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Bachelor of Commerce (B2001) | Level 1 • Part A Core | Monash University

Introduction to financial accounting

Course Code: ACC1100 • Module 4 Notes

Module 4: Liabilities, Equity, Financial Statement Presentation & Analysis

1. Current and Non-Current Liabilities, Provisions, and Contingent Liabilities

1.1 Classification Criteria under AASB 101

Under the AASB Conceptual Framework, a liability is a present obligation of the entity to transfer an economic resource as a result of past events. For Balance Sheet presentation, `AASB 101 Presentation of Financial Statements` (para. 69) requires entities to classify a liability as **current** when any of four conditions is met:

1. The entity expects to settle the liability in its normal operating cycle;
2. The entity holds the liability primarily for the purpose of trading;
3. The liability is due to be settled within twelve months after the reporting period; or
4. The entity does not have an unconditional right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.

All other liabilities are classified as **non-current**. Crucially, if a long-term bank loan is repaid in periodic instalments, the principal portion falling due within the next twelve months is separated and presented as a *current liability* (Current Portion of Long-Term Borrowings), while the remaining principal due beyond twelve months stays *non-current*.

1.2 Common Current Liabilities and Australian Payroll Obligations

Commercial Australian entities routinely carry trade accounts payable, bank overdrafts (repayable on demand), unearned revenue (customer deposits), net GST payable to the ATO, accrued expenses, and statutory payroll liabilities. Under Australian taxation and superannuation legislation, employers act as withholding and contribution intermediaries:

- **PAYG (Pay As You Go) Withholding Payable:** Income tax deducted by the employer from employees' gross wages and remitted to the ATO via the Business Activity Statement (BAS). PAYG withholding is *not* an additional expense to the employer; it reduces the net cash paid to employees and creates a current liability until remitted.
- **Superannuation Guarantee (SG) Payable:** Compulsory employer retirement contributions (currently 11.5% in FY2025, rising to 12.0% from 1 July 2025 under the *Superannuation Guarantee (Administration) Act 1992 (Cth)*) paid into employees' nominated superannuation funds. Unlike PAYG withholding, Superannuation Guarantee is an additional employer **expense** on top of gross wages.

Worked Australian Payroll Journal Entry

Suppose *Yarra Engineering Pty Ltd* processes a fortnightly payroll in July 2026 with Gross Wages of A$40,000, PAYG Income Tax Withheld of A$8,600, and compulsory Superannuation Guarantee at 12.0% ($40,000 \times 0.12 = 4,800$, i.e., A$4,800). Net cash paid to employees is $40,000 - 8,600 = 31,400$ (A$31,400).

- **Payroll Recognition Entry:** Dr Wages & Salaries Expense A$40,000; Dr Superannuation Expense A$4,800; Cr Cash at Bank A$31,400; Cr PAYG Withholding Payable A$8,600; Cr Superannuation Payable A$4,800.
- **Subsequent Statutory Remittance Entry:** When the company remits PAYG to the ATO and SG to super funds: Dr PAYG Withholding Payable A$8,600; Dr Superannuation Payable A$4,800; Cr Cash at Bank A$13,400.

Quarterly Australian BAS Clearing Consolidation

In practice, Australian entities settle GST Collected, GST Paid (Input Tax Credits), PAYG Withholding, and quarterly PAYG Income Tax Instalments together on a single **Business Activity Statement (BAS)** lodged with the ATO. For example, if at quarter-end an entity holds GST Collected of A$32,000, GST Paid of A$19,500, PAYG Withholding Payable of A$17,200, and a quarterly PAYG corporate tax instalment of A$6,500, the net ATO payment equals $(32,000 - 19,500) + 17,200 + 6,500 = 36,200$ (A$36,200). The clearing entry is: Dr GST Collected A$32,000; Dr PAYG Withholding Payable A$17,200; Dr Income Tax Expense / Prepaid Tax Instalments A$6,500; Cr GST Paid A$19,500; Cr Cash at Bank A$36,200.

1.3 Provisions and Contingent Liabilities under AASB 137

A **provision** is a liability of uncertain timing or amount (for example, product warranty obligations, employee annual leave and long service leave entitlements, or site restoration obligations). Under `AASB 137 Provisions, Contingent Liabilities and Contingent Assets` (para. 14), a provision is recognised on the Balance Sheet only when three cumulative criteria are satisfied: (1) the entity has a present obligation (legal or constructive) as a result of a past event; (2) it is **probable** (>50% likelihood) that an outflow of economic resources will be required to settle the obligation; and (3) a **reliable estimate** can be made of the obligation amount.

By contrast, a **contingent liability** is either a *possible* obligation arising from past events whose existence will be confirmed only by uncertain future events not wholly within the entity's control, or a *present* obligation that fails recognition because an outflow is not probable or cannot be measured reliably. Contingent liabilities are **not recognised** in the Balance Sheet; instead, unless the likelihood of outflow is remote, they are disclosed in the Notes to the financial statements. Contingent assets are never recognised until virtually certain.

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Worked Warranty Provision Example

Melbourne Appliance Co Ltd sells commercial dishwashers with a 2-year repair warranty. During FY2026, it sells 500 units at A$3,000 each (GST-exclusive sales = A$1,500,000). Based on historical engineering data, 10% of units require warranty servicing at an average repair cost of A$450 per unit. At 1 July 2025, the Provision for Warranties balance was A$6,000; during FY2026, actual warranty repairs paid in cash totalled A$22,000.

1. **Estimated FY2026 Warranty Expense:** $500 \times 10\% \times 450 = 22,500$ (A$22,500).
2. **Adjusting Entry at 30 June 2026:** Dr Warranty Expense A$22,500; Cr Provision for Warranties A$22,500.
3. **Recording Actual Warranty Claims Paid During FY2026:** Dr Provision for Warranties A$22,000; Cr Cash at Bank (or Spare Parts Inventory) A$22,000.
4. **Closing Provision Balance at 30 June 2026:** Opening (6,000) + Expense (22,500) − Claims Paid (22,000) = $6,500$ (A$6,500).

