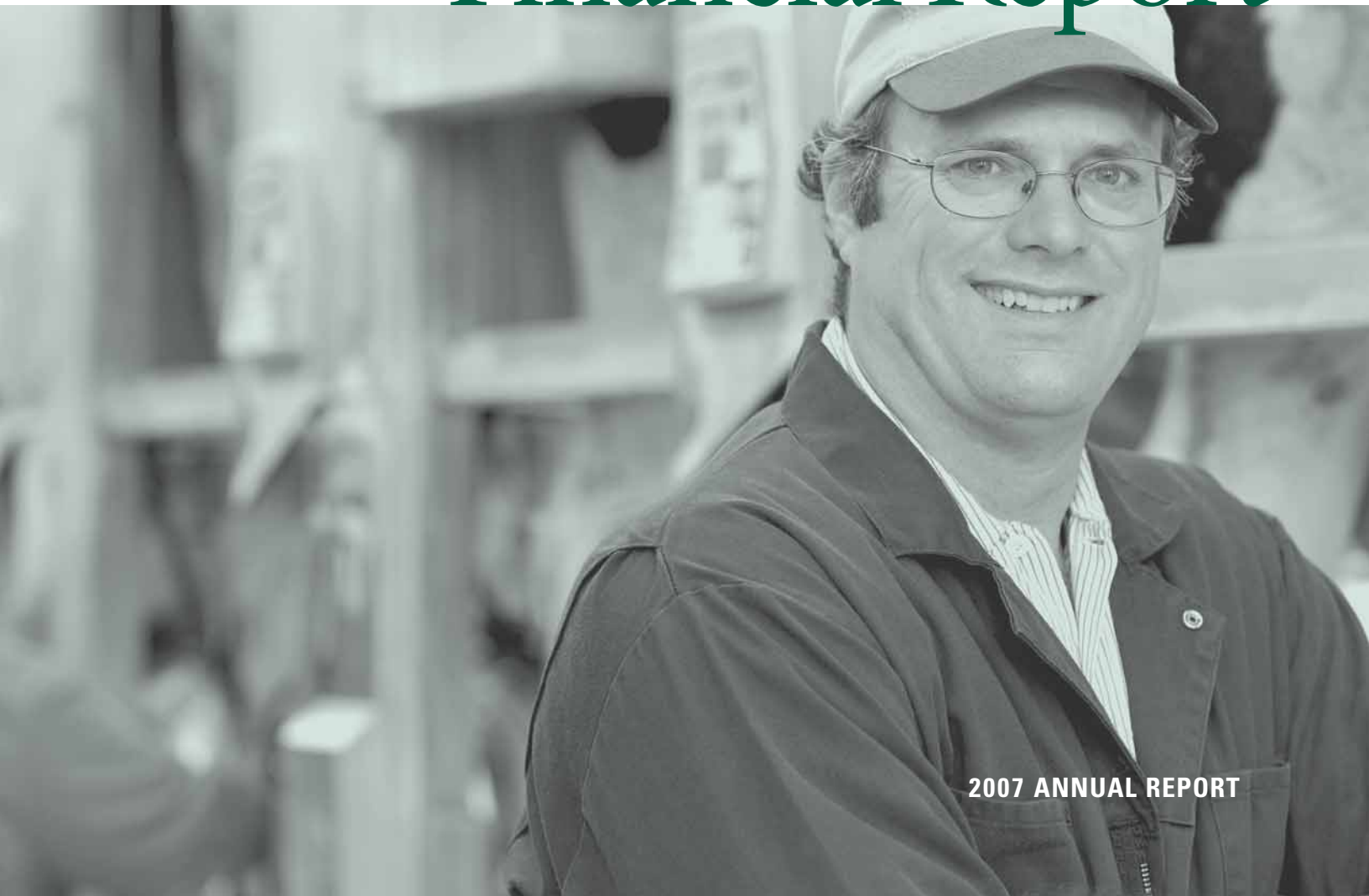




Maryland & Virginia
Milk Producers Cooperative Association, Inc.

