

January 2008

A Three-Decade Review of Club Capital-Budgeting Practices

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Recommended Citation

Damitio, James W. and Schmidgall, Raymond S. (2008) "A Three-Decade Review of Club Capital-Budgeting Practices," *Hospitality Review*: Vol. 26 : Iss. 1 , Article 2.

Available at: <https://digitalcommons.fiu.edu/hospitalityreview/vol26/iss1/2>

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Abstract

If clubs are to remain viable in the future, it is important for them to employ proper capital-budgeting techniques. This study reports on clubs' current capital-budgeting practices. It also compares current practices with those used by clubs over the previous two decades, starting in the 1980s.

A Three-Decade Review of Club Capital-Budgeting Practices

By James W. Damitio, and Raymond S. Schmidgall^A

If clubs are to remain viable in the future, it is important for them to employ proper capital-budgeting techniques. This study reports on clubs' current capital-budgeting practices. It also compares current practices with those used by clubs over the previous two decades, starting in the 1980s.

Expenditures for hospitality entities can be divided into two categories, revenue expenditures and capital expenditures. Revenue expenditures are expensed in the period in which they occur, while capital expenditures are expensed over more than one year. Schmidgall, Damitio, and Singh (1997) reported on how financial executives in the lodging segment of the hospitality industry discern between revenue and capital expenditures. The majority of the respondents in that study believed that guidelines needed to be developed to assist executives with capital budgeting.

Horngren, Datar, and Foster (2006) stated that the capital-budgeting process involves making long-term planning decisions for investments in projects. Schmidgall and Damitio (2001) described a club's capital budget as pertaining to planning for the acquisition of equipment, land, buildings, and other property.

Connolly and Ivey (2004) noted that in a difficult economy, hospitality budgets in general become tight. This, they said, leads to more scrutiny over requirements for capital-budgeting projects and the need for more sophisticated approaches to capital-budgeting decisions.

Ryan and Ryan (2002) stated that capital budgeting is one of the most important decisions facing the financial manager. In their study of large Fortune 1000 companies, they found that the Net Present Value (NPV) method was the most frequently used capital-budgeting technique, followed by the Internal Rate of Return (IRR) method.

Are hospitality firms in general using the more sophisticated techniques that large companies employ? Has the use of Discounted-Cash-Flow (DCF) models increased over the less sophisticated payback method?

Eyster and Geller (1981) compared the capital-budgeting practices of hospitality firms (both restaurant and lodging) for 1975 and 1980 and found a modest increase in the use of DCF models. Payback, however, appeared to be the preferred technique at the time. Schmidgall and Damitio (1990) studied the capital-budgeting practices of lodging chains to determine whether there had been significant changes in the techniques used since the Eyster and Geller study. They found significant increases in the use of IRR and NPV models.

Schmidgall and Damitio (2000) revisited the capital-budgeting practices of major lodging chains about a decade later. They found few significant changes in the method employed in evaluating capital projects. That study revealed that IRR continued to be the most popular capital-budgeting technique for lodging chains.

What about the capital-budgeting techniques used in the club segment of the hospitality industry? What techniques have clubs preferred to use in the 1980s, 1990s, and 2000s? Are clubs employing the more sophisticated DCF methods, or are they still using more simplistic approaches, such as payback?

A. Funding of this research was provided by the Club Foundation

Schmidgall (1986) conducted a study of private clubs in the 1980s and found that 30% of the respondents had not studied the costs/benefits of capital projects. Of the respondents who had used formal techniques, nearly 46% had used payback, 28% had used NPV, 19% had used IRR, and 7% had used a combination of techniques.

In a follow-up study involving clubs in the 1990s, Schmidgall (1998) found that 42% of the club executives reported using the payback approach to capital budgeting. In that study 35% had used NPV, 18% had used IRR, and the remaining 5% had used a combination of approaches. Thus a moderate increase in the use of DCF models had occurred in the club industry over those 11 years.

RESEARCH APPROACH

A questionnaire designed to investigate current capital-budgeting practices at private clubs included the following four major questions:

1. Does your club undertake a formalized cost/benefit study prior to acquiring property and equipment?
2. If you use a formalized cost/benefit study only for major items, what is considered to be major?
3. If a formalized cost/benefit study is made, what capital-budgeting approach is used?
4. If the payback approach is used, what is the maximum allowable payback period?

In addition, the questionnaire asked for the usual demographic data: The title of the respondent; and the type, size, and profitability of the club.

The questionnaire was mailed to 3,000 members of the Club Managers Association of America. Six hundred and twenty-three questionnaires were returned, resulting in a response rate of just over 20%.

