# FONTERRA CO-OPERATIVE GROUP LIMITED

## FINANCIAL STATEMENTS 2008

Dairy for life

# FINANCIAL STATEMENTS

The Directors hereby approve the financial statements for the 14 months ended 31 July 2008.

For and on behalf of the Board of Directors:

Henry van der Heyden
23 September 2008

David Jackson
23 September 2008

| PAYOUT TO SHAREHOLDER SUPPLIERS[1] | | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|---|
| | Notes | **$ million** | **Kg MS (million)** | **$ per kg MS** | $ million | Kg MS (million) | $ per kg MS |
| Cost of milk/milk price | 1 | **8,978** | **1,183** | **7.59** | 4,812 | 1,243 | 3.87 |
| Available value return | 2 | **364** | **1,183** | **0.31** | 728 | 1,243 | 0.59 |
| **Total available for payout** | | **9,342** | **1,183** | **7.90** | 5,540 | 1,243 | 4.46 |
| Less retentions from available value return | 2 | **(277)** | **1,183** | **(0.24)** | – | 1,243 | – |
| Supplier premiums | 1 | **33** | **1,183** | **0.03** | 52 | 1,243 | 0.04 |
| Payout to shareholder suppliers (after retentions) | | **9,098** | **1,183** | **7.69** | 5,592 | 1,243 | 4.50 |

(1) Payout to shareholder suppliers for 2007 is based on the actual payout calculation and does not incorporate subsequent adjustments relating to the transition to New Zealand Equivalents to International Financial Reporting Standards.

The accompanying notes form part of these financial statements.

# INCOME STATEMENT

FOR THE 14 MONTHS ENDED **31 JULY 2008**

| | | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|---|
| | Notes | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Revenue from sale of goods** | | **19,512** | 13,687 | **9,198** | 4,870 |
| Cost of goods sold | 1 | **(16,820)** | (10,853) | **(9,198)** | (4,870) |
| **Gross profit** | | **2,692** | 2,834 | **–** | – |
| Other operating income | | **108** | 96 | **31** | 5 |
| Selling and marketing expenses | | **(507)** | (436) | **(4)** | (2) |
| Distribution expenses | | **(502)** | (441) | **–** | – |
| Administrative expenses | | **(840)** | (640) | **(372)** | (236) |
| Net foreign exchange gains | | **9** | 30 | **–** | – |
| Other operating expenses | | **(362)** | (225) | **(93)** | (76) |
| **Operating profit/(loss) before finance costs, equity accounted income and tax** | 3 | **598** | 1,218 | **(438)** | (309) |
| Finance income | 4 | **76** | 24 | **497** | 372 |
| Finance costs | 4 | **(443)** | (358) | **(401)** | (340) |
| **Net finance (costs)/income** | | **(367)** | (334) | **96** | 32 |
| Share of profit of equity accounted investees | 10 | **158** | 73 | **–** | – |
| Impairment of equity accounted investees | 10 | **(142)** | (25) | **–** | – |
| **Profit/(loss) before tax** | | **247** | 932 | **(342)** | (277) |
| Tax credit/(expense) | 5 | **47** | (279) | **84** | 71 |
| **Profit/(loss) from continuing operations** | | **294** | 653 | **(258)** | (206) |
| Profit from discontinued operations (net of tax) | | **–** | – | **–** | – |
| **Profit/(loss) for the period (before value return)** | 2 | **294** | 653 | **(258)** | (206) |
| **Profit/(loss) for the period (before value return) is attributable to:** | | | | | |
| Shareholder suppliers | 2 | **244** | 622 | **(258)** | (206) |
| Minority interests | 2 | **50** | 31 | **–** | – |
| **Profit/(loss) for the period (before value return)** | | **294** | 653 | **(258)** | (206) |
| | | | | | |
| **Retained profit/(loss) for the period (after value return)** | | | | | |
| Profit/(loss) for the period (before value return) | 2 | **294** | 653 | **(258)** | (206) |
| Available value return | | **(364)** | (728) | **(364)** | (728) |
| Less retentions from available value return | | **277** | – | **277** | – |
| Value return paid to shareholder suppliers | 6 | **(87)** | (728) | **(87)** | (728) |
| Tax credit arising on value return paid to shareholder suppliers | 6 | **28** | 240 | **28** | 240 |
| **Retained profit/(loss) for the period (after value return)** | | **235** | 165 | **(317)** | (694) |

The accompanying notes form part of these financial statements.

# STATEMENT OF TOTAL RECOGNISED INCOME AND EXPENSE

FOR THE 14 MONTHS ENDED **31 JULY 2008**

| | | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|---|
| | Notes | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| Cash flow hedges: | | | | | |
| – net fair value gains | | **354** | 421 | **–** | – |
| – transferred and reported in revenue | | **(717)** | (197) | **–** | – |
| – transferred to goodwill | | **24** | – | **–** | – |
| – tax on cash flow hedge transactions | | **102** | (74) | **–** | – |
| – effect of tax rate change on cash flow hedge reserve | | **–** | 6 | **–** | – |
| Net investment hedges: | | | | | |
| – net fair value gains/(losses) | | **(178)** | 83 | **–** | – |
| – tax on net fair value gains/(losses) | | **54** | (26) | **–** | – |
| Foreign currency translation attributable to shareholder suppliers | | **162** | (89) | **–** | – |
| Foreign currency translation reserve transferred to profit/(loss) | | **(1)** | – | **–** | – |
| Foreign currency translation attributable to minority interests | | **12** | (18) | **–** | – |
| Share of equity accounted investees reserve movements | | **(1)** | – | **–** | – |
| **Income and expense recognised directly in equity** | 6 | **(189)** | 106 | **–** | – |
| Profit/(loss) for the period (before value return) | 6 | **294** | 653 | **(258)** | (206) |
| **Total recognised income and expense for the period** | | **105** | 759 | **(258)** | (206) |
| **Attributable to:** | | | | | |
| Shareholder suppliers | | **43** | 746 | **(258)** | (206) |
| Minority interests | | **62** | 13 | **–** | – |
| **Total recognised income and expense for the period** | | **105** | 759 | **(258)** | (206) |

The accompanying notes form part of these financial statements.

# BALANCE SHEET

AS AT **31 JULY 2008**

| | | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|---|
| | Notes | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| **ASSETS** | | | | | |
| **Current assets** | | | | | |
| Cash and cash equivalents | | **681** | 184 | **469** | 5 |
| Trade and other receivables | 7 | **2,216** | 2,139 | **8,093** | 7,166 |
| Inventories | 8 | **3,288** | 2,783 | **–** | – |
| Taxation receivable | | **31** | – | **201** | 304 |
| Derivative financial instruments | 19 | **183** | 698 | **179** | 698 |
| Other current assets | | **58** | 35 | **–** | – |
| **Total current assets** | | **6,457** | 5,839 | **8,942** | 8,173 |
| **Non-current assets** | | | | | |
| Property, plant and equipment | 9 | **4,292** | 4,232 | **74** | 33 |
| Investment in subsidiaries | | **–** | – | **6,860** | 6,860 |
| Equity accounted investments | 10 | **592** | 630 | **–** | – |
| Intangible assets | 11 | **2,680** | 2,507 | **30** | 43 |
| Deferred tax asset | 15 | **139** | 10 | **149** | 145 |
| Derivative financial instruments | 19 | **103** | 127 | **103** | 127 |
| Other non-current assets | | **176** | 149 | **65** | 76 |
| **Total non-current assets** | | **7,982** | 7,655 | **7,281** | 7,284 |
| **Total assets** | | **14,439** | 13,494 | **16,223** | 15,457 |
| **LIABILITIES** | | | | | |
| **Current liabilities** | | | | | |
| Bank overdraft | | **67** | 69 | **–** | 40 |
| Borrowings | 14 | **2,016** | 1,066 | **1,840** | 832 |
| Trade and other payables | 12 | **1,271** | 939 | **6,429** | 5,512 |
| Owing to suppliers | | **1,069** | 974 | **1,069** | 974 |
| Taxation payable | | **55** | 15 | **–** | – |
| Derivative financial instruments | 19 | **348** | 308 | **347** | 308 |
| Provisions | 13 | **233** | 115 | **66** | 51 |
| Other current liabilities | | **12** | 4 | **1** | 2 |
| **Total current liabilities** | | **5,071** | 3,490 | **9,752** | 7,719 |
| **Non-current liabilities** | | | | | |
| Borrowings | 14 | **4,502** | 4,059 | **2,886** | 3,108 |
| Capital notes | 16 | **35** | 35 | **35** | 35 |
| Derivative financial instruments | 19 | **155** | 296 | **155** | 296 |
| Provisions | 13 | **64** | 45 | **47** | 32 |
| Deferred tax liability | 15 | **288** | 534 | **–** | – |
| Other non-current liabilities | | **55** | 57 | **–** | 2 |
| **Total non-current liabilities** | | **5,099** | 5,026 | **3,123** | 3,473 |
| **Total liabilities** | | **10,170** | 8,516 | **12,875** | 11,192 |
| **EQUITY** | | | | | |
| Co-operative shares | 6 | **4,297** | 4,897 | **4,297** | 4,897 |
| Retained earnings | 6 | **18** | (166) | **(949)** | (632) |
| Foreign currency translation reserve | 6 | **(1)** | (38) | **–** | – |
| Cash flow hedge reserve | 6 | **(88)** | 149 | **–** | – |
| **Total equity attributable to shareholder suppliers** | | **4,226** | 4,842 | **3,348** | 4,265 |
| Minority interests | 6 | **43** | 136 | **–** | – |
| **Total equity** | | **4,269** | 4,978 | **3,348** | 4,265 |
| **Total liabilities and equity** | | **14,439** | 13,494 | **16,223** | 15,457 |

The accompanying notes form part of these financial statements.

# CASH FLOW STATEMENT

FOR THE 14 MONTHS ENDED **31 JULY 2008**

| | | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|---|
| | Notes | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Cash flows from operating activities** | | | | | |
| Cash was provided from: | | | | | |
| – Receipts from customers | | **19,537** | 13,894 | **9,226** | 4,900 |
| – Dividends received | | **129** | 44 | **–** | – |
| – Taxation received | | **1** | 32 | **–** | 20 |
| Cash was applied to: | | | | | |
| – Payments to creditors and employees | | **(7,922)** | (5,947) | **(393)** | (266) |
| – Payments for milk supplied | | **(10,299)** | (5,795) | **(8,855)** | (4,877) |
| – Taxation paid | | **(136)** | (64) | **–** | – |
| **Net cash flows from operating activities** | 17 | **1,310** | 2,164 | **(22)** | (223) |
| **Cash flows from investing activities** | | | | | |
| Cash was provided from: | | | | | |
| – Proceeds from disposal of property, plant and equipment | | **94** | 21 | **1** | – |
| – Cash received from minority interest | | **3** | – | **–** | – |
| – Proceeds from sale of subsidiaries, net of cash disposed | | **26** | 79 | **–** | – |
| – Repayment of advances | | **–** | 76 | **–** | – |
| – Proceeds from hedging of net investments | | **–** | 84 | **–** | 84 |
| – Repayment of loans to other entities | | **–** | 10 | **–** | – |
| – Net loans from subsidiaries | | **–** | – | **994** | 1,831 |
| Cash was applied to: | | | | | |
| – Acquisition of property, plant and equipment | | **(578)** | (431) | **(18)** | (5) |
| – Acquisition of intangibles | | **(38)** | (40) | **(14)** | (20) |
| – Acquisition of subsidiaries, net of cash acquired | 18 | **–** | (85) | **–** | – |
| – Purchase of minority interests | | **(292)** | – | **–** | – |
| – Acquisition of other non-current assets | | **(8)** | (11) | **(4)** | (6) |
| – Acquisition of equity accounted investments | | **(2)** | (315) | **–** | – |
| **Net cash flows from investing activities** | | **(795)** | (612) | **959** | 1,884 |
| **Cash flows from financing activities** | | | | | |
| Cash was provided from: | | | | | |
| – Net proceeds from borrowings | | **6,313** | 3,851 | **5,354** | 3,456 |
| – Proceeds from issue of co-operative shares | | **1,098** | 1,276 | **1,098** | 1,276 |
| – Proceeds from co-operative shares not yet issued | | **44** | – | **44** | – |
| – Repayment of deferred share receivable | | **–** | 1 | **–** | 1 |
| – Interest received | | **76** | 26 | **59** | 15 |
| Cash was applied to: | | | | | |
| – Interest paid | | **(457)** | (402) | **(359)** | (336) |
| – Net repayments of borrowings | | **(5,022)** | (3,791) | **(4,568)** | (3,715) |
| – Repurchase of capital notes | | **–** | (577) | **–** | (577) |
| – Surrender of co-operative shares | | **(1,425)** | (237) | **(1,425)** | (237) |
| – Surrender of peak notes | | **–** | (1,111) | **–** | (1,111) |
| – Dividends paid to minority interests | | **(16)** | (10) | **–** | – |
| – Value return payment to shareholder suppliers | | **(636)** | (466) | **(636)** | (466) |
| **Net cash flows from financing activities** | | **(25)** | (1,440) | **(433)** | (1,694) |
| **Net increase/(decrease) in cash and cash equivalents** | | **490** | 112 | **504** | (33) |
| Cash and cash equivalents at the beginning of the period | | **115** | 22 | **(35)** | (2) |
| Effect of exchange rate changes on cash balances | | **9** | (19) | **–** | – |
| **Cash and cash equivalents at end of period** | | **614** | 115 | **469** | (35) |
| **Reconciliation of closing cash balances to the balance sheet:** | | | | | |
| Cash and cash equivalents | | **681** | 184 | **469** | 5 |
| Bank overdraft | | **(67)** | (69) | **–** | (40) |
| **Closing cash balances** | | **614** | 115 | **469** | (35) |

The accompanying notes form part of these financial statements.

# STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

FOR THE 14 MONTHS ENDED **31 JULY 2008**

***a) General information***

Fonterra Co-operative Group Limited ("Fonterra", "Parent", or the "Company") is a co-operative company incorporated and domiciled in New Zealand. Fonterra is registered under the Companies Act 1993, the Co-operative Companies Act 1996, and the Dairy Industry Restructuring Act 2001, and is an issuer for the purpose of the Financial Reporting Act 1993.

On 24 January 2008 Fonterra changed its balance date to 31 July, there is no change in the season end date and no change in the dates for issuing or redeeming of shares. The later 31 July balance date better reflects Fonterra's financial performance from the sales of milk supplied in the season. Financial statements for Fonterra and consolidated financial statements have been prepared for the 14 months ended 31 July 2008. The comparative period is for the 12 months ended 31 May 2007 and therefore the comparative amounts shown in the income statement, statement of total recognised income and expense, the cash flow statement and related notes may not be directly comparable.

The consolidated financial statements comprise the Company, its subsidiaries (together referred to as the "Group") and the Group's interests in its equity accounted investees.

The Group is primarily involved in the collection, manufacture and sale of milk and milk derived products and is a profit-oriented entity.

***b) Basis of preparation***

On 1 June 2007 Fonterra adopted New Zealand Equivalents to International Financial Reporting Standards ("NZ IFRS"). These financial statements have been prepared in accordance with New Zealand Generally Accepted Accounting Practice ("NZ GAAP"). They comply with NZ IFRS, and other applicable Financial Reporting Standards, as appropriate for profit-oriented entities. These financial statements also comply with International Financial Reporting Standards ("IFRS").

NZ IFRS 1: First-time adoption of NZ IFRS, requires an entity to use the same accounting policies in its opening NZ IFRS balance sheet and throughout all the periods presented in its first NZ IFRS financial statements. The Group has adjusted amounts reported previously in financial statements prepared in accordance with its old basis of accounting ("Previous NZ GAAP"), except where exemptions from full retrospective application of NZ IFRS, allowable under NZ IFRS 1, have been applied. Note 26 explains the transition from Previous NZ GAAP to NZ IFRS.

These financial statements are prepared on a historical cost basis except for derivative financial instruments and the hedged risks on certain debt instruments, which are recognised at their fair values.

These financial statements are presented in New Zealand dollars ("$"), which is the Company's functional and presentation currency, and rounded to the nearest million.

