regard provide adequate quality of service. Procurement function has basic importance for the overall business in the hotel industry and a significant impact to the fulfillment of these requirements. These are the reasons why procurement is considered to be not just as an administrative function within the entity, but a profit center. Due to its very nature, procurement function is specific and represents a possible high risk area. These risks must be given adequate attention, which primarily requires the introduction of an effective procurement risk management system. The necessity for implementation of the risk management system in procurement of hotel industry provides basic principles and rules of procurement and in recent years their role has become very pronounced. Commitment to procurement risk management means first of all - the creation of procurement risk management strategy, which reflects the attitude of the management towards the risks they face in the procurement process. Main purpose of this strategy is to minimize risky procurement issues, to reduce it to an acceptable level or to completely eliminate them.

The subject of further attention of this paper is detailed consideration of procedures that should be implemented in the procurement process, which consists of several stages: 1) planning of procurement, 2) identification of potential suppliers, 3) analysis and elimination of competition, 4) evaluation of bids, 5) selection of potential suppliers, 6) decision of preferential supplier and 7) making of an agreement. Procurement risk management can be considered as a process that is characterized by two main activities: 1) Communication and consultation, 2) Supervision and detail review. Procurement risk in the hotel management, which represents a threat to business, needs to be detected on time, analyzed, estimated, ranked according to the intensity and priority, and consequently treated in the corresponding way. Communication and consultation activities are fundamental for managing the risks, and must be considered at each step in the procurement process.

In recent times under the influence of open market, usually unfair market competition, increased corruption and erosion of business ethics make the request for higher control over increasing demands in the risk management process. Lately we have witnessed that independent external

audit emerges and takes control over these processes. The expectations of external audit, in terms of its active support in the process of supporting procurement risk management, are widely given a special emphasis nowadays. External audit spreads out their additional services, which are beyond the International Standards of Auditing, and assists management in the risk process to make decisions within procurement. Audit activities should be aimed at assessing and analyzing risks through control of application, defined policies, procedures and legislation in the entire process of procurement risk management and bidding process. In the end, a system has been implemented to manage the enterprise risks, which includes external audit company as a form of monitoring company, with the ability to initiate accountability of all parties involved in the process of procurement risk management. Due to its topical importance and complexity and, at the same time, being very interesting in both theoretical and practical terms, this topic has become the focus of our attention in this paper.

Procurement risk management strategy

Procurement risk management system shows its effectiveness by using methods which primarily ensure that a business entity has appropriate risk management strategy. It reflects the attitude of business subject toward the risk which may endanger its existence and sustainability. Creation of strategies for managing the purchase risks depends on the size and complexity of operations, and requires a high level of knowledge and experience.

The most often used strategies are: 1) avoidance of a risk, meaning that the risk management uses the strategy to avoid risk, makes a decision to hold on activities that could generate risk; 2) reducing the probability of negative consequences ; 3) reducing the possibility of risk even to show up, with the benefits from prior experience, the expertise of staff and the existence of strong control; 4) transfer of risk, when management decides to transfer the risk on the other side, by ensuring the provision and bound guarantees; and 5) even acceptance of the risk when it assesses that consequences of the risk will not have negative impact on the procurement process.

As part of a risk management strategy in the procurement process, the procurement rules should be defined, which requires a business entity to trace the following rules (O'Regan, 2008):

1. Set a minimum price that will prevent an agreement between suppliers whenever possible.
2. Search for additional suppliers to participate in the procurement process, if it comes to a lack of potential suppliers. Increased participation of suppliers can be stimulated by publishing the implementation proceedings for tender job, bid opening.
3. Determine a reasonable period of time, so that potential suppliers could form their offers.
4. Provide security and reliability in the process of receiving the offer and accompanying documentation which has been sent from potential suppliers, and to estimate the risk of electronic communication.
5. Reduce the tender preparation and participation cost. The cost of participation may distract potential suppliers from participating in tenders, in cases where the formation of deals requires significant costs.
6. Provide a guarantee or deposit from potential suppliers (which will be usually return) when it comes to purchases of larger value. To protect a business entity from the risk of future shortfalls of potential suppliers, warranty is necessary.
7. Define the procedure for the protection of the so-called multiple offers. Risk in the tender procedure may show up when the suppliers bid via different names to leave impression that the competition is strong. These multiple offers leave the false impression of the competition existence, and consequently artificially favor high prices.

