

TFS SANDALWOOD PROJECT NO. 2

ANNUAL FINANCIAL REPORT
FOR THE YEAR ENDED 30 JUNE 2004

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MANAGER'S REPORT

The Directors of Tropical Forestry Services Ltd (ACN 081 046 353), Responsible Entity of TFS Sandalwood Project No.2 ("TFS 2") present their report together with the financial statements of the TFS Sandalwood Project No.2 ("the Project") for the period ended 30 June 2004 to the Growers in TFS 2.

Directors

The names of the Directors of Tropical Forestry Services Ltd during the period and at the date of this report are:

Frank Cullity WILSON
Graeme Eric SCOTT
Stephen Lee ATKINSON
Ronald Lionel EACOTT
Blaine David KIDD
Julius Luke MATTHYS
Thomas Nash CULLITY

Principal Activities

During the period the principal activity of the Project was the management of a Sandalwood plantation.

Change of State of Affairs

There was no significant change in the state of affairs of the Project.

Results of Operations and Likely Developments

The Project made a profit for the financial year ended 30 June 2004 of \$679,935.

This is due to an increase in the value of the plantation.

This plantation was established in 2000 and is now 4 years old.

The price of Sandalwood continues to rise at the Indian auctions in Tamil Nadu and at the latest auction in September 2004, on a relatively thin trade, the price had risen to \$US45,000 per tonne on average.

This compares with an average price per tonne of \$US35,000 at the same auctions in January 2003.

MANAGER'S REPORT (CONTINUED)

An extract from a report on the plantation by our independent expert forester, Mr Peter Kimber follows:

Present State of the Plantation

TFS 2 was planted in two different configurations with two different long-term host mixtures. The northern-most third of the plantation has the long-term hosts and the Sandalwood planted in different rows. The hosts in this area are alternate rows of *Cassia siamea* and *Cathormium umbellatum*. This part of the plantation is by far the most successful and would be up to expected growth rates and tree size if it were not for the earlier depredations of *Phytophthora* root rot. It is, nevertheless, good and getting better.

The southern two-thirds of the Plantation was planted as an intimate mixture of Sandalwood and the long-term host *Cathormium*. While the short-term *Sesbania formosa* hosts were still alive, the Sandalwood trees flourished. When they died out late in the second year (as was expected), the *Cathormium* long-term hosts were stunted and unthrifty due to their having been heavily shaded by the *Sesbania*, and were quite incapable of hosting the Sandalwood. As a result, the Sandalwood trees declined alarmingly. Fortunately, the land on which the plantation had been established previously carried a crop of *Leucena leucocephala* trees, used for cattle fodder. *Leucena* is a prolific producer of seed that lies dormant in the ground. With the cultivations that were made to maintain the plantation, *Leucena* seed was brought to the surface and germinated. Most of the southern part of the plantation is now hosted by *Leucena* and is recovering reasonably well. Patches where *Leucena* failed to germinate were very open and permitted the remnant *Cathormium* hosts to slowly recover. By June 2003 they were large enough to provide some sustenance to the parasitic Sandalwood.

In summary, a lot of management expertise and energy has gone into correcting poor plantation design and in controlling *Phytophthora* root rot over the past two years. The effort has been largely successful, but the Sandalwood trees remain somewhat smaller than would be expected at 4 years of age.

Maintenance Works Done in the Last Year

The plantation was irrigated on a number of occasions throughout the year and experimental infrastructure was established in an adjacent block of the plantation in order to determine the relationship between the level of moisture in the soil and the growth rates of the tree crop. Data collected from this during the 2004 dry season will provide guidelines as to the optimal time to irrigate the plantation. These will be applicable to TFS 2. Irrigation furrows between the rows of trees were maintained three times during the year using a "go-devil" – a set of opposed plough discs which cultivates to create a mound of soil with a furrow on either side, through which irrigation water can flow.

Sandalwood trees were pruned for the second time of three planned prunings aimed at creating branch-free boles up to 2.5 metres high.

Two aerial applications of the fungicide "Agriphos 600" at the rate of 20 litres of chemical per hectare were made at 6 month intervals in an attempt to render the Sandalwood trees resistant to the root-rotting fungus *Phytophthora* which had earlier caused severe defoliation and a worrying level of mortality. Control of the disease has been good with the exception of the eastern edge of the Plantation where the outlets from the water supply channel have leaked making the Plantation permanently wet a few metres in from the channel.

An aerial application of 100 kilograms per hectare of the fertiliser Diammonium Phosphate (DAP) was made in an attempt to assist the Sandalwood to recover from the setbacks they had suffered from *Phytophthora* and a lack of hosts over the past 18 to 24 months.