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions of accounting estimates are recognised in the period in which the estimates are revised and in any future periods affected.

In particular, information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements are described in the following notes:

- Policies (r) & (k) Calculation of Milk Price.
- Note 11 Intangible assets – Measurement of the recoverable amount of cash generating units and brands, and assessment of useful lives.
- Note 13 Provisions.
- Note 19 Financial instruments – Fair value of certain financial instruments.

***c) Basis of consolidation***

*Subsidiaries*

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Subsidiaries are included in the consolidated financial statements using the purchase method of consolidation from the date control commences until the date control ceases.

# STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets acquired, the difference is recognised directly in the income statement.

Minority interests not held by the Group are allocated their share of profit for the period in the income statement and are presented within equity in the balance sheet, separately from equity attributable to shareholder suppliers.

*Equity accounted investees (associates and jointly controlled entities)*
Associates are those entities in which the Group has significant influence but not control over the financial and operating policies. Jointly controlled entities are those entities over whose activities the Group has joint control, established by contractual agreement and requiring unanimous consent for strategic financial and operating decisions. Equity accounted investees are initially recognised at cost (including any goodwill identified on acquisition). Subsequent to initial recognition they are accounted for using the equity method in the consolidated financial statements. The consolidated financial statements include the Group's share of the profit or loss after tax of equity accounted investees, after adjustments to align to the accounting policies of the Group, from the date that significant influence or joint control commences until the date that significant influence or joint control ceases. When the Group's share of losses exceeds its interest in an equity accounted investee, the carrying amount of that interest is reduced to nil and no further losses are recognised except to the extent the Group has an obligation or has made payments on behalf of the investee. Dividends receivable from equity accounted investees are recognised in the Parent's income statement, while in the consolidated financial statements they reduce the amount of the investment.

*Transactions eliminated on consolidation*
Intra-group transactions, balances, and any unrealised income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with equity accounted investees are eliminated against the investment to the extent of the Group's interest in the investee. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

### *d) Foreign currency*

*Foreign currency transactions*
Foreign currency transactions are translated into the respective functional currencies of Group entities using the exchange rate at the dates of transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation, using the exchange rates at the reporting date, of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when deferred in equity as qualifying cash flow or qualifying net investment hedges.

*Translation of the financial statements into the presentation currency*
Where the Company's presentation currency differs from the functional currency of an entity, the assets and liabilities of the operation are translated from the functional currency into the presentation currency at the exchange rates at the reporting date. The income and expenses of these entities are translated at rates approximating the exchange rates at the dates of the transactions. Exchange differences arising on the translation of the financial statements of these entities and of borrowings and other currency instruments designated as hedges of such investments are recognised directly in the foreign currency translation reserve ("FCTR"). When an entity is partially disposed of or sold, the exchange differences that were recorded in equity are recognised in the income statement as part of the gain or loss on sale.

### *e) Financial assets and liabilities*

A financial asset or liability is recognised if the Group becomes a party to the contractual provisions of the asset or liability. A financial asset or liability is recognised initially (at trade date) at its fair value plus, in the case of a financial asset or liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the instrument. Financial assets and liabilities carried at fair value through profit or loss are initially recognised at fair value and transaction costs are expensed in the income statement.

After initial recognition, financial assets are measured at their fair values except for loans and receivables and held-to-maturity investments, which are measured at amortised cost using the effective interest method. After initial recognition, financial liabilities are measured at amortised cost using the effective interest method except for financial liabilities at fair value through profit or loss.

In the separate financial statements of the Parent, investments in subsidiaries and associates are stated at cost, less any impairment. Investments in associates are included within other non-current assets.

# STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

Financial assets are derecognised if the Group's contractual rights to the cash flows from the financial assets expire or if the Group transfers the financial asset to another party without retaining control or substantially all risks and rewards of the asset. Financial liabilities are derecognised if the Group's obligations specified in the contract expire or are discharged or cancelled.

Financial assets are classified on initial recognition into the following categories: at fair value through profit or loss, held-to-maturity investments, loans and receivables, and available-for-sale. Financial liabilities are classified as either fair value through profit or loss, or financial liabilities measured at amortised cost. The classification depends on the purpose for which the financial assets and liabilities were acquired. Management determines the classification of its financial assets and liabilities at initial recognition. The Group has not had any held-to-maturity investments or available-for-sale financial assets in the periods covered by these financial statements.

*(i) Financial assets and financial liabilities at fair value through profit or loss*
Financial assets and liabilities in this category are either classified as held for trading or designated as fair value through profit or loss. Derivatives are classified as held for trading unless designated as hedges. Other financial assets and financial liabilities may be designated at fair value through profit or loss where this eliminates an accounting mismatch, or where they are managed on a fair value basis.

*(ii) Held-to-maturity investments*
Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity for which there is a positive intention and ability to hold to maturity, other than those that are designated on initial recognition as either fair value through profit or loss or available-for-sale, or meet the definition of loans and receivables.

*(iii) Loans and receivables*
Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Trade and other receivables are classified as loans and receivables.

*(iv) Available-for-sale financial assets*
Available-for-sale financial assets are non-derivative financial assets that are either designated in this category or not classified in any of the other categories. Fair value changes are recognised directly in equity until the investment is either derecognised or determined to be impaired, at which time the cumulative gain or loss that was reported in equity is recognised in the income statement.

*(v) Financial liabilities measured at amortised cost*
Financial liabilities measured at amortised cost are non-derivative financial liabilities with fixed or determinable payments that are not quoted in an active market. Trade and other payables, and debt instruments are classified as financial liabilities measured at amortised cost.

### *f) Cash and cash equivalents*

Cash and cash equivalents comprise cash on hand, deposits held at call with banks, other short term highly liquid investments with original maturities of three months or less, and bank overdrafts.

### *g) Trade receivables*

Trade receivables are carried at their net realisable value.

### *h) Borrowings*

Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently measured at amortised cost using the effective interest method, with the hedged risks on certain debt instruments measured at fair value. Changes in fair value of those hedged risks are recognised in the income statement, except borrowings classified as net investment hedges.

Borrowings are classified as current liabilities unless the Group has an unconditional right to defer settlement of the liability for at least 12 months after balance date.

### *i) Trade and other payables*

Trade and other payables are carried at amortised cost.

### *j) Derivative financial instruments and hedging activities*

The Group uses derivative financial instruments within predetermined policies and limits in order to reduce its exposure to fluctuations in foreign currency exchange rates and interest rates.

The Group does not engage in speculative transactions or hold derivative financial instruments for trading purposes.

# STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

Derivatives are initially recognised at fair value on the date a derivative contract is entered into (the trade date) and transaction costs are expensed immediately. They are subsequently remeasured to their fair value. The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged. The Group designates certain derivatives as either:

- hedges of the fair value of recognised assets or liabilities, or a firm commitment (fair value hedges);
- hedges of a particular risk associated with a recognised liability or a highly probable forecast transaction (cash flow hedges); or
- hedges of a net investment in a foreign operation (net investment hedges).

The Group documents, at the inception of the transaction, the relationship between hedging instruments and hedged items, as well as its risk management objectives and strategy for undertaking various hedging transactions. The Group also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

The full fair value of a hedging derivative is classified as a non-current asset or liability when maturity of the hedged item exceeds 12 months. It is classified as a current asset or liability when the maturity of the hedged item is less than 12 months.

*(i) Fair value hedges*
Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recognised in the income statement, together with any changes in the fair value of the hedged asset or liability attributable to the hedged risk.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortised to profit or loss over the period to maturity.

*(ii) Cash flow hedges*
The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised directly in equity. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are transferred to the income statement when the hedged item affects profit or loss.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is recognised immediately in the income statement.

When the forecast transaction that is hedged results in the recognition of a non-financial asset (e.g. inventory or property, plant and equipment) the gains and losses previously deferred in equity are transferred from equity and included in the initial measurement of the cost of the asset.

*(iii) Net investment hedges*
Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity. The gain or loss relating to the ineffective portion is recognised immediately in the income statement.

Gains and losses accumulated in equity are included in the income statement when the foreign operation is partially disposed of or sold.

### *k) Inventories*

Inventories are stated at the lower of cost and net realisable value.

Net realisable value is the estimated selling price in the ordinary course of business, less the costs of completion and selling expenses.

The cost of dairy product manufactured from milk supplied in New Zealand is established by using the Milk Price component of payout (as outlined in the Payout to suppliers – Cost of Milk accounting policy) as the cost for raw milk supplied. In the case of manufactured inventories and work in progress, cost includes all direct costs plus that portion of the fixed and variable production overhead incurred in bringing inventories into their present location and condition.

### *l) Property, plant and equipment*

*Owned assets*
Items of property, plant and equipment are measured at cost less accumulated depreciation and impairment losses. Cost includes the purchase consideration and those costs directly attributable to bringing the asset to the location and condition necessary for

# STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

its intended use. Costs cease to be capitalised when substantially all the activities necessary to bring an asset to the location and condition for its intended use are complete. Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognised. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each financial reporting date.

Gains and losses on disposals are determined by comparing the proceeds with the carrying amount, and are recognised in the income statement.

*Depreciation*
Depreciation is calculated on a straight line basis to allocate the cost of the asset, less any residual value, over its estimated useful life. The range of estimated useful lives for each class of property, plant and equipment is as follows:

| | |
|---|---|
| Land | Indefinite |
| Buildings | 15 – 50 years |
| Plant, vehicles and equipment | 3 – 50 years |

*Leased assets*
Leases of property, plant and equipment where the Group assumes substantially all the risks and rewards of ownership are classified as finance leases.

Assets under finance leases are recognised as property, plant and equipment in the balance sheet. They are recognised initially at their fair value, or if lower, at the present value of the minimum lease payments. A corresponding liability is established and each lease payment allocated between the liability and interest expense using the effective interest method. The assets recognised are depreciated on the same basis as equivalent property, plant and equipment.

Leases that are not finance leases are classified as operating leases and the assets are not recognised on the Group's balance sheet. Operating lease payments are recognised as an expense on a straight line basis over the term of the lease.

***m) Intangible assets***

*Goodwill*
Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary or equity accounted investee at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of equity accounted investees is included in equity accounted investments and is tested for impairment as part of the overall balance. Any negative goodwill arising on an acquisition is recognised immediately in the income statement.

Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units for the purpose of impairment testing. The allocation is made to those cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose.

*Brands and other identifiable intangible assets*
Brands and other intangible assets purchased by the Group are recognised where the asset is controlled through custody or legal rights and could be sold separately from the rest of the business. Brands and other intangible assets have a combination of both indefinite and finite useful lives. Items with indefinite useful lives are tested annually for impairment and carried at cost less accumulated impairment losses. Items with finite useful lives are carried at cost less accumulated amortisation and accumulated impairment losses, and are amortised on a straight line basis to allocate the cost over their licence period. Assets that have been impaired are reviewed for possible reversal of impairment at each balance date.

*Computer software*
Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortised over their estimated useful lives, being three to eight years.

Costs associated with developing or maintaining computer software programmes are recognised as an expense as incurred. Costs that are directly associated with the development of identifiable and unique software products controlled by the Group, and that will

# STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Costs include the employee costs incurred as a result of developing software and an appropriate portion of relevant overheads.

Computer software development costs recognised as assets are amortised over their estimated useful lives, being three to eight years.

*Research and development expenditure*
All research expenditure is recognised in the income statement as incurred. Significant development expenditure is recognised as an asset when it can be demonstrated that the commercial production of the material or product, or use of the process, will commence.

Development expenditure recognised as an asset is stated at cost and amortised over the period of expected benefits on a straight line basis, not exceeding five years. Amortisation begins at the time that commercial production or use of the process commences. All other development expenditure is recognised in the income statement as incurred.

### *n) Impairment of non-financial assets*

Intangible assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment. Other assets are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the estimated recoverable amount of an asset is less than its carrying amount, the asset is written down to its estimated recoverable amount and an impairment loss is recognised in the income statement. The recoverable amount of an asset is the higher of its fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest level for which there are separately identifiable cash inflows (cash-generating units).

Non-financial assets other than goodwill that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date.

### *o) Provisions*

Provisions are recognised only in those circumstances where the Group has a present legal or constructive obligation as a result of a past event, when it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to the passage of time is recognised as a finance cost in the income statement.

### *p) Co-operative shares*

Co-operative shares are classified as equity. Incremental costs directly attributable to the issue of co-operative shares are recognised as a deduction from equity.

### *q) Revenue recognition*

Revenue from the sale of goods is recognised at the fair value of the consideration received or receivable, net of returns, discounts and allowances. Revenue is recognised when the amount of revenue can be reliably measured, significant risks and rewards of ownership of the inventory items have passed to the buyer, recovery of the consideration is probable, the associated costs and possible return of goods can be estimated reliably, and there is no continuing management involvement with the goods.

Dividend income is recognised when the right to receive payment is established.

### *r) Payout to suppliers*

Payout to shareholder suppliers comprises Cost of Milk, Supplier Premiums and Value Return.

*Cost of Milk*
The Cost of Milk comprises the volume of milk solids supplied by shareholders at the Milk Price for the season. Milk Price for the season is based upon a model determined by an independent valuer as part of the fair value share process, and broadly represents the maximum amount a hypothetical efficient competitor could afford to pay for milk and still make an adequate return on capital. The monthly commodity prices and hedged conversion rates achieved or forecast to be achieved by Fonterra are applied to this model to establish the Milk Price. Milk Price is recognised within cost of goods sold.

# STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

*Supplier Premium*

Supplier Premiums are paid for specialty milks, such as winter milk and colostrum. Supplier Premiums are recognised within cost of goods sold.

*Value Return*

The Value Return is comprised of payout to shareholder suppliers less the Cost of Milk and Supplier Premiums. Value Return is recognised directly in equity.

For accounting purposes the Value Return payout made to shareholder suppliers is treated as a transaction with them in their capacity as shareholders'. For the presentation of the interim financial statements the Value Return payment can not be reliably estimated and is therefore recognised within cost of goods sold as part of the total payout to shareholder suppliers. For presentation of the annual report, the Value Return payment is presented as a deduction directly from equity.

Payment for contract milk supplied is included in other purchases within cost of goods sold.

***s) Employee benefits***

Employee benefits primarily include short term employee benefits and defined contribution pension plans.

Short term employee benefits include salaries, wages, annual leave and sick leave, and are expensed on an undiscounted basis as the relevant service is provided.

Contributions to defined contribution pension plans are recognised as an expense in the period they are due. The Group has no further payment obligations once the contributions have been paid.

***t) Finance income and costs***

Finance income comprises interest income on funds on deposit. Interest income is recognised as it accrues using the effective interest method.

Finance costs comprise interest expense on borrowings, unwinding of the discount on provisions, gains and losses on the revaluation of debt hedges and the hedged risks on certain debt instruments, and gains and losses relating to forward points on forward exchange contracts. Interest expense and the unwinding of the discount on provisions are recognised in the income statement using the effective interest method. Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of that asset.

***u) Taxation***

Tax expense comprises current and deferred tax. Tax expense is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable or receivable on the taxable income or loss for the period, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable or receivable in respect of previous years.

Deferred tax is recognised, using the balance sheet method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred tax is measured at the tax rate that is expected to apply to the temporary differences when they reverse, based on laws that have been enacted or substantively enacted by the reporting date.

Deferred tax is not recognised on the following temporary differences:

- the initial recognition of goodwill;
- the initial recognition of assets and liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit; and
- differences relating to investments in subsidiaries and equity accounted investees to the extent that the timing of the reversal is controlled by the Group and it is probable that they will not reverse in the foreseeable future.

Deferred tax assets are recognised to the extent it is probable that future taxable profits will be available against which the temporary differences can be utilised.

# STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

***v) New International Financial Reporting Standards***

The Group has chosen to early adopt NZ IFRS 8: Operating Segments. NZ IFRS 8 requires qualitative and quantitative disclosures regarding the Group's operating segments and replaces NZ IAS 14: Segment Reporting. Mandatory adoption of NZ IFRS 8 is required for periods commencing on or after 1 January 2009.