The main benefits of implementing a high strategy of procurement risk management within a business entity are numerous. The following stand out as the most important ones:

1. Better understanding of the key risks and implications of risks in the procurement process,
2. Better management of resources,
3. More possibility to achieve the procurement plan,
4. More possibility to achieve the objectives and targets set for procurement,
5. Quicker response to internal and external changes,
6. More comprehensive and concise reporting rules on respect of the established procurement practices and procedures.

The success of risk management is the knowledge to assess how, when, and whether to accept the risk. Risks are reduced through a process of

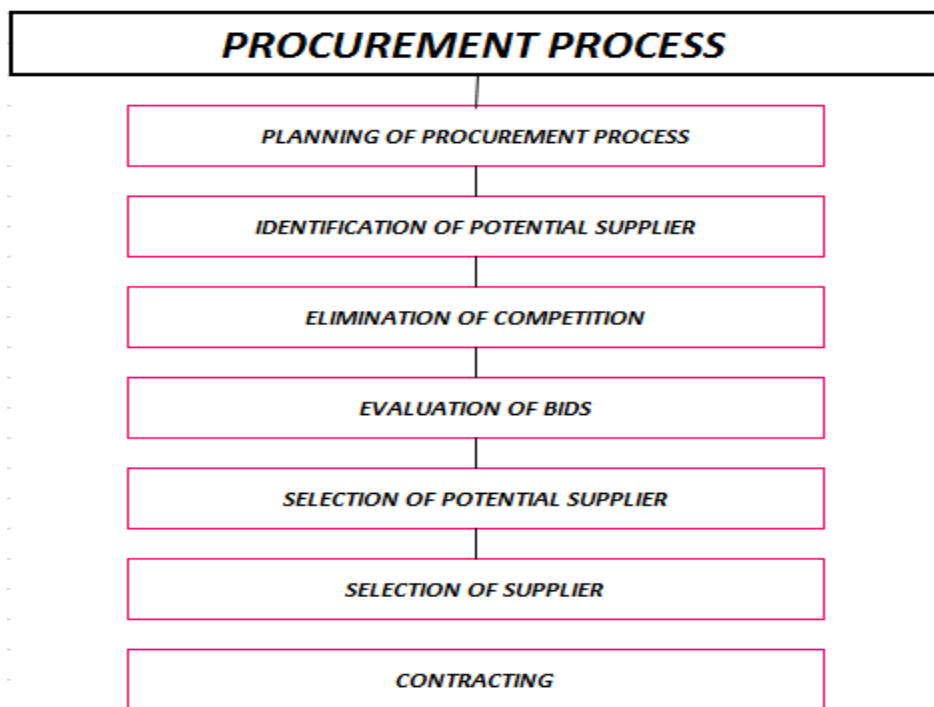
risk management in different ways, but most often with the result of controlling risk consequence.

Procurement implementation process and its risks

The process of procurement of the goods and services is a process that takes several phases: 1) planning of procurement, 2) identification of potential suppliers, 3) analysis and elimination of competition, 4) evaluation of bids, 5) selection of potential suppliers, 6) decision on preferential supplier, and 7) preparation of an agreement.

The procurement process has been displayed below in the following picture:

Picture 1: *The procurement process*



Procurement Planning. Procurement planning starts with the presentation of procurement strategies and preparation of a detailed plan which defines the procurement activities at the level of the business entity, then necessary time and available funds needed for the

implementation of the plan. Procurement planning is the first significant step in the process of procurement itself, necessary at the very beginning to enable the procurement activities been conducted on time, in accordance with the available funds, and all in order to meet the operational needs of the business entity. Procurement planning is a very important activity of the procurement function, which takes high responsibility. When procurement plans are not adequately set up, then there is a risk that this can negatively affect the operations inside the entity.

The most common risks associated with the procurement plans are (O'Regan, 2008):

- Risks of fraud that can occur due to many years of cooperation between employees in procurement and suppliers (periodic rotation of employees who manage the procurement process should be done, and that represents best control for reducing the risk of fraud).
- Accumulation of obsolete stocks,
- When the share of responsibilities within the purchasing function is not clearly documented and controlled,
- Shortages of materials that are harmful to the business entity and require emergency procurement activities,
- Discrepancy of needs and company liquidity (when the procurement plan does not comply with cash flow).