Employee Benefit Provisions under AASB 119 (Annual Leave and Long Service Leave)

In Australia, statutory employment entitlements under the *Fair Work Act 2009 (Cth)* and state Long Service Leave Acts create recurring employee benefit liabilities governed by `AASB 119 Employee Benefits`. Full-time employees accrue 4 weeks of paid **annual leave** per year of service (plus leave loading where applicable under modern awards); because employees hold an unconditional right to take or be paid out accumulated annual leave within 12 months, it is classified as a *current liability*. By contrast, **long service leave (LSL)** vests after an extended service threshold (typically 7 to 10 years depending on the Australian state or territory). Under `AASB 119`, the LSL provision for employees who have not yet reached unconditional vesting is measured using actuarial probability weightings of reaching the qualifying threshold, projected future wage inflation, and present-value discounting using high-quality corporate bond yields, split into current (unconditionally vested) and non-current (unvested) components.

1.4 Non-Current Liabilities and Loan Amortisation

Non-current liabilities—such as commercial mortgage loans, term bank facilities, and corporate debentures—are measured initially at fair value (net of transaction costs) and subsequently at **amortised cost** using the effective interest method. Each fixed instalment payment comprises two parts: *interest expense* calculated on the opening carrying principal, and *principal repayment* which reduces the remaining loan balance.

Worked 3-Year Bank Loan Amortisation Schedule

On 1 July 2025, *Port Phillip Retail Ltd* borrows A$100,000 from ANZ Bank at a fixed interest rate of 8.0% per annum, repayable in three equal annual instalments of A$38,803 every 30 June (verified via annuity formula $100,000 \div \frac{1-1.08^{-3}}{0.08} = 38,803.35$).

Year Ended 30 June	Opening Principal (A$)	Cash Instalment (A$)	Interest Expense (8%) (A$)	Principal Reduction (A$)	Closing Principal (A$)
2026 (Year 1)	100,000	38,803	$100,000 \times 8\% = 8,000$	$38,803 - 8,000 = 30,803$	69,197
2027 (Year 2)	69,197	38,803	$69,197 \times 8\% = 5,536$	$38,803 - 5,536 = 33,267$	35,930
2028 (Year 3)	35,930	38,804*	$35,930 \times 8\% = 2,874$	$38,804 - 2,874 = 35,930$	0

Note (*): Final payment rounded by A$1 to clear remaining principal exactly to A$0. At 30 June 2026, total closing debt of A$69,197 is split on the Balance Sheet into A$33,267 Current Borrowings (due in Year 2) and A$35,930 Non-Current Borrowings (due in Year 3).

1.5 Short-Term Interest-Bearing Notes Payable and Contingent Liability Matrix

Beyond trade payables and amortising bank loans, Australian businesses frequently issue short-term **promissory notes payable** to bridge working-capital seasonality. When a note's term crosses the 30 June reporting date, interest must be accrued proportionately under the accrual basis:

Worked Promissory Note Example: On 1 May 2026, *Geelong Timber Pty Ltd* borrows A$60,000 by signing a 90-day, 6.0% p.a. promissory note maturing on 30 July 2026 (assuming a 365-day year):

1. **1 May 2026 (Issuance):** Dr Cash at Bank A$60,000; Cr Notes Payable A$60,000.
2. **30 June 2026 (Year-End Accrual for 60 Days: 30 days in May + 30 days in June):** Accrued interest = $60,000 \times 0.06 \times \frac{60}{365} = 592$ (A$592, rounded to nearest dollar). Entry: Dr Interest Expense A$592; Cr Accrued Interest Payable A$592.
3. **30 July 2026 (Maturity Settlement for Remaining 30 Days):** Remaining FY2027 interest = $60,000 \times 0.06 \times \frac{30}{365} = 296$ (A$296). Total cash paid = $60,000 + 592 + 296 = 60,888$ (A$60,888). Entry: Dr Notes Payable A$60,000; Dr Accrued Interest Payable A$592; Dr Interest Expense A$296; Cr Cash at Bank A$60,888.

To apply `AASB 137` consistently across uncertain obligations and potential claims, preparers apply the probability and measurability decision matrix below:

Probability of Resource Outflow / Inflow	Obligation (Liability Side)	Possible Asset (Asset Side)
Virtually Certain (>95%)	Recognise as a liability (or accrual) on the Balance Sheet.	Asset is no longer contingent; recognise on Balance Sheet.
Probable (>50% to 95%)	Recognise a **Provision** on Balance Sheet (if reliably measurable); otherwise disclose as Contingent Liability.	Disclose as a **Contingent Asset** in the Notes (do not recognise).
Possible (≤50%, not remote)	Disclose as a **Contingent Liability** in the Notes (do not recognise).	Do not recognise and do not disclose.
Remote	Neither recognise nor disclose.	Neither recognise nor disclose.

2. Shareholders' Equity under the Corporations Act 2001 (Cth)

2.1 Nature of Corporate Equity and No-Par-Value Shares

Under the AASB Conceptual Framework, equity is the residual interest in the assets of the entity after deducting all liabilities ($\text{Equity} = \text{Assets} - \text{Liabilities}$). In Australia, following the *Company Law Review Act 1998* amendments to the *Corporations Act 2001 (Cth)*, shares have **no par value** (no nominal face value). Consequently, Australian companies do not record "Share Premium" or "Paid-in Capital in Excess of Par" accounts; the entire proceeds received from issuing shares (net of share issue transaction costs) are credited directly to **Share Capital**.

Companies commonly issue two classes of shares:

- **Ordinary Shares:** Carry full voting rights at general meetings, residual rights to dividends declared by directors, and residual claim to net assets upon winding up after all creditors and preference shareholders are satisfied.
- **Preference Shares:** Carry preferential rights to a fixed dividend rate (cumulative or non-cumulative) and priority capital return on liquidation, usually with restricted voting rights. Under `AASB 132 Financial Instruments: Presentation`, mandatorily redeemable preference shares carrying a contractual obligation to deliver cash are classified as *liabilities* rather than equity.

2.2 Accounting for Share Issues

A private company or listed entity raising equity via a private placement for immediate cash records a straightforward entry (for example, issuing 50,000 ordinary shares at A$2.40 each, incurring A$3,000 in brokerage/underwriting costs): Dr Cash at Bank A$120,000; Cr Share Capital A$120,000; followed by Dr Share Capital A$3,000; Cr Cash at Bank A$3,000 (under `AASB 132`, transaction costs of an equity transaction are deducted directly from equity, not expensed).