Financial Report



2007 ANNUAL REPORT

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Maryland and Virginia Milk Producers Cooperative Association, Inc.:

We have audited the accompanying consolidated balance sheets of Maryland and Virginia Milk Producers Cooperative Association, Inc. and subsidiaries (the Association) as of December 31, 2007 and 2006, and the related consolidated statements of operations, changes in capital fund, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Maryland and Virginia Milk Producers Cooperative Association, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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Reading, Pennsylvania
March 12, 2008

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Consolidated Balance Sheets

	December 31,	
	2007	2006
	<i>(In thousands)</i>	
Assets		
<i>Current assets</i>		
Cash and cash equivalents	\$ 10,398	\$ 3,641
Accounts receivable, net	67,224	59,631
Notes receivable	195	152
Inventories	15,570	12,722
Prepaid expenses and other	2,082	1,807
Total current assets	95,469	77,953
<i>Property, plant and equipment</i>		
Land and buildings	37,634	36,934
Machinery and equipment	41,177	41,509
Automobiles and trucks	4,535	4,388
Furniture, fixtures and office equipment	4,451	3,525
Construction in progress	345	733
Total property, plant and equipment	88,142	87,089
<i>Less accumulated depreciation</i>	47,495	45,200
Property, plant and equipment, net	40,647	41,889
<i>Patronage allocations receivable from other cooperatives</i>	3,032	3,349
<i>Goodwill</i>	9,200	9,200
<i>Other assets</i>	29,466	33,523
Total assets	\$ 177,814	\$ 165,914
Liabilities and Capital Fund		
<i>Current liabilities</i>		
Line of credit	\$ 10,110	\$ 7,090
Current installments of long-term debt	5,808	5,808
Current installments of obligations under capital leases	126	115
Allowance payable to producers for milk	52,994	32,384
Trade accounts payable	24,088	30,369
Accrued expenses	9,287	5,779
Total current liabilities	102,413	81,545
<i>Long-term debt, excluding current installments</i>	43,084	50,225
<i>Obligations under capital leases, excluding current installments</i>	144	271
<i>Deferred income taxes – noncurrent</i>	1,586	2,065
<i>Other liabilities</i>	1,256	851
<i>Minority interest</i>	1,621	1,267
Total liabilities	150,104	136,224
<i>Capital fund</i>	27,710	29,690
Total liabilities and capital fund	\$ 177,814	\$ 165,914

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Operations

	Year Ended December 31,	
	2007	2006
	<i>(In thousands)</i>	
Revenue		
Sales of members' and nonmembers' raw milk	\$ 578,101	\$ 455,181
Sales of milk, dairy and other products	533,053	431,811
Sales of equipment and supplies	4,688	4,303
Amounts deducted from gross amounts allowed to members for milk brokerage deductions	8,360	5,522
Total revenue	1,124,202	896,817
Cost of Goods Sold		
Milk and other	1,009,730	788,961
Manufacturing expenses	39,983	44,553
Total cost of goods sold	1,049,713	833,514
Gross profit	74,489	63,303
Expenses		
Selling, general and administrative	67,963	56,215
Interest	5,103	4,735
Minority interest	781	507
Total expenses	73,847	61,457
Other Income		
Interest	231	171
Patronage allocations from other cooperatives	574	207
Other, including gain on the sale of property and equipment	256	1,218
Total other income	1,061	1,596
Excess of revenue over costs and expenses before income taxes	1,703	3,442
Income taxes	259	466
Net revenue over costs and expenses	\$ 1,444	\$ 2,976

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Changes in Capital Fund

	<i>(In thousands)</i>
Balance, December 31, 2005	\$ 28,162
Net revenue over costs and expenses for the year ended December 31, 2006	2,976
Cash patronage and redemption of member equities	(1,448)
Balance, December 31, 2006	29,690
Net revenue over costs and expenses for the year ended December 31, 2007	1,444
Cash patronage and redemption of member equities	(2,036)
Other comprehensive income (loss)	(1,388)
Balance, December 31, 2007	\$ 27,710
Balance at December 31, 2007, Consists of:	
Member Class A Equities	\$ 10,779
Member Class B Equities (Special Allocations)	2,685
Nonmember income not distributed and current year income not yet allocated, after tax	15,634
Accumulated other comprehensive income (loss)	(1,388)
Balance, December 31, 2007	\$ 27,710

