



Grace Kreft
Sweet Bakery & Cakery
Xero Customer, Wellington, NZ



**BORN IN THE CLOUD, XERO'S MISSION
IS TO REWIRE THE GLOBAL ECONOMY,
CONNECTING MILLIONS OF BUSINESSES TO
THEIR ADVISORS, BANKS AND EACH OTHER.**

CONTENTS

Highlights	
pages	2-3
Chair & CEO review	
pages	4-7
Management commentary	
pages	8-22
Financial statements	
pages	23-44
Independent review report	
page	45
Corporate directory	
page	46

**OVER THE
6 MONTHS TO
30 SEPTEMBER
2018, XERO
DELIVERED:**

OPERATING REVENUE

\$256,527,000

 **UP 37% YOY**

SUBSCRIBERS

1,579,000

 **UP 380,000 YOY**

GROSS MARGIN

83%

 **UP 3PP* YOY**

*pp stands for percentage points

ANNUALISED MONTHLY RECURRING REVENUE

\$589,068,000

 **UP 40% YOY**

OPERATING CASH FLOWS

\$35,988,000

 **UP 139% YOY**

TOTAL LIFETIME VALUE OF SUBSCRIBERS

\$3.9b

 **UP 41% YOY**

CHAIR & CEO REVIEW



Graham Smith
Chair



Steve Vamos
Chief Executive

Dear shareholder

Xero delivered another strong set of results in the half year to 30 September 2018, with annualised monthly recurring revenue (AMRR) increasing by 40% to \$589.1 million and operating cash flows increasing from \$15.1 million to \$36.0 million.

Following the consolidation of Xero's listing on the ASX in February 2018 and subsequent inclusion in the S&P/ASX 100 index, we executed a number of significant initiatives in the first half of the year that position Xero for continued growth.

These initiatives included our acquisition of leading data capture solution Hubdoc, our partnership with US payroll provider Gusto, and successfully securing US\$300 million (NZ\$451 million) in capital via a convertible note offering. Xero intends to use this capital to enhance and extend our small business platform and ecosystem capabilities through complementary and targeted acquisitions and investments.

KEY HALF YEAR HIGHLIGHTS

- Operating revenue up 37% (33% in constant currency (CC)) on the same period last year to \$256.5 million
- Continued growth in AMRR, increasing by 40% (36% in CC) to \$589.1 million
- Average revenue per user (ARPU) increased 6% (3% in CC) from the same time last year to \$31.1

- Cash flows from operating activities for the half increased to \$36.0 million, a substantial improvement from \$15.1 million in the same period last year
- EBITDA of \$16.8 million, compared to \$15.6 million in H1 FY18
- Added more than \$1.146 billion (\$1.074 billion in CC) in total subscriber lifetime value (LTV) in the past year



REGIONAL HIGHLIGHTS

- Cloud accounting market leadership in Australia and New Zealand extended with subscriber growth of 24% to 981,000 and revenue up 30% (29% in CC) from the same period last year
- Market leadership in the UK continues with a 40% increase in subscribers to 355,000 and revenue up 56% (46% in CC) from the same period last year
- In the North American market, added 68,000 subscribers (up 62%) in the past year to reach 178,000 subscribers (an increase of 49,000, or 45%, excluding acquired Hubdoc subscribers). Revenue grew 40% (34% in CC). Good progress in developing the accounting partner channel in an underpenetrated cloud accounting market
- Rest of World subscribers increased by 38% to 65,000 and revenue increased 55% (48% in CC) from the same period last year

A PLATFORM CONNECTING SMALL BUSINESS

Xero has expanded from cloud accounting software to become a small business platform with 1.6 million subscribers and more than 700 connected apps in our ecosystem.

Xero invested heavily in its global product and platform, developing a significant range of new features, including:

- Xero Central, a one-stop-shop for our subscribers to manage their relationship with Xero
- Email-to-bills, simplifying bill entry by using automation and machine learning to automatically extract and populate key fields from PDF bills into Xero
- Profit and Loss at a glance on mobile, giving users a quick view of their profit and loss, and a breakdown of income and spending, from an Android or iOS dashboard

AN UPDATE FROM STEVE VAMOS

In my first seven months as Xero's CEO, we have continued to move at a rapid rate and achieved a number of important milestones, while continuing to execute our strategy.

Xero's founder Rod Drury set Xero an ambitious mission to rewire the global economy by connecting small business with their advisors, banks and each other. I am passionate about pursuing that mission.

The opportunity for Xero is significant, when you consider that less than a quarter of small businesses around the world benefit from cloud accounting solutions.

The positive impact Xero is having on small businesses is one of the most significant and rewarding technology driven changes I've experienced.

Every aspect of our business continues to evolve as we pursue our mission and further develop Xero as a global small business platform.

Spending time with Xero people and customers across the world has been a real highlight. At Xerocon Atlanta and Brisbane I experienced first-hand the incredible energy and engagement of our partners and the passion we share with them to help small businesses grow.

While change is a constant for us at Xero we remain focused on the principles that have led to our success to date. We live and breathe our values, focus on our people, and care deeply about the customers we serve and partners we work with.

My experience in the technology industry with global companies and start-ups has made it clear to me that people and the human experience is what matters most. We have strong leaders across Xero who can guide and inspire their teams through times of complexity and change, which is critical to our future success.

I'm often asked what my ambition is for Xero. Ultimately, I'd love to see every small business in the world gain the benefits of doing business in the cloud and to see Xero help make this a reality, while we continue to develop and grow into a great global technology company.



Steve Vamos

- Single Touch Payroll functionality, allowing Australian employers to comply with new Australian Taxation Office (ATO) payroll reporting requirements
- Making Tax Digital (MTD) feature set for VAT in the UK (currently in beta) delivering workflows in partnership with HMRC to help small businesses submit tax returns
- A new global API that allows any bank, fintech or other financial institution to sync bank feeds directly into the Xero platform

ACCOUNTING STANDARDS UPDATE

Xero has adopted three new accounting standards, effective from 1 April 2018, which have been reflected in this half year result and comparative statements. The standards are Financial Instruments (NZ IFRS 9), Revenue from Contracts with Customers (NZ IFRS 15) and Leases (NZ IFRS 16). Prior year comparatives including SaaS metrics have been restated, to reflect these new standards throughout this report.

POSITIONED FOR FURTHER GROWTH

We remain focussed on a disciplined execution of our strategy to drive growth and improve financial outcomes through operating efficiencies. We believe Xero is in a strong position to drive organic growth while targeting complementary acquisitions and investments.

We sincerely thank Xero's customers, accounting and bookkeeping partners, business platform partners and investors for your ongoing support. We also thank our people for their hard work and commitment to Xero.



Graham Smith
Chair



Steve Vamos
Chief Executive



ON 2018



STEVE VAMOS
CHIEF EXECUTIVE

**MANAGEMENT
COMMENTARY**

MANAGEMENT COMMENTARY

You should read the following commentary with the consolidated financial statements and the related notes in this report. Some parts of this commentary include information regarding the plans and strategy for the business, and include forward-looking statements that involve risks and uncertainties. Actual results and the timing of certain events may differ materially from future results expressed or implied by the forward-looking statements contained in the following commentary. All amounts are presented in New Zealand dollars (NZD), except where indicated. References to the comparative period are to the six months ended 30 September 2017.

Non-GAAP measures have been included, as we believe they provide useful information for readers to assist in understanding Xero's financial performance. Non-GAAP financial measures should not be viewed in isolation nor considered as substitutes for measures reported in accordance with NZ IFRS.

Xero has adopted NZ IFRS 9: Financial Instruments, NZ IFRS 15: Revenue from Contracts with Customers and NZ IFRS 16: Leases, effective from 1 April 2018. Prior year comparatives including metrics have been restated to reflect these new standards. See note 2 to the financial statements for more information on the impact on the financial performance and position of the Group.

Business results

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
Subscription revenue	249,041	183,064	36%
Other operating revenue	7,486	4,773	57%
Total operating revenue	256,527	187,837	37%
Cost of revenue	(44,250)	(37,227)	19%
Gross profit	212,277	150,610	41%
Percentage of operating revenue	83%	80%	3pp*
Total operating expenses	(215,706)	(167,341)	29%
Percentage of operating revenue	84%	89%	-5pp
Other income and expenses	(1,237)	(85)	NM**
Asset impairments	(17,757)	(1,550)	NM
Operating deficit	(22,423)	(18,366)	22%
Percentage of operating revenue	-9%	-10%	1pp
Net finance expense	(4,929)	(17)	NM
Income tax expense	(1,213)	(1,207)	0%
Net loss	(28,565)	(19,590)	46%
Percentage of operating revenue	-11%	-10%	-1pp

*pp stands for percentage points

**NM stands for not meaningful

Operating revenue growth was primarily driven by subscriber growth in all markets. Cost of revenue decreased as a proportion of operating revenue due to continued efficiencies in hosting costs and further productivity gains from investment in the customer service platform. Total operating expenses increased as Xero continued to invest in scaling its global business, new products, and quality subscriber growth. Total operating revenue increased by 37% while operating expenses grew proportionately less at 29%, driven by efficiencies and financial discipline. Operating deficit grew by 22%, being adversely impacted during the period by a \$16.3 million impairment related to the decision to discontinue the US payroll product and move to a full service solution in the US, provided by our partner Gusto, a US cloud-based payroll software provider. Without the impact of this impairment, operating deficit reduced by 67%.

Earnings before interest, tax, depreciation, and amortisation (EBITDA)

EBITDA disclosures (which are non-GAAP financial measures) have been included, as we believe they provide useful information for readers, to assist in understanding Xero's financial performance. EBITDA is calculated by adding back depreciation, amortisation, net finance expense, and income tax expense to net losses.

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
Net loss	(28,565)	(19,590)	46%
Add back: net finance expense	4,929	17	NM
Add back: depreciation and amortisation	39,182	33,963	15%
Add back: income tax expense	1,213	1,207	0%
EBITDA	16,759	15,597	7%
EBITDA margin	7%	8%	-1pp

EBITDA increased by 7% in the six months ended 30 September 2018 against the comparative period. EBITDA for the six months ended 30 September 2018 was impacted by non-cash asset impairments, including \$16.3 million relating to the Gusto partnership and \$2.3 million of transaction costs and operating losses from the acquisition of Hubdoc. EBITDA was also adversely impacted by \$2.8 million resulting from a reduction in capitalisation rates from 43% in the comparative period to 39% in the six months to 30 September 2018.

