

Appendix 4E



13 May 2021

Xero Limited

ARBN 160 661 183 (incorporated in New Zealand)

| | |
|-------------------------------|----------------------------|
| Reporting period | 12 months to 31 March 2021 |
| Previous corresponding period | 12 months to 31 March 2020 |

Results for announcement to the market

| | Amount (000s) | % change |
|---|---------------|----------|
| Revenues from ordinary activities | NZ\$848,782 | up 18% |
| Net profit from ordinary activities | NZ\$19,774 | up 493% |
| Net profit attributable to security holders | NZ\$19,774 | up 493% |

The Company does not propose to pay a dividend and no dividends were declared or paid for the reporting period.

Net tangible assets per share was NZ\$1.78 per share at 31 March 2021 (31 March 2020: NZ\$0.56 per share).

For additional Appendix 4E disclosure requirements refer to the financial statements contained in Xero Limited's 2021 Annual Report.

This report is based on the 2021 Annual Financial Report, which has been audited by Ernst & Young. The audit report is included as part of this profit announcement.

Authorised for release to the ASX by the Chair of the Board and the Chair of the Audit and Risk Management Committee.

XERO LIMITED

Annual Report 2021



Contents

| | |
|---------------------------------------|------------|
| Highlights | 2 |
| About Xero | 3 |
| Chair's Review | 5 |
| CEO's Review | 9 |
| Xero's response to COVID-19 | 19 |
| Social and environmental impact | 23 |
| Key Risks | 33 |
| Our Performance | 36 |
| The Board of Directors | 55 |
| Corporate Governance Statement | 57 |
| Remuneration Report | 73 |
| Independent auditor's report | 94 |
| Financial Statements | 99 |
| Notes to the Financial Statements | 103 |
| Directors' Responsibilities Statement | 138 |
| Disclosures | 139 |
| Corporate Directory | 147 |

Highlights

\$848.8m

Operating revenue

▲ Up 18% YOY

2.741m

Subscribers

▲ Up 456,000 YOY

\$963.6m

Annualised monthly recurring revenue

▲ Up 17% YOY

\$7.6b

Total subscriber lifetime value

▲ Up \$2.1b YOY

86.0%

Gross Margin Percentage

▲ Up 0.8PP YOY

\$56.9m

Free cash flow

▲ Up \$29.8m YOY

\$1.3b

Total available liquidity

Cash on hand, short-term deposits and undrawn committed debt facilities

\$191.2m

EBITDA

▲ Up \$53.5m YOY

A global ecosystem of **1,000+** connected apps

300+ connections to banks and financial service partners

Xero was included in the **2021 Bloomberg Gender-Equality Index** as one of only 13 companies headquartered in Australia or New Zealand

Xero was certified **carbon neutral** by the Australian Government's Climate Active program

Total value of invoices raised via Xero during FY21 - **\$984.9b**

Total value of transactions through Xero platform in FY21 - **\$4.2t***

*Incoming and outgoing transactions

About Xero

In this Annual Report, we showcase inspiring stories from Xero customers, partners and our people. We recognise that Xero would not be the company it is today without these communities. They share the world seen through their eyes, both during the past year, and as they look ahead to the future.

Xero is a cloud-based accounting software platform for small businesses with more than 2.7 million subscribers globally. Through Xero, small businesses and their advisors have access to real-time financial data any time, anywhere, and on any device.

Founded in 2006, Xero is a global business, domiciled in New Zealand and listed on the Australian Securities Exchange (ASX: XRO). Our team of more than 3,600 employees is driven by our purpose to make life better for people in small business, their advisors and communities around the world.

The relationships we have with our partners in the accounting and bookkeeping communities are part of what makes Xero unique. Xero's platform allows accountants and bookkeepers to collaborate with their small business clients on a single, up-to-date general ledger and manage their finances, including invoicing, payroll, tax compliance, cash flow, and much more.

Xero has built a thriving ecosystem of over 1,000 connected apps and more than 300 connections to banks and financial service providers. With apps that support everything from inventory and logistics to point of sale and project management, the Xero App Marketplace empowers small businesses to build their own toolkit to run all aspects of their business, and have them all work together seamlessly.

We are dedicated to building a socially conscious and environmentally sustainable business, benefitting the millions of customers we serve, their advisors, communities, and the shareholders and employees of Xero. We are committed to reducing our impact on the environment. During the year ended 31 March 2021 (FY21), Xero was certified carbon neutral by the Australian Government's Climate Active program.

Our commitment to gender diversity and inclusion was recognised with Xero's inclusion in the 2021 Bloomberg Gender-Equality Index.



THROUGH THEIR EYES

Real-time data key to supporting clients



Pamela Phillips | Xero Partner /
de Jong Phillips | United Kingdom

When COVID-19 hit, the de Jong Phillips team in Epsom, UK, was on the front foot. Instead of needing to spend time navigating working from home or figuring out how to embrace the cloud, director and co-founder Pamela Phillips and her team were straight on the phone with their clients, offering a much-needed listening ear and, in time, financial advice.

"With Xero, our clients' numbers are always up to date. The minute the pandemic happened, we could look into our clients' Xero accounts and see whether they had a cash flow issue, which enabled us to quickly advise if they needed to secure funding, or consider if they needed to access the furlough scheme or make redundancies. If we didn't have these quick insights, we would have had to spend months to get client files up to date. But we could help straight away – that was a massive help to our clients and made a huge difference to their stress levels at the time."

As the pandemic continued to dominate the business landscape, Pamela and her team realised they needed to streamline their client communication. "Those conversations evolved into Zoom webinars, many inspired by resources on Xero's Business Continuity Hub on Xero Central. We would follow up off the back of those with anyone who wanted a one-on-one conversation. This approach enabled us to reach more clients, and we also invited non-clients to our webinars, too."

de Jong Phillips' tech-savvy approach to business has played a key role in the survival of their clients' businesses. As UK businesses start to recover, the support Pamela and her team provide will continue to be invaluable.

Chair's Review



David Thodey AO
Chair of the Board

Dear shareholder,

We are seeing a significant shift in the way business is conducted around the world as digitisation accelerates across industries, and small businesses adopt cloud technologies. Operating at the intersection of technology and accounting, Xero is in a strong position to support our customers as they tackle these changes and realise the benefits of doing business in the cloud.

At the same time, we acknowledge that for many people around the world, this year has been disruptive and even tragic, as nations, families and communities grapple with the impacts of COVID-19.

As a director of Xero, I am encouraged to see first-hand how small business owners have navigated their way through constantly changing market conditions and customer demands – in some cases entirely revising their business models, and adopting new technologies and ways of serving customers.

Against this backdrop, our business continues to grow strongly. Xero's 2021 financial year (FY21) began on 1 April 2020 just as COVID-19 was escalating around the world.

Our teams at Xero have remained focused on responding to changing customer needs and introducing new products and services, while at the same time executing our growth strategy, completing a significant capital raise, and making three strategic acquisitions.

We are seeing small businesses turn to cloud-based tools such as Xero to inform and guide their business decisions. From forecasting cash flow to tax compliance and running payroll, Xero's small business platform continues to create value for our customers in today's operating environment.

We are pleased to report strong subscriber growth during FY21, as we welcomed new customers and churn rates remained low, demonstrating the value of a Xero subscription to our new and existing customers. After a first half challenged by COVID-19, we added new subscribers at a record rate in the second half of the year, highlighting the continued demand for cloud-based tools across all our markets.

Today, more than 2.7 million subscribers use Xero globally. They have access to Xero's ecosystem of more than 1,000 connected apps and over 300 connections to banks and financial service providers.

Looking ahead we are optimistic as new digitally native businesses are being launched, and existing businesses switch to online tools. More economies are reopening, or preparing to reopen, and small businesses are adapting their business models in preparation for a post-pandemic world.

Focus on strategic investments

Small businesses are seeking services beyond cloud accounting, and we are responding to this with continued investment in our platform and products, and by making targeted acquisitions of additional services and capabilities.

We were pleased to see significant confidence in Xero and our strategy when we undertook a successful capital raise of US\$700 million, via

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Small businesses are seeking services beyond cloud accounting, and we are responding to this with continued investment in our platform and products, and by making targeted acquisitions of additional services and capabilities.

zero-coupon convertible notes. We were able to raise an additional US\$408 million of capital, after associated transaction costs and early repayment of the majority of the existing 2023 convertible notes.

The new capital provides Xero with greater financial flexibility to pursue strategic investments and deliver ongoing innovation and support to our customers and partners. This includes the acquisitions completed recently, including Waddle, a cloud-based lending platform; Planday, a workforce management solution; and Tickstar, an e-invoicing infrastructure business.

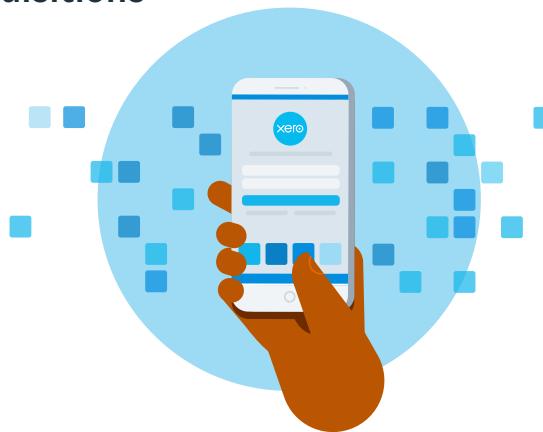
Responsible data use, security and trust

Our vision for Xero is to be the most insightful and trusted small business platform. Customer data is at the heart of this, and we are committed to ensuring that the data we hold is secure, used responsibly, transparently, and with consent.

We invest heavily to protect data on the Xero platform, and encourage our customers to adopt practices that help keep their accounts and data safe.

We continue to review and enhance our data governance, as well as provide policies and education to guide Xero employees on responsible data use – whether that is in designing products, developing features for customers, or entering into partnerships.

We also know that security is integral to building and operating a trusted platform. To better safeguard our customers, in March we began the implementation of multi-factor authentication (MFA) globally, which provides an extra layer of protection during login.



This year we enhanced our platform's security infrastructure and laid the foundations for greater automation and an improved operating model for our security services.

Xero's social and environmental impact

Xero was recognised with carbon neutral certification by the Australian Government's Climate Active program in February. The certification is the culmination of almost two years of work by our teams following our commitment to be carbon neutral across all areas of our business as part of our environmental sustainability program, Net Zero @ Xero.

From the beginning of our carbon neutral program, we have offset our calculated emissions through the purchase of carbon certified offset projects in Indonesia, India, and New Zealand. In FY21, we expanded our sponsorship of the Fishermans Bay Conservation Project near Akaroa in New Zealand. More information about Xero's FY20 carbon disclosure, emission reduction plans, and projects in place to offset our emissions can be viewed on the Climate Active website.

We remain focused on reducing Xero's impact on climate change. We intend to report on our response to climate change, in alignment with the standards of the Task Force on Climate-related Financial Disclosures. More information about our social and environmental impact program is on page 23.



Right: Xero team members, New Zealand

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In 2021, Xero earned a place in the Bloomberg Gender-Equality Index for the second consecutive year.

Risk management

As a high-growth company, we recognise that managing risks and opportunities is critical to the execution of our strategy and maintaining the trust of all stakeholders.

The Board takes this responsibility seriously, and Xero has a risk management framework in place that includes regular updates to the Board. Further information on our approach is on page 33 of this report.

Diversity and inclusion

At Xero, diversity means acknowledging, appreciating, and celebrating all the many ways we are different in all its forms, both visible and not. It includes differences that relate to gender, age, culture, ethnicity, race, disability, family status, language, religion, sexual orientation, gender identity, as well as differences in background, skills, work styles, perspectives, and experiences.

We are focusing on racial equality and diversity through several initiatives and partnerships. The global Black Lives Matter movement reinforced the need for everyone to tackle racism and racial inequality, a responsibility we take seriously at Xero. Recently, our team in the US entered a partnership with the National Association of

Black Accountants to bring greater parity for Black accounting and finance professionals through technical training, networking, and career opportunities.

Also paramount, is broad representation that reflects the diversity of the customers and communities we serve. We are taking steps so that, over time, our Board and leadership team better reflect this diversity.

Last year, we set numerical targets for representation of women at Xero. For our leadership team and across the company, we took a 40:40:20 approach – at least 40% women and 40% men, with the remaining 20% unspecified to allow for flexibility and to recognise that gender is non-binary.

For our Board, our target gender balance is at least three female directors and at least three male directors, with an intended Board size of seven to nine directors.

As of 31 March 2021, 63% of our leadership team and 42% of our employees were women, and we had three female and five male directors. More information about our initiatives in this area is in the corporate governance statement on page 57.

In 2021, Xero earned a place in the Bloomberg Gender-Equality Index for the second consecutive year. Xero is one of just 13 companies in the index headquartered in Australia or New Zealand. At the same time, we recognise there is more to do, and we look forward to creating a more diverse and inclusive organisation.

Our focus on developing people leaders at Xero aims to ensure we create and lead diverse teams, where each person feels they belong. In support

of this, we recently launched a leadership training program for all managers to equip them with tools to create and support an environment that is psychologically safe and inclusive.

Board update

As Chair of Xero's Board, I could not have navigated this year's challenges without the support and guidance of our experienced team of directors. With COVID-19, we had more frequent Board meetings as we worked with the management team to navigate the challenges of the pandemic. I would like to thank our directors for the extra time and counsel they have provided.

We were pleased to welcome Steven Aldrich, who joined the Board in October 2020. Steven is US-based, and his technology and product development expertise in small business services is proving invaluable as we execute our strategy in North America.

On behalf of the Board, thank you to Xero's leadership team and to all our Xero people for their exceptional efforts this year.

Conclusion

Looking ahead, we expect digital transformation to continue to accelerate around the world. As a company born in the cloud, Xero is well positioned to support our customers as they adapt to these digitally driven ways of working.

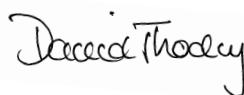


We are seeing small businesses turn to cloud-based tools such as Xero to inform and guide their business decisions. From forecasting cash flow to tax compliance and running payroll, Xero's small business platform continues to create value for our customers in today's operating environment.

As the world moves toward a post-pandemic state, all of us at Xero remain focused on our purpose of making life better for people in small business and their advisors and communities around the world.

The Board remains committed to supporting the business to invest in the growth of Xero as we see the significant global market opportunity for our products and services.

Sincere thanks to our customers, partners, and shareholders for the trust you place in Xero.

A handwritten signature in black ink that reads "David Thodey".

David Thodey
Xero Chair

CEO's Review



Steve Vamos
Chief Executive
Officer

Dear shareholder,

Xero has an important responsibility to meet the current and future needs of our customers by investing in product innovation and customer experience, and pursuing our vision to be the most insightful and trusted small business platform.

The last year has been deeply challenging for Xero people, our customers, partners and their communities. During the year, we focused our efforts on doing what we could to support our customers and partners' immediate needs, while continuing to pursue our longer-term purpose and strategy.

Xero finished FY21 strongly and enters FY22 with momentum and confidence in our long-term strategy.

There are a number of major global trends that help shape our strategy, particularly when considered through a 10-year lens. These include adoption of cloud technologies, digitisation of tax and compliance, innovation in financial services, and the post COVID-19 recovery of the small business economy.

This year brought home to many people in small businesses the need to understand their financial position in real-time and how it may change in future. Having this insight became more important than ever, and the value our customers place in their subscription and connection to the broader Xero community was clear.

Looking ahead we believe small businesses will be a major driver of economic recovery in a post-pandemic world. Small businesses make up more than 90% of businesses in the markets Xero operates in, and represent a significant proportion of employment and gross domestic product in those markets.

FY21 results update

We welcomed 456,000 net new subscribers in FY21, taking total subscribers to over 2.7 million globally. In the second half of the year, we added 288,000 subscribers – our strongest half-year period ever.

EBITDA, net profit and free cash flow increased strongly compared to FY20. This reflects top-line growth together with close management of expenses and considered capital allocation.

The impact of COVID-19 was most pronounced during the first few months of FY21, and we adopted a responsive spending and investment approach. As conditions and confidence improved in many of our markets, investment in growth picked up and coincided with the markedly higher subscriber additions in the second half of the year.

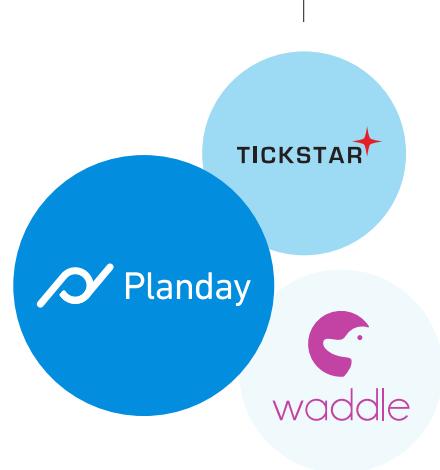
Execution of strategy

We made good progress in FY21 executing Xero's growth strategy. Xero's strategic priorities, set out below, guide our decision-making and how we invest.

- Drive cloud accounting adoption – increasing the penetration of small business cloud accounting software
- Grow the small business platform – extending and enriching Xero as a platform to help small businesses run their business
- Build for global scale and innovation – preparing Xero to realise our aspirations to become the most insightful and trusted small business platform



Planday, Xero's largest acquisition to date, provides a workforce management platform serving employers and their employees in Europe, the UK and the US.



Digitisation of tax and compliance continues to be a trend that is driving adoption of cloud accounting. An example is the UK Government's Making Tax Digital initiative, the next stages for which are coming up in 2022 for those under the VAT threshold and 2023 for Income Tax. During FY21 we continued to invest in readiness for these changes.

Supporting our priority to build for global scale and innovation, we raised US\$700 million of capital in new convertible notes at a zero-coupon rate and repaid the majority of the existing 2023 convertible notes. We were therefore able to successfully raise an additional US\$408 million of capital through the transaction. As we execute our strategy, the proceeds give us flexibility to, among other things, pursue strategic investments such as the three acquisitions we announced during the year, of Waddle, Planday and Tickstar.

In FY21, we acquired Waddle for a total consideration of up to AUD\$80 million (approximately NZD\$87 million). Waddle is a cloud-based lending platform that leverages accounting data to help small

businesses gain access to working capital and better manage cash flow. Waddle's addition to Xero will help grow our small business platform by solving for critical small business financial needs.

Planday is Xero's largest acquisition to date, purchased for up to €183.5 million (approximately NZD\$305 million). Planday provides a workforce management platform serving employers and their employees in Europe, the UK and the US. Planday simplifies worker scheduling, payroll compliance, and communication with employees. This acquisition will help grow Xero's small business platform by expanding it to serve more employing businesses and their employees.

In anticipation of e-invoicing growth worldwide, we acquired e-invoicing technology provider Tickstar for up to SEK150 million (approximately NZD\$25 million). Tickstar provides e-invoicing network access points and capabilities that promise to enable faster, more secure transactions and help drive cloud accounting.

Areas of planned strategic investment

| Strategic priorities | Drive cloud accounting | Grow small business platform | Build for global scale and innovation |
|-----------------------------|---|---|---|
| Areas of planned investment | Best-in-class cloud accounting for small business Extend access and distribution to serve all small businesses Serve small businesses with multi-lingual editions | Small business needs beyond accounting and compliance Payments and access to capital New applications leveraging data, artificial intelligence and machine learning | Attract, inspire and retain world class talent Robust technology to drive innovation at speed Optimised operational and financial structure |

Market highlights

North America

Subscribers grew by 18% in the year to 285,000 with a notable recovery in net additions in H2 FY21. Revenue increased by 2% (6% in constant currency (CC)) reflecting the loss of revenue from bundling Hubdoc into Xero Business Edition subscriptions in late FY20 and the absence of any Xerocon-related revenue in FY21.

UK

Subscribers grew by 17% to 720,000. Revenue grew by 22% (23% in CC). A marked recovery in H2 FY21 (the UK's second strongest half year period ever) resulted in net subscriber additions for the year of 107,000.



| | ANZ | | | | International | | | |
|---------------|------------------------------|-------------|--------|------|------------------------------|---------------|---------------|------|
| | Australia | New Zealand | | | United Kingdom | North America | Rest of World | |
| | FY21 | ▲YOY | FY21 | ▲YOY | FY21 | ▲YOY | FY21 | ▲YOY |
| Subscribers | 1.12m | +22% | 446k | +14% | 720k | +17% | 285k | +18% |
| Net additions | 201k | +7% | 54k | +32% | 107k | -29% | 44k | -4% |
| Revenue | \$384m | +20% | \$130m | +12% | \$224m | +22% | \$57m | +2% |
| | 1.56M SUBSCRIBERS (+20% YOY) | | | | 1.18M SUBSCRIBERS (+21% YOY) | | | |

Rest of World

Subscribers grew by 40% to 175,000, the largest annual increase this market has delivered to date. The largest contributors to subscribers were South Africa and Singapore. Revenue grew by 27% (32% in CC).



Australia

Subscribers grew by 22% in FY21 to reach 1,115,000. Revenue was up 20% (18% in CC). Good demand for Xero's revised Starter product and increased partner channel adoption helped drive Australia's best ever year for subscriber growth.

New Zealand

Subscribers grew by 14% in the year to 446,000. Revenue increased by 12%. This marked the best full year net subscriber performance in three years and demonstrates continued opportunity to move to the cloud, particularly in the partner channel.



Right: Xero customer, Poplar Petfood & Produce, Australia

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This year brought home to many people in small businesses the need to understand their financial position in real-time and how it may change in future.

Enhancing connections for our customers and accounting and bookkeeping partners

During the year, we enhanced Xero's customer experience by adding ecosystem apps, partnerships and bank feeds.

Xero now has an ecosystem of more than 1,000 connected apps. These apps provide vital services for our accounting and bookkeeping partners and small business customers in areas such as point of sale, inventory management and financial forecasting – to name just a few.

We extended our partnerships with financial institutions around the world, and, as a result, Xero now supports more than 300 connections to banks and financial service providers.

Our US customers gained direct connections to Citibank, Bank of America and Chase Bank in early 2021, following agreements made in previous years. Many of our US customers now have access to high quality, API-driven bank feeds that automatically import transactions into Xero from the four biggest US banks. We also launched a direct API bank feed with Nedbank in South Africa.

We expanded our payments capabilities, delivering a new way to manage and pay multiple bills at once in the UK in partnership with Wise (formerly known as Transferwise). We also enhanced our invoice payment experiences with Stripe and GoCardless, making it more seamless for businesses to accept payments.

To achieve our aspiration to make life better for people in small business, we want to get Xero into the hands of as many accountants and bookkeepers as possible. We know Xero helps to drive deeper and more meaningful conversations between advisors and their clients, based on accurate financial insights.

As part of our strategy to strengthen relationships with global accounting firms, in March we signed a global agreement with BDO. BDO is the first to be awarded Xero Global Partner status. Xero will become BDO's preferred accounting solution for its small and medium-sized clients worldwide. Initial participating member firms are expected to include BDO in Australia, New Zealand, the UK and Canada.

Talent and leadership

Attracting, retaining and inspiring world-class talent is a priority and critical to our growth. We aim to hire people who are purpose-driven, customer-centric and passionate about small business. Our team of Xero people around the world grew 19% to more than 3,600 employees, adding more than 550 employees over the year.

As Xero continues to scale and support more customers, we are expanding our product and technology teams globally. During the year, our Toronto office in Canada became Xero's North American hub for product and technology innovation. We also continued to invest in our existing hubs in Wellington, Auckland, Melbourne and Canberra.

We are proud of how our people responded to COVID-19, and delivered features that customers needed the most. During calendar year 2020, Xero's product and technology teams collectively doubled the number of back and front end application updates, even with the disruptions of COVID-19 and people moving to work remotely.

We continue to ensure that Xero's leadership team is structured to optimally address the needs of our customers and drive consistency of decision-making and sharing of ideas across all of our markets.

During the second half of FY21, we expanded the remit of Xero's Chief Customer Officer role to lead our global sales and customer functions including the Managing Directors in each region. The region Managing Directors continue to focus on building brand presence and driving subscriber momentum in the markets they lead.

Evolution of the Xero Small Business Insights program

We advanced our Xero Small Business Insights (XSBI) program by launching the monthly Xero Small Business Index in May 2021. This index measures a number of important indicators within the small business segment. It allows a unique country-by-country comparison of small business sales, wages, jobs and invoice payment times across Australia, New Zealand and the UK.

Created by Xero with help from Accenture, the Xero Small Business Index uses anonymised, aggregated data from hundreds of thousands of small businesses, to give monthly insights across our largest markets. Equipped with this information, policymakers have a clearer picture of the small business economy so they can make better-informed decisions.

Our people

I'd like to acknowledge and thank all Xero people around the world for their commitment, passion, and hard work during FY21. Our people have adjusted well to working from home despite many facing isolation, conducting homeschooling, and living with health and wellbeing concerns.

In the face of these challenges, I'm proud of how we have continued to support one another and our customers. We have demonstrated and lived our values, especially #team and #human.

We focused on supporting the wellbeing of our people and our customers during COVID-19 and established a wellbeing function within our people experience team to grow our efforts in this area. We created a wellbeing hub for our people, with resources for them and their families, including an information kit for parents, and we listened to our people through regular pulse surveys and Ask Me Anything sessions to understand how we could support them.

We also updated our flexible working policy to give our people choice in terms of where and what hours they work including adjustable start and finish times, compressed work weeks and remote working.

Outlook

Xero will continue to focus on growing its global small business platform and maintain a preference for reinvesting cash generated, subject to investment criteria and market conditions, to drive long-term shareholder value.

Total operating expenses (excluding acquisition integration costs) as a percentage of operating revenue for FY22 are expected to be in a range of 80–85% which is consistent with levels seen in the second half of FY21 and the pre-pandemic period. Integration costs, relating to the three acquisitions announced during FY21, are expected to increase total operating expenses as a percentage of operating revenue by up to 2% for FY22.

As previously stated, the acquisition of Planday is expected to contribute approximately three percentage points of additional operating revenue growth in FY22.

Product updates

We made significant investments in product development and technology in FY21, delivering new tools for small businesses and their advisors to manage and monitor their operations. We made enhancements that focus on providing fast and accurate data, streamlined workflows, and deeper insights to help our customers.

Below are some of the product initiatives and delivery highlights.

Starter plan

There has been strong uptake of our enhanced Starter plan, which is tailored for early-stage businesses with simpler needs, such as sole traders. The revised plan removed the limit on bank reconciliation and provides for the ability to approve and send up to 20 invoices per month. Like all Business Edition plans, it also includes Hubdoc for automated document collection and management.

Xero Tax UK

In FY21, we enabled UK accountants and bookkeepers to lodge company tax for their customers directly via Xero practice management tools. Xero Tax has helped to drive growth in our more developed markets, and we are investing for the next phases of Making Tax Digital in 2022 and 2023.

Payroll UK

Xero Payroll software was updated to process furlough leave for eligible current or reinstated employees, as well as apply for the HMRC Job Retention Scheme payments for employees.

Payroll Australia

We delivered tools to help Australian customers assess their eligibility for the JobKeeper wage subsidy, make payments to employees, and file the required reports to the Australian Taxation Office.

Short-term cash flow

This tool takes data from a customer's Xero account – such as their bank accounts, bills, and invoices – to produce a current view of cash flow. It projects a bank balance as much as 30 days into the future, showing the impact of existing bills and invoices if they're paid on time.

E-invoicing (Australia & New Zealand)

We launched the ability for customers to send e-invoices from Xero via the international Peppol network. E-invoicing eliminates manual entry and increases accuracy at the recipients' end, as data fields automatically populate in their e-invoicing software, and can contribute to faster payment.

Business snapshot

This is a visual dashboard of key financial metrics showing customers' business performance at a glance: income, expenses, average time to get paid, and average time to pay suppliers (debtor and creditor days), as well as their balance sheet position and cash balance.

Xero Projects - profitability

This new dashboard in Xero Projects provides at-a-glance visibility of the profitability of each project.

Practice management updates

Accountants and bookkeepers now see a unified client list across Xero HQ and Xero Practice Manager, enabling them to easily send documents for small businesses to sign remotely with Document Packs.

Conclusion

We are pleased with our progress in FY21 under challenging conditions, and we enter FY22 with continued focus on our purpose: to make life better for people in small business, their advisors and communities around the world.

We see tremendous opportunity and demand for small business to contribute to economic and social recovery, while recognising that COVID-19 is still impacting many people and communities.

Xero will continue to work hard to support our customers by continuing to invest in product development, strategic acquisitions and partnerships that enable us to address their current and future needs.

Thank you to our people, customers and partners, shareholders and everyone who supports Xero.



Steve Vamos

Chief Executive Officer

THROUGH THEIR EYES

Focus on Spotlight



Richard Francis, CEO | Xero App Partner | Spotlight Reporting | New Zealand

Spotlight Reporting, an app that delivers deep reporting and business insights, has been connected to Xero for a decade. When it joined Xero's ecosystem, it was one of a dozen app partners. Since then, Spotlight has expanded beyond its home country of New Zealand to serve customers globally.

"Xero's decision to allow its customers to share their accounting data with apps in 2010 opened up opportunities for us to support small business in new ways," says Spotlight CEO and founder Richard Francis.

Xero already had a suite of features and functionalities, and Spotlight's team was able to create solutions that extended these capabilities.

Richard added, "Suddenly we could turn real-time Xero data into meaningful and tailored performance reports with a click of a button. This added another layer of sophistication for our customers, enabling them to make real-time decisions to support their business."

Richard explains that Xero attracted the kind of accountants, bookkeepers and advisors that Spotlight wanted to work with – those who focused not just on taxes but advisory. This included strategy, mentoring, and producing visual forecasts and budgets that helped business owners reach their financial goals.

"If small and medium businesses are having better conversations with their advisors and making smarter decisions, then everyone benefits," says Richard.

Since 2010, Xero's ecosystem has attracted app partners that handle everything from inventory management and point of sale to employee rostering and more.

"Because Xero is continually innovating, we're motivated to do the same," says Richard. "We keep moving and offering capabilities that are different or extensions of what Xero does. And it works very well."

THROUGH THEIR EYES

Xero + apps – the secret to success



Kristen Buttress | Xero Customer |
Kristen's Kick-Ass Ice Cream | South Africa

For Kristen Buttress, Managing Director of Kristen's Kick-Ass Ice Cream in South Africa and Mauritius, using Xero alongside a suite of connected apps from the Xero App Marketplace, has enabled her to grow her business. It's also given her the most precious thing of all – more time with her two young children.

Kristen says handing her business reins over to her accountant, and putting her trust in Xero and apps Vend, Shopify, SimplePay, and Dext (previously ReceiptBank) just over a year ago, has been a game changer for her business and her personal life.

Vend and Shopify enabled Kristen to keep her business operating throughout COVID-19. During lockdown, facilitated by the two apps, she upgraded her website and started offering ice cream deliveries.

"I love how all the apps talk to each other, and integrate well with Xero. If I ever want to know how my business is doing, I can see my receivables, payables, and how my bank accounts are looking. And if I need any further information, my accountant walks me through it. It's enabled me to grow as a business owner and given me so much time back to work on my business and be with my family."

And being able to clearly see her accounts receivable via Xero has given her the confidence to move her wholesale clients from cash accounts to 30-day accounts, leading to more income from those customers, not to mention the time savings: "I used to spend about 30 hours a month on paperwork – now it's more like two!"

“

If I ever want to know how my business is doing, I can see my receivables, payables, and how my bank accounts are looking.





Xero's response to COVID-19

What drives Xero is our purpose: to make life better for people in small business, their advisors and communities around the world. During COVID-19, we acted to help our customers and people adapt to new ways of working in a number of ways.

COVID-19 Xero Crisis Management Team

comprising leaders from Xero teams globally is formed to monitor COVID-19 and make decisions to ensure the safety of our people and our business (March 2020)

Customer Response Team

is established to, among other things, assist small businesses, provide dedicated 24/7 guidance including how to access support from governments and Xero (March 2020)

Xero Hour

expands to more regions for small businesses, accountants and bookkeepers. These free online sessions offer advice from industry experts on marketing, business skills and wellbeing, and a forum to exchange knowledge (April 2020)

Xero HQ offers monthly revenue export to make it easier for accountants and bookkeepers to help identify clients across their practice that need government or additional support (May 2020)

March 2020

Shifted all Xero employees to remote working and closed all of our offices (March 2020)

Wellbeing Hub is launched with resources for Xero employees and their families, including a wellbeing kit to help with mental health and keeping active (April 2020)

April

Xero Payroll becomes JobKeeper-enabled for Australian customers to provide access to government stimulus packages, accommodate pandemic-related leave in the UK, and allow customers to calculate, apply for, and pay wage subsidies to employees in NZ (April 2020)

May

Education webinars are hosted for thousands of accounting and bookkeeping partners on how to help clients access government support for COVID-19 in Australia, the UK, and NZ (webinars hosted from March through June in Australia, UK, and NZ)

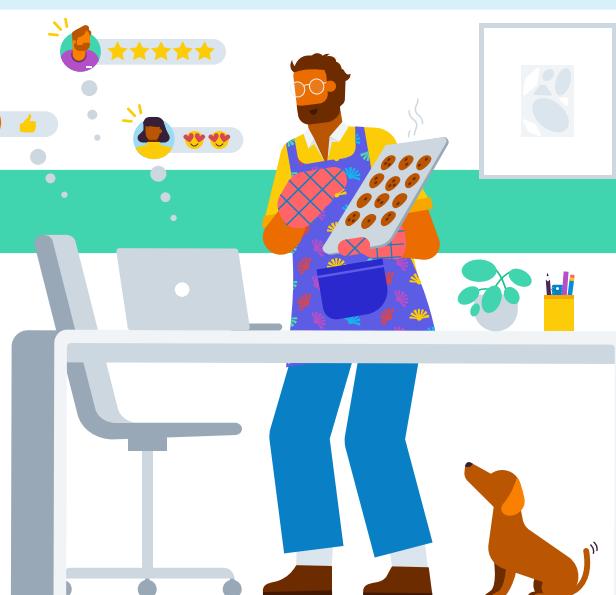
Increased wellbeing programs

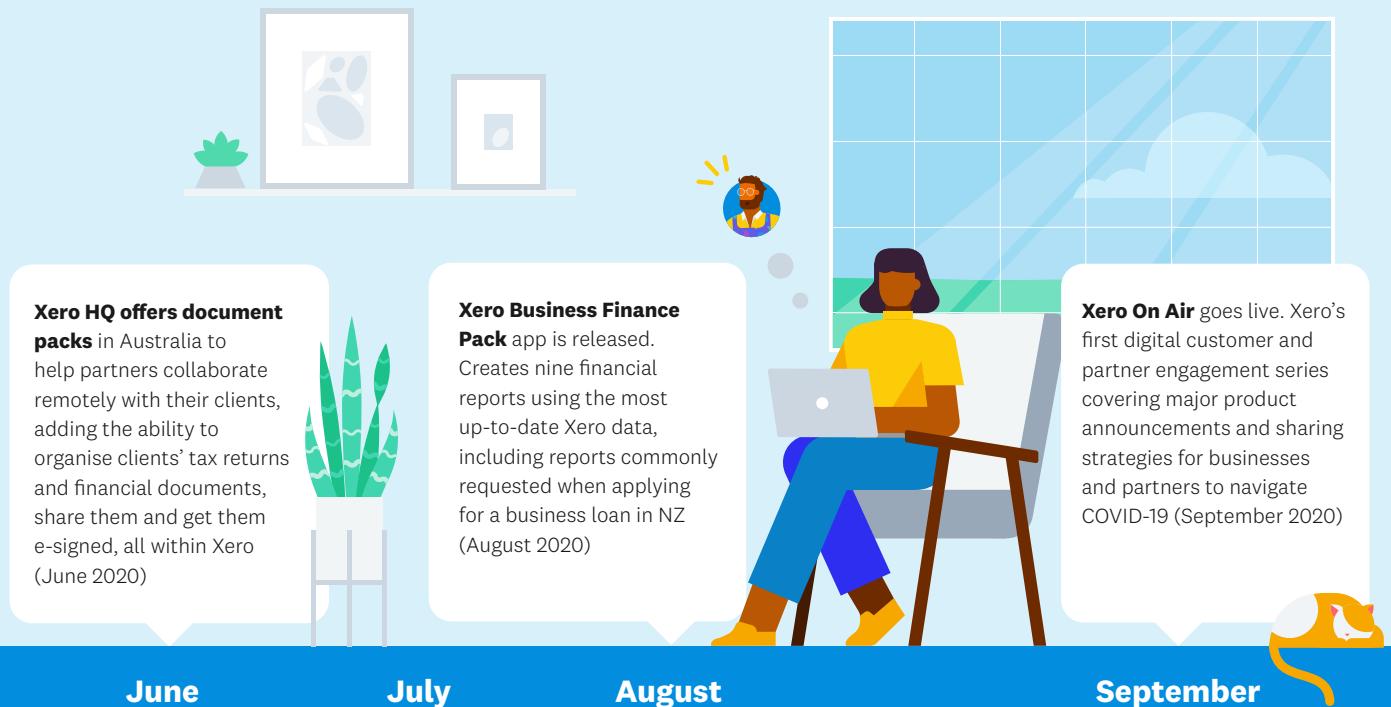
June 2020

Americas Town Hall session: Facilitated by a leading diversity and inclusion expert to provide Xero employees an opportunity for open dialogue on racism and racial inequity (June 2020)

September

Beyond Blue partnership: In Australia, our partnership with Beyond Blue is established, giving our partners access to a range of mental wellbeing content (September 2020)



**June****July****August****September**

Short-term cash flow product feature is enhanced for small business customers to project a 30-day bank balance, showing the impact of existing bills and invoices (June 2020)

Take Your Business Online kit is released for customers in NZ (July 2020)

Xero enhanced Starter plan is launched, removing limits on bank reconciliation and increasing invoicing limits to help sole traders, start-ups and customers with less complex needs (September 2020)

Xero Small Business Insights publishes Pandemic Insights report covering NZ, Australia, and the UK to show impacts of COVID-19 on small business and inform government policy (September 2020)

September**October****January 2021****March**

Head of Wellbeing: We appointed a Head of Wellbeing to promote the welfare of our people globally, with a focus on their psychological needs (September 2020)

Xero Assistance Programme: In NZ, the Xero Assistance Programme is extended from a pilot to provide free and confidential wellbeing support for customers, accounting and bookkeeping partners, and their employees and families (October 2020)

Shift Collab: We launch a partnership with Shift Collab in the US, offering a series of mental wellbeing workshops for our accounting and bookkeeping partners and our small business clients (January 2021)

Flexible work at Xero: Flexible policy evolves to give employees choice in terms of where and what hours they work, including compressed work weeks and remote roles (March 2021)

THROUGH THEIR EYES

Xero supports quick pivot to virtual team building



Michael Alexis / Xero Customer / Museum Hack and TeamBuilding / United States

When COVID-19 changed the events landscape across the world, Museum Hack owner Michael Alexis and his business partner, Tasia Duske, had to get creative. Practically overnight, their unconventional ‘renegade’ tours of museums in major US cities went on hold, and a new business was born – TeamBuilding.

In the whirlwind that followed, Xero’s accurate, up-to-date financial data and insights enabled Michael to get a clearer picture of his business performance, enabling him to form an action plan for survival.

“Having up-to-date figures is essential, especially during a time when there is so much fluctuation. Looking closely at our expenses, we identified where we could cut costs. We made the tough decision to lay off the majority of our staff and switched to our new virtual team building business.”

Virtual team building events such as ‘Tiny Campfire’ – including real s’mores – and ‘Gingerbread Wars’ – gingerbread decorating kits – are some of TeamBuilding’s most popular events. While they sound delicious and fun, Xero helped Michael identify their financial viability.

“During the holiday season, the gingerbread kits literally overwhelmed our delivery process – our couriers refused to take any more packages from us! Xero allowed us to see what revenue Gingerbread Wars was bringing in but also what it was costing us – particularly the cost of shipping in winter months when we were sending the kits out last minute. Revenue is nice, but operating costs and expenses are also important.”





Xero's social and environmental impact and diversity and inclusion programs

We are committed to building a diverse and inclusive business that operates sustainably for the benefit of the millions of customers we serve, their advisors and communities, our shareholders and the people at Xero.

Xero's social and environmental impact (SEI) and diversity and inclusion (D&I) programs are focused on meeting our responsibilities in these areas and scaling our business in a way that reduces our impact on the planet and builds and scales a diverse workforce.

Expanding and evolving these programs is a priority for Xero, and we enter FY22 having made progress toward this goal.

Our SEI program identifies four key categories:

- Supporting our people
- Supporting our communities
- Supporting our customers (business support)
- Supporting the environment

This section contains an update on our recent efforts under each of these categories.

Supporting our people

Work-life balance

Work-life balance is essential for wellbeing and is an area we focused on during FY21. In March we updated our flexible working policy to give our people choice in terms of where and what hours they work including adjustable start and finish times, compressed work weeks and remote working.

Having a healthy work-life balance is particularly important when starting or growing a family.

To help address the challenges our people face during this time, in FY21 we expanded Xero's parental leave policy.

All primary carers, regardless of how they become a parent, are entitled to full leave payments equivalent to 26 weeks. For employees whose partner has a child, adopts a child or brings one into their care, we offer up to six weeks of paid leave.

It can be difficult for new parents to jump straight back into work after time away. 'Keeping in touch' days help employees to keep connected with colleagues by returning to work for up to 10 days while on parental leave, paid at their usual salary.

