

Deed Administrators' Report to Creditors

ION Limited and subsidiaries
(Subject to Deed of Company Arrangement)

20 October 2010

ION Limited (ACN 009 106 272)

Yollatsac Limited (formerly Castalloy Limited) (ACN 007 528 583)

Yollatsac Manufacturing Pty Ltd (formerly Castalloy Manufacturing Pty Ltd) (ACN 007 838 986)

Yollatsac Wheels Pty Ltd (formerly Castalloy Wheels Pty Ltd) (ACN 007 894 984)

Core Cast Limited (ACN 097 447 660)

ION Light Metal Castings Pty Ltd (ACN 104 930 181)

ION Automotive Group Limited (ACN 104 279 156)

XIAS Pty Ltd (formerly ION Automotive Systems Pty Ltd) (ACN 104 930 109)

XITMS Pty Ltd (formerly ION Transmissions Pty Ltd) (ACN 099 982 180)

XCTA Pty Ltd (formerly Cootes Transport Pty Ltd) (ACN 010 383 016)

XCTS Pty Ltd (formerly Cootes Tanker Service Pty Ltd) (ACN 004 495 765)

XIRC Pty Ltd (formerly I.R. Cootes Pty Ltd) (ACN 004 801 076)

XLC Pty Ltd (formerly Liquip Corp Pty Limited) (ACN 082 859 970)

XLO Pty Ltd (formerly Liquip Overseas Pty Ltd) (ACN 094 440 589)

XLS Pty Ltd (formerly Liquip Sales Pty Ltd) (ACN 001 595 222)

XLSE Pty Ltd (formerly Liquip Service Pty Ltd) (ACN 082 859 989)

XLSV Pty Ltd (formerly Liquip Sales (Vict.) Pty Ltd) (ACN 005 691 761)

XST Pty Ltd (formerly Stevenson Transport Pty Ltd) (ACN 006 271 352)

(All subject to Deed of Company Arrangement)

Deed Administrators' Report to Creditors

20 October 2010

TABLE OF CONTENTS

GLOSSARY	1
PART A – UPDATE AND WAY FORWARD	9
1. Introduction	9
2. Executive Summary	10
2.1 The Fund and the Purpose of this Report	10
2.2 Contents of this Report	11
2.3 Potentially Actionable Disclosures and Non-Disclosures	12
2.4 Funding the growth strategy	13
2.5 Disclosures regarding Financial Outlook	15
2.6 Financial controls	16
2.7 Albury	16
2.8 Altona	17
2.9 Wingfield	18
2.10 North Plympton	18
2.11 Auckland, Kentucky and Energy Services	18
2.12 Next Steps	18
3. The Fund	20
3.1 Establishment of the Fund	20
3.2 Asset realisations	20
3.3 Current cash balance and investment of funds	22
4. Who can share in the Fund?	22
4.1 Provable debts and claims	22
4.2 Postponement of claims by members	22
4.3 Approach to determination of proofs	23
5. Calling for and lodgement of Proofs of Debt or Claim	23
5.1 Notice Inviting Proofs	23
5.2 Non-Shareholder proofs received	24
5.3 Shareholder proofs received	24
6. Estimated Return to Creditors	24
7. Updates to Creditors and Creditors' Committee meetings	25
8. Purpose of Report	26
9. The Way Forward	27
9.1 Court Application	27
9.2 Shareholders who have not yet lodged a proof of debt	28
9.3 Shareholders who have already lodged a proof of debt	28
9.4 Adjudication of Shareholder Proofs	28

PART B – OVERVIEW OF RESULTS OF INVESTIGATIONS	29
10. Overview of ION Group	29
10.1 Background	29
10.2 Officers and management personnel	29
10.3 Operational structure	30
10.4 Corporate structure	32
11. Overview of Forensic Investigations Process	32
11.1 Investigations for Section 439A Report	32
11.2 General nature of the Shareholder Claims	33
11.3 Factual and legal analysis required	34
11.4 Forensic investigation steps undertaken	34
11.5 Outcome of investigations	35
12. Factual Overview	35
12.1 Introduction	35
12.2 ION's growth strategy	36
12.3 Forecasts and funding of the growth strategy	36
12.4 Core businesses and implementation of the growth strategy	52
12.5 Financial controls	61
13. ION's disclosures regarding Financial Outlook	64
13.1 Background	64
13.2 Findings	64
14. Consequences if true position disclosed	67
14.1 Introduction	67
14.2 Alternate outcome based on full disclosure	70
14.3 Alternative funding proposals	74
14.4 Conclusion	75
15. Potentially Actionable Disclosures and Non-Disclosures	76
15.1 Introduction	76
15.2 Funding the growth strategy	76
15.3 Disclosures regarding financial outlook	78
15.4 Financial controls	79
15.5 Albury	79
15.6 Altona	80
15.7 Wingfield	81
15.8 North Plympton	81
15.9 Auckland, Kentucky and Energy Services	81
15.10 Causation and Loss	82
PART C – DETAILED RESULTS OF INVESTIGATIONS	83
16. Introduction	83
17. Financial Controls	83
17.1 Overview of areas of investigation	83
17.2 Evolution of the ION Group	84

17.3	Accounting software systems	85
17.4	Reporting structure and practices	85
17.5	Forecasts and budgets	88
17.6	Capital projects	91
17.7	Policies and Practices	95
18.	Albury	100
18.1	Introduction	100
18.2	Transmission strategy	101
18.3	Ford 4-speed transmissions	103
18.4	Ford 6-speed transmissions	106
18.5	Ford differentials	113
18.6	Ford transfer cases	116
18.7	SsangYong 4-speed transmissions	117
18.8	SsangYong 5/6-speed transmissions	122
18.9	Holden	127
18.10	China	128
19.	Altona	132
19.1	Introduction	132
19.2	Production and expansion capacity	133
19.3	Capital expenditure	134
19.4	Customer contracts and volumes	139
19.5	Profitability forecasts	143
20.	Wingfield	147
20.1	Introduction	147
20.2	Production and plant operation	148
20.3	Capital expenditure and commissioning and start-up costs	153
20.4	Actual and forecast profitability	158
21.	North Plympton	164
21.1	Introduction	164
21.2	Operational problems and profitability	164
21.3	Harley-Davidson	169
22.	Auckland	171
23.	Kentucky	173
24.	Energy Services	174
25.	ION's disclosures regarding Financial Outlook	174
25.1	Background	174
25.2	Overview	175
25.3	Approach to reconstruction of forecasts	176
25.4	Events impacting ION's forecasts	176
25.5	Current year expectations (FY 2004)	179
25.6	Future year expectations - Introduction	184
25.7	Future year expectations (FY 2005 onwards) - What was said to the market	184
25.8	Future year expectations (FY 2005 onwards) - Consideration of what was not said to the market	190

Annexure 1

Pooled and Non-Pooled Entities

195

195

GLOSSARY

1997 SsangYong Supply Agreement	Agreement between ION and SsangYong for the supply of 4-speed transmissions dated 15 October 1997.
ACIS	Automotive Competitiveness and Investment Scheme, a federal government investment program for the automotive industry.
Administrators	Colin McIntosh Nicol, Peter McKenzie Anderson, Robyn Beverley McKern, Murray Campbell Smith, Michael John Hill and Samuel Charles Davies, or any one or more of them, each in their capacity as a voluntary administrator of an entity or entities in the ION Administration Group.
Admitted Creditors	Has the meaning given in the DOCAs.
AGM	Annual General Meeting.
Albury	A factory site in Albury, NSW which manufactured transmissions and related products.
Alleged Contravening Conduct	Conduct by ION that shareholders have alleged amounts to Misleading or Deceptive Conduct and/or a Failure to Disclose.
Altona	The factory site and partly constructed V6 engine block plant located at Altona, Victoria.
Altona Forecasts	Capital expenditure forecasts relating to the Altona Project adopted by the Board between 11 February 2004 and 25 October 2004.
Altona Project	The construction of the Altona engine block plant pursuant to the Altona Proposal.
Altona Project Funding	Project specific funding arrangements for the Altona Project entered into by ION on 23 December 2003.
Altona Proposal	Proposal to develop an engine block manufacturing plant at Altona, approved by ION's Board on 27 May 2002.
April Guidance	Earnings and Investment Guidance published by ION on 27 April 2004, based on the figures in the April Model.
April Model	Financial model prepared by ION in April 2004 following the review and verification of its financial forecasts for the three years ending 30 June 2006.
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i> (Cth).

ASX	Australian Stock Exchange.
Auckland	ION's operations in New Zealand which manufactured alloy wheels.
August Announcement	Market update issued by ION on 24 August 2004 in connection with ION's results for the financial year ended 30 June 2004.
August Update	Forecasts provided by ION to prospective lenders on 5 August 2004 updating the information contained in the May IM.
Banks	CBA, NAB, Westpac, Mizuho and BNP (collectively).
Barra Program	Ford vehicle platform that was to run from approximately 2002 to 2005.
Beam Axle/Differential Unit	Product that presents differentials and beam axles as a single unit for vehicles without independent rear suspension systems.
BNP	BNP Paribas.
Board	The board of directors of ION Limited as comprised from time to time.
Brilliance	Shenyang Brilliance Jinbei Automotive Company.
BTR	BTR Automotive Pty Ltd.
Castalloy	Castalloy Limited, Castalloy Manufacturing Pty Ltd and Castalloy Wheels Pty Ltd, or any one of them.
CBA	Commonwealth Bank of Australia.
CEO	The chief executive officer of ION Limited from time to time.
CFO	The chief financial officer of ION Limited from time to time.
Chery	Chery Automobile Company.
Citigroup Conference	The Citigroup Small Caps Conference held on 10 November 2004.
Cootes	Cootes Holdings Pty Ltd.
Copperhead Program	Ford vehicle platform that was to run from approximately September 2005 to late 2007.
Corporations Act	<i>Corporations Act 2001</i> (Cth).
CPC	ION's Capital Projects Committee as described in paragraph 17.6.18.
CRC	ION's Capital Review Committee as described in paragraph 17.6.21.
Creditors' Committee	A Committee as defined in the DOCAs.

CY	Calendar year, being the 12 months prior to 31 December in the year stated.
Cyclone Program	Ford vehicle platform that was to commence in approximately late 2009.
D100	New SsangYong vehicle platform related to the Kyron model.
Deed Administrators	Colin McIntosh Nicol, Peter McKenzie Anderson, Robyn Beverley McKern, Michael John Hill and Samuel Charles, or any one of them, each in their capacity as deed administrators appointed pursuant to the DOCAs.
Deed Liabilities	Has the meaning given in the DOCAs.
Deloitte	Deloitte Touche Tohmatsu, ION's external auditor.
DOCAs	Deeds of company arrangement executed on 27 May 2005 by each of the Pooled Entities.
Draft SsangYong Agreement	Unexecuted agreement prepared by ION during the second half of CY2003 in relation to the supply of 4-speed transmissions to SsangYong.
DRP	Dividend reinvestment plan.
E100	New SsangYong vehicle platform related to the Korando model.
EBIT	Earnings before interest and tax.
EBITDA	Earnings before interest, tax, depreciation and amortisation.
ECI	Document prepared by Harley-Davidson in July 2003 entitled the 'Harley-Davidson Enterprise Wide Cost Imperative'.
Employee Entitlements	Has the meaning given in the DOCAs.
Engine Components Division	An operating division of ION as described in paragraph 10.3.4.
Entitlements	Has the meaning given in the DOCAs.
EPA	Environmental Protection Authority (South Australia).
EPS	Earnings per share.
Expansion Program	ION's planned capital expenditure projects as defined in the MOFA.
Expansion Program Certification	Certification required for drawdowns under tranche B of the MOFA.
Failure to Disclose	Failure to disclose matters to the market in breach of a publicly listed company's obligations pursuant to the Corporations Act and ASX Listing Rules.

February Altona Project Capex Increase	Event 5, which has the meaning given in paragraph 25.4.1.
February Announcement	ASX announcement dated 19 February 2004 in relation to ION's half year results to 31 December 2003.
February Placement	ION's equity raising through an institutional placement of \$55 million which concluded on 23 February 2004.
February Presentation	PowerPoint presentation published in February 2004 on the ASX website in relation to ION's half year results to 31 December 2003.
February SsangYong 4-speed Softening	Event 6, which has the meaning given in paragraph 25.4.1.
Final Williams Report	Report prepared by Williams, dated 21 October 2004 and titled 'Review of Major Capital Projects'.
Final Williams Report Capex Increases	Event 21, which has the meaning given in paragraph 25.4.1.
Ford	Ford Motor Company, Ford Motor Company of Australia Limited, and any related entity with which ION conducted business.
Ford 6-speed Bid Failure	Event 17, which has the meaning given in paragraph 25.4.1.
Ford Copperhead July Volume Reduction	Event 12, which has the meaning given in paragraph 25.4.1.
Ford Differential Bid Failure	Event 19, which has the meaning given in paragraph 25.4.1.
Ford MOU	Memorandum of Understanding between Ford and ION executed in 2002 in relation to the supply of 4-speed transmissions to Ford.
Ford Taurus Volume Replacement Delay	Event 3, which has the meaning given in paragraph 25.4.1.
Ford Transfer Case Bid Failure	Event 18, which has the meaning given in paragraph 25.4.1.
Fund	The fund established under clause 11 of the DOCAs.
FY	Financial Year, being the 12 months prior to 30 June in the year stated.
Group	ION Group.
Harley-Davidson	Harley-Davidson Motor Company or related entities with which ION conducted business.
HD Agreement	Agreement between ION and Harley-Davidson implementing the Harley-Davidson cost imperatives which were formally accepted by ION on 13 October 2003.

Holden	GM Holden Ltd or any related entity with which ION conducted business.
Holden MOU	Memorandum of Understanding between ION and Holden executed on 30 October 2002 in relation to the supply of engine blocks.
Holden Transfer Case Loss	Event 10, which has the meaning given in paragraph 25.4.1.
Hollow Castings	ION's Engine Components Division.
IAG	ION Automotive Group, a division of ION as described in paragraph 10.3.4.
IAG February 2004 Forecast	Revenue and capital expenditure forecasts for IAG, including forecasts beyond 2004, prepared in February 2004.
IAS	ION Automotive Systems, an operating division of ION as described in paragraph 10.3.4.
IAS Redundancy Program	Event 20, which has the meaning given in paragraph 25.4.1.
IES	ION Energy Services, a division of ION as described in paragraph 10.3.3.
ION	ION Limited and/or one or more of its subsidiaries.
ION Administration Group	ION Limited and its 22 Australian subsidiaries which were placed into voluntary administration on 7 December 2004.
ION Group	ION Limited and its 22 Australian and 7 foreign subsidiaries.
IRR	Internal rate of return.
Kentucky	ION's wheel manufacturing plant at Kentucky in the United States.
Kentucky Project	The recommissioning by ION of a wheel plant in Kentucky, United States.
Light Metal Castings	An operating division of ION as described in paragraph 10.3.4.
Liquidators	The liquidators appointed to the Non-Pooled Entities.
Liquip	Liquip Sales Pty Limited.
Liquip Acquisition	Event 2, which has the meaning given in paragraph 25.4.1.
March 2004 Altona Assessment	Recalculation of IRR for Altona in March 2004.
March 2004 Business Case	Review of business case for Wingfield Plant dated 12 March 2004 and presented to Board at the 15 March 2004 Board meeting.
March Altona Project Restatement	Event 7, which has the meaning given in paragraph 25.4.1.

March SsangYong 6-speed Notification	Event 8, which has the meaning given in paragraph 25.4.1.
March SsangYong Softening	Event 9, which has the meaning given in paragraph 25.4.1.
March Wingfield Project Restatement	Event 4, which has the meaning given in paragraph 25.4.1.
May 2002 Altona Assessment	Financial assessment of the Altona Proposal by the Board in May 2002.
May IM	Information memorandum prepared by ION, with the assistance of Grant Samuel, and issued to prospective lenders on 28 May 2004.
Misleading or Deceptive Conduct	Misleading or deceptive conduct contrary to the Corporations Act, TP Act and/or ASIC Act.
Mizuho	Mizuho Corporate Bank Ltd.
MOFA	Multi-Option Facility Agreement entered into by the Banks and ION on 16 September 2004, documenting arrangements for the Refinance.
NAB	National Australia Bank Limited.
Nautitech	ION's 6-speed development partner
Non-Pooled Entities	The five ION Administration Group entities that did not enter into the DOCAs (listed in Annexure 1).
North Plympton	The operations of Castalloy Limited, Castalloy Manufacturing Pty Ltd and Castalloy Wheels Pty Ltd located at the North Plympton site in South Australia.
North Plympton and Wingfield October Downgrade	Event 23, which has the meaning given in paragraph 25.4.1.
Notice Inviting Proofs	Notice issued by the Deed Administrators on 28 June 2005 inviting Formal Proofs of Debt or Claims.
November SsangYong Softening	Event 1, which has the meaning given in paragraph 25.4.1.
NPAT	Net Profit after Tax.
October 2003 Board Papers Forecast	Internal ION forecast for FY 2004 to FY 2006, presented to ION's Board on 27 October 2003.
October 2004 Forecast	Forecast for FY 2005 prepared by ION during October 2004.
October Auckland Softening	Event 22, which has the meaning given in paragraph 25.4.1.
Orion Program	Ford vehicle platform that was to run from approximately late 2007 to late 2009.
Peugeot	Peugeot France Automobiles Pty Ltd or related entities with which ION conducted business.

Placement Model	Financial model prepared in February 2004 with high level forecasting showing the quantum of equity and debt required for ION to fund its growth strategy through to FY 2006.
Pooled Entities	ION Limited and the other 17 entities which entered into the DOCAs (listed in Annexure 1).
Precision Sand Casting Process	A process ION intended to use to manufacture engine blocks at Altona.
Proton	Perusahaan Otomobil Nasional Berhad.
RDU	Rear Differential Units.
Refinance	ION's plan to refinance existing ION Group debt facilities and increase debt financing to the level required to fund ION's growth strategy.
Restated August Update	Restatement of the forecasts in the August Update prepared by the Deed Administrators.
Restated Kentucky Model	Restatement of the financial model used to estimate IRR for the Kentucky Project prepared by the Deed Administrators.
Restated May IM	Restatement of the forecasts in the May IM prepared by the Deed Administrators.
Risk Adjusted Restated August Update	Has the meaning given in paragraph 14.2.9.
Sale IM	Information Memorandum, including forecasts to FY 2008, dated 26 July 2004 and prepared by ION in connection with the possible sale of ION assets.
Second Meetings	Second meetings of creditors of the ION Administration Group held concurrently on 6 May 2005.
Section 439A Report	Report to creditors dated 15 April 2005 issued by the Administrators as required by section 439A of the Corporations Act.
September Announcement	Market update issued by ION on 24 September 2004 in relation to forecast profitability for FY 2005.
Shareholder Claims	Claims for damages made by current and former shareholders of ION.
SMT	Shenzhen Minghe Trading Company Limited.
SMT September Volume Concession	Event 16, which has the meaning given in paragraph 25.4.1.
SMT Supply Agreement	The Supply Agreement between ION and SMT executed on 24 June 2004.

SsangYong	SsangYong Motor Company or related entities with which ION conducted business.
SsangYong May Notifications	Event 11, which has the meaning given in paragraph 25.4.1.
SsangYong 28 July Softening	Event 14, which has the meaning given in paragraph 25.4.1.
SsangYong July Softening	Event 13, which has the meaning given in paragraph 25.4.1.
TP Act	<i>Trade Practices Act 1974 (Cth)</i> .
Transmissions Division	An operating division of ION as described in paragraph 10.3.4.
UBS Conference	UBS Emerging Companies Conference held on 20 October 2003.
UBS Presentation	PowerPoint presentation given by ION at the UBS Conference.
Voluntary Administration Liabilities	Has the meaning given in the DOCAs.
Westpac	Westpac Banking Corporation.
Wheels Division	An operating division of ION as described in paragraph 10.3.4.
William Buck	ION's internal auditor.
Williams	Ian Williams, who was appointed by ION as an independent engineer to review its existing and proposed capital projects and their estimated cost to completion.
Williams Status Report	Status report on ION's capital projects prepared by Williams and provided to ION on 19 September 2004.
Wingfield	The operations of Castalloy located at the Wingfield site in South Australia.
Wingfield Project	The purchase, development and commissioning by ION of a greenfield site in Wingfield, South Australia.
Wingfield and North Plympton Forecast Downgrade	Event 15, which has the meaning given in paragraph 25.4.1.
ZF Contract	Contract between Ford and ZF Lemforder for the supply of 6-speed transmissions.
ZF Lemforder	ZF Lemforder Australia Pty Limited or related entities with which Ford conducted business.

PART A – UPDATE AND WAY FORWARD

1. Introduction

- 1.1.1 On 7 December 2004, Colin Nicol and Peter Anderson of McGrathNicol were appointed administrators to ION Limited and its 22 Australian subsidiaries (collectively, the **ION Administration Group**) pursuant to Part 5.3A of the *Corporations Act 2001* (Cth) (the **Corporations Act**). In some instances, other partners of McGrathNicol, namely Robyn McKern, Murray Smith, Sam Davies and Mike Hill, were also appointed administrators to certain ION Administration Group entities (together with Colin Nicol and Peter Anderson, the **Administrators**).
- 1.1.2 As required by section 439A of the Act, the Administrators issued a report to creditors dated 15 April 2005 (the **Section 439A Report**) and called meetings of creditors to be held concurrently on 6 May 2005 (the **Second Meetings**).
- 1.1.3 At the Second Meetings, resolutions were passed by the creditors of ION Limited and of another 17 of the original 23 ION Administration Group entities (collectively the **Pooled Entities** - see Annexure 1) to the effect that each Pooled Entity enter into a deed of company arrangement.
- 1.1.4 On 27 May 2005, deeds of company arrangement were executed by each of the Pooled Entities (the **DOCAs**) and the Administrators of each Pooled Entity (other than Murray Smith) were appointed as the deed administrators of the DOCA for that entity (the **Deed Administrators**).
- 1.1.5 A copy of the DOCAs is available on the ION website www.ionlimited.com
- 1.1.6 Creditors' Committees for each Pooled Entity were also elected at the Second Meetings to consult with the Deed Administrators and receive and consider reports from them.
- 1.1.7 The creditors of the five ION Administration Group entities that did not resolve to execute a deed of company arrangement (the **Non-Pooled Entities** - see Annexure 1) resolved that those entities be wound up. The liquidators appointed to these entities were Colin Nicol and Peter Anderson (the **Liquidators**).
- 1.1.8 Since the initial appointment of the Administrators and the appointment of the Deed Administrators on 27 May 2005, the realisation of ION's¹ businesses and assets has been completed. The review of proofs of debt lodged by suppliers of goods and services and by financiers has largely been completed with only a small number of complex claims still in dispute. The only matter of significance still to be concluded is the adjudication of proofs of debt lodged (or to be lodged) by shareholders.
- 1.1.9 In this Report we set out details of the work that has been done to date in relation to shareholder claims and the steps which remain to be taken to enable the Deed Administrators to determine these claims and to distribute funds to creditors.

¹ When used in this Report, **ION** means ION Limited and/or one or more of its subsidiaries.

- 1.1.10 This Report includes a description of the relevant facts concerning the areas of investigation undertaken by the Deed Administrators in response to proofs of debt lodged by current and former shareholders of ION. The evidence on which this Report is based is voluminous and the facts are necessarily described here at a high level. The facts set out are as understood by the Deed Administrators based on the documents and other information (including witness statements) currently available to them and based on their assessment of that evidence. While the Deed Administrators have no reason to believe it to be the case, it is possible that other evidence exists which is currently unknown to them which may affect the conclusions in this Report.
- 1.1.11 Adjudication of shareholder proofs of debt will require assessment of the facts and legal issues which are specific to each individual proof. The Deed Administrators make no recommendation as to whether, or on what basis, any person lodges or amends a proof of debt and such persons should seek their own legal advice if they require assistance in that regard.

2. Executive Summary

2.1 The Fund and the Purpose of this Report

- 2.1.1 Pursuant to the DOCAs, a fund has been established comprising (amongst other things) the proceeds of the realisation of the Pooled Entities' assets (defined in the DOCAs as the **Fund**). Subject to payment of certain priority claims, the Fund is to be distributed on a pro rata basis to those persons whose provable debts and claims are admitted by the Deed Administrators. Funds on hand as at 30 June 2010 totalled approximately \$336 million.
- 2.1.2 Following the High Court's decision in January 2007 in the *Sons of Gwalia* case, and as the law currently stands, claims by ION shareholders who allege they have suffered loss as a result of ION's misleading conduct (ie, Shareholder Claims) are claims which, if admitted, are entitled to rank equally with the debts and claims of other unsecured creditors of ION.
- 2.1.3 To date, the Deed Administrators have received the following proofs of debt from persons seeking to share in distributions from the Fund.

\$million (approx)

Proofs of debt from suppliers of goods and services and financiers	545
Proofs of debt from current and former shareholders of ION	<u>122</u>
	<u>664</u>

- 2.1.4 The review and adjudication of proofs of debt from suppliers of goods and services and financiers is substantially complete, with a small number of complex claims still in dispute. Proofs of debt in this category which have been admitted or are still under review total approximately \$513 million.
- 2.1.5 In determining whether to admit or reject a proof of debt, the Deed Administrators have a duty to act in a quasi-judicial capacity. This requires them to have available the necessary

factual and legal material which will enable them to make a reasoned determination of each proof of debt.

- 2.1.6 The proofs of debt lodged to date by current and former ION shareholders (numbering approximately 3,300) have raised numerous factual and legal issues which have required thorough investigation by the Deed Administrators before they were in a position to determine those proofs.
- 2.1.7 In the course of reviewing the shareholder proofs it became apparent to the Deed Administrators that many shareholders appeared to have based their allegations on statements contained in the Section 439A Report. Given the timing and nature of the Section 439A Report, and as noted below in section 11, the information in that report was inconclusive and based on incomplete investigations.
- 2.1.8 Having now completed their detailed investigations, the Deed Administrators are in a position to report on their findings. This Report will assist current and former shareholders of ION to consider (based on the information now available) whether they have a basis for a claim against ION and, if they have not already done so, to lodge a proof of debt. For those who have already lodged proofs, this Report will assist those shareholders to refine their claims and, if considered appropriate by them, to lodge amended proofs of debt. In light of the new information in this Report, and to facilitate an efficient adjudication process, the Deed Administrators suggest that existing shareholder claimants re-submit their proofs of debt using the new Shareholder Claim Form referred to in section 2.12 below. The procedures for lodging new or amended proofs of debt can be found at www.ionlimited.com.au or by contacting the Deed Administrators' office on (03) 9038 3133. New or amended proofs must be received by the Deed Administrators by **13 December 2010**.
- 2.1.9 Until new and amended proofs of debt are received, it is not possible for the Deed Administrators to quantify with any certainty the full extent of potential Shareholder Claims and therefore the estimated return to ION creditors entitled to share in the Fund. Depending on the quantum of Shareholder Claims admitted, the estimated return to creditors would likely fall within the following ranges.

Estimated return scenarios to creditors of pooled entities

	High	Low
Shareholder claims	cents/\$	cents/\$
\$0	68	64
\$50 million	62	58
\$100 million	56	53
\$150 million	52	49
\$200 million	48	46

2.2 Contents of this Report

- 2.2.1 This Report is in three parts:

- (a) Part A (sections 3 to 9) which provides an update on the ION administration generally and explains the next steps required to enable the Deed Administrators to determine Shareholder Claims and distribute funds to creditors;
 - (b) Part B (sections 10 to 15) which provides an overview of the results of the Deed Administrators' investigations into the claims raised by shareholders, including (in section 15) a summary of their key findings;
 - (c) Part C (sections 16 to 25) which provides a detailed explanation of the results of the Deed Administrators' factual investigations into matters relevant to shareholder claims.
- 2.2.2 Having completed their forensic investigations, the Deed Administrators now have a detailed understanding of the events relevant to the Shareholder Claims – events that predominantly occurred in the period October 2003 to December 2004. An overview of the key events in that period is set out in section 12 of this Report. In addition, the Deed Administrators are in a position to make findings of fact in respect of a large number of issues relevant to the determination of Shareholder Claims. These findings are set out in sections 17 to 25 by reference to the various areas of investigation undertaken.
- 2.2.3 The Deed Administrators have also considered how the chronology of events leading to ION's administration in December 2004 may have altered if ION had made appropriate and timely disclosures of information affecting its forecasts and outlook to the market (and its financiers). The Deed Administrators analysis in this regard is set out in section 14. The matters in section 14 are particularly relevant to those persons who purchased shares on or after 10 September 2004.
- 2.3 Potentially Actionable Disclosures and Non-Disclosures**
- 2.3.1 While the Shareholder Claims received to date comprise of a wide variety of allegations, the vast majority involve claims that:
 - (a) ION failed to disclose matters to the market in breach of its disclosure obligations pursuant to the Corporations Act and the ASX Listing Rules (ie, Failure to Disclose); and/or
 - (b) ION engaged in misleading or deceptive conduct contrary to the Trade Practices Act and/or other similar legislative provisions (ie, Misleading or Deceptive Conduct).
- 2.3.2 For shareholders to have a valid claim against ION in respect of a Failure to Disclose or Misleading or Deceptive Conduct, they must establish each of the following elements:
 - (a) **breach** – that ION's conduct the subject of complaint constitutes a Failure to Disclose or Misleading or Deceptive Conduct pursuant to the relevant statutory provisions;
 - (b) **causation** – that the shareholder suffered loss by or as a result of that conduct because, for example, the conduct affected the shareholder's behaviour in relation to trading in ION shares; and
 - (c) **loss** – that the shareholder suffered a monetary loss (which must be calculated in accordance with the applicable legal principles).

2.3.3 In relation to the first requirement (breach), based on their investigations to date, the Deed Administrators have identified certain conduct of ION which, in their view, is likely to amount to a Failure to Disclose or Misleading or Deceptive Conduct. The relevant conduct is summarised in sections 2.4 to 2.11 below where the Deed Administrators also make some comments regarding the second element (causation) and what is required of shareholders in this regard if they wish to pursue a claim. The matters summarised in sections 2.4 to 2.11 are also covered in section 15 of this Report.

2.3.4 As noted earlier in this Report, the Deed Administrators make no recommendation as to whether, or on what basis, any person lodges or amends a proof of debt and such persons should seek their own legal advice if they require assistance in that regard.

2.4 Funding the growth strategy

2.4.1 In section 14 below, the Deed Administrators consider how the chronology of events leading to ION's administration in December 2004 (including its ability to raise the necessary capital to fund its growth strategy) may have altered if ION had made appropriate and timely disclosures of information affecting its forecasts and outlook to the market (and therefore its lenders). The Deed Administrators conclude that if ION had made such disclosures, ION's shares would probably have been suspended from trading from 10 September 2004 and ION is likely to have been placed into administration soon thereafter.

2.4.2 As noted in sections 2.5 and 2.7 below, ION is likely to be found to have breached its continuous disclosure obligations in failing to inform the market as soon as it was relevantly aware of:

- (a) a 17% decline in forecast Earnings Per Share (ie, EPS) for FY 2005 and the underlying reasons for that reduction (ie, from 5 August 2004); and
- (b) the loss of the Ford 6-speed transmissions contract notified to ION on 9 September 2004.

2.4.3 Those matters were also material to ION's existing and prospective lenders who were in the process of considering a request by ION that its existing debt facilities be refinanced and increased by approximately \$100 million to the level required to fund ION's growth strategy.

2.4.4 For the reasons set out in section 14 of this Report, the Deed Administrators have concluded that if those matters had been disclosed to the market (and therefore to lenders) it is likely that:

- (a) the committed offers of finance made by lenders on or about 20 August 2004 would not have been made;
- (b) after a period of investigation by the lenders, and disclosure on 9 September 2004 of the Ford 6-speed decision, there would have been grave doubts about the prospects of ION obtaining the necessary funding;
- (c) given ION's immediate cash needs, it would have gone into urgent discussions with its financiers regarding ongoing funding and, as a consequence, ION's shares would probably have been suspended from trading from 10 September 2004; and

- (d) lenders would ultimately have made a decision not to fund ION and, by mid September 2004, ION would have been in administration.
- 2.4.5 The Deed Administrators cannot be certain of the events that would have transpired if these disclosures had been made. The scenario outlined above is one which the Deed Administrators consider most likely on a balance of probabilities having regard to the available evidence, including the actual events which occurred in the lead up to ION's administration in December 2004. It is possible that if the matter were tested in the Courts, a different conclusion might be reached, either as to the consequences flowing from disclosure or as to the timing of the assumed events.
- 2.4.6 As to the second requirement (causation), if it is presumed that disclosure is likely to have lead to ION's shares ceasing to trade from 10 September 2004, there is an argument that shareholders making claims regarding shares purchased on or after that date need not provide individual evidence of causation. That is, it can be inferred from the circumstances that the relevant Failures to Disclose caused the loss (if any) sustained in respect of ION shares purchased on or after 10 September 2004. Again, this is a matter which has not been specifically tested in the Courts.
- 2.4.7 Having regard to the time and expense involved in litigating these issues, and their assessment of the balance of probabilities described above, the Deed Administrators have formed the view that shareholders making claims in respect of shares purchased on or after 10 September 2004 should have the option of resolving their claims expediently without the need to submit further detailed evidence of causation. This is dealt with further in section 15.10 below. As explained there, shareholders making claims concerning shares purchased on or after 10 September 2004 may elect not to submit any evidence of causation in respect of those shares and accept admission of their proof of debt at 80% of the loss suffered in respect of those shares (calculated in accordance with applicable legal principles).² In the Deed Administrators' opinion a compromise of such claims by way of a 20% discount is reasonable. Shareholders who would prefer to seek admission of their claims concerning shares purchased on or after 10 September 2004 without a discount, will be at liberty to do so, however, they are required to submit evidence of causation with their proofs of debt. If the causation evidence submitted is not accepted by the Deed Administrators, the shareholder's proof will be admitted at 80% of its value (calculated in accordance with applicable legal principles) and on the basis that any rights of appeal the shareholder may have are not affected.
- 2.4.8 The election referred to above may be made by relevant shareholders at the time of completing their Shareholder Claim Form (see section 2.12 – Next Steps). Shareholders should note, however, that if the compromise is accepted, that does not mean that the shareholder will receive payment of 80% of the loss claimed. It means that the shareholder's claim will be accepted by the Deed Administrators at 80% of its proper value and the shareholder will receive pro-rata distributions on that amount along with other unsecured creditors whose debts or claims are admitted to proof.

² This election is not available to any shareholder who was an officer or employee of ION or an associate of an officer or employee of ION at any time in the period 10 September to 7 December 2004.

2.5 Disclosures regarding Financial Outlook

2.5.1 The Deed Administrators have identified two aspects of ION's disclosures concerning financial outlook which are likely to amount to a Failure to Disclose or Misleading or Deceptive Conduct. They relate to:

- (a) ION's guidance regarding its forecast EPS for FY 2005; and
- (b) ION's failure to disclose information concerning FY 2005 significant items.

Shareholders wishing to pursue claims based on these likely breaches must submit causation evidence with their proofs of debt.

Forecast EPS for FY 2005

2.5.2 The April Guidance issued on 27 April 2004 included statements concerning ION's forecast profitability for FY 2005 and FY 2006. The April Guidance figures were based on a detailed financial model prepared by ION during April 2004 (ie, the April Model), however, the figures released to the market were conservative relative to the April Model. ION thereby built into the Guidance a buffer or margin for error.

2.5.3 On 5 August 2004, ION completed the preparation of revised forecasts for provision to its existing and prospective lenders which included revised forecasts for FY 2005 and FY 2006 (ie, the August Update). These forecasts took into account changes which had occurred in relation to the outlook for the Wingfield Project and the North Plympton business unit. As prepared, the August Update forecasts remained in line with the April Guidance. In other words, the buffer built into the April Guidance was sufficient to absorb these changes.

2.5.4 In fact, the August Update failed to take into account the impact on ION's forecasts of various other significant adverse events relating to the Albury business, (see paragraph 25.8.11 below). If those matters had been brought to account in the forecasts, the Deed Administrators consider that the forecasts would have shown a 17% reduction in EPS for FY 2005 against the April Guidance. This is based on the Deed Administrators' consideration and reconstruction of the August Update (see paragraphs 25.8.7 to 25.8.12 below).

2.5.5 In the Deed Administrators' view, ION's failure from 5 August 2004 to disclose the 17% reduction in its previous earnings guidance (and the reasons associated with that reduction) is likely to amount to a Failure to Disclose. It was not until 24 September 2004 that ION provided the market with any indication that its FY 2005 forecast earnings had changed.

FY 2005 significant items

2.5.6 On 26 October 2004 ION held its AGM at which it provided the market with an update on its forecast profitability for the financial year ended 30 June 2005. ION stated that, although it was very difficult to reliably forecast a figure at that time, it estimated that FY 2005 EBITDA would be approximately \$90 million 'before significant items'. However, no mention was made at the AGM or subsequently of the anticipated nature or value of significant items. In fact, at this time, ION anticipated significant items of \$22.6 million before tax, including \$11.8 million associated with the ongoing difficulties at the Wingfield

plant (see further paragraph 25.7.30 below). In the Deed Administrators' view, ION's failure to provide information known to it at the time concerning the expected nature and magnitude of significant items is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

2.6 Financial controls

2.6.1 In section 17 of this Report, the Deed Administrators set out the results of their investigations concerning the adequacy of ION's financial controls and the disclosures to the market alleged to have been made in relation to those controls. Based on their investigations to date, the Deed Administrators have not identified any conduct of ION in relation to its market disclosures (or any failure to disclose) concerning its financial controls which in their view is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

2.7 Albury

2.7.1 Details of the Deed Administrators' investigations in relation to the Albury business are set out in section 18 of this Report. Based on their investigations to date, the Deed Administrators have identified the following conduct of ION in relation to Albury which in their view is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

- (a) First, and most significantly, is ION's failure to notify the market about the loss of the Ford 6-speed contract on 9 September 2004. In section 18.4 below details of ION's attempts to put in place with Ford a contract for the supply of 6-speed transmissions are set out. As noted there, at a meeting on the afternoon of 9 September 2004, ION was informed by Ford that it had selected another supplier to meet its 6-speed transmission needs beyond 2008. ION failed to disclose this information to the ASX as it was required to do under its continuous disclosure obligations. In fact, ION's loss of the Ford contract did not become public until after ION went into administration.
- (b) Of less significance, but nevertheless likely to give rise to a breach are two statements by ION concerning the testing of its 6-speed prototype. At its AGM on 26 October 2004 and again at the Citigroup Conference on 10 November 2004, ION represented that its 6-speed prototype was currently being tested by 'customers'. These statements must be viewed in the context of the market's knowledge that ION had two primary potential 6-speed customers – Ford and SsangYong. In fact, only SsangYong was testing ION's 6-speed prototype at this time. Ford had never tested the prototype and on 10 August 2004 had declined ION's offer to test drive a car fitted with a prototype. Indeed, by the time these statements were made, Ford had already informed ION that it had lost the 6-speed contract.
- (c) Finally, ION made an error in quoting the wrong Ford 4-speed volume estimate at a presentation in October 2003. In particular, at the UBS Conference on 20 October 2003, ION represented that the expected 4-speed transmission volumes for supply to Ford for the period through to 2007 would be 116,000 units per annum. In circumstances where ION had entered into a Target Agreement with

Ford on 12 September 2003, which provided for a 4-speed transmission volume target of 75,000 units per annum from September 2005, it appears from the Deed Administrators' investigations that ION did not have reasonable grounds for making that representation. As noted in paragraph 18.3.10 below, by 19 February 2004, IAG forecasts presented to the market were based on the reduced figure of 75,000 units per annum. Given the timing and nature of this misrepresentation, the Deed Administrators expect that it is unlikely to have caused significant loss to shareholders. Nevertheless, shareholders wishing to pursue this claim must submit the necessary evidence establishing that they relied on the misrepresentation and thereby suffered loss.