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Cash Flows

Year Ended December 31,

	2007	2006
<i>(In thousands)</i>		
Operating Activities		
Net revenue over costs and expenses	\$ 1,444	\$ 2,976
Adjustments to reconcile net revenue over costs and expenses to net cash provided by operating activities:		
Depreciation and amortization	7,789	6,991
Gain on disposal of property, plant and equipment	90	60
Minority interest	781	507
Deferred income tax expense (benefit)	(228)	161
Changes in operating assets and liabilities:		
Patronage allocations receivable from other cooperatives	317	262
Accounts receivable, net	(7,593)	(6,156)
Notes receivable	(43)	93
Inventories	(2,848)	1,456
Prepaid expenses and other	(898)	433
Allowance payable to producers for milk	20,610	1,887
Trade accounts payable	(6,281)	5,552
Accrued expenses	3,508	1,125
Other liabilities	405	851
Net cash provided by operating activities	17,053	16,198
Investing Activities		
Purchases of property, plant, and equipment	(3,652)	(5,880)
Distributions paid to minority interest holder	(427)	(246)
Acquisition of fluid milk plant	-	(40,850)
Proceeds from sales of property, plant and equipment	56	104
Net cash used for investing activities	(4,023)	(46,872)
Financing Activities		
Cash patronage and redemption of member equities	(2,036)	(1,448)
Net proceeds (repayments) from borrowings on line of credit	3,020	(3,260)
Proceeds from long-term debt borrowings	-	39,750
Principal payments on debt	(7,141)	(4,016)
Principal payments under capital leases	(116)	(128)
Net cash (used for) provided by financing activities	(6,273)	30,898
Net increase in cash and cash equivalents	6,757	224
Cash and cash equivalents at beginning of year	3,641	3,417
Cash and cash equivalents at end of year	\$ 10,398	\$ 3,641
Supplemental cash flow information:		
Cash paid for:		
Interest	\$ 5,034	\$ 4,222
Income taxes, net of refunds	\$ 115	\$ (257)
Non-cash investing and financing activities:		
Capital lease obligations related to the acquisition of property, plant, and equipment	\$ -	\$ 26
Loan acquisition cost assumed as a result of long-term debt borrowings	\$ -	\$ 250

See accompanying notes to the consolidated financial statements.

Notes to the Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies and Other Information

NATURE OF OPERATIONS

Maryland and Virginia Milk Producers Cooperative Association, Inc. and subsidiaries (the "Association") is a dairy farmers' cooperative with members in Pennsylvania, Maryland, Virginia, Delaware, West Virginia, Kentucky, Tennessee, North Carolina, South Carolina, and Georgia. The principal purpose of the Association is to receive milk from its members and either market the milk to other processors or process it in its own plants. Within the Association are the following operating units: general management, cooperative operations, equipment, fluid milk processing, and manufacturing. The manufacturing operations include an 80% interest in Valley Milk Products, LLC ("Valley Milk") in Strasburg, Virginia. All significant intercompany accounts and transactions have been eliminated in consolidation.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of 90 days or less that are readily convertible to cash.

ACCOUNTS RECEIVABLE AND ALLOWANCE FOR DOUBTFUL ACCOUNTS

Accounts receivable are recorded at their invoiced cost and do not bear interest. The allowance for doubtful accounts is established through a provision for bad debts that is charged to expense. Accounts receivable are charged against the allowance when management believes that the collectibility of the amounts due is unlikely. The Association regularly evaluates the collectibility of its accounts receivable balances and establishes allowances for potentially uncollectible amounts. These allowances are estimates based on management's judgment and the use of assumptions. The actual collections against these accounts will likely differ from management's estimates.

INVENTORIES AND COST OF GOODS SOLD

Inventories are generally carried at the lower of cost or market, with cost determined using the first-in, first-out (FIFO) method. Amounts paid for members' milk, although generally based upon the minimum price specified by the Federal Market Administrator, are established monthly with approval of the Association's Board of Directors, and are determined, in part, upon anticipated operating results.

DEPRECIATION

Property, plant, and equipment are recorded at cost and depreciated on a straight-line basis over the estimated useful life of the respective assets, which range from three to forty years. Equipment and vehicles held under capital leases are stated at the present value of minimum lease payments and are amortized on a straight-line basis over the shorter of the lease term or estimated useful life of the asset. Depreciation expense was \$4,748,000 and \$4,600,000 for 2007 and 2006, respectively.