For public Initial Public Offerings (IPOs) or rights issues payable in stages (Application, Allotment, and Call), funds received before shares are formally allotted sit temporarily in a trust liability/clearing account (*Cash Trust* and *Application*) until directors allot the shares and transfer the capital into Share Capital.

Worked Multi-Stage Public Share Issue and Buy-Back Illustration

Suppose *Southern Aurora Minerals Ltd* offers 200,000 ordinary shares to the public at A$3.00 per share, payable A$1.20 on Application, A$1.00 on Allotment, and A$0.80 on First & Final Call. Applications are received for 220,000 shares (oversubscribed by 20,000 shares, which are refunded to unsuccessful applicants upon allotment):

1. **Receipt of Application Monies (220,000 × A$1.20):** Dr Cash Trust A$264,000; Cr Application A$264,000.
2. **Allotment of 200,000 Shares & Refund of Excess Applications:** Dr Application A$240,000; Cr Share Capital A$240,000 (transferring application capital); Dr Cash at Bank A$240,000; Cr Cash Trust A$240,000 (releasing trust funds to operating bank); Dr Application A$24,000; Cr Cash Trust A$24,000 (refunding 20,000 oversubscribed shares).
3. **Allotment Receivable & Collection (200,000 × A$1.00):** Dr Allotment A$200,000; Cr Share Capital A$200,000; followed upon cash receipt by Dr Cash at Bank A$200,000; Cr Allotment A$200,000.
4. **First & Final Call (200,000 × A$0.80):** Dr Call A$160,000; Cr Share Capital A$160,000; followed upon receipt by Dr Cash at Bank A$160,000; Cr Call A$160,000 (bringing total Share Capital to A$600,000).

Conversely, when an Australian company conducts an on-market **share buy-back** under sections 257A–257J of the *Corporations Act 2001 (Cth)*—for instance, repurchasing and cancelling 10,000 ordinary shares at A$3.50 each—Australian law requires bought-back shares to be cancelled immediately (no treasury shares are held), recorded as Dr Share Capital A$35,000; Cr Cash at Bank A$35,000.

2.3 Retained Earnings, Dividends, Share Splits, and Reserves

Retained Earnings represents accumulated net profits earned since incorporation that have not been distributed to shareholders as dividends or transferred to reserves. Under section 254T of the *Corporations Act 2001 (Cth)*, a company must not pay a dividend unless: (a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend (balance sheet net-assets test); (b) the payment is fair and reasonable to the company's shareholders as a whole; and (c) the payment does not materially prejudice the company's ability to pay its creditors.

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Once directors formally declare a final cash dividend (no further approval required), a binding legal liability arises: Dr Retained Earnings (or Dividends Declared) and Cr Dividends Payable. Under Australia's **dividend imputation system**, resident companies attach *franking credits* to dividends representing Australian corporate tax already paid (at 30% or 25%), preventing double taxation of corporate profits in the hands of Australian resident shareholders. For a fully franked dividend paid at corporate tax rate t, the maximum franking credit attached is:

$$\text{Franking Credit} = \text{Cash Dividend} \times \frac{t}{1-t}$$

Where:

- Cash Dividend: Cash dividend distributed to ordinary shareholders (in A$)
- t: Company's franking corporate tax rate (typically 0.30 for large companies or 0.25 for base rate entities)

For example, when *Port Phillip Retail Ltd* (tax rate $t = 0.30$) pays a fully franked cash dividend of A$34,000, the attached franking credit equals $34,000 \times \frac{0.30}{0.70} = 14,571$ (A$14,571), meaning resident shareholders declare A$48,571 of grossed-up taxable income and receive a A$14,571 tax offset against their personal income tax.

Two equity restructurings leave **total shareholders' equity unchanged**:

- **Bonus Issue (Share Dividend):** Issuing free new shares to existing shareholders in proportion to holdings by capitalising Retained Earnings or a Reserve (Dr Retained Earnings; Cr Share Capital). Total equity is unchanged, though Retained Earnings decreases and Share Capital increases.
- **Share Split:** Subdividing existing shares (e.g., a 2-for-1 split doubling share count from 100,000 to 200,000 shares) to improve market liquidity. No journal entry is required because total Share Capital dollar value does not change; only the memorandum number of issued shares updates.

2.4 Corporate Reserves, Dividend Reinvestment Plans, and Rights Issues

In addition to Share Capital and Retained Earnings, Australian Balance Sheets commonly report **Reserves** representing specific equity appropriations or unrealised gains required by AASB Standards:

- **Asset Revaluation Surplus (`AASB 116`):** Accumulates net upward fair value increments on non-current assets such as land and buildings. It is an *unrealised* reserve and is generally not distributed as cash dividends.
- **General Reserve:** Created voluntarily by directors transferring Retained Earnings (Dr Retained Earnings; Cr General Reserve) to signal that those profits are earmarked for long-term capital reinvestment or debt retirement rather than dividend payout.
- **Dividend Reinvestment Plans (DRPs):** Common among ASX 200 companies (such as Commonwealth Bank and Woolworths), DRPs allow shareholders to elect to receive newly issued ordinary shares instead of cash dividends (Dr Retained Earnings / Dividends Payable; Cr Share Capital), conserving corporate cash while expanding Share Capital.
- **Rights Issues vs Private Placements:** A *rights issue* offers existing shareholders the pro-rata right to subscribe for new shares at a discount to market price (protecting against ownership dilution), whereas a *private placement* issues shares directly to institutional investors under ASX Listing Rule 7.1 capacity limits.