FINDINGS

General Characteristics of Respondents

Ninety-one percent of the respondents held the title of general manager, while the remaining 9% held other titles, such as assistant manager or controller. It appears that virtually all respondents had knowledge of their clubs' capital-budgeting practices. The vast majority of the respondents (78%) were employed by country clubs, with the balance being executives of city, athletic or other types of clubs.

The size of the clubs' membership varied, with 36.5% of respondents having between 250 and 500 members, and 31% having between 501 and 750 members. When reporting annual gross revenues, including dues, the largest category of respondents' clubs (37.2%) indicated that their revenue was between \$3,000,001 and \$5,000,000. The next largest category of respondents' clubs (28.2%) reported annual revenue between \$5,000,001 and \$10,000,000. See Table 1 for additional detailed information on the size of respondents' clubs.

Table 1
Selected Demographics of Clubs

<u>Part A – Size of Clubs (Revenues)</u>	
<u>Annual Revenues</u>	<u>Percent</u>
< \$1,000,000	2.3%
1,000,000 – 2,000,000	10.1
2,000,001 – 3,000,000	15.6
3,000,001 – 5,000,000	37.2
5,000,001 – 10,000,000	28.2
> \$10,000,000	<u>6.6</u>
Total	<u>100.0%</u>

<u>Part B – Size of Clubs (Number of Members)</u>	
<u>Number of Members</u>	<u>Percent</u>
< 250	4.3%
250 – 500	36.5
501 – 750	31.0
751 – 1,000	12.1
1,001 – 2,000	12.7
> 2,000	<u>3.4</u>
Total	<u>100.0%</u>

Most private clubs are organized as not for profit, and many of them experience an excess of expenses over revenues. Since a major focus of many clubs is food-and-beverage operations, we used the bottom-line results of clubs' food-and-beverage operations as a surrogate measure for overall profitability. This measure is not impacted by dues and initiation fees in the way net income is impacted.

The median food-and-beverage profitability was zero, while the lower quartile was an 8% loss and the upper quartile was a 7% profit. The food-and-beverage operations at the

extremes, the 90th and 10th percentiles, showed profits of 13.8% and losses of 21.8%, respectively.

Research Results

Over 80% of the respondents indicated that they conducted a cost/benefit study at their clubs prior to acquiring property and equipment. However, the extent of the study appeared to vary significantly. Just over 37% indicated the study was informal, while 25% conducted a formal study for new acquisitions only. Still, another 20% considered the costs and benefits for all capital items, including new and replacement equipment purchases. Therefore, nearly one out of five clubs undertook no cost/benefit evaluation prior to the capital-budgeting decision!

Does the use of cost/benefit analysis of capital projects differ based on general demographics? As shown in Table 2, the size of the club (both in terms of annual revenues and number of members) suggests a difference in terms of whether a study is prepared for capital projects. However, the type of club and its profitability do not reveal any statistical difference with regard to whether a study is prepared for capital projects.

Table 2
Comparison of Demographics to Whether Study is Prepared

	<u>Chi Square</u>	<u>Significance</u>
Type of club	8.907	.446
Size – revenues	18.397	.031 *
Size – members	16.260	.062 **
Profitability	13.513	.141
* Statistically significant at the 5% level		
** Statistically significant at the 10% level		

Twenty-six percent of the smallest clubs (annual revenues of less than \$2,000,000) do not study the cost/benefits of their capital project. Thirteen percent of the largest clubs (annual revenues exceeding \$5 million), do not conduct a cost/benefit study. For the two remaining club-size categories, the percentage using cost/benefit analysis is in between these extremes. Similar results are noted regarding clubs that informally study the cost/benefit of capital projects. Forty-two percent of the smallest clubs conduct an informal study compared to 36% of the largest clubs. The two remaining club-size categories fall between these extremes, as shown in Table 3.

Table 3
Conduct of Cost/Benefit Studies by Size of Club (Annual Revenues)

	Size of Club (Annual Revenues)			
	<u>< \$2 million</u>	<u>\$2 to 3 million</u>	<u>\$3 to 5 million</u>	<u>> \$5 million</u>
No study conducted	26%	18%	15%	13%
Only informal study	42	40	39	36
Study – only major items	17	31	22	23
Study – all items	<u>15</u>	<u>11</u>	<u>24</u>	<u>28</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Table 4 shows the correlation between club size based on the number of members, and the conducting of cost/benefit studies for capital projects. Clearly, a bigger percentage of the largest clubs (> 1,000 members) conduct more studies than the smallest clubs do (< 500 members). Table 4 reveals the percentage of clubs conducting these studies by club size.

