

# Enterprise Analysis: Partial Budgeting

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## Glossary of Terms

### *Accounting*

The function of recording, classifying and summarizing, in terms of money, the events of a business. Accounting also includes interpreting results.

### *Accounts Payable*

The amount owed to other companies for goods or services provided. Accounts payable are unsecured debts documented only by the receipt of goods or services. Accounts payable are part of the Current Liabilities.

### *Accounts Receivable*

The amount due from other companies for goods and services provided. Accounts receivable are unsecured debts documented only by the receipt of goods or services. Accounts receivable are part of the Current Assets.

### *Accrual Accounting*

A system of accounting in which revenues and expenditures are recognized immediately as they are earned. This means recording receipts and expenditures for a service when the service is rendered, and for goods when they are delivered, rather than when payment is made or received. (See Cash Accounting for an alternate system.)

### *Activity Units*

Activity units or base is a measure of productive effort used to allocate overhead to products or departments. Examples of activity units or base include direct labor hours, direct labor dollars, and machine hours.

### *Allowance For*

A reduction from income on the expectation of a cost not yet incurred. For example, an allowance for bad debts provides a recognition that not all accounts receivable will be collected. The allowance for bad debts not only reduces the income but also the asset (in this example Accounts Receivable). Sometimes "Provision For" or "Reserve For" is used instead of allowance to mean the same thing.

### *Amortization*

A generic term. Includes various specific practices such as depreciation, depletion, write-off of intangibles, prepaid expenses, and deferred charges.

### *Assets*

Everything a company owns or is due it: cash, investments, money due it (e.g., Accounts Receivable), materials and inventories (which are called Current Assets), buildings, machinery, and equipment (which are called Fixed Assets), patents, research, and development (when capitalized), prepaid interest, leaseholds, and goodwill (which are all called Intangible Assets).

### *Balance Sheet*

A condensed statement showing the nature and amount of a company's assets, liabilities, and stockholders equity on a given date. In dollar amounts, the balance sheet shows what the company owned, what it owed, and the stockholders' ownership interest in the company.

### *Book Value*

The value of assets as shown on the company's books.

### *Break-Even Analysis*

Break-even analysis examines the changes in variable and fixed costs and in sales, usually as a function of production or sales volume. Break-even analysis focuses on the profit that results from changes in production level. Break-even analysis is useful primarily in planning for comparing the effect on profit of choosing among alternate courses of action. Break-even analysis is sometimes called Cost-Profit-Volume Analysis.

### *Budget*

An allocation of resources (capital, land, materials, human efforts, etc.) to accomplish a specified objective or result. Budgeting is one of the steps in planning.

### *Capital*

Capital is a term having many meanings. Capital is most commonly used to identify ownership in the business, which is equivalent to Stockholders' Equity, Owners' Equity, or Net Worth. The term is also sometimes used as the equivalent of Assets Employed, or to identify Capital (Fixed) Assets. (See also Working Capital.)

### *Capital Budgeting*

Allocation of capital to investment proposals whose benefits are to be realized in the future.

### *Capitalize*

The process of declaring an expenditure be recognized as an

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asset. The purpose of declaring the expenditure an asset is so that the appropriate portion of expenditure can be allocated to the time period which benefits from the expenditure. The means of allocating the expenditure to the right time period is called amortization, depreciation or depletion. Many companies capitalize Research and Development. Others charge R&D to earnings in the year in which the R&D is incurred.

#### *Cash*

Cash, the most liquid of all assets, refers only to those items which are unrestricted as to use - and are available readily - for the payment of any obligation of the business. Cash includes currency, coin, readily transferable money orders and checks, and demand deposits in bank accounts. Time, or savings, deposits may be classified as cash if the bank is not expected to exercise its privilege of requiring a waiting period before permitting withdrawals from such accounts.

#### *Cash Accounting*

A system of accounting in which income is recorded when received and expenditures are recorded when actually paid. (See Accrual Accounting for alternate system.)