EBITDA excluding the impact of non-cash share-based payments and impairments (a non-GAAP financial measure) is also provided as we believe it provides useful information to analyse trends in cash-based expenses.

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
EBITDA	16,759	15,597	7%
Add back: non-cash share-based payments	14,815	8,642	71%
Add back: non-cash impairments	17,757	1,550	NM
EBITDA excluding non-cash share-based payments and impairments	49,331	25,789	91%
Percentage of operating revenue	19%	14%	5pp

EBITDA excluding non-cash share-based payments and non-cash impairments improved by \$23.5 million over the comparative period.

Operating revenue

Subscription revenue comprises recurring monthly fees from subscribers to Xero's online software. Within a subscription, customers also receive support services and product updates.

Operating revenue also includes revenue from other related services, including attendance fees for conferences and events such as Xerocon, revenue share agreements with other financial web service providers, and the implementation of online accounting software services. Subscription revenue comprised 97% of operating revenue in both the current and comparative periods.

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change	change in constant currency
Subscription revenue	249,041	183,064	36%	33%
Other operating revenue	7,486	4,773	57%	55%
Total operating revenue	256,527	187,837	37%	33%

The 36% increase in subscription revenue during the year was primarily driven by year-on-year subscriber growth of 32%, adding 380,000 subscribers in the year.

Other operating revenue increased by 57%, driven by increases in both conference and financial web income. Conference income increased as a result of one additional Xerocon being held during the six months to 30 September 2018 when compared to the comparative period, as well as an increase in the number of attendees and exhibitors that attended Xerocon South. Financial web income has increased year-on-year as financial web partnerships are monetised, opening new revenue streams.

Constant currency operating revenue (a non-GAAP financial measure) is provided to assist readers in understanding and assessing Xero's financial performance during the year, excluding the impact of foreign currency fluctuations. Constant currency operating revenue is calculated by translating operating revenue for the six months ended 30 September 2018 at the effective exchange rates for the six months ended 30 September 2017.

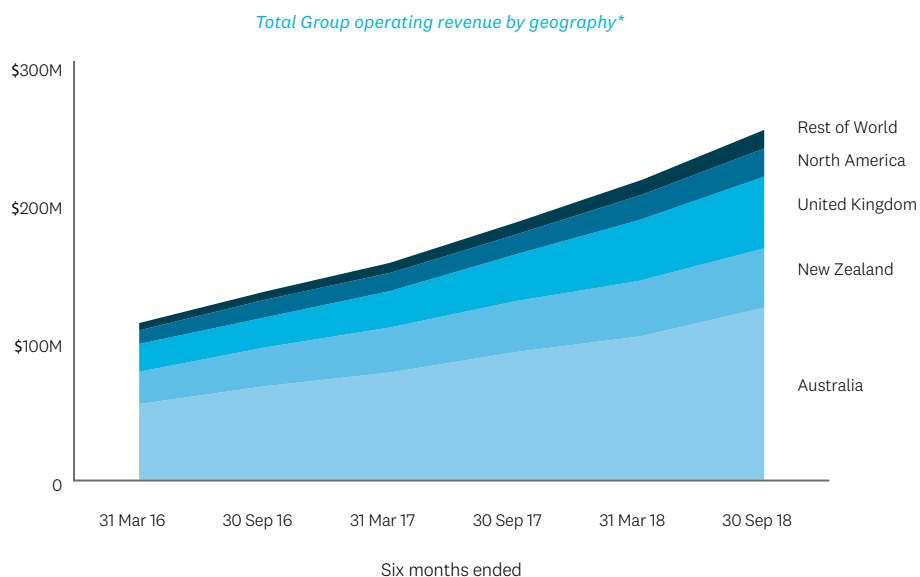
As 82% of Xero's operating revenue is denominated in foreign currencies, the comparatively weaker NZD against the Great British pound (GBP), Australian dollar (AUD) and United States dollar (USD) during the period had a positive impact on reported revenue. Constant currency operating revenue for the Group in the six months to 30 September 2018 was \$6.5 million lower than reported operating revenue. Year-on-year constant currency operating revenue growth was lower than reported revenue growth at 33%.

Operating revenue by geography

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change	change in constant currency
Australia	123,295	92,874	33%	31%
New Zealand	45,946	37,516	22%	22%
Australia and New Zealand (ANZ) total	169,241	130,390	30%	29%
United Kingdom	53,353	34,198	56%	46%
North America	20,442	14,571	40%	34%
Rest of World	13,491	8,678	55%	48%
International total	87,286	57,447	52%	43%
Total operating revenue	256,527	187,837	37%	33%

Operating revenue grew in all of Xero's geographies, with growth of 30% in the established ANZ markets largely due to the increased subscriber base. The two countries added 192,000 subscribers in the 12 months to 30 September 2018 combined. Constant currency operating revenue growth for the ANZ markets was lower at 29% with a slightly weaker average NZD against AUD compared to the same six month period last year.

International markets continue to exhibit strong growth, particularly in the UK and Rest of World markets, which achieved operating revenue increases of 56% and 55% respectively for the six months ended 30 September 2018.



**represents each region's contribution to total Group operating revenue for the respective period*

Subscriber numbers

Xero has refined its methodology regarding how it defines a subscriber. Now, subscribers to multiple Xero-owned but independently billed products (for example Xero and Hubdoc, or Xero and WorkflowMax) are counted as a single subscriber to the Xero platform. The comparative period has not been adjusted as the change in methodology did not have a significant impact on subscriber balances.

The revised definition of 'Subscriber' is: *each unique subscription to a Xero-offered product that is purchased by an accounting partner or an end-user and which is, or is available to be, deployed. Subscribers that have multiple subscriptions to integrated products on the Xero platform are counted as a single subscriber.*

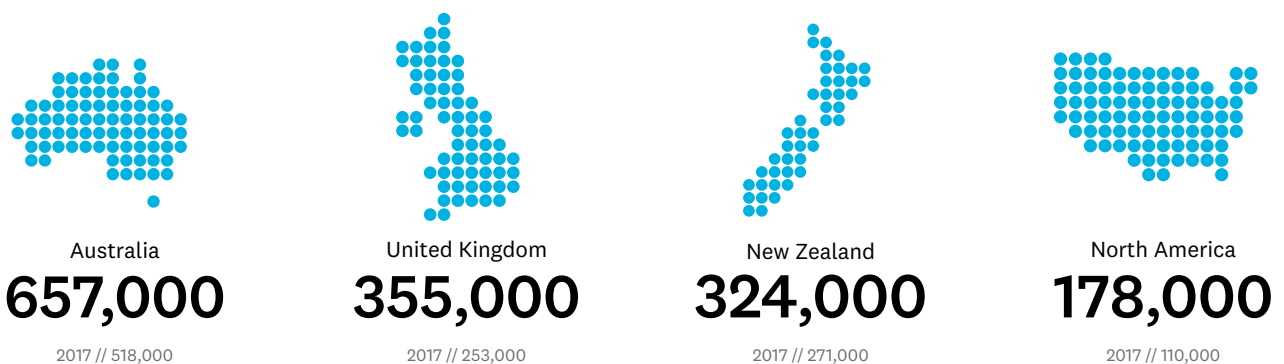
At 30 September	2018	2017	change
Australia	657,000	518,000	27%
New Zealand	324,000	271,000	20%
Australia and New Zealand (ANZ) total	981,000	789,000	24%
United Kingdom	355,000	253,000	40%
North America	178,000	110,000	62%
Rest of World	65,000	47,000	38%
International total	598,000	410,000	46%
Total subscribers	1,579,000	1,199,000	32%

Subscribers grew by 380,000 during the year, or 32%, bringing total subscribers to 1,579,000 at 30 September 2018.

North American subscribers at 30 September 2018 includes 19,000 subscribers acquired through the acquisition of Hubdoc. Excluding acquired Hubdoc subscribers, North American subscribers grew by 49,000 or 45%, and total Group subscribers grew by 361,000 or 30%.

ANZ grew by 192,000 subscribers or 24% in the year, as Xero continues to strengthen its presence in established markets. International subscribers grew at a higher rate, increasing by 188,000 or 46% (169,000 or 41% excluding acquired Hubdoc subscribers) in the year to 30 September 2018.

Regional subscribers at 30 September 2018*



*Rest of World subscribers of 65,000 at 30 Sep 2018 (47,000 at 30 Sep 2017)

Annualised monthly recurring revenue

Annualised monthly recurring revenue (AMRR), which is a non-GAAP financial measure, represents monthly recurring platform revenue at 30 September (including subscription revenue as well as revenue from transactional services, ancillary partner and small business products), multiplied by 12. It provides a 12 month forward view of revenue, assuming any promotions have ended and other factors such as subscriber numbers, transaction volumes, pricing, and foreign exchange remain unchanged during the year.

Constant currency AMRR (also a non-GAAP financial measure) is calculated by translating AMRR at 30 September 2018 at the foreign exchange rates at 30 September 2017, and is provided to assist in understanding and assessing year-on-year growth rates, excluding the impact of foreign currency fluctuations.

At 30 September	2018 (\$000s)	2017 (\$000s)	change	change in constant currency
ANZ	376,086	282,133	33%	33%
International	212,982	139,733	52%	42%
Total	589,068	421,866	40%	36%

The growth in AMRR was driven by both subscriber and average revenue per user (ARPU) growth. ARPU increases were due to increases in revenue from platform (non-accounting) services, such as financial web revenue, that grew at a faster rate than core accounting revenue, as well as price increases in Australia and New Zealand. Xero added \$167.2 million of AMRR in the year ended 30 September 2018, \$104.6 million of which was added in the six months ended 30 September 2018.

The weaker NZD exchange rate against GBP and USD at 30 September 2018 compared to 30 September 2017 had a favourable impact on the reported AMRR growth for the International segment, with constant currency AMRR growth of 42%, being 10 percentage points lower than the reported growth of 52%. In constant currency terms, total AMRR has grown by 36%, four percentage points higher than subscriber growth, led by higher ARPU in both the ANZ and International segments.