At the end, all activities in the planning of procurement should be designed to take place in accordance with the procurement strategy.

Identification of potential suppliers. In the process of identifying potential suppliers, business subject should primarily provide a database of existing and potential suppliers. The existing suppliers are those with whom we are already operating, while the potential suppliers are all those whose bids were not accepted in the past, as well as suppliers who do business for the first time. Identification of potential suppliers in the procurement process leads to healthy competition, helping businesses to get rid of over-reliance on pre-selected suppliers. Before any potential suppliers are included in the database, the functions of the procurement must provide the information on whether the potential suppliers:

- have technical possibility to deliver the required goods or services,
- have adequate financial stability,
- are able to fulfill the requirements of quality standards and
- are able to fully meet the other necessary procurement requirements.

During the formation of potential suppliers' database, the procurement function should exclude any supplier who does not meet the requested procurement criteria. In addition, it is necessary to check and review current database of existing suppliers, and to eliminate some of the existing suppliers from the database when they do not meet standards or on any other reasonable grounds. The most common reasons for that are: 1) failure to fulfill contract obligations; 2) bribery of certain members of the business entity or other forbidden actions; 3) conviction for crime or punishment; and/or 4) financial risk. Re-activation of the excluded suppliers in the database is allowed when they fulfill certain conditions. The specified person employed in the business entity decides whether the requirements for re-registration in the database are reliable or not. Whole procedure for check up and compliance with the procedure of reactivation of supplier must be fully documented.

The process of identifying potential supplier can be considered as:

1. Direct and
2. Indirect.

1) Direct identification of potential suppliers does not ensure that they will give us the expected benefits, and on the other hand we can face the possibility that among the chosen suppliers we can find the supplier who has been favored in some way.

2) Indirect identification of potential suppliers is conducted by market research to determine what is included in the field of potential suppliers. Market research can be focused on the market business analysis, existing or new technologies, catalogs and information that are usually taken from trade organizations and other institutions for trade and transport.

Elimination of the competition. The general principle is that healthy competition provides quality procurement. Despite this general principle, there are legitimate cases in which competition is severely reduced or completely eliminated. This happens in the case of (O'Regan, 2008):

1. The existence of only one appropriate supplier who will provide goods and services, where there is no competitive market.
2. When a new supplier of goods or services harmonizes with the existing supplier of goods and services.
3. When higher management aims to associate with specific suppliers in order to reach strategic goals for the company.

4. In case of urgent need for procurement, which is specifically conditioned, when it is obvious that the lack of procurement might resolve in significant costs or damage to company properties and workforce (inadequate procurement planning and mismanagement procurement process should not be an excuse for purchase at the last minute)
5. When the achievement of objectives requires specific procurement and where the price of the goods is not the most important factor for upmost business income.

Analysis of procurement offers. There are two ways to evaluate the bids of suppliers (O'Regan, 2008): 1) Technical evaluation and 2) Economic evaluation.

Technical evaluation of bids for the purpose of procurement includes activities aimed at the assessment of the technical characteristics of goods or services which are the subject of procurement. Technical characteristics can range from relatively simple to very complex characteristics, software engineering or other technical characteristics that require expert opinion. For specific types of procurement, technical evaluation usually consists of checking the completeness of the documentation submitted by potential suppliers and direct presentation (or model analysis) of goods or services. Expert assessment team has the task to express an opinion on whether the goods or services offered correspond to the technical characteristics requested by business entity. For these assessments the organization often uses the skilled employee inside the organization, but due to the lack of such personnel, business entity may engage a team of external experts. The most common examples include engineering consulting, property taxes, insurance, and broker services, depending on the characteristics of the object of procurement itself. In some cases it may be decided to carry out a full technical assessment of the entire procurement and in some cases the assessment can be partially arranged (for some types of goods or services). In certain situations, the technical characteristics of the procurement can be difficult to define in advance, which increases the risk that procurement will not meet the needs of the business entity.

Economic evaluation of the bids is done on the principle that for the lowest bid price one can get high-quality goods or services. Although the term commercial evaluation is frequently used, our preference is to use the term economic evaluation, because this estimate does not include only

price structure for offered goods, but it includes all the relative costs (price variance due to the exchange rate, fees, exchange of goods for an extra charge, the cost of training employees for the purpose of adequate usage of the goods, spare parts, etc.) In this case, any potential cost should be estimated on the appropriate basis.