#### *Cash Flow*

Cash Flow is the flow of liquid assets measured against time, as it comes into and goes out of, the company. Cash Inflow is normally sales. Cash Outflow is normally payments and cash expenditures.

Net Cash Flow is the difference between the Cash Inflow and Cash Outflow.

Cumulative Net Cash Flow is the sum of the Net Cash Flows taken at a point in time. For a given time period, cash flow can be approximated from profit by adding depreciation, depletion, or other expenses that have no effect on working capital. Cash flow information is often available from the Statement of Source and Application of Funds (also known as the changes to Financial Position Statement). (See also Cash.)

#### *Collateral*

Securities of other property by a borrower to secure repayment of a loan

#### *Cost*

Outlay incurred in the operation of a business enterprise including depreciation and amortization of capital assets.

#### *Cost Accounting*

Emphasizes the determination and control of costs. Cost information collected below the level of cost of goods sold is generally considered to be cost accounting. Outbreak of costs used in cost accounting includes direct and overhead, fixed and variable, direct costing, standard costing, controllable and uncontrollable costs.

#### *Costs, Fixed*

Costs which do not change over the near term as a function of a small variable such as production rate, machine hours, or direct labor hours.

#### *Costs, Variable*

Operating costs, either direct or overhead, which tend to vary in a traceable way and in the same time period as some other variable such as small change in production rate, machine hours, or direct labor hours. Perfectly variable costs vary linearly, semi-variable costs vary in some (nonlinear) fashion.

#### *Current Assets*

Those assets of a company which are reasonably expected to be realized in cash, or sold, or consumed during the normal operating cycle of the business. These include cash, marketable securities, account receivables, and other money due within one year, and inventories.

#### *Current Liabilities*

Money owed and payable by a company - usually within one year.

#### *Current Ratio*

A measure of liquidity of a company. The current ratio is the current assets divided by the current liabilities. Bankers like to see the current ratio equal to 2 or better.

#### *Debit*

A bookkeeping term representing an increase in assets or a decrease in liabilities or equity. (See also Credit.)

#### *Debt*

What a company owes, its liabilities.

#### *Depreciation*

Normally, charges against earnings to write off the cost, less salvage value, of an asset over its estimated useful life. It is a bookkeeping entry and does not represent any cash outlay nor are any funds earmarked for the purpose.

#### *Direct Costing*

Direct costing is used to control costs. Direct costing deals only with the direct and variable overhead costs. Direct costing is not acceptable for financial reporting in annual reports nor for income tax purposes. For that purpose, full-absorption costing is used.

#### *Direct Costs*

Those costs which can be uniquely, meaningfully, and economically traced to a unit of production. Direct costs include direct material and direct labor.

#### *Direct Labor*

Labor costs which can be uniquely, meaningfully, and economically traced to a unit of production. Direct labor usually includes salaries, wages, and fringe benefits on direct salaries and wages. Direct labor also includes purchased labor of a direct nature.

#### *Double-Entry Bookkeeping*

A bookkeeping system that is based on the dual nature of transactions; i.e., for every debit entry there must also be a credit entry. (See also Credit and Debit.)

**Equity**

The ownership interest of stockholders in a company. Sometimes also called Capital or Net Worth.

**Exposure**

The amount of cash which must be supplied to an undertaking from outside sources in order to meet the cash payment obligations generated by the project. At any given point in time, the exposure is equivalent to the cumulative net cash flow for the project to that point in time. Maximum Exposure is the maximum negative cumulative net cash flow encountered during the life of the project. Time to Maximum Exposure is the time after start of a project that the Maximum Exposure occurs.

**Fixed Assets**

All assets or prepaid services not completely consumed in a single operating cycle, and which accordingly require the completion of several or many cycles before they are completely liquidated (converted back into cash) and require replacement. Normally this will take more than a year. Examples of fixed assets include buildings, machinery, and equipment.