Worked Statement of Changes in Equity (*Port Phillip Retail Ltd*, FY2026)

Movement in Equity (A$)	Share Capital	Asset Reval. Surplus	Retained Earnings	Total Equity
Balance at 1 July 2025	300,000	20,000	110,000	**430,000**
Profit for the year ended 30 June 2026	—	—	84,000	84,000
Other Comprehensive Income: Land revaluation upward	—	30,000	—	30,000
Issue of 20,000 ordinary shares (net of issue costs)	50,000	—	—	50,000
Dividends declared and paid	—	—	(34,000)	(34,000)
Balance at 30 June 2026	**350,000**	**50,000**	**160,000**	**560,000**

3. Financial Statement Presentation (AASB 101) and Cash Flows (AASB 107)

3.1 Complete Set of Financial Statements under AASB 101

`AASB 101 Presentation of Financial Statements` (para. 10) prescribes a complete set of general purpose financial statements comprising: (1) Statement of Financial Position as at the end of the period; (2) Statement of Profit or Loss and Other Comprehensive Income for the period; (3) Statement of Changes in Equity; (4) Statement of Cash Flows; and (5) Explanatory Notes containing material accounting policy information and supporting schedules. Comparative figures for the immediately preceding period must be presented for all amounts.

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In the Statement of Profit or Loss, entities classify expenses either **by nature** (e.g., depreciation, employee benefits, raw materials consumed) or **by function** (e.g., Cost of Sales, Distribution Expenses, Administrative Expenses). When the functional format is used (standard for retail and manufacturing companies), `AASB 101` requires additional note disclosure of depreciation, amortisation, and employee benefits expense by nature.

Classification Basis	Statement of Profit or Loss Line Items (*Port Phillip Retail Ltd*, FY2026)	Key Characteristics & Disclosure Note
By Function (Cost of Sales Format)	Sales Revenue A$920,000 – Cost of Sales A$552,000 = Gross Profit A$368,000; Other Income A$6,000; Operating Expenses A$228,000; Finance Costs A$26,000; Tax A$36,000 → Net Profit A$84,000.	Highlights Gross Profit Margin directly; requires note breakdown of Depreciation (A$42,000) and Employee Benefits included inside Operating Expenses.
By Nature (Economic Input Format)	Sales Revenue A$920,000 + Other Income A$6,000 – Raw Materials/Merchandise Consumed A$552,000 – Employee & Admin Expenses A$186,000 – Depreciation A$42,000 – Finance Costs A$26,000 – Tax A$36,000 → Net Profit A$84,000.	Avoids arbitrary cost allocations across departments; commonly used by Australian service providers and mining companies.

3.2 Illustrative Financial Statements: *Port Phillip Retail Ltd* (FY2026)

The following financial statements for *Port Phillip Retail Ltd* (an ASX-style Melbourne merchandising entity with 175,000 weighted-average ordinary shares on issue and a 30 June 2026 share price of A$4.80) serve as the unified dataset for both our Cash Flow Statement (Section 3.3) and Financial Ratio Analysis (Section 4).

Statement of Profit or Loss (Year Ended 30 June 2026)	Amount (A$)
Sales Revenue (all credit sales, GST-exclusive)	920,000
Less: Cost of Sales	(552,000)
Gross Profit	**368,000**
Gain on Disposal of Store Equipment	6,000
Less: Operating Expenses (Wages & Admin 186,000 + Depreciation 42,000)	(228,000)
Earnings Before Interest and Tax (EBIT)	**146,000**
Less: Finance Costs (Interest Expense)	(26,000)
Profit Before Income Tax	**120,000**
Less: Income Tax Expense (30%)	(36,000)
Profit After Tax (Net Profit)	**84,000**

Note the distinction between **Income Tax Expense** (A$36,000, accrued at 30% on accounting profit under `AASB 112 Income Taxes`) and **Income Tax Paid** (A$34,000 on the Statement of Cash Flows, adjusted for the A$2,000 rise in Income Tax Payable from A$14,000 to A$16,000). Under Australian tax law, timing differences—such as warranty provisions expensed under `AASB 137` before cash repairs are tax-deductible, or accelerated ATO tax depreciation versus accounting depreciation—give rise to Deferred Tax Assets and Deferred Tax Liabilities in larger corporate groups.

Statement of Financial Position (as at 30 June)	2026 (A$)	2025 (A$)
Current Assets		
Cash and Cash Equivalents	86,000	45,000
Accounts Receivable (net)	114,000	90,000
Inventory	130,000	110,000
Prepaid Expenses	10,000	15,000
Total Current Assets	**340,000**	**260,000**
Non-Current Assets		
Land (revalued in FY2026)	210,000	180,000
Store Equipment (net of Accumulated Depreciation)	350,000	310,000
Total Non-Current Assets	**560,000**	**490,000**

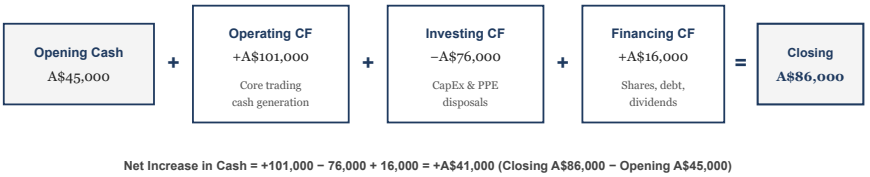
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Statement of Financial Position (as at 30 June)	2026 (A$)	2025 (A$)
Total Assets	**900,000**	**750,000**
Current Liabilities		
Accounts Payable (Inventory Suppliers)	82,000	70,000
Accrued Operating Expenses	18,000	12,000
Income Tax Payable	16,000	14,000
Current Portion of Bank Loan	24,000	24,000
Total Current Liabilities	**140,000**	**120,000**
Non-Current Liabilities		
Long-Term Bank Loan	200,000	200,000
Total Liabilities	**340,000**	**320,000**
Shareholders' Equity		
Share Capital (180,000 shares at 30 June 2026; 160,000 at 30 June 2025)	350,000	300,000
Asset Revaluation Surplus	50,000	20,000
Retained Earnings	160,000	110,000
Total Shareholders' Equity	**560,000**	**430,000**
Total Liabilities and Equity	**900,000**	**750,000**

3.3 Statement of Cash Flows under AASB 107

While accrual profit measures economic performance, an entity can report positive accounting profit yet still fail through cash insolvency. `AASB 107 Statement of Cash Flows` requires entities to classify cash inflows and outflows into three functional streams explaining the change in cash and cash equivalents between opening and closing dates:

- **Operating Activities:** Principal revenue-producing activities of the entity (cash receipts from customers, cash paid to suppliers and employees, interest paid, income taxes paid). Under `AASB 107`, Australian preparers are encouraged to present operating cash flows using the **Direct Method** (showing gross cash receipts and gross cash payments) supplemented by a note reconciling Net Profit to Net Operating Cash Flow (the **Indirect Method**).
- **Investing Activities:** Acquisition and disposal of long-term assets and other investments not included in cash equivalents (purchasing PPE, proceeds from selling PPE, acquiring investments).
- **Financing Activities:** Activities resulting in changes in the size and composition of contributed equity and borrowings (issuing shares, borrowing or repaying loan principal, paying cash dividends).