The Group has chosen to early adopt amendments made in February 2008 to NZ IAS 32: Financial Instruments: Presentation. The amendments allow Fonterra to continue to classify Fonterra's co-operative shares as equity instruments. Mandatory adoption of the amendments to NZ IAS 32 is required for periods commencing on or after 1 January 2009.

Fonterra has chosen to early adopt the amendments made in June 2008 to NZ IFRS 1: First-time Adoption of NZ IFRS and NZ IAS 27: Consolidated and Separate Financial Statements. The amendments allow Fonterra to use the Previous NZ GAAP carrying value of its investments in subsidiaries and associates as the deemed cost on transition to NZ IFRS. Mandatory adoption of the amendments to NZ IFRS 1 and NZ IAS 27 and their related consequential amendments is required for periods commencing on or after 1 January 2009.

The Group has chosen not to early adopt amendments made in November 2007 to NZ IAS 1: Presentation of Financial Statements. The amendments set out changes to the presentation of the financial statements but have no impact on recognition or measurement. Mandatory adoption of the amended NZ IAS 1 is required for periods commencing on or after 1 January 2009, therefore the Group will adopt these amendments in the financial year beginning 1 August 2009.

The Group has chosen not to early adopt amendments made in February 2008 to NZ IFRS 3: Business Combinations. The amendments impact the measurement of minority interests in an acquisition and the acquisition of a minority interest subsequent to an acquisition, step acquisitions, contingent consideration, acquisition costs and contingent liabilities of the acquiree. Mandatory adoption of the amended NZ IFRS 3 is required for periods commencing on or after 1 July 2009, therefore the Group will adopt these amendments in the financial year beginning 1 August 2009.

# NOTES TO THE FINANCIAL STATEMENTS

FOR THE 14 MONTHS ENDED **31 JULY 2008**

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 1 Cost of goods sold

| | Notes | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|---|
| | | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| Opening inventory | | **2,783** | 3,300 | **–** | – |
| Cost of milk | | **8,978** | 4,812 | **8,978** | 4,812 |
| Supplier premiums | | **33** | 52 | **33** | 52 |
| Payout to shareholder suppliers included in Cost of goods sold | | **9,011** | 4,864 | **9,011** | 4,864 |
| Other purchases | | **8,314** | 5,472 | **187** | 6 |
| Closing inventory | 8 | **(3,288)** | (2,783) | **–** | – |
| **Total cost of goods sold** | | **16,820** | 10,853 | **9,198** | 4,870 |

Fonterra processes approximately 95% of all New Zealand milk and accordingly there is not a market based price for raw milk acquired in New Zealand. The cost of milk is based on the milk price which is an estimate as it relies on a model using a combination of actual and forecast sales.

## 2 Reconciliation of Group profit for the period

| | CONSOLIDATED $ MILLION | |
|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| Profit for the period (before value return) | **294** | 653 |
| Comprises: | | |
| Value return paid to shareholder suppliers | **87** | 728 |
| Retention from value return | **277** | – |
| Available value return(1) | **364** | 728 |
| Tax effect of value return paid to shareholder suppliers | **(28)** | (240) |
| Tax effect of retention from value return | **(92)** | – |
| Tax effected total available value return | **244** | 488 |
| Adjustment to comparative profit arising on transition to NZ IFRS | **–** | 134 |
| Profit attributable to shareholder suppliers | **244** | 622 |
| Profit attributable to minority interests | **50** | 31 |
| | **294** | 653 |

Note:

(1) The value return available for payout is represented by total revenue less total costs (including the cost of milk) for the period after allowing for the minority interests share of profit (excluding NZ IFRS transition adjustments in 2007). Value return is the component of total payout that remains after deducting the cost of milk. Small fluctuations in milk price could have a material impact on the value return component of payout.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 3 Operating profit/(loss) before finance costs, equity accounted income and tax

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| The following items have been included in arriving at operating profit/(loss) before finance costs, equity accounted income and tax | | | | |
| Auditor's remuneration: | | | | |
| – Audit fees | **4** | 4 | **2** | 2 |
| – Other audit related services(1) | **1** | 1 | **1** | 1 |
| – Other services(2) | **1** | 1 | **–** | – |
| Operating lease expense | **64** | 62 | **5** | 4 |
| Restructuring costs | **7** | 25 | **1** | 19 |
| Research costs | **100** | 95 | **1** | 1 |
| Loss on disposal of investments | **–** | 2 | **–** | – |
| Loss on disposal of property, plant and equipment | **3** | – | **–** | – |
| Gain on disposal of investments | **15** | 3 | **–** | – |
| Gain on disposal of property, plant and equipment | **4** | 8 | **–** | 1 |
| Total employee benefits expense | **1,531** | 1,176 | **181** | 111 |
| Included in employee benefits expense are contributions to defined contribution plans | **46** | 22 | **1** | 1 |
| Change in fair value of financial instruments classified as held for trading | **(11)** | (176) | **–** | – |
| Net foreign exchange (gains)/losses on loans and receivables | **(25)** | 205 | **–** | – |
| Net foreign exchange (gains)/losses on financial liabilities measured at amortised cost | **2** | (24) | **–** | – |

Notes:

(1) Other audit related services include services for financial and IT controls assurance.

(2) Other services include financial reporting and advisory services.

## 4 Net finance (costs)/income

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| Interest income | **76** | 24 | **497** | 372 |
| Interest expense on financial liabilities measured at amortised cost | **(449)** | (312) | **(408)** | (294) |
| Change in fair value of forward points on cash flow hedges and net investment hedges | **168** | 10 | **–** | – |
| Change in fair value of hedged risks on debt instruments designated in a fair value hedge relationship | **(184)** | 336 | **(184)** | 336 |
| Change in fair value of derivative instruments designated as a fair value hedge | **14** | (451) | **14** | (451) |
| Change in fair value of financial instruments classified as held for trading | **8** | 59 | **177** | 69 |
| Finance costs | **(443)** | (358) | **(401)** | (340) |
| **Net finance (costs)/income** | **(367)** | (334) | **96** | 32 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 5 Tax credit/(expense)

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| Current tax credit/(expense) | **(174)** | (375) | **90** | 35 |
| Current tax – reduction in tax rate | **(24)** | – | **(15)** | – |
| Prior period adjustments to current tax | **18** | 11 | **5** | (1) |
| Deferred tax expense – origination and reversal of temporary differences | **227** | 44 | **4** | 52 |
| Deferred tax expense – reduction in tax rate | **–** | 41 | **–** | (15) |
| **Tax credit/(expense)** | **47** | (279) | **84** | 71 |
| | | | | |
| **Profit/(loss) before tax** | **247** | 932 | **(342)** | (277) |
| Prima facie taxation expense at 33% | **82** | 308 | **(113)** | (91) |
| Add/(deduct) taxation effect of: | | | | |
| Effect of tax rates in foreign jurisdictions | **(33)** | (12) | **–** | – |
| Difference in effective tax rate of equity accounted investees | **(1)** | (14) | **–** | – |
| Non-deductible expenses | **36** | 60 | **19** | 4 |
| Non-assessable income | **(148)** | (6) | **–** | – |
| Losses of overseas subsidiaries (recognised)/not recognised | **11** | (5) | **–** | – |
| Under/(over) provision prior year | **(18)** | (11) | **(5)** | 1 |
| Impact of change in tax rate | **24** | (41) | **15** | 15 |
| **Tax expense/(credit)** | **(47)** | 279 | **(84)** | (71) |
| | | | | |
| **Imputation credits:** | | | | |
| – Opening balance | | | **8** | 27 |
| – Tax payments net of refund | | | **–** | (19) |
| – Closing balance | | | **8** | 8 |
| | | | | |
| The imputation credits are available to the shareholder suppliers of the parent company: | | | | |
| Through the parent company | | | **8** | 8 |
| Through subsidiaries | | | **10** | 9 |
| | | | **18** | 17 |
| | | | | |
| **Dividend withholding payment credits:** | | | | |
| The dividend withholding payment credits are available to the shareholder suppliers of the parent company: | | | | |
| Through the parent company | | | **–** | – |
| Through subsidiaries | | | **1** | 1 |
| | | | **1** | 1 |
| | | | | |
| **Tax losses** | | | | |
| Gross tax losses available for which no deferred tax asset has been recognised | **45** | 156 | **–** | – |

In May 2007 the New Zealand Government announced that the company tax rate would reduce from 33% to 30%, effective for years beginning on or after 1 April 2008.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 6 Capital and reserves

| | ATTRIBUTABLE TO | | |
|---|---|---|---|
| **Consolidated $ millions** | **Co-operative shares** | **Peak notes** | **Supply redemption rights** |
| **Balance at 1 June 2007** | **4,897** | **–** | **–** |
| Profit for the period (before value return) | **–** | **–** | **–** |
| Income and expense recognised directly in equity | **–** | **–** | **–** |
| Value return paid to shareholder suppliers | **–** | **–** | **–** |
| Tax credit arising on value return paid to shareholder suppliers | **–** | **–** | **–** |
| Co-operative shares issued | **754** | **–** | **–** |
| Co-operative shares surrendered | **(1,354)** | **–** | **–** |
| Dividend paid to minority interests | **–** | **–** | **–** |
| Buyout of minority interests | **–** | **–** | **–** |
| Contribution from minority interests | **–** | **–** | **–** |
| **Balance at 31 July 2008** | **4,297** | **–** | **–** |
| | | | |
| **Balance at 1 June 2006** | 3,569 | 1,149 | 285 |
| Profit for the period (before value return) | – | – | – |
| Income and expense recognised directly in equity | – | – | – |
| Value return paid to shareholder suppliers | – | – | – |
| Tax credit arising on value return paid to shareholder suppliers | – | – | – |
| Co-operative shares issued | 1,699 | – | – |
| Co-operative shares surrendered | (316) | – | – |
| Supply redemption rights price differential | (55) | – | – |
| Surrender of supply redemption rights and peak notes | – | (1,149) | (285) |
| Dividend paid to minority interests | – | – | – |
| Buyout of minority interests | – | – | – |
| Disposal of subsidiary | – | – | – |
| Transfer between FCTR and retained earnings | – | – | – |
| **Balance at 31 May 2007** | 4,897 | – | – |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

| SHAREHOLDER SUPPLIERS | | | | | |
|---|---|---|---|---|---|
| Retained earnings | Foreign currency translation reserve | Cash flow hedge reserve | Total | Minority interest | Total equity |
| **(166)** | **(38)** | **149** | **4,842** | **136** | **4,978** |
| **244** | **–** | **–** | **244** | **50** | **294** |
| **(1)** | **37** | **(237)** | **(201)** | **12** | **(189)** |
| **(87)** | **–** | **–** | **(87)** | **–** | **(87)** |
| **28** | **–** | **–** | **28** | **–** | **28** |
| **–** | **–** | **–** | **754** | **–** | **754** |
| **–** | **–** | **–** | **(1,354)** | **–** | **(1,354)** |
| **–** | **–** | **–** | **–** | **(11)** | **(11)** |
| **–** | **–** | **–** | **–** | **(147)** | **(147)** |
| **–** | **–** | **–** | **–** | **3** | **3** |
| **18** | **(1)** | **(88)** | **4,226** | **43** | **4,269** |
| (306) | – | (7) | 4,690 | 128 | 4,818 |
| 622 | – | – | 622 | 31 | 653 |
| – | (32) | 156 | 124 | (18) | 106 |
| (728) | – | – | (728) | – | (728) |
| 240 | – | – | 240 | – | 240 |
| – | – | – | 1,699 | – | 1,699 |
| – | – | – | (316) | – | (316) |
| – | – | – | (55) | – | (55) |
| – | – | – | (1,434) | – | (1,434) |
| – | – | – | – | (14) | (14) |
| – | – | – | – | 10 | 10 |
| – | – | – | – | (1) | (1) |
| 6 | (6) | – | – | – | – |
| (166) | (38) | 149 | 4,842 | 136 | 4,978 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 6 Capital and reserves (continued)

| Parent $ millions | Co-operative shares | Peak notes | Supply redemption rights | Retained earnings | Total equity |
|---|---|---|---|---|---|
| **Balance at 1 June 2007** | **4,897** | **–** | **–** | **(632)** | **4,265** |
| Profit/(loss) for the period (before value return) | **–** | **–** | **–** | **(258)** | **(258)** |
| Value return paid to shareholder suppliers | **–** | **–** | **–** | **(87)** | **(87)** |
| Tax credit arising on value return paid to shareholder suppliers | **–** | **–** | **–** | **28** | **28** |
| Co-operative shares issued | **754** | **–** | **–** | **–** | **754** |
| Co-operative shares surrendered | **(1,354)** | **–** | **–** | **–** | **(1,354)** |
| **Balance at 31 July 2008** | **4,297** | **–** | **–** | **(949)** | **3,348** |
| | | | | | |
| **Balance at 1 June 2006** | 3,569 | 1,149 | 285 | 62 | 5,065 |
| Profit/(loss) for the period (before value return) | – | – | – | (206) | (206) |
| Value return paid to shareholder suppliers | – | – | – | (728) | (728) |
| Tax credit arising on value return paid to shareholder suppliers | – | – | – | 240 | 240 |
| Co-operative shares issued | 1,699 | – | – | – | 1,699 |
| Co-operative shares surrendered | (316) | – | – | – | (316) |
| Supply redemption rights price differential | (55) | – | – | – | (55) |
| Surrender of supply redemption rights and peak notes | – | (1,149) | (285) | – | (1,434) |
| **Balance at 31 May 2007** | 4,897 | – | – | (632) | 4,265 |

| Parent and Consolidated numbers 000's | Co-operative shares | Peak notes | Supply redemption rights |
|---|---|---|---|
| **Balance at 1 June 2007** | **1,279,675** | **–** | **–** |
| Issued | **127,543** | **–** | **–** |
| Surrendered | **(207,305)** | **–** | **–** |
| **Balance at 31 July 2008** | **1,199,913** | **–** | **–** |
| | | | |
| **Balance at 1 June 2006** | 1,208,085 | 38,307 | 59,144 |
| Issued | 285,790 | – | – |
| Surrendered | (52,950) | (38,307) | (59,144) |
| Consolidation transition | (161,250) | – | – |
| **Balance at 31 May 2007** | 1,279,675 | – | – |

**Co-operative shares**

Each shareholder supplying milk to the Company in a season is required to hold one co-operative share ("share") for each kilogram of milksolids obtainable from milk supplied to the Company by that shareholder, excluding milk supplied under contract supply or as unshared supply, in that season. Shareholders supplying under contract must hold at least 1,000 shares. This is known as the share standard.

In addition, suppliers are able to hold up to 20% of their opening shareholding as additional shares.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 6 Capital and reserves (continued)

Rights attaching to the shares include:

- voting rights on a poll or postal ballot of one vote per 1,000 kilograms of milksolids obtainable from milk supplied to the Company by a dairy farm during the season preceding that in which a poll or postal ballot is taken, less milksolids supplied under contract supply or as unshared supply;
- rights to a share in any value returns; and
- rights to share in any surplus on liquidation of the Company.

Shares are issued and surrendered at fair value. Shareholders may also elect, within the application period (15 December – 28 February), to issue and surrender shares at a default price which is +/– 7.5% of the interim fair value share price set by the Board of Directors ("the Board"). Fair value is determined on an annual basis for each season by the Board with the advice of an independent valuer. Fair value for the 2008/09 season has been set by the Board, after receiving Duff & Phelps estimated fair value range, at $5.57 per share (2007/08 season: $6.79 per share).

If a shareholder decreases supply during a season, the number of shares held will be re-apportioned between the number of minimum required shares (calculated using the share standard) and the number of additional shares that may be held. The retention of any additional shares will be automatic, up to 20% of a shareholder's opening capital, subject to Board discretion.

Any number of shares held in excess of the share standard that exceed 20% of a shareholder's opening capital will automatically be surrendered, subject to Board discretion, at the current season share price. A shareholder may elect to surrender additional shares held in excess of the share standard but not exceeding 20% of their opening capital.

Payment for the surrender of shares may be made at the option of the Company by:

- the payment of cash; or
- the issue of capital notes.