2.8 Altona

2.8.1 In section 19 of this Report, the Deed Administrators set out the results of their investigations concerning the Altona Project. Based on their investigations to date, the Deed Administrators have identified the following conduct of ION in relation to the Altona Project which in their view is likely to amount to a Failure to Disclose or Misleading or Deceptive Conduct. Once again, given the timing and nature of these likely breaches, the Deed Administrators expect that any loss arising from them will be limited. However, shareholders wishing to pursue claims based on these likely breaches must submit causation evidence as outlined in section 15.10.

- (a) From July 2003 relevant officers within ION had information that the Altona plant was being designed with an initial production capacity of 350,000 engine blocks per annum (the minimum capacity of the casting technology being used). ION had previously announced to the market that it had a contract with Holden for 200,000 engine blocks per annum and that the 'base load' of the plant was 200,000 units per annum. When ION became aware in July 2003 that the minimum base load was 350,000, it did not immediately disclose that information to the market. Instead, ION disclosed the increased production capacity on 19 February 2004.
- (b) ION's 2003 Annual Report issued in September 2003 stated that the initial installed capacity of the Altona plant was 200,000 units. In circumstances where it was known to ION that the minimum production capacity would be 350,000, this statement was incorrect. As noted above, ION provided the correct information to the market on 19 February 2004.
- (c) At its 2004 AGM on 26 October 2004, ION announced that the estimated costs across all of its capital projects had increased by approximately 15%. The capital projects were noted to include Altona. The actual increase for Altona, measured on a stand-alone basis was \$35 million (up from \$125 million to \$160 million) representing a 27% increase in that project's budget. In circumstances where ION had previously provided the market with specific information about Altona's forecast capital expenditure, failing to do so on this occasion is likely, in the Deed Administrators' view, to amount to a Failure to Disclose or Misleading or Deceptive Conduct.

2.9 Wingfield

- 2.9.1 In relation to the Wingfield Project (see section 20 of this Report), apart from the issue concerning significant items dealt with in paragraph 2.5.6 above, the Deed Administrators have identified the following conduct of ION which in their view is likely to amount to Misleading or Deceptive Conduct.
- 2.9.2 ION stated in the February Announcement on 19 February 2004 that completion of the Wingfield Project was 'on budget Stage 1'. In the circumstances, this statement gave a false impression of the position concerning Wingfield at this time. In fact, ION had already planned what was labelled as 'Stage 2' of the project, but this work was largely to resolve capacity constraints affecting the plant as initially designed. In addition, while the Stage 1 budget (as incorrectly prepared by ION) did not include any commissioning costs, it was clear by this stage that substantial costs would be involved in commissioning the plant. To say that Stage 1 was 'on budget', did not convey the full picture and is likely to be found to be misleading. ION subsequently informed the market on 27 April 2004, in the April Guidance, that there would be a cost overrun in relation to the Wingfield Project.
- 2.9.3 Shareholders claiming loss based on this likely breach (which the Deed Administrators expect will be limited) are required to submit evidence of reliance/causation as explained in section 15.10.

2.10 North Plympton

- 2.10.1 Based on their investigations to date (which are summarised in section 21 of this Report), the Deed Administrators have not identified any conduct of ION in relation to its market disclosures (or any failure to disclose) concerning the North Plympton business unit which in their view is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

2.11 Auckland, Kentucky and Energy Services

- 2.11.1 The Auckland, Kentucky and Energy Services business units are dealt with in sections 22 to 24 of this Report. Based on their investigations to date, the Deed Administrators have not identified any conduct of ION in relation to its market disclosures (or any failure to disclose) concerning Auckland, Kentucky or Energy Services which in their view is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

2.12 Next Steps

- 2.12.1 On 14 October 2010, on the Deed Administrators' application, the Federal Court made orders relating to:
- (a) the circulation of this Report; and
 - (b) the notification of prospective creditors of their potential right to lodge new or revised proofs of debt under the DOCAs.

Shareholders who have not yet lodged a proof of debt

- 2.12.2 As contemplated in those orders, shareholders who have not already lodged a proof of debt and wish to do so must complete a Form 535 Proof of Debt Form and a Shareholder Claim Form and lodge those documents with the Deed Administrators by **13 December 2010**. Details of the procedures for completing and lodging a proof of debt can be found at

www.ionlimited.com.au or by contacting the Deed Administrators' office on (03) 9038 3133.

As noted in the on-line procedures, and as explained further in section 15.10 below, all shareholders wishing to make a claim against ION must submit evidence of causation establishing how ION's conduct is said to have caused the shareholder's loss. In respect of claims concerning shares purchased on or after 10 September 2004, shareholders may elect not to submit any evidence of causation in respect of those shares and accept admission of their proof at 80% of the loss suffered in respect of those shares (calculated in accordance with the applicable legal principles).³ Further details concerning this election are set out in section 15.10 below and in the on-line procedures.

- 2.12.3 The required Form 535 and Shareholder Claim Form must be received by the Deed Administrators by **13 December 2010**.

Shareholders who have already lodged a proof of debt

- 2.12.4 Shareholders who have already lodged a proof of debt may wish to amend their existing proof of debt in light of the new information contained in this Report and the election which is now available in relation to claims concerning shares purchased after 10 September 2004. Once again, details of the procedures for completing and lodging an amended proof of debt can be found at www.ionlimited.com.au or by contacting the Deed Administrators' office on (03) 9038 3133. Any amended proof of debt must be received by the Deed Administrators by **13 December 2010**.

Adjudication of Shareholder proofs

- 2.12.5 Shareholder proofs of debt received by the Deed Administrators by **13 December 2010** will then need to be considered and adjudicated by the Deed Administrators. Adjudication of shareholder proofs of debt will require assessment of the facts and legal issues which are specific to each individual proof.
- 2.12.6 Those claims lodged which relate to shares purchased on or after 10 September 2004, where shareholders have elected to accept admission at 80% of their value, should be able to be dealt with relatively quickly, since the only major issue left for consideration by the Deed Administrators will be the proper calculation of the loss claimed.
- 2.12.7 Claims relating to shares purchased prior to 10 September 2004 will require consideration not only of the loss suffered (if any), but also whether the shareholder has established a relevant breach by ION and a causal link between that breach and the shareholder's loss. Once proofs of debt have been received, the Deed Administrators will be in a better position to assess the likely timing and process for dealing with these claims.
- 2.12.8 Once the full extent of Shareholder Claims can be quantified, the Deed Administrators will give consideration to whether an interim distribution under the DOCAs is appropriate.

³ This election is not available to any shareholder who was an officer or employee of ION or an associate of an officer or employee of ION at any time in the period 10 September to 7 December 2004.

3. The Fund

3.1 Establishment of the Fund

3.1.1 The DOCAs provide for the Deed Administrators to establish and administer a fund into which certain sums must be deposited, including the proceeds of the realisation of the Pooled Entities' assets (defined in the DOCAs as the **Fund**). The DOCAs provide for the distribution of the Fund by the Deed of Administrators to pay (in the following order):

- (a) first, the Voluntary Administration Liabilities and Deed Liabilities;
- (b) secondly, Employee Entitlements; and
- (c) thirdly, the Entitlements of Admitted Creditors.

3.1.2 Further details as to who can share in the Fund are set out in section 4 below.

3.1.3 The DOCAs also provide for the Deed Administrators to make interim distributions in their absolute discretion.

3.2 Asset realisations

3.2.1 The sale of the various businesses and assets of the Pooled Entities has been completed resulting in funds on hand, as at 30 June 2010, of \$336 million, net of costs of the administration.

3.2.2 A summary of the disposal of key businesses and assets is noted below.

ION Energy Services

3.2.3 The ION Energy Services (**IES**) business was sold to CHAMP Private Equity Group in January 2005 for approximately \$151 million net of lease liabilities and subject to adjustments for working capital, transaction costs and the transfer of employee entitlements.

3.2.4 The final value was consistent with an agreement for the sale of shares negotiated prior to the administration, adjusted to reflect the economic costs of the changed circumstances and the sale structure. In particular, it was necessary to change the sale structure from a sale of shares to a sale of assets, which resulted in higher stamp duty and other imposts. The sale value represented a considerable premium on book value.

Altona

3.2.5 In February 2005, the Administrators announced that the Altona engine block plant would not be completed as it was not commercially viable to do so. The Altona site was marketed for sale and by September 2005 it was sold for the sum of \$9.6 million, which exceeded the independent valuations obtained.

Wingfield

3.2.6 In March 2005, the Administrators announced that their efforts to sell the Wingfield plant as a going concern were unsuccessful and an orderly wind-down of the facility was implemented.

- 3.2.7 After extensive marketing campaigns, the Wingfield land and buildings were sold in April 2006 and the plant and equipment was sold in July 2006 for values approximating independent valuations. Settlement on the land sale occurred in late September 2006.

Kentucky

- 3.2.8 ION's automotive wheel plant in Warsaw, Kentucky was sold on 6 August 2005, after completion of the plant's construction. The headline price was US\$28 million plus working capital assets net of closing adjustments. The sale agreement included an 'Earn-Out' mechanism pursuant to which up to US\$4 million of the purchase price would be paid to the vendor over a 2 year period based on the plant's production output. Due to operational difficulties, the purchaser withheld payment of the earn-out and the escrow portion of the purchase price. The parties ultimately reached a commercial settlement on the disputed claims, the terms of which are confidential.

- 3.2.9 In December 2007 the Deed Administrators' US lawyers, who were finalising the solvent liquidation of the US entity, paid a liquidation dividend of US\$1.75 million to the Deed Administrators and a final dividend of US\$230,000 was paid in August 2008.

Albury

- 3.2.10 On 13 February 2006, the Deed Administrators announced that ION Automotive Systems (**IAS**) had executed a contract to sell its automotive transmission manufacturing facility in Albury and related intellectual property assets. The headline purchase price was \$48 million adjusted for warranties provided by the vendor and working capital assets and employee entitlements transferring to the purchaser.

- 3.2.11 After realisation of trading assets and liabilities excluded from the sale, the net cash contribution from the IAS business to the Fund was \$64 million. The sale was completed on 23 February 2006.

North Plympton

- 3.2.12 In August 2006, the Deed Administrators announced that an agreement had been executed for the sale of the Castalloy wheels business based at North Plympton to New Castalloy Pty Ltd, a subsidiary of the US domiciled Harley-Davidson Inc. The Harley-Davidson subsidiary purchased the majority of Castalloy's plant, equipment, intellectual property and inventory and offered ongoing employment to approximately 320 employees. The sale was effected on 29 September 2006.

- 3.2.13 A confidentiality provision prevents public disclosure of the sale transaction details, however, the Deed Administrators can disclose that the sale price exceeded valuation. The combination of trading cash flow and sale proceeds have yielded in excess of \$60 million since the appointment of the Administrators.

Auckland

- 3.2.14 On 1 July 2005, ION announced its plans to wind-down its New Zealand operations (based in Auckland) over a 12 month period. The wind-down was finalised in March 2006 and a liquidator was appointed to ION's New Zealand subsidiaries on 30 June 2006. In April 2007 the liquidator paid a dividend of approximately \$21.96 million to the Pooled Entities in accordance with the requirements of the DOCAs. A final dividend of approximately

\$681,000 was paid in June 2008. The sums received from the liquidation exceed previous going concern offers.

3.3 Current cash balance and investment of funds

- 3.3.1 Funds on hand for Pooled Entities have and continue to be invested on a commercial basis, including 11 am investment accounts, trade bills and term deposits totalling \$336 million as at 30 June 2010. A breakdown is shown below.

Investment of funds on hand at 30 June 2010

	\$'000
Cheque accounts	736
11am investment accounts	46
Trade bills	104,515
Term deposits	230,662
Total	335,959

4. Who can share in the Fund?

4.1 Provable debts and claims

- 4.1.1 As mentioned above, after payment of certain priority claims, including Employee Entitlements, the Fund is to be distributed to Admitted Creditors in respect of their Entitlements.

- 4.1.2 These terms are defined in the DOCAs, but essentially this means that those persons whose provable claims are admitted by the Deed Administrators for the purposes of distribution of the Fund are entitled to a share of the Fund on a proportionate basis. The DOCAs prescribe which claims are admissible to proof as follows.

a debt owing by, or a claim subsisting against a [Pooled Entity] (whether present or future, certain or contingent, ascertained or sounding only in damages) ... being a debt or claim which arose on or before 6 December 2004 and which would be admissible to proof against the [Pooled Entity] had that entity been wound up pursuant to Part 5.6 of the Act.

4.2 Postponement of claims by members

- 4.2.1 Distributions to creditors under the DOCAs are subject to clause 13 which has the effect of postponing payment of a claim owed by a Pooled Entity to a person in the person's capacity as a member of that entity, whether by way of dividends, profits or otherwise. These types of claims are postponed until all admitted claims made by persons other than members have been satisfied. This clause is expressed not to limit the operation of section 563A of the Corporations Act as it applies in relation to the DOCAs by reason of clause 12.6.

- 4.2.2 Clause 13 of the DOCAs mirrors the language of section 563A of the Act. As such, any judicial findings about the kinds of claims which are to be postponed pursuant to section 563A are directly relevant to the question of what kind of claims are owed by ION to a person in 'the person's capacity as a member of the entity' and therefore postponed under the terms of the DOCAs.

- 4.2.3 Until early 2007, there was uncertainty as to the legal position concerning the claims of shareholders who alleged they had been misled by ION (**Shareholder Claims**) and whether or not those claims ought to be postponed as contemplated by section 563A (and as incorporated into the DOCAs).
- 4.2.4 The position was finally settled by the High Court's decision in the *Sons of Gwalia* case in a judgment handed down on 31 January 2007.
- 4.2.5 As the law now stands, damages claimed by ION shareholders in respect of Shareholder Claims are not amounts owed to shareholders in their capacity as 'members' of ION and, accordingly, they are not claims that should be postponed. Shareholder Claims must be treated as claims made by creditors.
- 4.3 Approach to determination of proofs**
- 4.3.1 In determining whether to admit or reject a proof of debt, the Deed Administrators have a duty to act in a quasi-judicial capacity. This is reflective of their duty to distribute the assets of the Pooled Entities only among those persons truly entitled.
- 4.3.2 In order to carry out this quasi-judicial function, the Deed Administrators must have available to them the necessary factual and legal material which will enable them to make a reasoned determination of each proof of debt, including each proof lodged by an ION shareholder.

5. Calling for and lodgement of Proofs of Debt or Claim

5.1 Notice Inviting Proofs

- 5.1.1 In accordance with the regime prescribed in the DOCAs, the Deed Administrators issued a Notice Inviting Formal Proofs of Debt or Claim on 28 June 2005 (**Notice Inviting Proofs**).
- 5.1.2 The Notice Inviting Proofs requested that creditors who had not already lodged their claim submit proofs of debt on or before 15 July 2005. The Deed Administrators have continued to receive proofs of debt, including from ION's shareholders, since that date.
- 5.1.3 Corporations Regulation 5.6.48 (as incorporated into the DOCAs by clause 12.6) requires the Deed Administrators to give written notice of the day on or before which formal proofs must be submitted, by advertising that notice and sending it to *'every person who, to the knowledge of the [Deed Administrators], claims to be a creditor of the company, and whose debt or claim has not been admitted'*. In order to comply with this Regulation the Deed Administrators:
- (a) published the Notice Inviting Proofs in *The Australian* newspaper;
 - (b) sent the Notice Inviting Proofs to all persons, who to the knowledge of the Deed Administrators at that time, claimed to be a creditor of a Pooled Entity and whose debt or claim had not been admitted; and
 - (c) gave the Notice Inviting Proofs to the Australian Stock Exchange (**ASX**) and published it on the ION and McGrathNicol websites.
- 5.1.4 The persons to whom the Notice Inviting Proofs was sent included a small number of shareholders who had made claims to be creditors or who had given the Deed

Administrators notice of their intention to make claims. The Deed Administrators were not required to send the Notice Inviting Proofs to:

- (a) all 19,220 ION shareholders registered as at 7 December 2004; or
 - (b) all ION shareholders who purchased or sold shares prior to December 2004,
- as they had no knowledge at the time of any of those shareholders claiming to be creditors of ION.

5.2 Non-Shareholder proofs received

5.2.1 Proofs of debt admitted or under review for the Pooled Entities total \$513 million (excluding Shareholder Claims) and can be summarised as follows:

Proofs of debt	
	\$'000
Admitted	489,866
Under review	23,598
Total	513,464

5.2.2 The review of proofs of debt from suppliers of goods and services and financiers is substantially complete, with a small number of complex claims in dispute. From our assessments to date, the amount of admissible claims from financiers and suppliers of goods and services (excluding Shareholder Claims) will not exceed the estimates made in the Section 439A Report issued on 15 April 2005.

5.3 Shareholder proofs received

5.3.1 To date the Deed Administrators have received more than 3,300 proofs of debt from parties claiming to be ION shareholders, totalling approximately \$122.3 million. The make-up of the claimants categorised by their representatives is set out below.

Shareholders by representative		
Representative	Claims	Value \$000's
Bluestone Wealth Management	28	683
Cusoff Cudmore Knox Lawyers	15	6,186
Dawson & Partners Chartered Accountants	29	641
Dennis & Co.	764	29,406
Slater & Gordon	1,284	56,699
Unrepresented (includes former Shareholder Advocacy)	1,186	27,966
Others	14	713
Total	3,320	122,294

6. Estimated Return to Creditors

6.1.1 In the Section 439A Report to creditors issued in April 2005, the Deed Administrators estimated that the return to creditors under the DOCAs would fall within the range of

27 cents to 34 cents in the dollar. At that time, no allowance was made for claims from shareholders because the law entitling shareholders to claim as creditors in relevant circumstances had not been settled.

6.1.2 Since that original estimate, the proceeds from realisation of assets have exceeded the Deed Administrators' forecasts and claims from creditors other than shareholders have been lower than allowed for. On the other hand, the Deed Administrators have received proofs of debt from numerous shareholders as described in section 5. Significant uncertainty remains as to the amount that will be claimed by shareholders following the publication of the findings set out in this Report. On current estimates, and before accounting for Shareholder Claims, the return to creditors of the Pooled Entities would be between approximately 64 cents and 68 cents in the dollar.

6.1.3 Depending on the quantum of Shareholder Claims which are admitted, the estimated return to creditors of the Pooled Entities would likely fall within the following ranges.

Estimated return scenarios to creditors of pooled entities

	High	Low
Shareholder claims	cents/\$	cents/\$
\$0	68	64
\$50 million	62	58
\$100 million	56	53
\$150 million	52	49
\$200 million	48	46

7. Updates to Creditors and Creditors' Committee meetings

7.1.1 The Deed Administrators have kept the creditors of the Pooled Entities and Non-Pooled entities informed periodically on all relevant matters by way of regular updates and by convening regular meetings of the Committees of Creditors. The following table summarises the updates circulated to creditors and the dates on which Creditors' Committee meetings were held.

Updates to Creditors

Updates to Creditors

31 January 2005
28 February 2005
31 March 2005
7 July 2005
15 September 2005
28 November 2005
15 March 2006
5 July 2006
23 October 2006
31 January 2007
15 March 2007
20 September 2007
6 May 2008
20 March 2009
30 June 2009
30 September 2009
31 December 2009
30 April 2010
30 July 2010
24 September 2010
14 October 2010

Committee of Creditors meetings

30 June 2005
19 August 2005
28 October 2005
22 December 2005
15 February 2006
22 March 2006
5 September 2006
14 March 2007
15 August 2007
5 December 2007
28 May 2008
7 November 2008
21 September 2009
13 April 2010
18 October 2010

Copies of previous updates to creditors can be found on McGrathNicol's website
www.mcgrathnicol.com.

8. Purpose of Report

- 8.1.1 As noted above in section 5, the Deed Administrators have received a large number of proofs of debt from ION's current and former shareholders, containing numerous allegations of misconduct by ION. The number and variety of allegations have required the Deed Administrators to undertake extensive forensic investigations in order to obtain the information necessary to make determinations about the factual matters raised by shareholders in their proofs of debt.
- 8.1.2 In the course of reviewing the shareholder proofs of debt it became apparent to the Deed Administrators that many shareholders appeared to have based their allegations on statements contained in the Section 439A Report. Given the timing and nature of the Section 439A Report, and as noted below in section 11, the information in that report was inconclusive and based on incomplete investigations.

- 8.1.3 Having completed their detailed investigations, the Deed Administrators can now report on the results of those investigations. This Report will assist current and former shareholders of ION to consider (based on the information now available) whether they have a basis for a claim against ION and, if they have not already done so, to lodge a proof of debt. For those who have already lodged proofs, this Report will assist those shareholders to refine their claims and, if considered appropriate by them, to lodge amended proofs of debt. In light of the new information in this Report, and to facilitate an efficient adjudication process, the Deed Administrators suggest that existing shareholder claimants wishing to re-submit their proofs of debt do so using the new Shareholder Claim Form referred to in section 9 below.

9. The Way Forward

9.1 Court Application

- 9.1.1 On 30 July 2010, the Deed Administrators applied to the Federal Court for orders relating to:
- (a) the circulation of this Report to creditors and prospective creditors of ION (including shareholders); and
 - (b) the notification of prospective creditors of their potential right to lodge new or revised proofs of debt under the DOCAs.
- 9.1.2 The application was served on the Australian Securities and Investments Commission and on Slater & Gordon, as legal representatives of a large number of current and former shareholders of ION who have lodged proofs of debt under the DOCAs. Notice of the application was also given via publication of the Originating Process on the McGrathNicol and ION websites.
- 9.1.3 The Deed Administrators' application was heard on 17 August and 14 October 2010 and the Court made orders on 14 October 2010 to the following effect:
- (a) The Deed Administrators send to each of the following persons a notice advising them how they may lodge or amend a proof of debt under the DOCAs and how they may obtain a copy of this Report, namely:
 - (i) all those shareholders who have already lodged proofs of debt under the DOCAs; and
 - (ii) all those persons who purchased ION shares on or after 10 September 2004.

For those shareholders who have already lodged proofs of debt and are represented by Slater & Gordon or DC Legal (formerly Dennis & Co), the Deed Administrators are to send their notices to the shareholder's legal representative.
 - (b) The Deed Administrators publish a further Notice Inviting Formal Proofs of Debt or Claim in a national newspaper for three consecutive days.
 - (c) The Deed Administrators allow creditors and prospective creditors a period of 45 days after the publication of the last of the notices in (b) (effectively until

13 December 2010) to consider the contents of this Report and lodge new or varied proofs of debt.

9.2 Shareholders who have not yet lodged a proof of debt

9.2.1 Shareholders who have not already lodged a proof of debt and wish to do so must complete a Form 535 Proof of Debt Form and a Shareholder Claim Form and lodge those documents with the Deed Administrators by **13 December 2010**. Details of the procedures for completing and lodging a proof of debt can be found at www.ionlimited.com.au or by contacting the Deed Administrators' office on (03) 9038 3133. As noted in the on-line procedures, and as explained further in section 15.10 below, all shareholders wishing to make a claim against ION must submit evidence of causation establishing how ION's conduct is said to have caused the shareholder's loss. In respect of claims concerning shares purchased on or after 10 September 2004, shareholders may elect not to submit any evidence of causation in respect of those shares and accept admission of their proof at 80% of the loss suffered in respect of those shares (calculated in accordance with the applicable legal principles). Further details concerning this election are set out in section 15.10 below and in the on-line procedures.

9.2.2 The required Form 535 and Shareholder Claim Form must be received by the Deed Administrators by **13 December 2010**.

9.3 Shareholders who have already lodged a proof of debt

9.3.1 Shareholders who have already lodged a proof of debt may wish to amend their existing proof of debt in light of the new information contained in this Report and the election which is now available in relation to claims concerning shares purchased after 10 September 2004. Once again, details of the procedures for completing and lodging an amended proof of debt can be found at www.ionlimited.com.au or by contacting the Deed Administrators' office on (03) 9038 3133. Any amended proof of debt must be received by the Deed Administrators by **13 December 2010**.

9.4 Adjudication of Shareholder Proofs

9.4.1 Shareholder proofs of debt received by the Deed Administrators by 13 December 2010 will then need to be considered and adjudicated by the Deed Administrators.

9.4.2 In determining whether to admit or reject a proof of debt (either in whole or in part), the Deed Administrators have a duty to act in a quasi-judicial capacity. This is reflective of their duty to distribute the assets of the Pooled Entities only among those persons truly entitled. Adjudication of shareholder proofs of debt will require assessment of the facts and legal issues which are specific to each individual proof.

9.4.3 Those claims lodged which relate to shares purchased on or after 10 September 2004, where shareholders have elected to accept admission at 80% of their value, should be able to be dealt with relatively quickly, since the only major issue left for consideration by the Deed Administrators will be the proper calculation of the loss claimed.

9.4.4 Claims relating to shares purchased prior to 10 September 2004 will require consideration not only of the loss suffered (if any), but also whether the shareholder has established a relevant breach by ION and a causal link between that breach and the shareholder's loss.

Once proofs of debt have been received, the Deed Administrators will be in a better position to assess the likely timing and process for dealing with these claims.

- 9.4.5 Once the full extent of Shareholder Claims can be quantified, the Deed Administrators will give consideration to whether an interim distribution under the DOCAs is appropriate.

PART B – OVERVIEW OF RESULTS OF INVESTIGATIONS

10. Overview of ION Group

10.1 Background

- 10.1.1 ION is a public company listed on the ASX. It is the ultimate parent of 22 Australian registered companies and 7 foreign companies (collectively **ION Group**) (see section 10.4 for details of all companies in the ION Group).

10.2 Officers and management personnel

- 10.2.1 The officers of ION Limited during the 12 month period prior to the Administrators' appointment on 7 December 2004 were as listed below.

Officers of ION Limited

Name	Position	Appointed	Resigned
Gavin Paul Smith	Secretary	23/07/2004	Current at date of appointment
	CFO	25/09/2003	Current at date of appointment
Thomas Klinger	Director	9/09/1999	Current at date of appointment
George John Pizzey	Director	7/10/1999	Current at date of appointment
Roger Baden Flynn	CEO, Director	16/08/2004	Current at date of appointment
Malcolm McComas	Director	11/10/1999	Current at date of appointment
Ian Robertson Cootes	Director	15/05/2001	20/10/2004
Graeme Lester Salthouse	Managing Director	16/09/1999	21/09/2004
	Consultant	22/09/2004	Current at date of appointment
Gregory Francis John Kneebone	Secretary	29/08/2003	23/07/2004

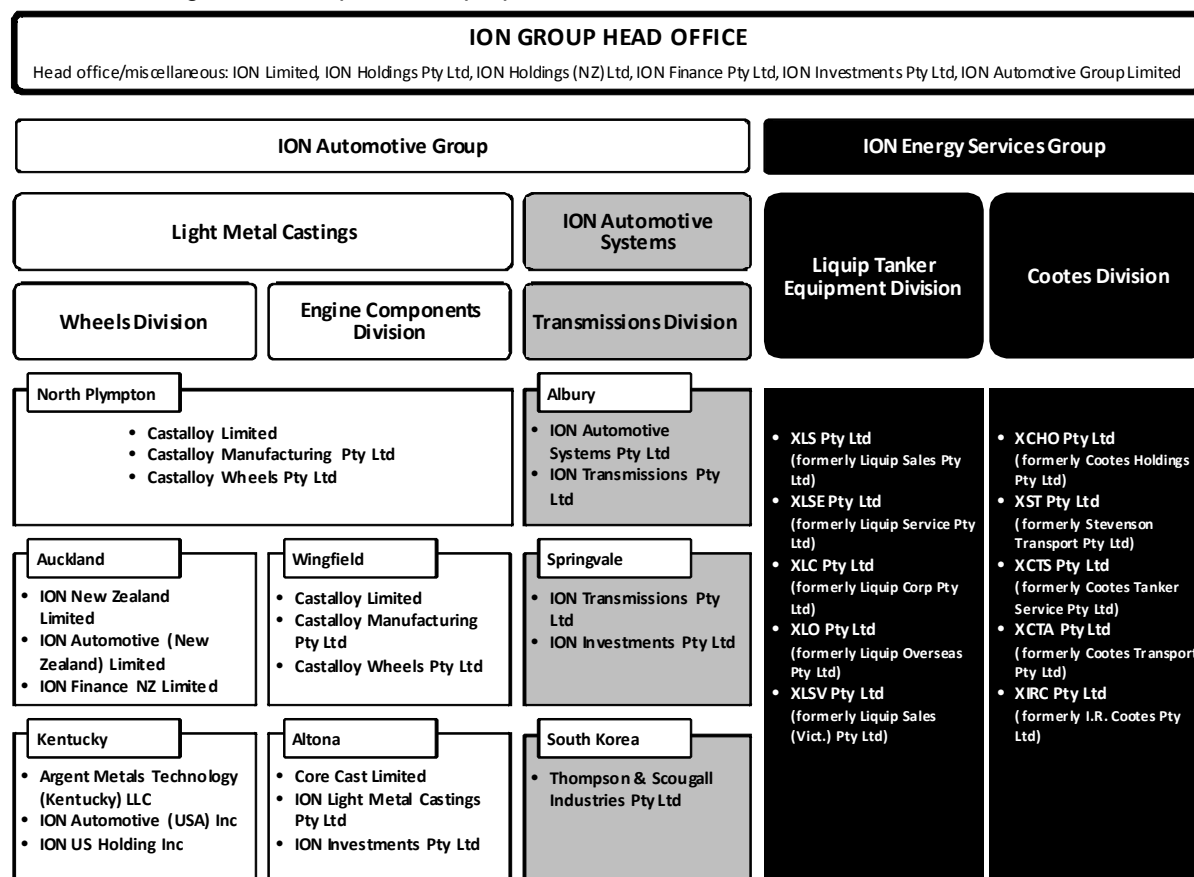
- 10.2.2 The key management personnel of ION's subsidiaries during the 12 month period prior to the Administrators' appointment on 7 December 2004 are listed below.

Key management personnel of ION Limited's subsidiaries

Name	Position	Appointed	Resigned
Leon Rex Andrewartha	CEO - ION Automotive Group	5/11/2004	Current at date of appointment
Barry John Clark	CEO - ION Automotive Group	1/01/2003	1/11/2004
Michael James Turner	General Manager - ION Automotive Systems	1/06/2003	Current at date of appointment
Kees Haverkamp	General Manager - Light Metal Castings	19/06/2003	1/07/2004
Veniero Stenta	General Manager - ION Energy Services	20/04/2004	Current at date of appointment
Neil Campbell	General Manager - LMC - NZ, Wheels & Suspensions Division	1/02/2004	Current at date of appointment
Paul Bibby	General Manager - LMC - Engine Components	3/05/2004	Current at date of appointment
John Carroll	Plant Manager - North Plympton	1/08/2003	Current at date of appointment
Michael Morrissey	Plant Manager - Wingfield	21/06/2004	Current at date of appointment
John Mlinarevic	Project Manager - Altona	1/03/2004	Current at date of appointment

10.3 Operational structure

10.3.1 At the time of the Administrators' appointment on 7 December 2004, the ION Group was organised for operational purposes as follows:



ION Group head office

- 10.3.2 The head office provided centralised executive and financial management, including corporate governance, secretarial, legal, financial reporting, taxation and treasury services.

ION Energy Services Group

- 10.3.3 ION Energy Services (ie, IES) conducted operations in fuel distribution, refuelling services and fuel equipment manufacture. The distribution operations traded in all of the mainland States of Australia, with the head office of Cootes located in Dandenong, Victoria. The manufacturing facilities of Liquip were located at Smithfield, New South Wales and Sunshine, Victoria.

ION Automotive Group

- 10.3.4 The ION Automotive Group (**IAG**) comprised two automotive component manufacturing operations: ION Automotive Systems (ie, IAS) and Light Metal Castings.

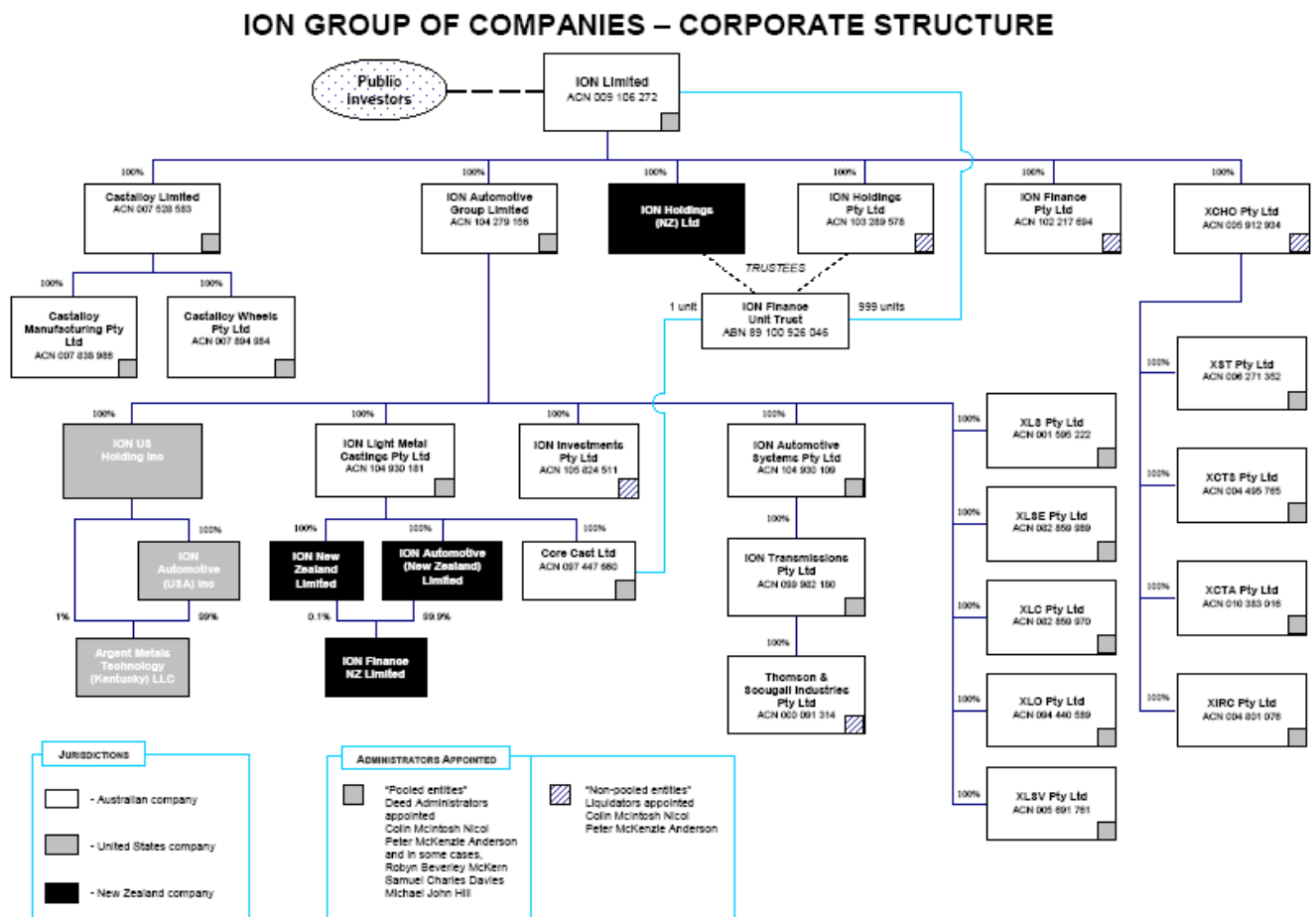
- (a) IAS (also referred to as 'ION Automotive Driveline Systems' and 'Driveline Systems') had a single operating division, the **Transmissions Division**. The Transmissions Division comprised:
- Albury – a factory in NSW which manufactured transmissions and associated products;
 - a related research and development facility in Springvale, Victoria, and
 - a warranty centre in South Korea.
- (b) Light Metal Castings had two operating divisions, that is:
- (i) the **Wheels Division** (also referred to as 'ION Alloy Wheels and Suspension Components'), which comprised:
- North Plympton - a casting foundry in South Australia which manufactured alloy wheels, swing arms and hubs for Harley-Davidson (and a second factory performing chroming at Kilkenny, South Australia). North Plympton's operations also straddled the Engine Components Division (see below);
 - Auckland - a factory located in Auckland, New Zealand which produced alloy wheels for US and Australian markets; and
 - Kentucky - a factory under construction at the time of the Administrators' appointment at Warsaw, Kentucky, US intended to produce large diameter alloy wheels for SUV markets in North America; and
- (ii) the **Engine Components Division** (also referred to as 'Hollow Castings'), which comprised:
- North Plympton - a casting foundry in South Australia, which (in addition to its operations as part of the Wheels Division discussed

above) manufactured oil pans and cylinders heads for Holden, Peugeot and Proton;

- Wingfield - a factory in South Australia, constructed in 2003 to manufacture automotive castings such as cylinder heads and inlet manifolds; and
- Altona - a factory site in Altona, Victoria which was under construction at the time of the Administrators' appointment, at which cast alloy engine blocks were to be manufactured.

10.4 Corporate structure

10.4.1 The chart below provides an outline of the ION Group's corporate structure. The Pooled Entities and Non-Pooled Entities are identified, together with details of the Deed Administrators and Liquidators appointed to those entities.



11. Overview of Forensic Investigations Process

11.1 Investigations for Section 439A Report

11.1.1 In the course of preparing the Section 439A Report, the Administrators retained KPMG Forensic to conduct an investigation into certain matters so that the Administrators were in

a position to report to creditors on those matters before the Second Meetings. The focus of these investigations was to ascertain:

- (a) whether there were causes of action that would only be available to a liquidator, and therefore would be relevant to the decision of creditors at the Second Meetings as to whether to vote in favour of a deed of company arrangement or liquidation; and
- (b) the chain of events leading to the Administrators' appointment.