When employees return to work following parental or partner's leave, with the support of their manager they can choose initially how they want to work including returning on a part-time basis.

Diversity and Inclusion

Diversity in the workplace is essential for high-performing and healthy teams. We actively seek a diverse pool of candidates and maintain a culture of inclusion to help our people feel valued and respected and to have a sense of belonging and fairness.

Xero considers D&I a priority in the creation of a sustainable business that is capable of delivering long-term value to shareholders and our broader communities. Xero embraces the diverse experience, ideas, skills and perspectives of our people – which enables us to innovate,

THROUGH THEIR EYES

Enjoying my time as a new parent



Tessa Khoo | Xero Employee | Marketing Director | Singapore

attract and retain top talent, and better reflect and serve our customers, partners, and our communities. Xero takes a broad view of the meaning of diversity and believes that through inclusion we will tap into the power of our people's differences.

We believe our Board and leadership team should reflect this diversity across a range of dimensions, including racial and ethnic diversity, and we will work towards more diverse representation over time.

Six key principles provide the framework for our goal of developing and maintaining a diverse and inclusive workplace and the implementation of initiatives to support this. They are:

- We value diversity because it reflects our customer base and ensures our people thrive
- We're all accountable to create an inclusive culture
- We're committed to attracting diverse talent and hiring fairly
- We support flexible ways of working
- We're committed to equal pay for equal work
- We have an obligation to champion diversity and inclusion in the community

We recognise the importance of an inclusive culture and representation that reflects the diversity of the customers and communities we serve.

In February 2021, we launched an inclusive leadership training program for our managers to ensure our leaders understand how to create and lead diverse teams.

What does support for parents typically look like in Asia?

Support for parents is very different in this part of the world. Women aren't encouraged to take maternity leave beyond the standard four months – there's an underlying social pressure to get back to work as soon as you can. I personally don't know anyone who has taken more time off. And new fathers or secondary carers typically don't take more than a week off work.

What does Xero's new parental leave policy mean for you?

In an environment where things are so uncertain, I'm grateful to work in an organisation that genuinely cares how it supports its people in both their personal and professional lives. The new Xero policy of six months' paid parental leave means I have more time to focus on my family and the huge transition we'll be going through. For me and other parents-to-be at Xero, it helps ease the social pressures that many new parents feel, and additionally makes a huge difference to fathers or secondary carers. Paternity leave isn't really a thing in Asia, but Xero's policy gives up to six weeks' fully paid parental leave to secondary carers, too.

How does going on parental leave affect your team?

Taking more time out from work creates more opportunities for my team. Part of Xero's parental leave policy includes paid 'keeping in touch' days, which enables new parents at Xero to feel included and supported by Xero while on leave. I want to stay connected while I'm on leave, so I'll be using those days. But it also gives me a chance to set the team up with the right support, so they can lead and flourish in new areas while I'm away.

Right: Our social and environmental impact framework



Extending our efforts on inclusion, in February 2021 we appointed a Head of Digital Accessibility. This role will help ensure Xero's product development considers customers who have sensory or cognitive impairments, or physical limitations, that could impact their ability to use our products.



As of 31 March 2021, 63% of our Xero leadership team¹ and 42% of our employees were women, and we had three female and five male directors on our Board.

Addressing racial inequality and diversity

We want to play our part in tackling systemic racial inequality. We want to welcome more people from underrepresented groups to Xero and strive to foster an inclusive, culturally safe work environment where people feel supported to build their careers.

Examples of initiatives undertaken this year include:

- We worked closely with a diversity and inclusion consulting expert on a plan to evaluate and increase the racial and ethnic diversity of our employees, beginning with North America. We recently expanded our diversity and inclusion team with the appointment of a diversity & inclusion program manager based in the US to help implement a plan and share lessons across our global business. The insights and actions from what we have learnt in North America are being considered for all our regions

- We conducted training for people leaders in North America focused on understanding the workplace experience of Black professionals, led by the Black Professionals in Tech Network
- Diversity is important to our accounting and bookkeeping partners as well. In early 2021, we partnered with the National Association of Black Accountants (NABA) in the US. We are working to drive awareness of Xero – both as a cloud accounting platform and an employer – and offer Black Xero employees professional development and growth opportunities through NABA
- In addition, we are teaming up with the Oakland Black Business Fund (OBBF) in Northern California. Xero will offer OBBF's small business and bookkeeping members access to our cloud accounting software, educational resources, and certification workshops

Gender balance

As of 31 March 2021, 63% of our Xero leadership team¹ and 42% of our employees were women, and we had three female and five male directors on our Board.

Outside of the Board level, across our organisation, we continue to work towards our long-term goal of women representing 50% of our employees who identify in the gender binary.

We're proud that Xero was included in the 2021 Bloomberg Gender-Equality Index for the second consecutive year. Xero is one of just 13 companies headquartered in Australia or New Zealand that have earned this distinction for 2021.

¹ Refer to the CEO Review, which sets out the expanded role for the Chief Customer Officer and new reporting lines for the Managing Directors in each region. These changes have increased diversity at the leadership team level.

More information about our initiatives to support gender diversity is set out in the Corporate Governance Statement (see page 57).

Supporting our communities

Xero Community Appeal

In July 2020, we launched the Xero Community Appeal, our first global fundraiser, to support charities helping the most vulnerable and marginalised people in the countries Xero is based. The appeal ran for six months through a fundraising portal with Xero customer, Catalyser (catalyser.com). To kick the appeal off, Xero pledged \$50,000 and matched all individual donations.

Together we raised almost \$200,000, which has been donated to charities in the regions that Xero operates in. This amount can provide:

- A safe night of accommodation for 1,400 women fleeing domestic violence in New Zealand
- 3,667 mental health consults in Australia and the UK
- 6,139 hygiene kits to help children in Asia stay healthy and minimise the risk of COVID-19 transmission
- Support for 457 Black youths in Canada to build the skills and confidence to run their own businesses

Supporting mental health

To support the mental health and wellbeing of New Zealanders, we continue to offer the Xero Assistance Programme (XAP) to our customers. This initiative provides free access to mental health support and counselling for all Xero's New Zealand accounting and bookkeeping partners. It also includes all subscribers to Xero Starter, Standard and Premium plans plus their employees and families.

Together we raised almost

\$200,000

for the Xero Community appeal,
enough for charities to pay for all
of the following:

A safe night of accommodation for

1,400

women fleeing domestic violence

3,667

mental health consults

6,139

hygiene kits to help children stay
safe during COVID-19

support for

457

Black youths to build the skills and
confidence to run their own businesses

THROUGH THEIR EYES

A place where my voice is heard and elevated



Dahalia Jenkins | Xero Employee |
Product Marketing Manager |
United States

What's it like working at Xero?

It's been a breath of fresh air. Taking the leap of faith to join Xero in April 2020, right as the world felt like it was falling apart, was really liberating. Even though I haven't yet met anybody I work with in person, it's been cool to be able to build relationships with team members around the world and still feel connected via our video meeting tools and All Hands meetings. I'm especially looking forward to meeting my colleagues in New York, who I'll be able to spend time with once the world opens up again.

What's been the highlight of your time at Xero so far?

A lot was happening in the US last year with the Black Lives Matter movement and other issues, and it was a lot to digest and take on. Unofficially, a group of us got together and formed an Employee Resource Group called Black Xero. We started Black Xero to have a virtual safe space where we could discuss everything impacting the US. Eventually, we expanded and started sharing information with the broader US team. Having great discussions about race relations and how we can come together to make things better has been wonderful. And having the support of Tony Ward (President, Xero Americas) and the leadership team made it possible for us to make our group legitimate.

Are there any initiatives or policies you've used in the past 12 months and what's your experience been?

Once a month or so, our people experience team in the US hosts workshops to help us with our mental health and general wellbeing. Sessions have covered topics such as nutrition, overcoming imposter syndrome, and breaking perfectionism. I know I'm a person who suffers from these things – they're always playing in the back of my head. Those sessions have been really helpful, and it's been refreshing to come together and just see that I'm not alone. I look forward to those sessions as they help me to work on myself in a safe environment.

The XAP service is 100% confidential and provided by Benestar, an expert provider in mental health services. The initiative is designed to offer treatment along with lifestyle advice that can prevent mental health issues from arising. In addition, XAP offers advice on physical health and managing relationships at home and work.

In Australia, Xero has partnered with Beyond Blue, a not-for-profit provider of mental health initiatives that provides our employees and accounting and bookkeeping partners with free access to mental health resources.

In 2020, we joined Shift Collab, a leader in mental health education, to deliver a series of mental health workshops to our employees across the US. We later expanded this to include separate sessions for accounting and bookkeeping partners and small business clients.

Community engagement

In FY21, we continued our community outreach and engagement program with the goal of fostering racial, gender and ethnic diversity among today's students, who are tomorrow's generation of talent. After shifting our program largely online due to COVID-19, our initiatives included creating an online coding adventure for young people in New Zealand, co-creating the Trailblazing Women in Tech quiz for girls aged 9 to 13 with the She# team and supporting a number of our people to participate as mentors in the GirlBoss Edge: Engineering & Technology online career accelerator for high school-age young women.

We are fortunate to have been able to resume some community engagement activities in person, such as hosting work experience days



for a group of young women and Māori and Pasifika students in New Zealand, ShadowTech days for teachers to spend a half-day alongside IT professionals, and a She# networking event for women working in technology.

In the US, we awarded the first Xero Forward Fund scholarships. These recognise outstanding students who bring unique backgrounds, perspectives and skills that will help influence the future of accounting. The three winners each received a US\$10,000 scholarship for tuition or other associated study costs.

Supporting non-profit organisations

To help local non-profit organisations, Xero's employee volunteer program Community Connect entitles all Xero employees to a paid day of leave each year. In FY21, our people volunteered in their local communities as COVID-19 restrictions allowed, contributing almost 3,000 hours.

Xero also provides over a million dollars in discounts annually to non-profit organisations and community groups through our non-profit discount program.

Responsible supply chain

We have a Supplier Code of Conduct at Xero and, using a risk-based approach, we have integrated it into our supplier due-diligence process. Our procurement team has received ethical procurement certification provided by the Chartered Institute of Procurement & Supply so that it can better recognise situations where we need to safeguard against unethical behaviours and consider modern slavery risks in our supply chain. We aim to have a positive impact through our influence on our supply chain and by working with socially conscious vendors.

Modern slavery and human trafficking

We remain vigilant on modern slavery risks, have policies and processes to help us address these risks, and we regularly assess the effectiveness of our actions. Given the visibility we have over our operations, we consider our modern slavery and human trafficking risk to be relatively low.

Most of our suppliers are located in New Zealand, Australia, the US and the UK. These countries have a low prevalence of modern slavery and governments that take strong action against it.

Xero's costs largely comprise technology-related and marketing and advertising-related goods and services, and our contracts require our suppliers to act in accordance with all applicable laws. Similarly, our recruitment process includes right-to-work checks for all employees to safeguard against human trafficking and modern slavery risks.

In March, we were one of more than 80 companies to sign a petition calling for the New Zealand Government to pass a Modern Slavery Act. This legislation would bring New Zealand into line with other jurisdictions and would require businesses to understand the risks of modern slavery in their purchasing, to publicly report on those risks, and take action to address them. Our current modern slavery statement, prepared under Australian and UK law, is available on our website.



Right: Steve Vamos, Xero CEO and Craig Hudson, Xero Managing Director - NZ & Pacific Islands at Fishermans Bay, New Zealand

activities to decrease our energy consumption (see below) and has purchased certified carbon offsets to offset 100% of our remaining carbon emissions.

Carbon offsets have been purchased from projects in Indonesia, India and New Zealand. This includes recently expanding our sponsorship of the Fishermans Bay Conservation Project near Akaroa in New Zealand. That means that in addition to the Fishermans Bay project's carbon benefits, we're also directly supporting biodiversity-related activities such as yellow-eyed penguin sanctuary habitat management; possum and predator pest control work; noxious weed control work; and provision and maintenance of safe tracks for public and educational groups.

In FY21, Xero was certified carbon neutral by the Australian Government's Climate Active program.

In addition, we have taken the following steps to support sustainability:

- Reducing electricity consumption via efficiency measures within Xero offices such as sensor and timer lighting, extensive use of LED lighting in all offices, working with air conditioning engineers and landlords to improve the efficiency of heating and cooling systems
- Cutting waste production and increasing recycling rates including e-waste collection and compost bins in some offices
- Making procurement decisions that consider the carbon intensity of our suppliers and our climate impact
- Evolving our flexible work policy to allow our people to choose how many days a week they work from home and how many in the office, with their manager's approval. We expect this will reduce carbon emissions associated with a reduction in people commuting to work

“

In FY21, our people volunteered in their local communities as COVID-19 restrictions allowed, contributing almost 3,000 hours.

Xero will continue looking into scalable resources and support models that help both us and small businesses operate in an environmentally conscious way.

Supporting the environment

Climate

Our environmental sustainability program Net Zero @ Xero is our commitment to carbon neutrality. As part of our journey to becoming carbon neutral, Xero has undertaken a number of

- Encouraging our people to use alternative modes of transport to get to work, such as cycling, by offering ‘end of trip’ facilities including showers, bike cages and lockers
- Purchasing Forest Stewardship Council-certified paper stock for jobs that require printing
- Proactively working with Amazon Web Services (AWS), our cloud services provider, to determine how we can operate our infrastructure more efficiently and mitigate future emissions. AWS is committed to running its business in the most environmentally friendly way possible and achieving 100% renewable energy usage for its global infrastructure by 2025

Each year our business is growing to serve more customers, and as we do so, we remain mindful of Xero’s impact on the natural environment and the climate. While we are proud of our progress on carbon neutrality, we recognise there is more to do to understand and minimise this impact.

As a key focus for Xero, we will be investing in this and setting targets that are appropriate and sustainable for the long term. A key step for FY22 will be to start our journey to report in alignment with the Recommendations of the Task Force on Climate-related Financial Disclosures.

Conclusion

We thank all of our people, partners and their communities, and investors for their support. We will share more on our efforts as the year unfolds.

For information on Xero’s social and environmental impact, and diversity and inclusion initiatives, visit xero.com/socialimpact

THROUGH THEIR EYES

Making a positive impact in many ways



Rae Biffin | Xero Employee |
Senior Post Production Artist |
Australia

What made you want to join Xero?

When I started looking for a new job, I sought out companies with values similar to my own, and companies with solid wellbeing policies. I did a lot of research about Xero's values and initiatives and I felt like the direction Xero was heading was also where I wanted to go. The Net Zero @ Xero initiative (our commitment to offset 100% of Xero's carbon emissions) is something that really attracted me, because it aligns with my own personal values. And it's nice to be able to come to work and see Xero taking positive steps when it comes to our environmental impact.

“

Having a supportive and approachable direct manager really enables me to bring my full self to work.

What's it like working at Xero?

I really enjoy working for a company that's striving to have a positive impact through supporting small business. And having a supportive and approachable direct manager really enables me to bring my full self to work. My direct manager is a wonderful listener and a calming presence, so having him on the team is something I'm grateful for.

How does Xero help you to be yourself at work?

Xero's #human value reflects the authenticity, passion, energy, and purpose that we all bring to work each day. Different opinions and ways of life are also welcomed. Knowing that most of my co-workers share this value, I find it easy to have conversations at work – even ones that might feel a bit tricky to navigate. That makes working as a team feel more effortless, and I'm able to focus more on the creative side of my work.



Understanding the importance of mental wellbeing



*Theo Redmond | Xero Employee |
Workplace Experience and Hospitality Assistant |
New Zealand*

What made you want to join Xero?

In 2016, I had the opportunity to work with Xero at an event called Fieldays – I was a barista at Xero's stand. I got a glimpse of Xero's culture and values and I thought it was amazing. Everyone was so kind and #human. So when a role came up, I didn't think twice about applying.

What's it like working at Xero?

I love that there is so much diversity at Xero and that everyone gets to bring their whole self to work every day. The big one for me is how much our leaders care about our wellbeing. I find it amazing that I can take paid wellbeing leave for my mental health, and that it's just a normal thing – as normal as having a cold. It's been awesome to not feel any kind of stigma or pressure about mental wellbeing.

What's been the highlight of your time at Xero so far?

Being able to connect with other Xeros (Xero employees) remotely through the COVID-19 level four lockdown. At first, it was a real challenge for me. I had to really think about how to give our team a platform where they could still feel engaged, inspired and empowered – but from home. I feel like that's a huge part of my role every morning with the barista service – I'm giving banter, I'm giving energy, I'm giving life. I'm basically setting the tone for everyone's day. I came up with Theo Talks, a 15 minute daily online talk show. Theo Talks really gave me a platform to connect and it also pushed me to challenge my fear of speaking in public. Now, I have the confidence to be part of productions like Xero On Air and Xerovision, and it's just turned into a beautiful thing.

I find it amazing that I can take paid wellbeing leave for my mental health, and that it's just a normal thing.

”



Key Risks

Xero is a long-term focused and high-growth business with operations located around the world. As a result, we address a variety of opportunities and face a range of risks, which we consider from a sustainable, long-term value creation perspective.

The Xero risk framework is designed to identify material financial and non-financial risks that may impact our ability to achieve our strategic objectives.

Risk assessment and mitigation are part of our culture at Xero, and responsibility is shared between the Board and senior managers. The Board sets and approves the risk framework and risk appetite statement, and provides oversight of management's execution of the framework.

Xero recognises that all management and employees have a role to play in this area. Therefore, we have aligned accountability for managing risk to the globally recognised 'Three Lines Model'. Key roles are outlined in the diagram below.

Xero's Risk Management Accountability Three Lines Model



The table below highlights some of the key risks facing Xero and the high-level mitigation activities we have in place.

| Strategic risks | Mitigation |
|--|---|
| Strategic execution Failure to execute our strategic initiatives leading to reduced revenue growth and reputational impacts | <ul style="list-style-type: none"> Program and project governance over strategic initiatives with regular review, oversight and reporting Alignment of strategic initiatives with annual operational plans, objectives and key results Executive sponsorship and accountability for each strategic initiative |
| Product delivery execution Failure to deliver new products and innovations that meet our customers' needs | <ul style="list-style-type: none"> Investment in engineering and product-development capability Prioritisation of initiatives to focus available resources and talent on delivery of highest priority projects Xero invests in targeted customer and market research programs, which are used to inform future product-development needs and priorities across Xero |
| Access to talent/ workforce planning Inability to attract, develop and retain talent to deliver on strategy | <ul style="list-style-type: none"> Attraction and retention strategies in place including flexible work practices and career development opportunities Continually exploring new resourcing options to ensure we can access talent Recruitment team in place across all regions Succession planning processes for key roles in place |
| Competitive intensity and disruption New technologies and/or competitors that impact Xero's ability to deliver on our strategic priorities and financial performance | <ul style="list-style-type: none"> Systems in place for monitoring and responding to competitor and market activity Development of strategic partnerships and pipeline of potential acquisitions Increased investment in core product development, along with additional resourcing options to enable faster product development |
| M&A and related business integration Failure to successfully realise value and/or integrate new acquisitions as planned | <ul style="list-style-type: none"> Board and leadership team oversight of integration activities and performance with corporate development team and Xero Investment Committee in place Board approved integration framework including pre-acquisition due diligence processes in place Dedicated M&A Integration Management Office established |
| Social and environmental (including climate) Failure to create a diverse and sustainable business, resulting in financial, reputational and brand damage | <ul style="list-style-type: none"> Regular review and oversight of Environmental, Social, and Governance (ESG) initiatives and risks by leadership team and Audit and Risk Management Committee Development of a road map underway to align with the Task Force on Climate-related Financial Disclosures (TCFD) guidelines for climate reporting Net Zero @ Xero carbon neutrality commitment Diversity and inclusion policy and procedures in place |
| Operational risks | |
| Platform stability Failure or disruption of our platform, resulting in customer churn and/or reputational damage | <ul style="list-style-type: none"> Strategic focus on, and investment in, best practice technologies and engineering capabilities Regular monitoring of and reporting on platform and database performance Disaster recovery, business continuity and crisis management plans in place |
| Data and cyber security breaches Security controls and processes are insufficient, leading to a breach and resulting in loss of data or system functionality, customer churn, and/or reputational damage | <ul style="list-style-type: none"> Governance and oversight mechanisms such as the Security Governance Group, Data Use and Governance Group, Audit and Risk Management Committee risk updates Data security and awareness programs for all Xero employees and partner education Best practice tools and processes in place to provide multi-layer protection against unauthorised access, e.g. multi-factor authentication, security penetration testing SOC2 and ISO 27001 compliance and certification, including regular external audits |

COVID-19 recovery

Failure to manage Xero's potential financial, operational, and people risks (and opportunities) from COVID-19

- Regular financial oversight and monitoring of impacts across our markets including Crisis Management Team
- Investment and strategic focus on opportunities created by increased digitisation trends
- Ongoing support of customers and employees

Wellbeing, health and safety

Failure to protect employees' wellbeing, health and safety

- Investment in dedicated programs and resources that support our employees, including Flexible Working and Respect and Responsibility Policies
- Regular surveys and reporting on employee wellbeing, and engagement metrics and trends

Legal, regulatory and compliance

Failure to manage legal, regulatory and compliance risks that may impact Xero's products, brand and/or financial returns

- Regular review and oversight of regulatory and compliance areas by the leadership team and Audit and Risk Management Committee
- Regular review and updates undertaken in monthly product risk and regulatory forums, and at the Security Governance Group and Data Use Governance Group
- Policies, procedures, training and education provided over key regulatory and compliance areas, supported by internal and external audits
- Proactive and regular dialogue with regulators and industry bodies

Financial risks

Capital access and management

Failure to allocate resources appropriately and productively and constraints on access to capital

- Maintaining strong relationships with banking partners and investors
- Regular review of capital strategy such as our recent convertible notes raising
- Governance oversight of capital allocation and investment by the Audit and Risk Management Committee and the executive level Treasury Governance Committee

Adverse global economic conditions

Significantly weakened global conditions, as a result of the pandemic, could harm our business and financial condition

- Regular financial oversight and monitoring across our markets
- Governance and oversight from the Board
- Detailed financial analysis and scenario modelling to enable responsive changes to spending and investment approaches

Emerging risks

Legal and regulatory changes

Failure to identify and manage changes to the regulatory environment that may introduce new risks and/or present new opportunities to our business

- Monthly product risk and regulatory forums
- Regulatory team to provide input on emerging changes and potential business impacts
- Global government relations function to coordinate proactive government and policy engagement strategy

Machine learning and artificial intelligence

Failure to manage risks and opportunities, leading to financial and reputational impacts

- Governance oversight from the Data Use Governance Group and focus on ethical and responsible use of data and machine learning
- Approach is framed by Xero Responsible Data Use Commitments, which include a specific commitment on reducing data and algorithmic bias that may adversely impact small business owners
- Emerging data literacy programs to drive awareness and understanding of best practice across the Xero engineering and analytics community

Our Performance

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 Xero's plans and strategy, 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 this commentary. All amounts are in New Zealand dollars (NZD) except where indicated. References to the period or FY21 are for the 12 months ended 31 March 2021. References to H1 FY21, or the first half, refer to the six month period ended 30 September 2020. References to H2 FY21, or the second half, refer to the six month period ended 31 March 2021. References to the comparative period or FY20 are for the 12 months ended 31 March 2020.

Non-GAAP measures have been included as Xero believes they provide useful information for readers to assist in understanding Xero's (the Group's) financial performance. Non-GAAP financial measures should not be viewed in isolation or considered as substitutes for measures reported in accordance with New Zealand equivalents to International Financial Reporting Standards (NZ IFRS).

As Planday A/S ('Planday') and Tickstar AB ('Tickstar') were acquired on 1 April 2021, their performance and position are not included in these results.

Business results

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|---------------------------------|------------------|------------------|------------|
| Subscription revenue | 828,106 | 696,220 | 19% |
| Other operating revenue | 20,676 | 22,011 | -6% |
| Total operating revenue | 848,782 | 718,231 | 18% |
| Cost of revenue | (118,893) | (106,582) | 12% |
| Gross profit | 729,889 | 611,649 | 19% |
| Gross margin percentage | 86.0% | 85.2% | 0.8pp* |
| Total operating expenses | (663,825) | (580,090) | 14% |
| Percentage of operating revenue | 78.2% | 80.8% | -2.6pp |
| Other income and expenses | (4,377) | 2,550 | NM** |
| Asset impairments | - | (1,427) | NM |
| Operating profit | 61,687 | 32,682 | 89% |
| Percentage of operating revenue | 7.3% | 4.6% | 2.7pp |
| Net finance expense | (105,623) | (22,845) | NM |
| Income tax credit/(expense) | 63,710 | (6,501) | NM |
| Net profit | 19,774 | 3,336 | NM |
| Percentage of operating revenue | 2.3% | 0.5% | 1.8pp |

*pp stands for percentage points

**NM stands for not meaningful

During FY21, Xero continued to execute its growth strategy, resulting in strong financial results despite the ongoing challenges of COVID-19. Xero delivered top-line revenue growth and operational discipline, along with an alignment of expenditure as appropriate to the operating environment presented by COVID-19. This has resulted in increases to EBITDA and free cash flow in the year.

The resilience of Xero's global business model has meant that, despite the impact of COVID-19 on Xero's financial and operating performance, Xero has been able to continue to invest in scaling its global business, developing new products, and driving quality subscriber growth. This investment was increased in the second half of the year as the impacts of COVID-19 on our markets became clearer, resulting in considerably lower EBITDA and free cash flow in the second half than in the first half.

Operating revenue growth was driven by subscriber growth in all markets. Xero reached key milestones in the first half of FY21 with both the Australian market and the International segment surpassing one million subscribers. In H2 FY21, Xero built on this with the ANZ segment surpassing 1.5 million subscribers. Xero ended FY21 with 2.7 million subscribers.

Gross margin improved by 0.8 percentage points compared to FY20. This was due to the realisation of further productivity gains from Xero Central (Xero's customer experience and community platform). Total operating expenses increased by 14% against the comparative period, but decreased by 2.6 percentage points as a proportion of operating revenue. This decrease was a result of Xero cutting back on expenditure early in the year in response to the uncertainty related to COVID-19. Operating costs increased in H2 FY21 as the operating environment and market opportunities became clearer. Growth in total operating revenue of 18% exceeded growth in total operating expenses, resulting in operating profit of \$61.7 million in FY21, up \$29.0 million from \$32.7 million in FY20.

The increase in net finance expense was largely driven by one-off losses on term debt on extinguishment of the 2023 convertible notes and recognition of the 2025 convertible notes. Lower market interest rates also contributed to a reduction in interest income, compared to FY20.

Net profit was impacted by losses on term debt and transaction costs relating to the extinguishment of the 2023 convertible notes and settlement of the 2025 convertible notes of \$72.8 million. Net profit was also impacted by a benefit to tax expense resulting from recognition of a deferred tax asset on New Zealand tax losses and carried forward R&D expenditure of \$65.0 million. The net impact of the convertible notes and the deferred tax one-offs in FY21 was an \$7.8 million loss resulting in \$19.8 million net profit.

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

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

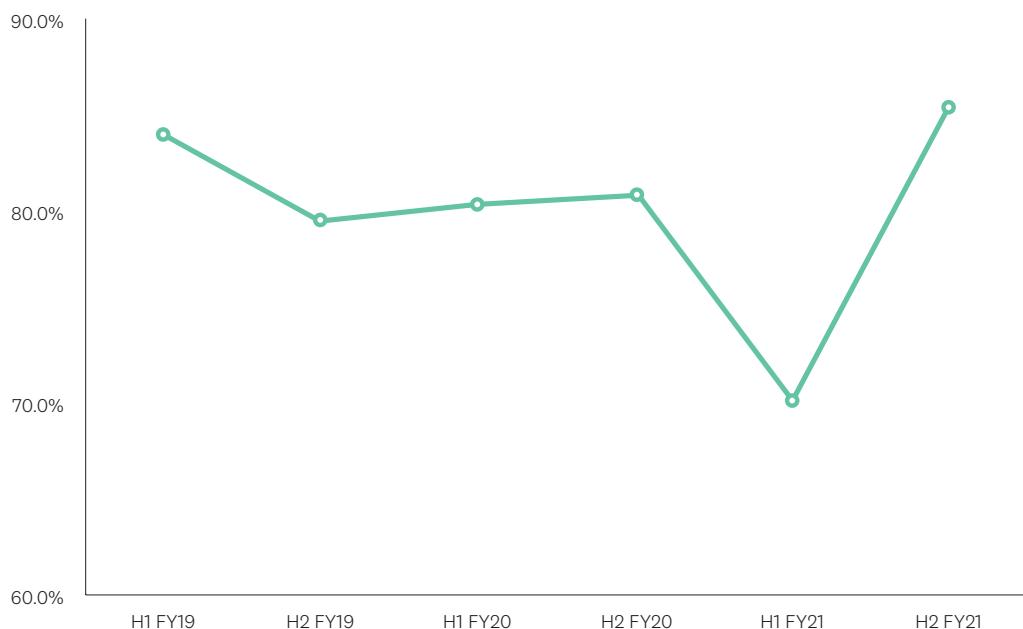
| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|---|------------------|------------------|------------|
| Net profit | 19,774 | 3,336 | NM |
| Add back: net finance expense | 105,623 | 22,845 | NM |
| Add back: depreciation and amortisation | 129,541 | 105,061 | 23% |
| Add back: income tax expense/(credit) | (63,710) | 6,501 | NM |
| EBITDA | 191,228 | 137,743 | 39% |
| <i>EBITDA margin</i> | 22.5% | 19.2% | 3.3pp |

EBITDA increased by \$53.5 million in FY21 compared to FY20, resulting in EBITDA margin increasing from 19.2% in FY20 to 22.5% in FY21. The increase in EBITDA was driven by a combination of revenue growth and operational discipline, which resulted in a decrease in spending as a proportion of operating revenue.

Revenue grew by 18% compared to FY20 due to subscriber growth of 20%. Total operating expenses as a proportion of operating revenue decreased from 80.8% in FY20 to 78.2% in FY21. This was driven by efficiencies, as well as deliberate decreases in H1 FY21 spend in response to the COVID-19 environment, particularly across the sales and marketing function.

In H1 FY21, total operating expenses decreased by 10.1 percentage points to 70.4% as a proportion of operating revenue compared to H1 FY20. In contrast, H2 FY21 total operating expenses increased 4.5 percentage points to 85.5% as a proportion of operating revenue compared to H2 FY20 (an increase of 15.1 percentage points from H1 FY21). This decrease in total operating expenses in H1 FY21, and subsequent increase in H2 FY21, reflects Xero's continual assessment of the operating environment, and the balance struck between responding to the operating environment and optimising long term growth. Xero continues to demonstrate a commitment to invest for the long-term with product design and development expenses increasing 40% compared to the comparative period, significantly higher than operating revenue growth of 18%.

Operating expenses as a percentage of operating revenue



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

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|---|------------------|------------------|------------|
| EBITDA | 191,228 | 137,743 | 39% |
| Add back: non-cash share-based payments | 42,731 | 34,336 | 24% |
| Add back: non-cash impairments | - | 1,427 | NM |
| EBITDA excluding non-cash share-based payments and impairments | 233,959 | 173,506 | 35% |
| <i>Percentage of operating revenue</i> | 27.6% | 24.2% | 3.4pp |

EBITDA excluding non-cash share-based payments and impairments for FY21 was \$234.0 million, an improvement of \$60.5 million or 35% compared to FY20. Operating revenue growth of 18% exceeded the growth of cash-based operating expenses, which grew by 12%. This resulted in EBITDA excluding non-cash share-based payments and impairments improving as a percentage of operating revenue by 3.4 percentage points.

Cash flows and liquidity

Free cash flow is a non-GAAP financial measure that has been included to demonstrate net cash generated by, and invested into, the business. Xero defines free cash flow as cash flows generated from operating activities less cash flows used for investing activities, excluding cash used for acquisitions of, and investments into, businesses and strategic assets.

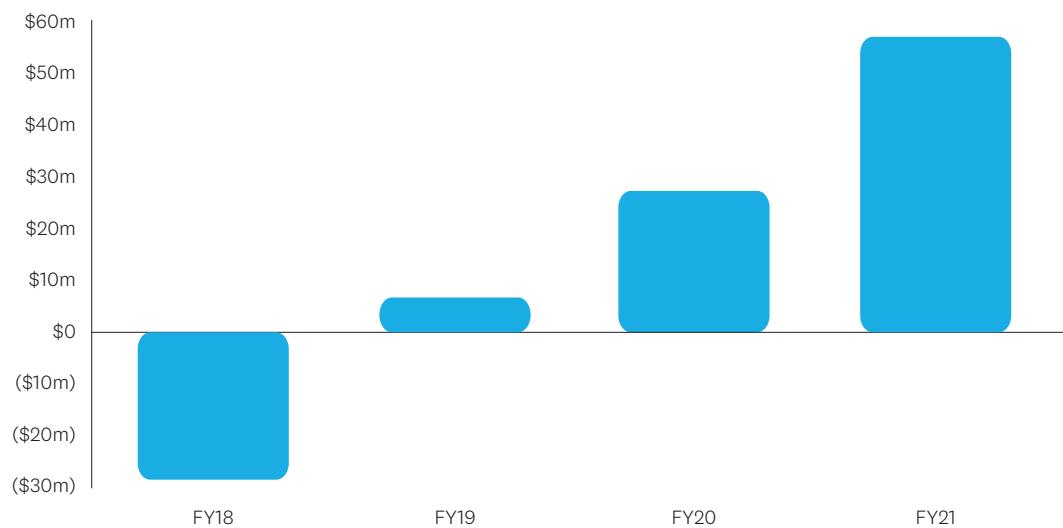
| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|---|------------------|------------------|-------------|
| Receipts from customers | 845,963 | 717,264 | 18% |
| Other operating cash flows | (627,324) | (550,635) | 14% |
| Total cash flows from operating activities | 218,639 | 166,629 | 31% |
| Investing activities | (197,970) | (139,524) | 42% |
| Add back: acquisitions | 36,277 | - | NM |
| Free cash flows | 56,946 | 27,105 | 110% |
| <i>Percentage of operating revenue</i> | 6.7% | 3.8% | 2.9pp |

Free cash flows increased by \$29.8 million in FY21, from \$27.1 million in FY20 to \$56.9 million. As a percentage of total operating revenue, this was a 2.9 percentage point increase from 3.8% in FY20 to 6.7% in FY21.

Receipts from customers increased by 18% or \$128.7 million to \$846.0 million in FY21. This aligns with the year-on-year increase in total operating revenue of 18% and subscriber growth of 20%. Cash flows from operating activities increased by \$52.0 million to \$218.6 million as receipts from customers grew at a faster rate (18%) than other operating cash flows (14%).

Cash outflows from investing activities, excluding acquisitions, increased by 16% or \$22.2 million. The increase was largely driven by higher capitalised spend on product design and development, which increased by \$28.5 million or 26% compared to FY20. The acquisition cash flows of \$36.3 million related to the acquisition of Waddle in October 2020. As Planday and Tickstar were acquired in April 2021, they are excluded from this result.

Free cash flows



Total available liquidity (defined as cash and cash equivalents, short-term deposits including proceeds from convertible notes, and undrawn committed debt facilities) at 31 March 2021 was \$1.3 billion. This comprised \$1.1 billion of cash and cash equivalents and short-term deposits as well as access to an undrawn committed standby debt facility of NZD150.0 million. The standby facility is in place to ensure Xero maintains access to prudent levels of operational liquidity, appropriate to the size and maturity of the business. The lender group for the standby facility consists of ANZ, BNZ, Citibank, and HSBC.

During the year, the Group raised NZD990.9 million to fund strategic investments and acquisitions through the concurrent buyback of its convertible notes that were to mature in October 2023 (2023 convertible notes) and issuance of new notes maturing in December 2025 (2025 convertible notes). The notes proceeds are held in USD and comprise NZD901.1 million of cash and cash equivalents and short-term deposits balance. Neither Xero's term debt nor the bank facilities mature in the next 12 months.

Operating revenue

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

Operating revenue includes subscription revenue as well as revenue from other related services, including attendance fees for conferences and events such as Xerocon, revenue share agreements with financial services providers including fintech partners, and the implementation of online accounting and other software services. Subscription revenue comprised 98% of operating revenue in FY21.

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change | change in constant currency* |
|--------------------------------|------------------|------------------|------------|---------------------------------|
| Subscription revenue | 828,106 | 696,220 | 19% | 19% |
| Other operating revenue | 20,676 | 22,011 | -6% | -5% |
| Total operating revenue | 848,782 | 718,231 | 18% | 18% |

*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 FY21 at the effective exchange rates for FY20.

Operating revenue growth of 18% from FY20 was due to the increase in subscription revenue of 19%. The subscription revenue increase was primarily driven by organic subscription growth, with subscriber numbers at 31 March 2021 increasing by 456,000 subscribers, or 20%, compared to 31 March 2020. In addition, an increase in subscribers using Xero add-ons such as payroll, projects, and expenses modules in FY21 compared to FY20 contributed further to the subscription revenue increase. These results reflect the value subscribers place on Xero's platform and Xero's ability to cater to small businesses' needs, both in times of economic uncertainty and strength.

Other operating revenue decreased by 6% (5% in constant currency). This was due to three Xerocon conference events (Brisbane, San Diego and London), as well as physical Xero roadshows being held in the comparative period. None of these events were held in-person in FY21 due to the COVID-19 pandemic. In lieu of an in-person conference, Xero ran Xero On Air, a free digital customer-engagement series, designed to connect, inspire, and share information with accounting and bookkeeping partners and small businesses around the world.

The impact to operating revenue from not holding conferences was partially offset by an increase in revenue from financial services. Xero partners with fintech providers to assist subscribers in accessing online financial solutions including invoice payment services and lending services, resulting in an associated share of revenue between Xero and the provider. Waddle, which was acquired in the current year, also contributed to other operating revenue in FY21. Other operating revenue excluding conference income increased by 56% compared to FY20.

As 85% of Xero's operating revenue is denominated in currencies other than NZD (the Group's functional currency), changes in foreign exchange rates over the year have influenced reported revenue. The impact of the comparatively weaker NZD against the Australian dollar (AUD) was offset by the impacts of the stronger NZD against the US dollar (USD) and Great British pound (GBP) during FY21 compared to FY20. This resulted in constant currency operating revenue for the Group being \$0.7 million lower than reported revenue.

Operating revenue by geography

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change | change in constant currency |
|--|------------------|------------------|------------|--------------------------------|
| Australia | 384,150 | 320,376 | 20% | 18% |
| New Zealand | 130,384 | 116,154 | 12% | 12% |
| Australia and New Zealand (ANZ) total | 514,534 | 436,530 | 18% | 16% |
| United Kingdom | 223,564 | 183,565 | 22% | 23% |
| North America | 56,558 | 55,398 | 2% | 6% |
| Rest of World | 54,126 | 42,738 | 27% | 32% |
| International total | 334,248 | 281,701 | 19% | 21% |
| Total operating revenue | 848,782 | 718,231 | 18% | 18% |

Operating revenue for FY21 was 18% higher than the comparative period, primarily driven by subscriber growth in all of Xero's geographies. In the ANZ segment, operating revenue increased by 18% (16% in constant currency), compared to 20% growth in subscribers. With the high level of cloud adoption in the ANZ market, Xero's continued revenue growth year-on-year reflects the value Xero offers.

Australia's operating revenue grew by 20% (18% in constant currency) compared to subscriber growth of 22%. The slightly lower growth in operating revenue compared to subscriber growth was mainly due to the comparative period including Xerocon revenue, with the Sydney conference due to take place in September 2020 cancelled as a result of COVID-19. New Zealand operating revenue grew by 12% compared to subscriber growth of 14%.

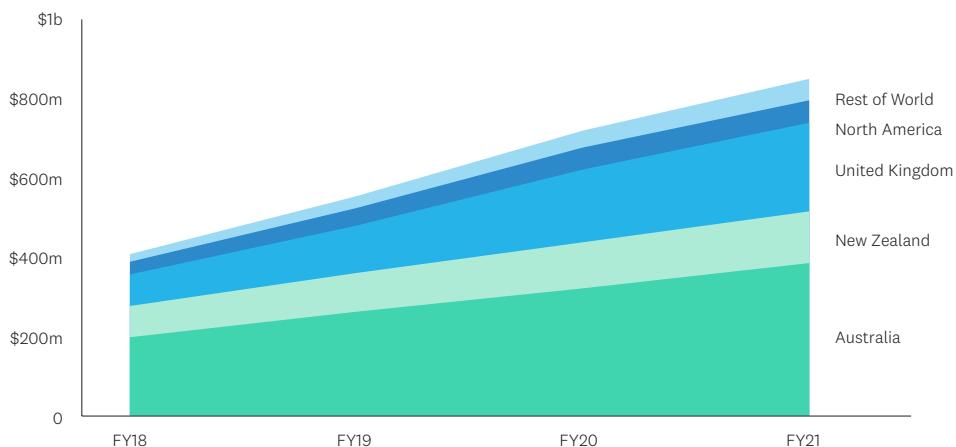
International operating revenue grew by 19%, or 21% in constant currency, in line with subscriber growth of 21%. Operating revenue growth in the UK of 22% was more than subscriber growth of 17%, due mainly to the growth of revenue from financial services, as well as further uptake in platform-related products such as payroll.