The Company also has the option to pay the surrender value in special circumstances by the issue of redeemable preference shares.

The expected cash outflow on redemption or repurchase of the shares is dependent on the fair value at that time, the number of shares redeemed or repurchased and the instrument used to settle the obligation, and accordingly cannot be reliably estimated.

If a shareholder increases supply during a season, any additional shares held will be used first to satisfy the increased minimum required shares under the share standard. If no, or insufficient, additional shares are held, the shareholder may:

- acquire the extra shares required under the share standard at the current season share price; or
- request unshared supply (at the discretion of the Company).

The amount of unshared supply entitlement shall not exceed 20% of a shareholder's opening capital or the increase in total production over the previous season. If a shareholder is granted unshared supply, they will not be required to purchase shares for the quantity elected. However, they will receive a lower payout for this unshared supply.

Additional shares acquired by shareholders are paid by:

- cash; or
- redeeming any capital notes held (at the discretion of the Company – not exercised to date).

**Cash flow hedge reserve**

The cash flow hedge reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

**Foreign currency translation reserve**

The foreign currency translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations as well as from the effective portion of translation or fair value changes of instruments that hedge the Group's net investment in foreign operations.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 7 Trade and other receivables

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| Trade receivables | **2,059** | 2,027 | **2** | 1 |
| Less: provision for impairment of trade receivables | **(29)** | (22) | **–** | – |
| Trade receivables less provision for impairment | **2,030** | 2,005 | **2** | 1 |
| Receivables from related parties[1] | **48** | 34 | **8,055** | 7,155 |
| Other receivables | **77** | 66 | **–** | – |
| **Total receivables** | **2,155** | 2,105 | **8,057** | 7,156 |
| Prepayments | **61** | 34 | **36** | 10 |
| **Total trade and other receivables** | **2,216** | 2,139 | **8,093** | 7,166 |

Note:

(1) There are no provisions for impairment on the receivables from related parties.

The movement in the provision for impairment of trade receivables during the period was as follows:

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| Opening balance at the beginning of period | **22** | 25 | **–** | – |
| Impairment loss recognised during the period | **13** | 5 | **–** | – |
| Utilisation of the impairment provision | **(3)** | (2) | **–** | – |
| Reversal of impairment loss to profit during the period | **(4)** | (3) | **–** | – |
| Foreign currency translation | **1** | (3) | **–** | – |
| **Closing balance at the end of period** | **29** | 22 | **–** | – |

## 8 Inventories

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| Raw materials | **385** | 251 | **–** | – |
| Finished goods | **3,100** | 2,608 | **–** | – |
| Impairment of finished goods | **(197)** | (76) | **–** | – |
| **Total inventories** | **3,288** | 2,783 | **–** | – |
| **Other disclosures:** | | | | |
| Inventories stated at net realisable value | **775** | 241 | **–** | – |
| Amount of inventories recognised in cost of goods sold during the period | **16,820** | 10,853 | **–** | – |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 9 Property, plant and equipment

| Consolidated $ million | Notes | Land | Buildings and leasehold improvements | Plant, vehicles and equipment | Capital WIP | Total |
|---|---|---|---|---|---|---|
| ***Net book value*** | | | | | | |
| **Balance as at 1 June 2007** | | **273** | **1,044** | **2,708** | **207** | **4,232** |
| Additions | | **8** | **–** | **–** | **566** | **574** |
| Transfer from capital WIP | | **–** | **46** | **413** | **(459)** | **–** |
| Transfer to intangible assets | 11 | **–** | **–** | **–** | **(16)** | **(16)** |
| Depreciation charge | | **–** | **(69)** | **(396)** | **–** | **(465)** |
| Impairment loss | | **–** | **–** | **(4)** | **–** | **(4)** |
| Disposals | | **(7)** | **(16)** | **(70)** | **–** | **(93)** |
| Foreign currency translation | | **7** | **20** | **37** | **–** | **64** |
| **Balance as at 31 July 2008** | | **281** | **1,025** | **2,688** | **298** | **4,292** |
| **At 31 July 2008** | | | | | | |
| Cost | | **281** | **1,352** | **4,405** | **298** | **6,336** |
| Accumulated depreciation and impairment | | **–** | **(327)** | **(1,717)** | **–** | **(2,044)** |
| **Net book value** | | **281** | **1,025** | **2,688** | **298** | **4,292** |
| ***Net book value*** | | | | | | |
| **Balance as at 1 June 2006** | | 276 | 1,045 | 2,715 | 225 | 4,261 |
| Additions | | – | – | – | 433 | 433 |
| Additions as a result of business combinations | | 1 | 3 | – | – | 4 |
| Transfer from capital WIP | | – | 79 | 368 | (447) | – |
| Depreciation charge | | – | (61) | (336) | – | (397) |
| Impairment loss | | – | – | (1) | – | (1) |
| Disposals | | – | (6) | (19) | – | (25) |
| Foreign currency translation | | (4) | (16) | (19) | (4) | (43) |
| **Balance as at 31 May 2007** | | 273 | 1,044 | 2,708 | 207 | 4,232 |
| **At 1 June 2006** | | | | | | |
| Cost | | 276 | 1,255 | 3,810 | 225 | 5,566 |
| Accumulated depreciation and impairment | | – | (210) | (1,095) | – | (1,305) |
| **Net book value** | | 276 | 1,045 | 2,715 | 225 | 4,261 |
| **At 31 May 2007** | | | | | | |
| Cost | | 273 | 1,306 | 4,059 | 207 | 5,845 |
| Accumulated depreciation and impairment | | – | (262) | (1,351) | – | (1,613) |
| **Net book value** | | 273 | 1,044 | 2,708 | 207 | 4,232 |

The Group leases plant, vehicles and equipment under a number of finance lease agreements.

The net book value of plant, vehicles and equipment subject to finance leases included within property, plant and equipment for the Group is $18 million (31 May 2007: $150 million).

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 9 Property, plant and equipment (continued)

| Parent $ million | Notes | Land | Buildings and leasehold improvements | Plant, vehicles and equipment | Capital WIP | Total |
|---|---|---|---|---|---|---|
| ***Net book value*** | | | | | | |
| **Balance as at 1 June 2007** | | **6** | **12** | **7** | **8** | **33** |
| Additions | | **–** | **–** | **–** | **19** | **19** |
| Transfers from other Group companies | | **–** | **18** | **20** | **–** | **38** |
| Transfer from capital WIP | | **–** | **1** | **7** | **(8)** | **–** |
| Transfer to intangible assets | 11 | **–** | **–** | **–** | **(5)** | **(5)** |
| Depreciation charge | | **–** | **(2)** | **(6)** | **–** | **(8)** |
| Disposals | | **–** | **–** | **(3)** | **–** | **(3)** |
| **Balance as at 31 July 2008** | | **6** | **29** | **25** | **14** | **74** |
| **At 31 July 2008** | | | | | | |
| Cost | | **6** | **40** | **64** | **14** | **124** |
| Accumulated depreciation and impairment | | **–** | **(11)** | **(39)** | **–** | **(50)** |
| **Net book value** | | **6** | **29** | **25** | **14** | **74** |
| ***Net book value*** | | | | | | |
| **Balance as at 1 June 2006** | | 6 | 12 | 11 | 5 | 34 |
| Additions | | – | – | – | 5 | 5 |
| Transfer from capital WIP | | – | 1 | 1 | (2) | – |
| Depreciation charge | | – | (1) | (5) | – | (6) |
| **Balance as at 31 May 2007** | | 6 | 12 | 7 | 8 | 33 |
| **At 1 June 2006** | | | | | | |
| Cost | | 6 | 14 | 26 | 5 | 51 |
| Accumulated depreciation and impairment | | – | (2) | (15) | – | (17) |
| **Net book value** | | 6 | 12 | 11 | 5 | 34 |
| **At 31 May 2007** | | | | | | |
| Cost | | 6 | 15 | 26 | 8 | 55 |
| Accumulated depreciation and impairment | | – | (3) | (19) | – | (22) |
| **Net book value** | | 6 | 12 | 7 | 8 | 33 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 10 Equity accounted investments

A list of significant equity accounted investees has been included in Note 24.

No significant equity accounted investees have been acquired, sold or reclassified during the period. During 2007 the only significant acquisition was a 43% interest in Shijiazhuang San Lu Group Company Limited ("San Lu"). The movement in the carrying value of equity accounted investees is as follows:

| | CONSOLIDATED $ MILLION | |
|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| Opening balance | **630** | 468 |
| – Share of results before tax | **159** | 74 |
| – Share of tax | **(1)** | (1) |
| Share of results after tax | **158** | 73 |
| Acquired | **2** | 206 |
| Disposals | **(4)** | – |
| Impairment of investment | **(142)** | (25) |
| Foreign currency translation | **76** | (49) |
| Dividends received | **(128)** | (43) |
| Closing balance | **592** | 630 |
| Amount of goodwill in carrying value of equity accounted investees: | | |
| Opening balance | **241** | 216 |
| Closing balance | **268** | 241 |

An industry wide contamination of milk in China has occurred. This has affected a large number of dairy companies within China including San Lu, a company 43% owned by Fonterra. This resulted in San Lu undertaking a nationwide recall of contaminated product which has significantly impacted on the operations of San Lu.

Fonterra has reviewed the carrying value of its investment in San Lu (which forms part of the Asia/AME reportable segment (Note 22)). As a consequence of this review, an impairment loss of $139 million has been recognised as "Impairment in Equity Accounted Investees". The recoverable amount has been determined based on an estimate of the fair value of the entity, given current market conditions.

The remaining $3 million impairment of investments relates to the investment in Britannia New Zealand Foods PVTE Limited.

The Group has provided financial guarantees to certain equity accounted investees as set out in Note 23. Commitments relating to the Group's interest in its equity accounted investees are set out in Note 21.

The following amounts represent the aggregate assets, liabilities, sales and results of significant equity accounted investees.

| | CONSOLIDATED $ MILLION | |
|---|---|---|
| | **As at and for the 14 months to 31 July 2008** | As at and for the 12 months to 31 May 2007 |
| **Assets:** | | |
| Non-current assets | **781** | 647 |
| Current assets | **1,171** | 875 |
| | **1,952** | 1,522 |
| **Liabilities:** | | |
| Long-term liabilities | **(242)** | (238) |
| Current liabilities | **(850)** | (533) |
| | **(1,092)** | (771) |
| **Net assets** | **860** | 751 |
| Income | **4,451** | 3,403 |
| Expenses (including interest and taxation) | **(4,141)** | (3,203) |
| **Profit after tax** | **310** | 200 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 11 Intangible assets

| | | CONSOLIDATED | | | | | PARENT |
|---|---|---|---|---|---|---|---|
| **$ million** | Notes | **Goodwill** | **Brands** | **Software** | **Other** | **Total Intangibles** | **Software** |
| **Net carrying amount** | | | | | | | |
| **At 1 June 2007** | | **838** | **1,437** | **225** | **7** | **2,507** | **43** |
| Acquired | | **–** | **–** | **34** | **4** | **38** | **14** |
| Arising on acquisition of minority interest | | **145** | **–** | **–** | **–** | **145** | **–** |
| Transfer from Capital WIP | 9 | **–** | **–** | **16** | **–** | **16** | **5** |
| Transfers to other Group companies | | **–** | **–** | **–** | **–** | **–** | **(21)** |
| Amortisation | | **–** | **(3)** | **(73)** | **(5)** | **(81)** | **(11)** |
| Disposals | | **–** | **–** | **(1)** | **–** | **(1)** | **–** |
| Foreign currency translation | | **20** | **35** | **1** | **–** | **56** | **–** |
| **Balance as at 31 July 2008** | | **1,003** | **1,469** | **202** | **6** | **2,680** | **30** |
| **At 31 July 2008** | | | | | | | |
| Cost | | **1,003** | **1,553** | **512** | **89** | **3,157** | **101** |
| Accumulated amortisation and impairment | | **–** | **(84)** | **(310)** | **(83)** | **(477)** | **(71)** |
| **Net carrying amount** | | **1,003** | **1,469** | **202** | **6** | **2,680** | **30** |
| **Net carrying amount** | | | | | | | |
| **At 1 June 2006** | | 758 | 1,445 | 243 | 7 | 2,453 | 34 |
| Acquired | | – | – | 35 | 5 | 40 | 20 |
| Arising on acquisition of subsidiaries | 18 | 75 | 3 | – | – | 78 | – |
| Arising on acquisition of minority interest | | 10 | – | – | – | 10 | – |
| Amortisation | | – | (6) | (53) | (5) | (64) | (11) |
| Impairment | | – | (9) | – | – | (9) | – |
| Disposals | | (5) | – | – | – | (5) | – |
| Reversal of impairment | | – | 15 | – | – | 15 | – |
| Foreign currency translation | | – | (11) | – | – | (11) | – |
| **At 31 May 2007** | | 838 | 1,437 | 225 | 7 | 2,507 | 43 |
| **At 1 June 2006** | | | | | | | |
| Cost | | 758 | 1,526 | 429 | 80 | 2,793 | 80 |
| Accumulated amortisation and impairment | | – | (81) | (186) | (73) | (340) | (46) |
| **Net carrying amount** | | 758 | 1,445 | 243 | 7 | 2,453 | 34 |
| **At 31 May 2007** | | | | | | | |
| Cost | | 838 | 1,518 | 463 | 85 | 2,904 | 100 |
| Accumulated amortisation and impairment | | – | (81) | (238) | (78) | (397) | (57) |
| **Net carrying amount** | | 838 | 1,437 | 225 | 7 | 2,507 | 43 |

Amortisation, impairment losses and reversal of impairment losses are recognised in other operating expenses in the income statement.

Other intangibles comprises internally generated capitalised development costs. Software may include internally generated capitalised development costs.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 11 Intangible assets (continued)

**Brands**

Included in brands are $1,426 million (31 May 2007: $1,396 million) that have indefinite useful lives. In concluding that a brand has an indefinite life, management considers its intention to acquire, hold and support brands for an indefinite period.

Indefinite life brands are tested annually for impairment through a value-in-use test using a discounted cash flow methodology.

In 2008 there were no individually material impairments or reinstatements to any brands. In 2007 there were no individually material impairments to any brands. The $15 million reversal of impairment losses in 2007 included $11 million relating to the Anmum brand. This arose from an increase in projected revenue and earnings, through market expansion, and a reduction in discount rates in key markets (2007: 7.1%–11.7%; 2006: 7.9%–15.1%).

**Goodwill**

The aggregate carrying amounts of goodwill allocated to each cash generating unit ("CGU") are as follows:

| | CONSOLIDATED $ MILLION | |
|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 |
| Fonterra Brands New Zealand (ANZ segment) | **575** | 575 |
| New Zealand Milk Australasia (ANZ segment) | **251** | 227 |
| Soprole (Latam segment) | **138** | – |
| Other | **39** | 36 |
| | **1,003** | 838 |

Goodwill for each CGU has been tested for impairment using a discounted cash flow on a value-in-use basis. Testing was undertaken in May 2008 and is prepared using external sources of information where appropriate, and past experience. Cash flow forecasts are based on the Group's three year plan, extrapolated for a further seven years, and then using a terminal year with a long term growth rate of 2.4%. Management considers a ten year forecast period to be appropriate given the long term nature of the dairy industry. A discount rate of 8.5% was applied to future cash flows.

Testing confirmed there was no impairment to the carrying value of the Group's goodwill. There was a significant amount of headroom between the value of each CGU and its net asset carrying values.