Selection of preferential suppliers. Procurement function should make the selection of suppliers that meet the criteria for the technical and economic evaluation of bids. Detail search for the most appropriate offer in the context of these suppliers is certainly the most important activity in the procurement process. For instance, if we are in the process of procurement selection of three potential suppliers for the installation of computer hardware sections with different possibilities of customer service, and different guarantees for delivery, where we support one supplier with additional value over another one with subtracted value of the offer, the process of deciding on and accepting certain offers must take into account all of these factors. In any case, the combination of economic and technical evaluation of bids, and all other factors are most important for the best approach of the proper selection of suppliers.

Selection of suppliers. The selection having been made and documentation completed, the procurement function is to inform the suppliers excluded from the process due to results of the elections bidder and also define and announce decision about the chosen supplier. All information relating to the disclosure of inappropriate suppliers should not be presented in extensive way. The most practical way is to present the following: 1) names of inappropriate potential suppliers, 2) decision regarding their exclusion, 3) indicate the reason for the exclusion and 4) display the list of deficiencies. In cases when the procurement is of greater value, a business entity can take the position that report (record) should be presented to the excluded bidders as well as company names of all involved and excluded bidders and the reasons of their exclusion.

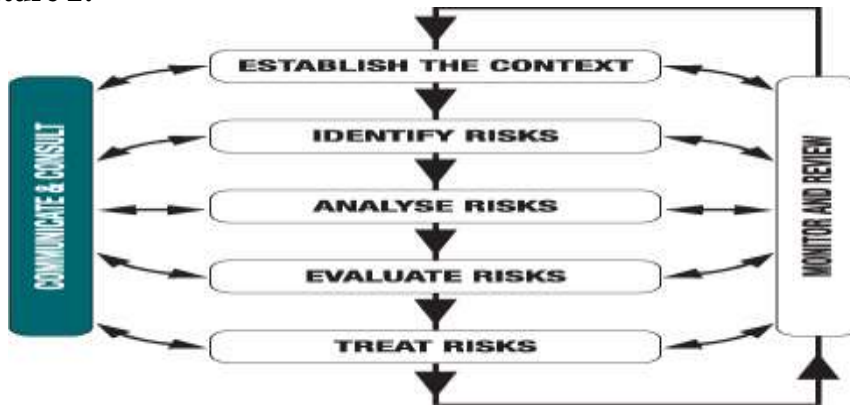
Making an Agreement. After selection of the bidder, a business entity informs selected supplier and prepares an agreement. In that agreement, mutual obligations and rights, as well as possible discrepancies in the case of unexpected event are closely defined. This is an area of high risk for business entity particularly when a contract was made for a foreign bidder, because of possible non-applicability of the contract for both sides (different regulations). With the comprehensive combination of skills and knowledge in defining the provisions of the contract, these risks can be

reduced. In order to minimize the risk, business entity should hire a legal team of experts in order to verify the content of the contract, whether it is according to all relevant legal requirements. Business entity should avoid long-term contracts, contracts which are preferential but difficult to cancel, the one which may push the organization in big problems. Special attention to renewal or non-renewal of supplier contracts could be considered as a punishment or even reward for meeting/failure to comply with agreement obligation.

Procurement risk management process

Procurement risk management system can be presented as a process characterized by two main activities: 1) Communication and consultation, 2) Supervision and review. The risk management process is displayed as in the following figure (AICST, 2006).

Picture 2:



1) **Communication and consultation** are fundamental activities for procurement risk management. They must be implemented in the whole process of risk management. Communication and consultation is a two-way process that needs to be established between management and all relevant parties in the process of purchasing. Every individual opinion and expertise need to be taken into account in order to better understand and assess the risks and prescribe the measures which need to be taken. All relevant information related to the procurement process need to be identified, processed and communicated in an appropriate form.

2) **Monitoring and review.** By its nature, risk is not a static process, but a variable one and requires constant monitoring of the various procedures

and processes, as well as the effectiveness of measures taken to prevent the occurrence of the result with a negative outcome.