North America operating revenue grew by 2%, or 6% in constant currency, which is lower than subscriber growth of 18%. Growth was impacted by the comparative period including revenue from Xerocon, as well as the decision to bundle Hubdoc within the Xero business edition product in March 2020. The Hubdoc bundling impacted North America more than other markets due to the majority of Hubdoc subscribers being in this region.

The Rest of World's performance of 27% growth (32% in constant currency) was driven by subscriber growth of 40%, with South Africa and Singapore the largest contributing markets. The comparatively lower growth in operating revenue than subscribers was due to strong subscriber additions in H2 FY21 compared to H1 FY21, the revenue for which will have greater impact in FY22.

Reported revenue has been adversely impacted by fluctuations in the foreign exchange rates, specifically the comparatively stronger NZD against both the GBP and USD on average during FY21 compared to FY20. In constant currency, operating revenue for the International segment is \$6.0 million higher than reported revenue.

Total Group operating revenue by geography*



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

Subscriber numbers

The definition of ‘subscriber’ is: *Each unique subscription to a Xero-offered product that is purchased by a user (e.g. small business or accounting partner) 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 31 March | 2021 | 2020 | change |
|--|------------------|------------------|------------|
| Australia | 1,115,000 | 914,000 | 22% |
| New Zealand | 446,000 | 392,000 | 14% |
| Australia and New Zealand (ANZ) total | 1,561,000 | 1,306,000 | 20% |
| United Kingdom | 720,000 | 613,000 | 17% |
| North America | 285,000 | 241,000 | 18% |
| Rest of World | 175,000 | 125,000 | 40% |
| International total | 1,180,000 | 979,000 | 21% |
| Total paying subscribers | 2,741,000 | 2,285,000 | 20% |

COVID-19 had a material impact in all markets, resulting in lower subscriber additions than expected particularly in the first six months of the year. However, H2 FY21 saw a positive shift in subscriber growth, as the adjustment to remote working practices and social distancing during the pandemic emphasised the importance of cloud-based solutions. Subscribers grew by 20% compared to 31 March 2020, bringing total subscribers to 2,741,000. In FY21, 456,000 net subscribers were added compared to 467,000 in FY20. Of the 456,000 subscribers added in FY21, 288,000 or 63% were added in H2 FY21, the most subscribers added in any half year period.

Xero continued to strengthen its presence in the established ANZ segment to finish the period with over 1.5 million subscribers. ANZ grew subscribers by 20%, or 255,000, from 31 March 2020. H2 FY21 was a record half year number of subscriber additions, despite H1 being historically stronger than H2 in ANZ.

The growth rate for subscribers in Australia improved from H1 FY21 to H2 FY21 with 201,000 subscribers added in FY21. This was a 22% increase in subscribers from 31 March 2020. This increase was a result of Xero’s presence and position as a market leader in the region, combined with easing COVID-19 restrictions in H2 FY21. This performance was assisted by the general digitisation of the economy, encouraging adoption of cloud-based software. In addition, using cloud-based software like Xero assisted subscribers in accessing the Australian Government’s COVID-19 JobKeeper payment scheme. The combination of these factors helped the retention of existing subscribers as well as helped gain new subscribers. New Zealand added 54,000 subscribers in FY21, growing 14% over the year.

The UK led the International segment, adding 107,000 subscribers in FY21 to end FY21 on 720,000 subscribers, an increase of 17% from 31 March 2020. The impact of COVID-19 in the UK restricted opportunities for growth. Despite this, the UK market has shown resilience with 77% of subscribers added in FY21 occurring in H2 FY21. This reflects the value of a Xero subscription and increasing cloud adoption in the region.

Despite a difficult operating environment as a result of COVID-19, North America subscriber numbers increased by 18%, or 44,000, compared to 46,000 added in FY20. Of the 44,000 net subscribers added in FY21, 34,000, or 77%, were added in H2 FY21, the largest organic increase in North America subscribers for a half.

Our Rest of World markets also performed strongly given the uncertain operating environment, with 50,000 subscribers added, representing 40% growth in FY21. Continued investment to drive growth in South Africa and Singapore has supported strong results in these markets during FY21.

Net subscriber additions



FY21
Region (% of total net additions)
● Australia (**44%**)
● New Zealand (**12%**)
● United Kingdom (**23%**)
● North America (**10%**)
● Rest of World (**11%**)



FY20
Region (% of total net additions)
● Australia (**40%**)
● New Zealand (**9%**)
● United Kingdom (**32%**)
● North America (**10%**)
● Rest of World (**9%**)

Regional subscriber numbers at 31 March 2021*



Australia

1,115,000

2020 | 914,000
▲ Up 22%



New Zealand

446,000

2020 | 392,000
▲ Up 14%



United Kingdom

720,000

2020 | 613,000
▲ Up 17%



North America

285,000

2020 | 241,000
▲ Up 18%

* Rest of World subscribers at 31 March 2021 175,000 (31 March 2020 125,000)

Annualised monthly recurring revenue

Annualised monthly recurring revenue (AMRR) is a non-GAAP financial measure, which represents monthly recurring revenue at 31 March 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 31 March 2021 at the foreign exchange rates at 31 March 2020 and is provided to assist in understanding and assessing year-on-year growth rates, excluding the impact of foreign currency fluctuations.

| At 31 March | 2021 (\$000s) | 2020 (\$000s) | change | change in constant currency |
|---------------|------------------|------------------|------------|--------------------------------|
| ANZ | 584,954 | 467,537 | 25% | 20% |
| International | 378,643 | 353,020 | 7% | 16% |
| Total | 963,597 | 820,557 | 17% | 18% |

Total Group

AMRR at 31 March 2021 was \$963.6 million, an increase of \$143.0 million, or 17%, from 31 March 2020. The principal driver of this growth was the increase in subscribers across the Group.

ANZ

AMRR for the ANZ segment increased by 25% to \$585.0 million compared to 31 March 2020, surpassing \$500 million in H1 FY21. This increase was driven by subscriber growth of 20%, which aligns to the AMRR year-on-year increase in constant currency. Constant currency AMRR growth of 20% was five percentage points lower than reported growth, due to the comparatively weaker NZD against the AUD at 31 March 2021 compared to 31 March 2020.

International

Reported AMRR growth in the International markets of 7% was heavily impacted by foreign exchange fluctuations. The stronger NZD against the USD and GBP at 31 March 2021 compared to 31 March 2020 accounted for a nine percentage point, or \$32.0 million, decrease on reported AMRR. In constant currency terms AMRR growth was 16%, comparatively lower than subscriber growth of 21% due to lower average revenue per user (ARPU).

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.

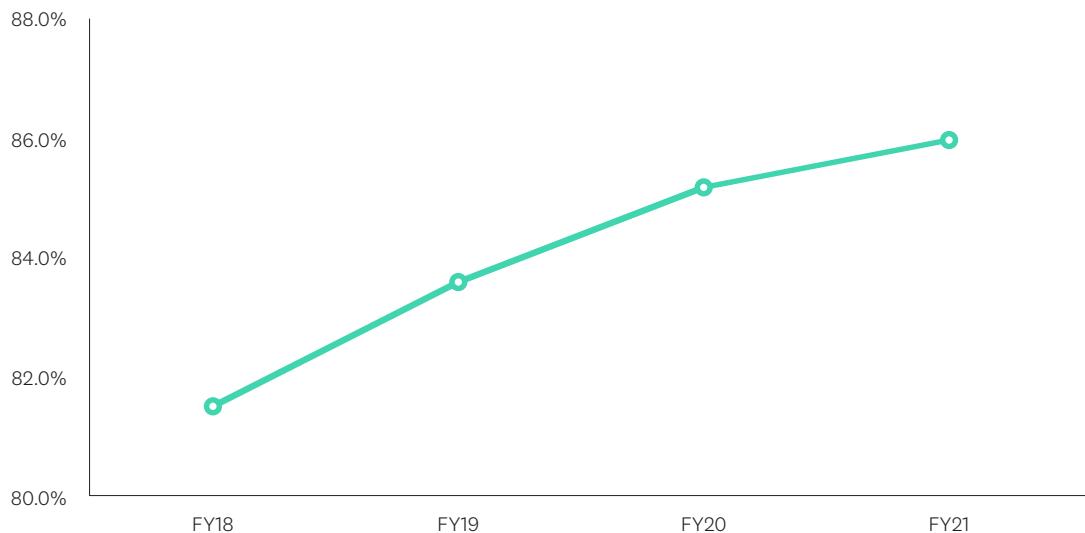
The costs include hosting and content distribution costs, bank feed costs, personnel and related expenses (including salaries, benefits, bonuses, and share-based payments) directly associated with cloud infrastructure and subscriber support, contracted third-party vendor costs, related depreciation and amortisation, and allocated overheads.

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|--------------------------------|------------------|------------------|------------|
| Operating revenue | 848,782 | 718,231 | 18% |
| Cost of revenue | (118,893) | (106,582) | 12% |
| Gross profit | 729,889 | 611,649 | 19% |
| <i>Gross margin percentage</i> | 86.0% | 85.2% | 0.8pp |

Gross profit was \$729.9 million for FY21, a 19% increase on the comparative period. This resulted in a gross margin of 86.0%, up 0.8 percentage points from FY20. This increase was driven by operating revenue growth of 18%, outgrowing cost of revenue growth by six percentage points. The 12% increase in cost of revenue was primarily due to an increase in cloud hosting costs as subscriber numbers grew, and continued focus on platform stability.

Productivity gains from the continued growth in use of Xero Central contributed to efficiencies in Xero's cost of revenue.

Gross margin percentage



Sales and marketing

Sales and marketing expenses consist of personnel and related expenses (including salaries, benefits, bonuses, the amortisation of capitalised 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. Costs also include relationship management costs incurred to support the existing subscriber base. Other costs included are external advertising costs, marketing costs, and promotional event costs, as well as allocated overheads.

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|---------------------------------|------------------|------------------|--------|
| Sales and marketing expenses | 307,948 | 312,852 | -2% |
| Percentage of operating revenue | 36.3% | 43.6% | -7.3pp |

Sales and marketing costs decreased by \$4.9 million, or 2%, compared to FY20, to \$307.9 million for FY21. The majority of sales and marketing costs are incurred to acquire 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 expected to be more than eight years on average).

Sales and marketing costs have decreased in FY21 due to deliberately reduced spending in response to the uncertainties presented by COVID-19, as well as the comparative period including three Xerocon events and physical roadshows. As a result, Xero carefully managed its variable costs, particularly during the first half of FY21 until the impacts of COVID-19 became clearer. There was a 10% decrease in sales and marketing spend in H1 FY21 compared to H1 FY20. In contrast to this, there was a 6% increase in H2 FY21 compared to H2 FY20. This demonstrates Xero's ability to take an agile approach to capital allocation, either to control costs or invest for growth, as appropriate for the operating environment.

The average cost of acquiring a subscriber increased to \$433 per gross subscriber added in FY21 compared to \$420 in FY20. This reflects slightly lower subscriber additions in FY21 compared to FY20.

As a percentage of operating revenue, sales and marketing expenses decreased by 7.3 percentage points, from 43.6% in FY20 to 36.3% in FY21. This percentage was heavily influenced by the reduction in spending during H1 FY21 in response to the COVID-19 environment. Sales and marketing expenses increased as a percentage of operating revenue by 8.5 percentage points from 31.9% in H1 FY21, to 40.4% in H2 FY21. This increase from H1 FY21 to H2 FY21 shows a trend towards more normalised levels of sales and marketing expenses as a percentage of revenue. Lower levels of sales and marketing expenditure seen in FY21 are not expected to be sustained over the next few years as Xero looks to maximise opportunities as the impact of COVID-19 lessens over time.

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 teams, 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 NZ IFRS is capitalisable 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.

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|---|------------------|------------------|------------|
| Total product design and development costs (including amounts capitalised) | 311,672 | 225,756 | 38% |
| Percentage of operating revenue | 36.7% | 31.4% | 5.3pp |
| Less capitalised development costs | (136,164) | (102,621) | 33% |
| Product design and development expense (excluding amortisation of amounts capitalised) | 175,508 | 123,135 | 43% |
| Less government grants | (5,206) | (5,164) | 1% |
| Add amortisation of capitalised development costs | 79,230 | 60,287 | 31% |
| Product design and development expenses | 249,532 | 178,258 | 40% |
| Percentage of operating revenue | 29.4% | 24.8% | 4.6pp |

Xero is strategically investing in developing its product and platform, ensuring a balance between developing new functionality and investing in the platform for long-term growth. Some key new product features in FY21 included:

- Making updates to Xero Payroll to support small businesses quickly accessing government subsidies during COVID-19. This included allowing Australian subscribers to enrol their employees for JobKeeper payments directly with the Australian Tax Office (ATO). Xero was the first major cloud accounting provider to market with this solution, which included building an employee eligibility calculator and enabling direct filing with the ATO through Single Touch Payroll (STP). In the UK, Xero also supported furlough leave and reporting to HMRC within Xero Payroll
- Releasing Xero Verify, our own multi-factor authentication app to make it simple for businesses to improve their security
- Releasing the new match-making tool within the advisor directory using innovative algorithms to match small businesses with the right accounting expertise
- Releasing eFiling with the South African Revenue Service in beta trial to support South African businesses to prepare, store, and submit VAT Returns within the Xero platform
- Enhancing the Starter plan (Early plan in the US), which removed the limits on bank reconciliation and increased the invoice limit to 20 per month to support small businesses with less complex accounting needs
- Accelerating the rollout of the Business Snapshot and short-term cash flow pilots in H1 FY21 to all Xero business edition plans to provide better visibility into cash flow and business performance
- Launching e-invoicing in Australia and New Zealand, allowing small businesses to send and receive invoices directly from Xero into their government customers' accounting systems
- Releasing the Pay with Wise (previously known as Transferwise) integration, allowing UK businesses to pay and manage multiple bills through Xero regardless of which bank customers use, and reconcile transactions easily
- Releasing practice management updates, including new functionality such as a unified client list across Xero HQ and Xero Practice Manager (XPM), enabling businesses to e-sign documents with Document Packs in Australia, enhancements to the Advisor Directory, and updates to Xero Tax in the UK

Total product design and development costs increased by \$85.9 million, or 38%, from \$225.8 million in FY20 to \$311.7 million in FY21. Of this, \$136.2 million was capitalised, with the balance of \$175.5 million included in the Income Statement within total product design and development expenses. As a proportion of operating revenue, total product design and development costs for FY21 (including amounts capitalised) increased by 5.3 percentage points to 36.7%. This highlights Xero's commitment to continuous investment in its global platform as Xero scales, even in times of uncertainty.

The capitalised portion of development costs increased by \$33.5 million or 33% from the comparative period. Capitalised development costs as a percentage of total product design and development costs was 43.7% for FY21. This was a 1.8 percentage point decrease from 45.5% in FY20. As more new projects began in FY21, research activities increased resulting in a higher proportion of research expenses relative to development costs.

The amortisation of previously capitalised product design and development expenditure of \$79.2 million was included as a non-cash expense in the Income Statement, giving total net expenses (after the netting off of government grants) of \$249.5 million for FY21. Amortisation of previously capitalised development costs increased due to higher intangibles balances than in FY20.

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, strategy, and corporate development employees, and the Xero Board. It also includes legal, accounting, and other professional services fees, insurance premiums, other corporate expenses, and allocated overheads.

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|-------------------------------------|------------------|------------------|--------|
| General and administration expenses | 106,345 | 88,980 | 20% |
| Percentage of operating revenue | 12.5% | 12.4% | 0.1pp |

General and administration expenses were \$106.3 million for FY21, \$17.4 million or 20% higher than FY20. The main growth areas were an increase in professional services to support Xero's acquisitions in FY21 as well as an increase in personnel-related expenses, which were largely attributable to the growth in employee headcount over the second half of FY21.

General and administration costs as a proportion of operating revenue increased marginally compared to FY20, by 0.1 percentage points to 12.5%.

Employees

| At 31 March | 2021 | 2020 | change |
|-------------|-------|-------|--------|
| Total Group | 3,642 | 3,055 | 19% |

Full-time equivalent employees (FTEs) increased by a record 587 or 19% in FY21, taking total FTEs to 3,642. This is compared to a 20% increase in subscribers, and 18% increase in operating revenue. The growth in FTEs reflects increased investment in product design and development increasing headcount by 39%, as well as strategic investment to prepare for future growth. Growth in product design and development was partially offset by reductions in headcount in the customer support area as efficiencies and automation continue to be realised.

Net finance expense

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) | change |
|--|------------------|------------------|-------------|
| Interest income on deposits | 5,155 | 13,432 | -62% |
| Total finance income | 5,155 | 13,432 | -62% |
| Loss on recognition/extinguishment of term debt | (67,169) | - | NM |
| Amortisation of debt discount and issuance costs | (21,781) | (17,023) | 28% |
| Lease liability interest | (6,053) | (6,280) | -4% |
| Interest on convertible notes | (5,783) | (11,010) | -47% |
| Bank standby facility costs | (1,852) | (1,691) | 10% |
| Other finance expense | (8,140) | (273) | NM |
| Total finance expense | (110,778) | (36,277) | 205% |
| Net finance expense | (105,623) | (22,845) | 362% |

Finance income in FY21 was \$5.2 million, a decrease of \$8.3 million, or 62%, from FY20. This was primarily due to lower global interest rates.

Finance expenses in FY21 increased by 205% driven by combined losses of \$67.2 million on recognition of the 2025 convertible notes and extinguishment of the 2023 convertible notes. Other finance expenses increased by \$7.9 million due to \$5.7 million worth of transaction costs relating to the buyback of the 2023 convertible notes and issuance of the 2025 convertible notes. Interest on convertible notes also decreased by 47%, or \$5.2 million, while the amortisation of debt discount and issuance costs increased by 28%, or \$4.7 million.

The decrease in interest results from the new convertible notes having a zero coupon interest rate, as compared to the 2023 convertible notes, which had a 2.4% coupon interest rate.

Amortisation of debt discount and issuance costs increased in FY21 from the comparative period as a result of an increase in the value of the conversion feature in the 2025 convertible notes as compared to the 2023 convertible notes.

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 user support costs.

| | ANZ (\$000s) | International (\$000s) | Total (\$000s) |
|---------------------------------|-----------------|---------------------------|-------------------|
| Year ended 31 March 2021 | | | |
| Operating revenue | 514,534 | 334,248 | 848,782 |
| Expenses | (175,341) | (251,500) | (426,841) |
| Segment contribution | 339,193 | 82,748 | 421,941 |
| Contribution margin percentage | 65.9% | 24.8% | 49.7% |
| Year ended 31 March 2020 | | | |
| Operating revenue | 436,530 | 281,701 | 718,231 |
| Expenses | (164,962) | (254,472) | (419,434) |
| Segment contribution | 271,568 | 27,229 | 298,797 |
| Contribution margin percentage | 62.2% | 9.7% | 41.6% |

ANZ

Operating revenue for FY21 increased by 18% compared to FY20, or 16% in constant currency, along with surpassing the 1.5 million subscriber milestone, cementing Xero's position as a market leader in the segment. Australia experienced operating revenue growth of 20%, while New Zealand grew by 12%.

Expenses in the ANZ segment increased 6% compared to FY20, impacted by the deliberate reduction in expenditure early in H1 FY21 until the impacts of COVID-19 became clearer. Xero was able to return to more regular expenditure levels in H2 FY21. This largely influenced the 3.7 percentage point increase in the contribution margin percentage for ANZ, as the segment contribution increased by \$67.6 million, or 25%.

International

Operating revenue in the International segment grew by 19% in FY21, or 21% in constant currency, driven by subscriber growth of 21%. The segment had a 204% increase in contribution margin compared to the comparative period, with a contribution of \$82.7 million compared to \$27.2 million in FY20.

As a percentage of revenue, the contribution margin improved substantially from 9.7% in FY20 to 31.6% in H1 FY21, due to the combination of revenue growth over the year, and a deliberate reduction in expenditure in response to the impacts of COVID-19 in H1 FY21. The contribution margin decreased to 24.8% in the second half of the year, driven by increased investment as the impacts of COVID-19 became clearer. The contribution margin remained comparatively lower than that of ANZ, reflecting the emphasis on investment in subscriber additions in the UK, North America, Asia, and South Africa as Xero continues to develop brand recognition and build distribution channels in these markets.

Key SaaS metrics

SaaS companies like Xero operate on many of the same performance metrics as traditional companies, such as revenue, cash flow, and customer numbers. However, understanding the performance of SaaS companies and being able to benchmark them is assisted by an understanding of SaaS-specific metrics. Below are some of the headline metrics Xero uses to manage and drive its performance.

Average revenue per user (ARPU) is calculated as AMRR (see definition on page 44) at 31 March, divided by subscribers at that time (and divided by 12 to get a monthly view).

CAC months are the months of ARPU to recover the cost of acquiring (customer acquisition costs: CAC) each new subscriber. The calculation represents the sales and marketing costs for the year excluding the capitalisation and amortisation of contract acquisition costs, less conference revenue (such as Xerocon), divided by gross new subscribers added during the same period, divided by ARPU.

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 churn), multiplied by ARPU, multiplied by the gross margin percentage. Group LTV is calculated as the sum of the individual segment LTV, 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 LTV derived from a subscriber in ANZ is currently on average 13.2 times the cost of acquiring that subscriber. Xero strives to maximise total LTV while optimising the level of CAC investment it undertakes in order to achieve a desirable LTV/CAC ratio. Xero can improve total LTV in multiple ways, such as increasing subscriber numbers, enhancing products and services for existing subscribers thereby increasing ARPU and/or reducing churn, and improving gross margin through cost efficiencies.

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

| At 31 March 2021 | ANZ | International | Total |
|-------------------------|-------|---------------|-------|
| ARPU (\$) | 31.23 | 26.74 | 29.30 |
| CAC months | 8.9 | 22.4 | 14.8 |
| Churn | 0.73% | 1.43% | 1.01% |
| LTV per subscriber (\$) | 3,682 | 1,608 | 2,789 |
| LTV/CAC | 13.2 | 2.7 | 6.4 |

| At 31 March 2020 | ANZ | International | Total |
|-------------------------|-------|---------------|-------|
| ARPU (\$) | 29.83 | 30.05 | 29.93 |
| CAC months | 9.7 | 18.1 | 14.0 |
| Churn | 0.84% | 1.59% | 1.13% |
| LTV per subscriber (\$) | 3,058 | 1,573 | 2,422 |
| LTV/CAC | 10.6 | 2.9 | 5.8 |

ANZ

ARPU increased by 5% compared to FY20. During FY21, the NZD weakened against the AUD, having a favourable impact on ARPU. The price change to Xero business edition plans in Australia in March 2021 also impacted ARPU favourably. These impacts were slightly offset by shifts in product mix, from higher priced to lower priced products, aided by the introduction of the enhanced Starter product. In constant currency terms, ANZ's ARPU was flat compared to 31 March 2020.

CAC months at 31 March 2021 was lower at 8.9 compared to 9.7 in the comparative period. This was the result of the increased subscriber additions in H2 FY21 for both Australia and New Zealand outpacing the growth in H2 FY20, in addition to decreased sales and marketing expenditure during the period.

Churn was 0.73% at 31 March 2021, a decrease of 0.11 percentage points from 0.84% in the comparative period. Churn increased slightly in the first few months of the year, before reducing to below pre-COVID-19 levels, indicating the value Xero products have to small businesses.

Lower churn, combined with the increase in ARPU and gross margin, drove LTV per subscriber to \$3,682 from \$3,058, a 20% (15% in constant currency) increase from 31 March 2020. Total ANZ subscriber LTV increased by \$1.7 billion, or 44%, to \$5.7 billion at 31 March 2021 compared to \$4.0 billion at 31 March 2020.

International

ARPU decreased by 11% in FY21. The comparatively stronger NZD against the USD and GBP negatively impacted ARPU. In constant currency terms, ARPU decreased by 3% compared to 31 March 2020. The decrease in constant currency was due to the shift towards a more efficient but lower ARPU partner channel.

CAC months increased from 18.1 months at 31 March 2020 to 22.4 months at 31 March 2021. Subscriber additions in H2 FY21 improved compared to H1 FY21 but remained lower than FY20. Despite no increase in sales and marketing costs, the comparatively lower subscriber additions combined with lower ARPU led to an increase in CAC months.

LTV per subscriber increased by 2% (11% in constant currency) due to a combination of lower churn and higher gross margin, partially offset by lower ARPU. Total International subscriber LTV increased by \$0.4 billion, or 23%, to \$1.9 billion at 31 March 2021 compared to \$1.5 billion at 31 March 2020.

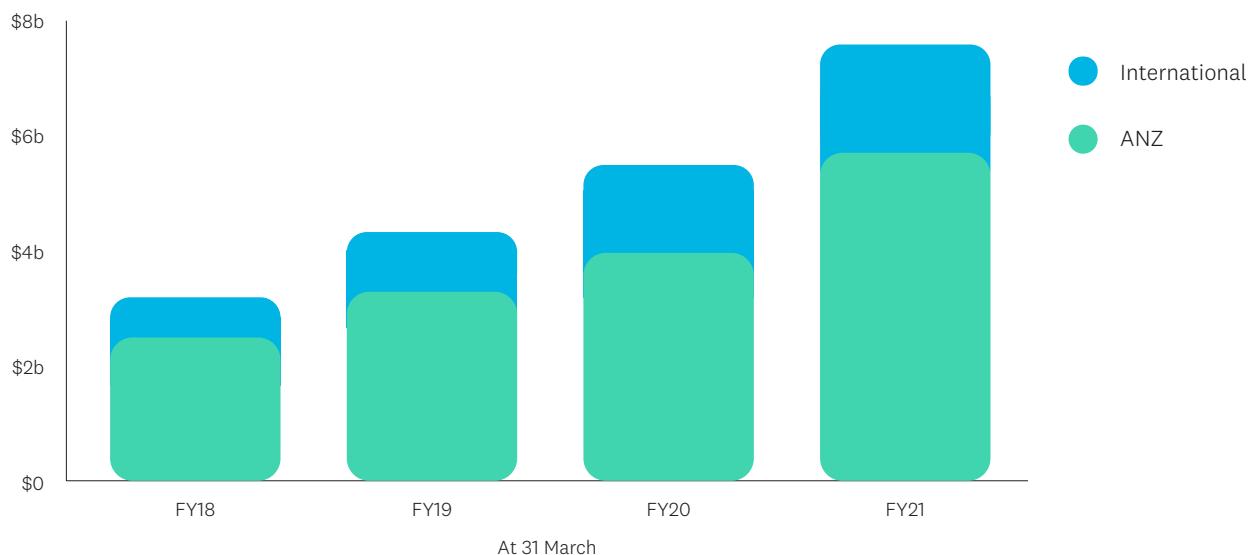
Total Group

Group ARPU decreased by 2% compared to 31 March 2020. This was partially due to the impact of foreign currency movements. ARPU decreased 1% in constant currency compared to 31 March 2020 due to product mix impacts.

Churn for the Group decreased by 0.12 percentage points to 1.01% from 1.13% in the comparative period. Combining this with the improved gross margin, LTV per subscriber increased by 15% to \$2,789 from \$2,422 at 31 March 2020, despite a 2% decrease in Group ARPU. In constant currency terms, LTV per subscriber increased by 14%.

Total subscriber LTV at 31 March 2021 was \$7.6 billion, an improvement of \$2.1 billion compared to 31 March 2020. CAC months increased 6% to 14.8 months when compared to 31 March 2020, as the combined impact of the International segment's lower ARPU and subscriber additions outweighed ANZ's improved performance in both.

Total lifetime value



THROUGH THEIR EYES

Advisory approach enables client success



Shayne Dueck | Xero Partner |
MNP | Canada

As head of Canadian accounting, tax and business consulting firm MNP's cloud service line, ease, Shayne Dueck and his team provide small and medium-sized businesses with 'always on' accounting and bookkeeping services, facilitated by Xero.

Using Xero gives ease real-world business insights, enabling them to be better business advisors rather than just producing year-end financial statements.

Adopting innovative features such as Xero's short-term cash flow tool, which was launched in June 2020 to help businesses project their cash flow, has enabled the ease team to dig deeper into their clients' books.

"We work with an energy technology company in Calgary that previously ran their accounts entirely through spreadsheets. Early into their journey with us, the greater visibility into their cash flow that Xero provided showed us they didn't have a handle on cash inflows or outflows. The owners were in the dark about their cash flow. We were able to use the cash flow tool to help them start preserving their cash and gain visibility over when cash is coming or going from their business. By connecting Xero with app partner Spotlight Reporting, which offers additional reporting and tracking KPIs, we were able to dig deep into what they could do to generate cash flow."

Now, the client is breaking even and surviving through COVID-19. The owners are a lot more confident in making business decisions, and they're finally able to sleep at night.

"It's pretty incredible to see how their team can now understand their cash flow and successfully run their business. Being able to partner with them to do that has been really satisfying."







David Thodey AO
Chair of the Board
Australia



Steven Aldrich
Non-executive
Director
USA



Mark Cross
Non-executive
Director
New Zealand



Rod Drury
Xero Founder /
Non-executive
Director
New Zealand

The Board of Directors

David is a business leader focused on innovation, technology and telecommunications, with more than 30 years of experience creating brand and shareholder value. He is currently chairman of Australia's national scientific research agency, the Commonwealth Scientific and Industrial Research Organisation (CSIRO), and Tyro, Australia's only independent EFTPOS provider, and a non-executive director of Ramsay Health Care, a global hospital group. David had a successful executive

career as CEO of Telstra, a significant Australian telecommunications company and as CEO of IBM Australia and New Zealand. In 2017, David was made an Officer (AO) in the General Division of the Order of Australia.

*Independent Director since June 2019
and Chair since February 2020
People and Remuneration Committee
Nominations Committee (Chair)*

Steven is an entrepreneur and professional director with more than 25 years' experience in creating and delivering products within the technology and accounting software industries. Steven is currently a non-executive director of Blucora, a provider of technology-enabled financial solutions, and Ruby Receptionists, a virtual customer engagement solution provider.

Steven has held a range of senior executive roles, including at GoDaddy, the world's largest services platform for entrepreneurs, where most recently he

was Chief Product Officer. Prior to this, Steven was the CEO of Outright, an online bookkeeping service, which was acquired by GoDaddy. Steven has also held various senior management roles at Intuit, including Vice President of Strategy and Innovation for the small business division. Steven holds a Bachelor of Arts in Physics from the University of North Carolina and an MBA from Stanford University.

*Independent Director since October 2020
People and Remuneration Committee*

Mark is an experienced professional director with more than 20 years of international experience in corporate finance and investment banking. Mark is currently a non-executive director (and audit and risk committee chair) of Chorus and Z Energy. Chorus and Z Energy are both dual-listed ASX/NZX businesses. He is Chair of Milford Asset Management and acting chair of Virsae, a communications management SaaS business.

Mark was at Deutsche Bank for 10 years, initially based in Sydney in Mergers and Acquisitions, then in London as a Managing Director and co-head of a

European M&A industry group. Mark holds a Bachelor of Business Studies (Accounting & Finance) degree from Massey University New Zealand, is a member of Chartered Accountants Australia and New Zealand, a chartered member of the New Zealand Institute of Directors and a member of the Australian Institute of Company Directors.

*Independent Director since April 2020
Audit and Risk Management Committee (Chair)*

For more than a decade, Rod led Xero to be a global software business and S&P/ASX 100 company. Rod started his career at Ernst & Young and went on to establish and lead a number of innovative technology businesses. Rod was an independent director on the NZX Board and the Trade Me Board. At the Deloitte Top 200 Awards in 2017, Rod was named Visionary

Leader of the Year. He was named Ernst & Young New Zealand Entrepreneur of the Year in 2013, and is a member of the New Zealand Hi-Tech Hall of Fame.

*Director since July 2006
Nominations Committee*

Lee has more than 20 years' experience internationally in the Financial Services industry and has held senior executive roles in marketing, strategy and risk in large scale customer-facing businesses. In 2020, Lee joined the Global Executive team at Afterpay and is responsible for driving the business' strategy for new platforms, products and services. Lee has been recognised by IBM as one of 40 Women Leaders in Artificial Intelligence across the globe for her work in delivering world-first innovations.

Dale is a former technology entrepreneur. Dale co-founded mobile pioneer Omega Logic in 1999, which co-launched prepay top-ups in the UK. She led the growth of top-up transactions to £450m within five years, then turned to investing and advising start-ups and won the British Angel Investor of the Year award in 2011. Dale is currently a non-executive director at the Cranemere Group, and a board advisor to Accelerate:Her. She was formerly a non-executive director and Trustee for the Peter Jones Foundation and a non-executive director at Sussex

Susan is an experienced business leader with a particular interest in helping companies to drive growth through technology, innovation and organisational culture. Susan is currently the chair of Vista Group and an independent director of Trustpower, Property for Industry and Arvida Group. Susan will not be standing for re-election at the Trustpower annual shareholder meeting later this year.

Susan is also a member of the New Zealand Markets Disciplinary Tribunal and a Board member of non-

Craig co-founded Australian small business accounting software provider MYOB in 1991. Craig built MYOB to be a popular business tool and brand which, in 2004, merged with Solution 6 to become Australia's largest IT company. Craig joined the Xero Board in 2009. He now spends the majority of his time working in the philanthropic sector.

Lee holds a Bachelor of Business from Auckland University of Technology (NZ), and is an alumni of Berkeley Haas School of Business. She is also a member of Chief Executive Women (CEW) which represents Australia's most senior and distinguished female leaders.

*Independent Director since April 2014
Audit and Risk Management Committee*



Lee Hatton
Non-executive
Director
Australia

Place Ventures and the Department for Business, Innovation & Skills. She holds an MBA from the London Business School and served on the Business Taskforce on EU Redtape for the British Prime Minister in 2013. Dale was awarded a CBE by Her Majesty the Queen in 2013, for services to business.

*Independent Director since April 2018
Audit and Risk Management Committee
Nominations Committee*



Dale Murray CBE
Non-executive
Director
United Kingdom

profit Global Women. Susan is a past director of ASB Bank and was a past Ministerial Appointee to The National Advisory Council for the Employment of Women. Susan is founding co-chair and a shareholder in fast-growing health and wellness company Organic Initiative Limited.

*Independent Director since February 2017
People and Remuneration Committee (Chair)
Nominations Committee*



Susan Peterson
Non-executive
Director
New Zealand

*Director since May 2009
People and Remuneration Committee
Nominations Committee*



Craig Winkler
Non-executive
Director
Australia

Corporate Governance Statement

Introduction from the Chair

Dear Shareholder,

Our Annual Report, including my Chair Review (see page 5) and the following Corporate Governance Statement, sets out Xero's approach to corporate governance.

The directors and leadership team share a commitment to nurturing a culture across Xero that seeks to embed and uphold the highest standards of corporate governance.

Xero's corporate governance framework is designed to support our operations, deliver on our strategy, monitor performance and ensure management of risk, and to do so in a manner that reflects the digital, global and high growth nature of Xero's business.

The Board has for some time taken a continuous improvement approach to corporate governance, particularly as Xero has continued to grow and evolve, as have the expectations of our investors and other stakeholders. We have continued to do this in FY21, in a particularly challenging environment worldwide. The Board made changes as the year progressed, including:

- During the pandemic, the Board met more frequently and received increased reporting on key financial and other metrics to monitor and appropriately respond to the impact of the pandemic on Xero, our customers, employees and stakeholders across regions
- Governance of fast-moving M&A transactions evolved. This included the establishment of an M&A authority framework and formation of a Board Advisory Group, with additional deal-specific Board meetings held as required to monitor, consider and approve transactions
- The Board responded to the unusual circumstances of the year by holding nine additional Board meetings and one additional nominations committee meeting, over and above the original schedule of meetings
- Where possible, Committee and Board meetings were separated by a number of days which facilitated greater consideration of matters and the ability to respond to the challenges of virtual meetings
- Following a review of the Board composition and skills matrix, Steven Aldrich a US based director with experience in technology and product development and small business, was appointed to the Board on 1 October 2020
- Rotation of the role of Chair of the Audit and Risk Management (ARM) Committee and People & Remuneration (P&R) Committee with Mark Cross appointed to Chair the ARM Committee and Susan Peterson appointed to Chair the P&R Committee

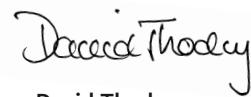
- Xero's continuous disclosure processes continued to evolve, including an updated Continuous Disclosure Policy and the introduction of supporting procedures and a disclosure committee charter
- Xero's Annual Meeting was held entirely virtually with all directors in attendance via videolink from Australia, New Zealand, the UK and the US
- A platform for the distribution of video content to the Board was developed to provide directors who are unable to travel to Xero offices with updates and insights into the day-to-day operations of the business

The Board takes a holistic view of governance and believes in the fundamental importance of diversity and inclusion. I have addressed this topic more fully in my Chair Review on page 5.

My fellow directors and I know that diversity and inclusion come together to create and maintain a strong culture across our business, which in turn drives good outcomes for our investors and other stakeholders. I am pleased that Xero's core value, #human, and flexible working policy and measures for diversity and inclusion and employee wellbeing saw Xero recognised as one of the Best Places to Work in Australia and New Zealand by the Australian Financial Review and BOSS Magazine in April 2021 (ranked fourth in the technology category).

In addition, the Board has an ongoing commitment to actively improve Xero's social and environmental impact which is addressed more fully in the SEI and D&I section on pages 23 to 32.

The Board is pleased that the focus and attention given to many facets of corporate governance, some of which I have outlined above, contribute to delivering great outcomes for our people, our customers and our investors.



David Thodey
Xero Chair

ASX principles and recommendations

Xero is listed on the Australian Securities Exchange (ASX) and is a New Zealand incorporated and domiciled company. From a regulatory perspective, this means that while the ASX Listing Rules apply to Xero, certain provisions of the Australian Corporations Act 2001 (Cth) do not.¹

Xero's corporate governance reporting framework has been developed with regard to the ASX Listing Rules and the ASX Council's Corporate Governance Principles and Recommendations (ASX Principles and Recommendations). This Corporate Governance Statement (Statement) addresses the recommendations contained in the 4th edition of the ASX Principles and Recommendations, which applies to Xero for the financial year ended 31 March 2021. This Statement is current as at 30 April 2021, and has been approved by the Board.

This Statement should be read in conjunction with this Annual Report and Xero's Investor Centre at www.xero.com/about/investors/governance, where full copies of Xero's corporate governance policies and charters can be found.

References to FY21 are to the financial year ended 31 March 2021.

¹ Xero complies with the ASX Listing Rules. As Xero is not incorporated in Australia, it is not a disclosing entity for the purpose of Chapter 2M of the Australian Corporations Act 2001 (Cth) (Financial reports and audits) and certain provisions of that chapter do not apply (e.g. section 295 regarding annual financial report, section 298 regarding directors' report or section 300A regarding remuneration reporting). As a New Zealand company, Xero's annual reporting is primarily governed by the Companies Act 1993 (New Zealand)

Principle 1: Lay solid foundations for management and oversight

The Board

Charter The Board Charter outlines the Board's roles and responsibilities and describes those matters expressly reserved for the Board's determination and those matters delegated to management. The Charter is available on Xero's website at www.xero.com/about/investors/governance/.

The Board is appointed by the shareholders (other than directors who are appointed by the Board to fill a casual vacancy, who must be subsequently approved by shareholders at the next Annual Meeting of the company), and meets sufficiently regularly to perform its role effectively. It comprises directors who bring a mix of skills, knowledge, experience, diversity and independence, together with a deep understanding of, and competence to deal with, current and emerging issues and to guide the business.

Responsibilities The Board is responsible for overseeing and appraising Xero's strategic direction, purpose, values, policies, performance, risk appetite and governance framework. To assist with carrying out its responsibilities, the Board has established the following standing Committees:

1. Audit and Risk Management Committee (ARM Committee)
2. People and Remuneration Committee (P&R Committee)
3. Nominations Committee

The Board may also delegate specific functions to ad hoc Committees from time to time.

Xero's Chief Executive Officer (CEO) has responsibility for the day-to-day management and administration of the Xero business, supported by the rest of Xero's leadership team. The CEO manages Xero in accordance with the strategic plan, annual budget and operating plan, risk appetite, and risk management strategies approved by the Board.

The Board monitors Xero's management and performance and ensures that management's activities are aligned with the expectations and are within the risk appetite and risk management framework set by the Board and management. The Board has a number of mechanisms to ensure this is achieved, including:

- Approving Xero's strategic plan, overseeing performance to ensure alignment with the strategic plan, and focusing Xero's activities on long-term shareholder value
- Assessing and making determinations on Xero's culture and management framework, governance policies, procedures and compliance, and relevant Board and Committee frameworks
- Approving Xero's financial statements, required reports and annual budget, as well as confirming Xero's financial position and overseeing and reviewing the integrity of Xero's accounting and corporate reporting systems
- Selecting the CEO, overseeing succession plans for Xero's leadership team, and approving policies, practices and measurable objectives for achieving diversity and inclusion
- Approving the remuneration framework, ensuring Xero's remuneration policies and practices fit with its strategic goals, and overseeing equity incentive programs
- Approving an annual operating plan and systems of financial and non-financial risk management, as well as confirming Xero has in place accurate and reliable reporting systems, internal controls, compliance activities, and systems to monitor the effectiveness of Xero's risk management framework

Appointment Before appointing a director, Xero undertakes appropriate background checks to determine that candidate's suitability. The qualifications of each director are detailed on pages 55 and 56 of this Annual Report.

