

13. FINANCIAL RISKS AND RISK MANAGEMENT

In the normal course of business, the Company is exposed to financial risks that have the potential to negatively affect its financial performance, including financial risks related to changes in interest rates, foreign currency exchange rates, the market prices of Weston and Loblaw common shares and liquidity. The Company is also exposed to credit and counterparty risks on certain of its financial instruments. These risks and the actions taken to minimize them are discussed below. While the Company employs strategies to minimize these risks, these strategies do not guarantee that events or circumstances will not occur that negatively affect the Company's financial condition and performance.

Liquidity

The Company's ability to obtain funding from external sources may be restricted by further downgrades in the Company's credit ratings, should the Company's financial performance and condition deteriorate. In addition, credit and capital markets are subject to inherent global risks that may negatively affect the Company's access and ability to fund its short term and long term debt requirements.

The Company mitigates these risks by actively maintaining appropriate levels of cash and cash equivalents, actively monitoring market conditions and diversifying its sources of funding and maturity profile.

Derivative Instruments

The Company uses over-the-counter derivative instruments, specifically cross currency basis swaps, interest rate swaps, equity forwards and swaps, and commodity futures and options, to manage its risks and costs associated with its net assets, financing activities, stock-based compensation plans and future purchases of raw materials. The fair value of derivative instruments is subject to changing market conditions which could negatively impact earnings. The Company maintains treasury centres that operate under policies and guidelines approved by the Board, covering funding, investing, equity, foreign currency exchange and interest rate management. The Company's policies and guidelines prohibit the use of any derivative instrument for trading or speculative purposes. See notes 1 and 24 to the consolidated financial statements for additional information about the Company's derivative instruments.

Foreign Currency Exchange Rate

Loblaw enters into cross currency basis swaps to manage its current and anticipated exposure to fluctuations in foreign currency exchange rates. Loblaw's cross currency basis swaps are transactions in which floating interest payments and principal amounts in United States dollars are exchanged against the receipt of floating interest payments and principal amounts in Canadian dollars. These cross currency basis swaps limit Loblaw's exposure to foreign currency exchange rate fluctuations on a portion of its United States dollar denominated assets, principally cash, cash equivalents and short term investments.

The Company's consolidated financial statements are expressed in Canadian dollars but a significant portion of its Weston Foods business occurs in United States dollars through its U.S. net investment. The U.S. net investment is translated into Canadian dollars at the foreign currency exchange rate in effect at each balance sheet date. As a result, the Company is exposed to exchange rate gains and losses which are recorded in other comprehensive loss with the offset in the reported Canadian dollar value of the related assets and liabilities included in the U.S. net investment. During 2007, the Canadian dollar appreciated relative to the United States dollar, resulting in a reduction of the Company's U.S. net investment and a corresponding increase in accumulated other comprehensive loss of

\$508 million. In addition, revenues and expenses of these self-sustaining foreign operations are translated into Canadian dollars at the average foreign currency exchange rate for the year. An appreciating Canadian dollar relative to the United States dollar will negatively impact year-over-year changes in reported sales, operating income and net earnings, while a depreciating Canadian dollar relative to the United States dollar will have the opposite impact.

Interest Rate

The Company enters into interest rate swaps to manage its current and anticipated exposure to fluctuations in interest rates impacted by market liquidity. Interest rate swaps are transactions in which the Company exchanges interest flows with a counterparty on a specified notional amount for a predetermined period based on agreed-upon fixed and floating interest rates. Notional amounts are not exchanged. The Company monitors market conditions and the impact of interest rate fluctuations on its fixed and floating interest rate exposure mix on an ongoing basis.