MANAGER'S REPORT (CONTINUED)

Conclusion

This Plantation is recovering after a difficult start and although the trees are somewhat below optimum size for their age, we hope that these trees will continue to recover and measurements are being taken on a regular basis to objectively assess their development.

Balance of Interests

As at 30 June 2004, the balance of lease interests held by Growers is 198.

Interests Held by Responsible Entity and Related Parties

At 30 June 2004, no lease interests are held by the Responsible Entity and 60 lease interests are held by Related Parties.

Environmental Regulations

The Project is not subject to any significant environmental regulations under any State, Commonwealth or Territory Law.

Fees Paid to Responsible Entity and Associates

Fees of \$67,787 were paid to Tropical Forestry Services Ltd, Manager of TFS Sandalwood Project No. 2 for provision of its services during the period ended 30 June 2004.

Insurance of Officers of the Company or Auditors

Neither the Project nor Tropical Forestry Services Ltd has, during or since the end of the period, in respect of any person who is or has been an officer of TFS Properties Ltd or a related body corporate or auditor of the Project:

- indemnified or made any relevant agreement for indemnifying against a liability, including costs and expenses in successfully defending legal proceedings; or
- paid or agreed to pay a premium in respect of a contract insuring against a liability for the costs or expenses to defend legal proceedings.

For and on behalf of the Directors of Tropical Forestry Services Ltd:



Graeme Eric Scott

Perth, 24th January 2005



Rix Levy Fowler

CHARTERED BUSINESS ADVISORS

Independent Audit Report to the Members of Tropical Forestry Services Sandalwood Plantation TFS 2

Partners:
Phillip Rix FCA
Ranko Matic CA
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Scope

The financial report and directors' responsibility

The financial report comprises the statement of financial position, statement of financial performance, statement of cash flows, accompanying notes to the financial statements, and the directors' declaration for Tropical Forestry Services Sandalwood Plantation TFS 2 (the project), for the financial year ended 30 June 2004.

The directors of the responsible entity are responsible for the preparation and true and fair presentation of the project's financial report in accordance with the Corporations Act 2001. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report.

Audit approach

We have conducted an independent audit of the financial report in order to express an opinion on it to the members of the project. Our audit has been conducted in accordance with Australian Auditing Standards to provide reasonable assurance whether the financial report is free of material misstatement. The nature of an audit is influenced by factors such as the use of professional judgement, selective testing, the inherent limitations of internal controls, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

We performed procedures to form an opinion whether, in all material respects, the financial report is presented fairly in accordance with the Corporations Act 2001 and Accounting Standards and other mandatory professional reporting requirements in Australia so as to present a view which is consistent with our understanding of the project's financial position, and performance as represented by the results of its operations and its cash flows.

Our procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial report, and the evaluation of accounting policies and significant accounting estimates made by the directors of the responsible entity.

While we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our audit was not designed to provide assurance on internal controls.

The audit opinion expressed in this report has been formed on the above basis.

Independence

In conducting our audit, we followed applicable independence requirements of Australian professional ethical pronouncements and the Corporations Act 2001.

Independent Auditor's Report

to the Members of Tropical Forestry Services Sandalwood Plantation TFS 2(continued)

Qualification

The financial report for the year ended 30 June 2003 has not been audited. Accordingly we are not in a position to and do not express an opinion on the comparatives for 2003.

Qualified Audit Opinion

In our opinion, except for the effects on the comparatives for 2003 of such adjustments, if any, as might have been determined to be necessary had the limitation on the scope of our work as discussed in the qualification paragraph not existed, the financial report of Tropical Forestry Services Sandalwood Plantation TFS 2 is in accordance with:

- (a) The Corporations Act 2001, including:
 - (i) giving a true and fair view of the project's financial position as at 30 June 2004 and of their performance for the year ended on that date; and
 - (ii) complying with Accounting Standards in Australia and the Corporations Regulations 2001; and
- (b) other mandatory professional reporting requirements in Australia.



RIX LEVY FOWLER
Chartered Business Advisors



PHILLIP RIX
Partner

DATED at PERTH this 24 day of January 2005

**STATEMENT OF FINANCIAL PERFORMANCE
FOR THE YEAR ENDED 30 JUNE 2004**

	Notes	2004 \$	UNAUDITED 2003 \$
REVENUE FROM ORDINARY ACTIVITIES			
Lease & Management Fees		67,787	67,187
Net increment in net value of Sandalwood trees	1(c)	<u>679,935</u>	<u>457,426</u>
		<u>747,722</u>	<u>524,613</u>
EXPENSES FROM ORDINARY ACTIVITIES			
Leasing expenses		24,076	23,476
Management fees		<u>43,711</u>	<u>43,711</u>
		<u>67,787</u>	<u>67,187</u>
NET OPERATING INCOME FROM ORDINARY ACTIVITIES		<u>679,935</u>	<u>457,426</u>

The Statement of Financial Performance should be read in conjunction with the accompanying notes.