All directors are appointed pursuant to formal letters of appointment or agreements setting out the key terms and conditions of their appointment, including:

- Remuneration
- Board, Committee and directors' duties, responsibilities and time commitment
- Board and individual performance evaluation
- Disclosure of interests and matters affecting independence
- Confidentiality
- The Board's policy on obtaining independent advice
- Insurance and deeds of indemnity

Board and Committee membership and meeting attendance The members of Xero's Board and Committees for FY21 is set out below. The number of meetings scheduled in advance for the year and attendance at those meetings is also set out below. Additional Board and Committee meetings are held to meet governance demands; in FY21 the Board held 9 additional meetings and the Nominations Committee held 1 additional meeting.

| Director | Board | | Nominations Committee | | ARM Committee | | P&R Committee | |
|-----------------------------|-------------------|----------|-----------------------|----------|-------------------|----------|-------------------|----------|
| | Held ¹ | Attended | Held ¹ | Attended | Held ¹ | Attended | Held ¹ | Attended |
| David Thodey | 8 | 8 | 5* | 5 | - | - | 5 | 5 |
| Steven Aldrich ² | 4 | 3 | - | - | - | - | 1 | 1 |
| Mark Cross ³ | 8 | 8 | - | - | 6* | 6 | - | - |
| Rod Drury ⁴ | 8 | 8 | 1 | 1 | - | - | - | - |
| Lee Hatton | 8 | 8 | - | - | 6 | 6 | - | - |
| Dale Murray | 8 | 8 | 5 | 5 | 6 | 6 | - | - |
| Susan Peterson | 8 | 8 | 5 | 5 | - | - | 5* | 5 |
| Craig Winkler ⁵ | 8 | 8 | 4 | 4 | 2 | 2 | 5 | 5 |

¹ Held represents the number of scheduled meetings held that the relevant director was eligible to attend. Some Committee meetings are open to optional attendance by other directors; such optional attendance is not reflected in the table

² Appointed as a Director 1 October 2020 and appointed to the P&R Committee 13 October 2020

³ Appointed as Chair of the ARM Committee 13 October 2020

⁴ Appointed to the Nominations Committee 13 October 2020

⁵ Appointed to ARM Committee 13 October 2020; resigned as a member of the Nominations Committee effective 31 October 2020

* Denotes Committee Chair

Company Secretary Chaman Sidhu is the Chief Legal Officer & Company Secretary of Xero. Her qualifications and experience are set out on Xero's website at www.xero.com/about/team/.

The Company Secretary is accountable to the Board, through the Chair, on all matters to do with the effective functioning of the Board. The formal reporting line of the Company Secretary is through the CEO. All directors have direct access to the Company Secretary.

Leadership Team

Appointment Before appointing a senior executive, Xero undertakes appropriate background checks to determine that candidate's suitability. All members of Xero's leadership team are appointed pursuant to formal letters of appointment or agreements setting out the key terms and conditions of their appointment, including remuneration.

Diversity and inclusion¹

Xero values diversity and inclusion and considers it a priority in the creation of a sustainable business capable of delivering shareholder value. Xero embraces the diverse experience, ideas, skills and perspectives of our people. The diversity of our people enables Xero to innovate, attract and retain top talent, and to better reflect and serve our customers, partners, and the communities we interact with every day. Xero takes a broad view of the meaning of diversity and believes that it's through inclusion that we will tap into the potential and power of our people's differences.

Diversity and Inclusion Policy Xero's Diversity and Inclusion Policy outlines requirements for the Board to establish measurable objectives for achieving diversity and to annually assess those objectives and the progress towards achieving them. This policy is available on Xero's website at www.xero.com/about/investors/governance/.

The policy reflects six key principles that provide the framework for Xero's goal of developing and maintaining a diverse and inclusive workplace and the implementation of initiatives to support this. The key principles are:

1. We value diversity because it reflects and serves our customers and ensures our people thrive
2. We're all accountable to create an inclusive culture
3. We're committed to attracting diverse talent and hiring fairly
4. We support flexible ways of working
5. We're committed to equal pay for equal work
6. We have an obligation to champion diversity and inclusion in the community

Xero's Head of Diversity and Inclusion leads our global diversity and inclusion strategy and initiatives and supports

our business to achieve diversity priorities and initiatives across our regions and functions.

Respect and Responsibility Policy Xero's Respect and Responsibility Policy supports a clear and consistent approach to equal opportunity, promotes a workplace free from discrimination, harassment, sexual harassment, and bullying, and sets out the internal process to resolve concerns and complaints. The policy is supported by an online training module for all employees and additional training for people managers.

Wellbeing At Xero, we value wellbeing and believe it is part of our commitment to create an inclusive work environment to support our employees, customers, and partners. During FY21, we focused on supporting the wellbeing of our people and our customers in the COVID-19 operating environment. This included a range of employee listening strategies, including internal pulse surveys, to understand our people's experience of the COVID-19 environment and how we could best support them. We created a Wellbeing Hub for our people with a range of resources for them and their families, including a resource kit for parents. We supported our people managers with a toolkit to help them prioritise the wellbeing of their teams and adapt to the challenges of remote working, and piloted a program of capability development for people managers around building resilient teams.

In September 2020, we appointed a global Head of Wellbeing to further develop our wellbeing strategy and consolidate and enhance our efforts to promote, protect, and support the wellbeing of our people. The initial focus of this strategy has been to deploy an evidence-based framework called the 'wellbeing climate', which seeks to understand how well our people's psychological needs are met during their experience of work. Integrating this framework into our systems and leadership capability enables Xero to better identify and respond to psychosocial risk, and provides a foundation to make evidence-based decisions about how work should be designed.

Digital accessibility In February 2021, we appointed a Head of Digital Accessibility to promote accessibility of Xero's products for our customers and ensure that diversity and inclusion is embedded in our product development approach.

¹ See also SEI and D&I Section on page 23 for more detail on Xero's diversity and inclusion initiatives

Measurable objectives for diversity In addition to the information contained in the SEI and D&I section (see pages 23 to 32), the following is a summary of progress achieved against Xero's measurable objectives for FY21, as approved by the Board:

Objective

Xero maintains a gender balance on its Board by having at least 3 female directors and at least 3 male directors*

Xero attracts diverse talent in the tech industry with particular focus on women in tech, and maintains:

- female representation on Xero's leadership team at or above 40%
- female representation across all employees at or above 40%

(This reflects a 40:40:20 target for these levels, i.e. 40% women and 40% men, with the remaining 20% unspecified to allow for flexibility and recognise that gender is not binary)

Xero is an inclusive work environment where different contributions and perspectives are valued and everyone can bring their whole self to work

Progress

- At 31 March 2021, Xero's Board was comprised of 3 women and 5 men

- **Progress on gender diversity:** At 31 March 2021, 42% of Xero's employees and 63%¹ of Xero's leadership team were women
- Included in the 2021 Bloomberg Gender-Equality Index recognising our commitment to supporting diversity in the workplace (our second consecutive year in this index) and accredited with the GenderTick from YWCA New Zealand
- **Community engagement:** Maintained our support for organisations and initiatives to attract and develop a more gender diverse workforce, including Code Like A Girl and Tech Girls Movement in Australia
- Continued our community outreach and engagement program in New Zealand with the aim of increasing gender and ethnic diversity in the early-stage pipeline of talent into tech. In response to COVID-19, online initiatives included an Online Coding Adventure for young people, co-creating the Trailblazing Women in Tech quiz for girls with the She# team and supporting our people to participate as mentors in the GirlBoss Edge: Engineering & Technology online career accelerator for high school aged young women. Some in-person activities have resumed, such as hosting school student work experience days for a group of young women and Pasifika students and ShadowTech days for teachers
- **Measurement & monitoring:** Evolved our internal diversity dashboard that tracks key diversity data to include new metrics and individual dashboards to support accountability for our leadership team
- To reflect our understanding that gender is not binary, began reporting internally and externally on the representation of gender diverse and non-binary people at Xero (based on self-identification) in addition to the representation of women
- **Gender pay equity:** Conducted our annual organisation-wide pay equity review at Xero and in the process of submitting the now annual gender pay gap report for our UK business for the period of 4 April 2019 to 5 April 2020
- **Hiring more inclusively and attracting diverse talent:** Relaunched Diversity and Inclusion in hiring training for our talent teams and interviewing at Xero training for hiring managers, including education about counteracting unconscious bias in the hiring process and utilisation of recruitment platforms promoting diversity such as Work180 in Australia and established new partnerships with Tech Returners in the UK, and the Black Professionals in Tech Network in the Americas
- **Networks for women:** The Empower employee resource group for women in the Americas and the Women of Xero community in Australia continued to organise events in support of gender equality at Xero

Some of the ways in which we continued to build our inclusive work environment during the year:

- **Inclusive leadership:** Developed an inclusive leadership learning program in response to challenges highlighted in the COVID-19 operating environment, with many of our people leaders remotely leading diverse, physically distributed teams for the first time. Following a successful pilot in November 2020, we are now offering this inclusive leadership program as foundational learning to build the inclusion capability of leaders across Xero, in support of our expectation that great people leaders at Xero build inclusive, resilient, and psychologically safe teams

* Given an intended board size of 7 - 9 directors, this equates to maintaining not less than 30% female representation and not less than 30% male representation on the Board

¹ Refer to CEO Review which sets out the expanded role for the Chief Customer Officer and new reporting lines for the Managing Director in each region. These changes have increased diversity at the leadership team level

Xero is an inclusive work environment where different contributions and perspectives are valued and everyone can bring their whole self to work

- **Cultural diversity survey:** Launched our first cultural diversity survey on World Day for Cultural Diversity in May 2020. The survey focused on three key indicators of cultural diversity that are meaningful from a global perspective: country of origin, languages we use, and identity. Our objective was to obtain a globally consistent baseline for cultural diversity across these indicators, and we shared the results of our survey internally and externally. Following this survey, we also reviewed our data around racial and ethnic diversity to understand how our workforce reflects the communities we operate in, so we can identify representation gaps and work to narrow these gaps over time
- **Addressing racism & racial inequality:** After a town hall session for our people in the Americas to discuss their reactions to Black Lives Matter and their experiences of systemic racism and racial inequality, our Americas leadership team worked with a local expert to develop an action plan to amplify our Diversity and Inclusion efforts in the region. This plan was informed by insights from focus groups conducted with employees and leaders in the Americas during August and September 2020. In February 2021, we appointed a Diversity and Inclusion Program Manager to support the implementation of this plan in the Americas, and help us share learnings across our global business. We also conducted allyship training for all people leaders in the Americas, focused on understanding the workplace experience of Black professionals, facilitated by a leader from the Black Professionals in Tech Network
- **Support for parents:** Launched a new program of inclusive benefits to support our people when they are starting or growing their family, including significantly increased leave benefits (up to 26 weeks as a top-up to 100% of base salary for all primary carers, and six weeks paid leave for partners), a standard ‘flexi-return’ policy when returning to work and 10 paid ‘keeping in touch’ days to ensure parents can stay connected to Xero while on leave. Our support for parents is available to all permanent employees globally, regardless of their gender identity, how they become a parent, or how long they have been with Xero
- **LGBTQI+ inclusion:** Installed all gender signage across the accessible bathrooms and shower rooms in our Wellington headquarters to create a more inclusive and welcoming environment for trans, gender diverse and non-binary employees and guests, with a plan to extend this initiative wherever possible in our offices globally. Options were introduced in Xero’s internal human resources system to enable employees to identify as non-binary or gender diverse. Highlighted significant events such as Pride Month in the northern hemisphere, Wear It Purple Day in Australia and LGBTQ History Month in the UK with internal communications, videos, educational posts and virtual events. Successfully piloted an ally skills training program in December 2020, with a broader rollout planned commencing with our Product team initially, to develop people’s confidence and practical skills to take effective action when they can best act as an ally
- **Sharing personal stories:** Promoted inclusion through creating awareness and understanding on topics such as neurodiversity (through a series of profiles of neurodivergent Xeros in our global #diversity channel) and invisible disabilities (through a personal story shared across our global business on International Day of People with Disability)
- **Mental health & wellbeing:** Delivered a range of mental health support and wellbeing resources in response to the COVID-19 environment, and offered all our people an additional day of paid wellbeing leave in the lead-up to World Mental Health Day
- **Cultural inclusion:** Promoted cultural awareness and inclusion by highlighting cultural and religious events such as Māori, Samoan, and Tongan language weeks and Matariki (Māori New Year) in New Zealand, Africa Day in the UK, NAIDOC Week (National Aborigines and Islanders Day Observance Committee) in Australia, and Ramadan and Lunar New Year globally. Our recently formed employee resource group, Black Xero, also curated a program of educational content and events for Black History Month in the Americas
- **Indigenous engagement in Australia:** Our Australian senior leadership team completed Indigenous cultural competency training to increase their knowledge, skills and confidence working with Aboriginal and Torres Strait Islander people and communities, with a view to building cultural competency within our business and beginning our reconciliation journey
- **Flexible Work:** After completing a rapid transition to fully remote working in response to COVID-19, we established a working group called Future of Work to guide our longer-term approach to Flexible Working recognising the significant connections between flexibility, wellbeing, and inclusion for our people. The working group delivered an updated Approach to Flexible Work policy that is underpinned by flexibility and choice for all employees

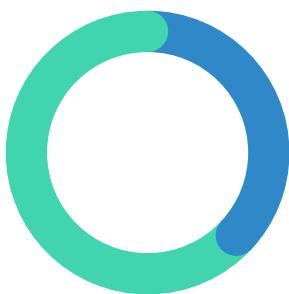
Our workforce demographics

We're committed to increasing transparency of our workforce data¹ as an important first step on our journey towards better reflecting the communities we operate in and the customers we serve. For the first time this year, we include data about age, racial and ethnic diversity.

We are committed to further understanding our global race and ethnicity profile and over the course of FY22 will develop measurable initiatives to improve our diversity.

Gender^{2, 3}

Executive leadership team



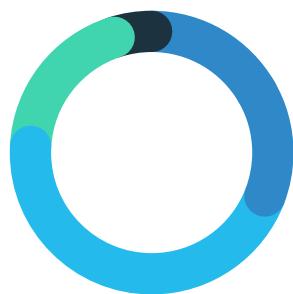
Employees



All people managers



Age³



Gender diversity statistics The proportion of women employed by Xero Limited and its subsidiaries (Xero Group) as at 31 March 2021 is shown below:¹

| At 31 March | 2021 women | 2021 men | 2021 total | 2021 % | 2020 women | 2020 men | 2020 total | 2020 % |
|------------------------------|------------|----------|--------------------|--------|------------|----------|--------------------|--------|
| Directors | 3 | 5 | 8 | 38% | 3 | 4 | 7 | 43% |
| Leadership team ⁴ | 5 | 3 | 8 | 63% | 5 | 7 | 12 | 42% |
| Employees | 1,535 | 2,093 | 3,650 ³ | 42% | 1,292 | 1,743 | 3,047 ³ | 42% |

¹ Gender and age data covers our global workforce. Race & ethnicity data is provided for countries where the majority of employees have answered an optional race/ethnicity question in Workday, our human resources information system. All data is self-reported, as at 31 March 2021.

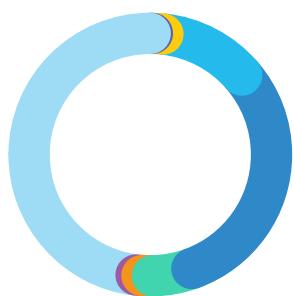
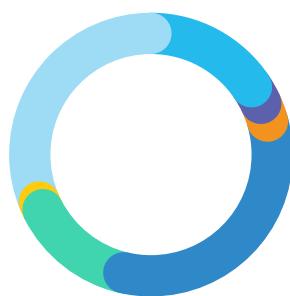
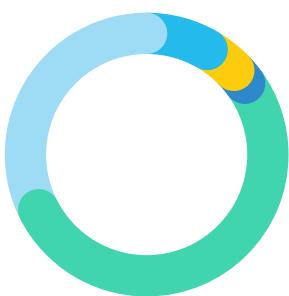
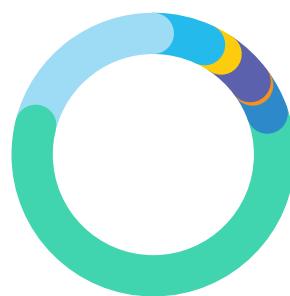
² Xero has an optional gender identification question that allows employees to choose from the following options: female, male, gender diverse, non-binary, none of the options offered and prefer not to say. Where employees have selected non-binary, gender diverse, none of the options offered or prefer not to say, their responses are included in the total. 42 employees (1.1%) were excluded from the total because they have not responded to the gender identification question.

³ These figures include permanent full-time, permanent part-time, fixed-term, casual employees and interns, and do not include contractors.

⁴ Xero's leadership team is defined as the CEO and all senior executives who report directly to the CEO. During FY21, our four regional leaders (who identify as male) became direct reports to the Chief Customer Officer. This reduced the number of direct reports to the CEO from 11 to 7 and increased the percentage of women on our leadership team. The number of women on the leadership team remained unchanged.

WGEA report notification Xero's Australian subsidiary, Xero Australia Pty Limited, submits an annual Workplace Gender Equality Report under the Australian Workplace Gender Equality Act 2012 (available once published on WGEA's website at www.wgea.gov.au).

Race & ethnicity¹

Australia²New Zealand³United Kingdom⁴United States⁵

¹ Gender and age data covers our global workforce. Race & ethnicity data is provided for countries where the majority of employees have answered an optional race/ethnicity question in Workday, our human resources information system. All data is self-reported, as at 31 March 2021.

² Categories in this donut broadly reflect the Australian Bureau of Statistics Standard Classification of Cultural and Ethnic Groups, 2019

³ Categories in this donut broadly reflect the Stats NZ Ethnicity Standard Classification, 2005

⁴ Categories in this donut broadly reflect the UK Government's harmonised list of ethnic groups, 2011

⁵ Categories in this donut broadly reflect US Equal Opportunity Employment Commission EEO-1 reporting categories

⁶ Aboriginal and Torres Strait Islander peoples are the First Peoples of Australia

⁷ Includes people who selected any of these descriptors in Workday: North African, Sub-Saharan African

⁸ Includes people who selected any of these descriptors in Workday: North-East Asian, South-East Asian, Southern and Central Asian

⁹ Includes people who selected any of these descriptors in Workday: North-West European, Southern and Eastern European

¹⁰ Includes people who selected any of these descriptors in Workday: Australian South Sea Islander, Oceanian Other

¹¹ Includes people who have not answered the race/ethnicity question in Workday, or who selected "None of the options offered" or "Prefer not to say"

¹² Includes people who selected any of these descriptors in Workday: Asian - Chinese / Indian / Other

¹³ Māori are the tangata whenua, the Indigenous people, of New Zealand

¹⁴ New Zealanders of European descent may also self-identify as Pākehā

¹⁵ Includes people who selected any of these descriptors in Workday: Asian - Bangladeshi / Chinese / Indian / Other / Pakistani

¹⁶ Includes people who selected any of these descriptors in Workday: Black - African / British

¹⁷ Includes people who selected any of these descriptors in Workday: Mixed - White & Asian / White & Black Caribbean / Other

¹⁸ Includes people who selected any of these descriptors in Workday: White - British / Irish / Other / Other European

Evaluation of the Board

On an annual basis, the Board, with assistance from the Nominations Committee, reviews and evaluates its performance (including against the requirements of the Board Charter) and the performance of Committees and individual directors.

These performance reviews are conducted both internally and, on a periodic basis, externally with the assistance of a facilitator. The Board conducted an internal performance review during FY21. This review evaluated Board, Committee, and individual director performance.

The Board, with guidance from the Nominations Committee, determines the size and composition of the Board, and the appointment, re-election or retirement of directors. A director does not participate in the decision regarding their own election or re-election.

After considering a number of factors, including the results of the performance reviews, the Board determines whether to endorse the directors who will stand for re-election at the Annual Meeting. Information relevant to the election or re-election of directors at an Annual Meeting, including their professional experience and all other material information relevant to a decision on whether or not to elect or re-elect a director, is included in the Notice of Meeting distributed each year in advance of the Annual Meeting.

Evaluation of the leadership team

The Chair of the Board, with support from the P&R Committee, reviews and makes recommendations on the performance evaluation of the CEO. The CEO, with oversight from the P&R Committee, reviews and makes recommendations on the performance evaluation of the rest of Xero's leadership team.

The performance of Xero's leadership team is reviewed annually. Performance reviews are conducted by assessing each executive's performance against specific and measurable quantitative and qualitative performance criteria. The assessment is then discussed with the P&R Committee. The performance criteria against which the executives are assessed are aligned with the financial and non-financial objectives of Xero.

Performance reviews for Xero's leadership team took place for FY21 in accordance with this process. The remuneration outcomes resulting from the performance reviews for the CEO and Chief Financial Officer (CFO) are detailed in pages 73 to 92 of this Annual Report in the Remuneration Report.

Principle 2: Structure the board to be effective and add value

Nominations Committee

Charter The Nominations Committee Charter sets out the Nominations Committee's role to, in summary, assist the Board in relation to Board and Committee size, composition, performance evaluation, succession planning, and director and CEO appointment. The Nominations Committee Charter is available on Xero's website at www.xero.com/about/investors/governance/.

The Nominations Committee Charter provides that the Committee will consist of a majority of independent directors, be chaired by an independent non-executive director, and have at least three members. The Committee composition meets these requirements. The Committee meets at least four times per year and all directors have a standing invitation to attend its meetings.

Details about the Nominations Committee membership and meeting attendance are set out under Principle 1 on page 58.

Responsibilities The Nominations Committee's duties and responsibilities include:

- Regularly reviewing and making recommendations to the Board as to the size and composition of the Board and its Committees
- Overseeing the search for, and selection of, new directors for nomination for appointment by the Board
- Making recommendations to the Board regarding the appointment of the CEO, as well as the nomination of directors for election or re-election by shareholders
- Overseeing and regularly reviewing an appropriate director induction program, as well as considering the professional development needs of directors and ensuring they have access to ongoing professional development as required
- Overseeing the regular assessment of, and making recommendations to the Board as to, the independence of each director and associated disclosures
- Developing succession plans for the Board to maintain an appropriate mix of skills, knowledge, experience, independence, and diversity

Director appointment In selecting and appointing new directors, the Board identifies and considers qualified potential candidates with the appropriate mix of skills, knowledge, experience, diversity, and independence that the Board and Committees are seeking to achieve, and the time commitment required from non-executive directors.

Suitable candidates are appointed by the Board and hold office until Xero's next Annual Meeting, where they are then eligible for election.

The director skills matrix was reviewed and updated following the appointment of additional directors in FY21 and the table below summarises the directors' relevant skills, and the Board is satisfied that the skills matrix demonstrates that the Board has the appropriate mix of skills and experience necessary to oversee the governance and operations of Xero.

| Capability | Number of directors with the capability | |
|--|--|-------------------|
| | High capability | Medium capability |
|  Cloud, online, and financial platforms Expertise in business software and delivering solutions at scale through SaaS, cloud and platforms | 3 | 4 |
|  Digital product management and marketing Digital product expertise with extensive expertise across technology trends, and implications and the software and technology product value chain | 2 | 5 |
|  Strategy and development Corporate strategy and development including M&A and strategic partnerships | 8 | - |
|  Go-to-market and customer experience Deep customer insight and advocacy. Go-to-market expertise including direct sales, internet sales and new markets, and specific customer channel experience | 6 | 2 |
|  Financial expertise Financial expertise with deep public company experience in finance, accounting, planning and investor relations | 2 | 5 |
|  International markets Exposure to at least two of Xero's key international markets (Asia, Americas, EMEA, New Zealand and/or Australian markets) | 2 | 6 |
|  Listed company governance; risk Depth of expertise in listed company governance, compliance and risk management | 4 | 4 |
|  People and culture Remuneration, workforce planning, talent, culture, and diversity and inclusion | 7 | 1 |

Independence

Xero considers a director to be independent when they are a non-executive director who is independent of management and free of any business or other relationship that could materially interfere with (or could reasonably be perceived to materially interfere with) the independent exercise of their unfettered judgement, having regard to the best interests of Xero as a whole.

In the context of director independence, ‘materiality’ is considered from both a Xero and an individual director perspective.

The Board makes an assessment of the independence of each director upon their appointment and annually thereafter. Directors are required to disclose to the Board relevant personal interests and conflicts of interest on an ongoing basis. In accordance with the definition of independence above, and having regard to the relevant factors listed in the ASX Principles and Recommendations, the following directors of Xero are considered to be independent:

- David Thodey (Chair)
- Steven Aldrich (Commenced 1 October 2020)
- Mark Cross
- Lee Hatton
- Dale Murray
- Susan Peterson

The length of service of each director is ascertainable from the information on pages 55 and 56 of this Annual Report.

Board composition and Chair

The Board Charter states that the Board will consist of a majority of independent non-executive directors. The Chair of Xero, David Thodey, is assessed as an independent non-executive director. The Chair’s role is to, in summary, lead the Board, facilitate constructive discussion at Board meetings, and ensure that the Board functions effectively and communicates the Board’s position to shareholders.

Board diversity and tenure

As at 31 March 2021

| Tenure | Gender | Location | Race & Ethnicity |
|-------------------------------|----------------------------|------------------------|---|
| 0-3 years 37.5% (3 directors) | Male 62.5% (5 directors) | NZ 37.5% (3 directors) | 100% White and/or European heritage (includes one director who also identifies as Pākehā (a New Zealander of European descent)) |
| 3-6 years 25% (2 directors) | Female 37.5% (3 directors) | AU 37.5% (3 directors) | |
| 6-9 years 12.5% (1 director) | | UK 12.5% (1 director) | |
| 9+ years 25% (2 directors) | | US 12.5% (1 director) | |

Induction

All new Board members are given appropriate induction to enable them to gain an understanding of Xero, its values, its people, and customers, its operations, its financial, strategic, and risk management position, and the rights, duties and responsibilities of the Board, its Committees, and management. In addition, ASX Listing Rules training is provided to Board members when they join the Board. Each new Board member has the opportunity to meet with existing Board members, Xero’s leadership team, and relevant members of the senior management team. All Board members are expected to maintain the skills required to discharge their respective roles, and are supported in this with access to training and professional development opportunities identified and overseen by the Nominations Committee.

Principle 3: Act ethically and responsibly

Code of Conduct

Xero has a Code of Conduct (the Code), which applies to all directors, officers, employees, contractors, and consultants of the Xero Group. The Code details Xero's standards and values and sets out expectations for behaviour and conducting business at Xero. The Code is underpinned by Xero policies, some of which are global and some of which are country specific, and include topics covering safety and wellbeing, respect and consideration, and workplace behaviour. The Code also sets out Xero's zero-tolerance approach to bribery, facilitation payments, and corruption in any form. The Board is informed of any material breaches of the Code.

The Code is available on Xero's website at <https://www.xero.com/about/investors/governance/> and is also made available to employees via Xero's intranet.

Whistleblower Policy

Xero has a Whistleblower Policy, which applies to everyone who currently works or formerly worked at any entity in the Xero Group (including all directors, officers, employees, contractors, consultants, volunteers, interns, casual workers, and agency workers) and to any current or former supplier of goods or services (whether paid or unpaid) to any entity in the Xero Group (and their employees). The policy also applies to the relatives, dependants, or spouses of any of those people. The policy aims to encourage a culture of openness and accountability within the Xero Group. It includes topics such as the types of concerns that can be raised, how to raise concerns, how whistleblowers will be protected and supported, and how Xero will investigate and deal with any concerns that are raised. The Board is informed of any material concerns reported under the policy.

The policy is available on Xero's website at <https://www.xero.com/about/investors/governance/> and is also made available to employees via Xero's intranet along with supporting information specific to relevant regions.

Modern Slavery and Human Trafficking Statement

Xero has published a statement (on behalf of itself and Xero Australia Pty Limited under Australia's Modern Slavery Act 2018 (Cth) and on behalf of itself and Xero (UK) Limited under the United Kingdom's Modern Slavery Act 2015) setting out the actions that it has taken to understand potential modern slavery risks related to its business and supply chains and to implement steps to prevent slavery and human trafficking.

This statement is available on Xero's website at www.xero.com/about/investors/governance/.

Principle 4: Safeguard integrity in corporate reporting

Audit and Risk Management Committee

Purpose The ARM Committee Charter (the ARM Charter) sets out the ARM Committee's role to, in summary, assist the Board in relation to financial reporting principles and policies, integrity of Xero's financial statements, audit functions, internal control processes, risk management, and legal and regulatory compliance. The ARM Charter is available on Xero's website at www.xero.com/about/investors/governance/.

The ARM Charter sets out that the Committee will:

- Consist of non-executive directors
- Be chaired by an independent director who is not the chair of the Board
- Have at least three members, a majority of whom are independent
- Be composed of members who are financially literate
- Have at least one member with accounting or related financial management expertise

The Committee composition meets these requirements. The Committee meets at least four times per year and all directors have a standing invitation to attend its meetings.

Details about ARM Committee membership and meeting attendance are set out under Principle 1 on page 58, and ARM Committee members' qualifications can be found at pages 55 and 56.

Responsibilities The ARM Committee is responsible for providing recommendations and advice to the Board on areas including:

- Reviewing financial statements and financial forecasts intended for external publication and the results of the half-year review and full-year audit
- Reviewing Xero's corporate and financial reporting and disclosure processes, as well as Xero's accounting policies and financial reporting practices
- Overseeing the effectiveness of the accounting and internal control systems
- Appointment, reappointment, removal, and remuneration or replacement of the external auditor as well as approving and reporting annually on the fees for and terms of the external auditor's engagement, and on the scope and adequacy of the audit plan of the external auditors
- Reviewing and reporting on the overall adequacy and effectiveness of relevant internal controls, processes, and compliance

- Approving and reviewing the structure of the Assurance function, the scope and adequacy of the program of work, and reviewing significant assurance findings and action taken by management to address these
- Annually assessing and reviewing the overall adequacy and effectiveness of Xero's risk management framework to satisfy itself that it continues to be sound and that Xero is operating with due regard to the risk appetite set by the Board, the methodology and processes for identifying, assessing, monitoring, and managing financial and non-financial risks, and the risk appetite

Reporting The Chair of the ARM Committee communicates the findings of the Committee to the Board at the next Board meeting.

To ensure that the external auditor remains independent at all times, non-audit work is authorised by the ARM Committee.

Xero is committed to ensuring that the external auditor carries out its function independently and has adopted an Auditor Independence Policy. The policy requires that the senior audit partner must be rotated at least every five years. The senior audit partner responsible for the FY21 audit commenced as Xero's audit partner in the FY21 financial year. The policy also requires the external auditor to confirm annually that it has complied with all professional regulations relating to auditor competency and independence.

The external auditor will attend and be available to answer shareholder questions at Xero's Annual Meeting.

Declaration regarding financial statements

As a New Zealand domiciled company, section 295A of the Australian Corporations Act 2001 (Cth) is not applicable to Xero. However, the CEO and CFO provide written statements to the Board in accordance with the ASX Principles and Recommendations, in respect of Xero's half and full year reporting periods. These statements confirm whether, in their opinion:

- The financial records of Xero have been properly maintained;
- The financial statements comply with the appropriate accounting standards;
- The financial statements give a true and fair view of the financial position and performance of Xero.

The CEO and CFO also confirm to the Board that their view is founded on the basis of a sound system of risk management and internal control which is operating effectively in all material respects.

Principle 5: Make timely and balanced disclosure

Continuous Disclosure Policy

Xero's Continuous Disclosure Policy describes the key obligations of the Board and Xero's leadership team to ensure that Xero complies with its disclosure obligations under the ASX Listing Rules. The Continuous Disclosure Policy applies to all directors and employees of Xero or any Xero group company, as well as any contractor, consultant, or other person who has agreed to comply with Xero's policies.

The Board is responsible for compliance with Xero's continuous disclosure obligations and has established a Disclosure Committee, comprising the CEO, the CFO, and the Chief Legal Officer & Company Secretary to support this primary responsibility and provide assurance. Xero's Chief Legal Officer & Company Secretary is primarily responsible for overseeing and coordinating all communications with the ASX, and is the Disclosure Officer for the purpose of the policy. Any briefing or presentation materials that contain price sensitive information will be released to the ASX before being communicated outside Xero. The Board receives copies of all material Market Releases as soon as possible after they have been released to the market.

Xero's Authorised Representatives, being those persons authorised to speak on behalf of Xero to major investors and analysts, include the Chair, the CEO, the CFO, the Executive General Manager of Investor Relations, the Executive General Manager of Communications, the General Manager of Corporate Communications, or their respective delegates, and any other person authorised by the CEO.

Xero's Continuous Disclosure Policy is available on the Xero website at www.xero.com/about/investors/governance/.

Principle 6: Respect the rights of security holders

Shareholder communication

Investor Centre Xero's website has a dedicated Investor Centre. This provides important information about Xero and its governance that is relevant to Xero's shareholders. Xero's Investor Centre includes:

- Xero's Board and Committee Charters, policies, and Constitution
- Profiles of Xero's directors and leadership team
- ASX Market Releases
- Half and full year financial results and investor presentations
- Links to live webcasts or conference calls for the financial results and other investor briefings
- Key upcoming dates in the financial calendar
- Historical financial reports and share price
- Details of Xero's share registrar, Link Market Services Limited
- An online form to enable investors to send enquiries directly to the Xero investor relations team

Xero's media releases can be found in the media section of the Xero website at <https://www.xero.com/about/media/announcements/>.

Annual Report and other shareholder communications

Alongside the publication of half and full year results, Xero's Annual Report is made available to shareholders electronically (and by post when elected) and includes relevant information about the operations of Xero and other required disclosures. Each shareholder also receives a Notice of Annual Meeting, inviting them to attend and participate in Xero's Annual Meeting.

Shareholders may elect to receive communications from, and send communications to, Xero and its share registry electronically.

Investor relations program

Xero has an investor relations function which operates a comprehensive and active investor relations program. The program supports Xero's commitment to ensure its shareholders receive important information in a timely and effective manner and facilitates regular dialogue with investors. Activities undertaken as part of the investor relations program include:

- Post-result and ad hoc meetings with institutional investors and analysts
- Attendance at a range of domestic, regional, and global investor conferences

- Pre-Annual Meeting engagement with our largest beneficial interest holders and the primary governance advisory bodies
- Engagement with the retail investor community through close involvement with shareholder associations

Annual Meeting

Xero encourages shareholders to attend our Annual Meeting and to ask questions of the Chair, Board, CEO, CFO and other attending members of Xero's leadership team:

- Shareholders are notified of the Annual Meeting in advance of the meeting in accordance with regulatory requirements
- Shareholder voting is conducted via a poll, and shareholders may vote electronically or by proxy
- Xero moved to a fully virtual Annual Meeting in FY20 in response to COVID-19. The meeting was held via an online platform provided by Xero's share registrar, Link Market Services Limited. Shareholders were able to watch the meeting live, vote, and ask questions online
- Xero's FY21 Annual Meeting will be fully virtual via an online platform provided by Xero's share registrar, Link Market Services Limited
- Noting the geographical spread of its shareholders, Xero carefully plans the timing and format (including accommodating virtual attendance) of its Annual Meeting to allow as many shareholders as possible to attend and participate

Principle 7: Recognise and manage risk

Risk Management Governance and Audit and Risk Management Committee

As mentioned under Principle 4 on page 68, the Board has established an ARM Committee that operates under the ARM Charter, which is available on Xero's website.

Risk management oversight and accountability is an integral part of Xero's overall governance and the Board has ultimate accountability for risk management, which includes ensuring that material risks facing Xero have been identified and that adequate controls, monitoring, and reporting mechanisms are in place and operating effectively. The ARM Committee assists the Board with its oversight of risk management, audit, and compliance.

The ARM Committee operates in accordance with the ARM Charter, which sets out its responsibilities for monitoring Xero's risk management, including how Xero identifies, assesses, and controls strategic, operational, and financial risks within the Board approved risk appetite. This is designed to ensure the adequacy and effectiveness of Xero's ongoing risk management program, including policies and guidelines relating to corporate governance, legal, regulatory and ethical compliance, business continuity management, data privacy, and information systems security.

Enterprise Risk Management framework

Xero has an enterprise risk management framework that is managed by the CFO and overseen by the ARM Committee.

There are several components to Xero's risk management framework including

- Policies and procedures covering key financial and non-financial risks
- Guidelines and limits for approval of all expenditure, including capital expenditure and investments
- Various strategic governance forums whose purpose includes oversight of key areas of risk, including the Security Governance Group and the Data Use and Governance Group
- Due diligence processes for M&A activities

A key component of Xero's risk management framework is the regular review of key risks and opportunities by Xero's leadership team. The Xero Group risk profile was developed, and continues to be reviewed and refined, through a series of workshops and discussions involving Xero's leadership team, senior management, and operational specialists.

The identified risks are included in a risk radar for review according to the key risk categories, which include strategic, operational, legal and compliance, financial and emerging risks. The risk radar is reviewed with each member of Xero's leadership team at least twice per year. Risks lying outside the boundaries of Xero's agreed risk appetite require proactive mitigation and include ongoing action plans, which are tracked and monitored on a periodic basis by Xero's leadership team.

Management of economic, environmental, and social sustainability risks

There are a number of risks that could materially impact Xero. As part of Xero's risk management process, Xero has identified and assessed those areas of risk that may impact the business. Effective monitoring and mitigation of these risks supports Xero's ongoing growth and protects returns.

The enterprise risk framework covers a broad range of financial and non-financial risks. Pages 33 and 35 of this Annual Report highlight a range of key risks including economic, environmental, and social sustainability related risks and how Xero manages or intends to manage those risks.

Xero operates in an online environment, with its operational model being primarily desk-based employees. Accordingly, Xero's direct environmental footprint is relatively small and is made up largely from the energy used in its offices, third-party data centres, and from the typical consumables of an online, desk-based business. However, we acknowledge that how we conduct our business has an impact on a range of stakeholders, the communities in which we operate, and on the environment more broadly.

We recognise the importance of climate change, which is included as a risk within our enterprise risk radar. We are working towards alignment with the Task Force on Climate-related Financial Disclosures which will provide additional insights on risks and opportunities, and allow us to drive further risk management focus across this key area of risk.

More information about our approach to social and environmental impact is available on pages 23 to 32 in this report and on Xero's website at www.xero.com/about/social-and-environmental-impact.

Review of risk appetite and risk framework

The ARM Committee reviews Xero's risk management framework at least annually to satisfy itself that it continues to be sound and that Xero is operating with due regard to the risk appetite set by the Board

The ARM Committee also reviews and approves the risk appetite parameters, and reviews the risk radar at least twice per year to ensure it has oversight of status, understands key changes, and monitors key mitigation action plans. The ARM Committee also receives risk 'deep-dive' updates on key risk areas.

The ARM Committee engaged an external provider to review Xero's risk management framework during FY21 and, based on the findings from that review, considered the current framework to be sound. In line with the desire to continually improve our risk management framework and ensure it evolves with the continued growth of the business, further investment in people, processes, and technology will be made in the coming year.

Principle 8: Remunerate fairly and responsibly

Internal audit

Xero has an internal Assurance function which provides independent and objective assurance and advice on Xero's organisational governance, risk management and internal control processes. The Assurance function assists the business in understanding and managing risk and provides confidence that the key elements of the business that are relied on to manage risk are in place and working effectively.

To maintain independence, the Executive General Manager of Risk and Assurance has a functional reporting line to the Chair of the ARM Committee (day to day reporting is to the Chief Financial Officer) and regularly meets with the Chair without other management present. The Head of Assurance reports to the Executive General Manager of Risk and Assurance and also has direct access to the Chair of the ARM Committee. The Assurance function develops an assurance plan which is approved by the ARM Committee twice per year. The ARM Committee receives and reviews reports regarding assurance activity undertaken and, through these reports, monitors the progress of management action plans.

People & Remuneration Committee

Charter The P&R Committee Charter (the P&R Charter) sets out the P&R Committee's role to, in summary, assist the Board in relation to overseeing the human resources activities of Xero, including overseeing strategies and policies relating to organisational structure and culture, remuneration, employee performance and development, and succession planning of Xero's leadership team (other than the CEO). The P&R Charter is available on Xero's website at www.xero.com/au/about/investors/governance/.

The P&R Charter provides that the Committee will consist of a majority of independent directors, be chaired by an independent non-executive director, and have at least three members. The Committee composition meets these requirements. The Committee meets at least four times per year and all directors have a standing invitation to attend its meetings.

Details about P&R Committee membership and meeting attendance are set out under Principle 1 on page 58.

Responsibilities The P&R Committee's duties and responsibilities include:

- Overseeing appointment, termination, performance, and succession planning of Xero's leadership team (other than the CEO)
- Reviewing and recommending to the Board Xero's remuneration strategy, structure and policy, and short and long-term incentive plans, including amendments to such plans and other material employee benefits
- Making annual recommendations to the Board about measurable objectives for achieving diversity and assessing the effectiveness of the Diversity and Inclusion Policy, measurable objectives for diversity and the progress toward achieving them

More information about the P&R Committee and Xero's approach to remuneration, including details of remuneration paid to directors (executive and non-executive) are set out in the 2021 Remuneration Report on pages 73 to 92 of this Annual Report. The Remuneration Report also contains information on Xero's policy for determining the nature and amount of remuneration for directors and senior executives.

Xero's Share Trading Policy prohibits employees and directors from entering into transactions that are intended to hedge or otherwise limit the economic risk of unvested or restricted Xero securities.