INTANGIBLE ASSETS

Included in other assets is an intangible asset for a supply agreement acquired in 2006 in the original amount of \$30,362,000 which is being amortized over ten years on a straight-line basis through March 2016. Amortization expense for the supply agreement was \$3,036,000 and \$2,277,000 for 2007 and 2006, respectively. Accumulated amortization at December 31, 2007 and December 31, 2006 was \$5,313,000 and \$2,277,000, respectively. Amortization expense for each of the next five years is expected to be approximately \$3,036,000 per year.

Also included in other assets are loan acquisition costs incurred in the amount of approximately \$280,000 which are being amortized ratably over the expected life of the respective loans. Amortization expense for loan acquisition costs was \$97,000 and \$75,000 for 2007 and 2006, respectively. Accumulated amortization was \$176,000 and \$79,000 at December 31, 2007 and December 31, 2006, respectively. Annual amortization expense for the next five years is expected to be \$96,000 (2008), \$4,000 (2009), \$3,000 (2010) and \$2,000 (2011).

GOODWILL

Goodwill represents the excess of purchase price over fair value of net assets of businesses acquired. Goodwill and other intangible assets that have indefinite lives are not amortized, but rather are tested for impairment at least annually. No impairment of goodwill has been recorded.

LONG-LIVED ASSETS

Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the asset to future net cash flows expected to be generated by the asset. If any such assets were considered to be impaired, the impairment to be recognized would be measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of, if any, are reported at the lower of the carrying amount or fair value less costs to sell.

PATRONAGE ALLOCATIONS

Patronage allocations from other cooperatives in the form of cash and certificates are recorded as revenue in the year received.

SIGNIFICANT SALES TO MAJOR CUSTOMERS

During 2007 and 2006, the Association had aggregate sales to the top five customers of \$362,994,000 and \$244,629,000, with accounts receivable balances related to these five customers representing 34.0% and 27.8% of total accounts receivable, respectively.

REVENUE RECOGNITION

Revenue is recognized when products are shipped and the customer takes ownership and assumes risk of loss, collection of the relevant receivable is probable, persuasive evidence of an arrangement exists, and the sales price is fixed or determinable.

CUSTOMER INCENTIVES

The Association occasionally negotiates incentives with customers as part of supply agreements. These incentives are capitalized in the consolidated balance sheets and are amortized as a reduction in sales over the estimated life of the agreements.

DISTRIBUTION COSTS

The costs of delivering products to customers are included in selling, general, and administrative expenses. These costs totaled approximately \$33,668,000 and \$30,238,000 in 2007 and 2006, respectively.

DERIVATIVE TRANSACTIONS

All derivative instruments are recorded on the balance sheet at their respective fair values. For all hedging relationships, the Association formally documents the hedging relationship and its risk-management objective and strategy for undertaking the hedge, the hedging instrument, the item, the nature of the risk being hedged, how the hedging instrument's effectiveness in offsetting the hedged risk will be assessed, and a description of the method of measuring ineffectiveness. This process includes linking all derivatives that are designated as cash flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Association also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of hedged items. Changes in the fair value of a derivative that is highly effective and that is designated and qualifies as a cash flow hedge are recorded in other comprehensive income (loss) to the extent that the derivative is effective as a hedge, until earnings are affected by the variability in cash flows of the designated hedged item. The ineffective portion of the change in fair value of a derivative instrument that qualifies as either a fair value hedge or a cash flow hedge is reported in earnings.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying value on the consolidated balance sheets of the Association's financial instruments approximates their fair value.

USE OF ESTIMATES

The Association makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results may differ from these estimates.

RECLASSIFICATIONS

Certain reclassifications have been made to the 2006 consolidated financial statements in order to conform to the 2007 presentation.

Note 2 Accounts Receivable

Accounts receivable, net, at year-end was as follows (in thousands).