11.1.2 In the Section 439A Report, the limitations on those investigations were stated as follows:

- (a) the investigations, although extensive, were incomplete;
- (b) the directors had not provided their views as to the events or the context of the events; and
- (c) no conclusion had been reached as to whether the findings provided evidence or sufficient evidence of wrongdoing or breach of duty by any party.

11.1.3 As such, these investigations, being preliminary in nature and having a different focus, were insufficient to enable the Deed Administrators to deal with the myriad of Shareholder Claims the subject of in excess of 3,000 shareholder proofs of debt received to date.

11.2 General nature of the Shareholder Claims

11.2.1 In general terms the Shareholder Claims contain allegations of:

- (a) misleading or deceptive conduct by ION contrary to the *Trade Practices Act* (Cth) 1974 (the **TP Act**) and the *Australian Securities and Investments Commission Act* (Cth) 2001 (the **ASIC Act**) in making certain representations to the market (**Misleading or Deceptive Conduct**); and
- (b) failure to disclose certain matters by ION to the market in accordance with its obligations as a publicly listed company under the Act (**Failure to Disclose**).

(The Misleading or Deceptive Conduct and the Failure to Disclose will together be referred to as the **Alleged Contravening Conduct**).

11.2.2 In more specific terms the Misleading or Deceptive Conduct alleged by the shareholders is conduct contrary to section 52 of the TP Act and section 12DA of the ASIC Act. The allegations of Failure to Disclose are allegations that ION has contravened section 674 of the Corporations Act.

11.2.3 Based on the Shareholder Claims lodged to date, it can be said that the vast majority of Alleged Contravening Conduct involves conduct of ION which took place between October 2003 and 7 December 2004 (when ION entered into voluntary administration).

11.2.4 The great majority of shareholders who have lodged Shareholder Claims allege that they took certain action (ie, they acquired shares or held shares) based on the Alleged Contravening Conduct of ION and, as a result, they suffered loss and damage. In most cases the loss which is claimed is the full purchase price of the shares held by the shareholder at 7 December 2004. A large proportion of the Shareholder Claims relate to more than one share purchase or more than one decision to retain ION shares.

11.3 Factual and legal analysis required

11.3.1 In order to be admitted to proof and to share in the Fund, shareholders must (like any other creditor) establish the relevant factual and legal basis of their claims. The Deed Administrators must, of course, satisfy themselves of that basis before admitting any proof in whole or in part. In general terms, the process of determining the Shareholder Claims involves the Deed Administrators making determinations about:

- (a) factual questions raised in each proof of debt as to whether various events occurred as alleged; and
- (b) legal questions raised by each proof of debt as to whether, if the facts can be established, there is a legal cause of action which can be made out in respect of that set of facts by the individual shareholder, having regard to his or her personal circumstances.

11.3.2 As a logistical matter, the large volume of Shareholder Claims, and the myriad of allegations raised by them, have required the Deed Administrators to:

- (a) identify all of the factual issues raised by the proofs of debt and the extent to which there are any common factual issues that can be grouped for the purposes of analysis; and
- (b) prioritise the focus of any investigation around key factual matters raised by large numbers of shareholders or which involve Shareholder Claims of significant value.

11.3.3 Given that there are to date approximately 3,300 Shareholder Claims containing a myriad of allegations, and many of the claims are made by unrepresented claimants, this process of analysis has taken some time to complete.

11.4 Forensic investigation steps undertaken

11.4.1 In order to investigate the factual matters relevant to the Shareholder Claims, the following steps were required to be undertaken by the Deed Administrators:

- (a) collate the myriad of shareholder allegations into general topics for investigation;
- (b) identify and collate among the multitude of ION documents relevant documents for consideration in relation to those allegations;
- (c) obtain relevant documents from former officers and directors and third parties through compulsory Court processes;
- (d) identify the facts which need to be established to adjudicate upon the shareholder allegations;
- (e) identify relevant witnesses among former employees and officers of ION and third parties who might be able to give evidence to substantiate relevant facts;
- (f) prepare witness packs for each of those witnesses in anticipation of taking their evidence;
- (g) conduct interviews or, as appropriate, public examinations of all of those witnesses to elicit evidence to enable the Deed Administrators to establish relevant facts;

- (h) ensure that the evidence collated is in an appropriate form to enable the Deed Administrators to rely on it reasonably for the purposes of their adjudication of the shareholder proofs;
- (i) make relevant findings of fact in connection with the allegations raised in the Shareholder Claims; and
- (j) conduct analyses on the findings of fact and how they accord with ION's market disclosures.

11.5 Outcome of investigations

- 11.5.1 Having completed the forensic investigation process, the Deed Administrators now have a detailed understanding of the events relevant to the Shareholder Claims – events that predominantly occurred in the period October 2003 to December 2004. An overview of the key events in that period is set out in section 12 below. In addition, the Deed Administrators are in a position to make findings of fact in respect of a large number of issues relevant to the determination of Shareholder Claims. These findings are set out by subject matter in sections 17 to 25 below.
- 11.5.2 In section 15, the Deed Administrators have identified those matters which in their view may form the basis of Misleading or Deceptive Conduct or Failure to Disclose claims against ION. The Deed Administrators have also considered how the chronology of events leading to ION's administration in December 2004 may have altered if ION had made appropriate and timely disclosures of information affecting its forecasts and outlook to the market and its financiers. The Deed Administrators analysis in this regard is set out in section 14. The matters in section 14 are particularly relevant to those persons who purchased shares on or after 10 September 2004.

12. Factual Overview

12.1 Introduction

- 12.1.1 In this section we set out an overview of the facts surrounding the key areas of investigation undertaken by the Deed Administrators.
- 12.1.2 In sections 12.2 and 12.3 we focus on ION's growth strategy and the events which occurred in relation to the funding of that growth strategy in the period October 2003 to November 2004, including ION's raising of debt and equity, the preparation and revision of its financial forecasts and ION's disclosures to the market regarding those matters.
- 12.1.3 In section 12.4 we set out a summary of the key issues affecting ION's various business areas in the lead up to the appointment of Administrators in December 2004. Each business area is dealt with in further detail in Part C of this Report. Section 12.5 contains a summary of the Deed Administrators' findings in relation to the adequacy of ION's financial controls, further details of which are provided in section 17.

12.2 ION's growth strategy

- 12.2.1 ION evolved via a series of acquisitions in the automotive parts and fuel distribution sectors commencing with the acquisition in 1999 of Castalloy (see section 17.2 for further details). The company became known as ION on 22 January 2001.
- 12.2.2 By October 2003, ION's automotive products business had operations at North Plympton, Albury and Auckland and a greenfield project at Wingfield, South Australia (the **Wingfield Project**) (which had been approved in May 2002) was nearing completion, with commissioning expected to commence shortly afterwards. Two other major capital projects, Altona and Kentucky (US), had also been approved by this time (in May 2002 and October 2003, respectively) and were in the early stages of their development (respectively, **Altona Project** and **Kentucky Project**). The IES operations continued to grow following the acquisition of the Cootes business in 2000 with the purchase of Stevenson's Transport in June 2003 and the subsequent acquisition of Liquip in December 2003.
- 12.2.3 By this time, ION's future growth strategy had taken shape and, although aspects of it continued to be refined, it essentially involved:
- (a) expansion through the development of greenfield sites (Wingfield and Altona) and the re-commissioning of the Kentucky wheel plant;
 - (b) growth via the expected increase in demand for existing products (with plant capacity increases as required) from existing customers and, importantly, from emerging markets such as China; and
 - (c) the development of new ancillary product lines (for example differentials and transfer cases) and next generation products (such as 5/6-speed transmissions) for sale to new and existing customers.

12.3 Forecasts and funding of the growth strategy

- 12.3.1 On 20 October 2003, ION made a presentation to the UBS Emerging Companies Conference (**UBS Conference**) using PowerPoint slides (**UBS Presentation**). The UBS Presentation was also published on the ASX website. Amongst other things, the UBS Presentation contained information about the funding of ION's capital projects.
- 12.3.2 At this time, ION planned to fund its growth strategy from three main sources of funds:
- (a) first, the existing group debt facilities of approximately \$225 million (which at this stage were not yet fully drawn);
 - (b) secondly, the operating cashflows ION expected to continue to generate from its existing businesses; and
 - (c) thirdly, project specific debt funding for all major capital projects.
- ION's aim was to maintain a gearing ratio of approximately 50%.
- 12.3.3 The project specific debt funding proposed (and which was ultimately used in relation to the Altona Project) involved a structure whereby advances made during the construction phase of a project were classified in the balance sheet as trade payables instead of interest bearing debt. Essentially, the trade payables properly represented liabilities owed

- by ION (or the relevant ION subsidiary) to the financier in respect of plant and equipment to be acquired by ION on completion of the project. When the plant was commissioned, ION would drawdown the funds required to meet the trade payables. Then the liability arising from the drawdown was classified as interest bearing debt in the balance sheet and taken into account in calculating ION's gearing ratio.
- 12.3.4 This treatment meant that the recognition of the liability as interest bearing term debt was effectively delayed until the procurement and construction phase of a project was completed. It was not, however, an off balance sheet arrangement.
- 12.3.5 ION disclosed its planned approach to project specific debt funding in the UBS Presentation, noting that it would consider further equity raising as plants came on stream, so as to maintain its desired 50% debt to equity ratio.
- 12.3.6 The UBS Presentation also contained information about ION's predicted earnings for FY 2004 and its indicative year end net debt position. It also provided indicative guidance as to revenue increases through to FY 2007. Further details of the contents of the UBS Presentation are set out in section 25 below.
- 12.3.7 It appears that the revenue forecasts included in the UBS Presentation were based on the then current forecasts for FY 2004 to FY 2007, details of which were presented to ION's Board on 27 October 2003 (see section 25 below) (**October 2003 Board Papers Forecast**).
- 12.3.8 On 28 October 2003, ION held its AGM. At the AGM, the managing director repeated the indicative revenue growth figures included in the UBS Presentation and made comment about the prospect of a capital raising in 2005. Consistent with ION's plan for funding its growth strategy, the chairman noted in his address at the AGM that ION:
- has strong cashflow and has arranged financing to meet its planned expansion which will be financed from existing resources and new specific capital project funding term finance from the Commonwealth Bank. Healthy balance sheet ratios and interest multiples will be maintained.
- 12.3.9 On 23 December 2003, documentation relating to the project specific funding arrangements for the construction of an engine block plant at Altona was executed (**Altona Project Funding**).
- 12.3.10 From about February 2004 ION's approach to funding its growth strategy moved away from using project specific debt funding with delayed debt recognition to one where the existing group debt facilities of \$225 million (maturing in FY 2006) would be refinanced and increased to the level required to fund the growth strategy (**Refinance**).
- 12.3.11 To facilitate the raising of this debt, while maintaining the target 50:50 gearing ratio at the peak debt position in FY 2006, it was recognised that an equity raising was required. Without that equity, ION's gearing ratio at its forecast peak debt position in FY 2006 would exceed 50%.
- 12.3.12 It was also recognised at this time that existing facilities were likely to be insufficient to meet ION's cashflow requirements to 30 June 2004 so the equity raising would also ensure sufficient funding was in place pending finalisation of the Refinance. Further details concerning the net debt projections for FY 2004 are provided in section 25.5 below.

- 12.3.13 At this time, a financial model was developed under the supervision of ION's chief financial officer (**CFO**) (**Placement Model**). The Placement Model was a high level forecasting document which was designed to show the quantum of equity and debt required through to FY 2006 to enable ION to fund its growth strategy. Work on the Placement Model was completed in mid February 2004. The Placement Model demonstrated that ION required additional funding of approximately \$190 million to complete its expansion process (split \$115 million debt/\$75 million equity to maintain target gearing ratio of 50:50). Importantly, the Placement Model also assumed that approximately \$90 million would be paid by way of dividends to shareholders over the three year period to the end of FY 2006.
- 12.3.14 Ultimately, ION raised \$63 million of additional equity - \$55 million from an institutional placement which was concluded by 23 February 2004 (**February Placement**) and \$8 million from a subsequent share purchase plan.
- 12.3.15 The equity raising ensured that ION had sufficient funding in place for the remainder of FY 2004 and paved the way for the Refinance process which was, at this stage, expected to be concluded by June 2004.
- 12.3.16 On 19 February 2004, ION published its results for the half year ended 31 December 2003 together with an ASX announcement (**February Announcement**). At this time, ION also published on the ASX website a PowerPoint presentation concerning its half year results (**February Presentation**). The February Announcement confirmed the FY 2004 earnings guidance given at the 2003 AGM and stated that ION had gone into a trading halt pending an announcement of a capital raising. The February Presentation contained updated information concerning the forecast net debt position for FY 2004 and revenue estimates through to FY 2007 (further details of which are set out in section 25 below).
- 12.3.17 During the course of the institutional placement in February 2004, some institutional investors made it known to members of ION's Board that they had lost confidence in Salthouse as ION's managing director. The Board also had concerns at this time about whether Salthouse was the right person to lead ION through its growth strategy. At a meeting on 15 March 2004, members of ION's Board communicated those concerns to Salthouse and indicated that the Board considered Salthouse's position as managing director was untenable.
- 12.3.18 During April 2004 (following Pizzey's appointment as executive chairman), ION undertook an intensive process of reviewing and verifying its financial forecasts for the three years ending 30 June 2006. The information was to be used as a base for a market update to be released as soon as possible during April and for the purpose of the upcoming Refinance process pursuant to which ION would seek to raise additional debt of approximately \$100 million. This verification process ultimately led to the production of a revised financial model (**April Model**).
- 12.3.19 The April Model demonstrated that, subject to raising the required debt finance, ION was able to fund its growth strategy.
- 12.3.20 On 27 April 2004, ION published an Earnings and Investment Guidance (**April Guidance**). The April Guidance provided updated profitability information for FY 2004 and included guidance on the forecast earnings per share (**EPS**) for FY 2005 and FY 2006. Further details concerning the contents of the April Guidance are set out in section 25 below. This

information was based on the figures in the April Model, although as noted in section 25 below, the figures in the April Guidance were more conservative than those in the April Model itself. For example EPS for FY 2005 were forecast in the April Model to be 27 cents whereas the April Guidance stated EPS for that year would be 'not less than 24 cents'.

12.3.21 At a meeting of ION's Board held on 14 April 2004, the Board resolved to appoint corporate finance advisers, Grant Samuel, to assist ION with the Refinance.

12.3.22 Prior to the Refinance, ION's debt facilities were as follows:

ION debt facilities				
Bank	Bill Facilities	Multi Option Facilities	Altona Project Funding	Total
CBA	20		90	110
NAB	80	10		90
Westpac	70	45		115
Total	170	55	90	315

12.3.23 The first step in the Refinance process was for ION to prepare a detailed information memorandum which would be provided to the financiers considering the advance of funds to ION. The information memorandum, which was ultimately issued to prospective lenders on 28 May 2004 (**May IM**), was prepared with the assistance of Grant Samuel. The financial forecasts set out in the May IM were produced using a model which was developed based on the information contained in the April Model and additional input data for FY 2007 and FY 2008. Using the model, ION (assisted by Grant Samuel) conducted sensitivity analyses of the financial impact of various hypothetical scenarios. Several of those sensitivity analyses were also included in the May IM. The Refinance was to have been concluded by 30 June 2004, noting ION's forecasts showed sufficient liquidity to this point.

12.3.24 At or about this time, developments were occurring in relation to the potential sale of some or all of ION's assets. Following approaches by a number of parties showing interest in the acquisition of ION assets, ION commenced preparation of an information memorandum to be provided to interested parties. This process was led by Graeme Salthouse. His son, Matthew Salthouse, who was Corporate Development Manager, was responsible for co-ordinating the preparation of the information memorandum. ION's Board was informed at its meeting on 21 July 2004 that the information memorandum was expected to be available for release by 26 July 2004.

12.3.25 The information memorandum dated 26 July 2004 (**Sale IM**) set out information about ION's various businesses and forecast financial information through to FY 2008. This forecast information was based on the May IM.

12.3.26 By the 21 July 2004 meeting of ION's Board, ION was still awaiting receipt of bank offers in respect of the Refinance. The Board re-emphasised at this meeting the importance of achieving committed offers before the announcement of ION's annual results on 24 August 2004. It also became apparent at this meeting and in the days following it, that the forecasts provided to prospective lenders in the May IM would need to be revised to take account of:

- (a) the write-off of capital expenditure and commissioning cost over runs incurred in connection with the Wingfield Project; and
 - (b) forecast EBITDA reductions for Wingfield and Plympton.
- 12.3.27 As part of the end of financial year reporting work done by ION, the Wingfield Project model was reviewed. The CFO presented the updated information regarding Wingfield to the Board at its meeting on 21 July 2004. The review revealed that a write-off in the carrying value of the Wingfield Project of \$36.1 million was required (see section 20.3 for further details concerning the Wingfield write-off).
- 12.3.28 By late July 2004 it was also recognised that the EBITDA forecasts for the Wingfield and North Plympton businesses required downward revision (see sections 20.4 and 21.2 below).
- 12.3.29 The EBITDA reductions relating to Wingfield and North Plympton amounted to \$63 million over the 4 years from FY 2005 to FY 2008, with a \$31 million reduction expected by FY 2006.
- 12.3.30 It was clear to the CFO and to Grant Samuel that the financial impact of these developments concerning Wingfield and North Plympton would require the figures in the May IM to be revised and the credit effect of those changes to be managed in a way which was acceptable to prospective lenders. At the time, Grant Samuel noted that the decrease in EBITDA made the revised base case worse than any downside sensitivity they had run as part of the May IM (other than new projects not proceeding). As noted in a memorandum from Grant Samuel to the CFO dated 29 July 2004:

Overall this is feeling quite a different deal to that presented to the Banks in the IM and as per the April statement and further adds to the credibility issues.
- 12.3.31 In a further memorandum to the CFO dated 30 July 2004, Grant Samuel noted:

The credit effect of these changes is quite substantial in that where previously we had orientated the credit around a spike in leverage to fund development that was quickly caught up to by growth in earnings we now have a larger spike in leverage potentially and a slower catch up in earnings.
- 12.3.32 Grant Samuel was also concerned that the change in the figures would create a credibility issue with prospective lenders. As noted in the memorandum of 30 July 2004:

Given the recent Board endorsed nature of the earning statement and forecasts in April and the IM in late May based largely on these forecasts ION has created a credibility issue (ie how could it be so wrong so quickly).
- 12.3.33 At a meeting with prospective lenders on 2 August 2004, ION gave a PowerPoint presentation titled 'Update Presentation to Financiers August 2004'. The presentation focused on various ION business units including IAS, IES and Light Metal Castings (excluding South Australia) in respect of which it was noted that there was 'No change in IM'. In respect of Wingfield and North Plympton, the presentation notes that the base case forecast in the May IM was no longer current. At this meeting ION indicated to prospective lenders that it was in the process of finalising the revised figures for these two businesses and examining the measures which could be implemented to restore the credit position to that reflected in the May IM.

- 12.3.34 Following the meeting with prospective lenders on 2 August 2004, ION continued with the preparation of the revised forecasts which were ultimately provided to prospective lenders on 5 August (**August Update**).
- 12.3.35 The August Update included revised forecasts reflecting the deterioration in the position of Wingfield and North Plympton but confirmed that the remainder of the business was tracking in line with the May IM forecasts. As outlined in section 25 below, the IAS business was not in fact performing in line with the May IM forecasts and also required downward revision. It appears that some attempt was made by the CFO to verify the forecast for IAS before the August Update was provided to prospective lenders. In an email dated 4 August 2004, IAG management confirmed that the FY 2005 EBIT figure IAS was 'going for' was \$49 million (which was the figure in the May IM).
- 12.3.36 The August Update stated that ION recognised that the revised forecasts affected the original proposed financing terms (as set out in the May IM) and that it intended to be proactive in addressing the possible concerns of prospective lenders. To that end, ION's new proposal included the following.
- (a) ION would reduce the amount of debt sought by \$30 million so as to ensure that the central measure of leverage being used (Net Debt/EBITDA) would remain at similar levels to the previous base case. This was to be facilitated by a reduction in forecast dividend payments by approximately \$45 million. It was envisaged that this would be achieved by the use of a fully underwritten dividend reinvestment plan (**DRP**).
 - (b) An independent engineer would be appointed to review the capital projects then underway and those which were under consideration. It was also proposed that confirmation would be provided by the independent engineer within 90 days that the expected cost to complete current projects was in line with the estimates provided by ION, with drawdowns limited to \$270 million⁴ pending that confirmation.
 - (c) The introduction of lender-based controls in the finance documentation to provide greater comfort and control in relation to the level of capital funding required to complete capital projects, aimed at mitigating the risk of cost overruns.
- 12.3.37 On 16 August 2004, Roger Flynn commenced as ION's managing director and chief executive officer (**CEO**).
- 12.3.38 By 20 August 2004, ION had received committed offers for \$440 million of debt (including the Altona Project Funding) from five banks – NAB, CBA and Westpac (who were existing lenders to ION) and Mizuho and BNP Paribas (collectively, **Banks**). This represented an increase in the existing bank facilities of approximately \$125 million, the biggest proportion of which was to be advanced by Mizuho and BNP Paribas, who between them agreed to provide facilities totalling \$90 million. ION accepted these offers and formal documentation was prepared over the course of the next month.

⁴ This was later increased to \$285 million in the final documentation (see paragraph 12.3.49 below).

- 12.3.39 During August 2004, ION appointed Ian Williams (**Williams**) as the independent engineer to review its existing and proposed capital projects, including to verify the estimated capital cost of those projects.
- 12.3.40 Meanwhile, the process in relation to the potential sale of ION businesses (commencing with the Sale IM) was continuing. By the time ION's Board meet for its 23 August 2004 meeting, ION had received various proposals in response to the Sale IM, including several proposals for the purchase of its IES business and a separate offer for the acquisition of the IAS business.
- 12.3.41 At the meeting of ION's Board held on 23 August 2004, the new managing director, Flynn, tabled his first report. The report referred to the July trading results which were measured against what was referred to as a working 'budget' which he believed was based on the April 2004 projections (meaning the April Model). Flynn's report also noted that those 'budgets' would be reviewed by management in one week and then brought to the Board.
- 12.3.42 On 24 August 2004, ION issued an announcement to the market in connection with its results for the financial year ended 30 June 2004 (**August Announcement**).
- 12.3.43 The August Announcement also noted the following in relation to ION's capital structure:
- ION has strengthened its capital structure with additional equity and increased borrowing capacity for the completion of planned Greenfield projects. The additional equity will enable ION to not materially exceed its 50% gearing target during the expansion phase.
- Equity:** During the second half of the year, an institutional placement and share purchase plan raised approximately \$64 million of new equity.
- Debt:** ION has recently received credit approved committed offers from a variety of domestic and offshore banks, totalling \$440 million. This facility will allow the funding of the capital program over the next 2 years and provide for tranches of funding over the next 3 to 5 years. The recapitalisation has allowed gearing levels and interest cover to remain at workable levels during the year while also providing a foundation for a controlled increase in debt as the expansion program peaks over the next two years.
- 12.3.44 As at 6 September 2004, the Refinance documentation was still being finalised. In the meantime, ION had exhausted its existing facilities of \$225 million and was required to arrange a temporary \$10 million increase in its existing overdraft facility with Westpac. It was intended that this amount would be repaid in full from the initial drawdown of the Refinance proceeds.
- 12.3.45 On 16 September 2004, ION executed a Multi-Option Facility Agreement (**MOFA**) which documented the Refinance arrangements put in place with the Banks. ION's Board had approved entry into the MOFA at a meeting held on 14 September 2004.
- 12.3.46 The MOFA provided for facilities totalling \$340 million. This was in addition to the Altona Project Funding which had been increased from \$90 million to \$100 million. The MOFA facilities were made up of various tranches. Tranches A, C and D, totalling \$210 million, were for a three year term and tranche B, totalling \$130 million, was for a five year term. The facilities made available to ION under the MOFA were unsecured although all entities in the ION Group were required to guarantee repayment. There were also restrictions in the MOFA relating to ION creating securities over its assets without the Banks' consent.

- 12.3.47 The MOFA also included provisions pursuant to which ION represented to the Banks that, as at 16 September 2004, the May IM and August Update were factually correct as at the time of their preparation and that any financial projections contained in them were based on reasonable assumptions. ION also represented that to the best of its knowledge it had disclosed to the Banks all the information that was material to an assessment by the Banks of the risks they assumed by entering into the MOFA.
- 12.3.48 Each tranche under the MOFA had a stated purpose. Tranche B was identified as the source of funding for what was identified in the MOFA as the '**Expansion Program**'. The Expansion Program was defined as:
- (a) the following capital expenditure projects currently underway:
 - (i) development of the Altona block plant to a capacity of 350,000 units per annum, the estimated total cost of land and building works being \$26 million;
 - (ii) development of the Altona block plant to a capacity of 350,000 units per annum, the estimated total cost of plant and equipment being \$100 million;
 - (iii) recommissioning of the Kentucky wheel plant to a capacity of 1.1 million units per annum at an estimated total cost of \$40 million;
 - (iv) commissioning of differentials production at the Albury plant at an estimated total cost of \$22 million;
 - (v) completion of the Wingfield engine component plant in South Australia at an estimated total cost of \$79 million; and
 - (b) the following capital expenditure projects under consideration but not committed to as at the time of executing the MOFA:
 - (i) increasing the capacity of the Kentucky wheel plant from 1.1 million units per annum to 1.8 million units per annum at an estimated cost of \$26 million;
 - (ii) production of 5/6 speed automatic transmission products at the Albury plant at an estimated cost of \$48 million; and
 - (iii) expanding the product range and capacity of the Albury plant through further production of differentials and new production of transfer cases at an estimated cost of \$53 million.
- 12.3.49 The key terms of the MOFA included the following:
- (a) Financial Covenants – ION was required to ensure that as at each of 30 June and 31 December certain financial covenants were met. These included the following.
 - (i) Liquidity Ratio - EBITDA⁵ to Net Interest not less than 4 times;
 - (ii) Leverage Ratio – Net Debt to EBITDA not greater than 3 times.

⁵ EBITDA was defined to mean pre tax earnings before taking into account borrowing costs, depreciation, amortisation and significant items.

- (b) Dividends – in respect of the next three scheduled dividend payments (including the dividend associated with FY 2004), ION was required to either:
 - (i) not declare any dividend;
 - (ii) maintain a fully underwritten dividend reinvestment plan; or
 - (iii) raise an amount of equity equivalent to the dividend payment
 thereby avoiding any cash leakage via dividend payments to shareholders.
- (c) Independent Engineer's Report – ION was required by mid December 2004 to provide confirmation from its independent engineer that the expected costs to complete those elements of the Expansion Program underway at the time of executing the MOFA were in line with the estimates provided or, if costs exceeded the estimate, to provide a revised estimate. If the revised cost to complete any element exceeded the previous estimate by 10% or more, then ION had to explain how it proposed to finance the increased cost. ION could not draw down on its facilities beyond \$285 million until it had provided the independent engineer's confirmation or revised estimate.
- (d) Drawdowns under tranche B – for drawdowns under tranche B, ION was required to provide a funding notice (signed by a director, the CFO or someone of at least that level of authority). The funding notice had to specify the estimated capital costs to complete the Expansion Program and confirm that ION had sufficient funding available to it after the drawdown to complete all elements of the Expansion Program (**Expansion Program Certification**).
- (e) Sale of Assets – ION and its subsidiaries were not permitted to dispose of any assets⁶ without the Banks' consent.

12.3.50 Following completion of the Refinance, ION's debt facilities were as follows:

ION debt facilities			
Bank	MOFA	Altona Project Funding	Total
CBA	25	100	125
NAB	105		105
Westpac	120		120
BNP	50		50
Mizuho	40		40
Total	340	100	440

12.3.51 On 17 September 2004 the funding notices required under the MOFA were signed by the CFO to facilitate the first drawdown of funds under various tranches of the MOFA. As required under the MOFA, the funding notice for the drawdown under tranche B included the Expansion Program Certification.

⁶ Other than permitted disposals (as defined under the MOFA) which included, for example, assets representing less than 5% of total assets.

- 12.3.52 The first drawdown under the MOFA occurred on 20 September 2004 and was for a total of \$235 million. These funds were used in their entirety to repay existing facilities, including the \$10 million temporary overdraft facility increase granted by Westpac on 6 September 2004.
- 12.3.53 The first meeting of ION's Board following the execution of the MOFA and the initial drawdown of funds was held on 22 September 2004.
- 12.3.54 At this meeting a number of important developments were reported to the Board, including:
- (a) that there was likely to be a further deterioration in ION's outlook for the then current financial year (FY 2005), particularly in relation to the IAG business;
 - (b) that a Status Report prepared by the independent engineer, Williams (**Williams Status Report**), (expressed to be for the week ending 17 September 2004) indicated that the estimated cost at completion of the Altona Project was likely to exceed the current board approved figure by some \$25 million (see paragraphs 19.3.26 to 19.3.28); and
 - (c) the developments concerning the Ford 6-speed business and the note in the September Board papers that ION had been advised that its transmissions business with Ford would cease at the Orion Program (see paragraphs 18.4.37 to 18.4.44).
- 12.3.55 Following the presentation of the revised IAG forecasts to the Board at this meeting, management was asked to do further work to verify the forecasts. The Board considered at its meeting on 22 September whether there was sufficient information available to make comment to the market on any change on ION's outlook. Management was asked by the Board to review the situation and to discuss the matter with the Board at the earliest opportunity. This ultimately led to the ASX announcement made on 24 September 2004 referred to below.
- 12.3.56 The Board also received a report at the 22 September 2004 meeting concerning the sale of business process. At this time there were four bidders short-listed for the sale of IES and one bidder for IAS. At the meeting, the Board indicated its support for pursuing these bids.
- 12.3.57 On 24 September 2004, ION issued a market update (**September Announcement**), in which it stated that it was not possible at that stage to predict forward profitability for the then current financial year (that is FY 2005) but that a review by the Board, the new managing director and senior executives indicated that profit in the December half was likely to be significantly lower than in the previous corresponding period and that profit in the second half was expected to be significantly better than in the first half. The September Announcement also noted in relation to bank funding that:

In mid-September the previously flagged \$440 million financing package with a group of five major banks was completed and final documentation signed. Initial drawdowns of funds against this three and five year facility have commenced in order to fund our continuing expansion program.

- 12.3.58 Similar statements concerning the bank funding were made in ION's 2004 Annual Report which was published on the ASX web-site on 30 September 2004 and sent to those shareholders who elected to receive it in late September 2004.
- 12.3.59 Prior to releasing the September Announcement ION's managing director and CFO met with representatives of the Banks to inform them of the announcement ION proposed to release that day.
- 12.3.60 In view of the uncertainty surrounding ION's outlook, particularly in relation to the then current financial year, ION undertook an urgent review of its FY 2005 forecasts.
- 12.3.61 Following the September Announcement, CBA (as agent for the Banks under the MOFA) wrote to ION on 29 September 2004 requesting further information about its financial outlook, including:
- (a) confirmation that the figures in the August Update were not materially impacted by the recent market announcement regarding weaker earnings;
 - (b) confirmation that, on the then current numbers, ION expected to meet all of its financial covenants for the 31 December 2004 and 30 June 2005 testing periods;
 - (c) information about ION's ability to satisfy the 'sufficiency of funding' undertaking for future tranche B drawdowns; and
 - (d) confirmation of the book values of the assets under consideration for sale.
- 12.3.62 In response, ION provided the Banks with some further information on 8 October and 15 October but did not provide the Banks with a substantive update regarding ION's financial outlook for FY 2005 until 21 October 2004. As mentioned below, prior to this, ION was still completing the work required on its revised forecasts.
- 12.3.63 On 11 October 2004 two funding notices were signed by the CFO to facilitate further drawdowns under the MOFA, including a drawdown under tranche B. The Expansion Program Certification required for the tranche B drawdown was included in the relevant notice.
- 12.3.64 On 12 October 2004, ION paid a half-yearly dividend of 6 cents per share (totalling in excess of \$15 million) as had been declared at the results presentation on 24 August 2004.
- 12.3.65 As mentioned above, the MOFA effectively required that there be no cash leakage by reason of dividend payments so that if ION chose to declare and pay a dividend it needed to have in place at that time a fully underwritten DRP or raise additional equity to cover the dividend payments actually made.
- 12.3.66 At the time the final dividend was paid on 12 October 2004, while ION had reinstated its DRP, that plan was not underwritten. The DRP was taken up in respect of 18.6% of shares, permitting retention of \$2.834 million cash otherwise required to be paid out as dividends.
- 12.3.67 At this stage (contrary to the requirement in the MOFA) no arrangements had yet been made for the equity raising required to meet the DRP shortfall (\$12.402 million). ION requested the Banks to defer consideration of this issue pending a review of the IES divestment process. In a letter to the Banks dated 15 October 2004 ION indicated that its

- preference was not to raise additional equity to meet the DRP shortfall until the outcome of the divestment process was known. ION assured the Banks that the DRP shortfall would be offset by a share placement if a divestment did not occur.
- 12.3.68 By mid October 2004, a memorandum of understanding had been executed with a prospective purchaser of the IAS business. On 13 October 2004, representatives of the prospective purchaser visited ION's head office to meet management and receive information on the revised outlook for the business. A document titled 'Revised Presentation to [Purchaser]' was prepared for the purposes of this meeting. ION's CFO was not involved in the preparation of this document and did not obtain a copy of it until 20 or 21 October 2004.
- 12.3.69 The presentation provided the prospective purchaser with revised figures relating to the expected demand for IAS products through to FY 2008. In each case, reductions in volumes were reported. By late October 2004, the prospective purchaser had withdrawn its bid.
- 12.3.70 By 15 October 2004, ION's management was in a position to provide draft forecast figures for FY 2005 to the Board for consideration at a meeting scheduled for Monday 18 October 2004. By this time the first quarter FY 2005 results were finalised and were able to be taken into account in the revised forecasts. As noted in the managing director's email to the Board attaching the draft forecasts, the forecasts assumed that:
- (a) ION would continue with its current major capital projects as planned, although at above the original capital costs;
 - (b) trading was in accordance with ION's then current, best available intelligence;
 - (c) all currently owned businesses would be held for the balance of the financial year; and
 - (d) there would be further redundancies at Albury.
- 12.3.71 Following the 18 October 2004 Board meeting, further adjustments were made to the forecasts and by 20 October 2004 the CFO's work on the revised forecasts had been completed.
- 12.3.72 On 19 October 2004 four funding notices were signed by the CFO to facilitate drawdowns under various tranches of the MOFA, including one under tranche B. This drawdown was required for the rollover of the 20 September 2004 drawdown. In relation to the tranche B notice, the usual Expansion Program Certification was given.
- 12.3.73 On 20 October 2004 Ian Cootes resigned as a director of ION.
- 12.3.74 On 21 October 2004, ION received Williams' final report titled 'Review of Major Capital Projects' (**Final Williams Report**).
- 12.3.75 While ION had until the middle of December 2004 to provide the independent engineer's report under the terms of the MOFA, it was recognised that drawdowns beyond the \$285 million cap were not permitted until the engineer's report had been provided and ION anticipated that it would need to drawdown beyond the \$285 million limit by early November 2004.

- 12.3.76 The independent engineer concluded that forecast capital expenditure for each of Wingfield, Kentucky and Altona exceeded the estimates contained in the MOFA. The projects exceeded the MOFA estimates by \$7 million, \$8.2 million and \$34 million, respectively. This represented an overall increase of 16% in the estimated costs of all projects currently under way as shown in the MOFA. Individual increases for Wingfield, Kentucky and Altona were 6.8%, 14.8% and 27% respectively. The estimates in the Final Williams Report incorporated contingency allowances which Williams put forward for the Board's consideration. For example, in relation to Altona, the report noted: 'In summary the Board should make provision of \$160 million to complete this project with a high level of confidence.' This figure included a \$5 million contingency and a further \$5 million allowance which was recommended to the Board by Williams 'to increase confidence' in the revised estimate.
- 12.3.77 By 21 October 2004 ION had finalised its revised forecast for FY 2005 and was in a position to provide it to the Banks. On 21 October 2004, the CFO sent an email to the Banks attaching a copy of the Final Williams Report together with the revised FY 2005 forecast.
- 12.3.78 At a meeting with representatives of the Banks on 22 October 2004, the Banks were also provided with a two page document headed 'Forecast Update for Banks and Board' which showed the forecast position with regard to bank covenants both before and after an IES divestment. The position was as follows:

Forecast bank covenant position

	Jun 04	Dec 04	Jun 05
Net debt (\$m)	196	320	342
Net debt/EBITDA	1.70	3.67	3.74
Net debt post IES sale (\$m)		160	207
Net debt/EBITDA post IES sale		1.83	2.52

This analysis demonstrated that a sale of the IES business would reduce ION's net debt position to a point which would ensure that as at 31 December 2004 and 30 June 2005, it would not be in breach of its Net Debt/EBITDA covenant (which was required under the MOFA to be less than 3 times.)

- 12.3.79 Any sale of the IES business required the Banks' consent. The position of the Banks was that they would only give consideration to consenting to the IES divestment once they had received further detailed information (as requested in a letter dated 22 October 2004), including revised forecasts for FY 2006 and FY 2007.
- 12.3.80 At a meeting of ION's Board on 25 October 2004, the Board resolved the estimate for ION's FY 2005 profitability. Based on the revised forecast as it stood on 21 October 2004, an EBITDA figure of \$90 million (before significant items) was settled.
- 12.3.81 On 26 October 2004, ION held its AGM. At the AGM, ION confirmed its estimated EBITDA for FY 2005 at \$90 million (before significant items). The CEO also noted in his address that:

Central to a growing company is the adequacy of cash to fund that growth. We have had good bank and share subscription support. Last month we put in place a \$440 million bank

facility in this regard. The possible sale of one or more businesses, which we have grown substantially and can sell at a healthy capital profit, is also a sensible option we have to reduce our gearing.

12.3.82 In his address to the AGM, the chairman also stated:

Yesterday, the Board accepted an external consultant's report on our major capital programme. This report increases the previous allowances on the major investments currently being undertaken by approximately 15%.