**Full-Absorption Costing**

A method of costing in which all costs associated with the production of goods (cost of goods sold) are charged to inventory (work in process) as the costs are incurred. Selling and general administrative costs are applied at the time of sale. (See also Direct Costing).

**Funds**

The term "Funds" is used in three different ways: (1) equivalent of cash, as in "petty cash fund," (2) equivalent of working capital (current assets minus current liabilities) - this is the most common meaning of funds in statements of the source and application of funds, and (3) "spending power" or "all financial resources" arising from external rather than internal transactions of a business.

**General and Administrative Costs**

Those costs associated with the operating part of the business but cannot be uniquely, meaningfully, and economically traced to production costs or selling costs. Examples of general and administrative costs are the operating manager's salary, the accounting department, and the training department.

**Gross Margin**

The difference between sales and cost of goods sold, also known as gross profit.

**Income Statement**

One of the basic financial statements. The income statement shows the sales less associated costs and the resulting net income (sometimes called net profit, net earnings, or simply earnings). The income statement is for a period of time, usually one year.

**Interest**

Payments a borrower pays a lender for the use of his money. A corporation pays interest on its bonds to its bondholders. (See also Bond and Dividend.)

**Inventories**

The term applied to materials and products while they are owned by the company prior to their sale. There are three basic types of inventory: Raw Materials Inventory, Work-In-Process Inventory, and Finished Goods Inventory. Inventories asset value is normally figured at the lower cost or market value. (See also FIFO and LIFO.)

**Investment**

An expenditure of money for income or profit, or to purchase something of intrinsic value such as a capital investment. (See also Return on Investment.)

**Investment Decision**

A decision which is expected to show benefits in future years. Contrasts to the tactical decision which is expected to show its benefits within the year. The investment decision includes the capital decision and the abandonment decision. The investment decision is sometimes called a strategic decision.

**Lease**

Usually a long-range commitment to pay a certain annual fee for the use of fixed assets. Occasionally leases are capitalized and entered on a balance sheet as an asset. In that case, the commitment to pay is discounted (see Discounted Cash Flow) and shown as a liability. Where a lease exists but is not shown as an asset, the Return on Assets may be misleading.

**Liabilities**

All claims against a corporation. Liabilities include accounts and wages and salaries payable, dividends declared payable, accrued taxes payable, fixed or long-term liabilities such as mortgage bonds, debentures, and bank loans.

**Lien**

A claim against property which has been pledged or mortgaged to secure the performance of an obligation. A bond is usually secured by a lien against specified property of a company.

**Line of Credit**

An informal arrangement between a bank and its customer regarding the maximum amount of unsecured credit the bank will permit at any one time. Usually, lines of credit are established for one year and are subject to one-year renewal.

**Liquidity**

Refers to the ability of a business to meet its obligations in the near future. Thus, liquidity also refers to length of time it takes to convert assets into cash for paying obligations. The faster an asset can be converted into cash, the more liquid it is.

**Net**

A prefix denoting that the quantity following is the difference of two numbers.

**Net Assets**

Total assets less total liabilities. In the case of a subsidiary of a division not having long-term debt, net assets reduces to total assets less current liabilities.

### *Net Income*

The profit of the business after interest and taxes have been deducted from the total operating and nonoperating profit. Also known as Net Profit or Earnings. When only interest has been deducted, it is often called Net Income Before Taxes.

### *Net Working Capital*

The more correct expression for working capital (Current Assets less Current Liabilities). Net working capital is used where confusion might develop because "working capital" is sometimes used as an equivalent to current assets.

### *Nonoperating Income*

Income which is not part of the normal operating income. Other income includes significant gains or losses from marketable securities. Nonoperating income also includes extraordinary income (or losses).

### *Operating Profit*

The profit resulting from normal operations of business; i.e., sales less operating costs.

### *Opportunity Costs*

Usually used in conjunction with an investment opportunity. The opportunity cost is the income lost as a result of not accepting the best alternate opportunity.

### *Overhead*

That part of the operating costs of a business which cannot be uniquely, meaningfully, and economically traced to the unit production of the business. Overhead includes selling costs, G&A, depreciation, and manufacturing overhead.