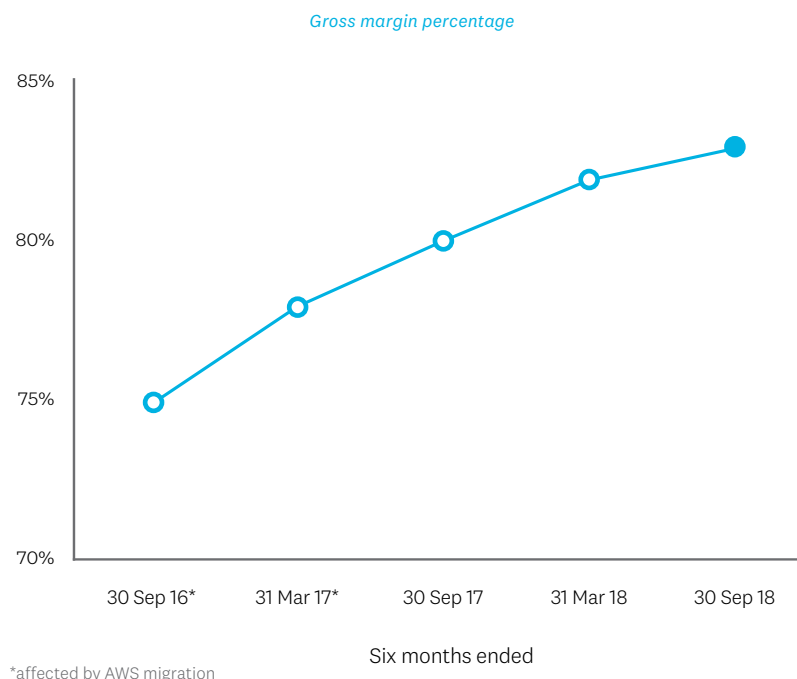
Gross profit

Gross profit represents operating revenue less cost of revenue. Cost of revenue consists of expenses directly associated with securely hosting Xero's services, sourcing relevant data from financial institutions and providing support to subscribers. The costs include hosting and content distribution costs, bank feed costs, personnel and related expenses (including salaries, benefits, bonuses and share-based payments) directly associated with cloud infrastructure and subscriber support, contracted third-party vendor costs, related depreciation and amortisation, and allocated overheads.

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
Operating revenue	256,527	187,837	37%
Cost of revenue	(44,250)	(37,227)	19%
Gross profit	212,277	150,610	41%
Gross margin percentage	83%	80%	3pp

Cost of revenue for the six months ended 30 September 2018 grew by \$7.0 million to \$44.3 million, representing a 19% increase when compared to the same period last year. The primary reasons for the change were increases in personnel costs related to higher headcount in Xero's customer support teams required to service more subscribers, and a 22% increase in hosting costs against the comparative period. Operating revenue growth of 37% resulted in gross profit increasing by \$61.7 million, or 41%, to \$212.3 million.

Cost of revenue decreased as a percentage of operating revenue compared with the same period last year due to efficiencies in hosting costs and in the customer support platform. Gross margin for the six months of 83% is an improvement of three percentage points compared to the six months ended 30 September 2017.



Sales and marketing

Sales and marketing expenses consist of personnel and related expenses (including salaries, benefits, bonuses, the amortisation of deferred commission costs and share-based payments) directly associated with the sales and marketing teams, and the cost of educating and onboarding both partners and small business customers. Other costs included are external advertising costs, marketing costs and promotional events, as well as allocated overheads.

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
Sales and marketing expenses	115,747	90,099	28%
Percentage of operating revenue	45%	48%	-3pp

Sales and marketing costs increased by \$25.6 million, or 28%, to \$115.7 million for the half year, compared to operating revenue growth of 37% and subscriber growth of 32%. The majority of sales and marketing costs are incurred in acquiring new subscribers and are expensed in the period, in contrast to the associated revenue from those subscribers which is recognised over the life of the subscriber (currently around seven and a half years on average). Note that sales commission costs are now deferred and amortised to sales and marketing costs over a five year period. Sales and marketing costs in the International markets increased by 31%, compared to operating revenue growth of 52% as investment is increased in new markets although moderating in the US. Sales and marketing costs in the ANZ markets increased by 25% compared to operating revenue growth of 30%.

The average cost of acquiring each subscriber has increased to \$402 per gross subscriber added compared to \$363 in the same period last year. The increase is due to foreign exchange and an increased investment into the more established ANZ markets while maintaining strong customer acquisition metrics.

As a percentage of operating revenue, sales and marketing costs decreased from 48% to 45% in the six months ended 30 September 2018 compared to the same period last year.

Product design and development

Product design and development costs consist primarily of personnel and related expenses (including salaries, benefits, bonuses and share-based payments) directly associated with product design and development employees, as well as allocated overheads.

The proportion of product design and development expenses that creates a benefit in future years and meets certain requirements under IFRS is capitalised as an intangible asset and is then amortised to the Income Statement over the estimated life of the asset created. The amount amortised relating to the Xero product and platform is included as a product design and development expense.

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
Total product design and development costs (including amounts capitalised)¹	80,333	68,950	17%
Percentage of operating revenue	31%	37%	-6pp
Less capitalised development costs	(31,715)	(29,619)	7%
Product design and development expenses (excluding amortisation of amounts capitalised)	48,618	39,331	24%
Less government grants	(2,379)	(2,174)	9%
Add amortisation of capitalised development costs	22,627	18,700	21%
Product design and development expenses	68,866	55,857	23%
Percentage of operating revenue	27%	30%	-3pp

¹ excludes impairments

Xero continues to invest in its global product and platform, developing a significant range of new features so far this year, including:

- Xero Central, a one-stop-shop for our subscribers to manage their relationship with Xero
- Making Tax Digital (currently in beta), allowing subscribers to manage VAT compliance digitally through integrated HMRC and Xero workflows
- Email-to-bills, simplifying bill entry by using machine learning to automatically extract and populate key fields from PDF bills into Xero
- Profit and Loss at a glance on mobile, giving users a quick view of their profit and loss, and a breakdown of income and spending, from their Android or iOS dashboard
- A global API allowing any bank or other financial institution to sync their bank feeds directly to the Xero platform
- Single Touch Payroll functionality, allowing Australian employers to comply with new Australian Taxation Office payroll reporting requirements

Total product design and development costs were \$80.3 million for the six months ended 30 September 2018, \$11.4 million higher than in the comparative period. Of this, \$31.7 million was capitalised, with the balance of \$48.6 million included as an expense in the Income Statement. The amount capitalised represents a capitalisation rate of 39% of total product design and development costs for the period, which is four percentage points lower than in the six months ended 30 September 2017.

The amortisation of previously capitalised product design and development expenditure of \$22.6 million was included as an expense in the Income Statement, giving a total net expense (after government grants) for the period of \$68.9 million. Non-cash amortisation of previously capitalised development costs increased due to higher intangibles balances than in the previous period.

As a proportion of operating revenue, total product design and development costs (including amounts capitalised) decreased six percentage points to 31% in the six months ended 30 September 2018 from 37% for the same period last year, as revenue continues to grow at a faster rate than product design and development costs.

Product design and development expenses increased by 23% on the comparative period as Xero continued to increase investment in product. As a proportion of operating revenue, product design and development expenses decreased to 27% in the six months ended 30 September 2018 from 30% in the comparative period.

General and administration

General and administration expenses consist of personnel and related expenses (including salaries, benefits, bonuses and share-based payments) for executive, finance, billing, legal, human resources and administrative employees. It also includes legal, accounting and other professional services fees, insurance premiums, other corporate expenses and allocated overheads.

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
General and administration expenses	31,093	21,385	45%
Percentage of operating revenue	12%	11%	1pp

General and administration costs were \$31.1 million for the six months ended 30 September 2018, \$9.7 million or 45% higher than in the six months ended 30 September 2017. The current period includes \$1.3 million of costs relating to the acquisition of Hubdoc and a \$2.2 million increase in executive non-cash share-based compensation.

General and administration costs as a proportion of operating revenue remained relatively consistent with the six months ended 30 September 2017, increasing one percentage point from 11% in the six months ended 30 September 2017 to 12% in the six months ended 30 September 2018.

Employees

At 30 September	2018	2017	change
Total Group	2,302	1,853	24%

Full-time equivalent (FTE) employees increased by 449 or 24% in the 12 months ended 30 September 2018, taking the total FTEs to 2,302, compared to a 32% increase in subscribers and 37% increase in operating revenue. The increase in FTEs includes 83 employees from Hubdoc that joined Xero as part of the acquisition. The slower growth compared to revenue and subscribers reflects the benefits of economies of scale and operating efficiencies.

Net finance expense

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
Interest income on deposits	782	1,227	-36%
Total finance income	782	1,227	-36%
Convertible note and call spread issue costs	(2,668)	-	NM
Finance lease interest expense	(2,023)	(1,073)	89%
Facility fees and other interest expense	(1,020)	(171)	496%
Total finance expense	(5,711)	(1,244)	359%

Finance income in the six months ended 30 September 2018 was \$0.8 million, a decrease of \$0.4 million or 36% from the comparative period due to lower cash and short-term deposit balances in the period.

Finance expense has increased by 359%, driven by interest on drawn term debt used for the acquisition of Hubdoc combined with fees relating to the undrawn committed standby facility. Finance lease interest increased by \$1.0 million due to leases for office space entered into during the last 12 months.

Cash flows

Net movement in cash excluding movement in short-term deposits, is a non-GAAP financial measure that has been included to show users net usage of cash and short-term deposits in the period. Xero manages cash and short-term deposits as a portfolio to maintain adequate liquidity while preserving capital.

Six months ended 30 September	2018 (\$000s)	2017 (\$000s)	change
Receipts from customers	255,128	188,940	35%
Other operating cash flows	(219,140)	(173,878)	26%
Total cash flows from operating activities	35,988	15,062	139%
Investing activities	(76,071)	(45,941)	66%
Total operating and investing cash flows	(40,083)	(30,879)	30%
Financing activities, excluding short-term deposits	35,587	1,445	NM
Currency revaluation	728	66	NM
Net movement in cash, excluding movement in short-term deposits	(3,768)	(29,368)	-87%

Receipts from customers increased by 35%, or \$66.2 million, to \$255.1 million and is closely aligned with reported revenue. Other operating cash outflows increased by 26%, or \$45.3 million, to \$219.1 million. Net cash flows from operating activities improved by \$20.9 million as receipts from customers increased by 35% while payments to suppliers increased by 26% compared to the comparative period.