12.3.83 Following the AGM, the CFO completed the work required to provide the Banks with revised forecasts for FY 2006 and FY 2007. By 28 October 2004 draft figures were available and were sent to the managing director. In the early hours of Sunday 31 October 2004, the CFO emailed the projections to ION's Board noting that even after a divestment of IES, an equity injection of at least \$100 million was required in order to ensure funding continuity. The projections demonstrated that without such an equity injection, ION would be in breach of its Net Debt/EBITDA covenant in FY 2006 as follows:

Revised forecast bank covenant position			
	FY 2005	FY 2006	FY 2007
Including Energy Services			
EBITDA (\$m)	95.5	133.1	172.4
Closing net debt (\$m)	354.7	532.8	453.6
Net debt/EBITDA (covenant ≤ 3.0)	3.71	4.00	2.63
Excluding Energy Services			
EBITDA (\$m)	86.2	110.9	148.8
Closing net debt (\$m)	219.0	409.9	342.7
Net debt/EBITDA (covenant ≤ 3.0)	2.54	3.70	2.30

12.3.84 On 1 November 2004 ION sent further information concerning ION's financial outlook to the Banks, including:

- (a) the updated forecasts for FY 2006 and FY 2007;
- (b) a memorandum from the managing director and the CFO in which ION sought:
 - (i) the Banks' approval for the sale of IES;
 - (ii) the Banks' approval for ION to drawdown funds under the MOFA beyond the \$285 million cap despite the capital cost overruns estimated in the Final Williams Report (as noted in the memorandum to the Banks dated 1 November 2004, ION needed to be able to access funds beyond the \$285 million cap by 5 November 2004).

ION also informed the Banks in this memorandum of its intentions in relation to a substantial equity raising of up to \$100 million, with an initial raising of \$50 million.

12.3.85 In essence, ION's position as put to the Banks was that it would:

- (a) draw down the necessary funds beyond the \$285 million cap to ensure adequate funding in the short term;
- (b) sell IES (the sale of which could be completed by the end of the calendar year);

- (c) use the sale proceeds to reduce Bank debt; and then,
 - (d) conduct an equity raising.
- 12.3.86 In the days immediately following receipt of the 1 November 2004 material, the Banks sought further information from ION in relation to a range of issues, including weekly cash flow forecasts showing peak net debt numbers in the forthcoming two weeks as well as weekly cash flows for the next three months.
- 12.3.87 On 4 November 2004 the CFO informed the Banks that ION's forecast peak outstandings under the MOFA for the fortnight beginning 8 November 2004 was \$305 million.
- 12.3.88 On 5 November 2004, CBA (as agent of the Banks under the MOFA) wrote to ION confirming that in order to make a final decision on the requested cap increase to \$305 million, the Banks required weekly cash flows for the next quarter as had been requested previously. In this correspondence, the Banks also reserved their rights in relation to what were said to be outstanding events of default and the right to appoint an investigating accountant.
- 12.3.89 On 7 November 2004 the CFO sent by email to the Banks the daily cash flow model for the quarter to 31 January 2005.
- 12.3.90 Meanwhile, ION retained the services of a recently retired senior stockbroker to advise on ION's equity raising options given the need for an equity raising identified in the CFO's memorandum to the Board sent on 31 October 2004.
- 12.3.91 On 10 November 2004, ION made a presentation at the Citigroup Small Caps Conference (**Citigroup Conference**) in which it confirmed its capital expenditure projections for FY 2005 and FY 2006. These estimates were in line with the information provided to the Banks on 1 November 2004. In this presentation, ION also commented on the potential sale of IES.
- 12.3.92 On 11 November 2004, ION received a letter executed on behalf of the Banks authorising ION to drawdown on the MOFA facility beyond the \$285 million cap but only to \$305 million and subject to the other terms set out in the letter. Those terms also included an agreement by the Banks not to act on existing events of default under the MOFA until 7 December (or such later date as may be agreed). The Banks also advised that, having previously reserved their right to appoint an investigating accountant, they proposed to commence discussion with a view to making such an appointment in the week commencing 1 December 2004.
- 12.3.93 On the same day, 11 November 2004, the CFO executed the required funding notice to facilitate a drawdown under tranche B of the MOFA. The funding notice was amended (as arranged with the Banks) so as to refer to the increased estimated capital cost of various projects and the sufficiency of funding certification was limited to 'committed' projects only.
- 12.3.94 On 17 November 2004, four funding notices were signed by the CFO. On this occasion, there were two draw downs from tranche A, one from tranche B and one from tranche D. For the tranche B notice, the sufficiency of funding certification was once again limited to committed projects and contained identical estimated capital costs as the funding notice executed on 11 November 2004.

12.3.95 On 23 November 2004, McGrathNicol were appointed as investigating accountants. Their role was to assess:

- (a) ION's current financial position;
- (b) ION's short-term funding requirements; and
- (c) the risks threatening the achievability of ION's medium term financial forecasts.

The primary objective of the review was to provide the Banks with sufficient information to assess ION's ability to meet future commitments.

12.3.96 By 25 November 2004, ION had still not secured the Banks' consent to the divestment of IES and, subject to receiving that consent, was endeavouring to sign a sale agreement within the next week. On that day, the managing director wrote to the Banks noting that it was his understanding that agreement had not been reached between the Banks regarding the application of the sale proceeds and requesting that the parties concerned resolve the matter with the utmost urgency. He also noted that any delay in the divestment process would materially adversely affect a timely closure of the deal and the cash realised.

12.3.97 On 3 December 2004, McGrathNicol issued their investigating accountants report.

12.3.98 On 3 December 2004, the CFO and the managing director wrote to the Banks setting out a high level plan which had been discussed by ION's Board at a meeting that afternoon and requesting a meeting with the Banks. The high level plan was stated to be as follows:

- Divest the Energy Services business upon receipt of the banks' approval. (cash received pre 25 December 2004)
- Reduce non core capital expenditure to a minimum
- Finalise all major capital projects currently approved
- Divest the Auckland/Kentucky wheels business via a trade sale or IPO
 - * appoint broker/adviser by 25 December 2004
 - * conclude process by 30 June 2005
- Equity raising (\$50m)
 - * go to market as soon as we can be transparent on Auckland/Kentucky divestment
 - * conclude process by 30 June 2005
- Joint venture or sale of Altona
 - * approach GM as potential partner (by 25 December 2004)
 - * plant fully commissioned by December 2005
 - * decision by December 2005 on sale arrangements
- Continue to review other divestment options
- Continue open flow of information to banks

12.3.99 On 5 December 2004, the managing director wrote to the Banks seeking their support for ongoing funding and a workout plan.

12.3.100 On 6 December 2004, CBA (as agent of the Banks under the MOFA) wrote to ION noting that an event or events of default had occurred under the MOFA and that the facility was cancelled.

12.3.101 In the absence of ongoing support from the Banks, on 7 December 2004, ION appointed the Administrators.

12.4 Core businesses and implementation of the growth strategy

Introduction

12.4.1 The core businesses and the key platforms for ION's growth strategy encompassed:

- (a) **Albury:** an existing facility which primarily manufactured 4-speed transmissions for sale to Ford and SsangYong, with 5 and 6-speed transmissions in development. Albury was also to manufacture differentials for supply to Holden and was intended to produce transfer cases once customers had been identified;
- (b) **Altona:** a greenfield development which was intended to manufacture engine blocks for Holden and other customers;
- (c) **Wingfield:** a greenfield facility which manufactured various engine components (including cylinder heads, inlet manifolds and oilpans) for Holden and Proton;
- (d) **North Plympton:** an existing facility which manufactured motorcycle wheels, hubs and swing-arm parts and accessories for Harley-Davidson, and hollow core cast engine components for Holden, Peugeot and Proton;
- (e) **Auckland:** an existing facility which manufactured alloy wheels and front cross-members primarily for sale to Ford in the United States and Australia;
- (f) **Kentucky:** a mothballed facility purchased by ION in April 2003 which was intended to manufacture wheels for sale to Ford and other customers; and
- (g) **Energy Services:** the business unit which conducted operations in fuel distribution, refuelling services, and fuel equipment manufacture.

12.4.2 Set out below is a summary of the key issues affecting these areas of ION's business in the lead up to the appointment of the Administrators in December 2004. Each business area is dealt with in further detail in Part C of this Report.

Albury

12.4.3 Albury was the manufacturing facility of the ION Automotive Systems (ie, IAS) business unit (which was a subset of ION Automotive Group (ie, IAG)). IAS was acquired by ION in April 2002 from BTR Nylex and following acquisition became a very significant contributor to the profits made by the ION Group as a whole (generating circa 50% of Group earnings).

12.4.4 The primary product manufactured by the Albury plant was a 4-speed transmission for sale to IAS' two major customers, Ford and SsangYong. ION was also seeking to supply transmissions, differentials and transfer cases to other companies, both in Australia and overseas. By 2003 ION (and its predecessor company) had been supplying transmissions to Ford for over 30 years and to SsangYong for over 5 years. ION understood that its 4-speed transmission would soon become outdated and that it needed to move quickly to

produce a viable 5 and/or 6-speed transmission if it was to retain its existing transmission business with Ford and SsangYong. The importance of this to ION's business is reflected in the amount of speculation by market analysts, particularly in the second half of FY 2004, that ION was at risk of losing its Ford transmissions business to a competitor after 2008 as Ford moved to 6-speed transmissions.

12.4.5 During 2003 and 2004, the outlook for the Albury plant was impacted by a number of significant events.

- (a) **Failure of 5-speed development program:** By early 2003, IAS (and its former owners) had spent approximately three years and \$20 million developing a 5-speed transmission. At this time it became apparent to ION that neither of its two key transmission customers required ION to supply them with a 5-speed transmission. In particular, SsangYong wanted ION to continue supplying 4-speed transmissions (although it had made arrangements with another supplier, Mercedes Benz, for the supply of some 5-speed transmissions) and Ford envisaged a gradual move directly to 6-speed transmissions. As a result, by August 2003 the 5-speed transmission project had been suspended and in early 2003 ION began to develop a 6-speed product. The 6-speed transmission was intended to be designed so that it could be configured as a 4, 5 or 6-speed transmission, depending on the customer's requirements. See section 18.2 below for further details.
- (b) **Decline in Ford 4-speed volumes:** By early 2003, ION was supplying approximately 115,000 4-speed transmissions to Ford per annum. In approximately January 2003, ION was informed that Ford had contracted with one of ION's competitors, ZF Lemforder, for the supply of 40,000 transmission units annually for Ford's Copperhead Program (which was to run from approximately September 2005 to late 2007) (**ZF Contract**). As a result, Ford forecast that its 4-speed requirements from ION for its Copperhead Program would decline to approximately 75,000 units per annum. On 1 July 2004, Ford informed ION that due to deteriorating market conditions it had reduced its estimated forecast volumes for the Copperhead Program to approximately 60,000 units per annum, the profit impact of which was possibly partially mitigated by volume penalties. See section 18.3 below for further details.
- (c) **Decline in SsangYong 4-speed volumes:** Until 2003, ION supplied SsangYong with approximately 100,000 to 110,000 4-speed transmissions per annum. In early 2003, SsangYong informed ION that it had decided to move to 5-speed transmissions for its Rexton model and had awarded the contract to Mercedes Benz (at the time of SsangYong's sourcing decision ION lacked a viable 5-speed product). Consequently, ION's projected 4-speed transmissions sales to SsangYong were reduced from approximately 110,000 units per annum to 80,000-90,000 units per annum, with effect from CY 2004. Between November 2003 and December 2004, the forecast figure of 80,000-90,000 units per annum was repeatedly downgraded as a result of declining demand from SsangYong and by September 2004 internal ION forecast volumes for FY 2005 had decreased to as low as 25,000 units. See section 18.7 below for further details.

- (d) **Failure to secure Ford 6-speed contract:** As at August 2003, ION remained uncertain as to when Ford would shift its entire product range to 6-speed transmissions, but understood that this would occur either during Ford's Orion Program (late 2007 to late 2009) or Cyclone Program (late 2009 to 2011). By February 2004, ION was aware that Ford's preferred strategy for the Orion Program involved using 6-speed transmissions for the majority of its transmission requirements. Accordingly, commencing late 2003, ION began a concerted campaign to win 6-speed transmission business from Ford for the Orion Program. ION estimated that, if won, the Ford Orion 6-speed business would result in annual revenues of approximately \$110 million (based on the supply of 60,000 6-speed transmissions per annum). This revenue would replace and not complement ION's existing 4-speed revenues from Ford. Despite ION's best efforts, on 9 September 2004 Ford advised ION that it had not been successful in securing Ford's 6-speed contract and therefore ION's transmissions business with Ford would conclude during 2008, when Ford made the switch from 4 to 6-speed transmissions for its entire vehicle range. See section 18.4 below for further details.
- (e) **Failure to secure SsangYong 5/6-speed contract:** Contrary to earlier indications, during the course of 2003 ION became aware that SsangYong planned to use 5/6-speed transmissions across its entire vehicle range. As a result ION quoted to SsangYong for two vehicle platforms, being the D100 and the E100 programs. A quotation provided by ION to SsangYong on 2 December 2003 for the supply of 5/6-speed transmissions was premised on an estimated volume of 70,000 units per annum (representing annual revenues of approximately \$128 million), and a five year production period commencing in June 2005. However, on or about 17 March 2004, ION was informed by SsangYong that even if it won the 5/6-speed contracts, forecast 5/6-speed volumes for FY 2006 were approximately 34,000 units. On 12 May 2004, ION became aware that it had not succeeded in securing the D100 5/6-speed contract (which comprised almost 21,000 of the forecast 34,000 units for FY 2006) and that 5/6-speed transmissions for the E100 project for SsangYong's domestic market would only be required commencing approximately January 2008. As at 7 December 2004, no decision had been made by SsangYong as to the identity of the supplier of transmissions for its E100 contract. The purchaser of IAS was ultimately successful in securing a 5/6-speed contract with SsangYong and commenced production in September 2007. See section 18.8 below for further details.
- (f) **Failure to secure Holden transfer cases contract:** On 7 May 2004, ION was informed that it had been unsuccessful in securing the transfer case contract for Holden's VE Program. This business had been forecast to produce annual revenues of approximately \$30 million from FY 2007. See section 18.9 below for further details.
- (g) **Failure to secure Ford transfer cases contract:** On balance the available evidence indicates that by late September 2004, ION was aware that it had not been successful in winning transfer case business from Ford for its Copperhead Program, involving the proposed supply to Ford of 16,000 units per annum

commencing in approximately mid 2005. See section 18.6 below for further details.

- (h) **Failure to secure Ford differentials contract:** By the end of September 2004, Ford had informed ION that it had not secured differentials business for Ford's Copperhead Program. This had represented potential revenues of \$60+ million per annum (based on 140,000 units) from early 2007 onwards, although estimated volumes appeared to fluctuate from 90,000 to 140,000 during 2004. See section 18.5 below for further details.
- (i) **SMT supply issues:** Commencing approximately mid-2003, ION began exploring opportunities to supply automatic transmissions into the Chinese market. In June 2003, ION signed a non-binding Memorandum of Understanding with SMT, a Chinese trading company, to collaborate in relation to the supply of 4-speed automatic transmissions, resulting in the execution of a supply agreement on 24 June 2004. The supply agreement provided that SMT would purchase a minimum of 20,000 4-speed automatic transmissions each year, commencing on or about 1 January 2005. However from July 2004 onwards, ION began to have concerns about SMT's ability to honour the supply agreement and on 9 September 2004 SMT requested 'significant volume concessions' from ION. See section 18.10 below for further details.
- (j) **Chery and Brilliance negotiations:** In addition to SMT, ION pursued opportunities with other Chinese companies, such as Chery and Brilliance, and aimed to sell 30,000 5/6-speed transmissions to these 'other' customers in FY 2006 which equated to revenue of approximately \$55.5 million. However, by 7 December 2004, ION's negotiations with Chery and Brilliance had not advanced past the quotation stage. See section 18.10 below for further details.

Altona

12.4.6 On 27 May 2002, ION's Board approved a proposal to develop an engine block manufacturing plant (the **Altona Proposal**). The Altona Proposal was driven by Holden's desire to source engine blocks for its new V6 engine (which was being produced in Australia) from a local supplier.

12.4.7 Key terms of the Altona Proposal were as follows:

- (a) capital expenditure of \$91.25 million (including land and buildings);
- (b) manufacture of an initial 200,000 engine blocks per annum for Holden;
- (c) annual revenue of approximately \$60 million for a period of ten years commencing in January 2006 based on sales to Holden;
- (d) an expectation that the Altona Proposal would generate an IRR of more than 20% (assuming a sale and lease back of the site) (see section 19.5 below for further details); and
- (e) the use of a manufacturing process for the engine blocks called the Precision Sand Casting Process (the **Precision Sand Casting Process**).

- 12.4.8 Consistent with the Altona Proposal, on 30 October 2002, ION signed a Memorandum of Understanding with Holden in relation to the supply of engine blocks (the **Holden MOU**). In the Holden MOU, Holden acknowledged that it was interested in purchasing 100% of the engine blocks required for its new V6 engine production from ION commencing in 2006. The Holden MOU did not refer to volume. However, it is apparent that ION exchanged various quotes with Holden during 2002 in which the initial quantum of engine blocks to be supplied was said to be 200,000 engine blocks per annum. ION informed the financial market on 30 October 2002 that it had won the contract from Holden for an initial 200,000 engine blocks per annum and that ION would build a modular plant to enable expansion to supply further demand at an investment of \$90 million.
- 12.4.9 Subsequent to approval of the Altona Proposal and prior to July 2003, ION management explored options for funding the Altona Project, engaged staff with expertise in the Precision Sand Casting Process, reviewed the original costings for the Altona Project, commissioned an engineering report and liaised with other potential customers including Lotus/Proton and Ford.
- 12.4.10 By June/July 2003, an expert US engineering team had commenced work on the Altona Project. Based on their expertise with the Precision Sand Casting Process, they commenced the design of equipment for 350,000 engine blocks per annum as this represented the basic minimum capacity of the Precision Sand Casting Process.
- 12.4.11 During the period from July 2003 until February 2004, ION's management were engaged in reviewing estimates and preparing working budgets for the Altona Project. Estimates included scope for the plant building to accommodate production of up to 700,000 engine blocks per annum.
- 12.4.12 By 19 February 2004, ION's forecast for the cost of the Altona Project had been revised and an increased forecast of \$125 million was incorporated in the presentation relating to ION's half-year results for 31 December 2003 as a component of the forecast capital costs for ION's Hollow Castings division (also referred to as the Engine Components Division). At a presentation to investors and market analysts on 19 February 2004, ION announced that the plant's production capacity at this time was to be 350,000 engine blocks per annum with forecast capital expenditure of approximately \$125 million. At this time the initial approved capital expenditure of \$91.25 million had not been exceeded in terms of costs spent or costs committed to the Altona Project.
- 12.4.13 The revised capital estimate was presented to the Board by the CFO on 15 March 2004 and adopted.
- 12.4.14 On 27 April 2004 ION announced to financial markets in the April Guidance that the capital estimate for the Altona Project was \$125 million and in line with previous guidance.
- 12.4.15 During the period June 2004 to September 2004, ION's management prepared various working documents or draft estimates which exceeded the \$125 million estimate. However, none of these were adopted by ION.
- 12.4.16 The Williams Status Report, dated 17 September 2004 and provided to ION's Board for the meeting to be held on 22 September 2004, forecast the capital cost to complete the Altona Project in the sum of \$151.464 million. On receipt of the Williams Status Report, ION

scheduled a workshop to look at ways of reducing the costs to complete the Altona Project. ION announced on 24 September 2004 (ie, in the September Announcement) that it had sought independent advice to review the cost to completion of ION's capital projects with completion of the review expected by November 2004. At this time, ION had not spent or committed in excess of \$125 million on the Altona Project.

- 12.4.17 The Final Williams Report of 21 October 2004 forecast a capital spend of \$160 million and was incorporated into ION's Board papers for the Board meeting of 25 October 2004. On 26 October 2004, ION announced at its AGM that the Board had accepted an external consultants report which increased costs across its capital projects by approximately 15%.
- 12.4.18 Throughout 2004, ION held the view that it would obtain contracts for an additional 150,000 engine blocks per annum at some point in the future, including subsequent to the start of production of the Altona plant. During the period 2001 to 2004, ION was pursuing opportunities for additional volumes with other potential customers including Ford, Proton/Lotus, DaimlerChrysler Germany, DaimlerChrysler US and Suzuki as discussed in section 19.4. Further, ION met with General Motors (Holden's parent company) in June 2004 to discuss additional volume from Holden.
- 12.4.19 Further details concerning the facts surrounding the Altona Project are set out in section 19 below.

Wingfield

- 12.4.20 At a meeting of ION's Board held on 27 May 2002, the Board approved a proposal for the purchase and development of a greenfield site at Wingfield, South Australia (ie, the Wingfield Project). The capital cost for the project was estimated in the proposal at \$38 million.
- 12.4.21 The proposal forecast that the Wingfield Project would generate revenue of \$64 million in its first year of operation and \$75 million per annum thereafter with an IRR of 48%. The revenue was to be generated from new contracts awarded for the production of components for Holden's HF V6 engine, namely cylinder heads, inlet manifolds and oilpans. It was the awarding of this contract that prompted the need to build Wingfield.
- 12.4.22 Commissioning at Wingfield began in late CY 2003, when ION began testing the production lines. It quickly became apparent that there were engineering and production problems with the plant.
- 12.4.23 The commissioning problems encountered at Wingfield not only delayed the commencement of full production but also required significant additional capital and operational expenditure, which caused extensive operating losses and a revaluation write-down.
- 12.4.24 These technical problems caused ION to miss its original targets for completion of commissioning. Between October 2003 and February 2004, ION revised its estimate of commencement of production from the April-June quarter 2004 to 1 July 2004. Later, in April 2004, ION again revised the date when it estimated full production would commence at Wingfield, delaying it until January 2005. Again, in July 2004 a further six month delay in reaching full production was identified and estimated at June 2005.

- 12.4.25 The Wingfield plant had been planned as a high volume continuous casting process, whereby parts being produced would flow sequentially from one process to another. This was a different method compared with the method used at ION's existing North Plympton plant, where castings were manufactured in batches. ION was not able to make the new Wingfield process work as intended and in order to achieve a continuous flow of production, unforeseen human intervention was required. As a consequence, additional employees were brought in, which increased the labour cost of producing components.
- 12.4.26 Capital expenditure on the Wingfield Project was initially estimated at \$38 million in May 2002. By October 2003, this had risen to \$63 million and then to \$74 million in March 2004. By November 2004, just prior to the appointment of Administrators, the capital expenditure committed or approved in respect of Wingfield had increased to an estimated \$109.7 million, of which \$91.6 million had been spent.
- 12.4.27 The increase in capital expenditure reflected a combination of:
- (a) approved increases in the scope of the project;
 - (b) capital expenditure increases which had not been anticipated at the outset but which were commercially justified by anticipated revenue increases or reduced production costs; and
 - (c) unanticipated costs, reflecting a combination of higher than expected commissioning costs, rectification work to enable the plant to function as planned, and inaccurate forecasting (a large proportion of these cost overruns or under budgeted costs were written off at 30 June 2004).
- 12.4.28 During its commissioning, in the period leading up to the appointment of the Administrators in December 2004, the financial performance of the Wingfield plant was significantly worse than ION had anticipated, which reflected the depth of the operational difficulties being experienced. Substantial losses were incurred at Wingfield throughout this period.
- 12.4.29 By August 2004 a detailed monthly budget for FY 2005 had been prepared for Wingfield. While production volumes increased from July 2004, ION was not able to achieve its budget. Sales volumes achieved were close to budget, however the cost of production continued to be significantly higher than expected, reflecting the ongoing production difficulties.
- 12.4.30 The actual loss for the five months ended 30 November 2004 was \$2.6 million compared with a budgeted loss of \$3.8 million. However, in addition to this operating loss, losses of \$13.1 million were incurred and treated as restructuring costs.
- 12.4.31 At December 2004, ION's most recent forecast for Wingfield was an EBITDA loss for FY 2005 of \$21.8 million (including restructuring costs). An annual profit of \$9 million was forecast for each subsequent year to FY 2008. In light of the plant's performance at this time and the continuing significant additional labour costs that were being incurred at December 2004, a substantial improvement in performance would have been required to achieve the most recent EBITDA forecast for years subsequent to FY 2005. By December 2004, the operational performance of the Wingfield plant had not reached the point where it was evident that profitable operations could be achieved.

- 12.4.32 Further details concerning the facts surrounding the Wingfield plant are set out in section 20 below.

North Plympton

- 12.4.33 IAG comprised a number of automotive component manufacturing operations. One of those was North Plympton, a casting foundry in South Australia manufacturing motor cycle wheels and various automotive parts. North Plympton was purchased by ION in December 1999 for \$16 million. North Plympton had been operating since 1953 and had one major customer for each of its main business lines – Harley-Davidson (Wheels Division) and Holden (Hollow Castings). North Plympton manufactured alloy wheels, swing arms and hubs for Harley-Davidson and manufactured oil pans and cylinder heads for Holden, and to a lesser extent Peugeot and Proton.
- 12.4.34 By July 2003 and throughout 2004, North Plympton experienced severe operational problems. The problems included: reduced yield causing production delays resulting in substantial air freight costs, high reject rates causing significant labour over-runs, increased equipment breakdowns causing excessive repair and maintenance costs, declining product quality containment and a standard costing system requiring improvement. North Plympton also had noise and odour emission problems which were the subject of discussions with the EPA.
- 12.4.35 North Plympton experienced a decline in profitability as a result of these operational problems in the 18 months leading up to the appointment of the Administrators. In order to improve North Plympton's financial performance, ION implemented various profit improvement initiatives. For instance, in January 2004, a profit improvement plan was introduced which resulted in the redundancy of approximately 100 positions with an estimated saving of \$6.3 million per annum and a direct one off redundancy cost of \$1.9 million.
- 12.4.36 The forecast supporting the April Guidance assumed that substantial cost reductions would be achieved through the implementation of the profit improvement program and predicted sales growth. This forecast recorded that EBITDA for North Plympton was expected to increase from \$9.0 million for FY 2004, to \$16.3 million for FY 2005 and \$20.4 million for FY 2006. The North Plympton forecast supporting the May IM was unchanged from the April Guidance. In the Deed Administrators' view some of the forecast cost savings in the April Model may have been optimistic but when the April Model forecasts are adjusted to take account of these matters, the forecasts nonetheless remain in line with the April Guidance.
- 12.4.37 Despite various profit improvement initiatives, North Plympton's financial position did not improve as planned. As a result, in the August Update, ION included an adjustment to North Plympton's forecast EBITDA for FY 2005 and FY 2006. Specifically, North Plympton's EBITDA forecast for FY 2005 was downgraded by \$6.3 million to \$10 million and the FY 2006 EBITDA forecast declined by \$8 million to \$12 million. The revenue component of the forecasts remained unchanged.
- 12.4.38 The explanation for the downgraded North Plympton EBITDA in the August Update was that the earnings for North Plympton over the latter stages of 2004 had been lower than expected principally due to the deterioration in material yields which then led to increases

in other costs. The earlier forecasts had also taken into account assumed cost savings which had not been achieved.

12.4.39 A further downgrade of the forecast EBITDA position of North Plympton for FY 2005 was reported to the Board on 29 October 2004. The downgrade represented a further deterioration of 3% from the August Update.

12.4.40 Further details concerning the facts surrounding the North Plympton operations are set out in section 21 below.

Auckland

12.4.41 In late 2001, ION purchased a wheels manufacturing business in Auckland, New Zealand, from Ford US. The business formed part of the Wheels Division of IAG and manufactured alloy wheels and front cross-members, primarily for sale to Ford in the United States and Australia.

12.4.42 In late 2003, Auckland's main customer, Ford, informed ION that it planned to wind down production of its Taurus model (which accounted for approximately 85% of the Auckland plant's production). At around the same time, Ford and ION entered new contracts for production at the Auckland plant. Production for the new model was expected to ramp up from around May 2004, replacing the Taurus volumes which were expected to decrease from around February 2004. However, in March 2004 ION was informed that due to production and launch issues at Ford, the new model volumes would not reach expectations until August 2004 and Taurus production would continue at low levels. These developments were appropriately reflected in the IAG February 2004 Forecast and then in the April Model.

12.4.43 In early 2004, ION also commenced plans to produce a portion of its Harley-Davidson volumes from the Auckland plant, with production scheduled to commence in early 2005. Throughout 2004, Auckland also attempted to win business from Holden, Land Rover and Lotus. At the time of the Administrators' appointment, Auckland had only run trials of the Harley-Davidson product and there were no contracts in place with any prospective new customers. As such, Auckland remained dependant on Ford as its main customer.

12.4.44 In October 2004, ION recognised that Auckland would continue to experience a softening in customer demand throughout FY 2005, primarily due to the lower demand from Ford and the continuing strength of the NZ\$. The forecast reduction in revenue was reflected in the October 2004 Forecast by a reduction in EBITDA of \$5.2 million in FY 2005 and \$2.6 million in both FY 2006 and FY 2007.

12.4.45 Further details concerning Auckland are set out in section 22 below.

Kentucky

12.4.46 On 31 March 2003, ION's Board approved the purchase of a mothballed facility in Warsaw, Kentucky, United States for US\$9 million. On 27 October 2003 the Board also approved capital expenditure of US\$46.3 million for the fit-out of that facility. It was intended that the facility would manufacture wheels for supply to Ford, with capacity to also supply other customers (***Kentucky Project***).

- 12.4.47 When the Board approved the necessary capital expenditure for the Kentucky Project, the project's IRR was above ION's hurdle rate of 20% and it appears there were opportunities to further enhance the return which were not yet taken into account in the project evaluation.
- 12.4.48 By late 2004 there was some deterioration in the IRR of the project (to 16%) due to increasing capital costs and decreasing projected revenues. Once again, this did not take account of the potential to improve the plant's return via additional opportunities.
- 12.4.49 At the time of the appointment of the Administrators to ION on 7 December 2004, ION's subsidiaries in the United States were still in the process of completing the Kentucky Project.
- 12.4.50 Further details concerning the Kentucky Project are set out in section 23 below.

Energy Services

- 12.4.51 A brief description of the IES business is included in section 24. The Deed Administrators have not identified in the course of their investigations any issues in respect of IES which are of relevance to potential claims by ION shareholders.

12.5 Financial controls

Introduction

- 12.5.1 The Deed Administrators reviewed the adequacy of ION's financial controls in the context of certain statements made by ION to the financial market.

Evolution of the ION Group

- 12.5.2 Relevant to an understanding of the matters affecting ION's financial controls is the evolution of the ION Group through a period of rapid growth via acquisitions and development of greenfield projects. Essentially, the ION Group evolved as a result of a series of acquisitions by Iron Carbide Australia Limited, a company established in 1984 and renamed ION Limited in January 2001.

Accounting software systems

- 12.5.3 The ION Group did not have a sophisticated and fully integrated accounting software system spanning all its various businesses and project developments. There were instead discrete accounting systems which ION had inherited as a result of its various business acquisitions. Financial information was aggregated from the various business sites using an accounting software package called TCM, and while the accounting systems were not fully integrated, the Deed Administrators found no evidence of this causing any significant problems with respect to the accuracy of historical data.

Reporting structure and practices

- 12.5.4 Reporting on operational and financial matters within the ION Group, and relevantly within IAG (and by IAG to the Board), was principally conducted on a monthly basis by written reports. The various reports had a focus on historical performance, production forecasts and tracking of new business opportunities.

- 12.5.5 The Deed Administrators are satisfied that there was an adequate information system in place (although not sophisticated) to capture developments in the IAG business relating to production and revenue forecasts.
- 12.5.6 The effective operation of the system relied heavily on employees at a divisional level recording accurately and on a timely basis in monthly management reports and new business reports pertinent developments with particular customers. The system failed whenever a relevant employee did not update information accurately or on a timely basis in the relevant monthly reports, due to the person's travelling commitments or other pressing commitments in the business or simply as a result of oversight or the person's inaccurate (subjective) assessment about the confidence rate of a customer taking forecast product.

Forecasts

- 12.5.7 With the appointment of a new CFO in late September 2003, ION embarked upon a process from late 2003 of formalising and adding more discipline to its divisional and group monthly forecasting. By early 2004, there had been considerable improvement in ION's financial reporting processes and short term cash flow forecasting.
- 12.5.8 ION prepared detailed long term forecasts in February 2004 for the period to FY 2006 (ie, the Placement Model) and a detailed revenue and capital expenditure forecast for IAG (ie, the IAG February 2004 Forecast), which included the forecast volumes for each major customer and/or product line.
- 12.5.9 In April 2004, ION released the April Guidance. The model supporting the April Guidance (ie, the April Model) was comprehensive and supported by detailed assumptions. By the time the April Guidance was released, ION had refined its processes for forecasting revenue. Financial forecasts for the three years ending 30 June 2006 were reviewed and re-worked to identify revenues, volumes and associated capex requirements according to the degree of uncertainty underpinning each relevant segment. Assumptions upon which the forecast was based were detailed by business unit.
- 12.5.10 It is unclear from the evidence whether the divisions were required to, or indeed undertook, a regular review of the long-term forecast in the April Model. The Board did however receive monthly updates on the forward outlook for the individual businesses for the current financial year, which were then consolidated by the CFO.

Capital Projects

- 12.5.11 Between 2002 and 2004 the Board of ION approved two greenfield projects, the Altona Project and the Wingfield Project and a brownfield project, the Kentucky Project. Each proposal was considered on the basis of its own business case which was developed by the relevant division and sponsored by the managing director to the Board.
- 12.5.12 ION had a policy that all new capital projects were required to yield a minimum IRR of 20% at the time of approval. In practice, this was seen as a guideline or target and there was a degree of flexibility. Each of the projects mentioned above was approved, among other things, on the basis of a consideration of the project's IRR presented by management to the Board. Despite some concerns in relation to the methodology employed and omissions of certain relevant data in the financial modelling, the Deed Administrators consider that at the time of approval of each capital project referred to above, the IRR for

the project was at or around or exceeded the Board's IRR policy of 20% for approval of projects.

- 12.5.13 Prior to early 2004 ION did not have a robust framework for monitoring capital expenditure. In early 2004, there was a push for more discipline over capital expenditure and, by March 2004, there was a greater level of formality. A number of committees were established to monitor capital expenditure, such as the Capital Review Committee and the Capital Projects Committee.

Policies and practices

- 12.5.14 A consequence of ION's expansion by acquisition was a lack of formal group-wide policies and procedures. The company made attempts to address this issue in 2004.
- 12.5.15 Until November 2004, ION did not have a formal manual documenting the accounting policies and procedures to be followed by ION personnel. This may have led to divergent practices in the various divisions. In February 2004, the Audit Committee resolved that formal group accounting policies be developed. However, these policies were not finalised until late November 2004.
- 12.5.16 In early 2004, ION set about developing various Group-wide management controls. As part of this process, ION's Board approved a Corporate Governance Manual on 16 June 2004. The extent to which this manual was distributed is unclear. The introduction of the Corporate Governance Manual did not seem to make a substantial difference to the manner in which the company was being run.
- 12.5.17 The Corporate Governance Manual contained a Disclosure Policy. Prior to the introduction of the Corporate Governance Manual, the Board considered disclosure issues at Board meetings on an ad hoc basis. The managing director made decisions about disclosure, which he would sometimes discuss with the Board. The Board relied on management to inform them when they needed to consider something for disclosure. This practice continued after the Disclosure Policy was introduced, notwithstanding the formal procedure set down in the Disclosure Policy. The Disclosure Policy was not widely distributed and officers and employees were not given training on disclosure obligations.
- 12.5.18 Risk management issues were discussed at an executive level. The directors identified key risk issues through their day-to-day management of the company and through Board papers. The Corporate Governance Manual contained Risk Management Guidelines and a Policy, but this did not cause any significant change to the existing practice. The Risk Management Guidelines refer to the establishment of a Risk Management Committee. It appears that such a committee was never formally established.
- 12.5.19 ION's Audit Committee managed the audit process with the external auditors. The Audit Committee does not appear to have conducted regular 'top-down' reviews of ION's financial controls and reporting processes and largely relied on the external auditor, Deloitte, to give it advice on these issues.
- 12.5.20 In October 2003 the CFO raised with the Board the issue of developing a more formal internal audit program. An employee was appointed in April or May 2004 to head up ION's internal audit function, but it appears to have taken some time to get the internal audit function operating. William Buck were ION's internal auditors for FY 2003. Their

appointment may have ceased some time in FY 2004. William Buck was not active in that role. Overall, ION did not have a solid internal audit function in 2003 and 2004. An internal audit function may have identified issues such as the accounting treatment used by ION in respect of certain Wingfield production costs (see section 20.4 below).

12.5.21 Further details concerning ION's financial controls are set out in section 17 below.

13. ION's disclosures regarding Financial Outlook

13.1 Background

13.1.1 A key aspect of the Deed Administrators' investigations has been to consider and assess the financial forecasts prepared by ION in the period October 2003 to November 2004 and to consider in light of those forecasts the reasonableness of related market disclosures. The Deed Administrators conclusions in this regard are summarised below and detailed findings are set out in section 25 of this Report.

13.1.2 Market expectations in relation to ION's projected financial performance for the current year (FY 2004), and future years (FY 2005 and beyond) were reset during this period with related announcements made in August 2003, October 2003, February 2004, April 2004 (ie, April Guidance), September 2004, and October 2004. While there were no market disclosures between April and September 2004, ION updated its long term forecasts in May (ie, May IM) and August 2004 (ie, August Update) as part of its refinancing process. The relevant extracts from these disclosures are set out in section 25.

13.1.3 The Deed Administrators reviewed ION's current year forecasts (FY 2004) (see section 25.5) and long term forecasts (FY 2005 onwards) (see sections 25.6 to 25.8). When assessing the forecasts, the Deed Administrators considered their appropriateness based on what was known by ION at relevant points in time. The Deed Administrators then reconstructed ION's forecasts at various intervals during the relevant period to include the estimated financial impact of various emerging issues as and when those issues ought, in the Deed Administrators view, to have been taken into account for forecasting purposes.

13.2 Findings

Current year expectations (FY 2004)

13.2.1 Notwithstanding initial deficiencies in ION's short-term forecasting processes, ION's disclosures in relation to the financial outlook for FY 2004 were found to be adequately supported by relevant prevailing information including recent trading performance, forward order guidance provided by customers, the status of and budget for capital projects, the cashflow impact of acquisitions and changes to net working capital requirements, and other relevant financial and non-financial data (see section 25.5).

13.2.2 In February 2004 ION announced a capital raising as part of a disclosure which revealed a significant increase in ION's forecast FY 2004 cash outflow and net debt position from that presented to the market in October 2003 in the UBS Presentation (see paragraphs 25.5.13 to 25.5.20). The capital raising was required to fund the acquisition of Liquip in December 2003, increased capital expenditure in relation to the Altona Project, and changes to ION's forecast working capital requirements to 30 June 2004. These developments transpired

subsequent to the statements made by ION in October 2003 to the effect that capital raising (other than for acquisitions) appeared unnecessary. Importantly, there had been no material change to ION's earnings outlook for FY 2004 at the time of this capital raising.

13.2.3 ION's reported results for FY 2004 (expressed on a pre-significant item basis) were consistent with the most recent guidance provided in April 2004.

13.2.4 The significant items included in ION's reported results for FY 2004 were disclosed on a timely basis by reference to ION's post financial year-end evaluation of major capital projects and asset carrying values conducted in consultation with external auditors (see paragraph 25.5.12).

