

ETERNAL TRAVEL LTD

Eternal Travel Ltd (ET) operates a chain of 21 upmarket travel agent outlets which are located in major cities throughout the UK.

The travel industry

Tour operators traditionally sell trips (ie, holidays and business trips) that include flights, accommodation and other services to consumers through travel agents which act as intermediaries. After offering a consumer advice and information from tour operators' databases, the travel agent makes a booking of a trip with the tour operator for system. In return for these services, the travel agent receives a commission from the tour operator for each booking, based on percentage of the value of the booking. For example if a consumer pays £1,000 to a travel agent for a holiday, the commission earned by the travel agent may be £100 and then the net price paid over by the travel agent to the tour operator would be £900.

For a number of years travel agents have faced competition from internet bookings made on-line directly by consumers with the tour operators. Until 20X5, the tour operators' on-line price to consumers was the same as the consumer would have paid when booking via a travel agent, so in saving the travel agent's commissions the tour operators made a higher profit. Since 20X5, however, tour operators have lowered on-line prices to consumers to around the net price paid by travel agents to the tour operators. As a consequence, there has been intense competition in the industry with many small travel agents ceasing to trade.

There are approximately 6,800 travel agent outlets in the UK. The 'big three' chains of travel agent outlets are part of vertically integrated companies which also comprise tour operators, airlines and hotels. They have about 1,750 travel agent outlets between them. The remainder are mainly small, independent chains.

Eternal Travel Ltd

ET's business model is to sell upmarket leisure and business trips to long distance locations. These normally include business class or first class air tickets and luxury hotel accommodation. The trips are frequently designed by ET to meet the individual requirements of a consumer, rather than being a standardised package.

ET also attempts to make high margins from selling 'extras' such as car hire, travel insurance and limousine airport transfers.

ET has maintained a network of 21 travel agent outlets since 20X1. Of these, 20 are shops in city centres, but a key part of the ET business is called Outlet21. This is located in an office within a large investment bank, Garrett plc (Garrett), in London. Outlet21 deals with all the business travel arrangements for Garrett's London based staff. Garrett employees needing to make a business trip provide details to ET staff, who make all the arrangements and the booking. ET staff are authorised to make payments to tour operators from the bank's funds and then to record the costs against the appropriate cost codes in the bank's management accounting system. ET is paid fees by Garrett at the end of each month based on a percentage of the value of the trips arranged. Garrett's finance staff make very few checks

on the costs incurred through ET and considerable discretion is given to ET employees over the cost and quality of the trips booked.

A crisis board meeting

The global economic downturn has caused a decline in ET's sales. As a consequence, a crisis board meeting was called. Jo Walker, the chief eternal, explained the problem: 'In the recession, higher-priced upmarket travel has suffered even more than other sectors of this market. In order to compete and make sales therefore, since January 20X9 the managers of each ET outlet have been given the authority to reduce the price that the consumer pays. This is done by reducing our commission percentage by up to a half. Unfortunately, many managers seem to be discounting too often and our margins have suffered.'

The finance director, Carol Gull, who is a chartered accountant, added: 'I don't believe that discounting is the right pricing strategy for an upmarket travel agent. It sends out the wrong message to consumers. On the positive side, however, we have tried to keep sales volumes high by giving managers an incentive to increase the number of bookings being made: the number of bookings is now a key performance indicator, and part of the managers' remuneration is based on this figure.'

The marketing director, Henry Hall, was looking ahead. 'I think the way forward for increasing volumes is in entering into a contractual arrangement with an upmarket provider of travel or accommodation. I have had tentative negotiations with the snooty Hotel Company (SHC). This company operates 25 luxury hotels, situated in high quality resorts around the world. Normally SHC would charge consumers £300 per room per night, but they are suffering low utilisation in the recession. To improve utilisation, SHC is willing to reduce its price to consumers. SHC has therefore offered to sell to our clients for £200 per room per night. We would need to guarantee to SHC that we would book a minimum of 600 room nights over the next year. Any shortfall would be payable by ET itself. Consumer bookings for SHC through ET were about 1,000 room nights last year, all at the full price of £300 per room per night. The commission rate for ET from SHC would remain at 10% of the room night price charged by SHC.'