Direct Method Operating Cash Flow Formulas and Worked Derivation

Additional FY2026 information for *Port Phillip Retail Ltd*: (1) Store Equipment with a carrying amount of A$20,000 (cost A$50,000, accumulated depreciation A$30,000) was sold for A$26,000 cash, yielding the A$6,000 gain; (2) new Store Equipment costing A$102,000 was purchased for cash (check: $310,000 + 102,000 - 42,000 \text{ depr.} - 20,000 \text{ sold} = 350,000$ closing net PPE); (3) all interest expense was paid in cash; and (4) land revaluation of A$30,000 is a non-cash event.

To convert accrual income statement figures into Direct Method operating cash flows, apply the working-capital conversion equations:

$$\text{Cash Received from Customers} = \text{Sales Revenue} - \Delta\text{Accounts Receivable}$$

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$$\text{Cash Paid to Suppliers} = \text{COGS} + \Delta\text{Inventory} - \Delta\text{Accounts Payable}$$

$$\text{Cash Paid for Operating Expenses} = \text{Cash-Based OpEx} + \Delta\text{Prepaid Expenses} - \Delta\text{Accrued Expenses}$$

Where:

- $\Delta\text{Accounts Receivable} = \text{Ending AR} - \text{Opening AR}$ (an increase in receivables means revenue was earned without yet collecting cash)
- $\Delta\text{Inventory} = \text{Ending Inventory} - \text{Opening Inventory}$ (gives Inventory Purchases when added to COGS)
- $\Delta\text{Accounts Payable} = \text{Ending AP} - \text{Opening AP}$ (an increase in payables defers cash outflow to suppliers)
- Cash-Based OpEx: Operating expenses excluding non-cash items such as Depreciation Expense
- $\Delta\text{Prepaid Expenses}, \Delta\text{Accrued Expenses}$: Year-on-year changes $(\text{Ending} - \text{Opening})$ in prepayments and accrued payables

1. **Cash Receipts from Customers:** $920,000 - (114,000 - 90,000) = 920,000 - 24,000 = 896,000$ (A$896,000).
2. **Cash Paid to Suppliers:** Purchases = $552,000 + (130,000 - 110,000) = 572,000$. Cash paid = $572,000 - (82,000 - 70,000) = 572,000 - 12,000 = 560,000$ (A$560,000).
3. **Cash Paid for Operating Expenses (excl. A$42,000 depreciation):** $186,000 + (10,000 - 15,000) - (18,000 - 12,000) = 186,000 - 5,000 - 6,000 = 175,000$ (A$175,000).
4. **Interest Paid:** A$26,000. **Income Tax Paid:** $36,000 - (16,000 - 14,000) = 34,000$ (A$34,000).
5. **Net Cash Provided by Operating Activities (Direct Method):** $896,000 - 560,000 - 175,000 - 26,000 - 34,000 = 101,000$ (A$101,000). Reconciling via the Indirect Method confirms this result: Profit After Tax (A$84,000) + Depreciation (A$42,000) – Gain on Disposal (A$6,000) – Increase in AR (A$24,000) – Increase in Inventory (A$20,000) + Decrease in Prepayments (A$5,000) + Increase in AP (A$12,000) + Increase in Accrued Expenses (A$6,000) + Increase in Tax Payable (A$2,000) = A$101,000.
6. **Investing & Financing Cash Flows:** Net Cash used in Investing Activities equals proceeds from PPE disposal (+A$26,000) less new Store Equipment acquired (–A$102,000) = –A$76,000. Net Cash from Financing Activities equals ordinary share issue proceeds (+A$50,000) less cash dividends paid (–A$34,000) = +A$16,000. Combining all three streams gives $+101,000 - 76,000 + 16,000 = +41,000$ (A$41,000), reconciling Opening Cash (A$45,000) to Closing Cash (A$86,000).

Statement of Cash Flows (Year Ended 30 June 2026 — Direct Method)	A$	Indirect Reconciliation Note	A$
Receipts from customers	896,000	Profit After Tax	84,000
Payments to suppliers	(560,000)	Add: Depreciation Expense	42,000
Payments for operating expenses	(175,000)	Less: Gain on Disposal of Equipment	(6,000)
Interest paid	(26,000)	Increase in Accounts Receivable	(24,000)
Income taxes paid	(34,000)	Increase in Inventory	(20,000)
Net Cash from Operating Activities	**101,000**	Decrease in Prepaid Expenses	5,000
Proceeds from sale of store equipment	26,000	Increase in Accounts Payable	12,000
Purchase of new store equipment	(102,000)	Increase in Accrued Operating Expenses	6,000
Net Cash used in Investing Activities	**(76,000)**	Increase in Income Tax Payable	2,000
Proceeds from issue of ordinary shares	50,000	**Net Cash from Operating Activities**	**101,000**
Dividends paid to shareholders	(34,000)		
Net Cash from Financing Activities	**16,000**		
Net Increase in Cash	**41,000**	Opening Cash (1 July 2025)	45,000
Closing Cash (30 June 2026)	**86,000**	**Closing Cash (30 June 2026)**	**86,000**

Free Cash Flow Analysis

Analysts frequently supplement the `AASB 107` Statement of Cash Flows by computing **Free Cash Flow (FCF)**, which measures discretionary cash remaining after funding capital replacements and shareholder dividends:

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> $$\text{Free Cash Flow} = \text{Net Operating Cash Flow} - \text{Capital Expenditures (CapEx)} - \text{Cash Dividends Paid}$$

Where:

- Net Operating Cash Flow: Net cash inflows generated by core operating activities under `AASB 107`
- Capital Expenditures (CapEx): Gross cash outflows to acquire property, plant, equipment, and intangibles
- Cash Dividends Paid: Cash distributions paid to equity holders during the reporting period

For *Port Phillip Retail Ltd* in FY2026, $\text{FCF} = 101,000 - 102,000 - 34,000 = -35,000$ (–A$35,000). The negative FCF does not indicate operating distress; rather, the company undertook major store equipment expansion (A$102,000 CapEx), financed constructively through equipment trade-in proceeds (A$26,000) and the A$50,000 ordinary share placement.