A copy of Xero's Share Trading Policy is available on Xero's website at www.xero.com/au/about/investors/governance/

Remuneration Report

In this report

| | |
|--|-----------|
| 1. Introduction | 74 |
| 2. Remuneration strategy | 76 |
| 3. Xero's performance | 79 |
| 4. Remuneration outcomes overview | 80 |
| 5. Directors and senior executives | 80 |
| 6. Remuneration governance | 81 |
| 7. Key remuneration components for the CEO and CFO | 82 |
| 8. STI outcomes in detail | 87 |
| 9. CEO and CFO remuneration | 88 |
| 10. CEO and CFO employment conditions | 89 |
| 11. Non-executive director remuneration | 89 |
| 12. Our team's remuneration | 91 |

1. Remuneration

Our Xero team faced many unexpected and serious challenges as a result of the COVID-19 global pandemic. Everyone across our business worked tirelessly to support our customers, while always prioritising the wellbeing of our team.

Despite this difficult backdrop, our business delivered continued strong momentum in Australia and New Zealand together with an impressive recovery in our international markets. These results are a credit to our team, our customers and our partners, who have demonstrated incredible resilience. We couldn't be more grateful for the incredible effort of all involved.

Our People and Remuneration Committee (P&R Committee) worked even more closely with our leadership team as the impact of the pandemic was felt. We prioritised the health and wellbeing of our people as we closed our offices in every region and rapidly adjusted to supporting new and emerging needs of our customers and partners across the globe.

Some of the ways in which we helped our people included:

- Providing a monetary allowance to purchase equipment to set up safely and ergonomically at home
- Ensuring all people leaders were supported with training to lead and support their teams remotely
- Increasing our internal communications to ensure that we were staying connected while working from home, and providing the information that our team needed, when they needed it
- Appointing a Global Head of Wellbeing to lead programs to promote the wellbeing of our global team, with a focus on their psychological needs
- Launching a wellbeing hub for our team and their families, including a wellbeing kit to help with mental health and keeping active
- Ensuring our #human value was amplified by increasing our use of video technology to host personal health and wellbeing and coaching sessions

During the early stages of the pandemic, a period of heightened uncertainty for our business, we made the decision to defer a number of planned initiatives including the annual remuneration review, grant of executive options, and setting of incentive-related performance targets.

As our offices closed, our teams took on the challenge of accelerating delivery while working remotely. The outstanding work delivered across the business from customer-facing, product and technology delivery, and corporate services teams, was integral in delivering Xero's financial performance.

During calendar year 2020, Xero's product and technology teams collectively doubled the number of back and front end application updates, even with the disruptions of COVID-19 and our people moving to work remotely. Our people experience team managed the largest ever increase in our people, adding over 550 full-time equivalent team members over the year. A large proportion of the new hires joined our team with remote set-up, onboarding, and induction.

As the year progressed and businesses across the globe settled into new ways of working, the P&R Committee reconsidered the performance targets and the remuneration initiatives that had initially been deferred. The P&R Committee also prioritised the need for fair recognition and reward of our Xero team as the competition for technology talent intensified across the globe.

As such, the remuneration review that had been paused earlier in the financial year was completed and, when and where appropriate against market benchmarks, salary increases were granted.

Our approach to reward and recognition is designed to support Xero's purpose, values, and the successful delivery of our strategy. This is key to our remuneration philosophy and practices.

This Remuneration Report outlines the principles and structure of Xero's remuneration of its directors and executives (being the CEO and direct reports of the CEO), with particular focus on the CEO Steve Vamos and CFO Kirsty Godfrey-Billy. We also provide details on the relationship between remuneration, Xero's FY21 performance, and shareholder outcomes.

In the interests of providing greater transparency and insight into our remuneration practices, this report goes beyond what we are required to disclose as a New Zealand incorporated company. As always, we welcome feedback on this evolving report.

1.1 Key developments in FY21

1.1.1 Xero's performance and short-term incentive (STI) outcomes

Xero achieved record subscriber growth in the second half of FY21, to achieve our strongest half-year period ever. In FY21, EBITDA, net profit and free cash flow increased strongly compared to FY20. This reflects top-line growth together with close management of expenses and considered capital allocation.

This performance is reflected in the outcomes against STI targets for the CEO and CFO. Both executives earned an STI award for FY21 of 110% of target (being 90% of maximum).

1.1.2 Review of remuneration structure

Each year Xero reviews its executive remuneration strategy and structure to ensure it is aligned to our strategic objectives and is fit for purpose. Two changes resulted from the most recent review completed during FY21. The first involved rebalancing executive remuneration by changing the mix of long-term equity (LTE), base salary, and STI components for both the CEO and executives. These changes capture Xero's continued evolution from its start-up origins to a global technology company, where competitive remuneration is an important factor in attracting and retaining executive talent.

The second change was the introduction of a new annual LTE plan. The new plan replaces the FY19 executive block options plan that involved a one-off grant of options vesting over one to four years, depending on grant date and the start date of new executives.

Under the new LTE plan, option grants will be made each year and vest in full, three years from May in the year options were granted. The move to an annual grant cadence helps to provide Xero, together with existing and future executives, a more dynamic and flexible form of long-term incentivisation.

Consideration was also given to an alternative equity vehicle or award structure. However the Board determined that the LTE plan has been effective in motivating, rewarding, and retaining executives to deliver against longer-term strategy and sustained shareholder value creation.

The new LTE plan provides alignment between shareholder and executive outcomes and incentivises long-term value creation. Options are granted with an exercise price based on the share price at the time (based on the 30-day volume weighted average price ("VWAP")), with the value in options for executives only being realised if the share price exceeds the exercise price set at the grant date.

The LTE remains subject to malus and clawback provisions, as outlined in section 2.4, and further details on the LTE plan are outlined in section 7.5.

As we grow and scale, we will continue to review the structure of our executive remuneration regularly to ensure we attract and retain the best global talent and remain market competitive.

1.1.3 Equity grants

During FY21, in addition to our annual remuneration strategy and structure review, we continuously monitored the appropriateness of our remuneration approach and outcomes in light of the challenges and uncertainties of COVID-19. Being conscious of the need for disciplined cost management, Xero decided it was appropriate to defer the FY21 LTE options grant scheduled to take place in May 2020, until October 2020. This action resulted in a significantly higher exercise price and fewer options being granted to executives than would have otherwise been the case.

1.1.4 Remuneration review outcomes

The monitoring of our approach to remuneration in FY21 also resulted in the P&R Committee deciding it was appropriate to postpone the planned review of executive remuneration, scheduled to take place in April 2020, until October 2020. Using market peer data, the remuneration review showed the CEO's target total remuneration was considerably lower than benchmark. In response, the LTE component of the CEO's target remuneration was increased while his base salary and target STI remained unchanged. As a result of the changes outlined in 1.1.2, the CFO's remuneration package was rebalanced to reduce the LTE component and increase the base salary and STI components.

There were no changes to the fees paid to non-executive directors during FY21. However, a scheduled review of the fee structure and fees paid began late in FY21, with any proposed changes to take effect in FY22.

2. Remuneration strategy

2.1 Our purpose and values

Xero's purpose is to make life better for people in small business, their advisors, and communities around the world. This purpose is underpinned by five values that are fundamental to everything we do, including our approach to remuneration and reward.

- Remuneration comprises a fixed and variable component, and Xero's variable remuneration structured to ensure simplicity
- STI for executives includes 'voice of customer' and 'voice of employee' metrics
- STI outcomes for executives are finalised having regard to Xero's values
- The Board has discretion to reduce or change deferred STI and LTE outcomes, to ensure no unfair benefit is obtained by the executive (see 2.4 below)

Xero's remuneration framework is designed to attract, inspire and retain best-in-class talent through a structure that:

- Ensures alignment with business strategy
- Supports sustainable long-term value creation for shareholders and other stakeholders
- Supports appropriate risk-taking and risk management

|  |  |  |  |  |
|---|--|--|---|--|
| #Human | #Challenge | #Team | #Ownership | #Beautiful |
| Xeros are authentic, inclusive and really care Kind and assume best intent Inclusive, approachable and show empathy Are willing to be vulnerable, share fears, failures and learnings | Xeros dream big, lead and embrace change Are curious and think big Welcome challenging conversations and do it with respect Lead and embrace change, seeking new and better ways | Xeros are great team players Champion Xero's purpose and priorities Work together to do what's best for Xero and our customers Appreciate and celebrate each other and success | Xeros deliver on our commitments Do what we say we will do Own our mistakes and take positive action Move fast to get the right things done | Xeros create experiences that people love Create experiences that inspire and delight Do high-quality work Go the extra mile |

2.2 Remuneration principles

As a global technology company, Xero is dependent on highly skilled, specialist team members to execute our strategy. Our ability to attract, retain, reward, and motivate our people is fundamental to our long-term success.

Our executive remuneration framework has been carefully and purposefully developed to enable this by offering:

- Fixed remuneration competitive with the market
- Short-term incentives based on challenging individual and company-wide targets, with a deferred equity component
- An options-based equity plan that is aligned with Xero's strategy, ensuring a focus on execution and long-term value creation

The relatively high proportion of equity within the remuneration structure, and the use of options as the equity instrument, continues to help ensure we attract highly skilled people. It also aligns executive performance with shareholder interests and rewards the effective execution of Xero's strategic plan over a multi-year period. The following summarises each remuneration principle and how it is reflected in our remuneration structure:

Alignment: A significant proportion of executive remuneration is contingent on share price, ensuring Xero executives receive rewards that mirror shareholder outcomes.

Fairness: Market competitive, up-front cash-based remuneration is balanced by equity remuneration with significant potential upside.

Collaboration: Performance conditions attached to STI are largely company-wide focused, with a less significant individual component. Collaboration is key to the way we work; hence performance metrics are focused on this. Significant equity components emphasise the value of delivering on Xero's company-wide strategic objectives, which are intended to drive long-term shareholder value. Xero's people must collaborate to earn personal rewards.

Simplicity: There are no complicated LTE performance measures that require extensive explanation or to which the executives do not have a direct line of sight – the structure simply incentivises long-term value creation. STI performance measures are aligned with the voices of the shareholder, customer, and employee and are clear and easily assessed.

Flexibility: Xero's short-term incentive performance measures combined with long-term options strike the right balance between ensuring that Xero executives have sufficient flexibility to respond to changing needs and circumstances, while always having regard to Xero's strategy, vision, and long-term value creation.

Incentivising appropriate risk-taking and managing risks further underpin our remuneration principles and structure. This approach to managing risk is borne out in a number of ways:

- STI measures, weightings, and targets are reviewed and approved annually by the P&R Committee and Board, ensuring oversight and independence from plan participants
- STI performance measures are calibrated to ensure they align to our values, Xero's strategy and Xero's risk appetite
- STI financial outcomes are only confirmed after audited results are finalised
- 50% of executives' STI awards are deferred for 12 months and awarded in equity rather than cash, and vesting of the equity component is subject to confirmation from the P&R Committee that no award adjustment events have occurred
- A three-year vesting period applies for annual options grants under the LTE, meaning that options are at risk and subject to malus and clawback for three years (as discussed below)
- All executive variable remuneration (being deferred STI and LTE) is subject to malus and clawback rules that allow the Board to adjust, lapse, or claw back unvested and vested awards in certain circumstances to ensure no unfair benefit is obtained by executives (see section 2.4)
- In certain circumstances, the Board is able to exercise discretion to adjust all elements of executive variable remuneration to ensure no unfair benefit is obtained by executives (see section 2.4)

Sections 7.4 and 7.5 contain further information about Xero's STI and LTE arrangements.

2.3 Remuneration structure

To foster tight alignment between the interests of executives and shareholders, Xero's executive remuneration structure is deliberately weighted to have a substantial proportion of total target remuneration at risk. A large part of this at-risk component consists of option grants, providing leverage, and an effective multi-year incentive aligned with Xero's high-growth strategy.

| Component | Description | Link to strategy and performance |
|----------------------------|---|---|
| Fixed annual remuneration | <ul style="list-style-type: none"> • Base salary • Retirement benefits (superannuation / KiwiSaver or local equivalent) | Reviewed annually based on individual skills, experience, accountabilities, performance, leadership, and behaviours. |
| Short-term incentive (STI) | <ul style="list-style-type: none"> • An at-risk component set as a percentage of base salary • Calculated based on achievement against a range of company-wide performance measures (financial and non-financial) and individual objectives • Paid after a one-year performance period (1 April to 31 March, aligned with Xero's financial year). STI comprises 50% cash and 50% deferred equity in the form of restricted stock units (RSUs). Each RSU entitles the executive to receive one Xero share on vesting. Deferred equity vests one year after grant, subject to continuing employment and confirmation that no award adjustment events have occurred | <p>Rewards delivery of key strategic and financial objectives, in line with the annual business plan, and rewards outcomes aligned to Xero's goals for growth and operational discipline.</p> <p>Organisational measures are approved by the P&R Committee and aligned with the strategic objectives of Xero.</p> |
| Long-term incentive (LTE) | <ul style="list-style-type: none"> • An at-risk component set as a percentage of base salary and granted annually to participating executives, which entitles the executive to Xero shares on vesting of the option and payment of the exercise price • Options vest in the third May following grant • New hires / promotions may be invited to participate in the annual options plan, with a pro-rata allocation to reflect their entry into the plan part way through the year • Vesting is subject to continued employment, which provides an additional time-based retention incentive. Vesting is also subject to confirmation that no award adjustment events have occurred | Rewards delivery against longer-term strategy and sustained shareholder value creation. Fosters alignment between shareholder, customer, and executive outcomes. |

2.4 Malus and clawback

All executive variable remuneration is subject to malus and clawback provisions, which apply to vested and unvested equity awards. These provisions give the P&R Committee broad discretion to adjust, lapse/forfeit, or require repayment of equity awards to ensure no unfair benefit is obtained by the executive. This is one of the ways that we embed risk management into our remuneration strategy and forms part of the P&R Committee's deliberations when considering whether to approve vest awards. Malus and clawback provisions will be relevant in a range of potential circumstances, for example where:

- An executive has acted fraudulently, dishonestly or is in breach of their obligations to Xero
- Xero becomes aware of a material misstatement in the financial statements of the Xero Group
- An executive commits an act which brings the Xero Group into disrepute
- An executive fails to perform any act reasonably and lawfully requested of that executive

2.5 Remuneration benchmarking

Executive remuneration is benchmarked to a specific S&P/ASX peer group that is determined to be similar to Xero in terms of size, scale, and operations. Each year, the peer group is reviewed and updated by Xero, in conjunction with an independent remuneration consultant. Xero's P&R Committee, in partnership with an external consultant, conducts a comparative analysis of the executive team's compensation against reported roles within that identified peer group.

3. Xero's performance

Xero's financial results over the last five years are shown below, along with STI outcomes:

| Measure | FY17 | FY18* | FY19 | FY20 | FY21 |
|--|----------------|----------------|---------------|---------------|---------------|
| Subscribers | 1,035,000 | 1,386,000 | 1,818,000 | 2,285,000 | 2,741,000 |
| Annualised Monthly Recurring Revenue | \$363,120,000 | \$484,421,000 | \$638,179,000 | \$820,557,000 | \$963,597,000 |
| Operating Revenue* | \$295,389,000 | \$406,659,000 | \$552,819,000 | \$718,231,000 | \$848,782,000 |
| Free Cash Flow* | (\$70,831,000) | (\$28,513,000) | \$6,451,000 | \$27,105,000 | \$56,946,000 |
| Average STI received as % of maximum (CEO/CFO) | 72% | 85% | 79% | 56% | 90% |

* Operating Revenue and Free Cash Flow for FY18 has been restated for changes in NZ IFRS 9, NZ IFRS 15, and NZ IFRS 16. FY17 has not been restated.

Xero's share price, total shareholder return, the S&P/ASX100 index return and STI outcomes over the last five years are shown below:

| Measure | FY17 | FY18 | FY19 | FY20 | FY21 |
|--|--------|--------|--------|---------|--------|
| Xero Share Price (AU\$)* | 18.10 | 33.44 | 48.65 | 67.91 | 126.53 |
| Xero Total Shareholder Return | 29.75% | 84.75% | 45.48% | 39.59% | 86.32% |
| ASX100 Total Shareholder Return | 22.78% | 3.08% | 14.16% | -12.60% | 33.03% |
| Average STI received as % of maximum (CEO/CFO) | 72% | 85% | 79% | 56% | 90% |

* Closing price for the last trading day in the financial year

4. Remuneration outcomes overview

Headline remuneration outcomes for Xero's CEO and CFO are disclosed in the graph below on a realisable basis for FY21, including:

- Fixed annual remuneration
- Realisable cash and deferred RSU STI awarded based on FY21 performance: 50% is paid in cash and 50% deferred into RSUs. Deferred RSUs are expected to be granted in May 2021 and vest in May 2022, subject to continued service and malus and clawback provisions. The number of RSUs granted is dependent on the share price at grant: 110 percent of target STI (90 percent of maximum) was awarded to each the CEO and CFO
- Value of the CEO's one-off performance-based RSUs that vested during FY21: based on FY19 performance measures, the second of three tranches of 6,794 RSUs vested during FY21
- Value of the CFO's options that vested during FY21: 20,000 options from a legacy grant in FY17 vested for the CFO during FY21, and 33,332 options from the FY19 executive block options grant



Further details on the CEO's and CFO's STI outcomes are outlined in section 8.

Further details on the CEO's and CFO's other remuneration elements and outcomes for the FY21 year are outlined in section 9.

5. Directors and senior executives

This report focuses on the remuneration of Xero's directors, CEO and CFO in FY21 as identified in the table below.

| Country of residence | Position | Period position was held during the year |
|--------------------------------|----------------|--|
| Executive | | |
| Steve Vamos | New Zealand | CEO |
| Kirsty Godfrey-Billy | New Zealand | CFO |
| Non-executive directors | | |
| David Thodey | Australia | Independent non-executive Chair |
| Rod Drury | New Zealand | Founder, non-executive director |
| Lee Hatton | Australia | Independent non-executive director |
| Dale Murray, CBE | United Kingdom | Independent non-executive director |
| Susan Peterson | New Zealand | Independent non-executive director |
| Craig Winkler | Australia | Non-executive director |
| Mark Cross | New Zealand | Independent non-executive director |
| Steven Aldrich | United States | Independent non-executive director |

6. Remuneration governance

Xero's remuneration governance framework is managed by the P&R Committee on behalf of the Board. The P&R Committee is tasked with ensuring that Xero's remuneration practices are aligned with Xero's strategic objectives and consistent with Xero's remuneration principles and risk appetite. The P&R Committee considers the interplay between remuneration structures and risk when designing frameworks and setting and determining remuneration outcomes.

6.1 Role of the People and Remuneration Committee

The P&R Committee operates under a charter, which is available on Xero's website at www.xero.com/about/investors/governance. The P&R Committee oversees Xero's strategies and policies relating to:

- Organisational structure and culture
- Remuneration
- Employee performance and development
- Succession planning for direct reports to the CEO (succession planning for the CEO is managed by the Nominations Committee)

The P&R Committee provides strategic, structural, and policy oversight of remuneration, employee performance and culture for the Xero workforce, making recommendations to the Board regarding HR policies, remuneration budgets, employee incentive plans and material employee benefits.

The P&R Committee's oversight of the remuneration of the CEO, and direct reports, involves close scrutiny of remuneration amounts and performance outcomes, including developing independent recommendations for CEO remuneration amendments and performance outcomes to be presented to the Board. The P&R Committee makes recommendations to the Board on STI and LTE plans and on remuneration arrangements for the CEO, and approves and informs the Board of the remuneration of the CFO and other executives.

The P&R Committee reviews and approves all equity and incentive payments to the executives, considering whether there are any reasons for delaying, holding back, or clawing back equity or incentive payments, as per the malus and clawback provisions.

The P&R Committee seeks input from management and engages the services of independent advisors where appropriate.

6.2 People and Remuneration Committee independence

Consistent with the ASX Corporate Governance Principles and Guidelines, the P&R Committee consists of four members of the Board, the majority of whom are independent, including the Chair. The current membership comprises:

- Susan Peterson (Chair)
- David Thodey
- Craig Winkler
- Steven Aldrich

Other members of the Board, the CEO, executives, and members of Xero's wider leadership team may be invited to attend meetings of the P&R Committee where appropriate.

6.3 External and independent advice

During the year, the P&R Committee engaged external consultants to provide guidance on Xero's remuneration framework given Xero's current and expected growth trajectory. This forms part of Xero's governance framework. The P&R Committee is entitled to obtain independent advice, independent of management, to ensure that decisions are made in the best interests of Xero.

6.4 No dealing or protection arrangements

Xero's Securities Trading Policy prohibits employees and directors from entering into transactions that are intended to hedge or otherwise limit the economic risk of unvested or restricted Xero securities.

Executives are not permitted to deal with their RSUs or options. All dealing of shares received on vesting or exercise of RSUs and options are subject to the rules outlined in the Securities Trading Policy.

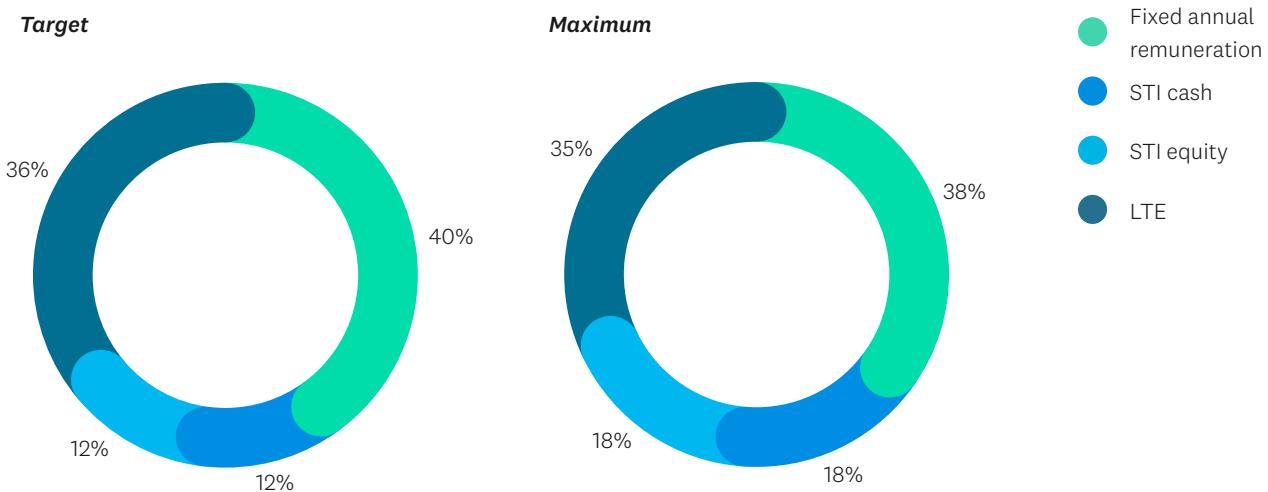
A copy of Xero's Share Trading Policy is available on Xero's website at www.xero.com/about/investors/governance.

7. Key remuneration components for the CEO and CFO

Further detail is outlined below on how the remuneration structure described in section 2.3 applies to the CEO and CFO.

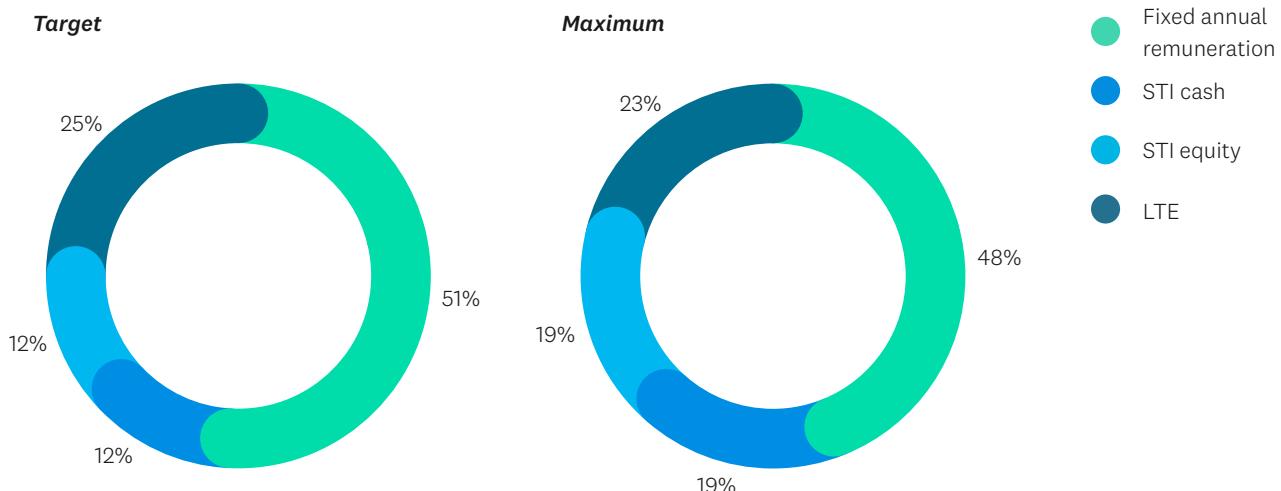
7.1 CEO remuneration mix

The CEO's remuneration mix is as follows:



7.2 CFO remuneration mix

The CFO's remuneration mix is as follows:



7.3 Fixed annual remuneration

Fixed annual remuneration is set in the context of Xero's wider, growth-orientated remuneration strategy and considers an individual executive's skills, experience, accountabilities, performance, leadership, and behaviours.

Fixed remuneration is reviewed annually to ensure that it continues to be appropriate and attract and retain key talent. This review process is conducted based on benchmarking data as described earlier.

For the CEO, the FY21 remuneration review process resulted in no change to his base salary for FY21.

For the CFO, the FY21 remuneration review process resulted in her base salary increasing to \$625,000 from \$550,000 as of 1 October 2020.

| Element | Details |
|------------|--|
| Components | Base salary Retirement benefits (superannuation, KiwiSaver or local equivalent) |
| Process | Set and reviewed annually based on individual skills, experience, accountabilities, performance, appropriate benchmarks, leadership and behaviours |

7.4 At risk – short-term incentive (STI)

STI is an at risk component of remuneration that is structured to reward progress towards and alignment with Xero's strategic and financial objectives as well as creation of value for customers, employees and shareholders in the financial period. STI payments are set as a percentage of base salary, based on level of responsibility and country of residence.

STI is calculated based on achievement against a range of organisational performance measures (financial and non-financial) and individual objectives and vesting outcomes are determined with regard to whether the executive has acted in accordance with Xero's values. The STI performance metrics have been chosen as they focus the CEO and CFO on growing global revenue and creating valued customer experiences while at the same time maintaining operational discipline. STI payments comprise 50% cash and 50% deferred equity in the form of RSUs.

For the CEO, the FY21 remuneration review process resulted in no change to his STI for FY21.

For the CFO, the FY21 remuneration review process resulted in her target STI increasing to \$312,500 (50% of base salary) from 1 October 2020, compared with 40% of base salary for FY20.

| Element | Details |
|-------------------------------------|--|
| Purpose | Focus participants on delivery of business objectives over a one year period. |
| Target opportunity (% base salary) | CEO 60%, CFO 50% (pro-rated to 45% for FY21, as the change from 40% to 50% was halfway through the year). |
| Maximum opportunity (% base salary) | CEO 74%, CFO 61%. |
| Performance period | Performance is measured from 1 April to 31 March. |
| Performance measures | Performance metrics measure success in relation to our key stakeholders, reflecting the voice of employee, customer, and shareholder. |
| Financial objectives (60%) | Financial objectives reflect the voice of shareholder - cash flow and net new monthly recurring revenue (MRR) targets. |
| Non-financial objectives (40%) | Non-financial metrics are based on: <ul style="list-style-type: none"> Voice of Customer – Partner and small business net promoter score (NPS) targets Voice of employee – Employee NPS and engagement targets Individual objectives – Goals aligned to company strategic objectives |
| Target setting | The targets set at the beginning of each financial year are reviewed and approved by the P&R Committee and are aligned to our longer-term strategic objectives. Given the uncertainty around the impact of COVID-19, the setting of STI company financial targets was delayed until August 2020. |
| Evaluation of performance | Performance against financial and non-financial objectives is determined at the end of the financial period after review of executive performance by the CEO, in consultation with the P&R Committee (and in the case of the CEO, by the Board). |
| Pay vehicle | 50% of STI awarded is paid in cash, with the remaining 50% issued in RSUs. |
| Vesting conditions | RSUs vest one year from grant date, subject to continued service. |
| Forfeiture and termination | Unless the Board determines otherwise, if the executive ceases employment, all unvested RSUs will lapse and all STI awards not yet paid are forfeited. |
| Change of control | The Board has broad discretion to determine the appropriate treatment of unvested RSUs on a change of control. Amongst other things, the Board may decide to vest/lapse unvested RSUs or settle them in cash instead of shares. If the Board does not exercise its discretion, unvested RSU's will vest pro rata, based on the proportion of the vesting period that has passed at the time of the change of control and the extent to which any applicable conditions have been satisfied. |
| Malus / Clawback provisions | Outlined in section 2.4. |
| Dividends and voting | RSUs do not carry an entitlement to dividends or voting prior to vesting. |

7.4.2 Link between remuneration and strategy

| Performance Measure | Weighting | Rationale for why chosen |
|---|-----------|---|
| Financial | | |
| Group net new monthly recurring revenue | 45% | Key indicator of financial performance Ensures continued focus on growth Aligns to 'Challenge', 'Team', and 'Ownership' values |
| Free Cash Flow | 15% | Key indicator of financial performance Ensures continued focus on disciplined allocation of capital Rewards appropriate balance between return generation and reinvestment in growth Aligns to 'Challenge', 'Team', and 'Ownership' values |
| Non-Financial | | |
| Individual objectives | 20% | Key indicator of individual executive performance Ensures continued focus on individual goals Rewards for individual performance Aligns to 'Challenge' and 'Ownership' values |
| Partner and Small Business net promoter score (NPS) | 10% | Key indicator of customer satisfaction Ensures continued focus on customer retention Aligns to 'Human', 'Challenge', 'Team', 'Ownership', and 'Beautiful' values |
| Employee engagement | 5% | Key indicator of employee satisfaction Ensures continued focus on employee engagement Aligns to 'Human', 'Challenge', and 'Team' values |
| Employee net promoter score | 5% | Key indicator of employee satisfaction Ensures continued focus on employee engagement Aligns to 'Human', 'Challenge', and 'Team' values |

7.5 At risk – long-term equity (LTE)

LTE is an at-risk component of executive remuneration that is structured to reward the effective execution of Xero's strategic plan over a multi-year period.

A new LTE plan was implemented during FY21. The pay vehicle remained as options, but the grant cycle is now annual. Further details are outlined in the table below.

For the CEO, the FY21 remuneration review process resulted in his LTE increasing from \$820,000 to \$1,080,000 (94% of base salary, compared with 72% of base salary in FY20).

For the CFO, the FY21 remuneration review process resulted in her LTE decreasing from \$350,000 to \$312,500 (50% of base salary, compared with 64% of base salary in FY20).

| Element | Details |
|-------------------------------------|---|
| Purpose | Rewards delivery against longer-term strategy and sustained shareholder value creation. Provides alignment between shareholder, customer, and executive outcomes and time-based retention through multi-year vesting. |
| Maximum opportunity (% base salary) | CEO 94%, CFO 50%. |
| Pay vehicle | Options with an exercise price based on the 30-day VWAP leading up to grant date. Options lapse two years from the date of vest. The exercise price acts as an in-built performance hurdle, incentivising executives to create value that increases the Xero share price above the exercise price over the vesting period. |
| Grant date | Options are granted annually. From FY22 this will be in or around July. Options were granted in November 2020 following a deferral from earlier in the year due to uncertainties relating to COVID-19. |
| Vesting conditions | Options all vest in the third May following grant. Options granted in November 2020 will vest in May 2023. |
| Forfeiture and termination | In the event of summary dismissal, all unvested options are forfeited, and all vested but unexercised options will lapse. In any other circumstances, all vested options will remain on foot and must be exercised within 30 days of ceasing employment, unless the Board decides otherwise. |
| Exercise of vested options | Executives are unable to exercise options during a closed period and are subject to Xero's Share Trading Policy and dealing restrictions as outlined in section 6.4. |
| Change of control | The Board has broad discretion to determine the appropriate treatment of vested and unvested options on a change of control. Amongst other things, the Board may decide to vest/lapse unvested options, settle them in cash instead of shares, or require vested options to be exercised within a specified period. If the Board does not exercise its discretion, unvested options will vest pro rata based on the proportion of the vesting period that has passed at the time of the change of control and the extent to which any applicable conditions have been satisfied. |
| Malus / Clawback provisions | Outlined in section 2.4. |
| Dividends and voting | Options do not carry an entitlement to dividends or voting prior to being exercised. |

7.6 Legacy CEO and CFO equity arrangements

Details of other equity grants made to the CEO and CFO before the current LTE was adopted are outlined below.

7.6.1 Legacy CEO equity arrangements

7.6.1.1 Legacy CEO RSUs

| Element | Details |
|-------------------------------------|--|
| Purpose | Focus participant on delivery of business objectives over a one-year period and provide time-based retention through multi-year vesting. |
| Target opportunity (% base salary) | 70% |
| Maximum opportunity (% base salary) | 140% |
| Performance period | Performance was measured from 1 April 2018 to 31 March 2019. |
| Performance measures | The performance metrics were as follows: Revenue growth 40 percent MRR 40 percent EBITDA 20 percent |
| Pay vehicle | RSUs |
| Grant details | A total of 32,658 RSUs were issued in April and June 2018 to account for maximum performance. Following confirmation of achievement against targets at the end of FY19, 12,276 RSUs were forfeited, leaving 20,382 RSUs to vest. |
| Vesting conditions | RSUs vest in three equal tranches in May 2019, 2020, and 2021. Vesting is contingent upon continued service and subject to malus and clawback. |
| Outcome | The first and second tranches of 6,794 RSUs vested in May 2019 and 2020. The third tranche of 6,794 RSUs will vest in May 2021. |

7.6.1.2 Legacy CEO options

| Element | Details |
|--------------------|--|
| Purpose | Executive team retention plan intended to reward delivery against longer-term strategy and sustained shareholder value creation. Provides alignment between shareholder, customer, and executive outcomes and time-based retention through multi-year vesting. |
| Pay vehicle | Options with an exercise price based on the 20-day VWAP leading up to grant date. Options lapse five years from grant date. |
| Grant details | 180,000 options were granted in August 2018. |
| Vesting conditions | Options vest in two equal tranches in June in each of the third and fourth years after grant. Vesting is contingent upon continued service and subject to malus and clawback. |
| Outcome | No options vested during FY21. |

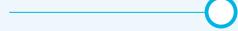
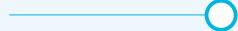
7.6.2 Legacy CFO equity arrangements

7.6.2.1 Legacy CFO options

| Element | Details |
|--------------------|---|
| Purpose | Executive team retention plan intended to reward delivery against longer-term strategy and sustained shareholder value creation. Provides alignment between shareholder, customer, and executive outcomes and time-based retention through multi-year vesting. |
| Pay vehicle | Options with an exercise price based on the 20-day VWAP leading up to grant date. Options lapse five years from grant date. |
| Grant details | 80,000 options were granted in June 2016, 80,000 options were granted in June 2018, and a further 20,000 options were granted in October 2018. |
| Vesting conditions | 2016 options vest in four equal tranches at each 12-month anniversary of the grant date. Vesting is contingent upon continued service and subject to malus and clawback. 2018 options vest in three equal tranches in June in each of the second, third, and fourth years after grant. Vesting is contingent upon continued service. |
| Outcome | 2016 options - tranches of 20,000 options vested in June 2017, 2018, 2019, and 2020. The first tranche of the 2018 options of 33,332 vested in June 2020. |

8. STI outcomes in detail

The annual outcomes achieved for the CEO and CFO are based on Xero's FY21 performance as follows:

| Objectives | Weighting | Outcome | | | |
|---------------------------------------|-----------|--|--|---------|--------------------------|
| | | Threshold | Target | Maximum | Outcome (% of target) |
| Company Objectives | | | | | |
| Voice of the shareholder ¹ | 60% |  |  | | 117.0% |
| Voice of the customer | 10% |  |  | | 100.0% |
| Voice of the employee | 10% |  |  | | 100.0% |
| Total Company Objectives | | | | | 61.8% |
| Individual Objectives | | | | | |
| CEO individual targets | 20% |  |  | | 100.0% |
| CFO individual targets | 20% |  |  | | 100.0% |
| Total CEO Outcome | | | | | 110.2% |
| Total CFO Outcome | | | | | 110.2% |

¹ For the voice of the shareholder component, there is the ability to out-perform up to 150% on the net new MRR measure. Further details on the measures, weightings and rationale can be found in 7.4.2

9. CEO and CFO remuneration

The following table provides details of the actual remuneration received by the CEO and CFO during FY21 and FY20. This represents the ‘take home pay’ of the CEO and CFO during those years, rather than the accounting values recognised by applicable accounting standards.

| Fixed remuneration | | | Variable remuneration ¹ | | | Additional value of all grants vested in the year, attributable to share price appreciation (\$000s) | Total remuneration received inclusive of share price appreciation (\$000s) | |
|----------------------------|------------------------------------|-----------------------------|--|-----|-----|--|--|-------|
| Salary (\$000s) | Superannuation/ KiwiSaver (\$000s) | Other ² (\$000s) | Accounting value of grants vested during the year, in the form of: | | | | | |
| Cash STI (\$000s) | Option/ Share grants (\$000s) | RSU grants (\$000s) | | | | | | |
| S Vamos FY 2021 | 1,145 | 54 | 57 | 281 | - | 514 | 459 | 2,510 |
| S Vamos FY 2020 | 1,145 | 54 | 79 | 270 | - | 246 | 167 | 1,960 |
| K Godfrey-Billy FY 2021 | 588 | 14 | 9 | 90 | 839 | 75 | 2,529 | 4,144 |
| K Godfrey-Billy FY 2020 | 550 | 14 | 2 | 75 | 184 | 110 | 940 | 1,875 |

¹ Includes the value of options and RSUs granted in prior years that vested in the year

² Other fixed pay relating to annual leave

The following tables present current at-risk equity and holdings for the CEO and CFO.

9.1 At-risk equity as at 31 March 2021

| | Opening balance ¹ | Granted during the year | Vested | Exercised | Lapsed/Forfeited | Closing balance |
|----------------|------------------------------|-------------------------|--------|-----------|------------------|-----------------|
| Options | | | | | | |
| CEO | 180,000 | 30,783 | - | - | - | 210,783 |
| CFO | 120,000 | 8,908 | 33,332 | 20,000 | - | 108,908 |
| RSUs | | | | | | |
| CEO | 18,118 | 3,296 | 11,324 | - | - | 10,090 |
| CFO | 1,261 | 1,056 | 1,261 | - | - | 1,056 |

¹ For options, includes all vested / unvested options that have not been exercised. For RSUs, only includes what has not been vested

9.2 Equity holdings as at 31 March 2021

| | Shares | Options | RSUs |
|-----|--------|---------|--------|
| CEO | 3,000 | 210,783 | 10,090 |
| CFO | - | 108,908 | 1,056 |

10. CEO and CFO employment conditions

| Item | Details |
|-------------------|---|
| Basis of contract | Ongoing (no fixed term) |
| Notice period | CEO – 6 months by either party CFO – 3 months by either party Shorter notice may apply by agreement |
| Base salary | Subject to annual review (but no adjustments to base salary are guaranteed) |

11. Non-executive director remuneration

The total remuneration available to non-executive directors is fixed by shareholders.

Currently, the annual total aggregate non-executive director remuneration is capped at \$2.2 million, as approved by shareholders at Xero's Annual Meeting in August 2019.

The Board sets the fees for the non-executive directors at a level that provides Xero with the ability to attract and retain directors of a high calibre. Directors have the option to receive their fees in cash or Xero shares.

The fees paid to non-executive directors are structured to reflect time commitment, responsibilities, and workloads. Target fees for non-executive directors are benchmarked to the Australian and New Zealand markets. However, where benchmarked non-executive director fees are higher in a director's local market, these are used as the benchmark for that director. This reflects the global composition of Xero's Board.

To preserve independence and impartiality, non-executive directors have not received any performance-related or at-risk compensation (such as options) since 2016. Xero does not provide any scheme for retirement benefits, other than statutory superannuation, for non-executive directors.

Below are the target annual fees payable to non-executive directors during FY21. Directors' fees are paid in New Zealand dollars in order to avoid exchange rate fluctuations impacting the annual fee cap.

| Country of residence | Chair (\$000s) | Director (\$000s) | Audit & Risk Management Committee Chair (\$000s) | People & Remuneration Committee Chair ¹ (\$000s) |
|----------------------|----------------|-------------------|--|---|
| New Zealand | 358 | 145 | 30 | 30 |
| Australia | 358 | 145 | 30 | 30 |
| United States | 358 | 252 | 30 | 30 |
| United Kingdom | 373 | 145 | 30 | 30 |

¹ No additional fees are currently paid for Chair of the Nominations Committee or for membership of any committee

Fees are reviewed every two years, with the latest review having commenced in the second half of 2020. The outcome of the review highlighted that, based on market practice, Committee member fees should be paid separately to the current remuneration fees. It also highlighted that Xero's fees were considerably lower than the median of our peer group. As a result of the review, directors who are members of the Audit and Risk Management Committee and P&R Committee, will receive an additional NZ\$19,000 annually, with effect from 1 April 2021. A decision on any further changes to the target annual fees has been postponed until later in 2021.