At the board meeting the finance director provided data on the UK travel industry and on ET (Exhibit). It was agreed at the end of the meeting to conduct a thorough review of ET's business.

Exhibit

UK industry data

| Years to 31 December | 20X7 | 20X8 | 20X9 |
|--|--------|--------|--------|
| Revenue of tour operators (£m) | 36,500 | 35,800 | 35,300 |
| Commissions of travel agents from making bookings (£m)* | 4,380 | 3,938 | 3,530 |
| Number of bookings through travel agents (000's) | 68,600 | 65,200 | 64,100 |
| *Includes transfer prices of vertically integrated companies | | | |

Company data – ET

| Years to 31 December | 20X7 | 20X8 | 20X9 |
|--|------|------|------|
| 20 city centre outlets | | | |
| Revenue of tour operators (£m) | 90 | 84 | 78 |
| Commissions from making bookings (£m) | 9 | 7.56 | 6.24 |
| Number of bookings (000's) | 30 | 27 | 24 |
| Sundry commissions (car rental, travel insurance etc) (£m) | 1 | 1.1 | 1.1 |
| Outlet21 | | | |
| Fees from Garrett (£m) | 3 | 3 | 3 |
| Ethical issue | | | |
| One of the ET employees working at Outlet21 recently resigned and sent the following letter to Carol Gull, the finance director. | | | |

I want to draw your attention to a couple of matters that have concerned me whilst working in Outlet21. ET employees have considerable discretion over the quality of the hotels and flight tickets being booked. As a result, relatively junior Garrett employees are being given the best accommodation and travel by some ET employees who are the 'rewarded' with gifts from these bank employees – sometimes amounting to over £100 per gift.

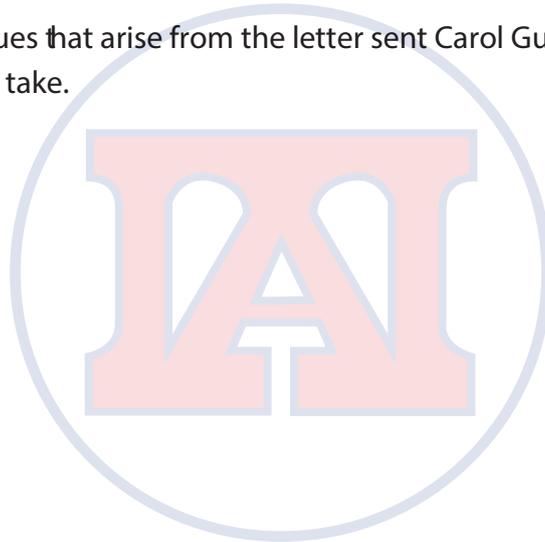
Also, Garrett has a charitable trust for education in Africa to which the bank's clients, employees and suppliers voluntarily contribute. Senior bank employees sometimes book with ET to go to Africa to open new schools that have been purchased from the trust's funds, and so gain publicity for the bank. When they do so, they stay in the best hotels and travel first class. I think that if this had been bank business then it would be fine, but it is becoming a major cost for the charitable trust and it seems unnecessary and inappropriate. Sometime the travel costs of the trips are even charged in full to the charitable trust, even though some commercial banking business also takes place.

Requirements

1. Using the Exhibit and other information provided, evaluate the performance of ET over the period 20X7 to 20X9. Make comparisons with the performance of the industry as a whole where appropriate. Indicate any additional key information that would be needed to make a fuller assessment of ET's performance in the period.
2. As part of ET's review of its business:
 - a) Discuss the likely effects of the pricing policy of discounting by reducing commission percentages; and
 - b) Assess the likely impact of the incentives for outlet managers being based on the key performance indicator of the number of bookings.

Ignore the contract with SHC.

3. Regarding the proposed contract with SHC:
 - a) Assess the benefits and risks that need to be taken into account before deciding whether to enter into the contract; and
 - b) Explain how risk can be managed if the contract is entered into.
4. Discuss the key ethical issues that arise from the letter sent Carol Gull and explain what actions she should take.



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