Cash outflows from investing activities increased by 66% or \$30.1 million, largely due to Xero's acquisition of Hubdoc, accounting for \$30.3 million of the total investing outflows. Excluding the acquisition of Hubdoc, investing activities decreased by \$0.2 million, compared to the comparative period.

The acquisition of Hubdoc contributed to the 30% increase in total operating and investing cash outflows from the comparative period. Excluding the acquisition of Hubdoc, total operating and investing cash outflows decreased by 68% or \$21.1 million on the comparative period, resulting in a \$9.8 million outflow.

Cash flows from financing activities, excluding short-term deposits, increased by \$34.1 million compared to the same period last year. This increase is attributable to the drawdown of a \$30.9 million term loan to fund the purchase of Hubdoc. When excluding this amount from financing activities, cash flows from financing activities increased by 228% compared to the comparative period due to cash inflows from employee share options exercised during the period.

The net movement in cash, excluding movement in short-term deposits, improved by \$25.6 million or 87%, when compared to the same period last year.

Segment information

Operating revenue is allocated to a segment depending on where the subscriber resides. Expenses include cost of revenue, sales and marketing costs incurred directly in-region, and an allocation of centrally managed costs and overheads, such as hosting and subscriber support costs.

	ANZ (\$000s)	International (\$000s)	Total (\$000s)
Six months ended 30 September 2018			
Operating revenue	169,241	87,286	256,527
Expenses	(71,535)	(88,462)	(159,997)
Other income	68	332	400
Segment contribution	97,774	(844)	96,930
<i>Contribution margin percentage</i>	58%	-1%	38%
	ANZ (\$000s)	International (\$000s)	Total (\$000s)
Six months ended 30 September 2017			
Operating revenue	130,390	57,447	187,837
Expenses	(60,157)	(67,169)	(127,326)
Other income	-	525	525
Segment contribution	70,233	(9,197)	61,036
<i>Contribution margin percentage</i>	54%	-16%	32%

ANZ – Operating revenue for the six months ended 30 September 2018 grew by 30% compared to the comparative period, at a higher rate than subscriber growth of 24% largely due to improvements in ARPU. This, along with cost efficiencies, resulted in the segment contribution for the half improving as a percentage of operating revenue from 54% to 58%. The improvement was driven by performance in both Australia and New Zealand. Across ANZ 192,000 subscribers were added in the 12 months ended 30 September 2018 to finish with 981,000 subscribers.

International – Operating revenue grew by 52% due to subscriber growth of 46%, foreign exchange rates and an additional Xerocon being held in the six months ended 30 September 2018. The contribution margin improved from -16% to -1% due to efficiencies and channel development, particularly in the United Kingdom and North America, while maintaining strong revenue growth. The contribution margin was comparatively lower than that of ANZ, reflective of the investment to accelerate growth in the United Kingdom, North America, and Asia as Xero continues to build brand recognition and distribution channels in these markets. International's contribution loss decreased to \$0.8 million in the six months ended 30 September 2018, compared to \$9.2 million in the six months ended 30 September 2017, due to a moderation of spend in North America.

KEY SAAS METRICS

Average revenue per user (ARPU) is calculated as AMRR at 30 September, divided by subscribers at that time (and divided by 12 to get a monthly amount).

CAC months are months of ARPU to recover the cost of acquiring each new subscriber. With the adoption of NZ IFRS 15 and the resulting spreading of contract acquisition costs, Xero has changed the calculation of CAC months to adjust for the deferral and amortisation of commissions paid to sales people. The revised calculation is sales and marketing costs for the year excluding the deferral and amortisation of commissions paid to sales people, less conference revenue (such as Xerocon), divided by gross new subscribers added during the same period, divided by ARPU.

MRR churn is the value of monthly recurring revenue (MRR) from subscribers who leave Xero in a month as a percentage of the total MRR at the start of that month. The percentage provided is the average of the monthly churn for the previous 12 months.

Lifetime value (LTV) is the gross margin expected from a subscriber over the lifetime of that subscriber. This is calculated by taking the average subscriber lifetime (one divided by MRR churn) multiplied by ARPU, multiplied by the gross margin percentage. Group LTV is calculated as the sum of the individual segment LTVs, multiplied by their respective segment subscribers, divided by total Group subscribers.

LTV/CAC is the ratio between the LTV and the cost to acquire that subscriber. For example, the lifetime gross margin derived from a subscriber in ANZ is currently on average 11.5 times the cost of acquiring that subscriber.

The table below outlines key metrics across Xero's segments:

<i>At 30 September 2018</i>	ANZ	International	Total
ARPU (\$)	32.0	29.7	31.1
CAC months	8.4	18.2	12.9
MRR churn	0.87%	1.55%	1.10%
LTV per subscriber (\$)	3,064	1,558	2,494
LTV/CAC	11.5	2.9	6.2

<i>At 30 September 2017</i>	ANZ	International	Total
ARPU (\$)	29.8	28.4	29.3
CAC months	7.8	18.7	12.4
MRR churn	0.84%	1.71%	1.11%
LTV per subscriber (\$)	2,857	1,311	2,328
LTV/CAC	12.2	2.5	6.4

ANZ – ARPU increased by 7%, driven by the higher value product mix and pricing in both Australia and New Zealand. Improved ARPU and gross margin led to a 7% improvement in LTV per subscriber. Total LTV increased by 33% to \$3.0 billion at 30 September 2018 compared to the same period last year. CAC months at 30 September 2018 was slightly higher when compared to the same period last year as Xero continues to invest to drive growth in the established Australian and New Zealand markets.

International – ARPU across the international markets increased by 5% due to the comparatively weaker NZD against the GBP and USD at 30 September 2018 compared to 30 September 2017. In constant currency terms, ARPU remained the same over the year to 30 September 2018. Lower churn and higher gross margin led to a 19% improvement in LTV per subscriber at 30 September 2018 compared to the same time last year. In constant currency terms, LTV per subscriber was 11% higher than at 30 September 2017. Total LTV for the international segment increased by 73% to \$932 million at 30 September 2018. CAC months at 30 September 2018 improved by 3% as compared to the same time last year. As a result of improvements across most metrics, LTV/CAC at 30 September 2018 was 2.9 times, a 16% improvement on 30 September 2017.

Total Group – ARPU increased by 6% (3% in constant currency), due to product mix and pricing in ANZ being offset by a shift towards the more efficient but lower ARPU partner channel, particularly in the International markets. LTV per subscriber increased 7% from the same period last year to \$2,494 per subscriber, due to the improvements in ARPU, churn and gross margin. Group constant currency LTV per subscriber at 30 September 2018 was 5% higher than at 30 September 2017. Total LTV at 30 September 2018 was \$3.9 billion, which is a \$1.1 billion improvement compared to 30 September 2017, with 24% of total LTV provided from the International segment. CAC months increased 4% to 12.9 months when compared to 30 September 2017 due to continued investment in the ANZ markets.

FINANCIAL STATEMENTS

FINANCIAL STATEMENTS

Income statement

<i>Six months ended 30 September</i>		2018	2017
	Notes	Unaudited (\$000s)	Restated Unaudited (\$000s)
Subscription revenue		249,041	183,064
Other operating revenue		7,486	4,773
Total operating revenue	4	256,527	187,837
Cost of revenue	5	(44,250)	(37,227)
Gross profit		212,277	150,610
<i>Operating expenses</i>			
Sales and marketing		(115,747)	(90,099)
Product design and development		(68,866)	(55,857)
General and administration		(31,093)	(21,385)
Total operating expenses	5	(215,706)	(167,341)
Asset impairments	7	(17,757)	(1,550)
Other expenses		(1,637)	(610)
Other income		400	525
Operating deficit		(22,423)	(18,366)
Finance income		782	1,227
Finance expense		(5,711)	(1,244)
Net loss before tax		(27,352)	(18,383)
Income tax expense		(1,213)	(1,207)
Net loss		(28,565)	(19,590)
Basic and diluted loss per share		(\$0.21)	(\$0.14)

Statement of comprehensive income

<i>Six months ended 30 September</i>		2018	2017
	Note	Unaudited (\$000s)	Restated Unaudited (\$000s)
Net loss		(28,565)	(19,590)
Other comprehensive income*			
Movement in cash flow hedges (net of tax)	12	798	564
Translation of foreign operations		1,751	500
Total other comprehensive income for the year		2,549	1,064
Total comprehensive loss for the period		(26,016)	(18,526)

* Items in other comprehensive income may be reclassified to the Income Statement.
The accompanying notes form an integral part of these financial statements.

Statement of financial position

	Notes	At 30 Sep 2018 Unaudited (\$'000s)	At 31 Mar 2018 Restated Audited (\$'000s)
Assets			
Cash and cash equivalents		21,187	20,955
Short-term deposits		55,000	59,000
Trade and other receivables		45,258	33,792
Receivable from convertible notes	14	453,446	-
Derivative assets	12, 14	82,287	2,508
Other current assets		966	993
Total current assets		658,144	117,248
Property, plant and equipment	6	73,139	61,804
Intangible assets	7	263,398	168,816
Deferred tax assets		1,029	500
Derivative assets	12	59	41
Other non-current assets		614	2,207
Total non-current assets		338,239	233,368
Total assets		996,383	350,616
Liabilities			
Trade and other payables		85,006	26,285
Employee entitlements		27,962	27,980
Term debt		30,850	-
Lease liabilities	8	7,962	7,531
Income taxes payable		603	537
Provisions		117	10
Derivative liabilities	12	768	822
Other current liabilities		6,626	5,484
Total current liabilities		159,894	68,649
Term debt	14	360,125	-
Lease liabilities	8	43,818	37,906
Deferred tax liabilities		1,983	613
Provisions		1,124	1,827
Derivative liabilities	12, 14	83,402	-
Other non-current liabilities		16,472	537
Total non-current liabilities		506,924	40,883
Total liabilities		666,818	109,532
Equity			
Share capital	9	607,607	537,744
Reserves		67,252	20,069
Accumulated losses		(345,294)	(316,729)
Total equity		329,565	241,084
Total liabilities and shareholders' equity		996,383	350,616

The accompanying notes form an integral part of these financial statements.