## 12 Trade and other payables

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| Trade payables | **458** | 346 | **–** | – |
| Accruals | **415** | 337 | **40** | 28 |
| Amounts due to related parties | **36** | 13 | **6,297** | 5,435 |
| Other payables | **123** | 84 | **46** | 33 |
| Total current payables and accruals (excluding employee entitlements) | **1,032** | 780 | **6,383** | 5,496 |
| Employee entitlements | **239** | 159 | **46** | 16 |
| **Total trade and other payables** | **1,271** | 939 | **6,429** | 5,512 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 13 Provisions

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Provision for restructuring and rationalisation:** | | | | |
| Opening balance | **42** | 44 | **23** | 21 |
| Additional provisions | **9** | 25 | **1** | 19 |
| Unused amounts reversed | **(2)** | – | **–** | – |
| Charged to income statement | **7** | 25 | **1** | 19 |
| Reclassification within note | **–** | (4) | **–** | (2) |
| Foreign currency translation | **–** | (1) | **–** | – |
| Utilised during the period | **(35)** | (22) | **(18)** | (15) |
| Closing balance | **14** | 42 | **6** | 23 |
| **Legal claims provisions:** | | | | |
| Opening balance | **47** | 39 | **36** | 38 |
| Additional provisions | **24** | 24 | **23** | 8 |
| Unused amounts reversed | **(1)** | (6) | **(1)** | (6) |
| Charged to income statement | **23** | 18 | **22** | 2 |
| Utilised during the period | **(12)** | (10) | **(1)** | (3) |
| Transferred from Parent to other Group entities | **–** | – | **(3)** | (1) |
| Closing balance | **58** | 47 | **54** | 36 |
| **Long term supply contracts provisions:** | | | | |
| Opening balance | **–** | – | **–** | – |
| Additional provisions | **93** | – | **–** | – |
| Charged to income statement | **93** | – | **–** | – |
| Closing balance | **93** | – | **–** | – |
| **Other provisions:** | | | | |
| Opening balance | **71** | 65 | **24** | 18 |
| Additional provisions | **94** | 61 | **40** | 28 |
| Unused amounts reversed | **(6)** | (9) | **(2)** | – |
| Charged to income statement | **88** | 52 | **38** | 28 |
| Reclassification within note | **–** | 4 | **–** | 2 |
| Reclassification to other balance sheet categories | **2** | – | **–** | – |
| Foreign currency translation | **2** | (3) | **–** | – |
| Utilised during the period | **(31)** | (47) | **(9)** | (19) |
| Transferred from Parent to other Group entities | **–** | – | **–** | (5) |
| Closing balance | **132** | 71 | **53** | 24 |
| **Total provisions** | **297** | 160 | **113** | 83 |
| Included within the balance sheet as follows: | | | | |
| **Current liabilities** | **233** | 115 | **66** | 51 |
| **Non-current liabilities** | **64** | 45 | **47** | 32 |
| **Total provisions** | **297** | 160 | **113** | 83 |

## 13 Provisions (continued)

The nature of the provisions are as follows:

- The provision for restructuring and rationalisation includes obligations relating to planned changes throughout the business to improve efficiencies and reduce costs. None of the provisions are individually significant. The value of the obligation is based on project plans, and the provisions are expected to be utilised in the next year.
- The legal claims provisions include obligations relating to tax, customs and duties and legal matters arising in the normal course of business. None of the provisions are individually significant. The timing and amount of the future obligations are uncertain, as they are contingent on the outcome of a number of judicial proceedings. The amount recognised has been based on management's best estimate of the amount that will be required to settle the obligation. The outcome of most of the obligations is not expected to be determined within the next year, and therefore most of the provision is classified as non-current.
- The provisions for long term supply contracts represents the estimated unavoidable losses expected to arise in relation to long term supply contracts entered into by the Group. The provision is expected to be largely utilised over the next 12 months.
- Other provisions arise in the normal course of business and relate to provisions for areas such as employee benefit provisions. None of the provisions are individually significant. The value of the obligation is based on management's best estimate of the amount that will be required to settle the obligation, and the provisions are expected to be utilised in the next year.

## 14 Borrowings

| | | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|---|
| | Notes | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| *Current* | | | | | |
| Commercial paper | | **1,605** | 517 | **1,605** | 517 |
| Unsecured bank loans | | **189** | 130 | **25** | 15 |
| Finance lease liabilities | | **12** | 119 | **–** | – |
| Medium term notes | | **210** | 300 | **210** | 300 |
| **Total current borrowings** | 19 | **2,016** | 1,066 | **1,840** | 832 |
| *Non-current* | | | | | |
| Commercial paper | | **2** | 2 | **–** | – |
| Unsecured bank loans | | **1,488** | 1,718 | **–** | 910 |
| Finance lease liabilities | | **55** | 69 | **–** | – |
| Medium term notes | | **2,957** | 2,270 | **2,886** | 2,198 |
| **Total non-current borrowings** | 19 | **4,502** | 4,059 | **2,886** | 3,108 |
| **Total borrowings** | | **6,518** | 5,125 | **4,726** | 3,940 |

Finance leases liabilities are secured over the related item of property, plant and equipment.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 14 Borrowings (continued)

Finance lease liabilities are payable as follows:

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| **Finance lease liabilities – minimum lease payments** | | | | |
| Not later than one year | **15** | 130 | **–** | – |
| Later than one year and not later than five years | **40** | 48 | **–** | – |
| Later than five years | **23** | 34 | **–** | – |
| | **78** | 212 | **–** | – |
| Future finance charges on finance leases | **(11)** | (24) | **–** | – |
| **Present value of finance lease liabilities** | **67** | 188 | **–** | – |
| The present value of finance lease liabilities is as follows: | | | | |
| Not later than one year | **12** | 119 | **–** | – |
| Later than one year and not later than five years | **33** | 39 | **–** | – |
| Later than five years | **22** | 30 | **–** | – |
| | **67** | 188 | **–** | – |

## 15 Deferred taxation

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| Deferred taxation comprises the following: | | | | |
| Property, plant and equipment | **(137)** | (206) | **8** | 7 |
| Intangible assets | **(351)** | (498) | **(9)** | (8) |
| Financial instruments | **124** | (95) | **(11)** | (16) |
| Employee entitlements | **54** | 50 | **6** | 5 |
| Inventory | **(3)** | 53 | **–** | – |
| Receivables, payables and provisions | **105** | 42 | **33** | 14 |
| New Zealand tax losses | **122** | 144 | **122** | 143 |
| Offshore tax losses | **–** | 12 | **–** | – |
| Other | **(63)** | (26) | **–** | – |
| | **(149)** | (524) | **149** | 145 |
| Movements for the period: | | | | |
| Opening balance | **(524)** | (492) | **145** | 108 |
| Recognised in profit or loss | **227** | 44 | **4** | 52 |
| Change in tax rate recognised in profit or loss | **–** | 41 | **–** | (15) |
| Recognised directly in equity | **156** | (118) | **–** | – |
| Acquired in a business combination | **–** | (1) | **–** | – |
| Foreign currency translation | **(8)** | 2 | **–** | – |
| Closing balance | **(149)** | (524) | **149** | 145 |
| Deferred tax balances are presented in the balance sheet as follows: | | | | |
| Deferred tax assets | **139** | 10 | **149** | 145 |
| Deferred tax liabilities | **(288)** | (534) | **–** | – |
| | **(149)** | (524) | **149** | 145 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 16 Capital notes

The capital notes are unsecured subordinated interest bearing obligations. Interest is payable on a quarterly basis at a rate of 8.74% per annum (31 May 2007: 8.62%). This rate is reset on 10 July each year.

The capital notes have no fixed maturity date and continue in existence until redeemed by the Company on an election date, or otherwise purchased by the Company through the secondary market, or off market after allotment with agreement from the holder, or are redeemed or purchased by the Company from its shareholders in accordance with the Company's constitution. The capital notes have an election date of 10 July each year. The Company has the option to redeem all or part of the capital notes for cash on each election date.

## 17 Operating cash flows

| | | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|---|
| | Notes | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Profit/(loss) for the period (before value return)** | | **294** | 653 | **(258)** | (206) |
| **Non-cash items:** | | | | | |
| Amortisation of intangibles | 11 | **81** | 64 | **11** | 11 |
| Depreciation | 9 | **465** | 397 | **8** | 6 |
| Impairment of intangibles | 11 | **–** | 9 | **–** | – |
| Reversal of impairment of intangibles | 11 | **–** | (15) | **–** | – |
| Movement in deferred taxation | | **(375)** | (69) | **(4)** | (40) |
| Gain on disposal of investments | | **(15)** | (1) | **–** | – |
| Gain on disposal of property, plant and equipment | | **(1)** | (8) | **–** | (1) |
| Share of profit of equity accounted investees | 10 | **(158)** | (73) | **–** | – |
| Impairment of equity accounted investees | 10 | **142** | 25 | **–** | – |
| Impairment of property, plant and equipment | 9 | **4** | 1 | **–** | – |
| Other non-cash items | | **29** | (3) | **–** | – |
| | | **172** | 327 | **15** | (24) |
| **Movement in working capital decrease/(increase):** | | | | | |
| Movement in inventories | | **(505)** | 512 | **–** | – |
| Movement in receivables and prepayments | | **(63)** | 126 | **(26)** | (385) |
| Movement in other current assets | | **492** | – | **519** | – |
| Movement in current taxation balances | | **9** | 38 | **103** | (65) |
| Movement in amounts due to and from associates | | **9** | (31) | **–** | (22) |
| Movement in owing to suppliers | | **95** | 282 | **95** | 282 |
| Movement in payables and accruals | | **356** | (253) | **92** | (28) |
| Movement in provisions | | **118** | 12 | **15** | 10 |
| | | **511** | 686 | **798** | (208) |
| Items classified as investing and financing activities | | **333** | 498 | **(577)** | 215 |
| **Net cash flows from operating activities** | | **1,310** | 2,164 | **(22)** | (223) |

There were no material non-cash transactions during the period, or for the year ended 31 May 2007.

## 18 Business combinations

There were no material business combinations during the period to 31 July 2008.

On 12 January 2007 Fonterra acquired the sales, marketing and distribution business of Norco Co-operative Limited for $85 million including transaction costs and stamp duty. The acquisition had the following effect on the Group's assets and liabilities on acquisition date:

| **$ million** | Notes | **Pre-acquisition carrying amount** | **Fair value adjustment** | **Recognised values on acquisition** |
|---|---|---|---|---|
| Total assets | | 11 | 3 | 14 |
| Total liabilities | | (3) | (1) | (4) |
| Net identifiable assets and liabilities | | 8 | 2 | 10 |
| Goodwill on acquisition | 11 | | | 75 |
| Consideration paid, satisfied in cash | | | | (85) |
| Cash acquired | | | | – |
| Net cash outflow | | | | (85) |

Pre-acquisition carrying amounts were determined based on applicable NZ IFRS's immediately before the acquisition. The values of assets, liabilities and contingent liabilities recognised on acquisition are their estimated fair values.

Goodwill recognised on the acquisition is attributable mainly to the estimated future cash flows and synergies arising from the acquisition.

## 19 Financial risk management

**Overview**

Exposure to foreign exchange, interest rate, credit and liquidity risks arise in the normal course of the Group's business.

The Board has overall responsibility for the establishment and oversight of the Group's risk management framework. The Board:

- has established risk management procedures to identify and analyse the risks faced by the Group;
- has approved a Treasury Policy that covers appropriate risk limits and controls (including but not limited to delegated authority levels and authorised use of various financial instruments); and
- monitors risks and adherence to limits.

The Group's overall risk management programme focuses primarily on maintaining a prudent risk profile that provides flexibility to implement the Group's strategies, while ensuring the optimisation of the return on assets. Risk management is carried out by a central treasury department ("Group Treasury"), which ensures compliance with the risk management policies and procedures set by the Board.

**Foreign exchange risk**

Foreign exchange risk is the risk of cash flow volatility arising from a movement in foreign exchange rates to which the Group may be exposed.

The Group operates internationally and is exposed to foreign exchange risk on sales, purchases, investments and borrowings that are denominated in foreign currencies.

The main impacts of foreign exchange movements on the Group arise from:

- transaction risk – variations in the New Zealand dollar value of the Group's sales receipts and other cash flows; and
- translation risk – the value of the Group's investment in foreign operations and the Group's foreign currency debt.

Approximately 75% of the Group's net foreign exchange exposure is against the United States Dollar.

The Group's objective is to ensure foreign exchange exposure is managed in a prudent manner in order to maximise the returns to shareholder suppliers.

In respect of transaction hedging the Group's policy is to hedge 100% of the net recognised foreign currency trade receivables and foreign currency trade payables, and up to 100% of forecast cash receipts from sales for a period of up to 18 months. The level of hedging undertaken is influenced by current exchange rates and the time until the expected cash flows occur, within the limits approved by the Board.

In respect of translation hedging, the Group hedges its material net translation exposure.

Group Treasury uses forward exchange contracts, currency options and cross currency interest rate swaps to hedge its foreign exchange risk. The Group's investments in foreign operations are hedged by a combination of derivative instruments and borrowings in the relevant currencies.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 19 Financial risk management (continued)

**Exposure to foreign currency risk**

The significant notional unhedged exposures to foreign currencies are as follows:

| | | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|---|
| | | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| USD | United States dollar | **159** | 407 | **(5,672)** | (6,710) |
| EURO | Euro dollar | **(23)** | (2) | **(447)** | (408) |
| AUD | Australian dollar | **510** | 961 | **(1,103)** | (91) |
| GBP | Great Britain pound | **69** | 84 | **(50)** | (35) |
| JPY | Japanese yen | **16** | 41 | **(48)** | (15) |
| BRL | Brazilian real | **149** | 97 | **(103)** | (79) |
| CLP | Chilean peso | **14** | 27 | **(190)** | (131) |
| CNY | Chinese yuan | **57** | 11 | **(131)** | (98) |
| SGD | Singapore dollar | **54** | – | **(310)** | – |

Parent carries economic hedge derivative contracts for risks that sit elsewhere in the Group.

Included in the analysis above are derivative contracts with notional balances of $4,230 million (31 May 2007: $5,596 million) in respect of forecast sale transactions.

**Foreign exchange sensitivity**

A general 10% movement in the value of the New Zealand dollar against the key currencies to which the Group is exposed would result in the following post-tax (assuming a tax rate of 33%) increase/(decrease) to equity and profit, before any adjustment to payout. A 10% movement in exchange rates is considered reasonably possible over the short term given historical fluctuations in the value of the New Zealand dollar.

| | CONSOLIDATED $ MILLION | | | | PARENT $ MILLION | | | |
|---|---|---|---|---|---|---|---|---|
| | **As at 31 July 2008** | | As at 31 May 2007 | | **As at 31 July 2008** | | As at 31 May 2007 | |
| | **Equity** | **Profit** | Equity | Profit | **Equity** | **Profit** | Equity | Profit |
| Impact on current period of a general 10% strengthening of the NZD | **139** | **(24)** | 272 | (101) | **–** | **–** | – | – |
| Impact on current period of a general 10% weakening of the NZD | **(186)** | **62** | (153) | 36 | **–** | **–** | – | – |

**Interest rate risk**

The Group's interest rate risk arises from its borrowings and funds on deposit. Borrowings issued and funds on deposit held at variable rates expose the Group to cash flow interest rate risk. Borrowings issued at fixed rates expose the Group to fair value interest rate risk.

The Group borrows a mixture of fixed and variable rate debt in a range of currencies. The Group actively hedges its repricing profile using interest rate swaps in accordance with its Treasury Policy in order to minimise the cost of debt and manage the volatility of finance costs. The Group's benchmark is to ensure between 20% and 55% of interest payments are fixed depending upon the maturity of the debt.

**Exposure to interest rate risk**

Sensitivities to interest rate risk have been assessed on the basis of a 100 basis point movement in interest rates. A 100 basis point movement is considered reasonably possible over the short term. Sensitivities are presented net of tax based on a tax rate of 33%.

## 19 Financial risk management (continued)

*Fair value sensitivity analysis*

A change in interest rates impacts the fair value of the Group's fixed rate debt instruments and its interest rate derivatives. Fair value changes impact on profit or loss for all interest rate derivatives and where hedged risks on certain debt instruments are recognised at fair value. All such fair value changes are recognised in the income statement. The fair value sensitivity to a 100 basis point movement in interest rates (based on financial assets and liabilities held at the reporting date) is as follows:

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| Fair value gain/(loss) from 100 bp increase | **44** | 36 | **41** | 38 |
| Fair value gain/(loss) from 100 bp decrease | **(47)** | (38) | **(44)** | (41) |

*Cash flow sensitivity analysis*

A change in the interest rates would also impact on interest payments and receipts on the Group's floating rate debt instruments (including the floating leg of any interest rate derivatives) recognised in the income statement. The cash flow sensitivity to a 100 basis point movement in interest rates (based on financial assets and liabilities held at the reporting date) is as follows:

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| One year cash flow impact of 100 bp increase | **(11)** | (13) | **16** | 13 |
| One year cash flow impact of 100 bp decrease | **11** | 13 | **(16)** | (13) |

**Credit risk**

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Group's receivables from customers.