Non-Cash Investing and Financing Activities (AASB 107 para. 43)

Material investing and financing transactions that do not require the immediate use of cash or cash equivalents—such as acquiring machinery directly via a vendor loan or lease liability, converting corporate debt into ordinary shares, issuing bonus shares, or revaluing land upward by A$30,000—must be **excluded** from the face of the Statement of Cash Flows so that cash-only flows remain transparent. Instead, `AASB 107` requires entities to disclose material non-cash investing and financing transactions elsewhere in the financial statement notes.

4. Financial Statement Analysis and Ratio Interpretation

4.1 Analytical Techniques: Horizontal, Vertical, and Ratio Analysis

Raw dollar figures on financial statements convey limited meaning in isolation; reporting A$84,000 of net profit is impressive for a boutique consultancy with A$200,000 in assets yet weak for a retailer deploying A$5 million in capital. Analysts apply three complementary techniques:

- **Horizontal (Trend) Analysis:** Evaluates percentage changes in financial statement items across consecutive years ($\frac{\text{Year}_t - \text{Year}_{t-1}}{\text{Year}_{t-1}} \times 100\%$). For *Port Phillip Retail Ltd*, Total Assets expanded by $\frac{900,000 - 750,000}{750,000} = 20.0\%$, driven largely by Store Equipment investment and Accounts Receivable growth ($+26.7\%$).
- **Vertical (Common-Size) Analysis:** Expresses every item on the Balance Sheet as a percentage of Total Assets, and every item on the Income Statement as a percentage of Sales Revenue. This neutralises size differences when comparing a smaller firm against an ASX-listed benchmark like Wesfarmers or JB Hi-Fi.
- **Ratio Analysis:** Computes mathematical relationships across liquidity, solvency, and profitability dimensions, evaluated against prior periods (intra-company), competitors (inter-company), and industry averages.

Worked Horizontal and Vertical Balance Sheet Analysis (*Port Phillip Retail Ltd*)

Balance Sheet Component	2026 (A$)	2025 (A$)	Change (A$)	Horizontal %	2026 Vertical (% TA)	2025 Vertical (% TA)
Cash and Cash Equivalents	86,000	45,000	+41,000	+91.1%	9.56%	6.00%
Accounts Receivable (net)	114,000	90,000	+24,000	+26.7%	12.67%	12.00%
Inventory	130,000	110,000	+20,000	+18.2%	14.44%	14.67%
Prepaid Expenses	10,000	15,000	−5,000	−33.3%	1.11%	2.00%
Total Current Assets	**340,000**	**260,000**	**+80,000**	**+30.8%**	**37.78%**	**34.67%**
Non-Current Assets (Land & Equipment)	560,000	490,000	+70,000	+14.3%	62.22%	65.33%
Total Assets	**900,000**	**750,000**	**+150,000**	**+20.0%**	**100.00%**	**100.00%**
Total Current Liabilities	140,000	120,000	+20,000	+16.7%	15.56%	16.00%
Long-Term Bank Loan	200,000	200,000	0	0.0%	22.22%	26.67%
Total Liabilities	**340,000**	**320,000**	**+20,000**	**+6.3%**	**37.78%**	**42.67%**
Total Shareholders' Equity	**560,000**	**430,000**	**+130,000**	**+30.2%**	**62.22%**	**57.33%**

Vertical analysis confirms a structural shift toward stronger solvency: Total Liabilities declined from 42.67% to 37.78% of Total Assets while Shareholders' Equity rose from 57.33% to 62.22%, funded by profitable retention and the FY2026 share issue.

4.2 Liquidity and Working-Capital Efficiency Ratios

Liquidity ratios measure an entity's short-term ability to meet maturing obligations within the next twelve months and convert working capital smoothly into cash:

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$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}, \qquad \text{Quick Ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Net Receivables}}{\text{Current Liabilities}}$$

$$\text{Receivables Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}, \qquad \text{Average Collection Period} = \frac{365}{\text{Receivables Turnover}}$$

$$\text{Inventory Turnover} = \frac{\text{Cost of Sales}}{\text{Average Inventory}}, \qquad \text{Days in Inventory} = \frac{365}{\text{Inventory Turnover}}$$

Where:

- $\text{Current Assets}, \text{Current Liabilities}$: Short-term assets and obligations expected to be realised or settled within 12 months
- Quick Assets: Most liquid current assets ($\text{Cash} + \text{Marketable Securities} + \text{Receivables}$), excluding Inventory and Prepayments
- $\text{Average Accounts Receivable} = \frac{\text{Opening AR} + \text{Ending AR}}{2}$
- $\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Ending Inventory}}{2}$

Worked Liquidity Calculations (*Port Phillip Retail Ltd*, FY2026)

1. **Current Ratio:** $\frac{340{,}000}{140{,}000} = 2.43 \text{ times}$ (improved from $\frac{260{,}000}{120{,}000} = 2.17$ in FY2025), indicating strong short-term coverage above A$2.00 of current assets per dollar of current debt.
2. **Quick (Acid-Test) Ratio:** $\frac{86{,}000 + 114{,}000}{140{,}000} = \frac{200{,}000}{140{,}000} = 1.43 \text{ times}$, confirming immediate obligations can be met without relying on inventory liquidation.
3. **Receivables Turnover & Collection Period:** Average AR = $\frac{90{,}000 + 114{,}000}{2} = 102{,}000$ (A$102,000). Receivables Turnover = $\frac{920{,}000}{102{,}000} = 9.02 \text{ times}$; Average Collection Period = $\frac{365}{9.02} = 40.5 \text{ days}$. If standard credit terms are 30 days, a 40.5-day collection cycle signals mild collection lag warranting credit-control review.
4. **Inventory Turnover & Days in Inventory:** Average Inventory = $\frac{110{,}000 + 130{,}000}{2} = 120{,}000$ (A$120,000). Inventory Turnover = $\frac{552{,}000}{120{,}000} = 4.60 \text{ times}$; Days in Inventory = $\frac{365}{4.60} = 79.3 \text{ days}$ to sell stock once acquired.