Future year expectations (FY 2005 onwards)

13.2.5 Long term forecasting processes were relatively unsophisticated prior to the appointment of a new CFO in September 2003. At that time the company did not have detailed, integrated long term forecast models incorporating consolidated cashflow/funds flow forecasting. By February 2004, ION's long term forecasting tools and processes had improved, and by April 2004 ION had a comprehensive long term forecast in place (see section 17.5).

13.2.6 Despite the absence of fully integrated long-term financial forecasting processes, future year revenue and earnings growth predictions made by ION in October 2003 and again in February 2004 were found to be reasonable in the context of approved capital projects, currently contracted revenue based on forward order guidance provided by customers, and identified growth opportunities based largely on quotations already provided to existing and prospective customers.

13.2.7 By contrast, the future year revenue and earnings growth predictions made by ION in the April Guidance (see paragraph 25.7.17) were supported by a properly constructed, fully integrated financial forecast (ie, the April Model). The April Guidance included the following forecast metrics:

Sales revenue in 2004/05 is forecast to increase by 10%, and in 2005/06 by more than 20%.

....

Earnings Per Share are expected to be not less than 24.0 cents in 2004/05 on the enlarged capital base and increasing in 2006.

13.2.8 With the exception of an overly optimistic profit improvement program for the North Plympton operations, the assumptions set out in the April Model were adequately supported by relevant prevailing information, including recent trading performance, forward order guidance provided by customers, the status of and budget for capital projects, identified new business opportunities, the cashflow impact of acquisitions and changes to net working capital requirements, and other relevant financial and non-financial data.

13.2.9 Importantly, the April Model showed a significantly more favourable financial outlook for key financial metrics by comparison to the April Guidance which provided ION with a degree of 'buffer' as internal forecasts were downgraded over time (see paragraph 25.7.20). The April Model, as adjusted by the Deed Administrators to account for North Plympton's overly optimistic profit improvement program remained favourable by

- reference to the April Guidance. As such, the Deed Administrators found that the disclosures made in the April Guidance in relation to the company's long term outlook were reasonable.
- 13.2.10 On 28 May 2004, ION issued the May IM to existing and prospective lenders (not released to the market). The forecasts prepared for the April Guidance (ie, the April Model) were incorporated into the May IM materially unchanged, and extended to FY 2008 (see paragraph 25.8.4 and following).
- 13.2.11 In early August 2004, ION prepared revised forecasts for provision to prospective lenders (ie, the August Update). The need for the August Update arose due to the deterioration in the position of the Wingfield and North Plympton business units which was identified in July 2004 (ie, the Wingfield and North Plympton Forecast Downgrade). The August Update represented that the performance of and outlook for the remaining business units remained in line with the May IM. The forecasts for these business units remained unchanged from the May IM (see paragraph 25.8.7 and following). Importantly, notwithstanding these adjustments, the August Update remained favourable by reference to the April Guidance (although the buffer embedded in the April Guidance was largely eroded by this revision – see paragraph 25.7.20).
- 13.2.12 The Deed Administrators have found that between April 2004 and September 2004 (a period during which no updated market guidance was provided), ION did not adequately consider the impact of certain subsequent developments on its forecasts for FY 2005 and beyond. These events included a deterioration by August 2004 in the outlook of the IAS business unit (the largest contributor to the ION Group's EBITDA at circa 50%) which was largely attributable to:
- (a) demand for the SsangYong 4-speed transmission softening; and
 - (b) the deferral of the 6-speed transmission project.
- (see paragraph 25.8.11 and following).
- 13.2.13 The Deed Administrators have found that ION's forecasts for FY 2005 and FY 2006, as disclosed in the April Guidance, contained a sufficient buffer for adverse developments to mitigate much of the negative changes that became apparent. However, the margin for error in the April Guidance was not sufficient to accommodate the following adverse developments:
- (a) the EPS forecast for FY 2005 was found to have declined to 21.4 cents per share by the end of May 2004, 11% lower than the April Guidance figure of 24 cents per share (see paragraph 25.8.6);
 - (b) the 10% revenue growth forecast for FY 2005 outlined in the April Guidance was found to have declined to 6.9% by the end of May 2004, representing a 3% reduction in the underlying revenue forecast for FY 2005 (see paragraph 25.8.6);
 - (c) the EPS forecast for FY 2005 was found to have declined further by early August 2004 to 20 cents per share (a reduction against the April Guidance of 17%) (see paragraph 25.8.12);

- (d) by early August 2004 the 10% revenue growth forecast for FY 2005 in the April Guidance had declined to 4.6%, representing a 5% reduction in the underlying revenue forecast for FY 2005 (refer to the Restated August Update in paragraph 25.8.12); and
 - (e) by early August 2004 the 20% plus revenue growth forecast for FY 2006 in the April Guidance was down to 15.8%, representing a 4% reduction in the underlying revenue forecast for FY 2006 (refer to the Restated August Update in paragraph 25.8.12).
- 13.2.14 As to whether ION was required to make forecast restatements to the market as a result of these exceptions, see section 15 of this Report.
- 13.2.15 It is instructive to consider what explanatory statement ION would have made in August 2004 to accompany a downgrade of the April Guidance. The Deed Administrators presume that any such statement would have referred to the less optimistic trading outlook for Wingfield, Plympton and Albury. In particular, in relation to Albury, some reference would presumably have been made to the delay in the 6-speed project relative to assumptions supporting the April Guidance. A review of market commentary shows that the market was well aware of the significance of Albury's cashflow to the ION Group and that many analysts considered it critical that ION secure a 6-speed contract from either or both of its existing customers (see section 18.3). Some analysts considered the two customer contracts interrelated, such that failure to secure a 6-speed contract with SsangYong would damage ION's prospects of securing a contract with Ford. Any statement which created further doubt in relation to ION's prospects in this regard may have had adverse ramifications for ION's equity value (and prospects of raising fresh equity) beyond the quantitative impact of the earnings correction itself.
- 13.2.16 It is also important to note that the forecast downgrades from April 2004 had different implications for lenders as compared to market disclosure considerations. This is due to the fact that the April Guidance disclosed significantly more conservative figures to the market than set out in the April Model, whereas the April Model was provided to prospective lenders in the May IM as the 'base case' forecast. Accordingly, by the time updated (or Restated) forecasts became worse than the April Guidance, there had already been a material deterioration in ION's base case Refinance forecast from the perspective of lenders. The Deed Administrators assessment of the likely implications of this deterioration on ION's refinancing prospects is discussed in section 14 below.

14. Consequences if true position disclosed

14.1 Introduction

- 14.1.1 As part of their investigations, the Deed Administrators have considered the extent to which the chronology of events leading up to ION's administration in December 2004 might have changed if ION had made appropriate and timely disclosures of information affecting its forecasts and outlook to its shareholders and the Banks.
- 14.1.2 If such disclosures had been made, the Deed Administrators believe it is likely that ION would have collapsed earlier than it actually did, probably in mid September 2004. It is

important to note that the Deed Administrators cannot be certain of the events that would have transpired if these disclosures had been made, however, the scenario outlined below is one which the Deed Administrators consider most likely on a balance of probabilities. This view takes into account the actual sequence of events that occurred from November 2004, after ION's lenders became aware of certain issues that were not previously disclosed and the extent to which ION's base case forecasts supporting the Refinance had deteriorated.

- 14.1.3 The Deed Administrators' analysis is premised on the fact that ION's capacity to complete its expansion program, and its ability to continue to trade in the short term depended on it obtaining additional funding via the Refinance which was finally consummated in September 2004. Importantly, by the time ION accessed the initial proceeds from the Refinance in September 2004 it had already fully exhausted existing facilities and had been granted bridging finance by Westpac (circa \$10 million).
- 14.1.4 The Refinance process formally commenced in early April 2004, when tenders were sought from corporate finance consulting firms (to assist with the Refinance process) and was expected to have been concluded by 30 June 2004. However, the process became protracted and in early August 2004 ION was required to disclose to its existing and prospective financiers a material deterioration in earnings outlook relative to the May IM (ie, the August Update). This forecast downgrade was attributed to North Plympton and Wingfield where profit improvement initiatives and production ramp up efforts were respectively falling well short of expectations. ION was able to largely offset the financial impact of this deterioration on the Refinance credit parameters by committing to dividend retention mechanisms. However, the downgrade disclosed in the August Update created a credibility issue for ION with its financiers given its close proximity to the May IM.
- 14.1.5 ION made no announcement to the market in connection with the revised outlook reflected in the August Update. As prepared by ION, the forecasts in the August Update remained in line with the conservative earnings projections given in the April Guidance.
- 14.1.6 As discussed in section 12.3 above, ION's Refinance advisor, Grant Samuel, warned the company in July 2004 that the forecast downgrade disclosed in the August Update would create a credibility issue for ION that would make for 'a fundamentally tougher debt transaction'. Significantly, Grant Samuel also noted that the revised base case forecast set out in the August Update was worse than any relevant downside sensitivity presented to financiers with the May IM (other than new projects not proceeding).
- 14.1.7 On 30 July 2004, Grant Samuel provided a briefing package to assist ION with the positioning of the August Update forecast adjustments at a meeting with existing and prospective financiers scheduled for 2 August 2004. This memorandum relevantly noted that:

The credit effect of these changes [August Update] is quite substantial in that where previously we have orientated the credit around a spike in leverage to fund development that was quickly caught up to by growth in earnings we now have a larger spike in leverage potentially and a slower catch up in earnings.

This is a major change in the dynamic of the earnings and balance sheet mix of the business and the capacity to cope with leverage.

...

Given the recent Board endorsed nature of the earning statement and forecasts in April and the IM in late May based largely on these forecasts ION has created a credibility issue (ie how could it be so wrong so quickly).

- 14.1.8 It is important to note that ION had assured lenders in the August Update that the outlook for the remaining business units (including IAS) remained in line with the May IM projections stating that:

Whilst the bulk of the business is tracking in line with the IM forecasts, the performance of Light Metal Castings in South Australia (Wingfield and North Plympton) is not at expected levels and needs revision.

- 14.1.9 It is also important to note that approximately \$90 million or 72% of the new money (ie, additional funding) being sought by ION via the Refinance was to be contributed by two new lenders, BNP and Mizuho. By comparison to existing lenders (ie, CBA, NAB and Westpac), the new lenders were assessing ION as a new credit at this time and could have withdrawn from the Refinance process at any time without regard to an existing exposure. It was therefore critical for ION to maintain the confidence of the new lenders.

- 14.1.10 The Refinance was secured by ION in late August 2004, subject to documentation which was subsequently executed on 16 September 2004. However, as discussed in section 12.3 above, to avoid lender concerns following the August Update downgrade, ION agreed to additional covenants and controls, including greater restrictions on dividend payments and a cap on facility limits pending review by an independent engineer of capital project budgets.

- 14.1.11 The Deed Administrators' investigations show that, by the time the August Update was issued on 5 August 2004, the outlook for IAS (the source of approximately half of ION's then current and projected operating cashflow) had in fact also changed significantly from both a quantitative (ie, financial) and qualitative (ie, strategic) perspective (see section 18). This was due largely to:

- (a) SsangYong's decision in May 2004 to defer the E100 5/6-speed project and to award the larger D100 5/6-speed platform to another supplier (thereby delaying and compromising ION's 5/6-speed transmission development strategy);
- (b) concerns beginning to emerge that ION's strategy to sell 4-speed transmissions into China (via SMT) would be delayed by technical issues experienced by SMT's customers impacting vehicle launch timetables;
- (c) notification from Holden in May 2004 that ION would not be awarded the transfer case contract; and
- (d) further downgrades (between May and July 2004) of forecast 4-speed demand from SsangYong for FY 2005.

These matters were not taken into account in the August Update. If they had, ION would have been required to make an announcement to the market downgrading its earnings guidance. Further, prior to the execution of the MOFA on 16 September 2004, ION became aware of certain other information relevant to its financial outlook which was also not disclosed to lenders (or the market), namely:

- (a) confirmation on 9 September 2004 by Ford Australia that ION would not be selected as the supplier of 6-speed transmissions for its next model platform, the Orion Program (see section 18.4); and
- (b) confirmation on 9 September 2004 from ION's Chinese distributor (SMT) of production issues likely to materially delay its planned off-take of 4-speed transmissions (and thus affect FY 2005 revenues), culminating in a request for relief from contracted minimum volume commitments (see section 18.10).

In addition, shortly after the MOFA was executed, but before the first draw down of funds on 20 September 2004, the Williams Status Report was issued which included preliminary advice that the cost of the Altona Project was likely to exceed budget by at least 20% (see section 19.3).

- 14.1.12 The Deed Administrators consider that events are likely to have unfolded differently after the submission of the August Update on 5 August 2004 if full disclosure of these issues had been made to lenders and, where appropriate, the market.

14.2 Alternate outcome based on full disclosure

- 14.2.1 If ION had disclosed the changed circumstances of IAS in the August Update (and to the market), a substantially different credit position would have been conveyed to existing and prospective lenders.

Restated August Update and loss of confidence

- 14.2.2 As outlined in section 25, a Restated August Update would have revealed a deterioration of 17% in the EPS forecast for FY 2005 relative to the April Guidance. It would also have reflected a fall of circa \$30 million in ION's forecast EBITDA for each of FY 2005 and FY 2006 (a decline of 20% and 17% respectively) compared to the May IM. This EBITDA decline is double that actually reported to financiers in the August Update. To maintain a peak Net Debt/EBITDA ratio of 2.2 at 30 June 2006 (consistent with ION's original base case forecast) in the context of this earnings deterioration, ION would have needed to reduce its peak forecast funding requirement (at 30 June 2006) by approximately \$80 million.
- 14.2.3 As previously mentioned, ION was able to offset the deterioration in Wingfield and North Plympton earnings by agreeing to retain dividends so as to maintain the lenders' credit position relative to the May IM (as measured by the central Net Debt/EBITDA ratio). This would not have been possible if the level of deterioration was as shown in the Restated August Update. In any event, the Deed Administrators consider that, if known to financiers, the undisclosed changes in the outlook for IAS would have had a more profound effect on ION's refinancing prospects, because of the importance of IAS to the ION Group's debt servicing capacity (as reflected in paragraph 14.2.2 above). Further, based on the Deed Administrators' analysis, the Restated August Update would have warranted a market disclosure revising the April Guidance, as outlined in section 25. Such a disclosure would have adversely impacted investor sentiment and ION's prospect of a capital raising (discussed later).
- 14.2.4 As the source of approximately half of ION's operating cashflow, it was critical that lenders remained confident about the outlook for IAS, and remained confident in ION's

management team and its ability to successfully execute ION's expansion program. The information that would have been contained in a Restated August Update would have created doubt about ION's business plan, which was primarily reliant on:

- (a) strong ongoing demand for existing products from existing customers;
- (b) demand from existing customers for new products (such as 6-speed transmissions, transfer cases and differentials);
- (c) successful expansion into new markets, such as SMT in China; and
- (d) successful execution of greenfield capital projects (including Wingfield and Altona).

Independent accountants' review

- 14.2.5 In the context of the adverse qualitative and quantitative impact that a Restated August Update would have had on lender confidence, the Deed Administrators believe it is likely that lenders would have commissioned a review by an independent accountant at this time, not only to evaluate the new facilities proposed (that is, a pre-lending review) but also to assess the risk under existing facilities (in the case of existing lenders). This is consistent with the Banks' actual response when ION finally downgraded its August Update forecasts in October 2004.
- 14.2.6 The new lenders (BNP and Mizuho), may well have declined the invitation to participate in the Refinance at this point or, alternatively, have reserved their position during the investigating accountants' review. The participation of the new banks was important. As noted above, it was these new lenders who would ultimately provide the bulk of the additional borrowings required by ION to complete its expansion program. While existing banks (CBA, NAB and Westpac) were looking to participate in the Refinance, it was not proposed that there be a significant increase in their existing exposures.
- 14.2.7 It is reasonable to assume that lenders would have commenced discussions regarding the appointment of investigating accountants by mid August 2004 and that the investigating accountants would not have actually commenced their review until terms of engagement had been agreed with both the lenders and ION itself. It is typical for this process to take some time whilst scope, fees and logistics are resolved. Assuming the review commenced in mid August, the earliest date for delivery of an investigating accountants' report would have been early September 2004. Accordingly, based on a reconstructed review timeline, an independent accountant would, during their review, have become aware of the concerns that emerged in relation to the cost of the Altona Project and ION's 4-speed distribution program into China (SMT). Furthermore, at around the earliest time the review could have been completed (ie, early September 2004), ION should have disclosed Ford's decision in relation to the 6-speed contract. This disclosure is likely to have had a further, profound adverse impact on ION's prospects of successfully completing the Refinance. Indeed, having regard to the cash position in which ION would have found itself at this time, news of this development with Ford is likely to have led to urgent discussions with ION's existing and prospective lenders as ION sought to clarify its prospects of obtaining the required funding. It is likely in those circumstances that ION would have sought a suspension of trading in its shares pending completion of the independent accountants' review and a final decision being made by the Banks.

- 14.2.8 Investigating accountants finalising their report in early September 2004 are likely to have concluded that ION faced significant strategic challenges and risks at each of its automotive business units and greenfield projects. These are summarised below.
- (a) There were numerous issues that were likely to materially impact the future operating cashflow of IAS, (the historical and forecast source of approximately half of the Group's earnings and operating cash flow). These issues included:
 - (i) concerns emerging in relation to ION's ability to extend the life of the existing 4-speed transmission by expanding into China (via SMT);
 - (ii) ever reducing demand from SsangYong for 4-speed transmissions (exacerbated at that time by the prevailing economic conditions in South Korea and the extent of surplus stock already held by SsangYong);
 - (iii) SsangYong's decision to award the larger of the two 5/6-speed programs being targeted by ION to Mercedes Benz (ie, D100) and to defer by 12 months its planned migration to 5/6-speed for the smaller program being targeted (ie, E100);
 - (iv) ION's failure to date to secure new contracts from Ford for ancillary products (eg. transfer cases, differentials); and
 - (v) ION's failure to secure a commitment from Ford in relation to ION's 6-speed prototype.
 - (b) The cost of the Altona Project was likely to have exceeded budget by approximately 20% with considerable commissioning risk remaining and uncertainty in relation to the project's economics given the level of committed volumes.
 - (c) ION's capacity to successfully complete the recommissioning of the Kentucky wheel plant on time and on budget was not supported by the experience of ION's other capital projects at that time (ie, Wingfield and Altona), and around 35% of projected FY 2008 volumes for Kentucky remained uncontracted.
 - (d) The Auckland plant remained wholly dependent on one customer (ie, Ford) from whom ION had no commitment in relation to business beyond 2007.
 - (e) There was uncertainty as to the future profitability of the Wingfield plant given the status of progress in rectifying the commissioning issues affecting production.
 - (f) There was uncertainty as to the future profitability of the North Plympton plant given the absence of any evidence of progress with profit improvement initiatives.
- 14.2.9 As is usual practice for assignments of this nature, an investigating accountants' report prepared at that time is likely to have included a downside or 'risk adjusted' forecast, based on the figures in the Restated August Update and adjusted to reflect the potential financial impact of the issues and risks outlined above (***Risk Adjusted Restated August Update***).
- 14.2.10 The Deed Administrators have considered the extent of further forecast adjustments an investigating accountant may have made for the purposes of assessing downside risk to ION's forecasts in early September 2004. The result of this analysis is a downside

sensitivity (based on the Restated August Update) incorporating the following assumptions:

- (a) further downgrade of Wingfield's earnings forecasts to reflect the prevailing uncertainty in relation to the medium term profitability of this facility;
- (b) further downgrade of North Plympton's earnings forecasts to reflect the risk that profit improvement initiatives may not deliver expected savings;
- (c) further downgrade of IAS' earnings forecasts to reflect:
 - (i) concerns emerging in relation to Chinese demand for ION's 4-speed transmissions (via SMT);
 - (ii) anticipated further softening of 4-speed demand from SsangYong based on prevailing off-take rate;
- (d) elimination of uncontracted volumes from Auckland forecast;
- (e) provision for an increase of circa 20% in the cost of the Altona project based on preliminary findings of the independent engineer; and
- (f) provision for a 10% increase in the cost of the Kentucky project based on ION's poor record of capital project cost management (ie, Wingfield and Altona).

14.2.11 The Deed Administrators' Risk Adjusted Restated August Update would have presented a significantly different outlook for ION by comparison to the base case forecast which ultimately secured the Refinance (ie, the August Update) including:

- (a) a further reduction in FY 2005 and FY 2006 Group EBITDA of circa \$46 million (33% of total) and \$50 million (28% of total), respectively;
- (b) a circa \$100 million increase in ION's forecast peak net debt (as at 30 June 2006) from approximately \$400 million to approximately \$500 million; and
- (c) a peak Net Debt/EBITDA ratio of 3.9 times (as at 30 June 2006) well above both the corresponding peak ratio of 2.2 times set out in the August Update and the proposed covenant of 3.0 times.

14.2.12 The funding impact of the abovementioned deterioration in the Net Debt/EBITDA ratio would have been approximately \$200 million by reference to the August Update peak of 2.2 times and approximately \$100 million by reference to the proposed covenant of 3.0 times. That is, in order to maintain peak Net Debt/EBITDA at 2.2 times (as provided for in the August Update base case forecast) it would have been necessary for ION to reduce its peak debt funding requirement by \$200 million. This analysis is broadly consistent with the assessment made by ION's CFO in late October 2004 which concluded that, notwithstanding a sale of IES, ION would need to raise at least \$100 million of fresh equity to maintain a Net Debt/EBITDA ratio of below 3.0 times.

14.2.13 In summary, the investigating accountants' review would have shown that:

- (a) ION faced significant strategic challenges and risks at each of its automotive business units and greenfield projects (see paragraph 14.2.8 above);
- (b) there was considerable downside risk to the achievement of ION's base case forecasts which could not be accommodated by further curtailing dividends or

within the constraints of the additional borrowings being sought by ION at that time (see paragraphs 14.2.9 to 14.2.12 above); and

- (c) ION had fully exhausted its existing banking facilities and its immediate committed cashflow requirements were substantial (amounting to approximately \$55 million for the three months to 30 November 2004) meaning that ION was unable to explore other funding options without significant further interim commitment from existing lenders (see section 14.3 below).

Likely decision by lenders

- 14.2.14 The Deed Administrators consider it likely that, in response to the findings of the investigating accountants outlined above, lenders would have elected not to advance further funds to ION leaving ION with no option but to appoint voluntary administrators. In reaching this conclusion the Deed Administrators have considered how these same lenders reacted in early December 2004 when ION sought their ongoing support in the face of a deteriorating outlook. Importantly, when faced with similar circumstances and alternatives (as set out in paragraph 14.2.13 above) in December 2004 (but without the knowledge of the loss of the Ford 6-speed contract), the Banks refused to provide additional support.

14.3 Alternative funding proposals

- 14.3.1 The Deed Administrators' recognise that if ION had disclosed its true outlook to lenders and to the market in August 2004, alternative funding options may have also been considered by ION and tabled with its lenders in the face of its deteriorating credit position. These may have included:

- (a) a commitment to undertake an immediate equity raising of say \$100 million, with any offer of funding by lenders being subject to the success of that equity raising (an equity raising of \$100 million is consistent with what ION identified as the minimum requirement when it sought the Banks' consent to draw down beyond the \$285 million facility limit in late October 2004 - this quantum of equity was also dependent on ION successfully divesting the IES business unit);
- (b) accelerating its asset divestment program commencing with a sale of IES; and/or
- (c) the suspension or cancellation of capital projects.

- 14.3.2 The Deed Administrators consider that the prospects of such alternatives resolving ION's funding requirements would have been unlikely for reasons including the following.

- (a) Having already raised equity in February 2004, ION could not have raised significant additional equity quickly via a placement (any substantial equity raising would have required a shareholder approval process to be undertaken, which would ordinarily take at least six weeks to accomplish).
- (b) The Deed Administrators doubt whether an equity raising of substance would have been achievable assuming full disclosure had been made at that time (including the Ford decision regarding the 6-speed contract) and the absence of additional debt funding. That is, just as the bank funding would have been conditional on a successful equity raising, the success of any equity raising would also have been

dependent on the availability of the bank funding. The prospect that lenders would have provided additional debt funding (even on a short term basis) in anticipation of a possible equity raising is doubtful in the Deed Administrators' view.

- (c) ION was not well advanced in its negotiations for the sale of IES at this time and, in any case, a sale of IES would not have restored ION's credit parameters to an acceptable level given the earnings contribution being made by IES. This was acknowledged by ION's CFO in a memorandum to the Board dated 29 October 2004 which stated:

Given the forecast net debt position even after the divestment of Energy Services, we have no alternative but to commit to an equity injection of at least \$100 million in order to ensure funding continuity.

This view is also supported by actual events in December 2004, when the completion of a sale of IES was imminent and the Banks nevertheless chose not to provide additional debt.

- (d) ION was still required to meet committed capex on its capital projects (contracted commitments to suppliers needed to be paid even if the projects were suspended) and operating cashflows were unlikely to be sufficient to sustain the business in the short term, particularly given the cash drain Wingfield was causing on the Group. Further still, the uncommitted projects that might have been considered for cancellation were required to replace products that were approaching the end of their lifecycle.

- 14.3.3 It is important to note that the above options were considered and rejected by the Banks in December 2004, when asked to provide significant interim funding in the hope that these outcomes could be achieved.

14.4 Conclusion

- 14.4.1 The Deed Administrators' analysis, leading to an earlier insolvency in mid September 2004, is a reconstruction of events as they are likely (in the Deed Administrators' view) to have unfolded having regard to the circumstances in which ION found itself at that time and the events which actually occurred in the lead up to ION's insolvency. More particularly, the scenario is based on:

- (a) the Deed Administrators' conclusions in relation to matters which ION ought to have disclosed to lenders and, where appropriate, to the market and their assessment of the significance of these matters;
- (b) the Deed Administrators' assessment of the impact of the August Update, and the likely incremental impact of additional adverse disclosures, on lender confidence;
- (c) the Deed Administrators' assessment of the funding and restructuring alternatives likely to have been available to ION in August/September 2004; and
- (d) the implications on this alternate scenario of the actual events which unfolded from early November 2004, when ION disclosed to its lenders the further deterioration in earnings forecasts and Williams' conclusion that the cost of capital projects would exceed budget by circa 15% (albeit that the disclosure of the loss of the Ford 6-speed contract remained withheld).

- 14.4.2 For these reasons the Deed Administrators consider that, on balance, the most likely outcome of full disclosure by ION to its lenders and shareholders from August 2004 is ION's insolvency in mid September 2004.

15. Potentially Actionable Disclosures and Non-Disclosures

15.1 Introduction

- 15.1.1 While the Shareholder Claims are comprised of a wide variety of allegations, the vast majority involve claims that:
- (a) ION failed to disclose matters to the market in breach of its disclosure obligations pursuant to the Corporations Act and the ASX Listing Rules (ie, Failure to Disclose); and/or
 - (b) ION engaged in misleading or deceptive conduct contrary to the Corporations Act, TP Act and/or ASIC Act (ie, Misleading or Deceptive Conduct).
- 15.1.2 For shareholders to have a valid claim against ION in respect of a Failure to Disclose or Misleading or Deceptive Conduct, they must establish each of the following elements:
- (a) **breach** – that ION's conduct the subject of complaint constitutes a Failure to Disclose or Misleading or Deceptive Conduct;
 - (b) **causation** – that the shareholder suffered loss by or as a result of that conduct because, for example, the conduct affected the shareholder's behaviour in relation to trading in ION shares; and
 - (c) **loss** – that the shareholder suffered a monetary loss (which must be calculated in accordance with the applicable legal principles).
- 15.1.3 In relation to the first requirement, based on their investigations to date, the Deed Administrators have identified the following conduct of ION which, in their view, is likely to amount to a Failure to Disclose or Misleading or Deceptive Conduct. The relevant conduct is described in sections 15.2 to 15.9 below by reference to each area of enquiry covered in this Report. In section 15.10, the Deed Administrators comment further on the requirements of causation and loss and what is required of shareholders in this regard if they wish to pursue a claim.
- 15.1.4 As noted earlier in this Report, the Deed Administrators make no recommendation as to whether, or on what basis, any person lodges or amends a proof of debt and such persons should seek their own legal advice if they require assistance in that regard.
- ### 15.2 Funding the growth strategy
- 15.2.1 In section 14 of this Report, the Deed Administrators consider how the chronology of events leading to ION's administration in December 2004 (including its ability to raise the necessary capital to fund its growth strategy) may have altered if ION had made appropriate and timely disclosures of information affecting its forecasts and outlook to the market (and therefore the Banks). The Deed Administrators conclude that if ION had made such disclosures, ION's shares would probably have been suspended from trading from 10 September 2004 and ION is likely to have been placed into administration soon

thereafter. In particular, as noted in paragraphs 15.3.6 and 15.5.1(a) below, ION is likely to be found to have breached section 674 of the Corporations Act and its continuous disclosure obligations in failing to inform the market as soon as it was relevantly aware of:

- (a) the 17% decline in forecast EPS for FY 2005 and the underlying reasons for that reduction (ie, from 5 August 2004); and
- (b) the loss of the Ford 6-speed transmissions contract notified to ION on 9 September 2004.

15.2.2 Those matters were also material to ION's existing and prospective lenders. For the reasons set out in section 14 of this Report, the Deed Administrators have concluded that if these matters had been disclosed to the market (and therefore to lenders) it is likely that:

- (a) the committed offers of finance made by the Banks on or about 20 August 2004 would not have been made;
- (b) after a period of investigation by the Banks, and disclosure on 9 September 2004 of the Ford 6-speed decision, there would have been grave doubts about the prospects of ION obtaining the necessary funding;
- (c) given ION's immediate cash needs, it would have gone into urgent discussions with the Banks regarding ongoing funding and, as a consequence, ION's shares would probably have been suspended from trading from 10 September 2004; and
- (d) the Banks would ultimately have made a decision not to fund ION and, by mid September 2004, ION would have been in administration.

15.2.3 As explained in paragraph 14.1.2 above, it is important to note that the Deed Administrators cannot be certain of the events that would have transpired if these disclosures had been made. However, the scenario outlined above is one which the Deed Administrators consider most likely on a balance of probabilities having regard to the available evidence. It is possible that if the matter were tested in the Courts, a different conclusion might be reached, either as to the consequences flowing from disclosure or as to the timing of the assumed events. Nevertheless, if it is presumed that disclosure is likely to have lead to ION's shares ceasing to trade from 10 September 2004, there is an argument that shareholders making claims regarding shares purchased on or after that date need not provide individual evidence of causation. Again, this is a matter which has not been specifically tested in the Courts.

15.2.4 Having regard to the time and expense involved in litigating these issues before the Courts and their assessment of the balance of probabilities described above, the Deed Administrators have formed the view that shareholders making claims in respect of shares purchased on or after 10 September 2004 should have the option of resolving their claims expediently without the need to submit further detailed evidence of causation. This is explained further in section 15.10 below. The Deed Administrators' assessment is not free from doubt in the absence of a determination by a Court. It is therefore appropriate for the Deed Administrators to admit claims relating to share purchases on or after 10 September 2004 after applying a discount to reflect this uncertainty. Shareholders who would prefer to make their claims concerning share purchases on or after 10 September 2004 without a discount, will be at liberty to do so, however, they will be required to submit evidence of

causation with their proofs of debt. If the causation evidence submitted is not accepted by the Deed Administrators, the shareholder's proof will be admitted at 80% of its value (calculated in accordance with applicable legal principles) and on the basis that any rights of appeal the shareholder may have are not affected.

15.3 Disclosures regarding financial outlook

15.3.1 The Deed Administrators have identified two aspects of ION's disclosures concerning financial outlook which are likely to amount to a Failure to Disclose or Misleading or Deceptive Conduct. They relate to:

- (a) ION's guidance regarding its forecast EPS for FY 2005; and
- (b) ION's failure to disclose information concerning FY 2005 significant items.

Shareholders wishing to pursue claims based on these likely breaches must submit causation evidence with their proofs of debt.

Forecast EPS for FY 2005

15.3.2 The April Guidance issued on 27 April 2004 included statements concerning ION's forecast profitability for FY 2005 and FY 2006. ION announced that its EPS for FY 2005 and FY 2006 were 'expected to be not less than 24 cents in 2004/05 and increasing in 2006' (see paragraph 25.7.17 below). The April Guidance figures were based on the April Model forecasts. The figures put to the market were conservative relative to the April Model which actually showed EPS for FY 2005 at 27 cents and for FY 2006 at 32.9 cents. ION thereby built into the Guidance a buffer or margin for error.

15.3.3 On 5 August 2004, ION prepared the August Update (for provision to the Banks) which included revised forecasts for FY 2005 and FY 2006 and which took into account the increased capital expenditure of the Wingfield Project and reductions in the expected profitability of both Wingfield and North Plympton. As prepared, the August Update forecasts remained in line with the April Guidance with EPS at 24.7 cents for FY 2005 and 29 cents for FY 2006. In other words, the buffer built into the April Guidance was sufficient to absorb these changes.

15.3.4 In fact, the August Update failed to take into account the impact on ION's forecasts of various other significant adverse events relating to the Albury business, (see paragraph 25.8.11 below). In summary, the matters which were not taken into account related primarily to SsangYong (Events 11, 13 and 14 – 4-speed volume reductions, loss of the D100 program and deferral of the use of 5/6-speed in the yet to be awarded E100 program) with some impact also from reductions in Ford 4-speed volumes (Event 12).

15.3.5 If those matters had been brought to account in the forecasts, the forecasts would have shown EPS for FY 2005 at 20 cents (17% lower than the April Guidance) and for FY 2006 at 24.7 cents.

15.3.6 In the Deed Administrators' view, ION's failure from 5 August 2004 to disclose the 17% reduction in its previous earnings guidance (and the reasons associated with that reduction) is likely to amount to a Failure to Disclose. It was not until 24 September 2004 that ION provided the market with any indication that its FY 2005 forecast earnings had changed.

FY 2005 significant items

- 15.3.7 On 26 October 2004 ION held its AGM at which it provided the market with an update on its forecast profitability for the financial year ended 30 June 2005. ION stated that, although it was very difficult to reliably forecast a figure at that time, it estimated that FY 2005 EBITDA would be approximately \$90 million 'before significant items'. However, no mention was made at the AGM or subsequently of the anticipated nature or value of significant items. In fact, at this time, ION anticipated significant items of \$22.6 million before tax, including \$11.8 million associated with the ongoing difficulties at the Wingfield plant (see further paragraph 25.7.30 below). In the Deed Administrators' view, ION's failure to provide information known to it at the time concerning the expected nature and magnitude of significant items is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

15.4 Financial controls

- 15.4.1 In section 17 of this Report, the Deed Administrators set out the results of their investigations concerning the adequacy of ION's financial controls and the disclosures to the market alleged to have been made in relation to those controls. Based on their investigations to date, the Deed Administrators have not identified any conduct of ION in relation to its market disclosures (or any failure to disclose) concerning its financial controls which in their view is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

15.5 Albury

- 15.5.1 Details of the Deed Administrators' investigations in relation to the Albury business are set out in section 18 of this Report. Based on their investigations to date, the Deed Administrators have identified the following conduct of ION in relation to Albury which in their view is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.
- (a) First, and most significantly, is ION's failure to notify the market about the loss of the Ford 6-speed contract on 9 September 2004. In section 18.4 below details of ION's attempts to put in place with Ford a contract for the supply of 6-speed transmissions are set out. As noted there, at a meeting on the afternoon of 9 September 2004, ION was informed by Ford that it had selected another supplier to meet its 6-speed transmission needs beyond 2008. ION failed to disclose this information to the ASX as it was required to do under its continuous disclosure obligations. In fact, ION's loss of the Ford contract did not become public until after ION went into administration.
 - (b) Of less significance, but nevertheless likely to give rise to a breach are two statements by ION concerning the testing of its 6-speed prototype. At its AGM on 26 October 2004 and again at the Citigroup Conference on 10 November 2004, ION represented that its 6-speed prototype was currently being tested by 'customers'. These statements must be viewed in the context of the market's knowledge that ION had two primary potential 6-speed customers – Ford and SsangYong. In fact, only SsangYong was testing ION's 6-speed prototype at this time. Ford had never tested the prototype and on 10 August 2004 had declined

ION's offer to test drive a car fitted with a prototype. Indeed, by the time these statements were made, Ford had already informed ION that it had lost the 6-speed contract.

- (c) Finally, ION made an error in quoting the wrong Ford 4-speed volume estimate at a presentation in October 2003. In particular, at the UBS Conference on 20 October 2003, ION represented that the expected 4-speed transmission volumes for supply to Ford for the period through to 2007 would be 116,000 units per annum. In circumstances where ION had entered into a Target Agreement with Ford on 12 September 2003, which provided for a 4-speed transmission volume target of 75,000 units per annum from September 2005, it appears from the Deed Administrators' investigations that ION did not have reasonable grounds for making that representation. As noted in paragraph 18.3.10 below, by 19 February 2004, IAG forecasts presented to the market were based on the reduced figure of 75,000 units per annum. Given the timing and nature of this misrepresentation, the Deed Administrators expect that it is unlikely to have caused significant loss to shareholders. Nevertheless, shareholders wishing to pursue this claim must submit the necessary evidence establishing that they relied on the misrepresentation and thereby suffered loss.
- 15.5.2 To the extent that other events concerning the Albury business (including downgrades in forecast volumes) affected ION's forecasts, those matters have been dealt with in detail in section 25 of this Report and the Deed Administrators' conclusions in that regard are set out in section 15.3 above.
- 15.6 Altona**
- 15.6.1 In section 19 of this Report, the Deed Administrators set out the results of their investigations concerning the Altona Project. Based on their investigations to date, the Deed Administrators have identified the following conduct of ION in relation to the Altona Project which in their view is likely to amount to a Failure to Disclose or Misleading or Deceptive Conduct. Once again, given the timing and nature of these likely breaches, the Deed Administrators expect that any loss arising from them will be limited. However, shareholders wishing to pursue claims based on these likely breaches must submit causation evidence as outlined in section 15.10.
- (a) From July 2003 relevant officers within ION had information that the Altona plant was being designed with an initial production capacity of 350,000 engine blocks per annum (the minimum capacity of the casting technology being used). ION had previously announced to the market that it had a contract with Holden for 200,000 engine blocks per annum and that the 'base load' of the plant was 200,000 units per annum. When ION became aware in July 2003 that the minimum base load was 350,000, it did not immediately disclose that information to the market. Instead, ION disclosed the increased production capacity on 19 February 2004.
 - (b) ION's 2003 Annual Report issued in September 2003 stated that the initial installed capacity of the Altona plant was 200,000 units. In circumstances where it was known to ION that the minimum production capacity would be 350,000, this

statement was incorrect. As noted above, ION provided the correct information to the market on 19 February 2004.