Statement of changes in equity

Unaudited	Notes	Share capital (\$000s)	Treasury shares (\$000s)	Accumulated losses (\$000s)	Share-based payment reserve (\$000s)	Foreign currency translation reserve (\$000s)	Cash flow hedge reserve (\$000s)	Premium on call spread options (\$000s)	Total equity (\$000s)
Restated balance									
at 1 April 2018		549,596	(11,852)	(316,729)	18,904	(102)	1,267	-	241,084
Net loss		-	-	(28,565)	-	-	-	-	(28,565)
Other comprehensive income		-	-	-	-	1,751	798	-	2,549
Total comprehensive loss		-	-	(28,565)	-	1,751	798	-	(26,016)
<i>Transactions with owners:</i>									
Share-based payments		15	12,681	(11,124)	-	12,766	-	-	14,323
Exercising of employee share options		15	13,456	-	-	(3,393)	-	-	10,063
Issue of shares – acquisition of Hubdoc		13	54,850	-	-	-	-	-	54,850
Premium on call spread options		14	-	-	-	-	-	35,261	35,261
Balance at 30 September 2018		630,583	(22,976)	(345,294)	28,277	1,649	2,065	35,261	329,565
Balance									
at 1 April 2017		532,583	(9,973)	(306,995)	10,224	(93)	(1,596)	-	224,150
Adjustment on adoption of new IFRS		-	-	15,180	-	-	-	-	15,180
Restated balance									
at 1 April 2017		532,583	(9,973)	(291,815)	10,224	(93)	(1,596)	-	239,330
Net loss		-	-	(19,590)	-	-	-	-	(19,590)
Other comprehensive income		-	-	-	-	500	564	-	1,064
Total comprehensive loss		-	-	(19,590)	-	500	564	-	(18,526)
<i>Transactions with owners:</i>									
Share-based payments		15	13,473	(12,534)	-	9,747	-	-	10,686
Exercising of employee share options		15	2,296	-	-	(612)	-	-	1,684
Restated balance									
at 30 September 2017		548,352	(22,507)	(311,405)	19,359	407	(1,032)	-	233,174

The accompanying notes form an integral part of these financial statements.

Statement of cash flows

Six months ended 30 September

	Note	2018 Unaudited (\$'000s)	2017 Restated Unaudited (\$'000s)
Operating activities			
Receipts from customers		255,128	188,940
Other income		2,451	2,587
Interest received		1,237	1,404
Payments to suppliers and employees		(217,675)	(174,791)
Interest paid		(3,128)	(1,073)
Income tax paid		(2,025)	(2,005)
Net cash flows from operating activities	10	35,988	15,062
Investing activities			
Capitalised development costs		(33,516)	(32,623)
Acquisition of Hubdoc		(30,312)	-
Purchase of property, plant and equipment		(6,939)	(9,665)
Capitalised contract acquisition costs		(7,032)	(5,232)
Rental bonds		1,728	72
Sale of property, plant and equipment		-	1,507
Net cash flows from investing activities		(76,071)	(45,941)
Financing activities			
Proceeds from borrowings		30,850	3,515
Repayment of borrowings		(733)	-
Payment of lease liabilities		(4,089)	(3,754)
Exercising of employee share options		10,063	1,684
Costs related to issue of convertible notes		(504)	-
Payments for short-term deposits		(37,000)	(41,000)
Proceeds from short-term deposits		41,000	66,000
Net cash flows from financing activities		39,587	26,445
Net decrease in cash and cash equivalents		(496)	(4,434)
Foreign currency translation adjustment		728	66
Cash and cash equivalents at the beginning of the period		20,955	27,699
Cash and cash equivalents at the end of the period		21,187	23,331

The accompanying notes form an integral part of these financial statements.

Notes to the financial statements (unaudited)

1. BASIS OF PREPARATION

These unaudited interim financial statements of Xero Limited ('the Company') and its subsidiaries (together 'the Group' or 'Xero') have been prepared in accordance with New Zealand Generally Accepted Accounting Practice and comply with the requirements of the New Zealand Equivalent to International Accounting Standard 34: *Interim Financial Reporting*, and International Accounting Standard 34: *Interim Financial Reporting*. The Company is a profit-oriented entity.

The Company is registered under the Companies Act 1993 and listed on the Australian Securities Exchange.

The unaudited interim financial statements for the Group for the six months ended 30 September 2018 were authorised for issue on 8 November 2018 in accordance with a resolution of the directors of the Company.

2. ACCOUNTING POLICIES

(a) Changes in accounting policies and disclosures

Except as described below the unaudited interim financial statements have been prepared using the same accounting policies and methods of computation as, and should be read in conjunction with, the financial statements and related notes included in the Group's annual report for the year ended 31 March 2018.

Certain comparative information has also been reclassified to conform with the current period's presentation.

The Group adopted the standards detailed below from 1 April 2018 resulting in restatements of comparative balances. No restatement of comparatives has been made outside of those required as a result of the new standards.

New Zealand Equivalent to International Financial Reporting Standard 15: *Revenue from Contracts with Customers*

NZ IFRS 15 replaces NZ IAS 18: *Revenue* and related interpretations and applies to all revenue arising from contracts with customers. The new standard establishes a five-step model to account for revenue arising from contracts with customers.

Under NZ IFRS 15 revenue is apportioned to individual performance obligations within customer contracts based on their relative stand-alone selling price. Based on certain criteria, revenue is then recognised either over time or at a point in time as these performance obligations are satisfied. The standard also requires the capitalisation of incremental costs of obtaining a contract, and costs directly related to fulfilling a contract, where these costs are expected to be recovered.

The majority of the Group's customers are on monthly contracts, resulting in NZ IFRS 15 not having a material impact on recognition of revenue.

Under NZ IFRS 15, costs directly attributable to the acquisition of revenue contracts are capitalised and amortised over a period consistent with the estimated pattern of revenue recognition. The Group identified commission costs as an incremental cost of obtaining revenue contracts. These costs were expensed as incurred prior to the adoption of NZ IFRS 15 and are now capitalised.

The Group adopted NZ IFRS 15 using the retrospective approach, resulting in restatement of comparative figures. All practical expedients available under this approach have been applied.

The effect of adopting NZ IFRS 15 on the Income Statement for the six months ended 30 September 2017 is as follows:

Income Statement (increase/(decrease))	(\$000s)
Subscription revenue	40
Sales and marketing expenses	(1,883)
Income tax expense	301
Net loss	(1,622)

The above effect on sales and marketing expenses includes a \$5.2 million decrease in commission expense and a \$3.4 million increase in amortisation expense.

The effect of adopting NZ IFRS 15 on the Statement of Financial Position as at 31 March 2018 is as follows:

Statement of Financial Position (increase/(decrease))	(\$000s)
Assets	
Intangible assets	24,035
Deferred tax assets	(2,658)
Liabilities	
Other current liabilities	41
Deferred tax liabilities	535
Equity	20,801

The adoption of NZ IFRS 15 also resulted in a reclassification in the Statement of Cash Flows between operating and investing cash flows. The reclassification resulted in a \$5.2 million increase in operating cash flows and a corresponding decrease in investing cash flows.

The Group's revenue accounting policies under the new standard are detailed below:

Subscription revenue comprises the fees from subscribers to Xero's small business platform. Within a subscription, customers may also receive other services such as support. Subscription-based arrangements generally have monthly contractual terms.

Other operating revenue comprises revenue from related services such as financial web income, platform, and conference income.

Where subscription, or other revenue arrangements, include more than one deliverable, Xero allocates revenue to these different deliverables based on the fair values of each and recognises revenue rateably as the services are performed, commencing with the date the service is made available to customers and all other revenue recognition criteria have been satisfied. If, at the outset of an arrangement, revenue cannot be measured reliably, revenue recognition is deferred until the relating fees become due and payable by the customer. Additionally, if at the outset of an arrangement it is determined that collectability is not probable, revenue recognition is deferred until the earlier of when collectability becomes probable or payment is received.

In accordance with NZ IFRS 15, Xero capitalises incremental costs of obtaining contracts. Capitalisable costs consist of sales commissions that have a direct relationship to new revenue contracts obtained. Costs capitalised are amortised to sales and marketing and expensed over the average period of benefit associated with the costs. The period of benefit for the contract acquisition asset is determined to be five years. Management have determined this as appropriate with reference to estimated customer lifespans and the useful lives of the software to which the commissions relate.

New Zealand Equivalent to International Financial Reporting Standard 9: *Financial Instruments*

NZ IFRS 9: *Financial Instruments* replaces NZ IAS 39: *Financial Instruments: Recognition and Measurement*, and brings together three aspects of the accounting for financial instruments: classification and measurement, impairment, and hedge accounting.

NZ IFRS 9 largely retains the existing requirements in NZ IAS 39 for the classification and measurement of financial liabilities. However, it eliminates the previous NZ IAS 39 categories for financial assets of held to maturity, loans and receivables, and available for sale. Under NZ IFRS 9, on initial recognition, a financial asset is classified as measured at amortised cost, fair value through other comprehensive income – debt investment, fair value through other comprehensive income – equity investment, or fair value through profit or loss.

Other than disclosure impacts, the adoption of NZ IFRS 9 has not had a significant effect on the financial instruments of the Group. The new classification and measurement of the Group's financial instruments are as follows:

- Measured at amortised cost – cash and cash equivalents, term deposits, trade and other receivables, term debt, and trade and other payables
- Fair value through other comprehensive income – foreign exchange hedge derivative assets and liabilities (designated hedges)
- Fair value through profit or loss – foreign exchange hedge derivative assets and liabilities (non-designated hedges), embedded conversion feature derivative of convertible note, and liability classified call spread options.

For financial assets, NZ IFRS 9 replaces the 'incurred loss' model in NZ IAS 39 with an 'expected credit loss' (ECL) model. ECLs are based on the difference between the contractual cash flows due in accordance with the contract and all the cash flows that the Group expects to receive. The shortfall is discounted at an approximation to the asset's original effective interest rate. Previously the Group recognised an impairment loss when trade receivables were past due. Under the new ECL model the Group uses a 12 month historical average default rate to calculate the expected credit loss for each customer group based on channel and location. The 12 month ECL is the portion of lifetime ECLs that results from default events that are possible within 12 months after the reporting date. However, when there has been a significant increase in credit risk since origination, the allowance will be based on the lifetime ECL. The adoption of the ECL requirements of NZ IFRS 9 resulted in increases in the impairment allowances of Xero's debt financial assets.