Cash Conversion Cycle (Working Capital Efficiency)

Combining inventory holding duration, customer collection duration, and supplier credit duration yields the **Cash Conversion Cycle (CCC)**—the net number of days cash remains tied up in working capital:

$$\text{Cash Conversion Cycle} = \text{Days in Inventory} + \text{Average Collection Period} - \text{Accounts Payable Period}$$

Where:

- Days in Inventory: Average days goods remain in warehouse before sale
- $\text{Average Collection Period}$: Average days elapsed between credit sale and cash collection
- $\text{Accounts Payable Period} = \frac{365}{\text{Purchases} \div \text{Average Accounts Payable}}$: Average days credit extended by suppliers

For *Port Phillip Retail Ltd*, Purchases = $552{,}000 + (130{,}000 - 110{,}000) = 572{,}000$ (A$572,000) and Average AP = $\frac{70{,}000 + 82{,}000}{2} = 76{,}000$ (A$76,000). Payables Turnover = $\frac{572{,}000}{76{,}000} = 7.53 \text{ times}$, giving Accounts Payable Period = $\frac{365}{7.53} = 48.5 \text{ days}$. Thus, $\text{CCC} = 79.3 + 40.5 - 48.5 = 71.3 \text{ days}$ of net working-capital financing required.

4.3 Solvency (Capital Structure) Ratios

Solvency ratios evaluate long-term financial survival and capacity to service ongoing interest commitments:

$$\text{Debt-to-Assets} = \frac{\text{Total Liabilities}}{\text{Total Assets}}, \qquad \text{Debt-to-Equity} = \frac{\text{Total Liabilities}}{\text{Total Equity}}, \qquad \text{Times Interest Earned} = \frac{\text{EBIT}}{\text{Interest Expense}}$$

Where:

- $\text{Total Liabilities}, \text{Total Assets}, \text{Total Equity}$: Closing Balance Sheet totals at 30 June 2026
- EBIT: Earnings Before Interest and Tax (Operating Profit plus non-operating gains before finance costs and income tax)
- Interest Expense: Gross finance costs incurred on borrowings during the period

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Worked Solvency Calculations (*Port Phillip Retail Ltd*, FY2026)

- **Debt-to-Assets:** $\frac{340,000}{900,000} = 37.78\%$ (down from $\frac{320,000}{750,000} = 42.67\%$ in FY2025, reflecting equity raising and retained profit growth).
- **Debt-to-Equity:** $\frac{340,000}{560,000} = 60.71\%$.
- **Times Interest Earned (Interest Coverage):** $\frac{146,000}{26,000} = 5.62$ times, demonstrating comfortable operating earnings headroom to service annual interest payments.

4.4 Profitability Ratios and DuPont ROE Decomposition

Profitability ratios assess management's effectiveness in generating operating margins and returns on invested assets and shareholder capital:

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Net Sales}}, \qquad \text{Net Profit Margin} = \frac{\text{Profit After Tax}}{\text{Net Sales}}$$

$$\text{ROA} = \frac{\text{Profit After Tax}}{\text{Average Total Assets}}, \qquad \text{ROE} = \frac{\text{Profit After Tax}}{\text{Average Total Equity}}$$

$$\text{EPS} = \frac{\text{Profit After Tax} - \text{Preference Dividends}}{\text{Weighted Average Ordinary Shares}}, \qquad \text{P/E Ratio} = \frac{\text{Share Market Price}}{\text{EPS}}$$

Where:

- $\text{Average Total Assets} = \frac{\text{Opening Assets} + \text{Ending Assets}}{2}$; $\text{Average Total Equity} = \frac{\text{Opening Equity} + \text{Ending Equity}}{2}$
- EPS: Earnings Per Share (in A$ per ordinary share, governed by `AASB 133 Earnings per Share`)
- P/E Ratio: Price-to-Earnings multiple reflecting market growth expectations relative to current earnings

To diagnose the underlying drivers of shareholder return, the **DuPont Identity** decomposes Return on Equity into three multiplicative levers—operating efficiency, asset productivity, and financial leverage:

$$\text{ROE} = \left(\frac{\text{Profit After Tax}}{\text{Net Sales}}\right) \times \left(\frac{\text{Net Sales}}{\text{Average Total Assets}}\right) \times \left(\frac{\text{Average Total Assets}}{\text{Average Total Equity}}\right)$$

Where:

- $\frac{\text{Profit After Tax}}{\text{Net Sales}}$: Net Profit Margin (cost control and pricing power)
- $\frac{\text{Net Sales}}{\text{Average Total Assets}}$: Asset Turnover (revenue generated per dollar of asset base)
- $\frac{\text{Average Total Assets}}{\text{Average Total Equity}}$: Equity Multiplier (financial leverage magnifying asset returns into equity returns)

Worked Profitability & DuPont Calculations (*Port Phillip Retail Ltd*, FY2026)

1. **Gross Profit Margin:** $\frac{368,000}{920,000} = 40.00\%$. **Net Profit Margin:** $\frac{84,000}{920,000} = 9.13\%$.
2. **Return on Assets (ROA):** Average Assets = $\frac{750,000+900,000}{2} = 825,000$ (A$825,000). ROA = $\frac{84,000}{825,000} = 10.18\%$.
3. **Return on Equity (ROE):** Average Equity = $\frac{430,000+560,000}{2} = 495,000$ (A$495,000). ROE = $\frac{84,000}{495,000} = 16.97\%$.
4. **DuPont Check:** Net Profit Margin (9.1304%) × Asset Turnover ($\frac{920,000}{825,000} = 1.1152$ times) × Equity Multiplier ($\frac{825,000}{495,000} = 1.6667$ times) $= 0.091304 \times 1.1152 \times 1.6667 = 16.97\%$.
5. **EPS, P/E Ratio & Dividend Payout:** $\text{EPS} = \frac{84,000}{175,000} = 0.48$ (A$0.48 per share). At a market share price of A$4.80, $\text{P/E Ratio} = \frac{4.80}{0.48} = 10.0$ times. Dividend Payout Ratio = $\frac{34,000}{84,000} = 40.48\%$, indicating 59.52% of earnings are retained to fund store expansion.