Framework maintaining. Business entity should establish a framework that defines the policies, procedures and rules for risk management, as well as criteria for sanctioning those who do not respect all requested. Executive officers as a result of consultation and communication work to gain an understanding of the essence of risk management, its objectives and tasks, as well as the factors that may affect the achievement of the objectives and tasks. Key information, meetings, decisions, results, and other important issues need to be documented.

Identification of the risk. Procurement risk management process should be designed in a way that identifies risks which need to be adequately managed. This step includes the analysis of the probability of risk occurrence, possible risk overcoming and the existing control measures. In order to ensure that all relevant risk processes are identified a systematic approach, risk management process needs to be established. The risk itself, by its nature is very variable – monitoring and controlling should be at that level that can easily identify the arousal of new risks.

Risk Analysis. The objective of risk analysis is to identify the processes that are most exposed to risk. It will provide assistance to the management to decide what risks to take into account and to formulate appropriate strategy for all necessary measures in order to ensure that the risk does not appear, or in case it does – not to leave negative consequences. Risk analysis implies undertaking activities relating to the analysis of probability of occurrence of the risk, consequences of risks and the existing control measures. Management defines control measures and evaluates their efficiency in order to reduce the probability of both risk occurrence and potential negative consequences. Risk analysis can be identified as 1) Qualitative measures used to describe the size of the existing issues and predictions of the probability that the risk should have a consequence and 2) Quantitative measures used to determine numerical values of the risks and their consequences.

Risk assessment. Risk assessment includes the increasing number of facts that combine attitudes about the risks, consequences and control, all linked in the events that we investigate. Management makes the decision about which risks must be controlled and in which order. Previous activity related to the risk analysis provides information for the decisions

which should be made. Decisions about risk treatment and their priorities need to be done with the acquired understanding of the different fields of procurement process, the values and the magnitude of potential negative consequences. In the process of risk assessment the essential role represents consultation and communication at all levels of management and execution of business tasks. Bearing in mind the fact that the circumstances that influence bringing up decisions about the risks can change during the time, it is of great importance to format the documentation on determined bases for risk prioritising, taking into consideration their size and value as well as decisions that some risks are not taken into account, and the reasons for it.

Risk treatment. Priorities in the treatment of risk must be in line with expectations, the value and risk assessment. Standard options for the treatment of risk are 1) risk avoidance, 2) reducing probability of occurrence of the negative consequences of changing risks, and 3) changing the exposure to the risk as the result of the risk reduction.

Introduction of monitoring in the procurement risk management process

Role of external audit in the procurement risk management process

The entire process of managing risks must be under control, especially when it comes to high-value procurement or procurement of great importance. This process must be controlled in order to perform the process for which it is intended. Monitoring is established to reduce the risk to a reasonable limit. Limit of monitoring / supervision depends on the willingness that management accepts. Monitoring should be introduced in the entire procurement process. More often than ever before, procurement risk management process has lately involved the external audit as a form of control, to implement certain activities which are beyond the purpose of International Standards of Audit. Expectations for external audit to assist management in the risk process procurement in recent years have been highly emphasized. External audit key tasks are to control the entire process of purchase, i.e. if it is consistently applied on approved procurement policy, which was adopted at the beginning of the business period, and to hand in a written report to the management of a business entity.

Audit activities in the process of implementation of the procurement

At each stage of the procurement process, the audit carried out certain activities with the aim of enabling procurement process to be carried out in accordance with the interests of the business entity.

In the process of procurement planning audit conducts the following activities:

- Checks that the business entity has a procurement plan and whether the procurement process takes place in accordance with the plan,
- Checks the records on whether an entity often renewed procurement plans and whether these plans periodically adjust the budget and cash flow,
- Check whether procurement plans arise from the procurement strategy which is harmonized with the defined objectives of the business entity.

In terms of identifying potential suppliers, audit activities are as follows:

- Check the database of existing and potential suppliers, whether records are kept, which provides information about the suppliers in the database, if they are real and not fictional, if their business activities are fair and transparent,
- Implement procedures that allow noting any sign which indicates that a potential supplier is favored at any stage of the procurement.

At the stage of elimination of competition from the procurement the audit should:

- Consider proposals and criticisms of managers in order to eliminate inadequate suppliers who pose a risk to the business entity,
- Warns of the presence of risk in cases where the purchase is made with strict reduction of competition,
- Check and supervise all activities of non-competitive procurement which are related to procurement, in order to control hazards that are present in such ways of procurement.