The Group applied hedge accounting prospectively. At the date of the initial application, all of the Group's existing hedging relationships were eligible to be treated as continuing hedging relationships. Consistent with prior periods, the Group has continued to designate the change in fair value of foreign exchange hedge derivative assets and liabilities in the Group's cash flow hedge relationships and, as such, the adoption of the hedge accounting requirements of NZ IFRS 9 had no significant impact on the Group's financial statements.

With the exception of hedge accounting which the Group applied prospectively, the Group applied NZ IFRS 9 retrospectively to all comparative periods, resulting in restatement of comparative figures. The effect of adopting NZ IFRS 9 on historical financial information is summarised below.

The Income Statement for the six months ended 30 September 2017 has been restated for the changes under NZ IFRS 9, resulting in an increase to sales and marketing expense, and decrease in net profit after tax, of \$21,000.

The effect of adopting NZ IFRS 9 on the Statement of Financial Position as at 31 March 2018 is as follows:

Statement of Financial Position (increase/(decrease))	(\$000s)
Assets	
Trade and other receivables	(201)
Deferred tax assets	30
Liabilities	
Deferred tax liabilities	(4)
Equity	(167)

New Zealand Equivalent to International Financial Reporting Standard 16: Leases

NZ IFRS 16: *Leases* replaces NZ IAS 17: *Leases*. It introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right of use asset, representing its right to use the underlying leased asset, and a lease liability, representing its obligation to make lease payments.

Under the new standard Xero recognises certain building and motor vehicle leases as right of use assets and lease liabilities. At lease inception the lease liability is measured at the present value of the remaining lease payments, discounted at Xero's incremental borrowing rate. Xero's borrowing rate is determined using an applicable reference rate, plus a credit margin based on indicative borrowing rates. The incremental borrowing rates applied are dependent on lease term and range between 5.04% and 10.05%. The unwind of the discount applied on recognition of a lease liability is recognised as interest expense in the Income Statement using the effective interest method.

Right of use assets are measured at inception at an amount equal to the lease liability. The right of use asset is subsequently depreciated using the straight-line method over the lease term. The useful lives of the right of use assets recognised under NZ IFRS 16 range from two to 12 years.

Xero presents right of use assets within property, plant and equipment, and lease liabilities, separately on the face of the Statement of Financial Position.

The Group adopted NZ IFRS 16 using the retrospective approach, resulting in a restatement of comparative figures.

The effect of adopting NZ IFRS 16 on the Income Statement for the six months ended 30 September 2017 is as follows:

Income Statement (increase/(decrease))	(\$000s)
Cost of revenue	(210)
Sales and marketing expenses	(317)
Product design and development expenses	(332)
General and administration expenses	(68)
Finance expense	1,074
Income tax expense	(39)
Net loss	108

The above changes include a decrease in rental expense of \$4.9 million, and increases in depreciation and interest expenses of \$4.0 million and \$1.1 million respectively.

The effect of adopting NZ IFRS 16 on the Statement of Financial Position as at 31 March 2018 is as follows:

Statement of Financial Position (increase/(decrease))	(\$000s)
Assets	
Trade and other receivables	(530)
Property, plant and equipment	40,632
Deferred tax assets	232
Liabilities	
Short-term lease liabilities	7,531
Long-term lease liabilities	37,906
Deferred tax liabilities	(91)
Provisions	86
Other long-term liabilities	(2,421)
Equity	(2,677)

The adoption of NZ IFRS 16 also resulted in a reclassification in the Statement of Cash Flows between operating and financing cash flows. The reclassification resulted in a \$3.8 million increase to operating cash flows and a corresponding decrease to financing cash flows.

(b) Critical accounting estimates

Except as noted above in relation to the adoption of new standards, the same significant judgements, estimates and assumptions included in the notes to the financial statements in the Group's annual report for the year ended 31 March 2018 have been applied to these interim financial statements.

3. SEGMENT INFORMATION

The Group operates in one business segment, providing online business solutions for small businesses and their advisors.

Xero has two operating segments: Australia and New Zealand (ANZ) and International. These segments have been determined based on the way the Xero Leadership Team (the chief operating decision-maker) reviews financial performance.

Segment operating expenses represent sales and marketing costs and service delivery costs, including both in-country costs and an allocation of centrally managed costs.

Unaudited	ANZ (\$000s)	International (\$000s)	Total (\$000s)
Six months ended 30 September 2018			
Operating revenue	169,241	87,286	256,527
Expenses	(71,535)	(88,462)	(159,997)
Other income	68	332	400
Segment contribution	97,774	(844)	96,930
Six months ended 30 September 2017 restated			
Operating revenue	130,390	57,447	187,837
Expenses	(60,157)	(67,169)	(127,326)
Other income	-	525	525
Segment contribution	70,233	(9,197)	61,036

Reconciliation from segment contribution to net loss before tax

Unaudited	2018 (\$000s)	2017 Restated (\$000s)
Six months ended 30 September		
Segment contribution	96,930	61,036
Product design and development	(68,866)	(55,857)
General and administration	(31,093)	(21,385)
Asset impairments	(17,757)	(1,550)
Other expenses	(1,637)	(610)
Finance income	865	1,227
Finance expense	(5,794)	(1,244)
Net loss before tax	(27,352)	(18,383)

At 30 September 2018, \$271.3 million, or 81%, of the Group's property, plant and equipment and intangible assets was domiciled in New Zealand (restated at 30 September 2017: \$170.5 million, or 76%).

Depreciation and amortisation by segment

Unaudited	2018 (\$000s)	2017 Restated (\$000s)
Six months ended 30 September		
ANZ	5,235	4,259
International	6,478	5,918
Corporate (not allocated to a segment)	27,469	23,786
Total depreciation and amortisation	39,182	33,963

Share-based payments by segment

Unaudited	2018 (\$000s)	2017 (\$000s)
Six months ended 30 September		
ANZ	2,679	1,762
International	4,215	2,846
Corporate (not allocated to a segment)	7,921	4,034
Total share-based payments	14,815	8,642

4. REVENUE

Operating revenue by geographic location

Unaudited	2018 (\$000s)	2017 Restated (\$000s)
Six months ended 30 September		
Australia	123,295	92,874
New Zealand	45,946	37,516
United Kingdom	53,353	34,198
North America	20,442	14,571
Rest of World	13,491	8,678
Total operating revenue	256,527	187,837

5. EXPENSES

Cost of revenue and operating expenses

Unaudited	2018 (\$000s)	2017 Restated (\$000s)
Six months ended 30 September		
Employee entitlements	142,745	114,325
Employee entitlements – share-based payments	17,237	10,578
Employee entitlements capitalised	(37,878)	(34,684)
Advertising and marketing	34,329	28,236
Platform costs	16,316	14,191
Consulting and contractors	8,751	6,783
Computer equipment and software	8,851	6,584
Travel-related costs	5,682	4,479
Superannuation costs	5,286	3,831
Communication, insurance and office administration	3,110	2,392
Rental costs	1,493	964
Staff recruitment	711	1,418
Directors' fees	564	495
Other operating expenses	13,577	11,013
Total cost of revenue and operating expenses excl. depreciation and amortisation	220,774	170,605

Depreciation and amortisation

Unaudited	2018 (\$000s)	2017 Restated (\$000s)
Six months ended 30 September		
<i>Relating to:</i>		
Amortisation of development costs	26,180	21,536
Amortisation of other intangible assets	4,931	3,879
Depreciation of property, plant and equipment	8,071	8,548
Total depreciation and amortisation	39,182	33,963
Total cost of revenue and operating expenses	259,956	204,568

Depreciation and amortisation included in function expenses as follows:

Cost of revenue	2,492	2,714
Sales and marketing	9,473	7,464
Product design and development	25,840	22,905
General and administration	1,377	880
Total depreciation and amortisation	39,182	33,963

6. PROPERTY, PLANT AND EQUIPMENT

Depreciation on assets is charged on a straight-line basis to allocate the differences between their original cost and the residual values over their estimated useful lives, as follows:

Leasehold improvements	Term of lease
Motor vehicles	5 years
Computer equipment	2 – 3 years
Furniture and equipment	2 – 7 years
Right of use asset	Term of lease

Movements in property, plant and equipment for the period were as follows:

Unaudited	Leasehold improvements (\$000s)	Motor vehicles (\$000s)	Computer equipment (\$000s)	Furniture and equipment (\$000s)	Right of use asset (\$000s)	Total (\$000s)
Cost						
Restated balance at 1 April 2018	14,938	27	5,817	10,761	57,690	89,233
Additions	5,531	–	2,722	1,627	11,009	20,889
Disposals and write-offs	(1,641)	(27)	(874)	(597)	(2,943)	(6,082)
Foreign exchange adjustment	225	–	167	318	1,995	2,705
Balance at 30 September 2018	19,053	–	7,832	12,109	67,751	106,745
Accumulated depreciation						
Restated balance at 1 April 2018	4,667	27	2,390	5,074	15,261	27,429
Depreciation	774	–	1,332	953	5,012	8,071
Disposals and write-offs	(651)	(27)	(865)	(600)	(1,048)	(3,191)
Foreign exchange adjustment	126	–	94	187	890	1,297
Balance at 30 September 2018	4,926	–	2,951	5,614	20,115	33,606
Net book value at 30 September 2018	14,127	–	4,881	6,495	47,636	73,139
Cost						
Restated balance at 1 April 2017	13,159	147	6,331	9,558	41,825	71,020
Additions	6,428	–	2,616	1,728	18,592	29,364
Disposals and write-offs	(561)	(89)	(3,005)	(107)	(3,292)	(7,054)
Foreign exchange adjustment	14	–	5	(39)	(372)	(392)
Restated balance at 30 September 2017	19,040	58	5,947	11,140	56,753	92,938
Accumulated depreciation						
Restated balance at 1 April 2017	5,955	135	3,009	4,611	16,448	30,158
Depreciation	2,102	9	1,326	907	4,204	8,548
Disposals and write-offs	(498)	(89)	(1,582)	(107)	(3,292)	(5,568)
Foreign exchange adjustment	(29)	–	16	(12)	(78)	(103)
Restated balance at 30 September 2017	7,530	55	2,769	5,399	17,282	33,035
Restated net book value at 30 September 2017	11,510	3	3,178	5,741	39,471	59,903

7. INTANGIBLE ASSETS

With the exception of goodwill, the useful lives of the Group's intangible assets are assessed to be finite. Assets with finite lives are amortised over their useful lives and tested for impairment whenever there are indications that the assets may be impaired.