Integrated Ratio Diagnostic Summary (*Port Phillip Retail Ltd*, FY2026)

Analytical Dimension	Ratio	FY2026 Result	Economic Interpretation
Liquidity	Current Ratio / Quick Ratio	2.43x / 1.43x	Healthy short-term buffer; liquid assets alone exceed current liabilities.
Efficiency	Collection Period / Days in Inv.	40.5 days / 79.3 days	Moderate collection lag; 71.3-day net Cash Conversion Cycle.

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Analytical Dimension	Ratio	FY2026 Result	Economic Interpretation
Solvency	Debt-to-Assets / Interest Cover	37.78% / 5.62x	Conservative leverage with strong operating interest coverage.
Profitability	Gross Margin / Net Margin	40.00% / 9.13%	Solid retail markup and disciplined post-tax net margin.
Returns	ROA / ROE (DuPont verified)	10.18% / 16.97%	Effective leverage amplification (1.67x equity multiplier) on asset returns.
Market Valuation	EPS / P/E / Payout Ratio	A$0.48 / 10.0x / 40.48%	Balanced reinvestment (59.5% retention) alongside franked cash dividends.

Vertical Income Statement & Peer DuPont Benchmarking

Comparing *Port Phillip Retail Ltd* (FY2026) on a common-size vertical basis against an Australian listed retail peer, *Bayside Mercantile Ltd*, illustrates how DuPont analysis exposes contrasting strategic models behind identical headline returns on equity:

Metric / Common-Size Income Line	Port Phillip Retail Ltd	Bayside Mercantile Ltd (Peer)	Analytical Comparison
Sales Revenue (Vertical Base)	100.00% (A$920,000)	100.00% (A$2,400,000)	Bayside operates at 2.6× higher revenue scale.
Cost of Sales (% of Sales)	60.00%	72.00%	Port Phillip sources higher-margin specialty goods.
Gross Profit Margin	**40.00%**	**28.00%**	Port Phillip commands superior pricing power (+12.0 pp).
Net Profit Margin (PAT / Sales)	9.13%	4.25%	Port Phillip retains more than double the net profit per sales dollar.
Asset Turnover (Sales / Avg Assets)	1.115×	2.000×	Bayside turns over inventory and store assets much faster.
Equity Multiplier (Avg Assets / Avg Eq.)	1.667×	2.000×	Bayside uses higher debt leverage (50% debt-to-assets).
Return on Equity (ROE)	**16.97%**	**17.00%**	Nearly identical ROE driven by margin vs volume + leverage.

4.5 Quality of Earnings and Limitations of Financial Statement Analysis

Before relying on historical ratios for lending or equity valuation, analysts assess **earnings quality**—the extent to which reported accrual profit is backed by verifiable operating cash inflows and sustainable core operations rather than one-off gains or aggressive accrual estimates. A widely used diagnostic is the **Quality of Earnings Ratio**:

$$\text{Quality of Earnings Ratio} = \frac{\text{Net Cash from Operating Activities}}{\text{Profit After Tax}}$$

Where:

- Net Cash from Operating Activities: Operating cash flow reported under `AASB 107`
- Profit After Tax: Accrual net profit reported under `AASB 101`

For *Port Phillip Retail Ltd* in FY2026, $\text{Quality of Earnings Ratio} = \frac{101,000}{84,000} = 1.20 \text{ times}$. Because operating cash inflows exceed accrual net profit by 20% (principally because non-cash depreciation of A$42,000 exceeds working capital build-up), reported earnings exhibit strong cash-flow backing.

Worked Managerial Decision Case: Working Capital Release via Credit Control

Suppose management of *Port Phillip Retail Ltd* identifies that its 40.5-day Average Collection Period exceeds its 30-day credit terms and implements automated EFT invoicing to restore ending Accounts Receivable to a strict 30-day collection target on A$920,000 annual credit sales:

1. **Target Ending Accounts Receivable:** $\text{Target AR} = \frac{920,000 \times 30}{365} = 75,616$ (A$75,616).
2. **Cash Released from Working Capital:** Comparing target AR (A$75,616) against actual 30 June 2026 AR (A$114,000) frees $114,000 - 75,616 = 38,384$ (A$38,384) in cash without raising external debt or equity.
3. **Strategic Impact:** Applying that A$38,384 cash release to retire current borrowings reduces Total Liabilities from A$340,000 to A$301,616 (lowering Debt-to-Assets from 37.78% to $\frac{301,616}{861,616} = 35.01\%$) and lifts FY2026 Free Cash Flow from –A$35,000 into positive

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territory (+A$3,384).

Even with cash-flow verification, sound analytical judgement requires recognising four structural limitations of accounting ratios:

- **Historical Cost and Inflation Distortion:** Carrying amounts on the Balance Sheet frequently mix historical acquisition costs across different decades with selectively revalued assets, distorting Asset Turnover and ROA comparisons between older and newly established enterprises.
- **Alternative AASB Accounting Policies:** Two economically identical companies can report different profits and carrying values solely because one adopts FIFO and Diminishing-Balance depreciation while the other uses Weighted Average inventory and Straight-Line depreciation.
- **Window Dressing and Year-End Seasonality:** Balance Sheet ratios capture a single snapshot on 30 June. Seasonal retailers (whose peak inventory occurs in November before Christmas) appear more liquid and leaner in late June than mid-year.
- **Omission of Non-Financial and Intangible Drivers:** Financial statements omit internally generated brand equity, human capital quality, customer loyalty, and emerging environmental, social, and governance (ESG) risks—increasingly addressed in Australia through mandatory climate-related financial disclosures (`AASB S2`) for large reporting entities.

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