Contracts for sale are only entered into with customers whose credit limits are in accordance with the Group's delegated authorities approved by the Board.

At balance date the analysis of Group trade and other receivables (excluding prepayments) is as follows:

| | | PAST DUE BUT NOT IMPAIRED | | | |
|---|---|---|---|---|---|
| $ million | Neither past due nor impaired | Less than 1 month past due | More than 1 month but less than 3 months past due | More than 3 months past due | Total |
| **2008** | **1,619** | **347** | **130** | **59** | **2,155** |
| 2007 | 1,833 | 193 | 61 | 18 | 2,105 |

Parent has no trade and other receivables that are past due (31 May 2007: nil).

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 19 Financial risk management (continued)

**Credit risk (continued)**
The Group does not hold collateral or security in relation to credit risk and has no undue concentrations of credit risk.

The Group limits its exposure to credit risk by investing in liquid securities and entering into derivative instruments with counterparties that have a credit rating of at least 'A-' from Standard and Poor's or equivalent. Given this high credit rating threshold, management does not expect any counterparty to fail to meet its obligations.

The maximum credit risk on cash and cash equivalents, trade and other receivables, derivative financial instruments and other investments is best represented by their carrying values.

The maximum credit risk in relation to financial guarantees Parent and Group have provided to the Group's equity accounted investees is $62 million (31 May 2007: $66 million). Parent and Group have also provided a financial guarantee to an external party with a maximum credit risk of $23 million (31 May 2007: $7 million). Parent has provided financial guarantees to other Group entities for which the maximum credit risk is $279 million (31 May 2007: nil).

**Liquidity risk**
Liquidity risk is the risk that the Group will not be able to meet its financial obligations as they fall due. The Group's approach to managing liquidity is to ensure that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group's reputation.

Typically the Group ensures that it has sufficient cash or facilities on demand to meet expected operational expenses for a period of at least 80 days, including the servicing of financial obligations; this excludes the potential impact of extreme circumstances that cannot reasonably be predicted, such as natural disasters, although back-up funding lines are maintained for such situations.

Group Treasury manages the Group's liquidity by retaining cash and marketable securities, the availability of funding from an adequate amount of committed credit facilities and the ability to close out market positions. At balance date the Group had undrawn lines of credit totalling $3,021 million (31 May 2007: $2,355 million).

The timing of the maturity of the current carrying value of the Group's cash flow hedges is as follows:

| | CONSOLIDATED $ MILLION | |
|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 |
| Current | **(69)** | 232 |
| Non-current (12–18 months) | **(8)** | 43 |
| Total carrying value | **(77)** | 275 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 19 Financial risk management (continued)

**Exposure to liquidity risk**

| | AS AT 31 JULY 2008 | | | | | |
|---|---|---|---|---|---|---|
| **$ million** | **Carrying amount** | **Contractual cash flows** | **3 months or less** | **3–12 months** | **1–5 years** | **More than 5 years** |
| ***Consolidated*** | | | | | | |
| **Non-derivative financial liabilities** | | | | | | |
| Borrowings | | | | | | |
| – Commercial paper | **(1,607)** | **(1,640)** | **(858)** | **(780)** | **–** | **(2)** |
| – Unsecured bank loans | **(1,677)** | **(1,940)** | **(198)** | **(122)** | **(1,617)** | **(3)** |
| – Finance lease liabilities | **(67)** | **(78)** | **(4)** | **(11)** | **(40)** | **(23)** |
| – Medium term notes | **(3,167)** | **(4,095)** | **(106)** | **(353)** | **(2,325)** | **(1,311)** |
| Capital notes | **(35)** | **(51)** | **(1)** | **(2)** | **(13)** | **(35)** |
| Bank overdrafts | **(67)** | **(67)** | **(67)** | **–** | **–** | **–** |
| Trade and other payables | **(2,101)** | **(2,101)** | **(2,101)** | **–** | **–** | **–** |
| | **(8,721)** | **(9,972)** | **(3,335)** | **(1,268)** | **(3,995)** | **(1,374)** |
| **Derivative financial instruments** | | | | | | |
| Gross settled derivatives | | | | | | |
| Gross settled derivatives – Outflow | | **(18,643)** | **(8,555)** | **(5,074)** | **(4,300)** | **(714)** |
| Gross settled derivatives – Inflow | | **18,054** | **8,407** | **4,873** | **4,199** | **575** |
| | **(216)** | **(589)** | **(148)** | **(201)** | **(101)** | **(139)** |
| Net settled derivatives | **(1)** | **(13)** | **7** | **34** | **(15)** | **(39)** |
| ***Parent*** | | | | | | |
| **Non-derivative financial liabilities** | | | | | | |
| Borrowings | | | | | | |
| – Commercial paper | **(1,605)** | **(1,638)** | **(858)** | **(780)** | **–** | **–** |
| – Unsecured bank loans | **(25)** | **(25)** | **(6)** | **(19)** | **–** | **–** |
| – Finance lease liabilities | **–** | **–** | **–** | **–** | **–** | **–** |
| – Medium term notes | **(3,096)** | **(4,024)** | **(35)** | **(353)** | **(2,325)** | **(1,311)** |
| Capital notes | **(35)** | **(51)** | **(1)** | **(2)** | **(13)** | **(35)** |
| Bank overdrafts | **–** | **–** | **–** | **–** | **–** | **–** |
| Trade and other payables | **(1,155)** | **(1,155)** | **(1,155)** | **–** | **–** | **–** |
| | **(5,916)** | **(6,893)** | **(2,055)** | **(1,154)** | **(2,338)** | **(1,346)** |
| **Derivative financial instruments** | | | | | | |
| Gross settled derivatives | | | | | | |
| Gross settled derivatives – Outflow | | **(18,156)** | **(8,133)** | **(5,010)** | **(4,299)** | **(714)** |
| Gross settled derivatives – Inflow | | **17,563** | **7,981** | **4,807** | **4,200** | **575** |
| | **(219)** | **(593)** | **(152)** | **(203)** | **(99)** | **(139)** |
| Net settled derivatives | **(1)** | **(13)** | **7** | **34** | **(15)** | **(39)** |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 19 Financial risk management (continued)

**Exposure to liquidity risk (continued)**

| | AS AT 31 MAY 2007 | | | | | |
|---|---|---|---|---|---|---|
| | Carrying amount | Contractual cash flows | 3 months or less | 3–12 months | 1–5 years | More than 5 years |
| ***Consolidated*** | | | | | | |
| **Non-derivative financial liabilities** | | | | | | |
| Borrowings | | | | | | |
| – Commercial paper | (519) | (526) | (193) | (331) | – | (2) |
| – Unsecured bank loans | (1,848) | (2,057) | (162) | (101) | (1,791) | (3) |
| – Finance lease liabilities | (188) | (212) | (33) | (97) | (48) | (34) |
| – Medium term notes | (2,570) | (3,274) | (95) | (421) | (1,304) | (1,454) |
| Capital notes | (35) | (51) | (1) | (2) | (13) | (35) |
| Bank overdrafts | (69) | (69) | (69) | – | – | – |
| Trade and other payables | (1,754) | (1,754) | (1,754) | – | – | – |
| | (6,983) | (7,943) | (2,307) | (952) | (3,156) | (1,528) |
| **Derivative financial instruments** | | | | | | |
| Gross settled derivatives | | | | | | |
| Gross settled derivatives – Outflow | | (16,631) | (5,857) | (6,440) | (3,330) | (1,004) |
| Gross settled derivatives – Inflow | | 16,547 | 6,220 | 6,634 | 2,807 | 886 |
| | 213 | (84) | 363 | 194 | (523) | (118) |
| Net settled derivatives | 8 | (63) | (5) | 31 | 20 | (109) |
| ***Parent*** | | | | | | |
| **Non-derivative financial liabilities** | | | | | | |
| Borrowings | | | | | | |
| – Commercial paper | (517) | (524) | (193) | (331) | – | – |
| – Unsecured bank loans | (925) | (994) | (22) | (62) | (910) | – |
| – Finance lease liabilities | – | – | – | – | – | – |
| – Medium term notes | (2,498) | (3,202) | (23) | (421) | (1,304) | (1,454) |
| Capital notes | (35) | (51) | (1) | (2) | (13) | (35) |
| Bank overdrafts | (40) | (40) | (40) | – | – | – |
| Trade and other payables | (1,035) | (1,035) | (1,035) | – | – | – |
| | (5,050) | (5,846) | (1,314) | (816) | (2,227) | (1,489) |
| **Derivative financial instruments** | | | | | | |
| Gross settled derivatives | | | | | | |
| Gross settled derivatives – Outflow | | (16,574) | (5,800) | (6,440) | (3,330) | (1,004) |
| Gross settled derivatives – Inflow | | 16,333 | 6,006 | 6,634 | 2,807 | 886 |
| | 213 | (241) | 206 | 194 | (523) | (118) |
| Net settled derivatives | 8 | (63) | (5) | 31 | 20 | (109) |

Amounts due to consolidated subsidiaries and repayable on demand (refer notes 12 and 23) have been excluded from the above table.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 19 Financial risk management (continued)

**Financial instrument classifications**

All financial assets other than derivatives are classified as 'loans and receivables'. All financial liabilities other than derivatives are classified as 'other amortised cost'.

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | As at 31 May 2007 | **As at 31 July 2008** | As at 31 May 2007 |
| Loans and receivables | **2,914** | 2,372 | **8,526** | 7,161 |
| Other amortised cost | **(8,721)** | (6,983) | **(12,213)** | (10,485) |
| *Derivative assets* | | | | |
| Designated in hedge relationships | **194** | 256 | **125** | – |
| Not designated in hedge relationships(1) | **92** | 569 | **157** | 825 |
| | **286** | 825 | **282** | 825 |
| *Derivative liabilities* | | | | |
| Designated in hedge relationships | **(457)** | (563) | **(195)** | (273) |
| Not designated in hedge relationships(1) | **(46)** | (41) | **(307)** | (331) |
| | **(503)** | (604) | **(502)** | (604) |

Note:

(1) Derivatives that are not designated in hedge relationships for hedge accounting purposes are still entered into by the Group as economic hedges over currency and interest rate exposure.

**Fair values**

The carrying values of financial instruments approximate their fair values other than as noted below:

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **As at 31 July 2008** | | **As at 31 July 2008** | |
| | **Carrying value** | **Fair value** | **Carrying value** | **Fair value** |
| Commercial paper | **(1,607)** | **(1,609)** | **(1,605)** | **(1,607)** |
| Unsecured bank loans | **(1,677)** | **(1,678)** | **(25)** | **(25)** |
| Finance lease liabilities | **(67)** | **(66)** | **–** | **–** |
| Medium term notes | **(3,167)** | **(3,141)** | **(3,096)** | **(3,070)** |

| | As at 31 May 2007 | | As at 31 May 2007 | |
|---|---|---|---|---|
| | Carrying value | Fair value | Carrying value | Fair value |
| Unsecured bank loans | (1,848) | (1,839) | (925) | (913) |
| Medium term notes | (2,570) | (2,577) | (2,498) | (2,506) |
| Capital notes | (35) | (39) | (35) | (39) |

**Basis for determining fair values**

The fair value of forward exchange contracts, currency options and collars, and cross currency interest rate swaps is based on their market price or generally accepted valuation methodologies.

The fair value of interest rate swaps is based on accepted valuation methodologies. These prices are tested for reasonableness by discounting estimated future cash flows based on the terms and maturity of each contract and using market interest rates for a similar instrument at the reporting date.

The fair values of financial liabilities are calculated by discounting the future contractual cash flows at the current market interest rates that are available for similar financial instruments.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 19 Financial risk management (continued)

**Capital management**

The Board's policy is to maintain a strong capital base so as to maintain shareholder, creditor and market confidence and to sustain future development of the business.

The Group's objective is to provide returns for shareholders and benefits for the other stakeholders and to maintain an optimal capital structure to reduce the cost of capital. The Group distributes its surplus by way of payout. In order to retain or modify the capital structure, the Group may decide to retain profits within the business.

The Board primarily monitors capital on the basis of the gearing ratio. This ratio is calculated as net interest bearing debt divided by total capital. Net interest bearing debt is calculated as total borrowings less cash and cash equivalents. Total capital is calculated as equity, as presented on the balance sheet (excluding the cash flow hedge reserve), plus net interest bearing debt.

The Group's target is to achieve a gearing ratio of between 45% and 55%. For the period ending 31 July 2008 the gearing ratio was 57% (31 May 2007: 51%). The current gearing ratio, driven both by high commodity prices and end of season equity adjustments, is above the Board's target level. An action plan is being implemented to return to the target level.

The Group is not subject to externally imposed capital requirements.

## 20 Contingent liabilities

The Group and Parent have no contingent liabilities as at 31 July 2008 (31 May 2007: nil).

In the normal course of its business Fonterra, its subsidiaries and associates are exposed to claims, legal proceedings and arbitrations that may in some cases result in costs to the Group. The Directors believe that these have been adequately provided for by the Group and there are no additional legal proceedings or arbitrations that are pending at the date of these financial statements that require provision or disclosure.

## 21 Commitments

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Capital expenditure and intangible asset commitments** | | | | |
| Capital expenditure and intangible assets contracted for at balance date but not recognised in the financial statements are as follows: | | | | |
| Buildings | **–** | 10 | **–** | – |
| Plant, vehicles and equipment | **177** | 92 | **1** | 1 |
| Intangible assets | **3** | – | **2** | 2 |
| **Total capital commitments** | **180** | 102 | **3** | 3 |

In respect to the Group's interest in equity accounted investees (see note 10), the Group's share of their capital expenditure commitments is nil (31 May 2007: nil).

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Operating lease commitments** | | | | |
| The Group leases premises, plant and equipment. The future aggregate minimum lease payments under non-cancellable operating leases are as follows: | | | | |
| Less than one year | **50** | 56 | **5** | 5 |
| One to five years | **107** | 119 | **11** | 13 |
| Greater than five years | **91** | 42 | **15** | 4 |
| Share of equity accounted investees operating lease commitments | **4** | 14 | **–** | – |
| **Total operating lease commitments** | **252** | 231 | **31** | 22 |

## 22 Segment reporting

The Group has four reportable segments that are defined by product type and geographic area to reflect how the Group's operations are managed.

The reportable segments identified below differ from those identified in the Group's most recent interim financial statements. This change reflects an enhancement of the Group's management and reporting structure as viewed by the Fonterra Leadership Team, who are the chief operating decision makers.

The Commodities & Ingredients segment includes the manufacturing business in New Zealand together with the integrated offshore supply chain, manufacturing operations and specialty ingredients business. Commodities & Ingredients generates its revenue primarily from ingredient milk products. All other reportable segments generate their revenue primarily from consumer products and exclude any part of the Group's operations that is included within Commodities & Ingredients.