Amortisation is recognised in the Income Statement on a straight-line basis over the estimated useful life of the intangible asset, from the date it is available for use. The estimated useful lives are as follows:

Software development	3 – 7.5 years
Software licences	1 – 3 years
Contract acquisition asset	5 years
Customer contracts	3 years
Patents, domains, brand and trademark costs	5 – 10 years

Movements in intangible assets for the period were as follows:

Unaudited	Note	Software development (\$000s)	Software licences (\$000s)	Contract acquisition asset (\$000s)	Other intangible assets (\$000s)	Goodwill (\$000s)	Total (\$000s)
Cost							
Restated balance at 1 April 2018		239,575	1,939	40,704	464	5,165	287,847
Additions*		35,557	-	7,094	-	-	42,651
Acquisitions	13	15,508	-	-	5,270	78,967	99,745
Disposals and write-offs		(11,909)	(786)	-	-	-	(12,695)
Impairments**		(30,346)				(5,165)	(35,511)
Foreign exchange adjustment		-	-	1,921	-	-	1,921
Balance at 30 September 2018		248,385	1,153	49,719	5,734	78,967	383,958
Accumulated amortisation							
Restated balance at 1 April 2018		100,429	1,757	16,669	176	-	119,031
Amortisation		26,180	182	4,474	275	-	31,111
Disposals and write-offs		(11,909)	(786)	-	-	-	(12,695)
Impairments**		(17,754)	-	-	-	-	(17,754)
Foreign exchange adjustment		-	-	867	-	-	867
Balance at 30 September 2018		96,946	1,153	22,010	451	-	120,560
Net book value at 30 September 2018		151,439	-	27,709	5,283	78,967	263,398

* Included in software development is \$5.0 million of externally purchased assets (2017: \$4.8 million).

** Included within impairments for the period ended 30 September 2018 is a \$16.3 million write-off of Xero's US payroll product and goodwill related to the acquisition of Monchilla, Inc. as a result of the strategic partnership entered into with external payroll provider, Gusto.

Unaudited	Note	Software development (\$000s)	Software licences (\$000s)	Contract acquisition asset (\$000s)	Other intangible assets (\$000s)	Goodwill (\$000s)	Total (\$000s)
Cost							
Restated balance at 1 April 2017		185,093	2,004	31,135	941	5,352	224,525
Additions		34,205	-	5,279	-	-	39,484
Disposals and write-offs		(846)	(15)	-	(11)	-	(872)
Impairments		(2,232)	-	-	-	-	(2,232)
Foreign exchange adjustment		-	-	(176)	-	-	(176)
Restated balance at 30 September 2017		216,220	1,989	36,238	930	5,352	260,729
Accumulated amortisation							
Restated balance at 1 April 2017		66,307	858	11,215	606	-	78,986
Amortisation		21,536	495	3,360	24	-	25,415
Disposals and write-offs		(846)	(15)	-	(11)	-	(872)
Impairments		(682)	-	-	-	-	(682)
Foreign exchange adjustment		-	-	(47)	-	-	(47)
Restated balance at 30 September 2017		86,315	1,338	14,528	619	-	102,800
Net book value at 30 September 2017		129,905	651	21,710	311	5,352	157,929

8. LEASE LIABILITIES

Lease liabilities are initially measured at the present value of the remaining lease payments, discounted at Xero's incremental borrowing rate. Subsequently they are measured at amortised cost using the effective interest method. Lease liabilities may be remeasured when there is a change in future lease payments arising from a change in an index or market rate, or if there is a change in the Group's estimate of the amount expected to be payable.

Unaudited	2018 (\$000s)	2017 Restated (\$000s)
Balance at 1 April	45,437	27,761
Leases entered into during the period	11,068	19,787
Principal repayments	(4,089)	(3,754)
Change in future lease payments	(1,889)	-
Foreign exchange adjustment	1,253	(196)
Balance at 30 September	51,780	43,598
Current	7,962	6,065
Non-current	43,818	37,533

9. SHARE CAPITAL

Unaudited	Notes	2018 (000s)	2017 (000s)
Balance at 1 April		138,449	137,761
Issue of ordinary shares – acquisition of Hubdoc	13	1,133	–
Issue of ordinary shares – exercising of employee share options	15	539	96
Issue of ordinary shares – employee restricted share plan	15	229	494
Issue of ordinary shares – restricted stock unit schemes	15	130	45
Issue of ordinary shares – directors' fees		6	7
Ordinary shares on issue at 30 September		140,486	138,403
Treasury shares		(831)	(1,118)
Ordinary shares on issue at 30 September excluding treasury shares		139,655	137,285

All shares have been issued, are fully paid, and have no par value.

During the period the Company acquired 100% of the ordinary shares of Hubdoc, issuing 1,133,303 ordinary shares as partial consideration at a deemed issue price of \$48.64.

During the period employees exercised 539,321 share options with a weighted average exercise price of \$18.66 (2017: 96,420 at a weighted average price of \$17.47).

During the period the Company allocated 344,003 shares under the employee restricted share plan, at a weighted average price of A\$45.15 (2017: 576,374 at a weighted average price of NZ\$25.75). Of the shares allocated, 228,459 were new shares issued, and 115,544 were the reissue of shares held as treasury stock (2017: 493,568 and 82,806 respectively).

During the period 199,213 restricted stock units (RSUs) vested, of which 129,643 were converted to shares, and the remaining 69,570 were surrendered to settle payroll tax liabilities (2017: 44,599 vested and converted; 4,567 vested and surrendered to settle payroll tax).

During the period, the Company issued 6,332 shares at a weighted average price of \$43.27 to directors in lieu of cash payment for directors' fees (2017: 7,131 shares at \$26.64).

10. RECONCILIATION OF OPERATING CASH FLOWS

Unaudited	2018 (\$000s)	2017 Restated (\$000s)
Six months ended 30 September		
Net loss	(28,565)	(19,590)
Adjustments:		
Depreciation	8,071	8,548
Amortisation	31,111	25,415
Deferred tax	(501)	18
Tax losses utilised	(320)	-
Other expenses	1,532	610
Loss on disposal of intangible assets	17,757	1,550
Employee share-based payments	14,312	8,350
Non-employee share-based payments	503	292
Bad debts	752	543
Other non-cash items	110	(19)
Changes in working capital items:		
Increase in trade receivables and prepayments	(9,302)	(3,131)
Decrease in interest receivable	371	177
Increase/(decrease) in trade payables and other related items	91	(7,054)
Increase/(decrease) in current tax payable	66	(647)
Net cash flows from operating activities	35,988	15,062

11. FINANCIAL INSTRUMENTS

Xero's hedging derivatives are recognised at fair value. Fair values are calculated using forward exchange rates that are quoted in an active market (level two on the fair value hierarchy). Foreign currency forward contracts are valued using a present value model that takes account of observable market inputs including spot exchange rates and forward rate curves.

Except for certain trade receivables, under NZ IFRS 9, the Group initially measures a financial asset at its fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs.

Under NZ IFRS 9, debt financial instruments are subsequently measured at fair value through profit or loss (FVPL), amortised cost, or fair value through other comprehensive income (FVOCI). The classification is based on two criteria: the Group's business model for managing the assets; and whether the instruments' contractual cash flows represent 'solely payments of principal and interest' on the principal amount outstanding (the 'SPPI criterion').

Xero's other financial instruments are carried at amortised cost. The carrying amounts of these assets and liabilities do not materially differ from their fair values.

There were no transfers between classes of financial instruments during the period.

12. HEDGE ACCOUNTING

The Group uses derivatives in the form of forward exchange contracts (FECs) and vanilla foreign exchange options (outright purchased options and vanilla collars) to reduce the risk that movements in the exchange rate will affect the Group's NZD cash flows. These hedges have been designated as a hedge of a highly probable forecast transaction (a cash flow hedge under NZ IFRS 9: *Financial Instruments*). The Group's policy is to hedge a portion of the next 18 months' forecasted cash flows.

During the period, a hedging gain of \$3.1 million (before taxation) was recognised in other comprehensive income (six months ended 30 September 2017: hedging loss of \$1.8 million). During the period, a gain of \$2.0 million (before taxation) was reclassified out of other comprehensive income to the Income Statement (six months ended 30 September 2017: loss of \$1.2 million). The remaining balance will be reclassified to the Income Statement in the 18 months following 30 September 2018.

Foreign exchange hedge position at 30 September 2018

Unaudited	Fair value (\$000s)	Notional amount hedged (NZD) (\$000s)
Derivative assets		
Buy USD – Sell NZD	2,797	37,936
Buy NZD – Sell AUD	588	66,065
Buy NZD – Sell GBP	22	8,855
Total	3,407	
Derivative liabilities		
Buy USD – Sell NZD	(228)	30,850
Buy NZD – Sell AUD	(124)	23,850
Buy NZD – Sell GBP	(512)	43,398
Total	(864)	

13. BUSINESS COMBINATIONS

On 2 August 2018 Xero acquired 100% of the ordinary shares in data capture solution provider Hubdoc, Inc. for consideration of NZ\$31.3 million cash, and NZ\$54.9 million in ordinary shares of Xero Limited. An additional US\$10 million in shares may be issued to the previous shareholders of Hubdoc, 18 months from acquisition date, if certain operational metrics are met.

The US\$10 million, or NZ\$14.6 million, in shares issuable in February 2020 is dependent on achievement of specific revenue and net cash flow targets. Of this amount, NZ\$5.4 million is issuable contingent both on the achievement of the revenue and net cash flow targets and on the continued service of Hubdoc's two founders. The proportion of this NZ\$5.4 million that is payable to the founders is considered compensation for their continued service and is excluded from the purchase price below, resulting in contingent consideration of NZ\$12.4 million. The remaining NZ\$2.2 million is recorded as compensation straight-line over the 18 month period from acquisition.