	2007	2006
Accounts receivable	\$ 67,806	\$ 61,806
Less allowance for doubtful accounts	(582)	(2,175)
	<u>\$ 67,224</u>	<u>\$ 59,631</u>

Net recoveries for doubtful accounts of approximately \$205,000 and \$321,000 for 2007 and 2006, respectively, are included in the consolidated statements of operations.

Note 3 Inventories

Inventory balances at year-end were as follows (in thousands).

	2007	2006
Equipment	\$ 562	\$ 621
Fluid Plants	7,962	6,750
Manufacturing Plants	7,046	5,351
	<u>\$ 15,570</u>	<u>\$ 12,722</u>

Note 4 Business Acquisition

In March 2006, the Association purchased a dairy processing plant in Landover, Maryland, along with a supply agreement giving the Association the right to supply milk and other products to a chain of supermarkets for a ten-year period. The total purchase price and related acquisition costs were approximately \$40,850,000, comprised of real estate of approximately \$5,894,000, equipment of approximately \$4,594,000, and a supply agreement of approximately \$30,362,000. The acquisition was financed substantially through bank debt.

Note 5 Long-Term Debt and Interest-Rate Swap Agreement

LONG-TERM DEBT

Long-term debt at year-end was as follows (in thousands):

	2007	2006
Bank term loans, payable in monthly installments of \$230,000 with a final balloon payment of \$33,560,000 due in January 2009; interest based on the LIBOR plus the bank's scheduled applicable margin that is variable based on a financial measure (7.49% at December 31, 2007 and 8.12% that December 31, 2006, respectively); secured by all assets of the Association excluding Valley Milk	\$ 36,320	\$ 39,080
Bank term loan, payable in monthly installments of \$167,000 through 2011, with the remaining balance of \$2,667,000 due in February 2012; interest based on the LIBOR plus the bank's scheduled applicable margin that is variable based on a financial measure (7.49% and 8.12% at December 31, 2007 and 2006, respectively); secured by all of the assets of the Association excluding Valley Milk	10,667	14,000
Bank term loan, payable in monthly principal payments of \$61,000 plus interest at 4.34% with final payment due February 2010; secured by property	1,593	2,328
Note payable to a corporation, payable in annual installments of \$312,000, plus interest at the Association's borrowing rate less 75 basis points (6.98% and 7.07% at December 31, 2007 and 2006, respectively); matures in September 2008; secured by Association assets	312	625
Total long-term debt	48,892	56,033
Less current installments of long-term debt	(5,808)	(5,808)
Long-term debt, excluding current installments	\$ 43,084	\$ 50,225

The bank term loans contain restrictive provisions regarding the maintenance of certain net worth and working capital amounts, as well as requiring the Association to maintain certain financial ratios.

Annual maturities of long-term debt for the next five years as of December 31, 2007 are as follows (in thousands).

Year	Amount
2008	5,808
2009	36,295
2010	2,122
2011	2,000
2012	2,667

LINES OF CREDIT

The Association has available a credit line, expiring in May 2008, in the amount of \$20,000,000 at December 31, 2007 and 2006 with interest based on the LIBOR plus the bank's scheduled applicable margin that is variable based on a financial measure (7.49% and 8.12% at December 31, 2007 and 2006, respectively). Cash borrowings on this line of credit were \$10,110,000 and \$7,090,000 at December 31, 2007 and 2006, respectively. The Association has an additional credit line, expiring in July 2009, in the amount of \$1,750,000 and \$1,500,000 reserved for letters of credit at December 31, 2007 and 2006, respectively. Letters of credit outstanding at December 31, 2007 and 2006, were \$1,650,000 and \$1,400,000, respectively. These lines of credit are secured by all of the assets of the Association excluding Valley Milk.

Valley Milk has an available line of credit with a bank for \$3,000,000. The line of credit bears interest at LIBOR plus 1.50% (6.73% and 6.70% at December 31, 2007 and 2006, respectively). There were no outstanding balances on this line of credit at December 31, 2007 and 2006. The line of credit is collateralized by Valley Milk's accounts receivable and inventory.