At the stage of technical and economic evaluation of bids, the audit activities are as follows:

- Verify that the entire process of evaluating the offers is transparent, objective and fair,

- Check if the assessment is documented and registered and whether all the reports are entrusted to an appropriate person of the business entity,
- Check the validity of the presented results of the assessment,
- Give an assessment of the methodology used for the economic and technical evaluation of procurement.

When the selection of suppliers is carried out the audit implements the following activities:

- Help management in finding the best way to encourage competition in the procurement process to offer high quality goods or services at the lowest price,
- Warn management of the risk of wrong procurements,
- Propose and support any significant reduction of competition in the procurement,
- Control the integrity and validity of the technical and economic assessment used for the selection of the suppliers,
- Give recommendations on the selection of suppliers based on the results of the technical and economic assessment.

At the stage of selecting suppliers and making a decision about signing the contract, the audit should:

- Participate as an observer without voting rights, to ensure the independence of management decision-making,
- Check if the procurement function has kept the records and archived drafted in a consistent manner and objectively,
- Check and assesses the correctness of tender documents,
- Evaluate the manner in which procurement function evaluates appropriate complaints concerning the correctness of the procurement activity.

At the stage of selecting suppliers it is estimated whether the contracts are made on good economic base of the business relationship between the supplier and the business entity.

Responsibility in the procurement risk management process

Speaking about procurement risk, the management is responsible for introducing an efficient system for risk management. Management task is to define the appropriate strategy, policies, rules and procedures for the

implementation of the procurement process. Every individual who is responsible for the implementation of defined rules, procedures and regulations, takes the responsibility of his/her own work.

Objectives of the external audit are based on such a review as to ensure protection of management information about the compliance of the procurement process, their strategy, policies, rules and procedures for procurement risk management. Audit findings and recommendations need to be communicated to a business entity in a written form, with full responsibility of the signed.

Summary

Bearing in mind the fact that the services in hotel industry have been considered as an integral part of services in tourism, and that tourism is one of the drivers of economic development in less developed countries like Serbia, in this paper we analyzed the issues that stress the importance of risk management in the hotel industry, in the process of procurement of goods and services. Management must make further efforts to establish an effective procurement risk management system in order to improve the quality of procurement, and meet the modern demands of service for accommodation and food. Managers cannot completely eliminate a risk, but they can significantly mitigate the impact of risks and unpleasant issues. For successful implementation of procurement procedures for goods and services, it is necessary first that the highest management level is aware of the risks that accompany the process of purchases. The analysis of potential losses is just as important as the analysis of the potential benefit that may arise as a result of decision-making in the procurement procedure. According to that, business entity needs to have appropriate strategy for managing a procurement risk. What kind of strategy business entity will create depends on business entity size and complexity of the transaction, which requires a high level of knowledge and experience.

Results of research show that if the procurement in the hotel industry aimed to have successful business, needs to: 1) establish a proper procurement risk management system, which primarily defines appropriate procurement policies and procedures, and the rules in the procurement process; 2) develop plans and procedures for the roles and responsibilities in the procurement risk management process; 3) get the employees trained to carry out the procurement process in accordance

with defined plans, policies, procedures and procurement rules; and 4) establish an effective system for monitoring the implementation of the procurement process. Factors that may affect the likelihood and consequences of the final outcome can be variable, as well as the facts that influence the cost of procurement.

This paper describes the procurement itself, as well as the procedure that is conducted by the management and staff in the procurement process, as well as the activities which audit should carry out from planning to contracting, at each stage of the procurement process. Research shows that an effective system for procurement risk management includes supervision, and in developed countries independent external audit is in charge for these kinds of processes. This form of control contributes to eliminate or minimize the risk, with the minimum consequences and better chances for achieving sustainability and success. This can be achieved through: 1) training inside business entity to recognize and take advantage of opportunities / chances; 2) achieving success in maintaining business entity and their ability to adequately adapt to unexpected risks and opportunities, and bring important decisions regarding risks.

Taking all into consideration, the results of this paper can offer the basis for further analyzing of the situation and prospects, procurement risk management in Serbia, which would certainly address the question of importance of risk management in procurement in hotel industry and their impact on the achievement of additional value to the business entities, strengthening economic growth, attracting tourists, both domestic and foreign, and contribution to the general economic development and social stability.

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