Table 4
Conduct of Cost/Benefit Studies by Size of Club (Number of Members)

	Size of Club – Number of Members			
	<u>< 500</u>	<u>500 – 750</u>	<u>751 – 1,000</u>	<u>> 1,000</u>
No study conducted	17%	14%	19%	13%
Only informal study	39	45	30	29
Study – only major items	25	21	35	29
Study – all items	<u>19</u>	<u>20</u>	<u>16</u>	<u>29</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Over 250 respondents indicated a cost/benefit study is conducted for major items only. However, what do the respondents consider major? Forty-four percent indicated that major meant over \$10,000, 25% indicated over \$1,000, 13% indicated over \$50,000, and 8% indicated over \$100,000. The remaining 10% indicated major meant expenditures in excess of other amounts. A comparison of types, sizes, and profitability of clubs to "what is major" revealed only a statistical difference for size based on annual revenues, as shown in Table 5.

Table 5
Comparison of Demographics to “What is Major?”

	<u>Chi Square</u>	<u>Significance</u>
Type of club	5.940	.430
Size – annual revenues	13.891	.031*
Size – members	4.998	.544
Profitability	6.579	.362
* Statistically significant at the 5% level		

Table 6 reveals the differences between the extremes—the smallest and largest clubs based on annual revenue. Major capital items are defined as greater than \$1,000 for 40% of the clubs with revenues less than \$2 million, and for 28% of clubs with sales over \$5 million. Expenditures greater than \$50,000 are defined as major by 16% of the smallest clubs and 30% of the largest clubs. Percentages for other club sizes and expenditures over \$10,000 are also shown in Table 6. To some degree, the larger the club (based on annual revenues), the larger the amount of capital expenditure in order for it to be considered major, as would be expected.

Table 6
Size of Club (Annual Revenues) Compared to “What is Major?”

	Size of Club (Annual Revenues)			
	<u>< \$2 million</u>	<u>\$2 to 3 million</u>	<u>\$3 to 5 million</u>	<u>> \$5 million</u>
Expenditure > \$1,000	40%	26%	42%	28%
Expenditure > \$10,000	44	62	41	42
Expenditure > \$50,000	<u>16</u>	<u>12</u>	<u>17</u>	<u>30</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

The most common capital-budgeting approach was payback, used by 43% of those conducting a formal study. Nearly an equal percentage of clubs used some DCF method. NPV was used by one-quarter of these clubs, while 17% used IRR. Fifteen percent included a combination of approaches. For example, common combinations were payback and NPV, or payback and IRR.

Does the use of these various approaches differ by type, size, or profitability of a club? Only the size of the club, based on annual revenues, appeared to suggest a difference in the approaches used, as revealed in Tables 7 and 8. We expected the larger clubs would use the more sophisticated capital-budgeting approaches, that is, NPV and IRR. However, the two smallest categories of clubs made the greatest use of the DCF approaches. Finally, what is the maximum

allowable payback period? The alternatives provided included *two, three, four, and five* years, and *other (please explain)*. The most common payback period, indicated by 44% of the respondents, was *five* years. Nineteen percent and 14% indicated *three* and *four* years, respectively. Only 3% indicated *two* years, while the remaining 20% indicated *other* and provided an alternative explanation. The explanations were primarily some other time period, such as seven or ten years, or “it depends.” The reason given for “it depends” included item, project life, and type of asset. A comparison of the maximum allowable payback period to the type, size, and profitability of clubs did not reveal any statistically significant differences.

Table 7
Comparison of Demographics to Capital-Budgeting Approach

	<u>Chi Square</u>	<u>Significance</u>
Type of club	6.031	.420
Size of revenues	18.763	.005 *
Size – members	6.502	.369
Profitability	6.116	.410
* Statistically significant at the 1% level		

Table 8
Size of Club (Annual Revenues) Compared to Capital-Budgeting Approach

	<u>Size of Club (Annual Revenues)</u>			
	<u>< \$2 million</u>	<u>\$2 to 3 million</u>	<u>\$3 to 5 million</u>	<u>> \$5 million</u>
Payback	33%	30%	51%	62%
NPV	28	51	26	24
IRR	<u>39</u>	<u>19</u>	<u>23</u>	<u>14</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Comparisons to Prior Studies

Schmidgall conducted similar capital-budgeting research for clubs in the 1980s and 1990s. It is interesting to compare the current responses with those from club executives during the prior two decades. First, are clubs today more likely to conduct a cost/benefit study of a proposed project than clubs in the past?