INTEREST-RATE SWAP AGREEMENT

The Association has outstanding variable-rate debt that exposes the association to variability in interest payments due to changes in interest rates. Management has determined it to be prudent to limit the variability of a portion of its interest payments. To meet this objective, in 2003, management entered into an interest-rate swap agreement to manage fluctuations in cash flows resulting from interest-rate risk. This swap changes the variable-rate cash flows exposure on a portion of the debt obligation to fixed cash flows. Under the terms of the interest-rate swap, the Association receives variable interest-rate payments and makes fixed interest payments, thereby creating the equivalent of fixed-rate debt.

By using derivative financial instruments to hedge exposures to changes in interest rates, the Association exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Association, which creates credit risk for the Association. The Association minimized the credit risk in derivative instruments by entering into transactions with a high-quality counterparty.

Market risk is the adverse effect on the value of the financial instrument that results from a change in interest rates. The market risk associated with interest rate contracts is managed by establishing the monitoring parameters that limit the types and degree of market risk that may be undertaken.

On May 7, 2003, the Association entered into a \$5,023,000 declining balance rate swap transaction with a termination date of February 13, 2010. The swap was executed with the purpose of fixing the rate on one of the Association's term loans. Under the terms of the agreement, the Association pays a fixed rate of 4.34% to a commercial bank on a monthly basis and, in return, the commercial bank pays the Association LIBOR plus 1.35% (6.55% and 6.70% at December 31, 2007 and 2006, respectively). The swap contract had remaining notional amounts of \$1,593,000 and \$2,328,000 as of December 31, 2007 and 2006, respectively. The fair value of the interest-rate swap was insignificant for both year-ends.

Note 6 Post-Retirement Benefit Plans

DEFINED-BENEFIT PENSION PLANS

The Association has a defined-benefit pension plan covering a portion of its nonunion employees. Effective January 1, 2003, the Association froze the benefits under this plan. The benefits are based on years of service and the employees' compensation at the time the plan was frozen. The cost of this program is being funded currently. The Association's funding policy is to contribute an amount that meets the requirements of the Employee Retirement Income Security Act of 1974.

The following table sets forth the plan's benefit obligations, fair value of plan assets and funded status at December 31, 2007 and 2006 (dollars in thousands).

	2007	2006
Benefit obligation at December 31	\$ 16,380	\$ 16,869
Fair value of plan assets (fixed income and equity mutual funds) at December 31	18,924	18,729
Funded status	\$ 2,544	\$ 1,860
Prepaid benefit cost recognized as other noncurrent assets in the consolidated balance sheets	\$ 2,544	\$ 3,642
Weighted-average assumptions as of December 31:		
Discount rate used to determine the pension obligation	6.00%	5.75%
Discount rate used to determine the benefit cost	5.75%	5.75%
Expected return on plan assets used to determine the benefit credit	8.10%	8.10%

The following table sets forth certain information related to the plan for the years ended December 31, 2007 and 2006 (in thousands).

	2007	2006
Benefit credit	\$ 518	\$ 466
Benefits paid	\$ 1,124	\$ 1,321

The weighted-average asset allocations of the plan at year-end were as follows.

Asset Category	2007	2006
Equity securities	31 %	39 %
Debt securities	66	61
Real estate	3	-
Total	100 %	100 %

The Association's investment policies and strategies for the plan do not use target allocations for the individual asset categories. The Association's goals are to maximize returns subject to certain risk management policies. The Association addresses diversification by the use of mutual fund investments whose underlying investments are in domestic and international fixed income and equity securities. These mutual funds are readily marketable and can be sold to fund benefit payment obligations as they become payable. A portion of the debt securities is invested with the plan custodian in a guaranteed investment contract.

The Association does not expect to contribute to the plan in 2008.

The benefits expected to be paid by the plan in each year 2008 through 2012 are approximately \$1,035,000, \$1,068,000, \$1,104,000, \$1,097,000 and \$1,111,000, respectively. The aggregate benefits expected to be paid in the five years from 2013 through 2017 are approximately \$5,439,000. The expected benefits are based on the same assumptions used to measure the Association's benefit obligation at December 31, 2007.

In 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans. This Statement requires the Association to recognize the funded status of this plan as an asset or liability in the consolidated balance sheet and recognize changes in funded status through other comprehensive income (loss). The Association implemented this statement for the year ended December 31, 2007. The effect of SFAS No. 158 was a reduction of other assets in the amount of approximately \$1,616,000 and a corresponding reduction in capital fund, net of approximately \$228,000 in deferred taxes.