Transactions between segments are based on estimated market prices.

| ***Reportable segment*** | ***Description*** |
|---|---|
| Commodities & Ingredients | Includes New Zealand Milk Supply, New Zealand Manufacturing, Sales and Operations Planning, Global Trade, Global Supply Chain, Fonterra Ingredients and Specialty Ingredients operations in North Asia, North America and Europe (including equity accounted investments), and Corporate. |
| ANZ | Represents operations in New Zealand (other than those included in Commodities & Ingredients) and Australia (including Milk Supply and Manufacturing). |
| Asia / AME | Represents operations and equity accounted investments in Asia (excluding North Asia), Africa and the Middle East. |
| Latam | Represents operations and equity accounted investments in South America. |

| **$ million** | **Commodities & Ingredients** | **ANZ** | **Asia / AME** | **Latam** | **Eliminations** | **Total Group** |
|---|---|---|---|---|---|---|
| ***Segment revenue*** | | | | | | |
| *14 months ended 31 July 2008* | | | | | | |
| Total external revenue | **13,517** | **3,302** | **1,904** | **789** | **–** | **19,512** |
| Inter-segment revenue | **2,009** | **696** | **84** | **53** | **(2,842)** | **–** |
| Total revenue | **15,526** | **3,998** | **1,988** | **842** | **(2,842)** | **19,512** |
| *Year ended 31 May 2007* | | | | | | |
| Total external revenue | 9,236 | 2,366 | 1,534 | 551 | – | 13,687 |
| Inter-segment revenue | 1,210 | 588 | 11 | 32 | (1,841) | – |
| Total revenue | 10,446 | 2,954 | 1,545 | 583 | (1,841) | 13,687 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 22 Segment reporting (continued)

| $ million | Commodities & Ingredients | ANZ | Asia / AME | Latam | Eliminations | Total Group |
|---|---|---|---|---|---|---|
| ***Segment profit*** | | | | | | |
| *14 months ended 31 July 2008* | | | | | | |
| Segment operating profit before depreciation, amortisation and non-recurring items | **824** | **266** | **96** | **119** | **(36)** | **1,269** |
| Depreciation | **(362)** | **(75)** | **(8)** | **(20)** | **–** | **(465)** |
| Amortisation | **(78)** | **(1)** | **(1)** | **(1)** | **–** | **(81)** |
| Share of royalty income | **2** | **1** | **–** | **17** | **–** | **20** |
| Non-recurring items | **(156)** | **12** | **(1)** | **–** | **–** | **(145)** |
| Segment profit before finance costs, equity accounted income and tax | **230** | **203** | **86** | **115** | **(36)** | **598** |
| Share of profit of equity accounted investees | **137** | **–** | **7** | **14** | **–** | **158** |
| Impairment of equity accounted investees | **–** | **–** | **(142)** | **–** | **–** | **(142)** |
| Segment profit before finance costs and tax | **367** | **203** | **(49)** | **129** | **(36)** | **614** |
| Unallocated finance income | | | | | | **76** |
| Unallocated finance costs | | | | | | **(443)** |
| Unallocated tax income/(expense) | | | | | | **47** |
| Profit/(loss) for the period (before value return) | | | | | | **294** |
| *Year ended 31 May 2007* | | | | | | |
| Segment operating profit before depreciation, amortisation and non-recurring items | 1,257 | 265 | 57 | 68 | 41 | 1,688 |
| Depreciation | (307) | (62) | (10) | (18) | – | (397) |
| Amortisation | (62) | (1) | – | (1) | – | (64) |
| Share of royalty income | – | 1 | – | 13 | – | 14 |
| Non-recurring items | (23) | (3) | – | 3 | – | (23) |
| Segment profit before finance costs, equity accounted income and tax | 865 | 200 | 47 | 65 | 41 | 1,218 |
| Share of profit of equity accounted investees | 53 | – | 15 | 5 | – | 73 |
| Impairment of equity accounted investees | – | – | (13) | (12) | – | (25) |
| Segment profit before finance costs and tax | 918 | 200 | 49 | 58 | 41 | 1,266 |
| Unallocated finance income | | | | | | 24 |
| Unallocated finance costs | | | | | | (358) |
| Unallocated tax income/(expense) | | | | | | (279) |
| Profit/(loss) for the period (before value return) | | | | | | 653 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 22 Segment reporting (continued)

| $ million | Commodities & Ingredients | ANZ | Asia / AME | Latam | Eliminations | Total Group |
|---|---|---|---|---|---|---|
| ***Segment assets*** | | | | | | |
| *As at and for the 14 months ended 31 July 2008* | | | | | | |
| Total assets | **9,061** | **3,737** | **1,374** | **892** | **(625)** | **14,439** |
| Equity accounted investments (included in total assets) | **282** | **–** | **62** | **248** | **–** | **592** |
| Expenditure on reportable non-current assets | **405** | **121** | **33** | **196** | **–** | **755** |
| *As at and for the year ended 31 May 2007* | | | | | | |
| Total assets | 9,060 | 3,351 | 1,248 | 602 | (767) | 13,494 |
| Equity accounted investments (included in total assets) | 241 | – | 187 | 202 | – | 630 |
| Expenditure on reportable non-current assets | 409 | 147 | 5 | 50 | – | 611 |

| | CONSOLIDATED $ MILLION | |
|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| ***Entity wide products and services*** | | |
| Consumer products – external revenue | **5,249** | 3,932 |
| Ingredients – external revenue | **14,263** | 9,755 |
| Total Group revenue | **19,512** | 13,687 |

| $ million | New Zealand | Australia | U.S.A. | Rest of world | Eliminations | Total |
|---|---|---|---|---|---|---|
| ***Geographical segment revenue*** | | | | | | |
| *14 months ended 31 July 2008* | | | | | | |
| Total external revenue | **9,918** | **2,213** | **1,911** | **5,470** | **–** | **19,512** |
| Inter-segment revenue | **4,846** | **613** | **47** | **206** | **(5,712)** | **–** |
| Total revenue | **14,764** | **2,826** | **1,958** | **5,676** | **(5,712)** | **19,512** |
| *Year ended 31 May 2007* | | | | | | |
| Total external revenue | 6,205 | 1,609 | 1,499 | 4,374 | – | 13,687 |
| Inter-segment revenue | 3,777 | 560 | 12 | 81 | (4,430) | – |
| Total revenue | 9,982 | 2,169 | 1,511 | 4,455 | (4,430) | 13,687 |
| ***Geographical segment reportable non-current assets*** | | | | | | |
| As at 31 July 2008 | **5,110** | **1,077** | **99** | **1,454** | **–** | **7,740** |
| As at 31 May 2007 | 5,181 | 953 | 90 | 1,294 | – | 7,518 |

Revenue is allocated to geographical segments on the basis of where the sale is legally recorded.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 23 Related party transactions

Note 24 identifies all significant equity accounted investees. All of these entities and key management personnel are related parties of the Group. Other related parties include entities controlled by or significantly influenced by key management personnel or their close family members.

Key management personnel include the Board and the Fonterra Leadership Team. The Board received Directors' fees totalling $2 million for the 14 months ended 31 July 2008 (year ended 31 May 2007: $2 million). The Fonterra Leadership Team received short term employee benefits of $12 million (year ended 31 May 2007: $9 million) and termination benefits of $1 million (year ended 31 May 2007: nil).

Other related party transactions are as follows:

**i) Sales and purchases**

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Sales of goods:** | | | | |
| Equity accounted investees | **431** | 341 | **–** | – |
| Other Group entities | **–** | – | **9,199** | 4,870 |
| | **431** | 341 | **9,199** | 4,870 |
| **Sales of services:** | | | | |
| Equity accounted investees | **4** | 4 | **–** | – |
| Other Group entities | **–** | – | **31** | 4 |
| | **4** | 4 | **31** | 4 |

Goods sold to related parties are primarily commodity products and are provided on an arms length basis, under normal trade terms.

Services provided to related parties include management fees and are provided on an arms length basis, under normal trade terms.

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Purchases of goods:** | | | | |
| Equity accounted investees | **459** | 238 | **–** | – |
| Other Group entities | **–** | – | **19** | 10 |
| Key management personnel | **210** | 103 | **210** | 103 |
| | **669** | 341 | **229** | 113 |
| **Purchases of services:** | | | | |
| Equity accounted investees | **2** | – | **–** | – |
| | **2** | – | **–** | – |

Goods purchased from related parties are primarily commodity products, which are acquired on an arms length basis and under normal trade terms.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 23 Related party transactions (continued)

**ii) Period end balances arising from sales/purchases of goods/services**

Provisions for doubtful debts on related party balances are disclosed in Note 7.

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Receivables from related parties:** | | | | |
| Equity accounted investees | **48** | 34 | **–** | – |
| Other Group entities | **–** | – | **19** | 17 |
| | **48** | 34 | **19** | 17 |
| **Payables to related parties:** | | | | |
| Equity accounted investees | **36** | 13 | **–** | – |
| Other Group entities | **–** | – | **19** | 238 |
| Key management personnel | **24** | 18 | **24** | 18 |
| | **60** | 31 | **43** | 256 |

**iii) Financing arrangements with related parties**

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Period end balances from financing arrangements** | | | | |
| *Receivables from related parties:* | | | | |
| Equity accounted investees | **78** | 83 | **–** | – |
| Receivables from other Group entities | **–** | – | **8,036** | 7,138 |
| | **78** | 83 | **8,036** | 7,138 |
| *Payables to related parties:* | | | | |
| Payables to other Group entities | **–** | – | **6,278** | 5,197 |
| | **–** | – | **6,278** | 5,197 |
| **Interest income/(expense) from financing arrangements** | | | | |
| *Interest income from related parties:* | | | | |
| Equity accounted investees | **7** | 4 | **–** | – |
| Other Group entities | **–** | – | **438** | 360 |
| | **7** | 4 | **438** | 360 |
| *Interest expense to related parties:* | | | | |
| Other Group entities | **–** | – | **(85)** | (50) |
| | **–** | – | **(85)** | (50) |

All loans to related parties are unsecured and repayable in cash on demand.

**iv) Financial guarantees**

The Parent and Group have provided financial guarantees for several equity accounted investees. The aggregate amount of equity accounted investees liabilities for which the Group is jointly and severally liable is $62 million (31 May 2007: $66 million). The Parent has provided financial guarantees for other Group entities totalling $279 million (31 May 2007: nil)

## 23 Related party transactions (continued)

**v) Co-operative share transactions with Directors**

| | CONSOLIDATED $ MILLION | | PARENT $ MILLION | |
|---|---|---|---|---|
| | **14 months to 31 July 2008** | 12 months to 31 May 2007 | **14 months to 31 July 2008** | 12 months to 31 May 2007 |
| **Co-operative shares issued/(surrendered)** | | | | |
| Issued | **35** | 11 | **35** | 11 |
| Surrendered | **(20)** | (3) | **(20)** | (3) |
| **Value return payment to Directors** | **2** | 16 | **2** | 16 |
| **Period end balances outstanding** | | | | |
| Payable to Directors | **–** | 11 | **–** | 11 |

## 24 Group entities

All subsidiaries, and equity accounted investees are involved in marketing, distribution, processing, technology or financing dairy products. All Group entities have a balance date of 31 July unless otherwise indicated (comparative balance date of 31 May unless otherwise indicated). Subsidiaries and equity accounted investees with different reporting dates from that of the Group is due to legislative requirements in the country the entity is domiciled. Equity accounted investees may also have a different balance date due to alignment with the other investors balance date or to align with the milk season.

The Companies Office has given exemptions for a number of Fonterra's subsidiaries to maintain balance dates different to that of the Group.

The Group holds investments in certain countries that have some limited restrictions on the repatriation of funds back to the Parent entity. This does not result in any significant restriction on the flow of funds for the Group.

The significant subsidiaries and equity accounted investees of the Group are listed below.

| | | Ownership interests (%) | |
|---|---|---|---|
| **Overseas subsidiaries** | **Country of incorporation** | **As at 31 July 2008** | As at 31 May 2007 |
| Australasian Food Holdings Pty Limited | Australia | **100** | 100 |
| Fonterra Brands (Australia) Pty Ltd | Australia | **100** | 100 |
| Fonterra Ingredients Australia Pty Ltd | Australia | **100** | 100 |
| New Zealand Milk (Australasia) Pty Limited | Australia | **100** | 100 |
| Fonterra (Brazil) Ltda(1) | Brazil | **100** | 100 |
| Soprole S.A.(1), (2) | Chile | **99.8** | 57 |
| Fonterra (Europe) GmbH | Germany | **100** | 100 |
| Fonterra (China) Ltd | Hong Kong | **100** | 100 |
| Fonterra (Italy) SpA | Italy | **100** | 100 |
| PT Fonterra Brands Indonesia | Indonesia | **100** | 100 |
| Fonterra Brands (Malaysia) Sdn Bhd | Malaysia | **100** | 100 |
| Fonterra (Mexico) S.A. de C.V.(1) | Mexico | **100** | 100 |
| Fonterra Brands Phils. Inc. | Philippines | **100** | 100 |
| Fonterra Brands (Asia Holdings) Pte Ltd | Singapore | **100** | 100 |
| Fonterra Brands (Singapore) Pte Ltd | Singapore | **100** | 100 |
| Fonterra Brands (New Young) Pte Ltd | Singapore | **51** | 51 |
| Fonterra (SEA) Pte Ltd | Singapore | **100** | 100 |
| Fonterra Brands Lanka (Private) Ltd | Sri Lanka | **100** | 100 |
| Fonterra Brands (Thailand) Ltd | Thailand | **100** | 100 |
| Fonterra (Logistics) Ltd | United Kingdom | **100** | 100 |
| Fonterra Brands (Americas), Inc | USA | **100** | 100 |
| Fonterra (USA) Inc | USA | **100** | 100 |
| Fonterra (Venezuela) S.A.(1) | Venezuela | **100** | 100 |

Notes:
(1) Balance date 31 December (comparative ownership interest % consistent at 31 December 2006).
(2) On 18 August 2008 Sociedad Productores de Leche S.A., Soprole was renamed Soprole S.A.

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 24 Group entities (continued)

| New Zealand subsidiaries | Country of incorporation | Ownership interests (%) As at 31 July 2008 | As at 31 May 2007 |
|---|---|---|---|
| Canpac International Limited | New Zealand | **100** | 100 |
| Fencepost.com Limited | New Zealand | **100** | 100 |
| Fonterra Brands Limited | New Zealand | **100** | 100 |
| Fonterra Brands (New Zealand) Limited | New Zealand | **100** | 100 |
| Fonterra Brands (Tip Top) Limited | New Zealand | **100** | 100 |
| Fonterra Limited | New Zealand | **100** | 100 |
| Fonterra (New Zealand) Limited | New Zealand | **100** | 100 |
| Kapiti Fine Foods Limited | New Zealand | **100** | 100 |
| New Zealand Dairy Board | New Zealand | **100** | 100 |
| NZagbiz Limited | New Zealand | **100** | 100 |
| Vialactia Biosciences (NZ) Limited | New Zealand | **100** | 100 |
| Whareroa Co-Generation Limited | New Zealand | **100** | 100 |

The ownership interest of the following entities is 50% or less. However, they have been consolidated on the basis that the Group controls them based on its capacity to determine the financing and operating policies that guide the activities of these entities and has an entitlement to a significant level of ownership benefits.

| Overseas subsidiaries 50% or less ownership | Country of incorporation | Ownership interests (%) As at 31 July 2008 | As at 31 May 2007 |
|---|---|---|---|
| Fonterra (Japan) Ltd | Japan | **50** | 50 |
| Fonterra Brands (Mauritius) Ltd(1) | Mauritius | **49** | 49 |
| Saudi New Zealand Milk Products Company Ltd(1) | Saudi Arabia | **49** | 49 |
| Fonterra Brands (Middle East) L.L.C. | UAE | **49** | 49 |

Note:

(1) Balance date 31 May (comparative ownership interest % consistent at 31 May 2007).

The ownership interest of the following entities is 50% or less and the Group is not considered to exercise a controlling interest. These entities are therefore accounted for as equity accounted investees.

| Overseas equity accounted investees not consolidated | Country of incorporation | Ownership interests (%) As at 31 July 2008 | As at 31 May 2007 |
|---|---|---|---|
| Dairy Partners Americas Argentina S.A.(1) | Argentina | **50** | 50 |
| DPA Manufacturing Holdings Limited(1) | Bermuda | **50** | 50 |
| Dairy Partners Americas Brasil Limitada(1) | Brazil | **50** | 50 |
| Shijiazhuang San Lu Group Company Limited(1) | China | **43** | 43 |
| AFF P/S(1) | Denmark | **25** | 25 |
| Dairy Partners Americas del Ecuador S.A.(1) | Ecuador | **50** | 50 |
| DMV Fonterra Excipients GmbH & Co KG(1) | Germany | **50** | 50 |
| Britannia New Zealand Foods PVTE Limited(2) | India | **49** | 49 |
| Dairy Industries (Jamaica) Limited(1) | Jamaica | **50** | 50 |
| Dairiconcepts, L.P.(1) | USA | **50** | 50 |
| Dairiconcepts Management, L.L.C.(1) | USA | **50** | 50 |
| Corporacion Inlaca, C.A.(1) | Venezuela | **25** | 25 |

Notes:

(1) Balance date 31 December (comparative ownership interest % consistent at 31 December 2006).