STATEMENT OF FINANCIAL POSITION
AT 30 JUNE 2004

	Notes	2004 \$	UNAUDITED 2003 \$
CURRENT ASSETS			
Cash	2	-	-
Receivables	3	5,874	-
Other	4	46,427	46,427
TOTAL CURRENT ASSETS		52,301	46,427
NON CURRENT ASSETS			
Sandalwood trees	5	2,742,680	2,062,745
Other	6	417,840	464,267
TOTAL NON CURRENT ASSETS		3,160,520	2,527,012
TOTAL ASSETS		3,212,821	2,573,439
CURRENT LIABILITIES			
Payables	7	5,874	-
Unearned income	8	46,427	46,427
TOTAL CURRENT LIABILITIES		52,301	46,427
NON-CURRENT LIABILITIES			
Unearned income	9	417,840	464,267
TOTAL NON-CURRENT LIABILITIES		417,840	464,267
TOTAL LIABILITIES		470,141	510,694
NET ASSETS		2,742,680	2,062,745
GROWERS' FUNDS			
Undistributed income reserve	10	2,742,680	2,062,745
EQUITY		2,742,680	2,062,745

The Statement of Financial Position should be read in conjunction with the accompanying notes.

**STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 30 JUNE 2004**

	Notes	2004 \$	UNAUDITED 2003 \$
CASH FLOWS FROM OPERATING ACTIVITIES			
<u>Inflows</u>			
Receipts from Growers		15,486	29,828
		15,486	29,828
<u>(Outflows)</u>			
Payments to Suppliers		(15,486)	(29,828)
		(15,486)	(29,828)
NET CASH INFLOWS/(OUTFLOWS) FROM OPERATING ACTIVITIES	12	-	-
NET INCREASE/(DECREASE) IN CASH HELD		-	-
Add opening cash brought forward		-	-
CLOSING CASH CARRIED FORWARD	2	-	-

The Statement of Cash Flows should be read in conjunction with the accompanying notes.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2004

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Accounting

The financial report is a general purpose financial report which has been prepared in accordance with the Project's constitution and the requirements of the Corporations Act 2001, which includes applicable accounting standards. Other mandatory professional reporting requirements (Urgent Issues Group Consensus Views) have also been complied with.

The financial report has been prepared in accordance with the historical cost convention, except for Sandalwood trees (which are self-generating assets), which are recorded at net market value.

(b) Revenue Recognition

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Project and the revenue can be reliably measured. Specific revenues are recognised as follows.

Operations revenue:

- Sandalwood lot sales (Establishment Fees) are recognised as revenue on acceptance of the application by the Responsible Entity.
- Lease and Management Fees are recognised as revenue in the period to which they relate.

(c) Sandalwood trees

Sandalwood trees are measured at their market value at each reporting date. The net market value is determined as being the net present value of expected future cash flows (discounted at a risk adjusted rate).

Net increments or decrements in the market value of the Sandalwood trees are recognised as revenues or expenses in the Statement of Financial Performance, determined as:

- (i) the difference between the total net market values of the trees recognised as at the beginning of the period and the total net market values of the trees recognised as at the reporting date; less
- (ii) costs incurred during the reporting period to acquire and plant Sandalwood trees.

Costs incurred in maintaining or enhancing trees are recognised as expenses when incurred. Therefore, those costs are not included in the determination of the net increment in net market values.

(d) Income Tax

Under current legislation, the scheme is not subject to income tax provided the growers are presently entitled to the income of the Project.

Unrealised gains and losses on investments which are regarded as income, are transferred to Growers' funds and are not distributable and assessable until realised.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2004 (CONTINUED)

(e) Cash and equivalents

For the purposes of the Statement of Cash Flows, cash and cash equivalents includes cash on hand and in banks, and short-term deposits at call.

(f) Receivables

Receivables are recognised and carried at original invoice amount, or the amount due less a provision for any uncollectible debts. An estimate for doubtful debts is made when collection of the full amount is no longer probable.

(g) Payables

Liabilities for creditors and other amounts are carried at cost which is the fair value of the consideration to be paid in the future for goods and services received. Payables to related parties are carried at the principal amount.