The Association contributed to union-sponsored pension plans for union employees at rates stipulated in the union contracts. Contributions to these plans were approximately \$482,000 and \$362,000 for the years ended December 31, 2007 and 2006, respectively.

401(K) PLANS

The Association has three contributory 401(k) plans under which eligible nonunion employees receive a match of up to 50% of the first 6% of each employee's compensation that is deferred and contributed to the plans, plus, for certain employees, a discretionary base contribution. The Association made contributions to the plans of approximately \$748,000 and \$751,000 in 2007 and 2006, respectively.

NON-QUALIFIED PLANS

The Association implemented a non-qualified pension plan in 2003 to supplement the retirement compensation of a select group of employees who experienced a significant decline in potential retirement benefits as a result of the freezing of the benefits of the defined-benefit pension plan. Expenses related to this plan of approximately \$111,000 and \$118,000 are included in the statements of operations for the years ended December 31, 2007 and 2006, respectively.

The Association implemented a non-qualified pension plan in 2004 to allow a select group of employees to defer a portion of their compensation. The Association makes no contributions to this plan.

The Association implemented a non-qualified pension plan in 2005 for the benefit of a select group of employees who have been disqualified from receiving certain benefits that they had been receiving under a 401(k) plan. Expenses related to this plan of approximately \$198,000 and \$157,000 are included in the statements of operations for 2007 and 2006, respectively.

A subsidiary of the Association sponsors a profit sharing plan in accordance with Section 401(k) of the Internal Revenue Code and a money purchase pension plan covering substantially all employees. Annually, the subsidiary may make a discretionary matching contribution and may also elect to contribute a discretionary profit sharing amount. Employer contributions under this plan were approximately \$40,000 and \$27,000 for the years ended December 31, 2007 and 2006, respectively. Under the Money Purchase Pension Plan, the employer contributes 5% of the employee's salary to the Plan. Employer contributions under this plan were approximately \$19,000 and \$17,000 for the years ended December 31, 2007 and 2006, respectively.

Note 7 Capital Fund

Effective April 1, 1999, the Association adopted a target equity structure for Member Class A equities that requires each member to maintain a specific amount of equity based on average annual production ("target equity"). The amount of the target equity and the production period used as the basis for the calculation shall be established by the Board of Directors based on the business needs of the Association. The Board of Directors shall set the amount of patronage distribution and the amount to be maintained as equity to satisfy the target equity requirements; and, at its discretion, may vary the percentage of cash and equity among members based on length of membership with the Association, the amount of equity required to satisfy the target amount, and other similar factors that it deems appropriate. Once a member achieves target equity, all patronage allocations to that member shall be distributed in cash, subject to the Association being able to distribute the specified amount of cash as determined by the Board of Directors. Upon termination of membership, capital fund balances in the target equity structure shall be paid in equal payments over an eight-year period commencing on the next date that patronage is paid following the first anniversary of such termination date, subject to the Association being able to distribute the specified amount of cash as determined by the Board of Directors. Equities allocated or assigned to former members totaled approximately \$3,281,000 and \$3,350,000 at December 31, 2007 and 2006, respectively. In conjunction with the adoption of the target equity structure, the Board of Directors agreed to assign the cumulative non-member income not distributed, after tax, as of April 1, 1999, with a remaining balance of approximately \$3,674,000 as of December 31, 2007, to equity holders based on their relative annual production for the years in which the nonmember income was earned by the Association. Such non-member income will not be allocated or paid to members except by specific action by the Board of Directors.

Member Class B equities represent patronage allocations receivable from Land O'Lakes, Inc. and are contemplated to be distributed in cash as patronage is redeemed, subject to the Association being able to distribute the specified amount of cash as determined by the Board of Directors.

Note 8 Income Taxes

The Association is a non-exempt agricultural cooperative and is taxed on all nonmember earnings and any member earnings not paid or allocated to members. The Association establishes deferred income tax assets and liabilities based on the difference between the financial statement and income tax carrying values of assets and liabilities using existing tax rates.

The components of income tax expense for the years ended December 31, 2007 and 2006 were as follows (in thousands).