Table 9 reveals little change from the prior study: 82% of the club executives today indicated they conduct a cost/benefit study when considering capital projects, compared to 85% in the 1990s. Cost/benefit studies were conducted for all capital-budgeting projects by 50% of the clubs responding in the 1990s, as compared to 45% in the current study. Thus, there appear

to have been minor changes in conducting cost/benefit studies over the past ten years, while there were very significant changes from the decade of the 1980s to the 1990s, as shown in Table 9.

Table 9
Clubs Conducting Cost/Benefit Studies

	Prior Studies		
	<u>1980s</u>	<u>1990s</u>	<u>Current Study</u>
Percentage conducting study	70%	85%	82%
Study—for all items	19%	50%	45%
Study – only major items	81%	50%	55%

Many club executives indicated that cost/benefit studies are conducted only for major items. In the 1980s over 80% indicated they studied relevant costs and benefits only for major items. Compare this to 50% and 55% of the club executives from the 1990s and the current studies, respectively. How has the quantification of "what is major" changed? A comparison of club executives' responses over the past three decades is revealed in Table 10. Only 25% of the respondents currently consider major to be *greater than \$1,000*, compared to 40% and 46% from the two prior studies. The *greater than \$10,000* amount has defined "what is major" for approximately 40% of the clubs over the decades: 37% in the 1980s, 35% in the 1990s, and 44% currently. The *greater than \$50,000* quantification has been constant (13%) over the three decades, while a new category in this study, *greater than \$100,000* or more, was indicated by 8% of the respondents. The *other* category has been 10% or fewer for all three studies. Overall, it appears the definition of major for capital projects has increased over the current decade compared to the past two decades. This should not be surprising because most capital purchases are more expensive in the 21st century than they were at the end of the 20th century.

Table 10
Size of Major Purchases

Prior Studies			
	<u>1980s</u>	<u>1990s</u>	<u>Current Study</u>
Greater than \$1,000	40%	46%	25%
Greater than \$10,000	37	35	44
Greater than \$50,000	13	13	13
Greater than \$100,000 or more	--	--	8
Other	<u>10</u>	<u>6</u>	<u>10</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>

The current survey included capital-budget approaches, namely payback, NPV and IRR. Table 11 reveals the research results over the last three decades. The payback approach continues to be used by over 40% of the clubs, according to the respondents. The more sophisticated approaches, NPV and IRR, by themselves are currently used by fewer clubs than in the past two decades; however, 15% of the clubs are using a combination of studies, a number significantly greater than in the past. Many of these combinations include DCF methods such as NPV and IRR.

Table 11
Capital-Budgeting Approach Used

Prior Studies			
	<u>1980s</u>	<u>1990s</u>	<u>Current Study</u>
Payback	46%	42%	43%
NPV	28	35	25
IRR	19	18	17
Combination	<u>7</u>	<u>5</u>	<u>15</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>

Finally, Table 12 reveals the maximum allowable payback period in years. The average for payback periods of two through five years is also shown in this exhibit. The average allowable payback period for clubs in the 1980s was 4.26 years. The research for the past decade (1990s) revealed a short average payback period of 3.57 years, while the average allowable payback period for the first decade of the 21st century, 4.27 years, was nearly equal to that shown in 1980s survey results. Overall it appears clubs responding in the 1990s were the exceptions across the three decades.

Table 12
Length of Maximum Allowable Payback Period

Prior Studies			
<u>Years</u>	<u>1980s</u>	<u>1990s</u>	<u>Current Study</u>
2	8%	14%	3%
3	19	35	19
4	12	8	14
5	61	27	44
Other	—	<u>16</u>	<u>20</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>
Average *	<u>4.26</u> years	<u>3.57</u> years	<u>4.24</u> years
* Excludes other			

SUMMARY, CONCLUSIONS, AND FUTURE RESEARCH

It appears that there are currently great differences among clubs as to how they approach capital-budgeting projects, not only in terms of whether a formal study is conducted but also in terms of the capital-budgeting technique used, if a formal study is conducted. Somewhat to our surprise, the smaller clubs currently appear to be making greater use of the more sophisticated DCF approaches to capital budgeting. We believe that this finding merits further research.

On the other hand, clubs' capital-budgeting approaches have not changed greatly in the past 25 years. The percentage of clubs using payback, the most common approach, has been between 42% and 46% over almost three decades. Unlike other segments of the hospitality industry, IRR and NPV do not appear to be gaining greater acceptance.

Future research should attempt to determine why more clubs are not using the more sophisticated DCF approaches to capital budgeting in times when there is increased pressure on most clubs' profitability. Research should also attempt to determine why smaller clubs are increasingly using DCF approaches. Also, further research should be done to determine whether club managers need to be educated about how DCF approaches work and how beneficial they are in the capital-budgeting process.

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