(h) Unearned Income

Prepaid Lease and Management Fees are recognised on a straight line basis over the term of the Project as this is considered to closely approximate the value of the service provided. The unearned portion is deferred and recorded as unearned income.

(i) Comparatives

The financial statements cover the period from 1 July 2003 to 30 June 2004. Comparative figures are shown for the period from 1 July 2002 to 30 June 2003.

(j) Goods and Services Tax

Revenues, expenses and assets are recognised net of the amount of GST, except where the amount of GST incurred is not recoverable from the Australian Taxation Office. In these circumstances the GST is recognised as part of the cost of acquisition of the asset or as part of an item of the expense. Receivables and payables in the Statement of Financial Position are shown inclusive of GST.

(k) Adoption of Australian Equivalents to International Financial Reporting Standards

Australia is currently preparing for the introduction of International Financial Reporting Standards (IFRS) effective for financial years commencing 1 January 2005. This requires the production of accounting data for future comparative purposes at the beginning of the next financial year.

The economic entity's management, along with its auditors, are assessing the significance of these changes and preparing for their implementation. Stakeholders will be kept informed as to the impact of these new standards on the financial statements as they are finalised.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2004 (CONTINUED)

	2004 \$	UNAUDITED 2003 \$
2. CASH		
Cash at bank	<u> -</u>	<u> -</u>
3. RECEIVABLES		
Outstanding fees (i)	<u> 5,874</u>	<u> -</u>
(i) Outstanding Establishment Fees represent monies receivable from Growers in accordance with the Lease and Management Agreement. No interest has been charged on amounts due.		
4. OTHER ASSETS		
Prepayments (i)	<u> 46,427</u>	<u> 46,427</u>
(i) Prepayments represent Lease and Management Fees paid to the Manager in advance of the period in which the lease management services are to be provided.		
5. SANDALWOOD TREES		
<i>at net market value</i>	<u> 2,742,680</u>	<u> 2,062,745</u>
(a) Physical quantity of Sandalwood trees owned		
Number of Sandalwood trees	9,511	9,511
Area under lease (Ha)	33	33
(b) Nature of asset		
Investors in the TFS Sandalwood Project No.2 who are referred to as "Growers" subscribed for Sandalwood Lots of size one-sixth of a hectare each upon which Sandalwood trees have been established.		
The Sandalwood plantation is situated at King Location 254, approximately 8 kilometres from the Western Australian township of Kununurra.		
The land upon which the Sandalwood plantation is located is owned by the Responsible Entity. Growers lease the land from the Responsible Entity for the duration of the life of the Project. The Project will continue in operation until the date on which the last of the Growers has been advised that the produce of the Sandalwood crop from each leased area which is leased by the Grower has been harvested and that the relevant Lease and Management Agreement has been terminated but in any event, not later than 30 June 2018.		
The net market value of the Sandalwood trees has been determined in accordance with a Directors' valuation.		

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2004 (CONTINUED)

	2004 \$	UNAUDITED 2003 \$
(c) Significant assumptions		
Significant assumptions made in determining the net market value of the trees are:		
<ul style="list-style-type: none"> • 100% of the trees will be harvested and sold in 2014/2015; • the price of Sandalwood is constant in real terms; • the costs expected to arise on harvest are constant in relative terms; and • the pre-tax average real rate at which the net cash flows have been discounted are at 17% per annum. 		
Cash flows exclude income taxes and are expressed in real terms.		
6. OTHER ASSETS		
Prepayments (i)	<u>417,840</u>	<u>464,267</u>
(i) Prepayments represent Lease and Management Fees paid to the Manager in advance of the period in which the lease and management services are to be provided.		
7. PAYABLES		
Accounts Payable		
Trust funds payable to Responsible Entity (i)	<u>5,874</u>	<u>-</u>
	<u>5,874</u>	<u>-</u>
(i) Trust funds payable to Responsible Entity represent the sum of monies payable by Growers to the Responsible Entity under the Lease and Management Agreement yet to be paid across to the Responsible Entity. No interest is payable on outstanding amounts.		
8. UNEARNED INCOME (CURRENT)		
Prepaid Lease & Management Fees	<u>46,427</u>	<u>46,427</u>
9. UNEARNED INCOME (NON-CURRENT)		
Prepaid Lease & Management Fees	<u>417,840</u>	<u>464,267</u>

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2004 (CONTINUED)