(2) Balance date 31 March (comparative ownership interest % consistent at 31 March 2007).

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 24 Group entities (continued)

| New Zealand equity accounted investees not consolidated | Country of incorporation | Ownership interests (%) As at 31 July 2008 | As at 31 May 2007 |
|---|---|---|---|
| RD1 Limited[1] | New Zealand | **50** | 50 |

Note:

(1) Balance date 31 May (comparative ownership interest % consistent at 31 May 2007).

## 25 Subsequent events

There were no material events subsequent to 31 July 2008 that would impact these financial statements.

## 26 Explanation of transition to NZ IFRS

***Consolidated***

*Reconciliation of NZ IFRS equity with Previous NZ GAAP at 31 May 2006.*

| $ million | Equity | Total Liabilities | Total Assets |
|---|---|---|---|
| Reported under Previous NZ GAAP | 5,145 | 7,935 | 13,080 |
| Deferred taxation[1] | (572) | 572 | – |
| Business combinations[2] | 127 | (5) | 122 |
| Fair value of land[3] | 126 | – | 126 |
| Financial instruments[4] | (49) | 317 | 268 |
| Recognition of tax losses[5] | 44 | (44) | – |
| Other adjustments | (3) | (2) | (5) |
| Total NZ IFRS adjustments | (327) | 838 | 511 |
| Restated under NZ IFRS | 4,818 | 8,773 | 13,591 |

*Reconciliation of NZ IFRS equity and profit with Previous NZ GAAP at and for the year ended 31 May 2007.*

| $ million | Equity | Total Liabilities | Total Assets | Profit for the period |
|---|---|---|---|---|
| Reported under Previous NZ GAAP | 5,016 | 7,615 | 12,631 | 31 |
| Deferred taxation[1] | (533) | 533 | – | 35 |
| Business combinations[2] | 174 | (4) | 170 | 47 |
| Fair value of land[3] | 125 | – | 125 | – |
| Financial instruments[4] | 143 | 424 | 567 | 39 |
| Recognition of tax losses[5] | 53 | (53) | – | 9 |
| Value return payment[6] | – | – | – | 488 |
| Other adjustments | – | 1 | 1 | 4 |
| Total NZ IFRS adjustments | (38) | 901 | 863 | 622 |
| Restated under NZ IFRS | 4,978 | 8,516 | 13,494 | 653 |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 26 Explanation of transition to NZ IFRS (continued)

**1. Deferred taxation**

Under NZ IFRS deferred tax is recognised on all temporary differences between the accounting carrying value and tax base for each asset and liability, which is known as the balance sheet approach. Under Previous NZ GAAP deferred tax was only recognised for the effect of timing differences between accounting and tax profits. This change in methodology results in the recognition of deferred tax under NZ IFRS that would have been considered permanent differences under Previous NZ GAAP and not recognised.

Under NZ IFRS deferred tax liabilities are recognised in respect of brands and property, plant and equipment revalued on the formation of the Group. The additional deferred tax liability recognised at 31 May 2007 is $471 million (31 May 2006: $525 million). The impact on profit for the year ended 31 May 2007 is an increase of $50 million, of which $47 million relates to the change in deferred tax recognition rates, and $3 million relates to the unwinding of deferred tax liability relating to property, plant and equipment revalued on the formation of the Group.

The application of the balance sheet approach to calculating deferred tax results in the recognition of the withholding tax payable on offshore subsidiaries' retained earnings to the extent the temporary difference will probably reverse in the foreseeable future. Under Previous NZ GAAP this liability only arose when the repatriation of retained earnings was recognised in the parent company's profit or loss. This has resulted in the recognition of a deferred tax liability at 31 May 2007 of $62 million (31 May 2006: $47 million), and a reduction in profit for the year to 31 May 2007 of $15 million.

**2. Business combinations**

The Group has taken advantage of the exemption available under NZ IFRS 1 and applied NZ IFRS to all business combinations only since 31 August 2005 and re-performed the fair value exercise on all business combinations subsequent to that date.

The key impacts for the Group in respect of the differences between Previous NZ GAAP and NZ IFRS relate to the amortisation of goodwill and the treatment of discounts on acquisition. Under NZ IFRS goodwill is no longer amortised but is subject to impairment testing. Discounts on acquisition are recognised in the income statement under NZ IFRS rather than being offset against the fair values of non-monetary items, as required under Previous NZ GAAP.

In respect of the business combinations re-opened, the recognition of additional deferred tax liabilities has resulted in an increase to the amount of goodwill recognised. The overall impact is to increase net assets at 31 May 2007 by $90 million (31 May 2006: $90 million), of which goodwill represents $86 million (31 May 2006: $85 million).

The effect of reversing goodwill amortisation from 31 August 2005 is to increase goodwill at 31 May 2007 by $63 million (31 May 2006: $24 million), and increase investments in associates at 31 May 2007 by $16 million (31 May 2006: $5 million). This results in an increase to profit for the year to 31 May 2007 of $50 million.

The impact of the change in treatment of the discount on acquisition is to increase property, plant and equipment at 31 May 2007 by $5 million (31 May 2006: $8 million). This results in a decrease to profit for the year to 31 May 2007 of $3 million.

**3. Fair value of land**

NZ IFRS 1 provides entities an exemption allowing the fair value of items of property, plant and equipment to be used as deemed cost on transition to NZ IFRS, without the requirement to revalue those items going forward. The Group has elected to apply this exemption to land on its balance sheet at the date of transition. The effect of this is to increase property, plant and equipment at 31 May 2007 by $125 million (31 May 2006: $126 million). The aggregate fair value of land at 31 May 2007 for which fair value is used as deemed cost on transition to NZ IFRS is $237 million (31 May 2006: $239 million).

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 26 Explanation of transition to NZ IFRS (continued)

**4. Financial instruments**

NZ IAS 39 requires all derivative instruments to be recorded at fair value in the balance sheet with the related changes in fair value recognised in the income statement unless the instruments qualify for hedge accounting and the strict NZ IAS 39 hedging criteria are met. The Group has applied hedge accounting wherever practicable. Where such instruments qualify as cash flow hedges the effective portion of changes in fair value of those instruments will be recorded directly in equity until the hedged transaction occurs. Where such instruments qualify as fair value hedges, changes in the fair value of the instruments along with changes in the fair value of the related debt will be recorded in the income statement. Where such instruments qualify as net investment hedges the effective portion of changes in fair value of those instruments will be recorded directly in equity until the foreign operation is disposed. The resulting financial instrument adjustments had the following impact on the transition and comparative balance sheets and the comparative profit for the period to 31 May 2007:

| | CONSOLIDATED $ MILLION | |
|---|---|---|
| | 31 May 2007 Dr/(Cr) | 31 May 2006 Dr/(Cr) |
| Current derivative assets | 493 | 226 |
| Prepayments | (53) | (56) |
| Non-current derivative assets | 127 | 98 |
| Current derivative liabilities | (302) | (255) |
| Non-current derivative liabilities | (108) | (95) |
| Impact of recognising derivative instruments at fair value | 157 | (82) |
| | | |
| Debt | 47 | 9 |
| Deferred tax liability | (61) | 24 |
| Impact on net assets | 143 | (49) |
| | | |
| Transition retained earnings adjustment | 42 | 42 |
| Impact on profit for the twelve months ended 31 May 2007 | (39) | – |
| Cash flow hedge reserve | (149) | 7 |
| Foreign currency translation reserve | 3 | – |
| Impact on total equity | (143) | 49 |

**5. Recognition of tax losses**

The Group has recognised additional New Zealand tax losses because of the recognition of deferred tax liabilities on other NZ IFRS adjustments. The Group still has unrecognised offshore tax losses. The effect of recognising tax losses at 31 May 2007 was to decrease the deferred tax liability by $53 million (31 May 2006: $44 million), and increase profit for the year to 31 May 2007 by $9 million.

**6. Value return payment**

NZ IAS 32 contains specific guidelines on distinguishing whether payments made to shareholders are in their capacity as shareholders or in their capacity as suppliers. Accordingly the value return payment is shown as a deduction from equity rather than profit. The impact is to increase profit for the year to 31 May 2007 by $488 million (being the value return payout of $728 million less the tax credit of $240 million). This has no overall impact on equity.

**7. Foreign currency translation reserve**

The Group has elected to apply the exemption in NZ IFRS 1 to reset the foreign currency translation reserve to nil on transition, by transferring the balance of $156 million to retained earnings, which has no overall impact on equity.

## 26 Explanation of transition to NZ IFRS (continued)

**8. Software**

Software, to the extent it is not an integral part of the related hardware, has been reclassified from property, plant and equipment to intangible assets. The total amount of the reclassification at 31 May 2007 is $225 million (31 May 2006: $243 million). The amortisation expense has also been reclassified from depreciation to amortisation. The total amount reclassified within the income statement for the twelve months ended 31 May 2007 is $53 million. This adjustment has no overall impact on equity.

***Parent***

*Reconciliation of NZ IFRS equity with Previous NZ GAAP at 31 May 2006*

| $ million | Equity | Total Liabilities | Total Assets |
|---|---|---|---|
| Reported under Previous NZ GAAP | 5,017 | 9,226 | 14,243 |
| Investment in subsidiaries[1] | – | – | – |
| Fair value of land[2] | 5 | – | 5 |
| Financial instruments[3] | – | 351 | 351 |
| Recognition of tax losses[4] | 44 | – | 44 |
| Other adjustments | (1) | – | (1) |
| Total NZ IFRS adjustments | 48 | 351 | 399 |
| Restated under NZ IFRS | 5,065 | 9,577 | 14,642 |

*Reconciliation of NZ IFRS equity and profit with Previous NZ GAAP at and for the year ended 31 May 2007*

| $ million | Equity | Total Liabilities | Total Assets | Profit/(loss) for the period |
|---|---|---|---|---|
| Reported under Previous NZ GAAP | 4,880 | 10,798 | 15,678 | (31) |
| Investment in subsidiaries[1] | (663) | – | (663) | (663) |
| Fair value of land[2] | 5 | – | 5 | – |
| Financial instruments[3] | – | 394 | 394 | – |
| Recognition of tax losses[4] | 53 | – | 53 | 9 |
| Value return payment[5] | – | – | – | 488 |
| Other adjustments | (10) | – | (10) | (9) |
| Total NZ IFRS adjustments | (615) | 394 | (221) | (175) |
| Restated under NZ IFRS | 4,265 | 11,192 | 15,457 | (206) |

# NOTES TO THE FINANCIAL STATEMENTS (continued)

FOR THE 14 MONTHS ENDED **31 JULY 2008**

## 26 Explanation of transition to NZ IFRS (continued)

**1. Investment in subsidiaries**

NZ IFRS requires investments in subsidiaries in the separate financial statements of the investor to be recognised either at cost, or at fair value in accordance with NZ IAS 39. Under Previous NZ GAAP Fonterra recognised its investments in subsidiaries at their net asset carrying values, with the annual change recognised in the income statement. NZ IFRS 1 provides an exemption to enable the investor to recognise investments in subsidiaries at deemed cost on transition to NZ IFRS. One of the options available to use as the deemed cost is the Previous NZ GAAP carrying amount on the date of transition. Accordingly Fonterra has established the deemed cost of its subsidiaries on transition and reversed the net asset value uplift recognised during 2007, resulting in a reduction of profit for the year to 31 May 2007 of $663 million. The aggregate deemed cost of subsidiaries for which deemed cost was their Previous NZ GAAP carrying amount is $7,523 million.

**2. Fair value of land**

NZ IFRS 1 provides entities an exemption allowing the fair value of items of property, plant and equipment to be used as deemed cost on transition to NZ IFRS, without the requirement to revalue those items going forward. Fonterra has elected to apply this exemption to land on its balance sheet at the date of transition. The effect of this is to increase property, plant and equipment at 31 May 2007 by $5 million (31 May 2006: $5 million). The aggregate fair value of land at 31 May 2007 for which fair value is used as deemed cost on transition to NZ IFRS is $6 million (31 May 2006: $6 million).

**3. Financial instruments**

NZ IAS 39 requires all derivative instruments to be recorded at fair value in the balance sheet with the related changes in fair value recognised in the income statement. Fonterra does not apply hedge accounting in the Parent's financial statements. Fonterra has a deed of novation in respect of all gains and losses arising on derivative financial instruments, to transfer such gains and losses recognised in the income statement to another entity within the Group. Therefore, on transition to NZ IFRS Fonterra has recognised all derivative instruments at their fair values in the balance sheet, with an offsetting entry to intercompany payables and receivables. This entry has no overall impact on equity.

**4. Recognition of tax losses**

Fonterra has recognised additional New Zealand tax losses because of the recognition of deferred tax liabilities on other NZ IFRS adjustments. The effect of recognising tax losses at 31 May 2007 was to decrease the deferred tax liability by $53 million (31 May 2006: $44 million), and increase profit for the year to 31 May 2007 by $9 million.

**5. Value return payment**

NZ IAS 32 contains specific guidelines on distinguishing whether payments made to shareholders are in their capacity as shareholders or in their capacity as suppliers. Accordingly the value return payment is shown as a deduction from equity rather than profit. The impact is to increase profit for the year to 31 May 2007 by $488 million (being the value return payout of $728 million less the tax credit of $240 million). This has no overall impact on equity.

**6. Software**

Software, to the extent it is not an integral part of the related hardware, has been reclassified from property, plant and equipment to intangible assets. The total amount of the reclassification at 31 May 2007 is $43 million (31 May 2006: $34 million). The amortisation expense has also been reclassified from depreciation to amortisation. The total amount reclassified within the income statement for the twelve months ended 31 May 2007 is $11 million. This adjustment has no overall impact on equity.

# AUDITORS' REPORT

TO THE SHAREHOLDERS OF **FONTERRA CO-OPERATIVE GROUP LIMITED**

PRICEWATERHOUSECOOPERS

We have audited the financial statements on pages 1 to 51. The financial statements provide information about the past financial performance and cash flows of the Company and Group for the period ended 31 July 2008 and their financial position as at that date. This information is stated in accordance with the accounting policies set out on pages 6 to 13.

**Directors' Responsibilities**

The Company's Directors are responsible for the preparation and presentation of the financial statements which give a true and fair view of the financial position of the Company and Group as at 31 July 2008 and their financial performance and cash flows for the period ended on that date.

**Auditors' Responsibilities**

We are responsible for expressing an independent opinion on the financial statements presented by the Directors and reporting our opinion to you.

**Basis of Opinion**

An audit includes examining, on a test basis, evidence relevant to the amounts and disclosures in the financial statements. It also includes assessing:

(a) the significant estimates and judgements made by the Directors in the preparation of the financial statements; and

(b) whether the accounting policies are appropriate to the circumstances of the Company and Group, consistently applied and adequately disclosed.

We conducted our audit in accordance with generally accepted auditing standards in New Zealand. We planned and performed our audit so as to obtain all the information and explanations which we considered necessary to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatements, whether caused by fraud or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

We carry out other assignments on behalf of the Company and Group in the areas of taxation compliance, transaction services, financial assurance, and international accounting standard advisory services. Partners and employees of our firm may deal with the Company and Group on normal terms within the ordinary course of trading activities of the Company and Group. The firm has no other relationship with, or interest in, the Company and Group.

**Unqualified Opinion**

We have obtained all the information and explanations we have required.

In our opinion:

(a) proper accounting records have been kept by the Company as far as appears from our examination of those records; and

(b) the financial statements on pages 1 to 51:

  (i) comply with generally accepted accounting practice in New Zealand;

  (ii) comply with International Financial Reporting Standards; and

  (iii) give a true and fair view of the financial position of the Company and Group as at 31 July 2008 and their financial performance and cash flows for the period ended on that date.

Our audit was completed on 23 September 2008 and our unqualified opinion is expressed as at that date.

PricewaterhouseCoopers

**Chartered Accountants**
Auckland