- (c) At its 2004 AGM on 26 October 2004, ION announced that the estimated costs across all of its capital projects had increased by approximately 15%. The capital projects were noted to include Altona. The actual increase for Altona, measured on a stand-alone basis was \$35 million (up from \$125 million to \$160 million) representing a 27% increase in that project's budget. In circumstances where ION had previously provided the market with specific information about Altona's forecast capital expenditure, failing to do so on this occasion is likely, in the Deed Administrators' view, to amount to a Failure to Disclose or Misleading or Deceptive Conduct.

15.7 Wingfield

- 15.7.1 In relation to the Wingfield Project (see section 20 of this Report), apart from the issue concerning significant items dealt with in paragraph 15.3.7 above, the Deed Administrators have identified the following conduct of ION which in their view is likely to amount to Misleading or Deceptive Conduct.
- 15.7.2 ION stated in the February Announcement on 19 February 2004 that completion of the Wingfield Project was 'on budget Stage 1'. In the circumstances, this statement gave a false impression of the position concerning Wingfield at this time. In fact, ION had already planned what was labelled as 'Stage 2' of the project, but this work was largely to resolve capacity constraints affecting the plant as initially designed. In addition, while the Stage 1 budget (as incorrectly prepared by ION) did not include any commissioning costs, it was clear by this stage that substantial costs would be involved in commissioning the plant. To say that Stage 1 was 'on budget', did not convey the full picture and is likely to be found to be misleading. ION subsequently informed the market on 27 April 2004, in the April Guidance, that there would be a cost overrun in relation to the Wingfield Project.
- 15.7.3 Shareholders claiming loss based on this likely breach (which the Deed Administrators expect will be limited) are required to submit evidence of reliance/causation as explained in section 15.10.

15.8 North Plympton

- 15.8.1 Based on their investigations to date (which are summarised in section 21 of this Report), the Deed Administrators have not identified any conduct of ION in relation to its market disclosures (or any failure to disclose) concerning the North Plympton business unit which in their view is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

15.9 Auckland, Kentucky and Energy Services

- 15.9.1 The Auckland, Kentucky and Energy Services business units are dealt with in sections 22 to 24 of this Report. Based on their investigations to date, the Deed Administrators have not identified any conduct of ION in relation to its market disclosures (or any failure to disclose) concerning Auckland, Kentucky or Energy Services which in their view is likely to amount to a Failure to Disclose and/or Misleading or Deceptive Conduct.

15.10 Causation and Loss

- 15.10.1 As noted above, for shareholders to have a valid claim against ION in respect of a Failure to Disclose or Misleading or Deceptive Conduct, they must establish not only a breach but also causation and loss (see paragraph 15.1.2 above).
- 15.10.2 As outlined in section 9 above, and subject to the matters noted below in relation to share purchases on or after 10 September 2004, all shareholders wishing to make a claim against ION must submit evidence of causation in support of their claim. The Shareholder Claim Form required to be completed by all shareholders lodging or amending a proof of debt sets out details of the information required to be provided.
- 15.10.3 There is, however, one qualification to these arrangements. Having regard to the nature of the breaches outlined in section 15.2 above and the likely significance of those matters if they had been disclosed to the market, in the interests of expediting the adjudication process the Deed Administrators have determined to make a compromise proposal to those shareholders who purchased shares on or after 10 September and who suffered loss as a result.⁷ For those shareholders, the Deed Administrators will not require causation evidence in respect of a claim concerning shares purchased on or after 10 September 2004, provided that the relevant shareholder proves the other aspects of the claim and otherwise agrees to a settlement of the claim by way of a 20% discount on the value at which such a claim is admitted to proof. The Deed Administrators are of the opinion that this would constitute a reasonable settlement of such a claim.
- 15.10.4 It follows that shareholders who purchased shares on or after 10 September 2004 and who wish to make a claim against ION in respect of shares purchased on or after that date, may elect to:
- (a) submit evidence of causation in support of their claim (as required for all shareholder claimants) and seek admission to proof of 100% of their claim; or
 - (b) submit no causation evidence in respect of shares purchased on and after that date and compromise their claim in respect of those shares so that it is admitted to proof for 80% of the loss suffered (calculated in accordance with the applicable legal principles).

This election may be made by relevant shareholders at the time of completing their Shareholder Claim Form. Shareholders should note, however, that if the compromise is accepted, that does not mean that the shareholder will receive payment of 80% of the loss claimed. It means that the shareholder's claim will be accepted by the Deed Administrators at 80% of its proper value and the shareholder will receive pro-rata distributions on that amount along with other unsecured creditors whose debts or claims are admitted to proof.

- 15.10.5 For those shareholders who elect to submit evidence of causation and seek admission to proof of 100% of their claim, if the causation evidence submitted is not accepted by the Deed Administrators, the shareholder's proof will be admitted at 80% of its value

⁷ This proposal is not available to any shareholder who was an officer or employee of ION or an associate of an officer or employee of ION at any time in the period 10 September to 7 December 2004.

(calculated in accordance with applicable legal principles) and on the basis that any rights of appeal the shareholder may have are not affected.

PART C – DETAILED RESULTS OF INVESTIGATIONS

16. Introduction

16.1.1 This part of the Report sets out in further detail the results of the factual investigations undertaken by the Deed Administrators in relation to matters relevant to the Shareholder Claims. The material is arranged by subject matter as follows.

- (a) Section 17 – Financial Controls.
- (b) Section 18 – Albury.
- (c) Section 19 – Altona.
- (d) Section 20 – Wingfield.
- (e) Section 21 – North Plympton.
- (f) Section 22 – Auckland.
- (g) Section 23 – Kentucky.
- (h) Section 24 – Energy Services.
- (i) Section 25 – ION's disclosures regarding financial outlook.

17. Financial Controls

17.1 Overview of areas of investigation

17.1.1 On 20 October 2003, the managing director of ION delivered a presentation to the UBS Conference. The presentation stated that 'ION has developed very strong financial management, always satisfying its financiers'.

17.1.2 On 4 May 2004, ION made an announcement to the ASX. A letter to shareholders was attached to the announcement, which stated that 'capital expenditure procedures are stringent, well disciplined and strongly controlled with myself as Chairman of the Capital Projects Committee'.

17.1.3 In light of the allegations raised by some shareholders in relation to the above statements, the Deed Administrators reviewed the adequacy of ION's financial controls. The Deed Administrators' investigation of the financial controls of the Group focused on:

- (a) the adequacy of accounting software systems (section 17.3 below);
- (b) the operational and financial reporting lines and the methods of reporting within spheres of management and by management to the Board (section 17.4 below);
- (c) the processes for preparation of budgets and forecasts (section 17.5 below);
- (d) the approval and review procedures for capital projects (section 17.6 below);

- (e) the policies and practices of the Group in relation to accounting, corporate governance, market disclosures and risk management (section 17.7 below); and
- (f) the Audit Committee and ION's internal audit function (paragraphs 17.7.35 onwards).

Each of these areas was examined in detail, and our observations follow below. In addition, in the context of the statement made on 20 October 2003, the Deed Administrators have considered ION's compliance with the banking covenants which were in place at the time the statement was made. The Deed Administrators have not identified any evidence of a breach of those financial covenants by ION.

17.2 Evolution of the ION Group

17.2.1 Relevant to an understanding of the matters affecting ION's financial controls is the evolution of the ION Group through a period of rapid growth via acquisitions and development of greenfield projects.

17.2.2 Essentially, the ION Group evolved as a result of a series of acquisitions by Iron Carbide Australia Limited, a company established in 1984 and renamed ION Limited in January 2001. A timeline of the evolution of the ION Group is as follows:

- (a) **December 1999:** Acquisition of Castalloy Limited, a manufacturer of motorcycle wheels and aluminium engine components.
- (b) **December 2000:** Acquisition of Cootes Holdings Pty Ltd, an oil and gas transport company. Cootes later formed part of ION Energy Services (ie, IES).
- (c) **August 2001:** Acquisition of a 75% interest in Argent Metal Technology Limited (subsequently known as ION Automotive (New Zealand) Ltd), a manufacturer of light alloy wheels for Ford US, based in Auckland, New Zealand. The remaining 25% interest was purchased in December 2001.
- (d) **February 2002:** ION Automotive commenced developing a greenfield site at Wingfield, South Australia, to support a new contract to supply engine components to Holden.
- (e) **April 2002:** Acquisition of the business of BTR Automotive Pty Limited, a manufacturer and supplier of transmission systems, based in Albury, New South Wales, which became ION Transmissions.
- (f) **October 2002:** Commencement by ION Automotive of planning for a new greenfield site at Altona, Victoria to support the supply of engine blocks to Holden from late 2005.
- (g) **May 2003:** Acquisition by US subsidiaries of ION Automotive of a non-operating manufacturing plant in Warsaw, Kentucky, re-commissioning of which commenced in October 2003 to supply Ford US with large diameter wheels.
- (h) **June 2003:** Acquisition of Stevenson Transport Pty Ltd, a liquid petroleum and gas distribution company. Stevenson Transport became a part of IES.

- (i) **December 2003:** Acquisition of Liquip Sales Pty Ltd and its subsidiaries, a designer and manufacturer of fluid transfer equipment. Liquip, together with Cootes and Stevenson Transport, comprised IES.

17.3 Accounting software systems

Overview

- 17.3.1 The ION Group did not have a sophisticated and fully integrated accounting software system spanning all its various businesses and project developments. There were instead discrete accounting systems which ION had inherited as a result of its various business acquisitions. Financial information was aggregated from the various business sites using an accounting software package called TCM, and while the accounting systems were not fully integrated, the Deed Administrators found no evidence of this causing any significant problems with respect to the accuracy of historical data.

Identification of systems and integration of financial information

- 17.3.2 Not all of ION's businesses conducted at the various sites used the same accounting software systems for their ledgers. Wingfield, North Plympton and Auckland used Movex software. Albury used the BAAN system and IES had a number of different systems. Altona and the Group head office used MYOB.
- 17.3.3 The use of different accounting software systems did not create any difficulties in aggregating financial information from various business sites. Personnel at the sites entered information already captured on the software system used by that business into an accounting package called TCM, and reports were then generated for use by the finance personnel at the Group's corporate head office in a common format using the information. TCM had been operational since at least September 2002.

17.4 Reporting structure and practices

Overview

- 17.4.1 Reporting on operational and financial matters within the ION Group, and relevantly within IAG (and by IAG to the Board), was principally conducted on a monthly basis by written reports. The various reports had a focus on historical performance, production forecasts and tracking of new business opportunities.
- 17.4.2 The Deed Administrators are satisfied that there was an adequate information system in place (although not sophisticated) to capture developments in the IAG business relating to production and revenue forecasts.
- 17.4.3 The effective operation of the system relied heavily on employees at a divisional level recording accurately and on a timely basis in monthly management reports and new business reports pertinent developments with particular customers. The system failed whenever a relevant employee did not update information accurately or on a timely basis in the relevant monthly reports, due to the person's travelling commitments or other pressing commitments in the business or simply as a result of oversight or the person's inaccurate (subjective) assessment about the confidence rate of a customer taking forecast product.
- 17.4.4 ION adopted a 'single line' reporting system at an operational level within various Group businesses. Within that framework, divisional financial controllers reported to the divisional

heads and did not also report directly to the CFO. The Deed Administrators' investigations reveal that between September 2003 to October 2004 there was a tension between management, particularly in IAG, and the CFO about the CFO having effective direct access to the divisional financial controllers. Whilst a single line reporting structure was adequate for a company the size of ION, at an operational level, management did not always report all relevant information on a timely basis to the CFO. As set out in section 25 below, this led to forecasts being prepared, which did not take into account potentially material events impacting on the forecasts.

Operational reporting lines

- 17.4.5 During the period from September 2003 to December 2004, ION used a single line reporting system at an operational level within the various Group businesses. Typically, by way of example, customer account managers reported to commercial managers, who in turn reported to divisional general managers, who reported to group heads (ie, IAG and IES). Group heads reported to the managing director who ultimately reported to ION's Board.

Financial reporting lines

- 17.4.6 Consistent with the focus on operational reporting, divisional financial controllers reported to divisional heads, divisional heads reported to group heads who, in turn, reported to the corporate office. The divisional financial controllers did not report directly to the CFO.
- 17.4.7 There is conflicting evidence as to whether there was a 'dotted line' reporting relationship and open lines of communication and a free flow of information between the divisional financial controllers and the CFO in the period between September 2003 and October 2004.
- 17.4.8 Following receipt of Deloitte's audit report for the half year ended 31 December 2003, the Audit Committee recommended in February 2004 that divisional financial controllers be required to report to the CFO as well as divisional heads. Despite this recommendation, and despite the Audit Committee following up this item during subsequent meetings, this item had not been implemented by the time of the Audit Committee meeting on 23 August 2004.
- 17.4.9 An internal memorandum dated 6 September 2004, circulated also to Deloitte, states that accounting personnel within the divisions would continue to have line responsibility upward through divisional management, but were obliged to meet agreed company-wide timetables, follow adopted accounting policies and co-operate in providing information requested by corporate office accounting staff.
- 17.4.10 Notwithstanding the internal memorandum, there is conflicting evidence as to when the reporting lines were changed to give the CFO effective direct access to divisional financial controllers and whether this was done informally prior to the relevant policies being documented. At the latest, such direct access occurred around mid October 2004.

Typical methods of operational and financial reporting

- 17.4.11 The Deed Administrators' investigations centred around the methods of reporting within IAG, which had three operating divisions: the Transmissions Division (ie, IAS), Wheels Division and Engine Components Division.

- 17.4.12 By way of example in relation to IAG, there were separate monthly written reports prepared in connection with the automotive systems operations (ie, Transmissions Division) at Albury, the Light Metal Casting operations (ie, Engine Components Division and Wheels Division) at Auckland and North Plympton, the operations at Wingfield, and the projects at Altona and Kentucky. Information was also communicated amongst management of the operating divisions and IAG management both orally and by way of email.
- 17.4.13 Typically, using the IAS operations as an example, the management report dealt with (as appropriate):
- (a) monthly historical matters such as production volumes against forecast and budget, profit and loss, occupational health and safety issues, cost control, purchasing, supply problems, quality concerns and other KPIs;
 - (b) production forecasts for the coming month; and
 - (c) a new business or future business section.
- 17.4.14 Again, using IAS as an example, there was a monthly new business report prepared, parts of which were extracted into the monthly management report:
- (a) the new business reports were spreadsheets tracking the progress of quotations and prospective business opportunities, and providing a summary of current activity so that management could understand the progress of each project;
 - (b) monthly updates in the report were based on emails and general correspondence – the spreadsheets were completed each month by the personnel responsible for each project and were attached as an appendix to the management report;
 - (c) the spreadsheets were not always updated accurately to reflect the current status – instances where updates did not occur included situations where the person responsible was travelling or had other pressing commitments in the business, or there appeared simply to have been an oversight or the person's inaccurate (subjective) assessment about the confidence rate of a customer taking forecast product; and
 - (d) there was a confidence rate for each customer. The confidence rate was an expression of personal opinion; there was no formula for the calculation of that confidence rate. The confidence rate was based on discussions that were being held with the customer, how things were progressing, and generally what was felt about the customer at that point in time.
- 17.4.15 The new business reports were reviewed and used by the finance department specific to that division for planning purposes and forecasting. The divisional financial controllers were responsible for preparing volume projections, as well as budgets and forecasts for their respective divisions and were also responsible for producing production and sales schedules. These projections, budgets and forecasts were discussed by the divisional financial controllers with the IAG financial controller.
- 17.4.16 More broadly, the management report and attached new business report for each operating division or location were provided to and reviewed by the IAG management team, led by the IAG head and by IAG's financial controller.

- 17.4.17 The IAG head in turn prepared a monthly IAG Management Report using the information in the management reports and new business reports of the various divisions and operations. The IAG Management Reports were provided to the managing director and the CFO.

Reporting to the Board

- 17.4.18 Typically there were separate management reports for the two main arms of the business, (IAG and IES) included in the monthly Board papers. For some months from May 2004, the management reports and new business reports for the operating divisions of IAG were attached to the IAG management reports included in the Board papers. This practice appears to have commenced in response to a Board request that the business units provide more information on their month-to-month performance. From 2004, all reports from the divisions to the Board were quite detailed. However, as is evident from the material in section 25, some potentially material events impacting on the forecasts were not reported on a timely basis to the Board.
- 17.4.19 From early 2003 divisional managers were requested to make regular presentations to the Board (either monthly or every second month) about the operational performance of their divisions and the new business initiatives that they were pursuing.

17.5 Forecasts and budgets

Overview

- 17.5.1 With the appointment of a new CFO in late September 2003, ION embarked upon a process from late 2003 of formalising and adding more discipline to its divisional and Group monthly forecasting. By early 2004, there had been considerable improvement in ION's financial reporting processes and short term cash flow forecasting.
- 17.5.2 ION prepared detailed long term forecasts in February 2004 for the period to FY 2006 (ie, the Placement Model) and a detailed revenue and capital expenditure forecast for IAG (ie, the IAG February 2004 Forecast), which included the forecast volumes for each major customer and/or product line.
- 17.5.3 In April 2004, ION released the April Guidance. The model supporting the April Guidance (ie, the April Model) was comprehensive and supported by detailed assumptions. By the time the April Guidance was released, ION had refined its processes for forecasting revenue. Financial forecasts for the three years ending 30 June 2006 were reviewed and re-worked to identify revenues, volumes and associated capex requirements according to the degree of uncertainty underpinning each relevant segment. Assumptions upon which the forecast was based were detailed by business unit.
- 17.5.4 It is unclear from our investigations whether the divisions were required to, or indeed undertook, a regular review of the long-term forecast in the April Model. The Board did, however, receive monthly updates on the forward outlook for the individual businesses for the current financial year, which were then consolidated by the CFO. In this context, and as mentioned further in paragraph 17.7.29 below, the Deed Administrators could find no evidence that ION's directors, executives, officers or employees undertook any training programs in relation to ION's market disclosure obligations. Such training would have enabled them to understand the significance of whether an event or collection of events

which caused a change in the forecast in the April Model might give rise to an obligation of disclosure by ION to the financial market.

Short term forecasts

- 17.5.5 As at September 2003, ION had a budget in place for FY 2004. Prior to September 2003, financial reporting occurred at a divisional, group (ie, IAG and IES) and consolidated level with a focus on actual performance by month and year to date against budget. To that time, ION did not have a focus on cash-flow and cash-flow forecasting, nor an integrated income, balance sheet and cash-flow forecast.
- 17.5.6 Following Rick Nagul's departure as CFO in August 2003 and Gavin Smith assuming that position in late September 2003, there commenced a more disciplined forecasting process. The preparation of forecasts fell within the new CFO's responsibility. ION introduced a rolling forecast, which looked at profit and loss, funds employed and cash-flow, as well as detailed reports for the Board. TCM was used as a tool to assist with the process. The financial controllers at each level of the business were required to follow this process. The new reporting system took approximately two to three months to establish.
- 17.5.7 The CFO's report to the Board for September 2003, dated 24 October 2003, states:
- A number of new financial reports have been included with this month's Board papers...over the next couple of months, we plan to progressively upgrade all financial information with an equal emphasis on profit and cashflow and funds employed.
- A monthly forecasting protocol has been introduced to ensure we have visibility of profit, cash flow and funds employed over the balance of this financial year. A further benefit will be to ensure all business units are accountable for funds employed and focus on returning an appropriate economic profit.
- 17.5.8 Each business unit was required to prepare a monthly current year forecast for the Board meetings. If the forecast changed between meetings it was to have been updated before the next Board meeting. The 'protocol' emanated from the additional information that had to be loaded into TCM. Once the business unit head signed off on the forecasts they were uploaded through TCM.
- 17.5.9 The practice was that the corporate head office personnel would review the forecasts to ensure all necessary information had been included, but did not review the accuracy of the data.
- 17.5.10 IAG did not have a manual or guidelines as to how to prepare forecasts. There was no document setting out the types of assumptions that had to be taken into account in preparing forecasts. It was up to each division to submit an assumptions list. IAG had a rolling forecast that was maintained on its future prospects, and the business units determined the likelihood of conversion for projects prior to assigning them a sensitivity or confidence rating. The business units would assess the likelihood of ION securing a project and track its progress through the new business reports.
- 17.5.11 Forecasting in the automotive industry was not without its difficulties given that customer contracts tended to be 'supply agreements' rather than 'take or pay' contracts and there were also long lead times to secure contracts for the manufacture of automotive products.

- 17.5.12 It was expected that forecasts would be factored into divisional and group monthly reporting each time customer schedules were received. If something occurred that affected a forecast, there was an expectation that the forecast for a particular division or group (ie, IAG and IES) would be updated.
- 17.5.13 ION continued to work in November 2003 to prepare additional forecasting reports. The CFO's report tabled at the Board meeting held on 2 December 2003 (dated 27 November 2003) states:
- Further reports have been added this month including projected financial performance and funds employed by month, together with cash flow reporting for each business segment. There are still some integration issues relating to the previous reports which will be resolved no later than January. The forecast information has been developed from each unit (all attached reports can be drilled down to location level) and the accuracy of forecasting will continue to improve as the synchronisation of profits/funds employed/cash is further developed and understood.
- The additional information will enable the computation of relevant measures of profitability including EBIT to Funds Employed (analysed EBIT/13 month average funds employed) and Economic Profit.
- 17.5.14 In their audit report for the half-year ended 31 December 2003 (prepared in February 2004), Deloitte commented that there had been a noticeable improvement at head office level since the June 2003 financial reporting process. Deloitte identified some areas for further improvement, particularly with respect to divisional reporting processes, with greater responsibility and accountability to be placed on the divisional finance teams and divisional controllers for the quality of financial information reported and addressing and resolving issues in a timely manner to the satisfaction of the Group CFO. This was a recurrent theme at audit committee level in August 2004, particularly with respect to business units not meeting reporting timetables.
- 17.5.15 By March 2004, the accuracy of ION's short term cash flow forecasting had improved considerably. By the March 2004 Board meeting, the Board requested that ION's management report on a monthly basis against material variances in the forecasts set out in the Placement Model prepared in February 2004, and any issues regarding capital adequacy for the purposes of planning for refinancing, and for market disclosures.
- 17.5.16 The budget for IAG for FY 2005 was not in place at the commencement of that financial year. The evidence suggests that the FY 2005 figures in the April Model were adopted as the budget for IAG for FY 2005. This matter was addressed at Board meetings in August and September 2004.
- Long term forecasts***
- 17.5.17 ION made statements to the financial market in October 2003 regarding its long term outlook. The Deed Administrators have been unable to locate among ION's records any detailed long term forecasts prepared around that time.
- 17.5.18 ION prepared detailed long term forecasts in February 2004 for the period to FY 2006 to quantify ION's funding requirements to 30 June 2006 (ie, the Placement Model). In addition, ION prepared detailed revenue and capital expenditure forecasts for IAG at this

time (ie, the IAG February 2004 Forecast). The IAG February 2004 Forecast included forecast volumes for each major customer and/or product line.

- 17.5.19 ION released the April Guidance on 27 April 2004. The April Model supporting the April Guidance was comprehensive and supported by detailed assumptions. By the time the April Guidance was released, ION had refined its process of forecasting revenue and growth. Financial forecasts for the three years ending 30 June 2006 were reviewed and reworked to identify revenues, volumes and associated capex requirements according to the degree of uncertainty underpinning each relevant segment. Assumptions upon which the forecast was based were detailed by the business units and discussed.
- 17.5.20 It is unclear from our investigations whether the divisions were required to, or indeed undertook, a regular review of the long-term forecast in the April Model. As is apparent from the material in section 25 below, IAS did not communicate material changes to its long term forecasts between April 2004 and August 2004 to the CFO, which resulted in the August Update being issued to prospective lenders without an amended forecast for that business unit. The forecast adjustments that were included in the August Update for Wingfield and North Plympton were the result of the CFO's own initiative as opposed to advice from these divisions. Further, the fact that the CFO was not aware of the forecast contained in a presentation to a prospective purchaser of IAS in October 2004 until after the event (refer to paragraph 12.3.68) demonstrates that business units were not communicating changes to long term forecasts on a timely basis to the CFO. The Board did however receive monthly updates on the forward outlook for the individual businesses for the current financial year, which were then consolidated by the CFO.
- 17.5.21 A further forecast was undertaken by ION for FY 2006 and FY 2007 which incorporated revenue downgrades. That forecast was provided to ION's financiers on 1 November 2004. The forecast incorporated a number of events which post-dated the preparation of the April Model and the release of the April Guidance.

17.6 Capital projects

Overview

- 17.6.1 Between 2002 and 2004 ION's Board approved two greenfield projects, the Altona Project and the Wingfield Project and a brownfield project, the Kentucky Project. Each proposal was considered on the basis of its own business case which was developed by the relevant division and sponsored by the managing director to the Board.
- 17.6.2 ION had a policy that all new capital projects were required to yield a minimum IRR of 20%. In practice, this was seen as a guideline or target and there was a degree of flexibility. Each of the projects mentioned above was approved, among other things, on the basis of a consideration of the project's IRR presented by management to the Board. Despite some concerns in relation to the methodology employed and omissions of certain relevant data in the financial modelling, the Deed Administrators consider that at the time of approval of each capital project referred to above, the IRR for the project was at or around or exceeded the Board's IRR policy of 20% for approval of projects.
- 17.6.3 Prior to early 2004 ION did not have a robust framework for monitoring capital expenditure. In early 2004, there was a push for more discipline over capital expenditure and, by March

2004, there was a greater level of formality. A number of committees were established to monitor capital expenditure, such as the Capital Review Committee and the Capital Projects Committee.

Relevant projects

- 17.6.4 Between 2002 and 2004 the following capital projects were approved by the Board of ION:
- (a) on 27 May 2002 the Board approved a greenfield project for the establishment of a plant at Altona, Victoria to manufacture engine blocks (ie, the Altona Project);
 - (b) on 27 May 2002 the Board approved a greenfield project for the establishment of a plant at Wingfield, South Australia to manufacture alloy components for engines (ie the Wingfield Project); and
 - (c) on 31 March 2003 and 27 October 2003 the Board approved a brownfield project for the purchase and redevelopment of a facility at Warsaw, Kentucky in the United States to manufacture wheels for supply to Ford (ie, the Kentucky Project).

Process for approvals

- 17.6.5 The genesis of each capital project came from within the relevant division of ION. The division had to prepare a business case for any capital expenditure to be incorporated into a formal proposal to ION's Board. Once management had reviewed the proposal, it was taken to the Board for formal approval by the managing director with the support of personnel from the relevant division.
- 17.6.6 In considering proposals in relation to capital projects the Board assessed, among other things, the project's IRR, being a discounted cashflow methodology. ION had a policy that required management to demonstrate at the time of approval of a proposal for a capital project that it would yield a minimum IRR of 20%. The IRR policy appears in public documents such as the UBS Presentation and in a presentation by the managing director at the 2003 AGM.
- 17.6.7 In practice, the IRR policy appears to have been considered by members of the Board as a guideline or target, and there was a degree of flexibility around the benchmark number of 20%. The Board recognised that some projects might not produce this result and allowed themselves some discretion if there were other strategic reasons for the project to proceed.
- 17.6.8 Prior to June 2004 there were no written guidelines identified by the Deed Administrators governing the way in which proposals for new capital projects were to be presented to the Board.

Approvals for Altona Project

- 17.6.9 The Altona Project was approved initially in May 2002 on the basis of:
- (a) capital expenditure of \$91.25 million including land and buildings;
 - (b) an expectation that the project would generate an IRR of more than 20% assuming a sale and leaseback of the site;
 - (c) the manufacture of an initial 200,000 engine blocks per annum for Holden with the potential for the manufacture of additional engine blocks for Ford in the future;

- (d) annual revenue of approximately \$60 million for a period of 10 years commencing in January 2006 achieved based on sales to Holden.
- 17.6.10 More detailed information concerning the Altona Project (including in relation to the approvals process) is set out in section 19 below. This information reveals that ION's Board considered the IRR for the Altona Project as a relevant factor in giving its initial approval for the project.
- 17.6.11 The initial approval reflected an IRR of 18.9%, increasing to 21.7% assuming a sale and leaseback of the site with scope for further improvement subject to receipt of government funding. A revised financial analysis for Altona which projected an IRR of 21.9% was also tabled at ION's Board meeting on 26 August 2002.

Approval for Wingfield Project

- 17.6.12 Detailed information (including in relation to the approvals process) for the Wingfield Project is set out in section 20 below. The IRR for the Wingfield Project was considered by ION's Board as a relevant factor in giving its initial approval for the project.
- 17.6.13 The Wingfield Project was approved in May 2002 on the basis of:
 - (a) capital expenditure of \$38 million;
 - (b) an expectation that the project would generate an IRR of 48%; and
 - (c) annual revenue of \$64 million in the first year of operation, and \$75 million per annum thereafter.
- 17.6.14 The Deed Administrators have reviewed the methodology utilised by ION to calculate the IRR for the Wingfield Project and have restated the IRR to reflect various items that they consider should have been included in the original IRR calculation. On the restated basis, the Deed Administrators consider that the IRR for the Wingfield Project would have been 26%, thereby continuing to exceed the approval hurdle rate of 20% (see paragraph 20.3.8).

Approval for Kentucky Project

- 17.6.15 The Kentucky Project was approved in March and October 2003 on the basis of:
 - (a) capital expenditure of US\$55.3 million (purchase of land and fit out of the existing moth balled facility); and
 - (b) an expectation that the project would generate an IRR of +20%.
- 17.6.16 The Deed Administrators have reviewed the methodology utilised by ION to calculate the IRR for the Kentucky Project. While there are aspects of the methodology which the Deed Administrators consider not to be best practice, a restatement of the financial model using the appropriate methodology still results in an IRR of +20% for the Kentucky Project (see section 23 below).

Review of capital projects/monitoring capital expenditure

- 17.6.17 The Board kept itself informed about ION's capital projects through the managing director's reports and IAG's reports in the Board papers and discussions at Board meetings. There were also some project management reports in relation to the Altona Project provided to the Board from time to time.

- 17.6.18 From late 2003, there was an increased focus on control of capital expenditure as follows.
- (a) ION issued a Capital Expenditure Policy on 20 November 2003, setting out ordering procedures for the Altona Project and Kentucky. A general procurement contract was attached to the policy for purchasing use.
 - (b) The managing director's report for the December 2003 Board meeting refers to the formation of a Management Committee, to propose and implement policy and to formulate a procedural manual, which would include the control of capital expenditure. The Deed Administrators have been unable to locate any evidence that the Management Committee ever operated and believe it subsequently evolved into the Capital Projects Committee (**CPC**) in early 2004.
- 17.6.19 In January and February 2004, there was a push for more discipline over capital expenditure, and the Board wanted greater emphasis on capital control. This arose in part out of the commissioning problems being experienced at Wingfield at the time (see section 20 below). The CPC was established in February/early March 2004 and its inaugural meeting occurred in March 2004. The managing director or the chairman led the CPC. The purpose of the CPC (as reported to the Board at its February 2004 meeting) was to 'provide over-arching discipline in the manner in which capital expenditure control is exercised over major projects and how routine capital expenditure is managed and controlled.'
- 17.6.20 At one stage the CPC was meeting every week or every fortnight, but the meetings became less frequent. A typical meeting would consist of an update on the status of the capital projects and consideration of the actual capital expenditure and discussion of any major changes or cost overruns. The CPC did not formally report to the Board, but its reporting appears to have been encompassed by other management reports to the Board.
- 17.6.21 A Capital Review Committee (**CRC**) was established in May 2004. From that time the CRC was active in considering the capital expenditure requirements of the various capital projects. It is unclear whether the CPC and CRC were two separate committees, the same committee with two different names, or substitutes for one another. It is most likely that the CPC and CRC were separate committees. Our investigations indicate that the CPC was a 'lower level' management committee that focused on operational issues, while the CRC considered major capital expenditure.
- 17.6.22 Capital Expenditure Guidelines were developed in May and June 2004 and issued in June 2004. The Capital Expenditure Guidelines were further updated in August and September 2004 to include clear procedures for the accounting of capital costs. The Guidelines confirm that the CRC was mandated by the Board to oversee all capital projects within the Group, with the main focus being the projects undertaken by IAG (due to the large capital spend). The Guidelines establish:
- (a) an approval and authorisation process for budgeted and non-budgeted capital expenditure;
 - (b) documentation and verification requirements for requests for capital expenditure;
 - (c) financial analysis in support of capital expenditure proposals;

- (d) procedures for the acceptance of customer quotations involving capital expenditure;
 - (e) processes for capital expenditure management;
 - (f) stakeholder analysis for significant expenditure in excess of \$750,000, with a focus on permits from government authorities and government financial assistance; and
 - (g) post-implementation reviews.
- 17.6.23 In August 2004, an independent engineer (ie, Williams) was appointed by ION to review all of its major capital projects in terms of achievability, costs, timing and project management. The Final Williams Report was received on 21 October 2004 and confirmed the need for capital expenditure in relation to the projects at levels above those previously allowed by management and approved by the Board.

17.7 Policies and Practices

Overview

- 17.7.1 In relation to ION's policies and practices, the Deed Administrators have conducted investigations into the following:
- (a) accounting policies;
 - (b) corporate governance;
 - (c) disclosure policies and practices;
 - (d) risk management;
 - (e) audit committee; and
 - (f) internal audit.
- Of the areas investigated, the one of particular significance is the disclosure policies and practices (discussed in paragraphs 17.7.21 to 17.7.30 below).
- 17.7.2 A consequence of ION's expansion by acquisition was a lack of formal Group-wide policies and procedures. The company made attempts to address this issue in 2004.
- 17.7.3 Until November 2004, ION did not have a formal manual documenting the accounting policies and procedures to be followed by ION personnel. This may have led to divergent practices in the various divisions. In February 2004, the Audit Committee resolved that formal Group accounting policies be developed. However, these policies were not finalised until late November 2004. Despite this, the Deed Administrators have found no evidence to suggest that the absence of formal accounting policies had a significant impact on the accuracy of ION's financial reporting during the relevant period.
- 17.7.4 In early 2004, ION set about developing various Group-wide management controls. As part of this process, ION's Board approved a Corporate Governance Manual on 16 June 2004. The extent to which this manual was distributed is unclear. The introduction of the Corporate Governance Manual did not seem to make a substantial difference to the manner in which the company was being managed.
- 17.7.5 The Corporate Governance Manual contained a Disclosure Policy. Prior to the introduction of the Corporate Governance Manual, the Board considered disclosure issues at Board

meetings on an ad hoc basis. The managing director made decisions about disclosure, which he would sometimes discuss with the Board. The Board relied on management to inform them when they needed to consider something for disclosure. This practice continued after the Disclosure Policy was introduced, notwithstanding the formal procedure set down in the Disclosure Policy. The Disclosure Policy was not widely distributed and ION's directors, executives, officers and employees were not given training on disclosure obligations. Such training would have enabled them to understand the significance of whether an event or collection of events which caused a change in the forecast in the April Model might give rise to an obligation of disclosure to the financial market.

- 17.7.6 Risk management issues were discussed at an executive level. The directors identified key risk issues through their day-to-day management of the company and through Board papers. The Corporate Governance Manual contained Risk Management Guidelines and a Policy. The Risk Management Guidelines refer to the establishment of a Risk Management Committee. It appears that such a committee never formally met and there was not any significant change to ION's existing practices following the approval by the Board of the Corporate Governance Manual.
- 17.7.7 ION's Audit Committee managed the audit process with the external auditors. The Audit Committee does not appear to have conducted regular 'top-down' reviews of ION's financial controls and reporting processes and largely relied on the external auditor, Deloitte, to give it advice on these issues.
- 17.7.8 In October 2003 the CFO raised with the Board the issue of developing a more formal internal audit program. An employee was appointed in April or May 2004 to head up ION's internal audit function, but it appears to have taken some time to get the internal audit function operating. William Buck were ION's internal auditors for FY 2003. Their appointment may have ceased some time in FY 2004. William Buck was not active in that role. Overall, ION did not have a solid internal audit function in 2003 and 2004. An internal audit function may have identified issues such as the accounting treatment used by ION in respect of certain Wingfield production costs (see section 20.4 below).

Accounting policies

- 17.7.9 As at early 2003 ION did not have any formal accounting policies.
- 17.7.10 An external consultant, William Buck was engaged to conduct a review of the management accounting reconciliation processes used by some of ION's subsidiaries for the 9 months ended 31 March 2003. The report noted several deficiencies with those processes, which were subsequently rectified by ION.
- 17.7.11 In August 2003, the Audit Committee met and discussed the consultant's report and the preparation of a formal policies and procedures manual.
- 17.7.12 The lack of a formal policies and procedures manual was identified by Deloitte as an area for improvement in their Audit Review Summary Report for the Half-Year Ended 31 December 2003. On 18 February 2004, the Audit Committee resolved that formal ION Group accounting policies be developed by 30 April 2004.
- 17.7.13 The CFO's heavy workload appears to have been the reason why the formal practices and procedures manual was not finished during that time.

- 17.7.14 In its Report to the Audit Committee for the Financial Year Ended 30 June 2004, Deloitte maintained its recommendation that ION formalise its accounting policies and procedures. On 23 August 2004, the Audit Committee resolved that the completed accounting manual would be presented to the Audit Committee on or around 1 December 2004. A contractor was engaged in August 2004 to assist with the preparation of the policies.
- 17.7.15 By November 2004, draft corporate accounting policies had been circulated and accepted by relevant management, and had been circulated to the chairman of the Audit Committee, who had accepted them subject to some suggested amendments that were being incorporated.

Corporate governance

- 17.7.16 On 31 March 2003, the ASX Corporate Governance Council released the ASX Governance Principles. The ION Board first formally considered the application of the ASX Governance Principles at its June 2003 Board meeting.
- 17.7.17 The topic of corporate governance is addressed in ION's annual report for FY 2003. There are statements acknowledging that the directors are responsible for the corporate governance practices of the company and that the business of the company is managed by its Board and that the directors meet as a Board on a regular basis throughout the year, and as committees of the Board, to carry out the duties involved in the governance process. There is also a statement that ION endorses the policy of complying with ethical standards, accounting standards and ASX requirements in both the literal interpretation and the spirit of such standards and requirements.
- 17.7.18 The first evidence that the Deed Administrators could locate of the development of a corporate governance manual for ION is in January/February 2004. Around that time, the company secretary distributed an 'off-the-shelf' handbook on corporate governance for review by the directors. The handbook was a proforma prepared by a large law firm which the company secretary had developed to suit ION. In a report to the Board as part of the papers for the March 2004 Board meeting, the company secretary recommended that a part day workshop be conducted to agree issues for further work. While this workshop did not take place, at the Board meeting in May 2004, the Board requested some changes to the document.
- 17.7.19 ION's Board approved a Corporate Governance Manual at the Board meeting on 16 June 2004. A memorandum was distributed to senior ION personnel on 21 June 2004 confirming that the Board had resolved to adopt the ASX Corporate Governance Guidelines in full from 1 July 2004. It is unclear from the Deed Administrators' investigations which persons within ION were provided with a copy of the Corporate Governance Manual.
- 17.7.20 By August 2004, ION's management had requested that certain ION personnel complete a questionnaire regarding Corporate Governance and in August 2004 the Chairman of the Audit Committee suggested that ION include its corporate governance practices on its website, although it is unclear if this was done.