	2004 \$	UNAUDITED 2003 \$
10. GROWERS' FUNDS		
Undistributed Income		
<i>Nature and purpose of reserve</i>		
The undistributed income reserve contains realised and unrealised income and expenses that are not yet assessable/deductible.		
Opening balance	2,062,745	1,605,319
Net operating income	<u>679,935</u>	<u>457,426</u>
Closing balance	<u><u>2,742,680</u></u>	<u><u>2,062,745</u></u>
11. DISTRIBUTIONS PAID AND PAYABLE		
No distributions were payable or paid during the period.		
12. STATEMENT OF CASH FLOWS		
(a) Reconciliation of Net Operating Income to the Net Cash Flows from Operating Activities.		
Net operating income	679,935	457,426
<u>Additions:</u>		
Decrease in prepaid expenses	46,427	46,427
Increase in payables	5,874	-
Decrease in receivables	<u>-</u>	<u>9,068</u>
	<u>52,301</u>	<u>55,495</u>
<u>(Deductions):</u>		
Increase in net receivables	(5,874)	-
Decrease in unearned income	(46,427)	(46,427)
Decrease in payables	-	(9,068)
Net movement in market value of Sandalwood trees	<u>(679,935)</u>	<u>(457,426)</u>
	<u>(732,236)</u>	<u>(512,921)</u>
Net cash inflow/(outflow) from operating activities	<u>-</u>	<u>-</u>
(b) Reconciliation of cash		
Cash balance comprises:		
Cash at bank	<u>-</u>	<u>-</u>

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2004 (CONTINUED)

13. RELATED PARTY DISCLOSURES

(a) Manager

The Manager of the TFS Sandalwood Project No.2 is Tropical Forestry Services Ltd, whose immediate and ultimate holding company is TFS Corporation Limited.

(b) Directors of the Manager

The Directors of the Manager during the period were:

Frank Cullity WILSON
Graeme Eric SCOTT
Stephen Lee ATKINSON
Ronald Lionel EACOTT
Blaine David KIDD
Julius Luke MATTHYS
Thomas Nash CULLITY

(c) Fees Paid or Payable to the Manager

The Manager receives all Establishment, Lease and Management Fees which have been paid by the Project during the period.

The Manager provides Sandalwood plantation establishment and management services for TFS 2 and carries out the custodial and administrative functions.

Transactions between TFS 2 and Tropical Forestry Services Ltd result from normal dealings with that company as the Project's Manager and holder of a dealer's license.

(d) Holdings of Directors and Director-related Entities

A total of 60 lease interests are held by Directors or parties related to Directors on the same terms and conditions as other Growers. No amount is outstanding at year-end.

14. AUDIT

(a) Auditors

Rix Levy Fowler are the auditors of the Project.

15. SEGMENT INFORMATION

The Project operates in one industry segment, being investment activities and in one geographical segment, being Australia.

16. SUBSEQUENT EVENTS

Since 30 June 2004, there has not been any matter or circumstance not otherwise dealt with in the financial report that has significantly affected or may significantly affect the Project.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2004 (CONTINUED)

	2004	UNAUDITED 2003
	\$	\$

17. FINANCIAL INSTRUMENTS

(a) Interest Rate Risk

Interest rate risk is the risk that a financial investment's value will fluctuate as a result of changes in market interest rates. The Project's exposure to interest rate risk is as follows:

Financial Assets

Cash	-	-
Weighted average debit interest rate (p.a.)	0%	0%
Weighted average credit interest rate (p.a.)	1.69%	1.69%
Interest rate type	Variable	Variable

The Project had no other financial assets or financial liabilities with exposure to interest rate risk as at balance date.

(b) Credit Risk

Credit risk represents the risk that a counterparty will fail to perform contractual obligations under a contract.

The Project's only credit risk exposure relates to debtors who comprise the receivable balance at 30 June 2004. A provision for doubtful accounts is recognised when collection of the full nominal amount is uncertain.

(c) Net Fair Value

The Project's financial assets and liabilities included in the Statement of Financial Position are carried at their net fair value. Refer to Note 1 for the methods and assumptions adopted in determining net fair values for Sandalwood trees.

DIRECTORS' DECLARATION FOR THE YEAR ENDED 30 JUNE 2004

In accordance with a resolution of the Directors of Tropical Forestry Services Ltd, I state that:

In the opinion of the Directors:

- (a) the financial statements and notes of the registered Project are in accordance with the Corporations Act 2001, including:
 - (i) giving a true and fair view of the registered scheme's financial position as at 30 June 2004 and its performance, as represented by the results of its operations and its cash flows for the period ended on that date; and
 - (ii) complying the Accounting Standards and the Corporations Regulations; and
- (b) there are reasonable grounds to believe that the registered scheme will be able to pay its debts as and when they become due and payable.

On behalf of the Board
Tropical Forestry Services Ltd



GRAEME ERIC SCOTT
DIRECTOR

Dated: this 24th day of January 2005