The total remuneration¹ of, and the value of other benefits received by, each non-executive director during FY21 was:

| Director | Country of residence | Role | Committee Chair | 2021 base fees (\$'000s) | 2021 Committee Chair fees (\$'000s) | 2021 Total fees (\$'000s) |
|-----------------------------|----------------------|-----------------|-----------------------|--------------------------|-------------------------------------|---------------------------|
| David Thodey, AO | Australia | Chair | Nominations Committee | 358 | - | 358 |
| Rod Drury | New Zealand | NED | - | 145 | - | 145 |
| Lee Hatton | Australia | Independent NED | ARM Committee | 145 | 18 ⁴ | 163 |
| Dale Murray CBE | United Kingdom | Independent NED | - | 145 | - | 145 |
| Susan Peterson | New Zealand | Independent NED | P&R Committee | 145 | 30 | 175 |
| Craig Winkler | Australia | NED | - | 145 | - | 145 |
| Mark Cross ² | New Zealand | Independent NED | ARM Committee | 145 | 13 ⁵ | 158 |
| Steven Aldrich ³ | United States | Independent NED | | 126 | - | 126 |
| Total | | | | 1,354 | 61 | 1,415¹ |

¹ Total remuneration is presented based on accounting expense and may include amounts earned, but not yet received

² Appointed director 1 April 2020

³ Appointed director 1 October 2020

⁴ Chair of ARM Committee 1 April 2020 to 31 October 2020

⁵ Chair of ARM Committee from 1 November 2020

The total remuneration¹ of, and the value of other benefits received by, each non-executive director during FY20 was:

| Director | Country of residence | Role | Committee Chair | 2020 base fees (\$'000s) | 2020 Committee Chair fees (\$'000s) | 2020 Total fees (\$'000s) |
|------------------------------|----------------------|-----------------|-----------------------|--------------------------|-------------------------------------|---------------------------|
| David Thodey AO ² | Australia | Chair | Nominations Committee | 143 | - | 143 |
| Rod Drury | New Zealand | NED | - | 138 | - | 138 |
| Lee Hatton | Australia | Independent NED | ARM Committee | 138 | 29 | 167 |
| Dale Murray CBE | United Kingdom | Independent NED | - | 138 | - | 138 |
| Susan Peterson | New Zealand | Independent NED | P&R Committee | 138 | 22 | 160 |
| Craig Winkler | Australia | NED | - | 138 | - | 138 |
| Former Director | | | | | | |
| Bill Veghte ³ | United States | Independent NED | - | 45 | 4 | 49 |
| Graham Smith ⁴ | United States | Former Chair | Nominations Committee | 399 | - | 399 |
| Total | | | | 1,277 | 55 | 1,332¹ |

¹ Total remuneration is presented based on accounting expense and may include amounts earned but not yet received

² Appointed director 27 June 2019, appointed Board Chair effective 1 February 2020

³ Ceased as a director effective 15 August 2019

⁴ Ceased as a director effective 31 March 2020

12. Employee remuneration

The following table shows the number of current and former employees of Xero whose remuneration and benefits for FY21 were within the specified bands above \$100,000.

| Remuneration including share-based remuneration | Number of employees | Remuneration including share-based remuneration | Number of employees |
|--|----------------------------|--|----------------------------|
| 100,000 to 109,999 | 232 | 680,000 to 689,999 | 2 |
| 110,000 to 119,999 | 188 | 740,000 to 749,999 | 2 |
| 120,000 to 129,999 | 204 | 750,000 to 759,999 | 2 |
| 130,000 to 139,999 | 194 | 760,000 to 769,999 | 1 |
| 140,000 to 149,999 | 152 | 770,000 to 779,999 | 1 |
| 150,000 to 159,999 | 163 | 780,000 to 789,999 | 1 |
| 160,000 to 169,999 | 132 | 860,000 to 869,999 | 1 |
| 170,000 to 179,999 | 110 | 950,000 to 959,999 | 1 |
| 180,000 to 189,999 | 112 | 980,000 to 989,999 | 1 |
| 190,000 to 199,999 | 63 | 1,040,000 to 1,049,999 | 1 |
| 200,000 to 209,999 | 100 | 1,060,000 to 1,069,999 | 1 |
| 210,000 to 219,999 | 67 | 1,070,000 to 1,079,999 | 1 |
| 220,000 to 229,999 | 49 | 1,100,000 to 1,109,999 | 1 |
| 230,000 to 239,999 | 45 | 1,120,000 to 1,129,999 | 1 |
| 240,000 to 249,999 | 51 | 1,160,000 to 1,169,999 | 1 |
| 250,000 to 259,999 | 33 | 1,200,000 to 1,209,999 | 1 |
| 260,000 to 269,999 | 29 | 1,210,000 to 1,219,999 | 1 |
| 270,000 to 279,999 | 21 | 1,220,000 to 1,229,999 | 1 |
| 280,000 to 289,999 | 15 | 1,230,000 to 1,239,999 | 1 |
| 290,000 to 299,999 | 18 | 1,270,000 to 1,279,999 | 1 |
| 300,000 to 309,999 | 16 | 1,290,000 to 1,299,999 | 1 |
| 310,000 to 319,999 | 11 | 1,440,000 to 1,449,999 | 1 |
| 320,000 to 329,999 | 10 | 1,610,000 to 1,619,999 | 1 |
| 330,000 to 339,999 | 11 | 1,650,000 to 1,659,999 | 1 |
| 340,000 to 349,999 | 5 | 1,680,000 to 1,689,999 | 1 |
| 350,000 to 359,999 | 7 | 1,810,000 to 1,819,999 | 1 |
| 360,000 to 369,999 | 9 | 1,820,000 to 1,829,999 | 1 |
| 370,000 to 379,999 | 7 | 1,850,000 to 1,859,999 | 1 |
| 380,000 to 389,999 | 7 | 1,880,000 to 1,889,999 | 1 |
| 390,000 to 399,999 | 6 | 1,940,000 to 1,949,999 | 1 |
| 400,000 to 409,999 | 2 | 2,090,000 to 2,099,999 | 1 |
| 410,000 to 419,999 | 2 | 2,190,000 to 2,199,999 | 1 |
| 420,000 to 429,999 | 3 | 2,340,000 to 2,349,999 | 1 |
| 430,000 to 439,999 | 1 | 2,360,000 to 2,369,999 | 1 |
| 440,000 to 449,999 | 3 | 2,500,000 to 2,509,999 | 1 |
| 450,000 to 459,999 | 2 | 2,750,000 to 2,759,999 | 1 |
| 460,000 to 469,999 | 1 | 3,010,000 to 3,019,999 | 1 |
| 480,000 to 489,999 | 3 | 3,730,000 to 3,739,999 | 1 |
| 490,000 to 499,999 | 2 | 3,740,000 to 3,749,999 | 1 |
| 540,000 to 549,999 | 1 | 3,930,000 to 3,939,999 | 1 |
| 560,000 to 569,999 | 1 | 4,140,000 to 4,149,999 | 1 |
| 570,000 to 579,999 | 2 | 4,240,000 to 4,249,999 | 1 |
| 620,000 to 629,999 | 1 | 4,500,000 to 4,509,999 | 1 |

The remuneration covered in the table includes monetary payments received and share-based payments vested (i.e. restricted shares, RSUs and vested options). The table above includes remuneration received by the CEO and CFO.

The value of options vested during the year has been calculated as the difference between the exercise price of those options and the share price on the day the options vest (become exercisable). Our methodology in calculating the value of equity for employees has been chosen as it provides a closer representation of the actual remuneration received during the year and is consistent with the approach made within the CEO and CFO remuneration disclosures detailed above.

Consolidated Financial Statements

| | |
|---|------------|
| Independent auditor's report | 94 |
| Financial Statements | 99 |
| Income Statement | 99 |
| Statement of Comprehensive Income | 99 |
| Statement of Financial Position | 100 |
| Statement of Changes in Equity | 101 |
| Statement of Cash Flows | 102 |
| Notes to the Financial Statements | 103 |
| General information | |
| 1. Reporting entity and statutory base | 103 |
| 2. Basis of accounting | 103 |
| Performance | |
| 3. Segment information | 104 |
| 4. Revenue | 105 |
| 5. Expenses | 105 |
| 6. Finance income and expense | 107 |
| 7. Earnings per share | 108 |
| Operating assets and liabilities | |
| 8. Trade and other receivables | 109 |
| 9. Property, plant and equipment | 110 |
| 10. Intangible assets | 111 |
| 11. Trade and other payables | 114 |
| 12. Other current liabilities | 114 |
| 13. Lease liabilities | 115 |
| 14. Contingent consideration | 116 |
| Funding and risk | |
| 15. Term debt | 116 |
| 16. Financial instruments, capital and financial risk management | 118 |
| 17. Derivatives and hedge accounting | 125 |
| 18. Share capital | 127 |
| Group structure | |
| 19. Business combinations | 128 |
| 20. Group entities | 129 |
| Other information | |
| 21. Current and deferred income tax | 130 |
| 22. Reconciliation of operating cash flows | 132 |
| 23. Changes in financial assets and liabilities arising from financing activities | 133 |
| 24. Share-based payments | 133 |
| 25. Key management personnel and related parties | 136 |
| 26. Commitments and contingencies | 136 |
| 27. Events after balance sheet date | 137 |
| Directors' responsibilities statement | 138 |

Independent auditor's report to the Shareholders of Xero Limited



Report on the audit of the financial statements

Opinion

We have audited the financial statements of Xero Limited ("the company") and its subsidiaries (together "the Group") on pages 99 to 137, which comprise the consolidated statement of financial position of the Group as at 31 March 2021, and the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended of the Group, and the notes to the consolidated financial statements including a summary of significant accounting policies.

In our opinion, the consolidated financial statements on pages 99 to 137 present fairly, in all material respects, the consolidated financial position of the Group as at 31 March 2021 and its consolidated financial performance and cash flows for the year then ended in accordance with New Zealand equivalents to International Financial Reporting Standards and International Financial Reporting Standards.

This report is made solely to the company's shareholders, as a body. Our audit has been undertaken so that we might state to the company's shareholders those matters we are required to state to them in an auditor's 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 audit work, for this report, or for the opinions we have formed.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (New Zealand). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report.

We are independent of the Group in accordance with Professional and Ethical Standard 1 *International Code of Ethics for Assurance Practitioners (including International Independence Standards) (New Zealand)* issued by the New Zealand Auditing and Assurance Standards Board, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

During the year Ernst & Young has provided R&D tax credit advice and other assurance services related to the Group's compliance with ISO 27001 and the issuance of the 2025 convertible notes. Post year end Ernst & Young provided non-assurance services to a subsidiary acquired post year end relating to data extraction. 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. Ernst & Young uses the Group's platform in delivering services to some clients. We have no other relationship with, or interest in, the Group.

Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current year. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, but we do not provide a separate opinion on these matters. For each matter below, our description of how our audit addressed the matter is provided in that context.

We have fulfilled the responsibilities described in the *Auditor's responsibilities for the audit of the financial statements* section of the audit report, including in relation to these matters. Accordingly, our audit included the performance of procedures designed to respond to our assessment of the risks of material misstatement of the financial statements. The results of our audit procedures, including the procedures performed to address the matters below, provide the basis for our audit opinion on the accompanying consolidated financial statements.

Capitalised Software Development Costs

Why significant

Intangible assets make up 59% of the Group's non-current assets. The most significant of these intangible assets is capitalised software development costs.

The Group capitalises costs incurred in the development of its software. These costs are then amortised over the estimated useful life of the software.

The Group's process for calculating the value of internally developed software involves judgment as it includes estimating time which staff spend developing software and determining the value attributable to that time.

NZ IAS 36 *Impairment of Assets* requires finite life intangible assets (including capitalised software development costs) be tested for impairment whenever there is an indication that the intangible assets may be impaired. This assessment requires judgment including consideration of both internal and external sources of information. The Group concluded there was no indication the finite life intangible assets may be impaired.

Disclosures relating to the capitalised software development costs, including key assumptions, are included in Note 10 of the consolidated financial statements.

How our audit addressed the key audit matter

Our work on capitalised software development costs focused on the Group's process for estimating the time and cost spent by staff on software development that can be capitalised in accordance with NZ IAS 38 *Intangible Assets*.

Our audit procedures included:

- Assessing the nature of a sample of projects against the requirements of NZ IAS 38 *Intangible Assets* to determine if they were capital in nature;
- Assessing the procedures applied to determine the rates applied to capitalise payroll costs;
- Assessing the effectiveness of controls over the processing of payroll costs; and
- Assessing capitalised costs with reference to payroll information for a sample of employees.

We assessed the factors the Group considered regarding potential impairment of capitalised software development costs and whether any indicators of impairment existed. This included having regard to:

- Significant changes in the extent or manner in which associated software is used;
- Potential or actual redundancy or disposal of developed software;
- Amortisation periods applied to developed software relative to past experience of software lifecycles; and
- Significant changes in the market in which the assets are used.

We assessed the adequacy of the disclosures related to capitalised software development costs and related impairment considerations in the consolidated financial statements.

Goodwill Impairment Testing

Why significant

The Group's balance sheet includes \$126.1 million of goodwill at 31 March 2021. This consists of \$78.8 million in relation to the 100% acquisition of Hubdoc Inc in August 2018 and \$47.3 million in relation to the acquisition of Waddle Holdings Pty Limited in October 2020.

NZ IAS 36 *Impairment of Assets* requires goodwill be tested for impairment annually irrespective of whether there are any indicators of impairment and this assessment requires judgment including consideration of both internal and external sources of information.

The goodwill of \$126.1 million is allocated to three cash generating units (CGUs); Waddle, Australia and New Zealand (ANZ), and International.

The Group assessed goodwill impairment by using a multiple approach for the ANZ and International CGUs and a discounted cashflow approach for the Waddle CGU.

Disclosures relating to goodwill impairment, including key assumptions, are included in Note 10 of the consolidated financial statements.

How our audit addressed the key audit matter

We assessed the Group's models and judgments in their annual impairment test. Our audit procedures included:

- Using our valuation specialists to:
 - assess whether the methodology applied in the multiple approach and the discounted cashflow model met the requirements of NZ IAS 36 *Impairment of Assets*;
 - consider the discount rates and terminal growth rates used in the discounted cashflow impairment model;
 - consider the revenue multiple used in the multiple based impairment model;
- Assessing the appropriateness of cash flow forecasts considering historical cash flows, our knowledge of the businesses and relevant external information. Given the current economic uncertainty as a result of the COVID-19 pandemic, we placed a particular focus on assumed subscriber and associated revenue growth forecasts;
- Validating the revenue used in the multiple based approach to revenue for the year ended 31 March 2021;
- Performing sensitivity analysis around key drivers of the impairment models, including the sensitivity of the results to changes in future projected cash flows and the revenue multiples used;
- We assessed the adequacy of the disclosures related to goodwill impairment considerations in the consolidated financial statements. This included assessing whether the assumptions which have the most significant effect on the determination of the recoverable amount of CGUs have been appropriately disclosed in the consolidated financial statements.

Convertible Notes and Related Call Spreads

Why significant

During the year, the Group issued USD700 million of zero coupon convertible notes maturing in 2025. The convertible notes are listed on the Singapore Exchange Securities Trading Limited (SGX-ST). In connection with the issuance, Xero also entered into call spread transactions.

The Group also redeemed 99% of the USD300 million 2023 2.375% coupon convertible notes in December 2020. The 2023 convertible notes were settled using a mix of cash and shares.

Decisions regarding the appropriate accounting treatment for the convertible notes and associated call spreads required judgment as did the valuation of the convertible notes and call spreads at the relevant dates. Xero engaged a third party to value the 2023 and 2025 convertible notes and the related call spreads at the transaction dates and, where relevant, at year end. Note 15 of the financial statements describes these transactions and the related valuations and accounting.

How our audit addressed the key audit matter

Our work on the convertible notes and call spreads focused on the appropriateness of the accounting treatments as well as the judgements made in determining their valuations. Our audit procedures included:

- Involving our financial instrument accounting specialists to consider and challenge the accounting treatments of the settlement of the 2023 convertible notes and unwind of the associated call options as well as the issue of the 2025 convertible notes and associated call options;
- Consideration of the external valuation of the derivative instruments and the conversion elements of the notes by engaging our financial instrument valuation specialists to assess the appropriateness of the valuation methods adopted, the inputs used in the valuations and the resulting valuation amounts adopted by management; and
- Considering the disclosures in the financial statements for appropriateness.

Information other than the financial statements and auditor's report

The directors of the company are responsible for the Annual Report, which includes information other than the consolidated financial statements and auditor's report.

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained during the audit, or otherwise appears to be materially misstated.

If, based upon the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Directors' responsibilities for the financial statements

The directors are responsible, on behalf of the entity, for the preparation and fair presentation of the consolidated financial statements in accordance with New Zealand equivalents to International Financial Reporting Standards and International Financial Reporting Standards, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the directors are responsible for assessing on behalf of the entity the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (New Zealand) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

A further description of the auditor's responsibilities for the audit of the financial statements is located at the External Reporting Board's website: <https://www.xrb.govt.nz/standards-for-assurance-practitioners/auditors-responsibilities/audit-report-1/>. This description forms part of our auditor's report.

The engagement partner on the audit resulting in this independent auditor's report is Simon O'Connor.

Ernest & Young

Chartered Accountants

Wellington

13 May 2021

Financial Statements

Income Statement

| Year ended 31 March | Notes | 2021 (\$000s) | 2020 (\$000s) |
|-------------------------------------|----------|------------------|------------------|
| Subscription revenue | | 828,106 | 696,220 |
| Other operating revenue | | 20,676 | 22,011 |
| Total operating revenue | 4 | 848,782 | 718,231 |
| Cost of revenue | 5 | (118,893) | (106,582) |
| Gross profit | | 729,889 | 611,649 |
| <i>Operating expenses</i> | | | |
| Sales and marketing | | (307,948) | (312,852) |
| Product design and development | | (249,532) | (178,258) |
| General and administration | | (106,345) | (88,980) |
| Total operating expenses | 5 | (663,825) | (580,090) |
| Other income and expenses | | (4,377) | 2,550 |
| Asset impairments | | – | (1,427) |
| Operating surplus | | 61,687 | 32,682 |
| Finance income | 6 | 5,155 | 13,432 |
| Finance expense | 6 | (110,778) | (36,277) |
| Net profit/(loss) before tax | | (43,936) | 9,837 |
| Income tax credit/(expense) | 21 | 63,710 | (6,501) |
| Net profit | | 19,774 | 3,336 |
| Basic earnings per share | 7 | \$0.14 | \$0.02 |
| Diluted earnings/(loss) per share | 7 | (\$2.66) | \$0.02 |

Statement of Comprehensive Income

| Year ended 31 March | Note | 2021 (\$000s) | 2020 (\$000s) |
|--|------|------------------|------------------|
| Net profit | | 19,774 | 3,336 |
| Other comprehensive income* | | | |
| Movement in cash flow hedges (net of tax) | 17 | (6,730) | 845 |
| Translation of foreign operations (net of tax) | | (6) | (3,393) |
| Total other comprehensive loss for the year | | (6,736) | (2,548) |
| Total comprehensive income for the year | | 13,038 | 788 |

* Items of other comprehensive income may be reclassified to the Income Statement when specific conditions are met

The accompanying notes form an integral part of these financial statements

Statement of Financial Position

| | Notes | At 31 March 2021 (\$'000s) | At 31 March 2020 (\$'000s) |
|---|--------|----------------------------------|----------------------------------|
| Assets | | | |
| <i>Current assets</i> | | | |
| Cash and cash equivalents | | 657,849 | 108,027 |
| Short-term deposits | | 452,814 | 428,052 |
| Trade and other receivables | 8 | 86,397 | 55,877 |
| Income tax receivable | | 762 | - |
| Derivative assets | 17 | 861 | 124,698 |
| Other current assets | | 5,622 | 1,856 |
| Total current assets | | 1,204,305 | 718,510 |
| <i>Non-current assets</i> | | | |
| Property, plant and equipment | 9 | 109,358 | 86,638 |
| Intangible assets | 10 | 484,017 | 342,246 |
| Deferred tax assets | 21 | 103,267 | 3,751 |
| Derivative assets | 15, 17 | 122,813 | - |
| Other non-current assets | | 268 | 2,543 |
| Total non-current assets | | 819,723 | 435,178 |
| Total assets | | 2,024,028 | 1,153,688 |
| Liabilities | | | |
| <i>Current liabilities</i> | | | |
| Trade and other payables | 11 | 44,751 | 42,954 |
| Employee entitlements | | 78,007 | 39,893 |
| Lease liabilities | 13 | 10,580 | 11,755 |
| Income tax payable | | 1,046 | 2,679 |
| Derivative liabilities | 15, 17 | 6,221 | 3,157 |
| Other current liabilities | 12 | 28,219 | 15,694 |
| Total current liabilities | | 168,824 | 116,132 |
| <i>Non-current liabilities</i> | | | |
| Term debt | 15 | 854,078 | 424,587 |
| Derivative liabilities | 15, 17 | 120,861 | 121,972 |
| Lease liabilities | 13 | 83,950 | 60,871 |
| Contingent consideration | 14 | 35,907 | 2,840 |
| Deferred tax liabilities | 21 | 6,300 | 1,114 |
| Other non-current liabilities | | 8,162 | 3,806 |
| Total non-current liabilities | | 1,109,258 | 615,190 |
| Total liabilities | | 1,278,082 | 731,322 |
| Equity | | | |
| Share capital | 18 | 1,293,320 | 677,540 |
| Reserves | | (226,612) | 85,362 |
| Accumulated losses | | (320,762) | (340,536) |
| Total equity | | 745,946 | 422,366 |
| Total liabilities and shareholders' equity | | 2,024,028 | 1,153,688 |

The accompanying notes form an integral part of these financial statements

Statement of Changes in Equity

| Notes | Share capital (\$000s) | Treasury shares (\$000s) | Share-based payment reserve (\$000s) | Accumulated losses (\$000s) | Foreign currency translation reserve (\$000s) | Cash flow hedge reserve (\$000s) | Call spread options reserve (\$000s) | Total equity (\$000s) |
|--|---------------------------|-----------------------------|---|--------------------------------|--|-------------------------------------|---|--------------------------|
| Balance at 1 April 2020 | 687,341 | (9,801) | 49,479 | (340,536) | (2,489) | 3,111 | 35,261 | 422,366 |
| Net profit | – | – | – | 19,774 | – | – | – | 19,774 |
| Other comprehensive loss | – | – | – | – | (6) | (6,730) | – | (6,736) |
| Total comprehensive income | – | – | – | 19,774 | (6) | (6,730) | – | 13,038 |
| <i>Transactions with owners:</i> | | | | | | | | |
| Share-based payments, net of tax | 18, 24 | 31,756 | 7,910 | 43,979 | – | – | – | 83,645 |
| Exercising of employee share options | 18, 24 | 44,578 | (12,700) | – | – | – | – | 31,878 |
| Issue of shares | 15, 18 | 531,536 | – | – | – | – | – | 531,536 |
| Unwind of call spread options | – | – | – | – | – | – | (400,189) | (400,189) |
| Premium on call spread options, net of issuance costs | – | – | – | – | – | – | 63,672 | 63,672 |
| Balance at 31 March 2021 | 1,295,211 | (1,891) | 80,758 | (320,762) | (2,495) | (3,619) | (301,256) | 745,946 |
| Balance at 1 April 2019 | 638,234 | (10,386) | 30,902 | (343,872) | 904 | 2,266 | 35,261 | 353,309 |
| Net profit | – | – | – | 3,336 | – | – | – | 3,336 |
| Other comprehensive income/(loss) | – | – | – | – | (3,393) | 845 | – | (2,548) |
| Total comprehensive income | – | – | – | 3,336 | (3,393) | 845 | – | 788 |
| <i>Transactions with owners:</i> | | | | | | | | |
| Share-based payments, net of tax | 18, 24 | 16,282 | 585 | 23,497 | – | – | – | 40,364 |
| Exercising of share options | 18, 24 | 17,353 | – | (4,920) | – | – | – | 12,433 |
| Issue of shares – deferred consideration for acquisition of Hubdoc | – | 15,472 | – | – | – | – | – | 15,472 |
| Balance at 31 March 2020 | 687,341 | (9,801) | 49,479 | (340,536) | (2,489) | 3,111 | 35,261 | 422,366 |

The accompanying notes form an integral part of these financial statements

Statement of Cash Flows

| Year ended 31 March | Notes | 2021 (\$'000s) | 2020 (\$'000s) |
|--|-----------|-------------------|-------------------|
| Operating activities | | | |
| Receipts from customers | | 845,963 | 717,264 |
| Other income | | 6,089 | 5,609 |
| Interest received | | 6,827 | 14,363 |
| Payments to suppliers and employees | | (609,671) | (542,760) |
| Interest paid | | (19,089) | (19,460) |
| Income tax paid | | (11,480) | (8,387) |
| Net cash flows from operating activities | 22 | 218,639 | 166,629 |
| Investing activities | | | |
| Capitalised development costs | | (139,809) | (111,296) |
| Business acquisitions, net of cash acquired | | (36,277) | - |
| Capitalised contract acquisition costs | | (11,093) | (13,682) |
| Purchase of property, plant and equipment | | (10,561) | (13,872) |
| Other investing activities | | (230) | (674) |
| Net cash flows from investing activities | | (197,970) | (139,524) |
| Financing activities | | | |
| Proceeds from issuance of convertible notes, net of issuance costs | | 976,060 | - |
| Call spread options | | (80,921) | - |
| Payments for buyback of convertible notes | | (415,305) | - |
| Proceeds from unwind of call spread options | | 108,633 | - |
| Financing transaction costs | | (5,670) | - |
| Payment of lease liabilities | 13 | (11,632) | (13,417) |
| Lease incentives | 13 | 495 | 504 |
| Exercising of share options | | 31,878 | 12,433 |
| Proceeds from borrowings | | 814 | - |
| Payments for short-term deposits | | (855,428) | (785,753) |
| Proceeds from short-term deposits | | 795,540 | 734,563 |
| Net cash flows from financing activities | | 544,464 | (51,670) |
| Net increase/(decrease) in cash and cash equivalents | | 565,133 | (24,565) |
| Foreign currency translation adjustment | | (15,311) | 11,065 |
| Cash and cash equivalents at the beginning of the period | | 108,027 | 121,527 |
| Cash and cash equivalents at the end of the period | | 657,849 | 108,027 |

The accompanying notes form an integral part of these financial statements

Notes to the Financial Statements

1. Reporting entity and statutory base

Xero Limited ('the Company') is registered under the New Zealand Companies Act 1993 and is listed on the Australian Securities Exchange (ASX). The Company is required to be treated as an FMC Reporting Entity under the Financial Markets Conducts Act 2013 and the Financial Reporting Act 2013.

The consolidated financial statements of the Company and its subsidiaries (together 'the Group' or 'Xero') for the year ended 31 March 2021 were authorised in accordance with a resolution of the directors for issue on 13 May 2021.

2. Basis of accounting

(a) Basis of preparation

The audited consolidated financial statements of the Group have been prepared in accordance with Generally Accepted Accounting Practice in New Zealand (NZ GAAP) and the Financial Reporting Act 2013. The Group is a for-profit entity for the purposes of complying with NZ GAAP. The consolidated financial statements comply with New Zealand equivalents to International Financial Reporting Standards (NZ IFRS), other New Zealand accounting standards, and authoritative notices that are applicable to entities that apply NZ IFRS. The consolidated financial statements also comply with International Financial Reporting Standards.

Other than where described below, or in the notes, the consolidated financial statements have been prepared using the historical cost convention.

The consolidated financial statements are presented in New Zealand dollars (\$) (the 'presentation currency'). Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency').

(b) Changes in accounting policies and disclosures

The accounting policies and disclosures adopted are consistent with those of the previous year.

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

(c) Standards or interpretations issued but not yet effective and relevant to the Group

In April 2020 the New Zealand Accounting Standards Board issued amendments to IAS 1: *Presentation of Financial Statements*. The amendments are effective for Xero from 1 April 2023. The amendments will result in the current classification of the term debt and embedded conversion feature derivative liability components of Xero's 2025 convertible notes.

There are no other standards or amendments that have been issued but are not yet effective that are expected to have a significant impact on the Group.

The Group has not adopted, and currently does not anticipate adopting, any standards prior to their effective dates.

(d) Critical accounting estimates

In applying the Group's accounting policies, management continually evaluates judgements, estimates, and assumptions based on experience and other factors, including expectations of future events that may have an impact on the Group. All judgements, estimates, and assumptions made are believed to be reasonable based on the most current set of circumstances available to the Group. Actual results may differ from the judgements, estimates, and assumptions made.

Significant judgements, estimates, and assumptions made by management in the preparation of these financial statements are outlined within the financial statement notes to which they relate.

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 how 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.

| | ANZ (\$000s) | International (\$000s) | Total (\$000s) |
|---------------------------------|-----------------|---------------------------|-------------------|
| <i>Year ended 31 March 2021</i> | | | |
| Operating revenue | 514,534 | 334,248 | 848,782 |
| Expenses | (175,341) | (251,500) | (426,841) |
| Segment contribution | 339,193 | 82,748 | 421,941 |
| <i>Year ended 31 March 2020</i> | | | |
| Operating revenue | 436,530 | 281,701 | 718,231 |
| Expenses | (164,962) | (254,472) | (419,434) |
| Segment contribution | 271,568 | 27,229 | 298,797 |

Reconciliation from segment contribution to net profit/(loss) before tax

| | 2021 (\$000s) | 2020 (\$000s) |
|-------------------------------------|------------------|------------------|
| Year ended 31 March | | |
| Segment contribution | 421,941 | 298,797 |
| Product design and development | (249,532) | (178,258) |
| General and administration | (106,345) | (88,980) |
| Asset impairments | – | (1,427) |
| Other income and expenses | (4,377) | 2,550 |
| Finance income | 5,155 | 13,432 |
| Finance expense | (110,778) | (36,277) |
| Net profit/(loss) before tax | (43,936) | 9,837 |

Depreciation and amortisation by segment

| | 2021 (\$000s) | 2020 (\$000s) |
|--|------------------|------------------|
| Year ended 31 March | | |
| ANZ | 14,401 | 14,125 |
| International | 20,931 | 18,799 |
| Corporate (not allocated to a segment) | 94,209 | 72,137 |
| Total | 129,541 | 105,061 |

At 31 March 2021, \$422.5 million, or 71%, of the Group's property, plant and equipment and intangible assets was domiciled in New Zealand (2020: \$361.2 million, or 84%).

Share-based payments by segment

| | 2021 (\$000s) | 2020 (\$000s) |
|--|------------------|------------------|
| Year ended 31 March | | |
| ANZ | 9,890 | 7,601 |
| International | 9,468 | 8,110 |
| Corporate (not allocated to a segment) | 23,373 | 18,625 |
| Total | 42,731 | 34,336 |

4. Revenue

Operating revenue by geographic location

| Year ended 31 March | 2021 (\$'000s) | 2020 (\$'000s) |
|--------------------------------|-------------------|-------------------|
| Australia | 384,150 | 320,376 |
| United Kingdom | 223,564 | 183,565 |
| New Zealand | 130,384 | 116,154 |
| North America | 56,558 | 55,398 |
| Rest of World | 54,126 | 42,738 |
| Total operating revenue | 848,782 | 718,231 |

Subscription revenue

Subscription revenue comprises recurring monthly fees from subscribers to Xero's cloud-based software products. Subscribers are invoiced monthly. Unbilled revenue at balance date is recognised in the Statement of Financial Position as accrued income and included within trade and other receivables. Unearned revenue at balance date is recognised in the Statement of Financial Position as income in advance and included within other current liabilities.

Subscription revenue is recognised as performance obligations under contracts with customers are met. Performance obligations for subscriptions to Xero's cloud-based software consist of the provisioning of the software and related support services over the term of the contract. Where the performance obligations of add-ons are usage-based (such as payroll and expenses), revenue is recognised consistent with the usage profile.

Other operating revenue

Other operating revenue primarily comprises revenue from related non-subscription services such as financial services products, including invoice payment services and Waddle's invoice lending platform services.

Performance obligations under fintech arrangements include the referral of customers to the revenue share counterparty and the continued servicing of that customer by the counterparty.

5. Expenses

Overhead allocation

The presentation of the Income Statement by function requires certain overhead costs to be allocated to functions. These allocations require management to apply judgement. Facilities, internal use information technology costs, and depreciation and amortisation relating to internal use software have been allocated to functions on a headcount basis. Recruitment costs have been allocated according to the number of employees hired in each function during the period.

Sales tax

The Income Statement and the Statement of Cash Flows have been prepared so that all components are stated exclusive of sales tax, except where sales tax is not recoverable. All items in the Statement of Financial Position are stated net of sales tax with the exception of trade receivables and trade payables, which include sales tax payable. Sales tax includes Goods and Services Tax and Value Added Tax where applicable.

Cost of revenue and operating expenses

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) |
|--|------------------|------------------|
| Employee entitlements | 456,938 | 371,679 |
| Employee entitlements capitalised | (124,440) | (106,758) |
| Share-based payments | 55,857 | 45,174 |
| Share-based payments capitalised | (13,126) | (10,838) |
| Advertising and marketing | 92,586 | 113,227 |
| Platform costs | 52,136 | 40,252 |
| Computer equipment and software | 29,851 | 23,657 |
| Consultants and contractors | 35,343 | 18,936 |
| Superannuation costs | 19,201 | 15,094 |
| Communication, insurance and office administration | 6,402 | 7,962 |
| Rental costs | 6,073 | 5,768 |
| Auditor's remuneration | 572 | 471 |
| Travel-related costs | 454 | 16,356 |
| Other operating expenses | 35,330 | 40,631 |
| Total cost of revenue and operating expenses excl. depreciation and amortisation* | 653,177 | 581,611 |

* Includes grant income of \$5.7 million (2020: \$5.2 million)

Depreciation and amortisation

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) |
|--|------------------|------------------|
| <i>Relating to:</i> | | |
| Amortisation of development costs | 90,929 | 69,452 |
| Amortisation of other intangible assets | 13,683 | 12,574 |
| Depreciation of property, plant and equipment | 24,929 | 23,035 |
| Total depreciation and amortisation | 129,541 | 105,061 |
| Total cost of revenue and operating expenses | 782,718 | 686,672 |
| <i>Depreciation and amortisation included in function expenses as follows:</i> | | |
| Product design and development | 90,002 | 68,490 |
| Cost of revenue | 8,664 | 7,105 |
| Sales and marketing | 26,668 | 25,819 |
| General and administration | 4,207 | 3,647 |
| Total depreciation and amortisation | 129,541 | 105,061 |

Auditor's remuneration

The auditor of the Group is Ernst & Young New Zealand.

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) |
|---|------------------|------------------|
| Fees for auditing the statutory financial statements | 384 | 373 |
| Fees for other assurance and agreed-upon-procedures services under legislation or contractual arrangements not required to be provided by the auditor | | |
| Assurance related* | 153 | 80 |
| Fees for other services | | |
| Tax compliance** | 29 | 16 |
| Other non-audit services | 6 | 2 |
| Total auditor's remuneration | 572 | 471 |

* Assurance related services relate to the provision of a comfort letter over convertible notes issuance and ISO 27001 certification. The comfort letter procedures were closely related to the financial statement audit

** Tax compliance services relate to assistance with the preparation of R&D tax incentive claim in Australia

6. Finance income and expense

Finance income

Finance income comprises interest income on cash and cash equivalents and short-term deposits. Interest income is recognised as it is accrued using the effective interest method. The effective interest method calculates the amortised cost of the financial asset and allocates the interest income over its expected life.

Finance expense

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) |
|--|------------------|------------------|
| Loss on recognition/extinguishment of term debt* | 67,169 | - |
| Amortisation of debt discount and issuance costs | 21,781 | 17,023 |
| Lease liability interest | 6,053 | 6,280 |
| Interest on convertible notes | 5,783 | 11,010 |
| Bank standby facility costs | 1,852 | 1,691 |
| Other finance expense** | 8,140 | 273 |
| Total finance expense | 110,778 | 36,277 |

* Consists of \$62.5 million loss on extinguishment of 2023 convertible notes and \$4.7 million loss on initial recognition of the 2025 convertible notes

** Other finance expense for the year ended 31 March 2021 includes \$5.7 million of expensed transaction costs relating to the buyback of the 2023 convertible notes and issuance of the 2025 convertible notes

7. Earnings per share

The Group presents basic and diluted earnings per share (EPS) data for its ordinary shares.

Basic EPS is calculated by dividing the net profit attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares on issue during the year, excluding shares held as treasury shares.

Diluted EPS is determined by adjusting the net profit attributable to ordinary shareholders and the weighted average number of ordinary shares on issue for the effects of all potential dilution to ordinary shares, which comprise convertible notes, restricted shares, options, and restricted stock units (RSUs). Instruments are only treated as dilutive when their conversion to ordinary shares would decrease EPS or increase the loss per share.

| Year ended 31 March | 2021 (000s)* | 2020 (000s)* |
|---|--------------------|-----------------|
| Net profit after tax | \$19,774 | \$3,336 |
| Add back: foreign exchange revaluation on contingent consideration included in ordinary shares for basic calculation before the date of share issue, net of tax | - | (\$44) |
| Net profit attributable to equity holders of the Group, used in calculating basic EPS | \$19,774 | \$3,292 |
| Add back: revaluation gain on call spread transactions | (\$418,850) | - |
| Net profit/(loss) attributable to equity holders of the Group, used in calculating diluted EPS | (\$399,076) | \$3,292 |
| Weighted average number of ordinary shares for basic EPS | 143,522 | 140,922 |
| <i>Effect of dilution from:</i> | | |
| Call spread transactions | 4,363 | - |
| Share options | 1,411 | 1,376 |
| Restricted shares | 133 | 450 |
| Restricted stock units | 485 | 404 |
| Weighted average number of ordinary shares adjusted for the effect of dilution | 149,914 | 143,152 |
| Basic earnings per share | \$0.14 | \$0.02 |
| Diluted earnings/(loss) per share | (\$2.66) | \$0.02 |

* Except for per share amounts

Dilutive earnings per share is negative in the current year due to the add back of significant revaluation gains on the 2023 call spread transactions. The 2023 convertible notes, that are closely linked to the 2023 call spread transactions but are not included in the calculation of diluted earnings per share, would have had an offsetting positive impact on net profit of \$496 million had they been also included in diluted earnings per share.

The weighted average number of shares outstanding used in computation of diluted earnings per share does not include the effect of the following potentially outstanding shares. The effects of these potentially outstanding shares were not included in the calculation because their effect would be anti-dilutive or they were out of the money.

| Year ended 31 March | 2021 (000s) | 2020 (000s) |
|---|----------------|----------------|
| Convertible note | 6,057 | 6,474 |
| Call spread options | 1,694 | 6,474 |
| Contingent consideration | 97 | 132 |
| Share options | 8 | - |
| Total potentially outstanding shares | 7,856 | 13,080 |

8. Trade and other receivables

| At 31 March | 2021 (\$000s) | 2020 (\$000s) |
|--|------------------|------------------|
| Prepayments | 42,930 | 22,617 |
| Accrued income | 24,943 | 22,750 |
| Trade receivables | 8,658 | 7,614 |
| Provision for doubtful debts | (402) | (633) |
| Interest receivable | 700 | 2,534 |
| Other receivables | 9,568 | 995 |
| Total trade and other receivables | 86,397 | 55,877 |

Trade and other receivables are initially recognised at the fair value of the amounts to be received. They are subsequently measured at amortised cost (using the effective interest method) less impairment losses.

Trade receivables relate primarily to the monthly subscriptions to Xero's cloud-based software products. Subscriptions are charged monthly, the majority being paid by direct debit. At 31 March 2021, trade receivables of the Group of \$0.4 million were past due and are considered partially impaired (2020: \$0.9 million).

Other receivables at 31 March 2021 includes \$9.2 million receivable in relation to shares that were sold to cover employees' withholding obligations under Xero's employee share-based compensation plans. A corresponding liability is recognised in employee entitlements.

Key estimates and assumptions

In accordance with NZ IFRS 9: *Financial Instruments*, the Group recognises impairment losses using the Expected Credit Loss (ECL) model. ECLs are based on the difference between the contractual cash flows due in accordance with the contract and the cash flows that the Group expects to receive. The shortfall is discounted at an approximation to the asset's original effective interest rate. Under the ECL model, impairment losses may be measured as either the 12-month ECL, which is the portion of lifetime ECLs that result from default events that are possible within 12 months after the reporting date, or the lifetime ECL, which is the expected credit loss resulting from all possible default events over the expected life of the financial instrument. The Group has elected to use the lifetime ECL model to calculate the impairment for trade receivables.

A six-month historical default rate is applied to the current period trade receivable balance to calculate any impairment. The carrying amount of the asset is reduced through the use of a provision account, and the amount of the loss is recognised in the Income Statement. When a receivable is uncollectible, it is written off against the provision account for receivables. Subsequent recoveries of amounts previously written off are credited to the Income Statement.