Disclosure policies and practices

- 17.7.21 There was no written disclosure policy at ION prior to 16 June 2004 other than what was contained in ION's 2003 Annual Report (a brief description that ION at all times endorsed the policy of complying with ASX requirements).
- 17.7.22 The practice within ION was for the managing director to have regular informal meetings with senior management at which key issues were identified. The managing director made decisions about disclosure, which he would sometimes discuss with the Board. Prior to June 2004 the Board considered disclosure issues at Board meetings on an ad hoc basis or the managing director would circulate issues by email to the non-executive directors who would be invited to comment.
- 17.7.23 The managing director would generally write the first draft of an announcement and circulate it to members of the Board. ION occasionally sought legal advice on disclosures, although the legal advice seems to have related more to the content and method of disclosure, rather than the need to give disclosure.
- 17.7.24 From 16 June 2004, ION adopted a Disclosure Policy as part of its Corporate Governance Manual. That Disclosure Policy established a Disclosure Committee, which had responsibility for:
- (a) ensuring that ION complied with its disclosure obligations;
 - (b) determining what information could or should be disclosed to the market;
 - (c) establishing procedures for the reporting of information for disclosure and monitoring compliance with the policy;
 - (d) overseeing and co-ordinating the disclosure of information to the ASX, shareholders, analysts, stockbrokers, media and the public; and
 - (e) educating officers and employees on ION's disclosure policy and procedures.
- 17.7.25 According to the Board Charter in the Corporate Governance Manual:
- (a) the Board is responsible for approving all financial reports and material reporting and external communications by ION in accordance with ION's 'External Communications Policy'; and
 - (b) the Board must supervise the public disclosure of all matters that the ASX recommends be publicly disclosed, consistent with the Disclosure Policy, and it must provide a commentary of any decision not to make such disclosure.
- 17.7.26 According to the Board Charter, it was a specific duty of the chairman, in consultation with the managing director, to approve and/or delegate authority for the approval of all material ASX and other investor and shareholder releases. Similarly, it was a specific duty of the managing director, in consultation with the chairman, to approve all material ASX and other investor and shareholder releases.
- 17.7.27 The Disclosure Policy describes the type of information that might trigger a disclosure and includes examples in an appendix. One such example is a change of 20-25% in ION's financial forecast or expectation. This is different to the large law firm's 'off-the-shelf' manual, which stipulates a 10-15% change (consistent with ASX Guidance Note 8). There

is no clear evidence why a 20-25% threshold was adopted in the Corporate Governance Manual.

- 17.7.28 There is no evidence to suggest that the Disclosure Committee ever formally met following its establishment. Despite the policy, the evidence indicates that the directors continued to consider issues on a case-by-case basis. That is, the Disclosure Policy appears never to have been put into practice.
- 17.7.29 The Disclosure Policy states that all directors, executives, officers and employees of ION must be issued with a copy of the policy and attend training programs. The evidence indicates that no such training programs took place (either before or after the issue of the Disclosure Policy), although there is a memorandum in June 2004 to various ION personnel indicating that the Board had adopted the ASX Corporate Governance Guidelines in full from 1 July 2004. It is unclear which of the officers, managers and senior personnel in the business units received a copy of the Disclosure Policy.
- 17.7.30 In ION's Annual Report for FY 2004, dated 17 September 2004, there is a statement that the Board authorises all disclosures necessary to ensure compliance with ASX Listing Rule disclosure requirements.

Risk management

- 17.7.31 Prior to 16 June 2004, there is no evidence of a formal risk management system or formal risk management policies being in place. Risk management issues were discussed at an executive level. The directors also identified key risk issues through their day-to-day management of the company and through Board papers.
- 17.7.32 Risk Management Guidelines and a Policy were adopted by ION as part of the Corporate Governance Manual on 16 June 2004. This appears to have been the first time that ION had a formal policy or guidelines concerning risk management. The Risk Management Guidelines state that the Board will establish a Risk Management Committee.
- 17.7.33 There is no evidence that the Risk Management Committee ever met formally prior to the appointment of the Administrators. There does not appear to have been any real change to the existing practice after the Risk Management Policy was approved.
- 17.7.34 The Deed Administrators have not found any evidence to suggest that the absence of a Risk Management Policy has an adverse impact on ION's operations during the relevant period.

Audit Committee

- 17.7.35 The Audit Committee was established in 2000. Its responsibilities (as described in ION's FY 2004 Annual Report) included overseeing:
- (a) the adequacy of ION's accounting system and internal control environment;
 - (b) the effectiveness of accounting controls;
 - (c) the identification of improvements to ION's internal controls, policies and financial disclosures; and
 - (d) the integrity and quality of ION's financial information, including financial information provided to ASIC, ASX and shareholders.

- 17.7.36 It appears that, in practice, the key role of the Audit Committee was to manage the audit process with Deloitte. The CFO was the Audit Committee's primary point of contact and was responsible for the preparation of consolidated statutory accounts.
- 17.7.37 The Audit Committee did not appear to have conducted regular 'top-down' reviews of ION's financial controls and reporting processes. The Audit Committee largely relied on the external auditor, Deloitte, to give it advice on these issues. The Audit Committee embarked upon a process of documentation of various policies and practices which ultimately led to the adoption by the Board in June 2004 of a Corporate Governance Manual.
- 17.7.38 It is unclear whether the Audit Committee actually looked at the integrity and quality of ION's financial information, including financial information provided to ASIC, ASX and shareholders. The members of the Audit Committee may have had some involvement in disclosure, but it was not a specific focus.
- 17.7.39 Minutes of the Audit Committee meetings were circulated to the Board, usually as part of the Board papers. The Minutes of Audit Committee meetings were usually noted in the Minutes of ION's Board meetings.

Internal audit

- 17.7.40 The chairman of the Audit Committee appears to have been responsible for ION's internal audit function during FY 2004. William Buck appears to have been engaged to act as internal auditor in FY 2003, although that firm was not very active. Their appointment may have ceased some time in FY 2004.
- 17.7.41 In October 2003, at the instigation of the new CFO, ION employed another contractor to look at control issues and reconciliations. The appointee subsequently became an employee in early 2004.
- 17.7.42 At the October 2003 Board meeting there was discussion about internal audit and of the reorganisation of the corporate finance area. The CFO raised the issue of developing a more formal internal audit program.
- 17.7.43 In late April or May 2004 an employee was appointed to head up ION's internal audit function, but it appears to have taken some time to get the internal audit function operating. ION did not have a solid internal audit function at the time of the appointment of the Administrators.

18. Albury

18.1 Introduction

- 18.1.1 The Albury business was acquired by ION in April 2002 and was the key manufacturing facility of IAS. It was one of ION's most important production sites and was a very significant contributor to the profits made by the ION Group as a whole.
- 18.1.2 The primary product manufactured at the Albury plant was a 4-speed transmission for sale to IAS' two major customers, Ford and SsangYong. It was intended by ION that Albury

would also produce 5/6-speed transmissions for sale to Ford and SsangYong, once those companies had made the switch from 4-speed transmissions.

18.1.3 ION also envisaged Albury manufacturing differentials and transfer cases for sale to Ford, Holden and other companies. It was also intended that Albury would, if ION was able to win the business, produce transmissions for Chinese automotive manufacturers.

18.1.4 The Deed Administrators' investigations into the Albury business has focussed on the following areas:

- (a) ION's transmission strategy (section 18.2);
- (b) Ford 4-speed transmissions (section 18.3);
- (c) Ford 6-speed transmissions (section 18.4);
- (d) Ford differentials (section 18.5);
- (e) Ford transfer cases (section 18.6);
- (f) SsangYong 4-speed transmissions (section 18.7);
- (g) SsangYong 5/6-speed transmissions (section 18.8);
- (h) Holden (section 18.9); and
- (i) China (section 18.10).

Each of these areas is dealt with in further detail below.

18.2 Transmission strategy

18.2.1 By 2003, ION (and its predecessor company) had been supplying transmissions to Ford for over 30 years and to SsangYong for over 5 years. ION understood that its 4-speed transmission would soon become outdated and, as a result, by early 2003, ION and its former owners had spent approximately 3 years and \$20 million developing a 5-speed transmission.

18.2.2 At this time it became apparent to ION that neither of its two key transmission customers (SsangYong and Ford) were interested in a 5-speed transmission and that this technology was already being overtaken by other developments in the transmissions market. In particular, in early 2003:

- (a) SsangYong informed ION that it wanted ION to continue supplying 4-speed transmissions; and
- (b) Ford informed ION's management that Ford was looking to use 6-speed transmission technology across its vehicle range and that a 5-speed transmission was not required.

In addition, in January 2003 Ford notified ION's management that it had contracted with one of ION's competitors (ZF Lemforder) for the supply of 40,000 6-speed transmission units per annum for high torque vehicles starting in mid 2005 (the timing of the Copperhead model upgrade).

18.2.3 It appears that in early 2003 Ford did not have a firm timetable in place for the move to use solely 6-speed transmissions for its vehicles, but was targeting the commencement of its Orion Program (in late 2007).

- 18.2.4 As a result of these developments, in early 2003, ION decided to develop a 6-speed transmission and by August 2003 the 5-speed transmission project had been suspended.
- 18.2.5 Commencing early 2003, ION explored two primary avenues for developing a 6-speed transmission:
- (a) the manufacture, under licence, by ION of a ZF Lemforder designed 6-speed transmission; and
 - (b) the development by ION of its own proprietary 6-speed transmission.
- 18.2.6 As at August 2003, ION remained uncertain as to when Ford would shift its entire product range to 6-speed transmissions, but understood that this would occur either during Ford's Orion (late 2007) or Cyclone (late 2009) programs.
- 18.2.7 Despite the efforts of ION and ZF Lemforder and the support of Ford, by approximately December 2003 ION and ZF Lemforder had determined that the proposed licence to manufacture 6-speed transmissions (utilising a joint venture structure) was not feasible on volume grounds. Its economic viability was dependent on having SsangYong also commit to 6-speed transmissions and despite indications from SsangYong that it intended to move to 6-speed transmissions, it declined to do so at that time.
- 18.2.8 It appears that the decision not to proceed with the joint venture resulted in the deferral, and then ultimately the cancellation (in approximately December 2003), of the proposed construction of an associated sequencing plant at Campbellfield (which was first proposed in mid-2003 and was to have, among other things, assembled ZF Lemforder 6-speed transmissions).
- 18.2.9 ION thereafter focused on its second option (which it had been developing in parallel) - to develop its own proprietary 6-speed transmission. Due to staff shortages and to buttress generally ION's in-house technical knowledge, an outside engineering consulting firm, Nautitech, was engaged to assist ION to develop its new transmission. In early 2004, ION and Nautitech pitched the resulting 6-speed transmission to Ford on at least two occasions. The pitch was against the backdrop of ION knowing that Ford's preferred strategy for the Orion Program involved utilising a ZF Lemforder designed 6-speed transmission for the majority of its transmission requirements.
- 18.2.10 In early 2004, ION also investigated the possibility of supplying upgraded 4-speed transmissions to Ford for its Orion Program. However, once it had become clear to Ford that such a transmission would offer very little cost advantage over ION's proposed 6-speed transmission, Ford lost interest in the proposal and ION focused on the sale to Ford and SsangYong of its proprietary 6-speed transmission.
- 18.2.11 ION held the belief that if it was successful in selling its 6-speed transmission to either Ford or SsangYong, the other would follow. From here, ION would be in a position to pitch to new customers in China.
- 18.2.12 Contemporaneously with the development of a 6-speed transmission, ION investigated the possibility of broadening the range of driveline products being produced at Albury to include, particularly, differentials and transfer cases.

18.3 Ford 4-speed transmissions

- 18.3.1 As at 2002, ION (and its predecessor company) had been supplying transmissions to Ford for over 30 years in accordance with various Memoranda of Understanding and supplemented by Target Agreements and Statements of Work.
- 18.3.2 On 21 February 2002, Ford and ION executed an MOU for the supply of 4-speed transmissions to Ford (the **Ford MOU**). At that time ION was to supply Ford's Barra program (which was to run from approximately 2002 to 2005) (**Barra Program**) and this MOU was to remain in effect and governed ION's supply of 4-speed transmissions to Ford for the Copperhead Program (approximately September 2005 to late 2007).
- 18.3.3 ION was to supply Ford with up to 115,000 4-speed transmissions per annum for Ford's Barra program.
- 18.3.4 Throughout 2004, Ford's actual demand for Barra program transmissions typically fell several hundred units short of forecast volumes per month. This had been an issue for ION since at least September 2002. ION expended considerable efforts in rectifying or limiting the shortfall, but little could be done because Ford was not contractually bound to take particular monthly volumes of transmissions and was itself faced with softening market conditions. This reduction in demand continued throughout 2004. As the chairman noted in his address to ION's 2004 AGM (on 26 October 2004):
- In our Automotive Group, solid performance was recorded from our core businesses for the full year to June 30 although some weakness in demand was seen late in the year. The lower demand for transmissions from the Albury plant has continued into the current financial year.
- 18.3.5 In January 2003 Ford notified ION's management that it had contracted with one of ION's competitors (ZF Lemforder) for the supply of 40,000 6-speed transmission units annually for the Copperhead Program for high torque vehicles (ie, the ZF Contract).
- 18.3.6 On or about 12 September 2003, ION and Ford executed a Target Agreement for the supply of 4-speed transmissions for the Copperhead Program (commencing approximately September 2005 and concluding approximately 1 January 2008). The Target Agreement provided for estimated annual target volumes (subject to market conditions) of 75,000 units (including transmission sales for use in the Ford Territory), which was a reduction of circa 40,000 units from ION's previous sales volumes to Ford of approximately 115,000 units per annum. This reduction in demand was directly attributable to Ford having entered into the ZF Contract for the supply of 40,000 6-speed transmission units annually for the Copperhead Program. The reduction in demand applied from the commencement of Ford's Copperhead Program in approximately September 2005. Based on ION's then current long term revenue forecasts (ie, the October Board Papers Forecast) the 40,000 unit reduction from September 2005 represented a reduction in FY 2006 and FY 2007 forecast revenue of 4.4% and 4.2% respectively.
- 18.3.7 ION subsequently took a number of steps in order to attempt to mitigate the effects of the ZF Contract. For example, analysts commented that ION's success in winning the Holden differentials contract could be viewed as a means to offset approximately half of the Ford Transmission contract that, it was speculated, would potentially be progressively lost between 2005 and 2008. Also, by February 2004 ION had negotiated a price increase of

\$48 per unit for its 4-speed transmission to partly compensate it for the loss of volumes to ZF Lemforder during the Copperhead Program.

- 18.3.8 On 20 October 2003, ION's managing director gave a presentation at the UBS Conference (ie, the UBS Presentation), which relevantly stated:

CUSTOMERS

Current

Ford Motor Company of Australia Ltd

Customer Since 1970

*Products	Transmissions, Alloy Wheels, Engine Crossmembers
*Supply Period	1970-2007
*Volumes (Units) Per Annum:	Transmissions - 100,000

...

CUSTOMERS

Future – Contracts Won Today - Ford

*Products	Sequencing transmissions – Territory program
*Start of Production	April 2004
*Contract period	3 years
*Initial Volume (Units) Per Annum:	16,000

- 18.3.9 The managing director's address at ION's 2003 AGM on 28 October 2003 was made in a question and answer format. It contained the following question and answer in relation to Ford transmission business:

Q. Ford to satisfy its customers will require 6-speed transmissions. ION will have to obtain technical cooperation to supply the product. This could result in margin loss and intellectual property loss.

A. ION has strong 4-speed technology and contracts with Ford and SsangYong to 2007 with expected continuing demand beyond and emerging demand from China for what is a proven world competitive, low cost profitable product. Sales and profits from 4 speed transmissions are set to continue for the next decade.

- 18.3.10 An indication of the downgraded Ford 4-speed volumes was provided in the February Presentation made on 19 February 2004. The presentation included a graph labelled 'IAG Revenue Path' which revealed an anticipated \$50 million decline in 'Transmission Old Customer' revenue between FY 2004 and FY 2006. This represented a reasonable estimate of the impact of the decline in Ford 4-speed volumes to 75,000 units per annum commencing during FY 2006.

- 18.3.11 On 12 March 2004, UBS released an analyst's report which stated:

ION currently supplies manual and 4-speed automatic transmissions to Ford Australia and SsangYong Motor Co...These two contracts are due to expire in late calendar year 2006...

The key risk we see is with the Ford contract and we rate ION's chances of renewing it as very low. The reason is that Ford are likely to move to a 6-speed transmission across all falcon engine variants and ION is not likely to be able to satisfy technical requirements.

Bell Potter Securities Limited reproduced the same report on 15 March 2004.

- 18.3.12 On 19 April 2004, there was speculation in an analyst's report released by Goldman Sachs JBWere that a key factor in the recent decline in ION's share price (down approximately 33 percent from 19 February 2004) was:

...the risk that Ford Australia may upgrade its transmissions from the 4-speed transmission currently supplied by ION to a 5- or 6-speed transmission supplied by a competitor...the potential loss of the entire Ford Australia transmission contract from F2005...is a "worst case" scenario... we actually put a low probability to ION losing the entire Ford Australia transmissions contract in F2005. We believe there are 2 more likely outcomes; (1) the contract is lost progressively over a number of years and (2) ION toll manufactures on behalf of a competitor but at potentially lower margins.

The report goes on to note that Goldman Sachs JBWere understood that Ford was 'actively considering an upgrade to a 5- or 6-speed transmission.'

- 18.3.13 On 27 April 2004, ION issued the April Guidance, stating:

Current contracts to supply Ford Australia with 4-speed automotive transmissions are firm until 2008. ION believes it is well placed to retain all Ford business relative to its product range beyond 2008.

- 18.3.14 On 27 April 2004, Goldman Sachs JBWere made the following comment in relation to the April 2004 Guidance:

We understand that ION has not received any indication from Ford Australia that suggests that they will retain their contract in the event Ford moves to 6-speed transmissions. The purpose of the statement was to clarify to the market that, contrary to press speculation, ION had not lost the Ford Australia 4-speed transmissions contract.

- 18.3.15 On 28 April 2004, JP Morgan issued an analyst's report about ION titled 'Trading Update – Earnings Downgrade', which states of ION:

Ford Transmissions

It stated that Ford transmission contracts are firm until 2008 and it is confident of retaining these beyond 2008. We are very confident that it will not retain these contracts beyond 2008 and it is important to note that the contracts gradually tail off towards 2008 (from 2006).

The first contract which is likely to be lost is the transmissions for the High Torque engine Falcon derivatives. This represents around 7% of the contract or 20,000 units. We presume that Ford will progressively offer a 6-Speed transmission as an option on all models toward 2008.

- 18.3.16 On 1 July 2004, Ford informed ION that Ford's present revised estimated forecast volumes for the Copperhead Program (scheduled to commence in approximately September 2005) was approximately 61,175 units per annum. ION intended to address this reduction in volume by increasing the transmission unit price previously quoted to Ford.
- 18.3.17 ION's Annual Report, dated 17 September 2004, stated that 'ION holds contracts with Ford of Australia until 2008...'
- 18.3.18 On or about 13 October 2004, ION prepared a document titled 'Revised Presentation to [Purchaser]' (apparently without the involvement of the Board or CFO), which notes that 'since compiling the MOU, demand from Ford has softened marginally' and states that 'Ford has indicated they will be progressively changing their sourcing to ZF [Lemforder] with demand diminishing in the period to 2008'.

18.3.19 An email sent from Ford to ION's management on 22 October 2004 attaches a revised Memorandum of Understanding and states that this would cover the supply of transmissions 'to last Job Copperhead Falcon & last Job Copperhead Territory, which is expected to occur by March 2008 & Sept 2008 respectively'. This is consistent with the supply of 4-speed transmissions to Ford ceasing at the end of Ford's Copperhead Program.

18.3.20 On 29 October 2004, Shaw Stockbroking Limited issued an analyst's report which stated that ION's '4 speed transmission contracts with Ford...expire in 2007-08'.

18.4 Ford 6-speed transmissions

18.4.1 As mentioned above, by January 2003, Ford had contracted with one of ION's competitors (ie, ZF Lemforder) for the supply of 40,000 6-speed transmission units annually for the Copperhead Program (ie, the ZF Contract).

18.4.2 By early 2003 it was clear to ION that Ford was not interested in ION's 5-speed transmission and intended to move directly to a 6-speed transmission. As a result, in early 2003 ION began to develop a 6-speed product in order to compete for the next round of transmissions business from Ford – being the Orion Program (approximately late 2007 to late 2009).

18.4.3 In early 2003 ION met with Ford to discuss what business opportunities existed for ION with Ford, particularly in relation to 6-speed transmissions. At the time of this meeting Ford was in the early stages of reviewing its drivetrain strategy for the Orion Program (which was to commence production in late 2007). Ford's product development timetable required Ford to make a final sourcing decision for a 6-speed transmission supplier by mid-2004.

18.4.4 Commencing in 2003 (and without ION's knowledge), Ford began to consider informally the possibility of ceasing its commercial arrangements with ION and by approximately mid-2004 Ford had in place a formally documented planning process for the possible termination of the ION relationship.

18.4.5 Ford was aware that if it ended its relationship with ION, this would potentially have serious ramifications for the viability of ION's Albury plant and in turn might jeopardise ION's supply of 4-speed transmissions to Ford. Moreover, Ford wanted to avoid prejudicing its negotiating position with ZF Lemforder (ION was the only competing transmissions supplier). Accordingly, Ford's review of its relationship with ION was undertaken on a highly confidential basis within Ford and Ford was very careful in its communications with ION, even as it became increasingly clear within Ford during 2004 that its longer term strategy lay with moving away from ION.

18.4.6 Ford informed two of ION's managers during discussions on a number of occasions that Ford was prepared to work with ION to explore opportunities to supply components other than transmissions and was prepared to give ION the opportunity to put forward a business case in relation to these other product lines. In particular, transfer cases and differentials were discussed as potential replacement business for the 6-speed transmission program, should ION be unsuccessful in its bid for the 6-speed contract.

- 18.4.7 On 21 October 2003, JP Morgan issued an analyst's report which noted that 'the loss of the Ford Transmission contract looks increasingly likely (ie, no ION contract manufacturing involvement with ZF)'.
- 18.4.8 On 28 October 2003, the managing director in his address to ION's 2003 AGM relevantly stated:
- ION has not lost the 6-speed transmission business. Ford are yet to make their decisions. ION believes it will be a participant when awarded.
- 18.4.9 While ION met with Ford in January 2003 to discuss the supply of 6-speed transmissions, it appears that it was not until late 2003 and then into 2004 that ION began a concerted campaign to win 6-speed transmission business from Ford. In November 2003, a meeting was held between Ford and ION at ION's offices in Richmond, at which the parties discussed ION's future strategy and ION gave a short presentation in relation to its proposed 6-speed transmission. It appears that Ford reacted with surprise when informed that ION intended to produce a 6-speed transmission (given that it had taken ION three years to develop its 5-speed transmission).
- 18.4.10 On 28 January 2004, the Australian Financial Review published an article titled 'ION to Consolidate Growth' which stated:
- Another deal that may be changing is ION's contract with Ford Australia to supply four-speed transmissions, with industry speculation that it may lose out to ZF if Ford moves to six-speeds.
- "It's up to Ford to tell the world what they're going to do with their transmissions", Mr Salthouse said.
- This article was consistent with ongoing media speculation about whether ION would secure the 6-speed contract with Ford.
- 18.4.11 During February and March 2004, ION's management had a number of discussions with Ford in relation to opportunities for ION to supply 6-speed transmissions and other components to Ford. On 27 February 2004, ION met with Ford's engineering personnel and presented its 6-speed transmission.
- 18.4.12 Despite Ford's stated preference to use a ZF Lemforder 6-speed transmission for the majority of its Orion vehicle range, ION continued to pitch its 6-speed transmission design to Ford with a view to supplying 6-speed transmissions at the Orion stage. ION's strategy for changing Ford's position, partly rested on the significant cost saving which its 6-speed transmission offered over the competing ZF Lemforder product.
- 18.4.13 At a further meeting with Ford on 2 March 2004, there were additional discussions regarding ION's proposed 6-speed transmission. At this meeting ION set out in more detail its proposal to develop and supply its own proprietary 6-speed transmission and noted that the transmission would be an extension of its existing 4-speed transmission, rather than the development of an entirely new transmission. Ford informed ION that it would only be prepared to retain ION as a supplier of 6-speed transmissions for the Orion Program if ION produced a ZF Lemforder 6-speed transmission. Ford reiterated this position in a number of later telephone conversations with members of ION's management.

- 18.4.14 Despite this feedback from Ford, ION nevertheless sought to convince Ford that it had the capability to develop its own 6-speed transmission model to meet Ford's requirements.
- 18.4.15 Ford's views were split between its engineering personnel (who did not believe that ION had the capability to produce a 6-speed transmission to meet Ford's technical requirements within the available time) and its purchasing division (who were more focused on the significant cost advantage, in the order of 25%, which ION's transmission offered over the competing ZF Lemforder product).
- 18.4.16 The resistance of Ford's engineering personnel to ION's proposed 6-speed transmission was a feature of each meeting between the two companies, including the final 6-speed specific meeting on 4 March 2004 between ION and Ford US's transmission engineering experts. Representatives of ION and Nautitech (ION's 6-speed development partner) travelled to the US for this meeting.
- 18.4.17 Despite the negative sentiment of Ford's engineers (in both Australia and the US) and management (who made it clear that Ford would only consider an ION 6-speed transmission if it was based on a ZF Lemforder design), ION remained focused on obtaining at least some of Ford's 6-speed business. A detailed engineering report issued by Ford US's engineers in March 2004, following the meeting in the US, noted that 'ION/Nautitech have a good start on what can be a fine transmission... We also have extremely low confidence that the timing is credible. The transmission will require significant development time that is not adequately represented in the current ION plan.'
- 18.4.18 While ION's management received the Ford US engineering report, the evidence indicates that ION's Board was not made aware of the contents of the engineering report. Instead, the Board was advised in the managing director's report for February 2004 (dated 11 March 2004), that ION had presented to Ford in the US and that 'Ford was exhibiting strong interest in the product'.
- 18.4.19 ION's management was aware that while Ford's engineering personnel were not receptive to ION's proposed 6-speed transmission, ION had strong support from the purchasing division of Ford who were naturally more focused on the significant cost advantage which ION's transmission offered. Furthermore, ION understood (possibly incorrectly) that Ford US's view would not necessarily dictate the final sourcing decision.
- 18.4.20 Discussions between Ford and ION in relation to Ford's 6-speed business appear to have taken place without ION ever receiving a Request for Quotation or Statement of Works from Ford. This was because Ford only issued Requests for Quotation to prospective suppliers to formally request costing and other technical information for a project and the issuing of a Request for Quotation indicated Ford's intention to solidify its interest in dealing with a potential supplier. ION's proposal to supply 6-speed transmissions never approached the stage at which Ford was prepared to issue a Request for Quotation and Ford made this clear to ION during discussions with ION management.
- 18.4.21 After March 2004, ION continued to discuss its 6-speed proposal with Ford, but these discussions occurred during Ford and ION's regular meetings in relation to the existing 4-speed transmission supply agreement (ie, as opposed to being specifically scheduled to discuss ION's 6-speed transmission).

- 18.4.22 As noted above, on 12 March 2004, UBS released an analyst's report which stated as follows:

The key risk we see is with the Ford contract and we rate ION's chances of renewing it as very low. The reason is that Ford are likely to move to a 6-speed transmission across all falcon engine variants and ION is not likely to be able to satisfy technical requirements. ION's expertise is in 6-cylinder engines. Ford has also been linked to other suppliers of late. We estimate the revenue value of this contract at \$150-160m.

Bell Potter Securities reproduced the same report on 15 March 2004.

- 18.4.23 On 15 March 2004, ION's management gave a presentation to the Board successfully seeking approval for \$2.2 million in capital expenditure for the construction of initial prototype 6-speed transmissions, with a view to having the prototypes built by the end of April 2004. The slides which accompanied the presentation stated in part:

Risks

Ford are committed to a global strategy which is not ION at this time. Opportunity does exist. Once the design is proven it will then be offered to Ford as a low cost 6 speed option for their 6 cylinder vehicle range.

- 18.4.24 This is consistent with the option suggested by ION to Ford that Ford utilise ZF Lemforder's 6-speed transmission for its high end vehicles, but ION's cheaper transmission for the remainder of its vehicles. The evidence indicates that by this time ION had accepted that, at best, it would obtain only a proportion of Ford's 6-speed business for the Orion Program (because ZF Lemforder would supply 6-speed transmissions for Ford's high end vehicles).

- 18.4.25 On 19 April 2004 Goldman Sachs JBWere issued an analyst's report which attempted to quantify the impact on ION's share price of the potential loss of the Ford transmissions contract. The report was based on a worst case scenario, being the loss of the entire contract from FY 2005. It estimated that the contract was worth approximately 58 cents per ION share and, if lost, could reduce their DCF valuation to \$1.57 per share. The report stated that, more importantly, if ION did lose the contract it may result in serious implications for the company's balance sheet and cash flow position. It noted that a key factor weighing on the stock was the risk that Ford may upgrade its transmissions from the 4-speed transmission currently supplied by ION to a 5 or 6-speed transmission supplied by a competitor. A low probability was placed on ION losing the entire Ford transmissions contract in FY 2005, one of the more likely outcomes being that the contract would be lost progressively over a number of years.

- 18.4.26 On 27 April 2004, ION issued the April Guidance which included the following statement:

Current contracts to supply Ford Australia with 4-speed automotive transmissions are firm until 2008. ION believes it is well placed to retain all Ford business relative to its product range beyond 2008.

- 18.4.27 On 27 April 2004, Goldman Sachs JBWere issued an analyst's report about ION titled 'Company update – but still no word on Ford contract', which relevantly stated:

FORD AUSTRALIA TRANSMISSION CONTRACT

ION today reassured the market that it had not lost its contract to supply 4-speed transmissions to Ford Australia. ION said that 'current contracts to supply Ford Australia

with 4-speed automatic transmissions are firm until 2008. ION believes it is well placed to retain all Ford business relative to its product range beyond 2008.'

In other words, Ford will buy any 4-speed transmissions it needs from ION until 2008. However, we do not believe this statement provides any new information regarding whether ION will have a role to play in the supply of transmissions to Ford Australia if Ford chooses to upgrade to a 5/6-speed transmission. We believe there remains a risk that if (and when) Ford upgrades its high torque models to a 5/6 speed transmission, it will buy them from another supplier. We do not expect any clarification of this issue until Ford Australia makes its plans clear. The timing of this remains uncertain.

- 18.4.28 On 28 April 2004, JP Morgan issued an analyst's report about ION titled 'Trading Update – Earnings Downgrade', which relevantly stated:

Ford Transmissions

It [ION] stated that Ford transmission contracts are firm until 2008 and it is confident of retaining these beyond 2008. We are very confident that it will not retain these contracts beyond 2008 and it is important to note that the contracts gradually tail off towards 2008 (from 2006).

- 18.4.29 There was a view within ION that ION's prospects of securing 6-speed transmission business with Ford beyond 2008 hinged substantially on its success in winning 6-speed transmission business with SsangYong. This is significant because by 12 May 2004, ION was aware that even if it was successful in securing 6-speed transmissions business with SsangYong, production would not commence until September 2006 (for SsangYong's limited export market) and January 2008 (for SsangYong's domestic market) (see paragraph 18.8.18) and no decision would be made on a supplier until August or September 2004 – which was the same timeframe as when Ford was expected to make its 6-speed sourcing decision.
- 18.4.30 During the period March to August 2004, Ford developed a clear preference to use ZF Lemforder 6-speed transmissions and to enter into a supply contract with ZF Lemforder but it did not communicate this to ION. Until Ford had reached satisfactory terms with ZF Lemforder, Ford did not move to terminate its occasional discussions with ION in relation to ION's proposal to supply 6-speed transmissions.
- 18.4.31 It appears that by July 2004, ION's proposal to supply 6-speed transmissions to Ford had progressed to the point of fitting an ION owned Ford vehicle with a prototype ION 6-speed transmission.
- 18.4.32 In early August 2004, in order to showcase the performance and capability of ION's 6-speed transmission, ION arranged for Ford's personnel to test drive the ION owned Ford vehicle fitted with the prototype.
- 18.4.33 On 10 August 2004, Ford emailed ION declining the offer of the test drive, ostensibly due to 'issues with availability of people'. This was consistent with Ford's preference to award the entirety of its 6-speed business to ZF Lemforder. However, consistent with its approach at that time, Ford did not communicate any final sourcing decision to ION because of the risk that it might prejudice production of 4-speed transmissions at ION's Albury plant, and/or adversely impact its negotiating position with ZF Lemforder.

- 18.4.34 The email from Ford dated 10 August 2004 stated that due to 'issues with availability of people' the test drive should be cancelled and 'arrangements be made for a less structured drive event early September for myself and possibly one or two others when our calendar pressure is less intense'.
- 18.4.35 Consistent with its view that the 6-speed contract with Ford had not been lost, ION appears to have remained in contact with Ford in the weeks after the test drive was cancelled (however all such meetings with Ford took place, as they had since March 2004, in the context of the regular meetings held to discuss the existing 4-speed transmission supply agreement, as opposed to being specifically scheduled to discuss ION's 6-speed transmission).
- 18.4.36 No significant new information about ION's prospects of winning the Ford 6-speed transmission business was provided to the Board between the publication of the April Guidance on 27 April 2004 and September 2004 (ie, IAS management maintained its positive stance).
- 18.4.37 On the afternoon of 9 September 2004, at Ford's request, two of ION's managers attended a meeting at Ford's head office and were informed that Ford had selected ZF Lemforder as the supplier of 6-speed transmissions for the Orion Program and that Ford's decision was final. Ford also stated that it had decided to produce 6-speed models from the beginning of the Orion Program in March 2008 and as a result Ford would not continue purchasing 4-speed transmissions from ION beyond March 2008.
- 18.4.38 The message from Ford was clearly understood by the two attending ION managers and, consistent with it, there were no relevant further discussions or meetings with Ford regarding ION's proposal to supply 6-speed transmissions for the Ford Orion Program (excluding a final meeting on 8 December 2004, after the appointment of the Administrators, at which Ford repeated its decision).
- 18.4.39 By 13 September 2004, ION's managing director was aware of the outcome of the meeting with Ford. ION's managing director considered that it was necessary to investigate this information further with the ION managers involved in order to determine its significance and, in particular, whether it represented Ford's final decision or was merely a negotiating tactic. From 13 to 19 September 2004, the two ION managers who attended the meeting with Ford were in China on business. There is no evidence that the managing director discussed this matter further prior to 22 September 2004 – the day of the Board's September meeting.
- 18.4.40 The remainder of ION's Board, with one possible exception, were not aware of the matters arising from the meeting with Ford on 9 September 2004 until either the 22 September 2004 Board meeting, or in the period immediately prior to the meeting while reviewing the Board papers for the meeting which relevantly included the following statement:

Orion Program

ION has been advised that our transmission business with Ford will cease at the Orion platform.

This statement was included on page 12 of the 39 page IAG management report for August dated 10 September 2004 and not given any particular prominence either in the IAG report or the Board papers generally.

- 18.4.41 While contrary evidence does exist, overall, the evidence indicates that at the 22 September 2004 Board meeting ION's Board was informed by the more senior of the two ION managers who had attended the meeting with Ford, that it remained unclear whether ION had been unsuccessful in securing the Ford 6-speed transmissions contract and that further investigations were required to confirm the position.
- 18.4.42 As a result of the uncertainty surrounding the status of ION's efforts to secure 6-speed business with Ford, the Board instructed the manager in question and the managing director to contact Ford to clarify the position.
- 18.4.43 It was also decided by the Board that any discussion of a possible public announcement be deferred pending confirmation of whether ION had in fact failed to secure 6-speed business with Ford (a number of other factors were also considered by the Board in this respect, including that the Ford 6-speed business was not due to commence for four years).
- 18.4.44 Following the 22 September 2004 Board meeting (and up to the date of appointment of the Administrators on 7 December 2004), there were no further Board discussions concerning the Ford 6-speed business or whether ION should make a formal announcement about the (possible) loss of that business.
- 18.4.45 On 23 September 2004, one of ION's managers attended a meeting with Ford. At the meeting there was discussion about the making of a public announcement about Ford's decision in relation to the 6-speed transmission supply contract for the Orion Program. ION informed Ford that it was comfortable with a public announcement being made but that it did not intend to make an announcement about the matter at that time. There is no evidence that the Board was advised of the matters discussed at this meeting.
- 18.4.46 On 24 September 2004, Citigroup Smith Barney issued an analyst's report about ION, which relevantly stated:
- While many will no doubt seek to pick a bottom in the stock, we argue that this is a dangerous game given the operational challenges still facing the business:
- ...
- Uncertainty over transmission business – significant uncertainty remains regarding forward transmission arrangements with key customers, SsangYong and Ford. Both companies are anticipated to progress future models to 5/6 speed transmission platforms and, while ION continues to lobby for this business, its upside appears limited (with success arguably resulting in the company returning to FY 2003 volumes) while the downside appears significant (we estimate that failure to win both these contracts could result in a loss in excess of 60% of current group EBIT) ...
- 18.4.47 On or about 13 October 2004, a document was prepared by ION (apparently without the involvement of its Board or the CFO) titled 'Revised Presentation to [Purchaser]' which relevantly included the following statement:
- Ford has indicated they will be progressively changing their sourcing to ZF with demand diminishing in the period to 2008.

- 18.4.48 On 22 October 2004, Ford sent an email to one of ION's managers attaching revisions to the Ford MOU, which confirmed that the parties' transmissions business would terminate at the conclusion of the Copperhead Program (ie, during 2008).
- 18.4.49 On 26 October 2004, ION held its 2004 AGM and ION's CEO relevantly made the following statements:
- An example of success was properly resourcing our new 6-speed development project and rapidly getting prototypes into our customers' cars. ...
- In the third two-month period we plan to: ...secure 6-speed transmission orders.
- 18.4.50 ION's chairman in his address to shareholders at the 2004 AGM relevantly stated:
- We are also proud that the Six Speed Automatic Transmission, currently under test with customers, recently won the prestigious Engineering Excellence Award from the Institute of Engineers, Australia.
- 18.4.51 At a presentation at the Citigroup Conference on 10 November 2004, ION stated that '6-speed prototypes [were] currently being tested by potential customers'.
- 18.4.52 In November 2004 ION's Managing Director contacted Ford in order to arrange a meeting to discuss 6-speed transmissions. The subsequent meeting was held on 8 December 2004 (after the appointment of the Administrators) and at the meeting Ford confirmed its decision to award the entirety of its 6-speed business to ZF Lemforder.
- 18.4.53 On or around 15 December 2004, ION's managing director received an email from Ford in response to the 8 December 2004 meeting, confirming that Ford would use an alternative 6-speed transmissions supplier for the Orion Program.