### *Overhead Rate*

Overhead rate is used to allocate overhead to a department or product. Overhead to be allocated to a product is the overhead rate multiplied by the activity units or base used in producing the product. (See also Activity Units.)

### *Partnership*

A company owned by two or more people, all of whom equally share legal responsibility for the liabilities of the business. A limited partnership, some of the partners, known as the limited partners, have only limited responsibility.

### *Payback*

The point where the cumulative cash inflow (usually sales) of an undertaking just equals the cumulative cash outflow. The time from the start of a project to its Payback Point is the Payback Period.

### *Present Value*

Literally, the value today (at present) of an amount of money to be paid in the future. The present value depends on the interest rate assumed between now and that future time at which the money will be paid. Present value gives rise to a form of discounted cash flow. (See also Discounted Cash Flow and Internal Rate of Return).

### *Prime Interest Rate*

The interest rate paid by the most credit-worthy customers to a bank. Prime rate is above the rate the bank has to pay for money from the Federal Reserve or from its own depositors.

### *Profit*

The dollar value of the sales, less the cost of goods sold, is the Operating Profit or Profit Before Interest and Taxes (PBIT). When interest and taxes are deducted and nonoperating income added to the operating profit, the term is referred to as Net Profit, Net Earnings, or Net Income.

### *Provisions For*

(e.g., Provision for Income Tax). A phrase used to show an estimated amount has been taken into consideration. Provision for income tax means the amount of tax has been estimated and included as a cost, therefore as a reduction in profit (See also Allowance.)

### *Return on Assets (ROA)*

A form of Return on Investment, defined as the ratio of operating profit to assets employed. ROA is generally used as an indicator of the operating efficiency of a company or division. ROA as described here is a useful measure of operating efficiency but if used to motivate, operating managers may put the emphasis in the wrong place. Several alternate forms of ROA are preferred for motivating managers. Some examples of alternate forms of ROA include: "Return on Undepreciated Assets" (operating profit divided by total assets plus accumulated depreciation). "Return on Net Assets" (operating profit less interest divided by total assets less current liabilities), "Return on Capital" (net income divided by total assets), and "Return on Tangible Assets" (net income divided by total assets less intangible assets).

### *Return on Equity (ROE)*

A form of Return on Investment, defined as the ratio of net income to net worth. ROE is generally regarded as the single most symptomatic indicator of the success of a company.

### *Return on Investment (ROI)*

Conceptually, ROI is simply the ratio of the income to the investment cost. Because there are many different ways of measuring income and investment, ROI is a more generic term. Return on Equity (ROE) and Return on Assets (ROA) are more specific forms of Return on Investment.

### *Revenues*

A term equivalent to sales. Usually used in service-type companies, especially in professional services where sales might connote a violation of ethics in obtaining business. In utilities or transportation, "Operating Revenues" is the term used.

### *Source and Application of Funds Statement*

Shows trends during a period of time, usually a year. Shows primarily trends in working capital but sometimes cash and total resources. Sometimes referred to as Funds Statement or Changes in Financial Position Statement.

### *Tactical Decision*

A decision whose benefits will show during the ensuing year. For decisions whose benefits occur sometime after the ensuing year, see Investment Decision.

### *Turnover*

Turnover is a generic name for a number of different ratios used in the analysis of financial statements. The ratio of particular interest in determining return on assets is the ratio of sales to assets employed (sometimes called Turnover of Assets). When the turnover is multiplied by the percent of return on sales (oper-

ating profit divided by sales), the result is Return on Assets (ROA). Inventory Turnover, a different turnover ratio, is usually annual sales divided by inventory. Inventory Turnover is a measure of whether a company is carrying excessive inventories.

### *Working Capital*

Current assets less current liabilities. The part of the current assets equal to the current liabilities must be used to meet the short-term debts. What remains of current assets is free for other uses in the business, and hence is net working capital or, simply, Working Capital.

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