The number of shares issued on settlement of the contingent consideration will be based on the five day volume weighted average price of Xero Limited shares preceding issue date. Based on management's projections it is expected that the performance targets will be met and therefore the contingent consideration is recorded at 100%. Management will continue to assess the probability of performance achievement throughout the 18 month period and will record any revaluation adjustments accordingly.

Goodwill of \$78.9 million has been recognised because Hubdoc's expertise and technology will enable the Group to accelerate its ability to streamline the collection and classification of the data small businesses and their advisors need in order to focus on driving better business outcomes.

The following values are recognised in the financial statements in respect of the Hubdoc acquisition:

Unaudited	2 August 2018 (\$000s)
Assets acquired and liabilities assumed	
Software development asset	15,508
Customer contracts intangible asset	3,809
Brand intangible asset	1,461
Goodwill	78,967
Tangible assets acquired	2,028
Tangible liabilities assumed	(3,152)
Net assets acquired	98,621
Consideration transferred	
Cash	31,291
Shares issued	54,904
Contingent consideration	12,426
Total consideration	98,621

The acquired software development asset, customer contracts, and brand have been determined to have useful lives of 7.5 years, 3 years, and 5 years respectively.

For the period from acquisition date to 30 September 2018, Hubdoc contributed \$1.2 million in operating revenue and \$1.0 million in net loss. If the acquisition had occurred on 1 April 2018, management estimates that consolidated revenues and net loss would have been \$3 million and \$2.5 million higher respectively for the six months ended 30 September 2018.

14. CONVERTIBLE NOTES AND CALL SPREAD TRANSACTIONS

On 26 September 2018, Xero Investments Limited, a wholly owned subsidiary of Xero Limited, entered into an offering for US\$300 million of convertible notes with pricing finalised on 27 September 2018. The convertible notes were settled on 4 October 2018, and listed on the Singapore Exchange Securities Trading Limited (SGX-ST) on 5 October 2018. The settlement amount is recorded as a receivable at 30 September 2018.

The notes have a coupon interest rate of 2.375% per annum, payable six-monthly in arrears. The initial conversion price of the notes is US\$46.3386 per ordinary share based on a fixed exchange rate of A\$1.00 = US\$0.72745.

The notes are unsubordinated, are unsecured obligations of Xero, and are scheduled to mature on 4 October 2023. The settlement of the notes will be in cash unless Xero elects to settle in shares, in which case Xero will be obliged to deliver ordinary shares to relevant noteholders. The cash settlement amount will be calculated based on the volume weighted average price of the ordinary shares over a 90 day trading period.

In connection with the issuance of the notes, Xero entered into derivative financial instruments in the form of call spread transactions.

Term debt and conversion feature derivative

The conversion feature of the notes requires bifurcation from the notes and is accounted for as a derivative financial liability. The fair value of the embedded conversion derivative at the time of issuance was \$85.0 million and was recorded as a discount for purposes of accounting for the debt component of the notes. This discount is amortised as interest expense using the effective interest method over the term of the notes. The notes' embedded conversion derivative is carried on the consolidated Statement of Financial Position at its estimated fair value and is adjusted at the end of each reporting period, with any unrealised gain or loss reflected in the consolidated Income Statement. The fair value at 30 September 2018 was \$83.3 million.

The principal amount, unamortised debt discount, and unamortised issue costs of the notes as at 30 September 2018 are as follows:

Unaudited	(\$000s)
Principal amount	453,446
Unamortised debt discount	(85,375)
Unamortised issuance costs	(7,946)
Term debt	360,125

Call spread transactions

In connection with the issuance of the notes, Xero entered into call spread transactions, which are expected to reduce potential dilution to shareholders upon conversion of the notes and to offset any cash payments Xero is required to make in excess of the principal amounts on conversion. The call spread transactions consist of 6.5 million "lower strike" call options purchased with an average strike price equal to the conversion price of the notes, and 6.5 million "upper strike" call options sold with an average strike price of US\$60.5966. The call spread transactions expire in October 2023. The aggregate cost of the call spread was \$44.9 million, which was paid from proceeds of the convertible notes.

The lower strike call options are accounted for as derivative assets and are carried on the consolidated Statement of Financial Position at their estimated fair value. The derivative assets are adjusted to fair value each reporting period, with unrealised gains or losses reflected in the consolidated Income Statement. The fair value of the lower strike derivative asset was \$80.8 million on 27 September 2018, and \$78.9 million as at 30 September 2018.

The upper strike call options are accounted for as equity, and are initially recognised at their fair value, less transaction costs. The carrying value of the upper strike option, net of \$0.6 million in issue costs, is \$35.3 million.

Transaction costs

The Group incurred \$11.2 million of transaction costs related to the issuance of the convertible notes and call spread transactions. Transaction costs relating to the convertible notes have been allocated between the debt component and the conversion derivative using the proportions on initial measurement of the instrument. Costs attributed to the debt component will be amortised to finance expense over the term of the convertible notes using the effective interest method. Costs attributable to the conversion derivative were immediately recognised in the Income Statement. Transaction costs related to the call spread transactions have been attributed equally between the lower call options and the upper call options, with the lower call option costs immediately recognised in the Income Statement. Costs attributable to the upper strike call options are deducted from the amount recognised in equity.

15. SHARE-BASED PAYMENTS

The Group operates equity-settled, share-based compensation plans, under which employees provide services in exchange for non-transferable options, restricted stock units (RSUs), or shares. The value of the employee services rendered for the grant of non-transferable options, RSUs and shares is recognised as an expense over the vesting period, and the amount is determined by reference to the fair value of the options, RSUs and shares granted.

Employee restricted share plan

Movements in the number of unvested restricted shares are as follows:

Unaudited	2018 Number of shares (000s)	2017 Number of shares (000s)
Unvested shares at 1 April	522	582
Granted	344	576
Forfeited	(51)	(76)
Vested	(3)	(9)
Unvested shares at 30 September – allocated to employees	812	1,073
Forfeited shares not yet reallocated – held by Trustee	19	45
Total	831	1,118
Percentage of total ordinary shares	0.6%	0.8%
Ageing of unvested shares		
Vest within one year	426	524
Vest after one year	386	549
Total unvested shares at 30 September	812	1,073

The number of shares awarded pursuant to the restricted share plan does not equal the number of shares created for the scheme as forfeited shares are held in the trust and reissued.

Share options scheme

Movements in the number of options outstanding were as follows:

Unaudited	2018 Weighted average exercise price (\$)	2018 Options (000s)	2017 Weighted average exercise price (\$)	2017 Options (000s)
Outstanding at 1 April	20.65	2,225	18.55	2,188
Granted	38.22	1,951	24.06	415
Forfeited	17.51	(35)	17.58	(261)
Exercised	18.66	(539)	17.47	(96)
Expired	38.24	(63)	–	–
Outstanding at 30 September	30.36	3,539	19.74	2,246
Exercisable at 30 September	18.96	376	21.12	512

Restricted stock units

Movements in the number of RSUs outstanding were as follows:

Unaudited	2018 Weighted average grant date fair value (\$)	2018 RSUs (000s)	2017 Weighted average grant date fair value (\$)	2017 RSUs (000s)
Outstanding at 1 April	21.64	401	17.41	327
Granted	45.83	251	25.75	204
Forfeited	26.66	(25)	19.12	(41)
Converted to shares	20.62	(130)	17.27	(45)
Surrendered to pay payroll tax	20.68	(70)	20.58	(5)
Outstanding at 30 September	36.00	427	21.03	440

The Group withholds shares under certain circumstances to settle tax obligations on vesting. Based on the market share price at 30 September 2018, future cash payments to meet tax obligations are expected to be \$2.1 million (2017: \$2.3 million).

16. EVENTS AFTER THE BALANCE SHEET DATE

There were no significant events between balance date and the date these financial statements were authorised for issue.

INDEPENDENT REVIEW REPORT

To the Shareholders of Xero Limited (“the company”) and its subsidiaries (together “the group”)



OPINION

We have reviewed the interim financial statements on pages 23 to 44, which comprise the statement of financial position of the group as at 30 September 2018 and the income statement, statement of comprehensive income, statement of changes in equity and statement of cash flows of the group for the six month period ended on that date, and a summary of significant accounting policies and other explanatory information.

This report is made solely to the company's shareholders, as a body. Our review has been undertaken so that we might state to the company's shareholders those matters we are required to state to them in a review report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's shareholders as a body, for our review work, for this report, or for our findings.

DIRECTORS' RESPONSIBILITIES

The directors are responsible for the preparation and fair presentation of the interim financial statements which comply with New Zealand Equivalent to International Accounting Standard 34: Interim Financial Reporting and for such internal control as the directors determine is necessary to enable the preparation and fair presentation of the interim financial statements that are free from material misstatement, whether due to fraud or error.

REVIEWER'S RESPONSIBILITIES

Our responsibility is to express a conclusion on the interim financial statements based on our review. We conducted our review in accordance with NZ SRE 2410 Review of Financial Statements Performed by the Independent Auditor of the Entity. NZ SRE 2410 requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects, in accordance with New Zealand Equivalent to International Accounting Standard 34: Interim Financial Reporting. As the auditor of the group, NZ SRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial statements.

BASIS OF STATEMENT

A review of interim financial statements in accordance with NZ SRE 2410 is a limited assurance engagement. The auditor performs procedures, primarily consisting of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing (New Zealand). Accordingly we do not express an audit opinion on those financial statements.

We provide remuneration benchmark information, Type II assurance services on Xero's technology controls in accordance with NZ ISAE 3402, Australian research and development tax credit related compliance services, assurance services related to the issuance of convertible notes and the Group's preparation for compliance with ISO 27001. Other than these services and our role as independent auditor, we have no other relationship with, or interest in, the Group.

Partners and employees of our firm may deal with the Group on normal terms within the ordinary course of trading activities of the business of the Group.

CONCLUSION

Based on our review nothing has come to our attention that causes us to believe that the accompanying interim financial statements, set out on pages 23 to 44, do not present fairly, in all material respects, the financial position of the group as at 30 September 2018 and its financial performance and cash flows for the six month period ended on that date in accordance with New Zealand Equivalent to International Accounting Standard 34: Interim Financial Reporting.

Our review was completed on 8 November 2018 and our findings are expressed as at that date.

Ernst & Young

Chartered Accountants
Wellington
8 November 2018

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