9. Property, plant and equipment

| | Right of use asset (\$'000s) | Leasehold improvements (\$'000s) | Furniture and equipment (\$'000s) | Computer equipment (\$'000s) | Total (\$'000s) |
|---------------------------------|---------------------------------|-------------------------------------|--------------------------------------|---------------------------------|--------------------|
| <i>Year ended 31 March 2021</i> | | | | | |
| Opening net book value | 54,807 | 16,743 | 9,578 | 5,510 | 86,638 |
| Additions | 43,063 | 7,227 | 1,455 | 2,028 | 53,773 |
| Disposals* | (4,043) | (53) | (26) | (14) | (4,136) |
| Depreciation expense | (15,113) | (3,744) | (2,299) | (3,773) | (24,929) |
| Foreign exchange adjustment | (1,666) | 4 | (154) | (172) | (1,988) |
| Closing net book value | 77,048 | 20,177 | 8,554 | 3,579 | 109,358 |
| <i>At 31 March 2021</i> | | | | | |
| Cost | 108,818 | 30,674 | 14,743 | 9,582 | 163,817 |
| Accumulated depreciation | (31,770) | (10,497) | (6,189) | (6,003) | (54,459) |
| Closing net book value | 77,048 | 20,177 | 8,554 | 3,579 | 109,358 |

* \$40 million of right of use asset disposals relates to disposal of lease liabilities (2020: \$6.8 million)

| | Right of use asset (\$'000s) | Leasehold improvements (\$'000s) | Furniture and equipment (\$'000s) | Computer equipment (\$'000s) | Total (\$'000s) |
|---------------------------------|---------------------------------|-------------------------------------|--------------------------------------|---------------------------------|--------------------|
| <i>Year ended 31 March 2020</i> | | | | | |
| Opening net book value | 63,440 | 15,474 | 7,542 | 5,035 | 91,491 |
| Additions | 8,312 | 4,866 | 4,478 | 4,770 | 22,426 |
| Disposals | (6,795) | (87) | (366) | (41) | (7,289) |
| Depreciation expense | (12,614) | (3,662) | (2,355) | (4,404) | (23,035) |
| Impairment reversals | 207 | - | - | - | 207 |
| Foreign exchange adjustment | 2,257 | 152 | 279 | 150 | 2,838 |
| Closing net book value | 54,807 | 16,743 | 9,578 | 5,510 | 86,638 |
| <i>At 31 March 2020</i> | | | | | |
| Cost | 79,552 | 23,836 | 15,374 | 11,602 | 130,364 |
| Accumulated depreciation | (24,745) | (7,093) | (5,796) | (6,092) | (43,726) |
| Closing net book value | 54,807 | 16,743 | 9,578 | 5,510 | 86,638 |

Key estimates and assumptions

Property, plant and equipment are stated at historical cost less accumulated depreciation.

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** |
| Right of use asset* | Term of lease** |
| Computer equipment | 2–3 years |
| Furniture and equipment | 2–7 years |

* Substantially all of the right of use asset relates to building leases

** Lease terms range between 2–12 years

10. Intangible assets

| | Software development (\$'000s) | Contract acquisition asset (\$'000s) | Other intangible assets (\$'000s) | Goodwill (\$'000s) | Total (\$'000s) |
|---------------------------------|-----------------------------------|---|--------------------------------------|-----------------------|--------------------|
| Year ended 31 March 2021 | | | | | |
| Opening net book value | 227,151 | 33,078 | 3,244 | 78,773 | 342,246 |
| Additions* | 155,206 | 11,471 | 697 | - | 167,374 |
| Acquisitions | 27,340 | - | 5,534 | 47,108 | 79,982 |
| Amortisation expense | (90,929) | (11,579) | (2,104) | - | (104,612) |
| Foreign exchange adjustment | (160) | (1,069) | 27 | 229 | (973) |
| Closing net book value | 318,608 | 31,901 | 7,398 | 126,110 | 484,017 |
| At 31 March 2021 | | | | | |
| Cost | 505,485 | 61,340 | 12,328 | 126,110 | 705,263 |
| Accumulated amortisation | (186,877) | (29,439) | (4,930) | - | (221,246) |
| Closing net book value | 318,608 | 31,901 | 7,398 | 126,110 | 484,017 |

* Included in software development additions is \$275 million of external costs capitalised (2020: \$17.3 million)

| | Software development (\$'000s) | Contract acquisition asset (\$'000s) | Other intangible assets (\$'000s) | Goodwill (\$'000s) | Total (\$'000s) |
|---------------------------------|-----------------------------------|---|--------------------------------------|-----------------------|--------------------|
| Year ended 31 March 2020 | | | | | |
| Opening net book value | 177,695 | 28,727 | 4,536 | 78,773 | 289,731 |
| Additions | 120,542 | 13,829 | 345 | - | 134,716 |
| Amortisation expense | (69,452) | (10,937) | (1,637) | - | (82,026) |
| Impairments | (1,634) | - | - | - | (1,634) |
| Foreign exchange adjustment | - | 1,459 | - | - | 1,459 |
| Closing net book value | 227,151 | 33,078 | 3,244 | 78,773 | 342,246 |
| At 31 March 2020 | | | | | |
| Cost | 370,563 | 60,360 | 6,075 | 78,773 | 515,771 |
| Accumulated amortisation | (143,412) | (27,282) | (2,831) | - | (173,525) |
| Closing net book value | 227,151 | 33,078 | 3,244 | 78,773 | 342,246 |

Key estimates and assumptions

Software development

Costs that are directly associated with the development of software are recognised as intangible assets where the following criteria are met:

- It is technically feasible to complete the software product so that it will be available for use
- Management intends to complete the software product and use or sell it
- There is an ability to use or sell the software product
- It can be demonstrated how the software product will generate probable future economic benefits
- Adequate technical, financial, and other resources to complete the development and to use or sell the software product are available
- The expenditure attributable to the software product during its development can be reliably measured

Other development expenditure that does not meet the above criteria is recognised as an expense when incurred. Development costs previously recognised as expenses are not recognised as assets in a subsequent period. Research costs, and costs associated with maintenance, are recognised as an expense when incurred.

At 31 March 2021, if software development capitalisation rates had been 10% higher/lower with all other variables held constant, the impact on operating expenses would have been \$13.6 million lower/higher.

Contract acquisition assets

In accordance with NZ IFRS 15: *Revenue from Contracts with Customers*, Xero capitalises incremental costs of obtaining customer 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 sold to which the commissions relate.

Other intangible assets

Other intangible assets consist of patents, domains, brands, and trademark costs, along with customer contracts. Other intangible assets acquired in a business combination are initially measured at cost, which is their fair value at the date of acquisition. Internally generated assets, excluding capitalised development costs, are not capitalised and expenditure is recognised in the Income Statement when it is incurred.

Useful lives of 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 |
| Contract acquisition asset | 5 years |
| Customer contracts | 3–7 years |
| Patents, domains, brands, and trademark costs | 5–10 years |

Impairment considerations

At each reporting date, the Group assesses whether there is any indication that an asset may be impaired. Where an indicator of impairment exists, the Group makes a formal estimate of the recoverable amount. Where the carrying value of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

The recoverable amount is the greater of fair value less costs to sell or the asset's value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows.

Goodwill is tested at least annually for impairment, or whenever indicators of impairment exist.

An impairment loss is recorded if its recoverable amount is less than its carrying amount. The recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate.

Goodwill and goodwill impairment testing

Goodwill represents the excess of purchase consideration over the fair value of net assets acquired in a business combination. Goodwill is allocated to cash-generating units (CGUs), which are the lowest level of assets for which separately identifiable cash flows can be attributed. Of Xero's goodwill at 31 March 2021, \$78.8 million relates to the acquisition of Hubdoc Inc., and \$47.3 million relates to the acquisition of Waddle. The Group performed a detailed impairment review of goodwill and concluded there was no impairment for the year ended 31 March 2021. In accordance with NZ IAS 36: *Impairment of Assets*, the recoverable amount of goodwill for the purpose of impairment testing is determined as the higher of an asset's fair value less costs to sell and its value in use. The methodology applied for the current year testing is outlined below.

Waddle goodwill

Waddle goodwill has been allocated to the Waddle, ANZ, and International CGUs as follows:

| At 31 March 2021 | Waddle CGU (\$000s) | ANZ CGU (\$000s) | International CGU (\$000s) | Total (\$000s) |
|--------------------|------------------------|---------------------|-------------------------------|-------------------|
| Goodwill allocated | 36,962 | 7,424 | 2,951 | 47,337 |

The recoverable amount of the Waddle CGU was calculated on the basis of value in use using a discounted cash-flow model. Future cash flows were projected for a period of five years, with an average annual growth rate of 287%. Growth reflects the fact that revenues are expected to increase at a much higher rate than expenses as economies of scale are achieved. A terminal growth rate of 5% and a post-tax discount rate of 20% were applied. The terminal growth rate is determined based on the long-term anticipated growth rate of the business.

The forecast financial information is based on both past experience and future expectations of CGU performance. The major inputs and assumptions used in performing an impairment assessment that require judgement include revenue forecasts, operating cost projections, discount rates, terminal growth rates, and future technology paths. Based on sensitivity analysis performed, no foreseeable changes in the assumptions would cause the carrying amounts of the Waddle CGU to exceed its recoverable amount.

The recoverable amounts of the ANZ and International CGUs were calculated on the basis of fair value less costs of disposal in accordance with NZ IFRS 13: *Fair Value Measurement*. Fair value was determined using a revenue multiple of 16.7. This input is classified as level two on the fair value hierarchy and is based on revenue multiples of comparable companies. Based on sensitivity analysis performed, no foreseeable changes in the assumptions would cause the carrying amounts to exceed their recoverable amounts.

Hubdoc goodwill

Hubdoc goodwill is allocated across the ANZ and International CGUs. Of the \$78.8 million of goodwill, \$39.0 million is allocated to ANZ and \$39.8 million is allocated to International.

The recoverable amounts of the ANZ and International CGUs for the purpose of impairment testing of the Hubdoc goodwill are calculated on the basis of fair value less costs of disposal in the same manner as used for the Waddle goodwill as noted above. Based on sensitivity analysis performed, no foreseeable changes in the assumptions would cause the carrying amounts of the CGUs to exceed their recoverable amounts.

11. Trade and other payables

| At 31 March | 2021 (\$000s) | 2020 (\$000s) |
|---------------------------------------|------------------|------------------|
| Trade payables | 13,386 | 10,615 |
| Accrued expenses | 24,011 | 23,440 |
| Sales tax payable | 7,354 | 8,899 |
| Total trade and other payables | 44,751 | 42,954 |

The Group recognises trade and other payables initially at fair value and subsequently at amortised cost using the effective interest method. The amounts are unsecured and non-interest bearing.

12. Other current liabilities

| At 31 March | Notes | 2021 (\$000s) | 2020 (\$000s) |
|--|-------|------------------|------------------|
| Income in advance | | 13,113 | 9,607 |
| Contingent consideration | 14 | 10,712 | - |
| Term debt | 15 | 2,604 | - |
| Accrued interest | | 20 | 5,812 |
| Other short-term liabilities | | 1,770 | 275 |
| Total other current liabilities | | 28,219 | 15,694 |

The Group recognises other current liabilities, excluding contingent consideration, initially at fair value, and subsequently at amortised cost using the effective interest method. Contingent consideration is recognised at the present value of expected future cash flows. Adjustments are made to the fair value where expected achievement against targets changes.

Income in advance is recognised when the Group has received consideration prior to services being rendered. All income in advance from the prior period was subsequently recognised as revenue in the year.

13. Lease liabilities

| | 2021 (\$000s) | 2020 (\$000s) |
|---------------------------------------|------------------|------------------|
| Balance at 1 April | 72,626 | 82,849 |
| Leases entered into during the period | 36,402 | 5,988 |
| Lease incentives received | 495 | 504 |
| Principal repayments | (11,632) | (13,417) |
| Change in future lease payments | (1,511) | (6,213) |
| Foreign exchange adjustment | (1,850) | 2,915 |
| Balance at 31 March | 94,530 | 72,626 |
| | | |
| Current | 10,580 | 11,755 |
| Non-current | 83,950 | 60,871 |

Under NZ IFRS 16: *Leases*, the Group is required to recognise lease liabilities for contracts identified as containing a lease, except when the lease is for 12 months or less, or the underlying asset is of low value.

Payments associated with short-term leases and leases of low-value assets are recognised on a straight-line basis as an expense in the Income Statement. Low-value assets comprise IT equipment and small items of office furniture. The expense relating to low-value assets for the year ended 31 March 2021 was \$3.7 million (2020: \$2.8 million).

Lease liabilities are initially measured at the present value of the remaining lease payments, discounted at the Group's incremental borrowing rate. Subsequently, the carrying value of the liability is adjusted to reflect interest and lease payments made. Lease liabilities may be re-measured 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.

The Group assesses at lease commencement whether it expects to exercise renewal options included in contracts. Where it is reasonably certain that renewal options will be exercised, the extension period is included in the lease liability calculation.

14. Contingent consideration

| | Note | 2021 (\$'000s) |
|-------------------------------|------|-------------------|
| Balance at 1 April | | 2,840 |
| Additions | 19 | 42,314 |
| Unwinding of discount | | 1,761 |
| Change in fair value estimate | | (543) |
| Foreign exchange adjustment | | 247 |
| Balance at 31 March | | 46,619 |
| | | |
| Current | | 10,712 |
| Non-current | | 35,907 |

Contingent consideration comprises the Group's assessment of amounts payable to vendors in respect of the Instafile and Waddle business combinations. Additions to contingent consideration consists of \$41.1 million relating to the acquisition of Waddle, and an additional \$1.2 million relating to the acquisition of Instafile.

Of the above, \$21.6 million is expected to be settled in shares and \$25.0 million in cash. The non-current portion of contingent consideration is expected to become payable following the achievement of specified product and revenue milestones between April 2022 and September 2023.

15. Term debt

In September 2018, Xero Investments Limited, a wholly owned subsidiary of the Company, made an offering of USD300 million of convertible notes (the '2023 convertible notes'). The notes were scheduled to mature on 4 October 2023.

In November 2020, Xero Investments Limited made a new convertible notes offering of USD700 million (the '2025 convertible notes'). In conjunction with the settlement of the 2025 notes, Xero Investments Limited entered into a buyback of the 2023 convertible notes and unwound the existing call spread options.

Buyback of the 2023 convertible notes

In December 2020, Xero Investments Limited repurchased USD297.0 million of the 2023 convertible notes for a total consideration of USD666.4 million, being settled for USD292.2 million in cash and USD374.2 million in the ordinary shares of Xero Limited.

At extinguishment, the bond component of the notes, which was historically accounted for at amortised cost, was settled at fair value. The settlement resulted in a \$62.5 million loss on extinguishment being recognised in the Income Statement.

The conversion feature derivatives were carried in the Statement of Financial Position at their estimated fair value, and adjusted at each reporting period with any gains or losses being recorded in the Income Statement. During the year, the Group recognised a \$421.1 million revaluation loss in the Income Statement relating to the conversion feature derivatives. At extinguishment, the value of the conversion feature derivative relating to the December 2020 redemption was \$513.4 million.

A further USD1.2 million of the 2023 notes was redeemed in cash in January 2021 at par. The remaining USD1.8 (\$2.6 million) million of the 2023 notes is expected to be cash settled in May 2021 based on the volume-weighted average price of the ordinary shares over the preceding 90 day trading period. The unredeemed portion of the notes is accounted for at fair value based on the current share price. At 31 March 2021, the values of the bond component and embedded derivative were \$2.6 million and \$2.9 million respectively. The bond component and the embedded derivative are included in other current liabilities and other current derivative liabilities respectively. The net impact on the Income Statement of the January 2021 settlement, and expected settlement of the May 2021 redemptions was a \$0.9 million loss.

Unwind of the 2023 call spread transactions

The lower strike call options were accounted for in the Statement of Financial Position at their estimated fair value. The derivative assets were adjusted to fair value at each reporting period, with unrealised gains or losses reflected in the Income Statement. During the period, the Group recognised a \$418.8 million revaluation gain in the Income Statement relating to the 2023 lower strike call options. At unwind, the value of the lower strike call options was \$510.2 million.

The upper strike call options were accounted for as equity and initially recognised at their fair value less transaction costs. On unwind the upper strike call options are settled at their current fair value. The unwind resulted in a \$400.2 million loss being recognised in equity.

2025 convertible notes and conversion feature derivative

In November 2020, Xero Investments Limited made an offering of USD700 million of zero coupon convertible notes. The convertible notes were settled and listed on the SGX-ST on 2 December 2020.

The notes have a zero coupon interest rate. The notes are unsubordinated, unsecured obligations of Xero, and have a final maturity date of 2 December 2025. 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 the preceding 75-day trading period. The initial conversion of the notes is USD134.72 per ordinary share based on a fixed exchange rate of AUD1.00 = USD0.73.

The conversion feature of the notes is required to be separated from the notes and is accounted for as a derivative financial liability. The fair value of the conversion feature derivative at the time of issuance was \$146.4 million and was recorded at a discount for the purpose of accounting for the debt component of the notes. The discount is amortised as interest expense using the effective interest method over the term of the notes.

The principal amount, unamortised debt discount, unamortised issuance costs, and net carrying amount of the liability component of the 2025 notes at 31 March 2021 are as follows:

| At 31 March | 2021 (\$000s) |
|----------------------------|------------------|
| Principal amount | 1,002,400 |
| Unamortised debt discount | (133,266) |
| Unamortised issuance costs | (15,056) |
| Term debt | 854,078 |

At initial recognition, the fair value of the 2025 notes was determined using a market interest rate for an equivalent non-convertible bond. The notes are subsequently recognised at amortised cost. The fair value of the debt component of the 2025 notes at 31 March 2021 was \$862.2 million.

Call spread options

In connection with the issuance of the 2025 notes, Xero purchased call spread options which are expected to reduce potential dilution to shareholders upon conversion of the notes, by offsetting any cash payments Xero may be required to make in excess of the principal amounts on conversion. The call spread options will be effective at offsetting dilution on conversion of the notes up to a share price of USD174.64 (AUD237.76). The call spread options consist of 0.7 million lower strike call options purchased with an average strike price equal to the conversion price of the notes, and 0.7 million upper strike call options sold with an average strike price of USD174.64. Both the lower call and upper call options are exercisable into a total of approximately 5.2 million ordinary shares. The call spread options have expiry dates between 13 August 2025 and 25 November 2025. The net cost of the call spread was \$80.9 million, which was paid from the proceeds of the 2025 notes.

The lower strike call options are accounted for as derivative financial assets and are accounted for at their fair value. The upper strike call options are accounted for as equity, and are recognised at their initial fair value, less transaction costs. The carrying value of the upper strike call options is \$63.7 million.

Transaction costs

Transaction costs relating to the 2025 notes have been allocated between the debt component and the conversion derivatives using the relative proportions of these on initial measurement of the instruments. Costs attributed to the debt component of \$14.7 million are amortised to finance expense over the term of the notes using the effective interest method. Costs attributable to the conversion derivatives of \$2.6 million were recognised immediately in the Income Statement. Transaction costs related to the call spread options have been attributed between the lower strike call options and upper strike call options, with the lower strike call option costs of \$0.6 million being recognised immediately in the Income Statement. Costs attributable to the upper strike call options of \$0.6 million are deducted from the amount recognised in equity.

An additional \$2.5 million in costs relating to the extinguishment of the 2023 notes and unwind of the existing call spread options were recognised immediately in the Income Statement.

16. Financial instruments, capital and financial risk management

Financial instruments

Financial instruments recognised in the Statement of Financial Position include cash and cash equivalents, short-term deposits, receivables and payables, contingent consideration, term debt, and derivative financial instruments. The Group's policy is that no speculative trading in financial instruments may be undertaken.

Classification and fair values

Xero has carried out a fair value assessment of its financial assets and liabilities at 31 March 2021 in accordance with NZ IFRS 9.

Under NZ IFRS 9, financial instruments are classified as either measured at amortised cost, fair value through other comprehensive income, or fair value through profit or loss. The classification of the Group's financial instruments into these categories is included in the table below.

The carrying values of the Group's other financial instruments do not materially differ from their fair value.

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

Key estimates and assumptions

The Group's foreign exchange derivatives, conversion feature, call option derivative assets and contingent consideration liabilities are recognised at fair value. Fair value of foreign exchange derivatives are determined using forward exchange rates that are quoted in an active market (level two on the fair value hierarchy).

The fair values of the conversion feature and call option derivative assets relating to the convertible notes are determined using valuation techniques. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity-specific estimates (level two on the fair value hierarchy). Inputs into the valuation include share price volatility and time to expiration.

The fair value of contingent consideration is determined using valuation techniques such as probability weighted forecasts of meeting certain product development and revenue targets (level three on the fair value hierarchy), and is discounted using the Group's weighted average cost of capital.

| | Financial assets at amortised cost (\$000s) | Financial instruments at fair value through profit or loss (\$000s) | Financial liabilities at amortised cost (\$000s) | Total carrying value (\$000s) |
|---|---|--|--|-------------------------------------|
| At 31 March 2021 | | | | |
| <i>Assets</i> | | | | |
| Cash and cash equivalents | 657,849 | - | - | 657,849 |
| Term deposits | 452,814 | - | - | 452,814 |
| Trade and other receivables | 18,524 | - | - | 18,524 |
| Derivative assets (foreign currency derivatives)* | - | 1,551 | - | 1,551 |
| Derivative assets (call spread options) | - | 122,123 | - | 122,123 |
| Other current assets | 4,937 | - | - | 4,937 |
| Other non-current assets | 268 | - | - | 268 |
| Total financial assets | 1,134,392 | 123,674 | - | 1,258,066 |
| <i>Liabilities</i> | | | | |
| Trade and other payables | - | - | 37,397 | 37,397 |
| Derivative liabilities (foreign currency derivatives)* | - | 3,956 | - | 3,956 |
| Derivative liabilities (conversion feature on convertible notes) | - | 123,126 | - | 123,126 |
| Term debt | - | - | 854,078 | 854,078 |
| Other current liabilities | - | 13,316 | 846 | 14,162 |
| Contingent consideration | - | 35,907 | - | 35,907 |
| Total financial liabilities | - | 176,305 | 892,321 | 1,068,626 |

At 31 March 2020

| | | | | |
|---|----------------|----------------|----------------|----------------|
| <i>Assets</i> | | | | |
| Cash and cash equivalents | 108,027 | - | - | 108,027 |
| Term deposits | 428,052 | - | - | 428,052 |
| Trade and other receivables | 10,510 | - | - | 10,510 |
| Derivative assets (foreign currency derivatives)* | - | 7,347 | - | 7,347 |
| Derivative assets (call spread options) | - | 117,351 | - | 117,351 |
| Other non-current assets | 1,327 | - | - | 1,327 |
| Total financial assets | 547,916 | 124,698 | - | 672,614 |
| <i>Liabilities</i> | | | | |
| Trade and other payables | - | - | 34,055 | 34,055 |
| Derivative liabilities (foreign currency derivatives)* | - | 3,256 | - | 3,256 |
| Derivative liabilities (conversion feature on convertible notes) | - | 121,873 | - | 121,873 |
| Term debt | - | - | 424,587 | 424,587 |
| Other current liabilities | - | - | 5,812 | 5,812 |
| Other non-current liabilities | - | 2,840 | - | 2,840 |
| Total financial liabilities | - | 127,969 | 464,454 | 592,423 |

* Foreign currency derivatives are hedge accounted when possible with unrealised gains and losses recognised in other comprehensive income until the underlying cash flows are realised, at which point the gains and losses are reclassified to the Income Statement

Capital management

The capital structure of the Group primarily consists of equity raised by the issue of ordinary shares in the Company and issued debt.

Xero manages its capital to ensure that it maintains an appropriate capital structure to support the business and maximise shareholder value. The Group's capital structure is adjusted based on business needs and economic conditions. During the year ended 31 March 2021, Xero issued USD700 million of convertible notes for the purpose of investments into strategic and complementary businesses and assets which are in line with the Group's strategy to drive long-term shareholder value, and for general corporate purposes. Xero repurchased USD298.2 million of the 2023 convertible notes, utilising USD293.4 million of cash from the new convertible note proceeds, along with the issuance of USD374.2 million in share capital.

Xero's \$150 million standby debt facility remains undrawn at 31 March 2021. There are no current plans to draw down on the facility. The facility provides Xero with additional liquidity to cover unforeseen operating cash flow requirements. Counterparties to the facility are ANZ, BNZ, HSBC, and Citibank. The facility expires in August 2022.

In November 2020 an additional AUD30 million facility was entered into, with HSBC as the sole counterparty. The facility was put in place to fund the Waddle loans receivable portfolio on an ongoing basis and expires in August 2022. At 31 March 2021 the facility is drawn by AUD0.8 million. The drawn balance is included in other current liabilities at 31 March 2021.

Financial risk management

The Group is exposed to the following risks through the normal course of business and from its use of financial instruments:

- a. Market risk
- b. Liquidity risk
- c. Credit risk

The following presents both qualitative and quantitative information on the Group's exposure to each of the above risks, along with policies and processes for managing risk.

(a) Market risk

The Group is exposed to market risk primarily through changes in foreign currency exchange rates and interest rates.

Foreign currency risk

Nature of risk

Foreign currency risk is the risk that changes to foreign currency exchange rates negatively impact the Group's New Zealand dollar (NZD) net cash flows.

Exposure and risk management

Xero is exposed to currency risk from the operations of foreign subsidiaries and foreign currency denominated expenses in the parent Company. The Group has significant operations in four currencies, being Great British pounds (GBP), Australian dollars (AUD), United States dollars (USD), and Canadian dollars (CAD), with exposures to other currencies to a lesser degree. The material exposures are USD and CAD outflows, as well as AUD and GBP inflows. In order to reduce the impact of short-term movements in exchange rates, the Group's treasury policy requires a portion of the next 18 months' cash flows to be hedged with forward exchange contracts and vanilla options (outright purchased options and vanilla collars), except for AUD and GBP cashflows, where hedging a portion of the next 24 months' forecast cashflows is permitted within the policy threshold.

The Group's exposure to monetary foreign currency financial instruments and lease liabilities is outlined below in NZD:

| | AUD (\$000s) | USD (\$000s) | GBP (\$000s) | CAD (\$000s) | EUR (\$000s) |
|---|-----------------|------------------|-----------------|-----------------|-----------------|
| At 31 March 2021 | | | | | |
| <i>Exposures</i> | | | | | |
| Cash and cash equivalents, and short-term deposits | 8,137 | 757,230 | 13,173 | 2,170 | 145,619 |
| Trade and other receivables | 2,024 | 1,068 | 2,820 | 155 | – |
| Other current assets | 4,937 | – | – | – | – |
| Trade and other payables | (9,257) | (4,217) | (5,619) | (1,409) | (1,505) |
| Other current liabilities | (8,078) | (2,624) | (3,460) | – | – |
| Contingent consideration | (35,907) | – | – | – | – |
| Lease liabilities | (4,321) | (8,850) | (30,480) | (454) | – |
| Term debt (including conversion feature) | – | (1,002,400) | – | – | – |
| Derivative financial instruments (foreign currency derivatives) | 161,684 | (29,146) | 101,745 | (9,850) | (503) |
| Total foreign currency exposure | 119,219 | (288,939) | 78,179 | (9,388) | 143,611 |

At 31 March 2020

| | | | | | |
|---|---------------|------------------|---------------|-----------------|----------|
| <i>Exposures</i> | | | | | |
| Cash and cash equivalents, and short-term deposits | 8,525 | 419,699 | 9,004 | 2,310 | – |
| Trade and other receivables | 1,387 | 3,695 | 2,736 | 174 | – |
| Trade and other payables | (8,766) | (7,019) | (6,187) | (524) | – |
| Other current liabilities | – | (5,812) | – | – | – |
| Other non-current liabilities | – | – | (2,840) | – | – |
| Lease liabilities | (5,392) | (13,523) | (1,794) | (1,223) | – |
| Term debt (including conversion feature) | – | (500,526) | – | – | – |
| Derivative financial instruments (foreign currency derivatives) | 85,164 | (31,517) | 63,990 | (13,231) | – |
| Total foreign currency exposure | 80,918 | (135,003) | 64,909 | (12,494) | – |

At 31 March, a movement of 10% in the NZD would impact the Income Statement and Statement of Changes in Equity (after hedging) as detailed in the table below:

| | 10% decrease | 10% increase | | |
|--|------------------|------------------|------------------|------------------|
| | 2021 (\$000s) | 2020 (\$000s) | 2021 (\$000s) | 2020 (\$000s) |
| <i>Impact on:</i> | | | | |
| Net profit/(loss) before income tax (increase/(decrease)) | 14,365 | (1,751) | (11,753) | 1,432 |
| Equity (before income tax) (increase/(decrease)) | (57,624) | 12,646 | 47,147 | (10,214) |

This analysis assumes a movement in the NZD across all currencies and only includes the effect of foreign exchange movements on financial instruments. All other variables remain constant.

Interest rate risk

Nature of risk

Interest rate risk is the risk that changes in interest rates negatively impact the Group's financial performance or the value of its financial instruments.

Exposure and risk management

The Group's interest rate risk arises from its cash and cash equivalents and short-term deposit balances, and when term debt at fixed rates is refinanced. Cash and cash equivalents comprise cash in hand, deposits held on call with banks, funds invested in money market funds, and other short-term and highly liquid investments with original maturities of 90 days or less. Surplus balances are placed in short-term investments at fixed rates. The repricing of these at maturity exposes the Group to interest rate risk. Money market funds invested into include a broad range of highly rated short-term fixed income securities and calculate investment returns on a daily basis. Changes to interest rates will impact the returns generated by each fund. The convertible notes would give rise to interest rate risk at maturity (December 2025) if the Group were to refinance at prevailing interest rates, with higher interest rates increasing the cost of debt financing should they be in effect at this time.

The Group does not currently enter into interest rate hedges. However, management regularly reviews its investment and funding arrangements to ensure it achieves the best returns on its funds while maintaining access to necessary liquidity levels to service the Group's day-to-day activities.

Sensitivity to interest rate risk

If interest rates for the year had been 1.0% higher/lower with all other variables held constant, the impact on the interest income and net profit of the Group would have been \$9.6 million higher/lower, and accumulated losses \$9.6 million lower/higher (2020: \$5.4 million). This analysis assumes that the cash and cash equivalents and short-term deposits balance was consistent with the year end balance throughout the year.

(b) Liquidity risk

Nature of risk

Liquidity risk is the risk that the Group cannot pay contractual liabilities as they fall due.

Exposure and risk management

At 31 March 2021 the Group held cash and cash equivalents of \$657.8 million and term deposits of \$452.8 million, which are available to be used to service the Group's day-to-day activities and for investments into strategic and complementary businesses and assets. The \$150 million syndicated standby facility provides additional liquidity to cover unforeseen operating cash flow requirements. The AUD30.0 million facility, of which AUD29.2 million is undrawn at 31 March 2021, provides additional liquidity to fund expansion of the Waddle loans receivable portfolio.

The liquidity risk that arises on maturity of the convertible notes in December 2025 is being closely monitored by management, with the intention that there will be repayment or refinancing plans in advance of this to ensure that the Group has sufficient liquidity to meet its contractual obligations as they fall due.

The Group's exposure to liquidity risk based on undiscounted contractual cash flows relating to financial liabilities and lease liabilities is summarised below:

| | Less than 12 months (\$000s) | Between 1 and 2 years (\$000s) | Between 2 and 5 years (\$000s) | Over 5 years (\$000s) | Total contractual cash flows (\$000s) | Carrying amount (\$000s) |
|---|------------------------------------|--------------------------------------|--------------------------------------|--------------------------|---|--------------------------------|
| At 31 March 2021 | | | | | | |
| <i>Non-derivative financial liabilities</i> | | | | | | |
| Trade and other payables | 37,397 | – | – | – | 37,397 | 37,397 |
| Lease liabilities | 16,338 | 12,830 | 39,746 | 55,776 | 124,690 | 94,530 |
| Other current liabilities | 10,621 | – | – | – | 10,621 | 10,536 |
| Term debt | – | – | 1,002,400 | – | 1,002,400 | 854,078 |
| Contingent consideration | – | 3,901 | 19,032 | – | 22,933 | 17,952 |
| Contractual cash flows | 64,356 | 16,731 | 1,061,178 | 55,776 | 1,198,041 | 1,014,493 |
| <i>Derivative financial liabilities</i> | | | | | | |
| Derivative liabilities | 2,858 | – | – | – | 2,858 | 2,858 |
| Forward exchange contracts | – | – | – | – | – | (3,956) |
| Inflows | 231,507 | 39,483 | 7,561 | – | 278,551 | – |
| Outflows | (40,028) | (8,207) | (7,561) | – | (55,796) | – |
| Contractual cash flows | 194,337 | 31,276 | – | – | 225,613 | (1,098) |

| | Less than 12 months (\$000s) | Between 1 and 2 years (\$000s) | Between 2 and 5 years (\$000s) | Over 5 years (\$000s) | Total contractual cash flows (\$000s) | Carrying amount (\$000s) |
|---|------------------------------------|--------------------------------------|--------------------------------------|--------------------------|---|--------------------------------|
| At 31 March 2020 | | | | | | |
| <i>Non-derivative financial liabilities</i> | | | | | | |
| Trade and other payables | 34,055 | – | – | – | 34,055 | 34,055 |
| Lease liabilities | 18,446 | 16,468 | 33,470 | 53,003 | 121,387 | 72,626 |
| Term debt | 11,887 | 11,887 | 524,301 | – | 548,075 | 430,399 |
| Other non-current liabilities | – | 2,840 | – | – | 2,840 | 2,840 |
| Contractual cash flows | 64,388 | 31,195 | 557,771 | 53,003 | 706,357 | 539,920 |
| <i>Derivative financial liabilities</i> | | | | | | |
| Forward exchange contracts | – | – | – | – | – | (3,256) |
| Inflows | 62,563 | 3,095 | – | – | 65,658 | – |
| Outflows | (65,158) | (3,128) | – | – | (68,286) | – |
| Contractual cash flows | (2,595) | (33) | – | – | (2,628) | (3,256) |

(c) Credit risk

Nature of risk

Credit risk arises in the normal course of Xero's business on financial assets if a counterparty fails to meet its contractual obligations.

Exposure and risk management

Financial instruments that potentially subject the Group to credit risk principally consist of cash and cash equivalents, short-term deposits, derivatives, bonds and deposits, loan receivables portfolio, and receivables.

The Group manages credit risk by placing cash, short-term deposits, and derivative contracts with high-quality financial institutions. The exposure to the credit risk of the call option counterparties means that in the event of default the Group may have to pay an increased amount on settlement of the convertible notes. The Group manages liquidity factoring in any risk of default. The credit risk associated with trade receivables is small due to the inherently low transaction value and the distribution over a large number of customers.

Other current assets include the acquired Waddle loans receivable portfolio, which consists of secured loans made to small businesses based on a customer's nominated accounts receivable. The Group assesses the creditworthiness of the loans receivable portfolio on a pooled basis due to the composition of the loans having similar characteristics, being small homogeneous loans with similar risk profiles. The Group has assessed the credit risk of the loans receivable portfolio as low, due to low historic default rates and the distribution of the portfolio being over a number of customers.

Group financial assets subject to credit risk at balance date are as follows:

| At 31 March | 2021 (\$000s) | 2020 (\$000s) |
|--|------------------|------------------|
| Cash and cash equivalents | 657,849 | 108,027 |
| Short-term deposits | 452,814 | 428,052 |
| Trade and other receivables | 18,524 | 10,510 |
| Derivative financial assets | 123,674 | 124,698 |
| Other current assets | 4,937 | - |
| Non-current assets | 268 | 1,327 |
| Total financial assets subject to credit risk | 1,258,066 | 672,614 |

A summary of the Group's exposure to credit risk on cash and cash equivalents, short-term deposits, and derivative assets categorised by external credit risk grading is as follows:

| At 31 March | 2021 (\$000s) | 2020 (\$000s) |
|--|------------------|------------------|
| <i>Cash and cash equivalents and short-term deposits</i> | | |
| AAAm | 398,147 | - |
| A-1+ | 469,880 | 470,121 |
| A-1 | 236,791 | 60,379 |
| A-2 | 5,845 | 5,579 |
| Total cash and cash equivalents and short-term deposits | 1,110,663 | 536,079 |
| <i>Derivative assets</i> | | |
| A-1+ | 946 | 5,917 |
| A-1 | 122,728 | 118,781 |
| Total derivative assets | 123,674 | 124,698 |
| Total exposure to credit risk | 1,234,337 | 660,777 |

Of the Group's trade and other receivables, other current assets and non-current assets, \$9.2 million are with counterparties with an A-1 external credit risk rating. The remaining amounts are with counterparties who have no external credit risk rating. Due to the nature of the Group's business, the balances do not consist of any concentration of risk that is considered individually material.

17. Derivatives and hedge accounting

The Group's derivative financial instruments consist of forward exchange contracts, vanilla foreign exchange options (outright purchased options and vanilla collars), conversion feature of the convertible notes, and call spread options entered into in connection with the convertible notes.

| At 31 March | 2021 (\$000s) | 2020 (\$000s) |
|---|------------------|------------------|
| <i>Current derivative assets</i> | | |
| Forward exchange contracts | 861 | 5,732 |
| Call spread options | - | 117,351 |
| Foreign exchange options | - | 1,615 |
| <i>Non-current derivative assets</i> | | |
| Call spread options | 122,123 | - |
| Forward exchange contracts | 690 | - |
| Total derivative assets | 123,674 | 124,698 |
| <i>Current derivative liabilities</i> | | |
| Conversion feature of convertible notes | (2,858) | - |
| Forward exchange contracts | (3,363) | (1,937) |
| Foreign exchange options | - | (1,220) |
| <i>Non-current derivative liabilities</i> | | |
| Conversion feature of convertible notes | (120,268) | (121,873) |
| Forward exchange contracts | (593) | (39) |
| Foreign exchange options | - | (60) |
| Total derivative liabilities | (127,082) | (125,129) |

Foreign currency hedges

The Group uses derivatives in the form of forward exchange contracts and vanilla foreign exchange options (outright purchased options and vanilla collars) to reduce the risk that movements in foreign exchange rates will affect the Group's NZD cash flows. Whenever possible, 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 determines the existence of an economic relationship between the hedging instrument and the hedged item based on the currency and timing of respective cash flows. Derivatives in hedge relationships are designated based on a hedge ratio of 1:1. Hedges that do not have a highly probable forecast transaction are recognised as ineffective hedges.

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income. The gain or loss relating to the ineffective portion is recognised immediately in the Income Statement. Amounts accumulated in equity are reclassified to the Income Statement in the periods when the hedged transaction affects profit and loss. Only the intrinsic value of options are designated as hedge relationships with movements in the time value of foreign exchange options recognised immediately in the Income Statement. The Group has taken up the option under NZ IFRS 9 to defer forward points into other comprehensive income.

During the year, a net hedging loss of \$9.0 million (before taxation) was recognised in other comprehensive income (2020: gain of \$6.8 million). During the year, a gain of \$0.4 million (before taxation) was reclassified out of other comprehensive income to the Income Statement (2020: gain of \$5.6 million). The remaining balance will be reclassified to the Income Statement in future reporting periods as the relevant hedging instruments mature.

Hedge position

The Group's hedge accounted financial instruments are as follows:

| At 31 March | 2021 Average forward price | 2021 Fair value (\$000s) | 2021 Notional amount hedged (NZD) (\$000s) | 2020 Average forward price | 2020 Fair value (\$000s) | 2020 Notional amount hedged (NZD) (\$000s) |
|-------------------------------|----------------------------------|--------------------------------|---|----------------------------------|--------------------------------|---|
| <i>Derivative assets</i> | | | | | | |
| Buy USD – Sell NZD | 0.7256 | 575 | 14,470 | 0.6692 | 3,388 | 28,180 |
| Buy CAD – Sell NZD | 0.9097 | 177 | 4,672 | 0.8692 | 528 | 13,231 |
| Buy NZD – Sell AUD | 0.9139 | 93 | 21,885 | 0.9332 | 3,034 | 85,164 |
| Buy NZD – Sell GBP | 0.4937 | 283 | 16,203 | – | – | – |
| Total | | 1,128 | | | 6,950 | |
| <i>Derivative liabilities</i> | | | | | | |
| Buy USD – Sell NZD | 0.6719 | (752) | 20,092 | – | – | – |
| Buy CAD – Sell NZD | 0.8656 | (51) | 4,044 | – | – | – |
| Buy NZD – Sell AUD | 0.9265 | (1,498) | 144,637 | – | – | – |
| Buy NZD – Sell GBP | 0.5144 | (1,655) | 85,542 | 0.5051 | (2,643) | 53,665 |
| Total | | (3,956) | | | (2,643) | |

Conversion feature and call option derivatives

The conversion feature derivative liability of the 2025 convertible notes represents an embedded derivative financial instrument in the host debt contract. The conversion feature represents the Group's obligation to issue Xero Limited shares (or an equivalent amount of cash) should noteholders exercise their conversion option. The embedded conversion derivatives are carried in the Statement of Financial Position at their estimated fair value and adjusted at the end of each reporting period, with any unrealised gain or loss reflected in the Income Statement. During the year ended 31 March 2021, the Group recognised a \$27.1 million revaluation gain in the Income Statement relating to the 2025 conversion feature derivative.

In connection with the issue of the 2025 convertible notes, the Group entered into call spread options. The lower strike call options mirror the conversion option embedded in the convertible notes, and are accounted for as derivative assets in the 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 Income Statement. During the year ended 31 March 2021, the Group recognised a \$24.3 million revaluation loss in the Income Statement relating to the lower strike call options.