	2007	2006
Current tax expense	\$ 487	\$ 305
Deferred tax expense (benefit)	(228)	161
Total income tax expense	<u>\$ 259</u>	<u>\$ 466</u>

The effective tax rate for the years ended December 31, 2007 and 2006 differs from the statutory rate primarily as a result of the following.

	2007	2006
Statutory Rate	34.0 %	34.0 %
Patronage refunds	(22.0)	(23.6)
State income tax, net of federal benefit	(4.1)	(0.6)
Other	7.3	3.7
Effective income tax rate	<u>15.2 %</u>	<u>13.5 %</u>

Temporary differences are pro-rated between patronage and non-patronage income for tax return and net deferred tax computations. At December 31, 2007 and 2006, the Association has recorded a net deferred income tax liability for the following amounts (in thousands).

	2007	2006
Deferred Tax Assets:		
Allowance for doubtful accounts	\$ 82	\$ 131
Amortization of intangible assets	220	128
Accrued annual leave	252	273
Other	283	236
Total deferred tax assets	<u>837</u>	<u>768</u>
Deferred Tax Liabilities:		
Fixed asset depreciation	1,377	1,478
Prepaid pension asset	586	614
Other	71	101
Total deferred tax liabilities	<u>2,034</u>	<u>2,193</u>
Net deferred tax liability	<u>\$ 1,197</u>	<u>\$ 1,425</u>
Deferred Tax Asset - Accumulated		
Other Comprehensive Income (Loss):		
Defined benefit pension plan	<u>\$ 228</u>	<u>\$ -</u>

Net current deferred income taxes of approximately \$617,000 and \$624,000 for 2007 and 2006, respectively, are included in current assets as prepaid expenses and other.

In 2006, the FASB released FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes. FIN 48 provides accounting guidance for the uncertainty in income taxes recognized in accordance with SFAS No. 109, Accounting for Income Taxes. The Association is required to adopt the provisions of FIN 48 at December 31, 2008. At this time, management has not determined the effect of FIN 48 on its financial statements.

Note 9 Commitments and Contingencies

LEASES

The Association is obligated under capital leases for certain vehicles and equipment that expire in various years through 2011. At December 31, 2007 and 2006, the gross amount of trucks and equipment held under these leases, included in property, plant and equipment, was approximately \$656,000 and \$1,089,000, respectively, and the related accumulated amortization recorded was approximately \$511,000 and \$479,000, respectively. Amortization of assets held under capital leases is included in depreciation and amortization expense. The Association also has several non-cancelable operating leases that expire over the next eight years.

Future minimum lease payments under the non-cancelable operating leases and future minimum capital lease payments as of December 31, 2007, were as follows (in thousands):

Year	Capital Leases	Operating Leases
2008	\$ 136	\$ 1,854
2009	141	1,573
2010	6	1,312
2011	2	1,122
2012	-	772
2013 and thereafter	-	758
Total minimum lease payments	285	<u>\$ 7,391</u>
Less imputed interest	<u>(15)</u>	
	270	
Less current installments of obligations under capital leases	<u>(126)</u>	
Obligations under capital leases, excluding current installments	<u>\$ 144</u>	

Rent expense for operating leases was approximately \$3,160,000 and \$2,752,000 for the years ended December 31, 2007 and 2006, respectively.

LEGAL MATTERS

The Association is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Association's financial position, results of operations or liquidity.

SELF-FUNDED INSURANCE

A portion of the Association's exposure for workers' compensation and automobile coverage is self-funded by the Association. The Association's self-funded liability is limited to \$350,000 per workers' compensation claim and \$250,000 per automobile accident claim, with an aggregate liability of approximately \$3,500,000. The liability limits apply through March 2008. The consolidated statements of operations include the effect of actual premiums paid under these policies, losses incurred and funded by the Association, and a reserve for unfunded potential losses. As of December 31, 2007, the Association had reserves of approximately \$808,000 for estimated losses under these plans.

In 2007, the Association elected to become self-funded for the health insurance liabilities of its employees. The Association's liability under this plan is limited to \$100,000 per incident, with an aggregate annual liability of \$3,863,000. As of December 31, 2007, the Association had reserves of approximately \$750,000 for estimated unpaid claims under this plan.



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