Common Share Market Price

Changes in Weston and Loblaw common share prices impact the Company's stock-based compensation costs. The Company strives to manage these exposures by entering into equity swap and forward transactions. In 2007, Weston had cumulative outstanding equity swaps in respect of 1.7 million common shares and Loblaw had cumulative outstanding equity forwards in respect of 4.8 million common shares. These swaps and forwards allow for several methods of settlement including net cash settlement. They change in value as the market prices of the underlying common shares change and provide a partial offset to fluctuations in Weston's and Loblaw's stock-based compensation costs, including the restricted share units plan expense, when the market prices of Weston and Loblaw common shares exceed the exercise price of the related employee stock options. When the market prices of Weston and Loblaw common shares are lower than the exercise price of the related employee stock options, these equity derivatives will provide a partial offset only to the restricted share units plan expense. The amount of net stock-based compensation cost recorded in operating income is mainly dependent upon the number of unexercised stock options and restricted share units and their vesting schedules relative to the number of underlying common shares on the equity derivatives and the level of and fluctuations in the market prices of the underlying common shares.

Changes in the Loblaw common share price impact the Company's interest and other financing charges. In 2001, Weston entered into an equity forward sale agreement based on 9.6 million Loblaw common shares at an original forward price of \$48.50 per Loblaw common share which, under the terms of the agreement, had increased to a forward price of \$72.06 (2006 – \$67.64) per Loblaw common share as at December 31, 2007. The forward matures in 2031 and will be settled in cash as follows: Weston will receive the forward price and will pay the market value of the underlying Loblaw common shares at maturity. The obligation of Weston under this forward is secured by the underlying Loblaw common shares. Weston entered into this forward to partially offset any repayment risk associated with its Series A, 7.00% and Series B Debentures. Weston recognizes a non-cash charge or income, which is included in consolidated interest expense and other financing charges, representing the fair value adjustment of Weston's forward sale agreement for 9.6 million shares. The fair value adjustment in the forward contract is a non-cash item resulting from fluctuations in the market price of the underlying Loblaw shares that Weston owns. Weston does not record any change in the market price associated with the Loblaw shares it owns. At maturity, if the forward price is greater than the market price, Weston will receive a cash amount equal to the difference. If the forward price is less than the market price, Weston will pay a cash amount equal to the difference. Any cash paid under the forward contract could be offset by the sale of Loblaw shares.

Credit

The Company is exposed to credit risk resulting from the possibility that counterparties may default on their financial obligations, or if there is a concentration of transactions carried out with the same counterparty or of financial obligations which have similar economic characteristics such that they could be similarly affected by changes in economic conditions. Exposure to credit risk relates to derivative instruments, cash equivalents and short term investments, amounts receivable from Weston Foods customers and suppliers, PC Bank's credit card receivables and accounts receivable from independent franchisees, associates and independent accounts.

The Company may be exposed to losses should any counterparty to the Company's financial or non-financial derivative agreements fail to fulfill its obligations. The Company has sought to minimize potential counterparty risk and losses by conducting transactions for its derivative agreements with counterparties that have at minimum a long term "A" credit rating from a recognized credit rating agency and by placing risk adjusted limits on its exposure to any single counterparty for its financial derivative agreements. The Company has internal policies, controls and reporting processes, which require ongoing assessment and corrective action, if necessary, with respect to its derivative transactions. In addition, principal amounts on cross currency basis swaps and equity swaps and forwards are each netted by agreement and there is no exposure to loss of the original notional principal amounts on the interest rate swaps and equity swaps and forwards.

Management's Discussion and Analysis

Credit risk associated with the Company's cash equivalents and short term investments results from the possibility that a counterparty may default on the repayment of a security. The Company attempts to mitigate this risk through policies and guidelines that require issuers of permissible investments to have at minimum a long term "A" credit rating from a recognized credit rating agency and that specify minimum and maximum exposures to specific issuers and that specify the type of instruments to be held by the Company.

Weston Foods performs ongoing credit evaluations to assess the financial condition of its new and existing suppliers and customers for amounts receivable from these counterparties.

Loblaw's exposure to credit risk from *PC* Bank's credit card receivables and receivables from independent franchisees, associates and independent accounts results from the possibility that customers may default on their payment obligation. *PC* Bank manages the credit card receivable risk by employing stringent credit scoring techniques, actively monitoring the credit card portfolio and reviewing techniques and technology that can improve the effectiveness of the collection process. In addition, these receivables are dispersed among a large, diversified group of credit card customers.

Loblaw accounts receivable from independent franchisees, associates and independent accounts are actively monitored on an ongoing basis and settled on a frequent basis in accordance with the terms specified in the applicable agreements.