18. Share capital

| | Notes | 2021 (000s) | 2020 (000s) |
|---|-------|----------------|----------------|
| Balance at 1 April | | 141,851 | 140,774 |
| Issue of ordinary shares – buyback of 2023 convertible notes | 15 | 3,750 | - |
| Issue of ordinary shares – exercising of employee share options | 24 | 952 | 504 |
| Issue of ordinary shares – restricted stock unit schemes | 24 | 314 | 266 |
| Issue of ordinary shares – employee restricted share plan | 24 | 97 | 67 |
| Issue of ordinary shares – exercising of director share options | | - | 60 |
| Issue of ordinary shares – acquisition of Hubdoc | | - | 176 |
| Issue of ordinary shares – directors' fees | | - | 4 |
| Ordinary shares on issue at 31 March | | 146,964 | 141,851 |
| Treasury shares | | (133) | (339) |
| Ordinary shares on issue at 31 March excluding treasury shares | | 146,831 | 141,512 |

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

During the year, the Company issued 3,750,005 shares at a price of AUD135.86 to part fund the buyback of the 2023 convertible notes.

During the year, employees exercised 952,438 share options with a weighted average exercise price of \$33.26 (2020: 504,021, \$22.70).

During the year, 341,519 RSUs vested, of which 313,527 were converted to shares with a weighted average price of \$72.64. The remaining 27,992 were surrendered to settle payroll withholding obligations (2020: 327,917 vested, 266,190 converted at a weighted average price of \$48.01, 61,727 surrendered to settle payroll withholding obligations).

During the year, the Company allocated 133,589 shares under the employee restricted share plan, at a weighted average price of AUD93.88 (2020: 141,582, AUD63.95). Of the shares allocated, 97,131 were new shares issued, and 36,458 were the reissue of shares held as treasury shares (2020: 66,823 and 74,759 respectively).

19. Business combinations

On 1 October 2020, Xero acquired 100% of the ordinary shares in invoice financing platform Waddle, for consideration of AUD35.9 million cash (including completion adjustment of AUD4.9 million). An additional AUD24.5 million in shares of Xero Limited and AUD24.5 million in cash may be payable to the previous shareholders of Waddle dependent on the achievement of certain product development and revenue milestones over the period to September 2023.

Of the AUD49 million contingent consideration, AUD14 million is payable based on the achievement of specific product and business integration milestones. The remaining AUD35 million contingent consideration is dependent on the achievement of specified revenue milestones. All contingent consideration payments are payable 50% in cash and 50% in shares, unless otherwise agreed.

The number of shares issued on settlement of the contingent consideration will be based on the 20-day 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 achievement throughout the 36-month period and will record any revaluation adjustments accordingly.

Goodwill of \$47.1 million has been recognised to reflect Waddle's expertise and technology that will enable the Group to grow Xero's small business platform and help our customers better manage cash flow and gain access to working capital.

| | 1 October 2020 (\$000s) |
|--|----------------------------|
| Assets acquired and liabilities assumed | |
| Software development asset | 27,340 |
| Customer contracts intangible asset | 5,010 |
| Brand intangible asset | 524 |
| Goodwill | 47,108 |
| Tangible assets acquired | 7,286 |
| Tangible liabilities assumed | (7,293) |
| Net assets acquired | 79,975 |
| Consideration transferred | |
| Cash* | 38,832 |
| Contingent consideration | 41,143 |
| Total consideration | 79,975 |

* Net of cash acquired as part of the business combination, cash outflows relating to the acquisition were \$36.3 million

The acquired software development asset, customer contracts, and brand are determined to have useful lives of 7 years, 7 years, and 5 years respectively.

For the period from acquisition date to 31 March 2021, Waddle contributed \$2.1 million in operating revenue and \$0.2 million in net loss. If the acquisition had occurred on 1 April 2020, management estimates that consolidated operating revenue and net profit would have been an additional \$2.4 million higher and \$0.4 million lower respectively for the year ended 31 March 2021.

20. Group entities

Consolidation subsidiaries are all entities over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date that control ceases.

Inter-company transactions and balances between Group companies are eliminated on consolidation.

The financial statements of each of the Group's subsidiaries are prepared in the functional currency of that entity. The functional currency is determined for each entity based on factors such as the principal trading currency. The assets and liabilities of these entities are translated at exchange rates existing at balance date. Revenue and expenses are translated at rates approximating the exchange rates ruling at the dates of the transactions. The exchange gains or losses arising on translation are recorded in other comprehensive income and accumulated in the foreign currency translation reserve in equity.

| | Country of incorporation | Balance date | Interest 2021 (%) | Interest 2020 (%) |
|---------------------------------------|--------------------------|--------------|-------------------|-------------------|
| Xero (NZ) Limited | New Zealand | 31 March | 100 | 100 |
| Xero (UK) Limited | United Kingdom | 31 March | 100 | 100 |
| Xero Australia Pty Limited | Australia | 31 March | 100 | 100 |
| Xero, Inc. | United States | 31 March | 100 | 100 |
| Xero (Singapore) Pte. Ltd | Singapore | 31 March | 100 | 100 |
| Xero Software (Canada) Ltd | Canada | 31 March | 100 | 100 |
| Xero (HK) Limited | Hong Kong | 31 March | 100 | 100 |
| Xero South Africa (Pty) Ltd | South Africa | 31 March | 100 | 100 |
| Xero Trustee Limited | New Zealand | 31 March | 100 | 100 |
| Hubdoc Inc. | Canada | 31 March | 100 | 100 |
| Hubdoc Pty Limited | Australia | 31 March | 100 | 100 |
| Hubdoc (UK) Limited | United Kingdom | 31 January | 100 | 100 |
| Xero Investments Limited | New Zealand | 31 March | 100 | 100 |
| Waddle Holdings Pty Limited | Australia | 30 June | 100 | - |
| Waddle Loans Pty. Ltd. | Australia | 30 June | 100 | - |
| Waddle SaaS Pty Ltd | Australia | 30 June | 100 | - |
| Waddle Servicing Pty Ltd | Australia | 30 June | 100 | - |
| Waddle IP Pty. Ltd. | Australia | 30 June | 100 | - |
| Waddle Loans Limited | New Zealand | 30 June | 100 | - |
| Xero (NZ) Holdings Limited | New Zealand | 31 March | 100 | - |
| Xero (Australia) Holdings Pty Limited | Australia | 31 March | 100 | - |

21. Current and deferred income tax

Tax expense comprises current and deferred tax. Income tax is recognised in the Income Statement or Statement of Comprehensive Income except when it relates to items recognised directly in equity (in which case the income tax is recognised in equity). Income tax is based on tax rates and regulation enacted in the jurisdictions in which the entities operate.

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax is based on the expected manner of realisation of the carrying amount of assets and liabilities, using tax rates enacted or substantially enacted at the end of the reporting period.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available, against which the asset can be utilised.

Income tax expense

The tax on the Group's profit/(loss) before tax differs from the theoretical amount that would arise using the New Zealand statutory income tax rate as follows:

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) |
|---|------------------|------------------|
| Accounting profit/(loss) before income tax | (43,936) | 9,837 |
| At the New Zealand statutory income tax rate of 28% | (12,302) | 2,754 |
| Non-deductible expenditure | (2,197) | 370 |
| Prior period adjustment | (1,833) | (116) |
| Recognition of historic unrecognised tax losses | (55,060) | (14,036) |
| Tax rate variance of subsidiaries | 2,371 | 847 |
| Current year tax losses/deferred expenditure not recognised | 5,311 | 16,682 |
| Income tax (credit)/expense | (63,710) | 6,501 |
| <i>Comprising:</i> | | |
| Income tax payable | 9,410 | 9,196 |
| Prior period adjustment | (1,833) | (116) |
| Deferred tax | (16,334) | (1,565) |
| Recognition of tax losses | (55,060) | - |
| Tax losses utilised | - | (972) |
| Effect of changes in foreign currency | 107 | (42) |
| Income tax (credit)/expense | (63,710) | 6,501 |

Deferred income tax

| | Derivatives (\$000s) | Provisions and employee benefits (\$000s) | Tax depreciation (\$000s) | Tax losses and R&D expenditure (\$000s) | Total (\$000s) |
|--|-------------------------|---|------------------------------|---|-------------------|
| Year ended 31 March 2021 | | | | | |
| <i>Deferred tax asset balances</i> | | | | | |
| At 1 April 2020 | – | 9,288 | (2,858) | (2,679) | 3,751 |
| Prior period adjustment | – | (336) | 1,296 | 1,861 | 2,821 |
| Charged to Income Statement | – | 24,677 | (26,257) | 73,371 | 71,791 |
| Charged to equity | (792) | 17,371 | – | 8,304 | 24,883 |
| Impact of change in tax rates | – | 204 | (183) | – | 21 |
| At 31 March 2021 | (792) | 51,204 | (28,002) | 80,857 | 103,267 |
| <i>Deferred tax liability balances</i> | | | | | |
| At 1 April 2020 | (1,209) | 14,646 | (22,977) | 8,426 | (1,114) |
| Prior period adjustment | – | 90 | (263) | 10 | (163) |
| Recognition of deferred tax on business combination | – | – | (5,814) | – | (5,814) |
| Charged to Income Statement | – | (14,470) | 22,403 | (8,351) | (418) |
| Charged to equity | 1,209 | – | – | – | 1,209 |
| At 31 March 2021 | – | 266 | (6,651) | 85 | (6,300) |
| Year ended 31 March 2020 | | | | | |
| <i>Deferred tax asset balances</i> | | | | | |
| At 1 April 2019 | – | 5,661 | (2,849) | (1,199) | 1,613 |
| Prior period adjustment | – | (547) | 584 | 647 | 684 |
| Charged to Income Statement | – | 4,153 | (547) | (2,718) | 888 |
| Charged to equity | – | (23) | – | 591 | 568 |
| Impact of change in tax rates | – | 44 | (46) | – | (2) |
| At 31 March 2020 | – | 9,288 | (2,858) | (2,679) | 3,751 |
| <i>Deferred tax liability balances</i> | | | | | |
| At 1 April 2019 | (881) | 9,276 | (19,048) | 8,864 | (1,789) |
| Prior period adjustment | – | (267) | 39 | (412) | (640) |
| Charged to Income Statement | – | 2,185 | (3,968) | 2,462 | 679 |
| Charged to equity | (328) | 3,452 | – | (3,460) | (336) |
| Tax losses utilised | – | – | – | 972 | 972 |
| At 31 March 2020 | (1,209) | 14,646 | (22,977) | 8,426 | (1,114) |

Key estimates and assumptions

Recognised tax losses and temporary differences

A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available, against which the deductible temporary differences can be offset.

The Group has reviewed previously unrecognised New Zealand tax losses and has determined that it is now probable that future expected taxable profits will arise for which the tax losses and other unrecognised temporary differences (primarily comprising carried forward R&D expenditure) can be utilised. Current shareholder continuity further supports the recognition of a deferred tax asset. Accordingly, in the year to 31 March 2021, the Group has recognised a deferred tax asset of \$83.1 million in respect of New Zealand tax losses and carried forward R&D expenditure.

The Group's recognised deferred tax asset and deferred tax liability are expected to be recovered and realised by \$15.6 million and \$0.34 million respectively within the next 12 months. Deferred tax assets and liabilities have been offset where the balances are due to/receivable from the same counterparties.

Carried forward R&D expenditure

The Group has elected to defer the deduction of research and development expenditure in accordance with sections DB 34(7) and EE 1(5) of the Income Tax Act 2007.

The estimated deferred research and development expenditure available to the Group is \$94.6 million (2020: \$85.4 million).

The deferred research and development expenditure can be deducted from taxable income in future periods, and the ability to carry forward deferred research and development expenditure is not dependent on maintaining shareholder continuity.

Unrecognised tax losses and temporary differences

The Group has estimated unrecognised tax losses available to carry forward and other unrecognised temporary differences in overseas jurisdictions of \$170.6 million (2020: \$133.2 million) subject to shareholder continuity being maintained (as applicable), noting that deferred tax assets are recognised for carried forward tax losses to the extent of deferred tax liabilities.

22. Reconciliation of operating cash flows

| Year ended 31 March | 2021 (\$'000s) | 2020 (\$'000s) |
|---|-------------------|-------------------|
| Net profit | 19,774 | 3,336 |
| <i>Adjustments:</i> | | |
| Depreciation | 24,929 | 23,035 |
| Amortisation | 104,612 | 82,026 |
| Loss on recognition/extinguishment of term debt | 67,169 | - |
| Share-based payments | 42,731 | 34,336 |
| Amortisation of debt discount and issuance costs | 21,781 | 17,023 |
| Recognition of historic unrecognised tax losses | (55,060) | - |
| Deferred tax and current taxes recognised in equity | (1,772) | (1,565) |
| Bad debts | 1,331 | 1,974 |
| Other non-cash items | 11,684 | (2,435) |
| Tax losses utilised | - | (972) |
| Impairment of assets | - | 1,427 |
| <i>Changes in working capital:</i> | | |
| Increase in receivables and prepayments | (34,053) | (5,833) |
| Decrease in interest receivable | 1,672 | 931 |
| Increase/(decrease) in trade payables and other related items | (23,880) | 6,396 |
| Increase/(decrease) in current tax payable | (2,570) | 721 |
| Increase in employee entitlements | 36,785 | 4,304 |
| Increase in income in advance | 3,506 | 1,925 |
| Net cash flows from operating activities | 218,639 | 166,629 |

23. Changes in financial assets and liabilities arising from financing activities

| Year ended 31 March 2021 | At 1 April 2020 (\$000s) | Proceeds (\$000s) | Payments (\$000s) | Amortisation expense (\$000s) | Foreign exchange movement (\$000s) | Other non- cash items* (\$000s) | At 31 March 2021 (\$000s) |
|--|-----------------------------|----------------------|----------------------|-------------------------------------|---|---------------------------------------|---------------------------------|
| Short-term deposits | 428,052 | (795,540) | 855,428 | – | (35,126) | – | 452,814 |
| Call spread option derivative assets** | 117,350 | (510,160) | 145,341 | – | (24,981) | 394,573 | 122,123 |
| Term debt and conversion feature | (546,460) | (976,060) | 415,305 | (21,781) | 61,285 | 87,901 | (979,810) |
| Other current liabilities | – | (814) | – | – | (12) | – | (826) |

| Year ended 31 March 2020 | At 1 April 2019 (\$000s) | Proceeds (\$000s) | Payments (\$000s) | Amortisation expense (\$000s) | Foreign exchange movement (\$000s) | Other non- cash items (\$000s) | At 31 March 2020 (\$000s) |
|--|-----------------------------|----------------------|----------------------|-------------------------------------|---|--------------------------------------|---------------------------------|
| Short-term deposits | 336,819 | (734,563) | 785,753 | – | 40,043 | – | 428,052 |
| Call spread option derivative assets** | 73,999 | – | – | – | 10,720 | 32,631 | 117,350 |
| Term debt and conversion feature | (435,098) | – | – | (17,023) | (61,181) | (33,158) | (546,460) |

* Other non-cash movements reflect the loss on extinguishment of the 2023 convertible notes, and the fair value of the bond component and embedded conversion derivative relating to the issuance of the 2025 convertible notes

** Excludes cash flows related to equity classified call spread option derivatives

24. Share-based payments

The Group operates equity-settled, share-based compensation plans, under which employees provide services in exchange for non-transferable options, RSUs, or restricted shares. The value of the employee services rendered for the grant of non-transferable options, RSUs, and restricted 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 restricted shares granted.

Employee restricted share plan

Under the employee restricted share plan, ordinary shares in the Company are issued to a trustee, Xero Limited Employee Restricted Share Trust, a wholly owned subsidiary, and allocated to participants on grant date, using funds lent to them by the Company.

The shares are beneficially owned by the participants. The length of retention period before the shares vest is up to three years. If the individual is still employed by the Group at the end of each specific period, the employee is given a bonus that must be used to repay the loan and shares are then transferred to the employee. The weighted average grant date fair value of restricted shares granted during the year was AUD93.88 (2020: AUD63.95) and was determined by the volume-weighted average price of the Company shares preceding the grant date. Shares with a grant date fair value of \$17.6 million vested during the year (2020: \$11.1 million). The Group has no legal or constructive obligation to repurchase or settle the shares for cash.

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

| | 2021 Number of shares (000s) | 2020 Number of shares (000s) |
|---|------------------------------------|------------------------------------|
| Outstanding restricted shares at start of period | 313 | 371 |
| Granted | 134 | 142 |
| Forfeited | (17) | (61) |
| Settled | (304) | (139) |
| Outstanding restricted shares at 31 March – allocated to employees | 126 | 313 |
| Forfeited shares not yet reallocated – held by Trustee | 7 | 26 |
| Total | 133 | 339 |
| Percentage of total ordinary shares | 0.1% | 0.2% |
| Ageing of unvested shares | | |
| Vest within one year | 83 | 138 |
| Vest after one year | 43 | 44 |
| Total unvested shares at 31 March* | 126 | 182 |

* 31 March 2020 balance varies from the total above due to shares that vested on 31 March 2020 but were not settled until 1 April 2020

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

Share options scheme

Options are granted to selected employees and executives. Options are conditional on the completion of the necessary years of service (the vesting period) as appropriate to that tranche.

The options tranches vest within four years from the grant date. No options can be exercised later than the second anniversary of the final vesting date. There were 65 holders of options at 31 March 2021 (2020: 52).

The Group has no legal or constructive obligation to repurchase or settle the options in cash.

Movements in the number of options outstanding and their related weighted average exercise prices are as follows:

| | 2021 Weighted average exercise price (\$) | 2021 Options (000s) | 2020 Weighted average exercise price (\$) | 2020 Options (000s) |
|--------------------------------|---|---------------------------|---|---------------------------|
| Outstanding at start of period | 42.04 | 2,861 | 31.91 | 2,995 |
| Granted | 110.24 | 456 | 64.85 | 763 |
| Forfeited/expired | 52.27 | (88) | 37.12 | (333) |
| Exercised | 33.26 | (952) | 22.07 | (564) |
| Outstanding at 31 March | 58.98 | 2,277 | 42.04 | 2,861 |
| Exercisable at 31 March | 37.10 | 264 | 21.32 | 288 |

The weighted average share price on the date of exercise for options exercised in the year ended 31 March 2021 was AUD102.27 (2020: AUD67.94). The weighted average remaining contractual term of options outstanding at 31 March 2021 is 3.7 years (2020: 3.1 years).

Options outstanding at 31 March fall within the following ranges:

| Granted | Exercise price | 2021 Options (000s) | 2020 Options (000s) |
|---------|----------------------|---------------------|---------------------|
| 2016–17 | NZD17.51 – NZD19.50 | 75 | 445 |
| 2017–18 | NZD25.75 – NZD32.48 | 66 | 190 |
| 2018–19 | AUD34.00 – AUD48.33 | 1,134 | 1,463 |
| 2019–20 | AUD51.82 – AUD83.04 | 546 | 763 |
| 2020–21 | AUD79.50 – AUD138.28 | 456 | – |
| | | 2,277 | 2,861 |

The weighted average fair value of options granted during the year, determined using the Black-Scholes valuation model, was \$29.98 per option (2020: \$18.89).

The significant inputs into the model were the market share price at grant date, the exercise price as shown above, expected annualised volatility of between 34.1% and 36.1%, a dividend yield of 0%, an expected option life of between three and five years, and an annual risk-free interest rate of between 0.2% and 0.4%.

The volatility input is measured as the standard deviation of continuously compounded share returns and is based on a statistical analysis of daily share prices over a period consistent with the options' expected life.

Restricted stock units

RSUs are issued to certain employees and executives of the Group. On the grant date, an RSU agreement is entered into between employee and Company stipulating the number of units granted and their vesting schedules. On the vest date, the RSUs are converted to ordinary shares in the Company.

No cash consideration is required to be paid on vesting of the RSUs. The fair value of RSUs granted in the year ended 31 March 2021 was \$32.8 million (2020: \$28.1 million) as determined by the volume-weighted average share price. The RSUs are conditional on the employees completing up to three years' service (the vesting period) and are, for the most part, converted to shares in equal amounts over the vesting period.

Movements in the number of RSUs outstanding and their related weighted average grant prices are as follows:

| | 2021 Weighted average grant date fair value (\$) | 2021 RSUs (000s) | 2020 Weighted average grant date fair value (\$) | 2020 RSUs (000s) |
|---|--|------------------|--|------------------|
| Outstanding at start of period | 60.16 | 379 | 38.89 | 370 |
| Granted | 101.72 | 359 | 66.00 | 425 |
| Forfeited | 80.53 | (45) | 53.71 | (89) |
| Converted to shares | 72.64 | (314) | 48.01 | (266) |
| Surrendered to settle payroll withholding obligations | 48.78 | (28) | 34.33 | (61) |
| Outstanding at 31 March | 90.00 | 351 | 60.16 | 379 |

The Company withholds shares under certain circumstances to settle tax withholding obligations on vesting. Based on the market share price on 31 March 2021, future cash payments to meet tax withholding obligations on the vesting of RSUs are expected to be \$0.2 million (2020: \$1.5 million).

25. Key management personnel and related parties

Key management personnel

Key management personnel are defined as those persons having authority and responsibility for planning, directing, and controlling the activities of the Group, directly or indirectly, and include the directors, the Chief Executive, and the Chief Financial Officer. Xero's key management personnel were redefined in the current year as a result of the impact COVID-19 had on the way the business was managed and the increased need for financial discipline in an uncertain environment. As a result, year-over-year balances are not comparable.

The following table summarises remuneration paid to key management personnel.

| Year ended 31 March | 2021 (\$000s) | 2020 (\$000s) |
|---|------------------|------------------|
| Short-term employee benefits | 2,307 | 8,329 |
| Directors' fees | 1,415 | 1,332 |
| Share-based payments - options | 2,327 | 7,807 |
| Share-based payments - restricted stock units | 296 | 1,360 |
| Share-based payments - employee restricted share plan | - | 147 |

Related party transactions

During the year Atomic.io Limited, a related party by way of a 19% shareholding and common directorship of a Xero director, provided product development and support services to the Group of \$296,000.

During the year OTO60 Tourism Limited, a related party by way of being wholly owned and governed by a Xero director, provided client sales and marketing event services to the Group of \$20,000.

Other than that related to the remuneration of key management personnel there are no balances or commitments outstanding with related parties as at 31 March 2021.

A number of key management personnel, or their related parties, hold positions in other entities that result in them having control or significant influence over the financial or operating policies of these entities. A number of these entities subscribe to services provided by the Group. None of these related party transactions are significant to either party, and are completed on arm's length terms. There were no related party transactions during the year other than as detailed above.

No amounts with any related parties have been written off or foregone during the year (2020: nil).

26. Commitments and contingencies

Capital commitments

Capital commitments of \$15.2 million for building fit-outs were contracted for at 31 March 2021 but not yet incurred (2020: \$1.2 million).

Contingent liabilities

There were no contingent liabilities at 31 March 2021 (2020: nil).

27. Events after balance sheet date

Planday acquisition

On 1 April 2021, Xero acquired 100% of the ordinary shares in cloud-based workforce management business Planday A/S and subsidiaries ('Planday'), pursuant to an agreement dated 4 March 2021. The acquisition will enable Xero to continue its strategy to grow the small business platform.

Consideration for the acquisition comprised an upfront cash payment of EUR85.6 million and shares of EUR70.1 million, including an adjustment for working capital, with further contingent consideration of up to EUR27.8 million payable 50% in shares and 50% in cash subject to meeting certain product and revenue milestones.

Tickstar acquisition

On 1 April 2021, Xero acquired 100% of the ordinary shares in e-invoicing infrastructure business Tickstar AB ('Tickstar'), pursuant to an agreement dated 24 March 2021. The acquisition aligns with Xero's strategic priority to drive adoption of cloud accounting around the world.

Consideration for the acquisition comprised an upfront cash payment of SEK30 million and shares of SEK30 million, including an adjustment for working capital, with further contingent consideration of up to SEK90 million payable 50% in shares and 50% in cash subject to meeting certain product and revenue milestones.

At the date these financial statements were authorised for issue, the initial accounting for the respective Planday and Tickstar business combinations had not been completed due to the time required to complete the valuations of the acquired intangibles, along with the work required to align the accounting policies of the acquired companies to that of the Xero Group. This information will be included in the Group's interim report for the six months ended 30 September 2021.

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

Directors' Responsibilities Statement

The directors are required to prepare financial statements for each financial year that present fairly the financial position of the Group and its operations and cash flows for that period.

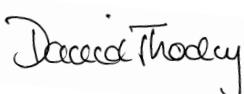
The directors consider these financial statements have been prepared using accounting policies suitable to the Group's circumstances, that these have been consistently applied and are supported by reasonable judgements and estimates, and that all relevant financial reporting and accounting standards have been followed.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy, at any time, the financial position of the Group and to enable them to ensure that the financial statements comply with the Companies Act 1993 (New Zealand). They are also responsible for safeguarding the assets of the Group and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

During the year ended 31 March 2021, the principal activities of the Group were for the provision of online business solutions for small businesses and their advisors. Other than as disclosed in this Annual Report, there were no significant changes in the state of affairs or activities of the Group during the year.

The Board authorised these financial statements for issue on 13 May 2021.

For and on behalf of the Board



David Thodey
Chair
Xero Limited
13 May 2021



Mark Cross
Director
Xero Limited
13 May 2021

Disclosures

All financial figures in this section of the Annual Report are in New Zealand dollars except where indicated otherwise. References to FY21 are to the financial year ended 31 March 2021. References to FY20 are to the financial year ended 31 March 2020. Xero Group means Xero Limited (Xero) and its subsidiaries.

Equity holdings of Directors, CEO & CFO

| At 31 March 2021 | Number of ordinary shares (Shares) | Number of unlisted options (Options) | Number of restricted stock units (RSUs) |
|--------------------------------|---------------------------------------|---|--|
| Non-executive directors | | | |
| David Thodey ¹ | 8,461 | - | - |
| Rod Drury ² | 11,914,789 | - | - |
| Lee Hatton | 5,378 | - | - |
| Dale Murray | 950 | - | - |
| Susan Peterson | 3,340 | - | - |
| Craig Winkler ³ | 6,675,990 | - | - |
| Mark Cross ⁴ | 2,500 | - | - |
| Steven Aldrich | - | - | - |
| CEO and CFO | | | |
| Steve Vamos | 3,000 | 210,783 | 10,090 |
| Kirsty Godfrey-Billy | - | 108,908 | 1,056 |

¹ Shares are held by Aspiring Co Pty Limited on behalf of the Thodey Family Trust. David Thodey is a director of Aspiring Co Pty Limited and the beneficiaries of the Thodey Family Trust are the immediate family members of David Thodey

² Shares are held by Rodney Kenneth Drury, Anna Margaret Clare Stuck, and Scott Moran, as trustees of the Rodanna Ventures Trust. The beneficiaries of the Rodanna Ventures Trust are Anna Margaret Clare Stuck, Rodney Kenneth Drury and their immediate family members.

³ 6,654,545 Shares are held by Givia Pty Limited, the trustee of an Australian charitable trust. Craig Winkler is a director of Givia Pty Limited; he and his family members are not beneficiaries of the trust. 21,445 Shares are held by a custodian for the benefit of Bangarie Investments Pty Limited. Craig Winkler is a director of Bangarie Investments Pty Limited

⁴ Shares are held by Alpha Investment Partners Limited on behalf of Alpha Investment Trust. Mark Cross is a director of Alpha Investment Partners Limited and the beneficiaries of Alpha Investment Trust are Mark Cross and the immediate members of his family.

Entries recorded in the Interests Register

Xero maintains an interests register in accordance with the Companies Act 1993 (New Zealand).

Directors' interests

Directors disclosed the following relevant interests, or cessations of interest, during FY21.

| Director/Entity | Relationship |
|---|---|
| David Thodey | |
| National COVID-19 Coordination Commission (NCCC) ¹ | ceased to be deputy chair |
| Vodafone Group Plc | ceased to be a director |
| Mark Cross | |
| MFL Mutual Fund Limited / Superannuation Investments Limited | ceased to be chair and director |
| Lee Hatton | |
| Afterpay Limited | appointed Executive vice president |
| Suncorp Group Limited | ceased to be chief executive officer of banking and wealth division |
| Dale Murray | |
| Seedrs | ceased to be an advisor |
| Susan Peterson | |
| Arvida Group Limited | director |
| ASB Bank Limited | ceased to be a director |
| Rod Drury | |
| OTO60 Tourism Limited | director and shareholder |
| Steven Aldrich* | |
| Blucora, Inc. | director |

¹ Finite commitment, at the request of the Australian Government, to advise on Australia's economic and social response to COVID-19

* Commenced 1 October 2020

Share dealings of directors

Directors disclosed the following acquisitions or disposals of relevant interests in Xero Shares during FY21.

| Registered holder | Date of acquisition/disposal | Consideration per Share (AUD) | Number of Shares acquired/ (disposed) |
|--|------------------------------|----------------------------------|--|
| David Thodey | | | |
| Aspiring Co Pty Limited ¹ | 31 August 2020 | \$101.34 | 4,000 |
| Rod Drury² | | | |
| Rodanna Ventures Trust ² | 3 September 2020 | \$99.00 | (2,000,000) |
| Rodanna Ventures Trust ² | 30 November 2020 | \$133.02 | (1,756,485) |
| Rodanna Ventures Trust ² | 1 December 2020 | \$133.51 | (48,505) |
| Lee Hatton | | | |
| Lee Hatton | 26 September 2020 | \$97.77 | (4,000) |
| Susan Peterson | | | |
| Susan Peterson | 14 September 2020 | \$89.84 | 710 |
| Craig Winkler³ | | | |
| Givia Pty Limited ³ | 3 September 2020 | \$100.00 | (1,000,000) |
| Givia Pty Limited ³ | 30 November 2020 | \$132.97 | (1,000,000) |
| Givia Pty Limited ³ | 2 December 2020 | \$133.00 | (600,000) |
| Mark Cross | | | |
| Alpha Investment Partners Limited ⁴ | 3 September 2020 | \$101.90 | 2,500 |

¹ Shares are held by Aspiring Co Pty Limited on behalf of the Thodey Family Trust. David Thodey is a director of Aspiring Co Pty Limited and the beneficiaries of the Thodey Family Trust are the immediate family members of David Thodey

² Shares are held by Rodney Kenneth Drury, Anna Margaret Clare Stuck, and Scott Moran, as trustees of the Rodanna Ventures Trust. The beneficiaries of the Rodanna Ventures Trust are Anna Margaret Clare Stuck, Rodney Kenneth Drury and their immediate family members

³ Craig Winkler is a director of Givia Pty Limited, the trustee of an Australian charitable trust. Craig Winkler and his family members are not beneficiaries of the trust. See ASX announcement dated 16 May 2017 for information on disposals by Givia Pty Limited

⁴ Shares are held by Alpha Investment Partners Limited on behalf of Alpha Investment Trust. Mark Cross is a director of Alpha Investment Partners Limited and the beneficiaries of Alpha Investment Trust are Mark Cross and the immediate members of his family.

Insurance

In accordance with the Companies Act 1993 (New Zealand), Xero has continued to insure its directors and officers (through renewal of its D&O insurance policy) against potential liability or costs incurred in any proceeding, except to the extent prohibited by law.

Deeds of Indemnity

Xero has provided deeds of indemnity to all directors and officers of Xero and its subsidiaries for potential liabilities and costs they may incur for acts or omissions in their capacity as directors or officers of Xero or its subsidiaries, to the extent permitted by law.

Remuneration Reporting

Xero's remuneration policy and practices are summarised on pages 73 to 92 of this Annual Report.

Shareholder Information

The shareholder information set out below is current as at 6 April 2021, unless otherwise specified.

Issued capital The total number of issued Shares in Xero at 31 March 2021 was 146,964,510, of which 132,713 Shares were held on a restricted basis in connection with Xero's share-based compensation plans.

Distribution of shareholding

| Range | Name of holders | % | Shares | % |
|-------------------|-----------------|---------------|--------------------|---------------|
| 1 to 1,000 | 34,715 | 92.46 | 6,036,834 | 4.08 |
| 1,001 to 5,000 | 2,304 | 6.14 | 4,766,378 | 3.22 |
| 5,001 to 10,000 | 277 | 0.74 | 2,002,268 | 1.35 |
| 10,001 to 100,000 | 175 | 0.47 | 4,702,091 | 3.18 |
| 100,001 and over | 35 | 0.09 | 130,364,818 | 88.16 |
| Total | 37,506 | 100.00 | 147,872,389 | 100.00 |

There were 303 holders of less than a marketable parcel of Shares as at 6 April 2021, based on a market price of AUD \$135.00 per Share.

RSUs and Options There were 64 individuals holding a total of 2,274,884 Options and 2,130 individuals holding a total of 350,341 RSUs. RSUs are a conditional contractual right to be issued an equivalent number of Shares in Xero.

Substantial holdings and limitations on the acquisition of securities Xero is a New Zealand incorporated and domiciled company listed on the ASX. From a regulatory perspective, this means that while the ASX Listing Rules apply to Xero, certain provisions of the Australian Corporations Act 2001 (Cth) do not. Xero is not subject to chapters 6, 6A, 6B, and 6C of the Australian Corporations Act 2001 (Cth) dealing with the acquisition of its Shares (including substantial holdings and takeovers). The Companies Act 1993 (New Zealand) applies to Xero and certain provisions of the Financial Markets Conduct Act 2013 (New Zealand) also apply to Xero (including in relation to financial reporting, but not including the provisions relating to substantial shareholdings).

There is no requirement on Xero's substantial shareholders to provide substantial product holder notices to Xero. Xero has not received any such notices during FY21.

Key limitations on the acquisition of Shares in Xero are imposed by the following New Zealand legislation: Commerce Act 1986, Overseas Investment Act 2005, and Takeovers Act 1993, together with various regulations and codes promulgated under such legislation.

Top 20 holders The names of the 20 largest holders of Xero Shares as at 6 April 2021 are listed below.

| Name | Number of shares held | Shares % of issued capital |
|---|-----------------------|-------------------------------|
| 1. HSBC Custody Nominees (Australia) Limited | 50,286,890 | 34.01 |
| 2. J P Morgan Nominees Australia Limited | 29,971,970 | 20.27 |
| 3. Rodney Kenneth Drury & Anna Margaret Clare Stuck & Scott Moran | 11,914,789 | 8.06 |
| 4. Citicorp Nominees Pty Limited | 9,636,027 | 6.52 |
| 5. Givia Pty Limited | 6,654,545 | 4.50 |
| 6. National Nominees Limited | 3,004,488 | 2.03 |
| 7. BNP Paribas Noms Pty Ltd <DRP> | 2,351,960 | 1.59 |
| 8. HSBC Custody Nominees (Australia) Limited - GSCO ECA | 2,250,018 | 1.52 |
| 9. Custodial Services Limited <Beneficiaries Holding A/C> | 1,781,347 | 1.20 |
| 10. JBWere (NZ) Nominees Limited <56968 A/C> | 1,745,207 | 1.18 |
| 11. Citicorp Nominees Pty Limited <Colonial First State Inv A/C> | 1,740,718 | 1.18 |
| 12. BNP Paribas Nominees Pty Ltd <Agency Lending DRP A/C> | 1,598,103 | 1.08 |
| 13. Nelson Nien Sheng Wang & Pei-Chun Ko <Wang Family A/C> | 1,138,688 | 0.77 |
| 14. Australian Foundation Investment Company Limited | 870,500 | 0.59 |
| 15. BNP Paribas Nominees Pty Ltd Six Sis Ltd <DRP A/C> | 832,389 | 0.56 |
| 16. Solium Nominees (Australia) Pty Ltd <VSA A/C> | 823,749 | 0.56 |
| 17. HSBC Custody Nominees (Australia) Limited <NT-Comnwth Super Corp A/C> | 495,932 | 0.34 |
| 18. BNP Paribas Nominees Pty Ltd <IB AU Noms Retail Client DRP> | 445,582 | 0.30 |
| 19. HSBC Custody Nominees (Australia) Limited - A/C 2 | 354,483 | 0.24 |
| 20. National Nominees Limited <N A/C> | 259,000 | 0.18 |
| Top 20 holders of fully paid Shares (total) | 128,156,385 | 86.67 |
| Other shareholders (balance on register) | 19,716,004 | 13.33 |
| Grand total | 147,872,389 | 100.00 |

Voting rights Xero has a single class of Shares on issue. Where voting at a meeting of shareholders is by voice or a show of hands, every shareholder present in person, or representative, has one vote. On a poll, every shareholder present in person, or by representative, has one vote for each fully paid Share. In practice, Xero ensures that all resolutions at shareholder meetings are decided by a poll rather than a show of hands.

On-market buy-back There is no current on-market buy-back for Xero Shares.

Company Information

Donations The Xero Group made charitable donations totalling \$145,459 during FY21. The Xero Group made no donations to political parties during FY21.

Company directors The following persons held office as directors of Xero Limited during FY21.

| Directors | Directors who ceased to hold office during FY21 |
|----------------------|---|
| David Thodey (Chair) | |
| Steven Aldrich | |
| Mark Cross | |
| Rod Drury | |
| Lee Hatton | |
| Dale Murray | |
| Susan Peterson | |
| Craig Winkler | |

Company subsidiaries and directors as at 31 March 2021 Xero had 21 wholly owned subsidiaries as shown in the table below. The following persons held office as directors of Xero's subsidiary companies during FY21.

| Jurisdiction | Subsidiary | Directors | Directors who ceased to hold office during FY21 |
|---------------------|---------------------------------------|---|--|
| Australia | Hubdoc Pty Limited | Kirsty Godfrey-Billy Trent Innes Chaman Sidhu | |
| | Xero Australia Pty Limited | Kirsty Godfrey-Billy Trent Innes Chaman Sidhu | |
| | Xero (Australia) Holdings Pty Limited | Kirsty Godfrey-Billy Trent Innes Chaman Sidhu | |
| | Waddle Holdings Pty Limited | Kirsty Godfrey-Billy Chaman Sidhu Simon Creighton | |
| | Waddle Loans Pty Limited | Kirsty Godfrey-Billy Chaman Sidhu Simon Creighton | |
| | Waddle SaaS Pty Limited | Kirsty Godfrey-Billy Chaman Sidhu Simon Creighton | |
| | Waddle Servicing Pty Limited | Kirsty Godfrey-Billy Chaman Sidhu Simon Creighton | |
| Canada | Hubdoc Inc. | Bill Kimball Andy Burner Kirsty Godfrey-Billy | Will Buckley (resigned effective 15 October 2020) |
| | Xero Software (Canada) Ltd | Bill Kimball Andy Burner Kirsty Godfrey-Billy | Will Buckley (resigned effective 15 October 2020) |
| Hong Kong | Xero (HK) Limited | Kevin Fitzgerald Kirsty Godfrey-Billy Damien Tampling | |
| New Zealand | Xero Investments Limited | Anna Curzon Kirsty Godfrey-Billy Craig Hudson | |
| | Xero (NZ) Limited | Anna Curzon Kirsty Godfrey-Billy Craig Hudson | |
| | Xero Trustee Limited | Kirsty Godfrey-Billy | |
| | Xero (NZ) Holdings Limited | Anna Curzon Kirsty Godfrey-Billy Craig Hudson | |

| | | | |
|----------------|-----------------------------|---|---|
| New Zealand | Waddle Loans Limited | Anna Curzon Kirsty Godfrey-Billy Damien Tampling | Simon Creighton (resigned effective 1 October 2020) |
| Singapore | Xero (Singapore) Pte. Ltd | Kevin Fitzgerald Kirsty Godfrey-Billy Damien Tampling | |
| South Africa | Xero South Africa (Pty) Ltd | Kirsty Godfrey-Billy Colin Timmis Gary Turner | |
| United Kingdom | Hubdoc (UK) Limited | Damon Anderson Kirsty Godfrey-Billy Gary Turner | |
| | Xero (UK) Limited | Damon Anderson Kirsty Godfrey-Billy Gary Turner | |
| United States | Xero, Inc. | Kirsty Godfrey-Billy Tony Ward Andy Burner | |

Corporate Directory

| Registered offices | Directors | Leadership team | Other Company Information |
|--|--|--|---|
| New Zealand 19-23 Taranaki Street Te Aro, Wellington 6011 New Zealand Contact: www.xero.com/about/contact | David Thodey, AO (Chair) Steven Aldrich Mark Cross Rod Drury Lee Hatton Dale Murray, CBE Susan Peterson Craig Winkler | Steve Vamos Chief Executive Officer Anna Curzon Chief Product Officer Kirsty Godfrey-Billy Chief Financial Officer Rachael Powell Chief Customer Officer Mark Rees Chief Technology Officer Nicole Reid Chief People Officer Chaman Sidhu Chief Legal Officer & Company Secretary Damien Tampling Chief Strategy & Corporate Development Officer | Company numbers 183 0488 (New Zealand) ARBN 160 661 183 (Australia) Web address www.xero.com Auditor Ernst & Young Stock exchange Xero's ordinary shares are listed on the ASX Share registrar Link Market Services Limited Level 13, Tower 4, 727 Collins Street Melbourne, Vic 3000 Australia Telephone: +61 1300 554 474 |
| Australia 1/6 Elizabeth Street Hawthorn, Vic 3122 Australia Contact: www.xero.com/about/contact | | Regional Managing Directors | |
| | | Craig Hudson Managing Director, New Zealand & Pacific Islands Trent Innes Managing Director, Australia & Asia Gary Turner Managing Director, United Kingdom & EMEA Tony Ward President, Americas | |