18.5 Ford differentials

- 18.5.1 In October 2003, ION successfully quoted for a five year agreement to supply Holden with ZF Lemforder differentials, to be manufactured under licence at ION's Albury manufacturing plant. The contract was for ION to supply Holden with 180,000 differentials per annum (annual revenue of approximately \$68 million), commencing in approximately April 2006. The contract was part ION's strategy to broaden the range of driveline products being manufactured at ION's Albury manufacturing plant to extend beyond transmissions.
- 18.5.2 In late 2003, ION was aware that Ford was not entirely satisfied with the differential product being supplied by its competitor, Dana Australia. In light of this and given its success in winning the Holden differentials contract, IAS management decided to pursue the opportunity to supply differentials to Ford.
- 18.5.3 On 20 October 2003, ION's managing director gave a presentation at the UBS Conference (ie, the UBS Presentation), which relevantly stated:
2. New Business Secured
- ...
- Differential licensing deal with world renowned producer – announcement pending
 - Quoting for additional differential business
 - Albury potential new supplementary business \$140m
- ...

Major Capital Projects – New Revenue Pending

...

Automotive	Spending (\$m)	Revenue (\$m)
Differential project		
• 2005/06	40-50	140

- 18.5.4 On 21 November 2003, ION provided Ford with a quotation for the supply of differentials for Ford's Copperhead Program with a start of production in January 2007 (timed as a 'running change' for the Ford Copperhead Program which was due to commence in mid-2005), an estimated volume of 110,000 units per annum and a supply period of five years. Both the start of production and estimated volume changed repeatedly during the subsequent negotiations.
- 18.5.5 The differentials were to be manufactured by ION under licence from ZF Lemforder.
- 18.5.6 The quotation submitted by ION was for rear differential units (**RDU**) for vehicles with independent rear suspension systems (this comprised the bulk of Ford's differential requirements). In early 2004, Ford requested that ION prepare an additional quotation for a beam axle differential unit (this product involved differentials and beam axles being presented as a single unit for vehicles without independent rear suspension systems (**Beam Axle/Differential Unit**)). ION's management understood that Ford made this request because it intended to award the RDU and Beam Axle/Differential Unit contracts to the same supplier (this was currently Dana Australia).
- 18.5.7 By mid-February 2004 ION had received informal oral feedback from Ford's engineering personnel that ION's quotation was attractive to it.
- 18.5.8 On 19 February 2004, ION released its results for half year to 31 December 2003. In the accompanying February Presentation, ION indicated that its total differentials revenue was expected to increase by \$90 million between 2004 and 2007.
- 18.5.9 On 27 April 2004, ION issued the April Guidance, which relevantly stated:

New Products – Albury

...

In addition to the 5/6 speed transmission, ION has developed a differential and in 2003 was awarded a 5 year contract to supply the Holden Commodore with differentials from 2006. Current capital cost estimates are approximately \$19m. This new product development is in line with our strategy for diversification at Albury. It is expected that further differential contracts will be won and that transfer cases for AWD/4WD applications will be added to the product range.

The April Guidance did not include any forecast information for Ford differential sales.

- 18.5.10 On 4 May 2004, ION issued an ASX release stating:
- All plants are being built against long term supply agreements. It is revenue from these new contracts and other "brownfield investments" for differentials and 6-speed transmissions, when introduced, which will provide future success and profitability.
- 18.5.11 Base case forecasts, dated 26 May 2004 and prepared for the May IM, forecast differential revenues of:

- (a) \$68.2 million in FY 2007; and
 - (b) \$88.2 million in FY 2008.
- 18.5.12 While the forecasts do not include a breakdown of revenues on a customer basis, forecast revenues from the sale of differentials to Ford (calculated by deducting Holden differential revenue from total differential revenue) appear to be:
- (a) \$0 in FY 2007; and
 - (b) \$20 million in FY 2008.
- 18.5.13 On 18 June 2004, ION submitted a quotation to Ford with respect to the Beam Axle/Differential Units based on a contract period of 5 years with an estimated annual volume of 30,000 units.
- 18.5.14 On 28 July 2004, an employee of ION met with Ford and was informed that while the RDU quotation was price competitive, the quotation for the Beam Axle/Differential Unit was uncompetitive because of the high unit cost of the beam axle component. For this reason, Ford rejected both ION differential quotations. ION's management was made aware of the outcome of the meeting and the fact that further discussions were to take place between ION, ZF Lemforder and Ford in an attempt to improve the competitiveness of the Beam Axle/Differential Unit quotation.
- 18.5.15 IAS management commenced work to reduce the price of the Beam Axle/Differential Unit. In addition, IAS management held a number of engineering meetings with Ford and ZF Lemforder to address engineering concerns which Ford had about the Beam Axle/Differential Unit and associated potential warranty issues.
- 18.5.16 On 24 August 2004, ION issued an announcement to the market in connection with its results for the financial year ended 30 June 2004, titled 'ION Achieves Improved Trading Profit' (ie, the August Announcement), which states:

FUTURE OUTLOOK

The company has a well defined growth path for the immediate future based on the 4 major organic growth initiatives of

...

- drive line products including 5 and 6 speed transmissions, differentials and transfer cases at Albury, New South Wales.

- 18.5.17 Despite ION's efforts to address Ford's concerns, by 26 August 2004 (following a meeting with Ford), it appeared unlikely that ION would win this contract, although a formal decision was not expected from Ford for another two weeks. By the end of September, however, ION had been informed that both of its quotations had been formally rejected by Ford.
- 18.5.18 Following the rejection of its two quotations, ION shifted focus to the supply of differentials for Ford's Orion Program (which was due to commence in 2008). ION attempted to capture this business by co-operating with ZF Lemforder to develop a complete suspension module for Ford's Orion vehicles and thereby entirely replace Dana Australia as Ford's differential and rear suspension unit supplier (this was referred to as the 'second attack' proposal).

18.5.19 ION and ZF Lemforder held a number of meetings in relation to the 'second attack' proposal, but by late November / early December 2004 the two companies had concluded that the proposal was not feasible and as a result ION's plans to supply differentials to Ford ended.

18.5.20 Nevertheless, on or about 24 November 2004 ION received three Request for Quotation packages from Ford in relation to differentials and beam axles for the Orion Program. ION submitted quotations in response to these Request for Quotation packages after the appointment of the Administrators on 7 December 2004.

18.6 Ford transfer cases

18.6.1 During the period mid to late 2003, ION determined that it wanted to quote for Ford's transfer case business (estimated at 16,000 units per annum and commencing at Ford's Copperhead model update in mid 2005). This was part of ION's strategy to broaden the range of driveline products being produced at Albury to extend beyond transmissions.

18.6.2 Consistent with this strategy, on 19 November 2003 ION gave a presentation to Ford concerning, among other matters, potential opportunities for ION to supply Ford with a wide variety of components, including transfer cases.

18.6.3 It appears that ION never received a 'Request for Quotation' document from Ford setting out transfer case specifications for the Copperhead Program, but despite this, ION submitted a quote for Ford's Copperhead Program transfer case business on 23 January 2004.

18.6.4 ION never received a formal response from Ford to its quotation. During 2004 discussions continued between ION and Ford concerning opportunities for ION to supply transfer cases to Ford. It is unclear when ION first determined, or should have determined, that its bid for Ford's Copperhead transfer case business had been unsuccessful. On balance, the available evidence supports the view that ION gained the requisite knowledge by late September 2004.

18.6.5 Following the loss of the Copperhead Program transfer case business, from around October 2004 ION briefly considered instead pitching its transfer cases to Ford for its Orion Program (with a 2008 start of production date). On or about 13 October 2004 in a presentation to a potential purchaser of the IAS business, ION stated:

It is however, likely that the transfer case business will commence with Ford before the 07/08 period with technical discussions currently proceeding...

However nothing seems to have come of this prior to the appointment of the Administrators on 7 December 2004.

18.6.6 During 2004 ION made some general statements to the financial market concerning its attempts to secure transfer case business, but these were not specific to Ford. In particular:

- (a) the April Guidance, dated 27 April 2004, states that ION expected transfer cases for AWD/4WD applications to be added to its product range. However the forecasts that were prepared by ION to support this market announcement did not include any potential volumes for Ford transfer cases during FY 2005 and FY 2006.

- (b) the August Announcement, dated 24 August 2004, states:

FUTURE OUTLOOK

The company has a well defined growth path for the immediate future based on the 4 major organic growth initiatives of

...

- drive line products including 5 and 6 speed transmissions, differentials and transfer cases at Albury, New South Wales...

- (c) the ION 2004 Annual Report, dated 17 September 2004, states that ION has identified transfer cases for potential four wheel and all wheel drive customers, as a product to add to its range.

18.7 SsangYong 4-speed transmissions

- 18.7.1 Since 1997, ION (and its predecessor companies) had been supplying 4-speed transmissions to SsangYong under a Supply Agreement dated 15 October 1997 (**1997 SsangYong Supply Agreement**).
- 18.7.2 The 1997 SsangYong Supply Agreement concluded on 31 December 2002, however a retrospective extension by exchange of letters was executed on 3 July 2003 in order to allow the agreement to continue in effect until a new supply agreement was executed.
- 18.7.3 A draft of a new agreement was prepared by ION during the second half of 2003 (**Draft SsangYong Agreement**) and had a proposed termination date of 31 December 2007. It appears that the Draft SsangYong Agreement was never executed by the parties and, in fact, may not even have been provided to SsangYong. Accordingly, the 1997 SsangYong Supply Agreement appears to have remained in effect throughout 2003 and 2004.
- 18.7.4 The 1997 SsangYong Supply Agreement envisaged that ION would supply a maximum of 100,000 4-speed transmissions per annum to SsangYong (although the estimate included in the agreement was approximately 40,000 to 60,000 units per annum). Rather than providing for SsangYong to purchase fixed annual volumes, the 1997 SsangYong Supply Agreement included volume bands which adjusted the unit price by reference to the annual sales volume. The evidence indicates that in the automotive parts industry it was common for customers to adjust volume demand with their suppliers in order to accommodate their own production and sales requirements. This applied to ION's relationship with SsangYong both before and during 2004. During 2003 and 2004, ION's forecast 4-speed transmission sales to SsangYong fluctuated in accordance with SsangYong's forecast vehicles sales. SsangYong would amend forecast demand levels from month to month by incorporating them into shipment schedules and ION would then seek to accommodate these fluctuations. ION considered that SsangYong was generally good at notifying it in advance if a reduction in volumes was required.
- 18.7.5 In early 2003, SsangYong informed ION that it would be moving to 5-speed transmissions for its Rexton model and had awarded the contract to Mercedes Benz (at the time ION lacked a 5-speed transmission product). As a result, ION's projected 4-speed transmissions sales to SsangYong were reduced from approximately 110,000 to approximately 80,000-90,000 units per annum, with effect from calendar year 2004.

- 18.7.6 The Draft SsangYong Agreement, prepared by ION during the second half of 2003, contained the following forecast volumes (expressed to be subject to market conditions) for the supply of 4-speed transmissions to SsangYong. The figure for 2003 is based on actual sales at the time of drafting, the remainder are estimates.

Forecast volumes					
	CY 2003	CY 2004	CY 2005	CY 2006	CY 2007
Units	110,000	81,670	86,780	88,860	102,102

- 18.7.7 The lower estimated volumes for 2004 to 2006 reflected ION having lost the supply rights for SsangYong's Rexton model (representing approximately 30,000 transmissions per annum). This represented no more than approximately 3.3%, 5% and 3.8% of the Group's then forecast total revenue for FY 2004, FY 2005 and FY 2006, respectively.⁸
- 18.7.8 While the Draft SsangYong Agreement was not signed, the evidence discloses that ION was operating on the basis that SsangYong had nevertheless agreed to use ION's 4-speed transmissions for its D100 project through to the end of 2007 and that minimum volumes would be approximately 85,000 per annum.
- 18.7.9 On 20 October 2003, ION's managing director gave a presentation at the UBS Conference (ie, the UBS Presentation) which relevantly states:

Customers Current	SsangYong Motor Company
* Products	Transmissions
* Supply Period	1996-2007
* Markets	Korea
* Volumes (Units) Per Annum:	Transmissions – 90,000

- 18.7.10 On 21 October 2003, Citigroup issued an analyst's report which relevantly stated:

Five-speed transmission opportunities limited

We understand that one of ION's competitors (potentially Mercedes) will supply 5-speed transmissions to Ssangyong from FY05e for some or all of the models that currently source ION's 4-speed transmissions. As such, ION may need to replace the high level of EBIT currently generated by its 4-speed transmission contract with Ssangyong ... which expires in 2007.

- 18.7.11 In his address to ION's AGM on 28 October 2003, ION's managing director made the following statement:

ION has strong 4-speed technology and contracts with Ford and SsangYong to 2007 with expected continuing demand beyond and emerging demand from China for what is a proven world competitive, low cost profitable product. Sales and profits from 4 speed transmissions are set to continue for the next decade.

- 18.7.12 Between 23 November 2003 and late 2004, SsangYong repeatedly downgraded its forecast supply volumes for FYs 2004 to 2007. Over this period, forecast 4-speed

⁸ Assuming relevant forecast was similar to October 2003 Board Papers Forecast. The Deed Administrators have not been able to locate any long-range forecasts for the Group prior to October 2003.

transmission volumes for FY 2005 decreased from approximately 80,000 per annum to approximately 35,000 (and possibly 25,000) per annum. The reductions in forecast volumes advised to ION by SsangYong are summarised in the following table and further details concerning the reductions are set out below.

Forecast 4-speed transmission volumes			
Date of notification of forecast by SsangYong	2004	2005	2006
23/11/2003	60,270		
25/02/2004	49,770 - 62,370		
17/03/2004		55,000	37,000 (+13,250 E100 4-speed)
4/05/2004		42,840	
12/05/2004	45,000	40,000	43,000
30/06/04 (approx)		42,840 - 35,490	
28/07/2004		35,000	
Sept 04 (approx)		25,000 - 35,000	

(normal text indicates FY; *italics* indicates CY).

- 18.7.13 These reductions were caused by a variety of factors including an economic downturn in South Korea, high inventories held by SsangYong, problems within SsangYong's workforce, obsolete SsangYong vehicle models, and financial difficulties at SsangYong.
- 18.7.14 Another cause of ION's fluctuating forecasts during 2003 and 2004 for calendar years 2005 onwards, were repeated changes by SsangYong to the transmission requirements and timing of its D100 and E100 programs (see section 18.8).
- 18.7.15 On 23 November 2003, ION received a document from SsangYong titled 'SYMC Production & IAS A/T Forecast' which estimated supply requirements for calendar 2004 as 60,270 units. ION expected that these volumes would have been applied relatively consistently across the year, with 29,400 units in the first half of the year and 30,870 units in the second half of the year. The reduction in forecast volumes for 2004 was attributed by ION's management to a number of factors including depressed economic conditions in South Korea and SsangYong's aim of reducing its parts inventory. The volume reductions notified on 23 November 2003 represented approximately 0.7% and 4.7% of ION's then forecast total Group revenue for FY 2004 and FY 2005, respectively.⁹
- 18.7.16 Also during November 2003, SsangYong informed ION that it had decided that its D20DT engine (which was a diesel engine not specific to either the D100 or E100 program) would require 5/6-speed transmissions from June 2005 onwards. This contrasted with ION's previous understanding (as at August 2003) that it had secured the contract to supply 4-speed transmissions for the D20DT engine application for SsangYong's D100 program (with a minimum of 85,000 4-speed transmissions per annum) until the end of 2007. SsangYong's decision indicated to ION that as of June 2005 its supply of 4-speed transmissions to SsangYong would begin to run-off. Ultimately, the anticipated reduction

⁹ Based on October 2003 Board Papers Forecast which was used as the basis of the UBS Presentation.

- in 4-speed volumes was replaced in part by E100 4-speed volumes which were due to commence from September 2005 (see paragraphs 18.7.21 and 18.7.26).
- 18.7.17 As a consequence of this new information from SsangYong, on 2 December 2003 ION submitted a quotation to SsangYong for the supply of 5/6-speed transmissions for the D20DT engine, for 70,000 units per annum with an estimated start of production date of June 2005.
- 18.7.18 On or around 25 February 2004, SsangYong provided ION with an update of the 'SYMC Production & IAS A/T Forecast' document for calendar year 2004 (the previous version was dated 23 November 2003) outlining revised monthly supply requirements based on two different case scenarios:
- (a) 'Case #1: Current Production Plan' forecast 62,370 units per annum; and
 - (b) 'Case #2: Production Reduction' forecast 49,770 units per annum.
- 18.7.19 One of ION's senior employees attributed the reduction in Case #2 to issues confronting SsangYong such as reduced market demand, lack of buyer enthusiasm for SsangYong's older models and resulting excess stock levels. Assuming an even spread of volume throughout the calendar year, at worst, the potential volume reductions notified on 25 February 2004 represented a reduction of approximately 1.7% and 7.7% of ION's then forecast total Group revenue for FY 2004 and FY 2005, respectively.¹⁰
- 18.7.20 Between 15 and 17 March 2004 SsangYong informed ION that the D100 program would require 5/6-speed transmissions from January 2005 onwards (not from June 2005 as previously advised). As such, run-off of SsangYong 4-speed transmission volumes would commence 6 months earlier than previously anticipated. Meanwhile, ION still had no communication from SsangYong as to which supplier had won the 5/6-speed transmission contracts for the D100 and E100. SsangYong also informed ION at this time that the E100 program would require 5/6-speed transmissions commencing in the January 2006.
- 18.7.21 On or about 17 March 2004, SsangYong informed ION's management of further reductions in demand for 4-speed transmissions for FYs 2005 and 2006 to approximately 55,000 units and 37,000 units per annum, respectively. The 17 March 2004 information also noted that the FY 2006 figures excluded SsangYong's forecast requirements of 13,250 E100 6-speed transmissions for that financial year (these volumes later became 4-speed volumes when the 6-speed project was delayed to 2007 – see paragraph 18.7.26 below). At this time, SsangYong had also provided start of production information in relation to the D100 (see paragraph 18.8.13) which put estimated volumes for the D100 at 20,700 for FY 2006. The net effect of these changes represented a reduction in the then forecast total Group revenue of approximately 1.6% for FY 2005 and 2.8% for FY 2006.¹¹
- 18.7.22 On 19 April 2004, a reduction to approximately 75,000 units per annum as a result of the loss of the Rexton volumes was (incorrectly) reported in a Goldman Sachs JBWere analyst's report (see paragraph 18.7.5 above).

¹⁰ Based on February 2004 Placement Model which was used as the basis of the February Presentation.

¹¹ Based on February 2004 Placement Model which was used as the basis of the February Presentation.

18.7.23 On 27 April 2004, ION published the April Guidance which stated:

The Trading EBIT has been impacted by reduced volumes from SsangYong, and a reduction in wheel sales to Ford USA for the Taurus vehicle.

...

The company is continuing to supply SsangYong with 4-speed automotive transmissions with planned sales through to 2006.

18.7.24 On 4 May 2004, SsangYong informed one of ION's senior employees of a further reduction in FY 2005 volumes to 42,840 units per annum (being 3,360 transmission per month from June 2004 to December 2004 and 3,780 vehicles per month for January 2005 to June 2005). This represented a reduction of approximately 0.5% of the ION Group's then forecast total revenue for FY 2005.¹²

18.7.25 It does not appear that ION's management or the Board were made aware of this latest forecast from SsangYong and, in fact, the IAS management report for April 2004 (dated 10 May 2004 and prepared by ION's management), which was included in the Board papers for the 19 May 2004 ION Board meeting, includes out of date information insofar as it forecast the sale of 3,780 transmissions per month to SsangYong from June 2004 onwards (ie, instead of 3,360 transmissions per month from June 2004 to December 2004 and 3,780 vehicles per month for January 2005 to June 2005).

18.7.26 On 12 May 2004 SsangYong wrote to ION informing it that it had decided to utilise ION's existing 4-speed transmission for its E100 program from September 2005 until the end of 2007 (and requested a quotation from ION for this). As a second stage, ION and another supplier would participate in the development of a 5-speed transmission for use in the E100 program for the export market (from September 2006) and the domestic market (from January 2008). A decision would be made in August or September 2004 as to which supplier would ultimately be selected to provide the 5-speed transmissions. ION understood the lack of reference in the letter to the D100 program to indicate that it had been unsuccessful in securing this (5/6-speed) transmissions business.

18.7.27 The 12 May letter noted that 4-speed transmissions volumes for the E100 program were forecast as:

E100 4-speed transmission volume forecast

Item	CY 2004	CY 2005	CY 2006	CY 2007
Current 4 speed	45,000	40,000	13,000	13,000
E100 4 speed	-	-	30,000	30,000
Total	45,000	40,000	43,000	43,000

18.7.28 The net effect of the 12 May notification from SsangYong was a reduction in the ION Group's then forecast total revenue for FY 2004, FY 2005 and FY 2006 of approximately 0.3%, 1.9% and 5.5%, respectively.¹³

¹² Based on the April Model which formed the basis of the April Guidance.

¹³ Based on the April Model forecast.

- 18.7.29 On 20 May 2004, ION provided SsangYong with three formal quotations in relation to the 4 and 5/6-speed aspects of the E100 program. The 4-speed quotation utilised the 4-speed volumes notified to ION by SsangYong on 12 May 2004.
- 18.7.30 It does not appear that ION's Board or the CFO were notified of the contents of the 12 May letter at this time.
- 18.7.31 In late June 2004, one of ION's senior employees was sent to South Korea in response to ION's concerns about the consistently decreasing forecasts being received from SsangYong.
- 18.7.32 The broad outcome of the meeting appears to have been recorded in an internal ION email dated 26 July 2004 which was sent to ION's management and notes that SsangYong was itself faced with difficult financial circumstances, large stock inventories and slow sales. Attached to the email were two case scenarios for 4-speed sales to SsangYong for FY 2005:
- (a) Case 1 – Existing SsangYong schedule: 42,840 units;
 - (b) Case 2 – SsangYong's 'current thoughts': 35,490 units.
- At worst, the potential volume reduction for FY 2005 notified on 26 July 2004 represented a reduction of approximately 3.3% of the ION Group's then forecast total revenue for that year.¹⁴
- 18.7.33 ION's management requested that the 'Case 2' volumes be included in ION's budget for FY 2005.
- 18.7.34 In an email dated 28 July 2004 and circulated amongst certain ION employees, SsangYong's 'current thoughts' were confirmed (being approximately 35,000 units for FY 2005). It does not appear that ION's Board or management were informed at this time of the confirmation from SsangYong of its forecast volumes.
- 18.7.35 Internal ION forecasts suggest that as at September 2004 ION regarded expected SsangYong 4-speed volumes for FY 2005 to be at around 25,000 (on a pessimistic view) and 35,000 (on an optimistic view).
- 18.7.36 On 26 October 2004, ION held its 2004 AGM and ION's chairman stated:

In our Automotive Group, solid performance was recorded from our core businesses for the full year to June 30 although some weakness in demand was seen late in the year. The lower demand for transmissions from the Albury plant has continued into the current financial year. ...

18.8 SsangYong 5/6-speed transmissions

- 18.8.1 As at 2003, ION was supplying SsangYong with 4-speed transmissions under a Supply Agreement dated 15 October 1997 (ie, the 1997 SsangYong Supply Agreement).
- 18.8.2 In the period to early 2003, ION had spent approximately three years and \$20 million developing a 5-speed transmission as a replacement for its 4-speed product.

¹⁴ Based on the April Model forecast.

- 18.8.3 In early 2003, SsangYong informed ION that it would be moving to 5-speed transmissions for its Rexton model and had awarded the contract to Mercedes Benz (at the time ION lacked a fully developed 5-speed transmission product). At that time, SsangYong also indicated to ION that a 4-speed transmission was otherwise suitable for SsangYong's production requirements.
- 18.8.4 Due to this and a corresponding lack of interest from Ford, the 5-speed transmission project was ultimately suspended.
- 18.8.5 As a result of these developments, in early 2003 ION began to move to develop rapidly a viable 6-speed product. Then, during the course of 2003, ION's management became aware that SsangYong was looking ultimately to use 5-speed transmissions across its entire range, not only for the Rexton model. As such, ION proceeded with the development of its 6-speed transmission in a manner which allowed it to be configured as a 4, 5 or 6-speed transmission.
- 18.8.6 The two 5/6-speed transmission programs for which ION ultimately quoted to SsangYong were the 'D100' program (which related to the supply of 5/6-speed transmissions for 2.7 litre diesel engines for SsangYong's Kyron model) and the 'E100' program (which related to a replacement for SsangYong's Korando vehicle).
- 18.8.7 In late November 2003, ION's management met with SsangYong in Korea to present ION's proposed 5/6-speed transmission. While SsangYong's purchasing department gave ION's presentation a hostile reception, a more encouraging response was received from SsangYong's engineering team.
- 18.8.8 On 2 December 2003, ION submitted to SsangYong a quotation for the supply of 5/6-speed transmissions, premised on an estimated volume of 70,000 units per annum and a five year production period commencing in June 2005. Since the quotation was submitted following discussions with SsangYong, rather than in response to a formal Request for Quotation, the assumptions on which the quotation was based had to be determined by ION without instruction from SsangYong. For example, the estimated annual volume of 70,000 units was a combined volume for the D100 and E100 programs and was based on a volume which ION then considered to be commercially viable and a reasonable long-term target in relation to SsangYong. The price set out in the quotation could then be adjusted in later negotiations depending on the volume which SsangYong indicated that it was looking to purchase. Assuming that the 70,000 5/6-speed units were to replace all 4-speed supply in FY 2006 and FY 2007, this represented a respective 2.9% and 2.3% reduction in the ION Group's then forecast revenue.¹⁵
- 18.8.9 While ION accepted that a June 2005 start of production date represented a very tight timetable, ION believed that it was achievable, provided SsangYong made a decision quickly as to the identity of its preferred 5/6-speed transmission supplier.
- 18.8.10 While awaiting a response from SsangYong to its quotation, ION continued to perform generic transmission development work, but by early March 2004 ION had still not heard from SsangYong about the identity of its preferred supplier. The continuing delay by

¹⁵ Based on the October 2003 Board Papers Forecast.

- SsangYong was causing concern to ION because of the potential impact on ION's tight timetable.
- 18.8.11 As a result, between 6 and 11 March 2004 a number of emails were exchanged between ION and SsangYong, in which ION expressed its concern at the continuing delay by SsangYong in selecting a 6-speed transmission supplier and the impact which this could have on ION's ability to meet SsangYong's timing requirements.
- 18.8.12 At this time, SsangYong was also air-freighting a vehicle and three engines to ION to enable prototype transmissions to be trialled. On 15 March 2004, ION's Board approved the capital expenditure required to build the prototypes.
- 18.8.13 Between 15 and 17 March 2004 ION's management received from SsangYong volume and start of production information for each of the D100 and E100 programs. The information received from SsangYong included the following:
- (a) production for the D100 program would now commence in the first half of 2005, not June 2005 as previously advised (the delayed response from SsangYong meant that ION was very concerned that it would be unable to meet this start of production date and considered that this made it extremely difficult for ION to secure this contract);
 - (b) the E100 program was to start production in the first half of 2006 (this represented a far more achievable timeframe for ION);
 - (c) from commencement, the E100 program would operate as a 5/6-speed program;
 - (d) estimated volumes for FY 2006 were 20,700 D100 and 13,250 E100 5/6-speed transmissions (this was a significant reduction from the 70,000 units per annum which had formed the basis of ION's 2 December quotation); and
 - (e) SsangYong was yet to make a decision as to the identity of the supplier(s) for the D100 and E100 programs.
- 18.8.14 On 27 April 2004, ION issued the April 2004 Guidance, which relevantly stated:
- SsangYong is collaborating with ION in the development of a new 5/6 speed transmission.
- 18.8.15 The forecast prepared to support the April Guidance included 33,950 6-speed transmission units in FY 2006 having a total revenue of \$62.8 million. This was consistent with the March advice from SsangYong and was categorised in the forecast as not contracted.
- 18.8.16 On 29 April 2004, ION gave a series of presentations to SsangYong in relation to the 5/6-speed.
- 18.8.17 By May 2004 initial prototypes had been built (at ION's cost) and were being tested by ION.
- 18.8.18 On 12 May 2004, SsangYong wrote to ION advising as follows:
- (a) ION would continue supplying 4-speed transmissions to SsangYong for the E100 program until September 2006, pushing back the original June 2005 start of production date for 5/6-speed transmissions by more than 12 months.
 - (b) commencing September 2006, SsangYong would require a limited number of 5/6-speed transmissions for the export market;

- (c) SsangYong would not require 5/6-speed transmissions for its domestic market (which comprised the large majority of its transmissions requirements) until January 2008, ie, SsangYong would not solely use 5/6-speed transmissions for the E100 program until January 2008;
- (d) ION would be required to compete with a rival supplier (which ION understood to be Mercedes Benz) in relation to the 5/6-speed component of the E100 program; and
- (e) SsangYong's volume requirements for the E100 program (initially as a 4-speed program and later as a 5/6-speed program) would replace, rather than complement, ION's existing sales of 4-speed transmissions to SsangYong.

The letter did not include any estimated volumes for the 5/6-speed component of the E100 program.

- 18.8.19 SsangYong's failure to mention ION's role in respect of its D100 program was understood by ION to indicate that it had been unsuccessful in securing that contract for the supply of 5/6-speed transmissions.
- 18.8.20 ION was generally disappointed with the delay to the commencement of 5/6-speed transmission manufacturing, as it interrupted ION's plans for exposure in the marketplace as a credentialed 5/6-speed supplier. However, one of ION's senior employees observed that the delay allowed ION to develop its 5/6-speed transmission in a more controlled manner and extended by 12 months the time available for capital investment and engineering activities.
- 18.8.21 While the loss of the D100 5/6-speed contract impacted on ION's forecast revenues, the delay to the E100 program did not, for practical purposes, have such an impact, because it did not result in the associated revenues being 'lost' to ION, but rather being converted from 5/6-speed revenues to 4-speed revenues.
- 18.8.22 In response to SsangYong's letter, on 20 May 2004 ION provided SsangYong with three formal quotations in relation to the 4 and 5/6-speed aspects of the E100 program (based on an estimated volume of 70,000 transmissions per annum). While at least one of ION's senior employees was aware that the E100 contract on its own would not require 70,000 transmission units per annum, he anticipated that once the volumes were lowered the per unit price could be increased accordingly. ION's management appears to have shared this view.
- 18.8.23 On 25 and 26 May 2004, a meeting was held between various SsangYong, Nautitech and ION personnel to discuss specifics of the E100 program, including ION's recent quotations for the 4-speed aspect of that program. The D100 program does not appear to have been discussed at the meeting. At this time, SsangYong was still to advise ION of the identity of its supplier of 5/6-speed transmissions for the E100 program but a decision was expected in June 2005 for September 2006 start of production.
- 18.8.24 By June 2004, an ION prototype 5/6-speed transmission had been installed in a SsangYong vehicle and during July 2004 correspondence was exchanged between ION and SsangYong in relation to the calibration testing of the transmission. SsangYong

- conducted an engineering evaluation of the transmission during September 2004 and provided technical feedback to ION identifying certain development issues of concern.
- 18.8.25 Following publication of ION's preliminary financial results for FY 2004 on 24 August 2004, a number of analysts' reports were released. Overall the reports indicated concern over the continuing uncertainty about whether ION would be successful in securing the SsangYong 5/6-speed contract.
- 18.8.26 On 14 and 22 October 2004, revised quotations for the 4 and 5/6-speed aspects of the E100 program were submitted by ION to SsangYong. The revised quotations were based on far lower volumes than the 70,000 units per annum assumed by the 20 May 2004 quotations (being, 2,500 units in 2006, 5,000 units in 2007 and 30,000 units in 2008 and beyond).
- 18.8.27 On 26 October 2004, ION held its 2004 AGM and ION's CEO relevantly made the following statements:
- An example of success was properly resourcing our new 6-speed development project and rapidly getting prototypes into our customers' cars.
- ...
- In the third two-month period we plan to: ...secure 6-speed transmission orders.
- At the same meeting, the chairman stated:
- We are also proud of the Six Speed Automatic Transmission, currently under test with customers, recently won the prestigious Engineering Excellence Award from the Institute of Engineers, Australia.
- 18.8.28 On 29 October 2004, Shaw Stockbroking Limited issued an analyst's report which relevantly stated:
- The sustainability of the Transmission Division's earnings (50% of total) is under a cloud. These earnings are presently based on the 4 speed transmission contracts with Ford and SsangYong, which expire in 2007-08. Determination of the follow-on SsangYong 6-speed contract is expected soon and ION management have reiterated to us their confidence in securing it. Success would give the market some confidence (a commercial and technically capable product) that ION will subsequently secure the Ford contract. Failure though would bring into question the operational viability of the Albury plant beyond 2008...
- 18.8.29 On 10 November 2004, ION gave a presentation to the Citigroup Conference during which ION stated:
- 6-speed prototypes currently being tested by potential customers.
- 18.8.30 SsangYong continued to delay its decision as to the identity of its supplier of transmissions for the 5/6-speed aspect of the E100 program. This was despite SsangYong having previously informed ION that the decision would be made in August or September 2004 and then later indicating an October / November 2004 decision date. Ultimately, SsangYong had still not notified ION of its decision when ION entered administration on 7 December 2004.
- 18.8.31 The purchaser of IAS, Drivetrain Systems International, was subsequently successful in securing the contract to provide SsangYong with 5/6-speed transmissions and commenced production in September 2007.

18.9 Holden

- 18.9.1 In early 2003, ION was looking for opportunities to extend its production capabilities at Albury beyond transmissions to include differentials and transfer cases. Having secured the Holden differentials contract, IAS management decided to pursue Holden's transfer case business, which was seen as a logical step to take because transfer cases utilised similar technology and manufacturing processes to differentials.
- 18.9.2 Accordingly, in early 2003 ION developed transfer case designs and concepts and approached Holden to explore potential business opportunities for Holden's VE program.
- 18.9.3 On 25 July 2003, Holden provided ION with a draft Statement of Requirements for the proposed transfer case business.
- 18.9.4 In approximately July or August 2003, ION gave a presentation to Holden in relation to the potential transfer case business and Holden's response was considered by ION to be 'encouraging'. As a result, ION commenced work to prepare a full quotation package for the Holden transfer case business.
- 18.9.5 On 20 October 2003, ION's managing director gave a presentation to the UBS Conference (ie, the UBS Presentation) which indicated that transfer case production was expected to commence at Albury in 2004/05 with a predicted spend of \$25-30 million and expected revenues of \$60 million (these estimates appear to have been premised on the potential sale of transfer cases to customers in Australia, South Korea, China and possibly India).
- 18.9.6 At ION's 2003 AGM held on 28 October 2003, ION's chairman stated that ION anticipated the manufacture of transfer cases to begin at Albury after June 2004.
- 18.9.7 In his address to ION's 2003 AGM, the managing director stated:
- ION has new products – [transfer cases and differentials] – based on these existing skills. This is an excellent example of expanding intellectual property to grow revenue and profit.
- ...
- Transfer case and differentials (ZF collaboration) – managed from Albury; established know-how. This is add on business.
- 18.9.8 By 18 November 2003, ION had received Request for Quotation packages for the Holden VE front differential and transfer case.
- 18.9.9 On 19 March 2004, ION submitted a quotation for the supply of transfer cases to Holden, which provided for start of production in February 2007 and end of production in January 2015, with Australian volume of 30,000 units per annum and global total volume of 49,500 units per annum. These volumes fluctuated during subsequent negotiations.
- 18.9.10 While the quotation does not include pricing information, a number of internal documents indicate an estimated unit price of \$603 – giving rise to projected annual revenues of approximately \$29.8 million.
- 18.9.11 In the week commencing 26 April 2004, ION began face-to-face negotiations with Holden to finalise the sourcing of transfer cases for Holden's VE program.
- 18.9.12 On 27 April 2004 ION issued the April Guidance stating:

It is expected that ... transfer cases for AWD/4WD applications will be added to the product range.

- 18.9.13 As part of ION's negotiations with Holden to finalise the sourcing of transfer cases for Holden's VE program, a meeting was held between ION and Holden on 7 May 2004. The outcome of the meeting was not positive for ION. ION was informed that because the product which was being targeted (ie, transfer cases) was for use in a global platform, Holden was concerned about ION's ability to comply with its benchmarking and testing requirements in the available time and also had concerns about the unproven nature of ION's transfer cases product. It appears that ION's problems at Wingfield may have also influenced Holden's decision.
- 18.9.14 Following the loss of the Holden VE business, ION intended to target other local suppliers as well as China for transfer case business.
- 18.9.15 Although a number of internal documents were not updated to reflect the loss of the Holden transfer case business until August 2004, the evidence indicates that the 7 May 2004 meeting with Holden effectively signalled the end of ION's attempts to secure the Holden VE transfer cases business.
- 18.9.16 On 24 August 2004, ION issued an announcement to the market in connection with its results for the financial year ended 30 June 2004, titled 'ION Achieves Improved Trading Profit', (ie, the August Announcement) which relevantly stated:

FUTURE OUTLOOK

The company has a well defined growth path for the immediate future based on the 4 major organic growth initiatives of

...

- drive line products including 5 and 6 speed transmissions, differentials and transfer cases at Albury, New South Wales.

- 18.9.17 ION's 2004 Annual Report, dated 17 September 2004, stated that ION had identified transfer cases for potential four wheel and all wheel drive customers, as a product to add to its range.
- 18.9.18 While ION's management was aware of the outcome of the meeting on 7 May 2004 and the associated loss of the Holden transfer case business, no evidence has been identified to indicate that the Board or the CFO was informed of the failure of ION's quotation at this time (or, in fact, at all).

18.10 China

SMT 4-speed transmissions

- 18.10.1 ION's management began exploring opportunities to supply 4-speed automatic transmissions into the Chinese market, for use by Chinese vehicle manufacturers, from about mid 2003. Initially this was to occur via a relationship with SMT, a trading company that had contacts within several of the Chinese car manufacturers. Eventually, ION hoped to develop relationships directly with Chinese vehicle manufacturers.
- 18.10.2 On 27 June 2003, ION signed a non-binding Memorandum of Understanding with SMT to collaborate in relation to the supply to the Chinese market of 4-speed electronic automatic

transmissions (suitable for rear wheel drive and four wheel drive vehicle applications), transfer cases and other related products.

- 18.10.3 On 14 August 2003, ION submitted a quote to supply SMT with 4-speed transmissions. The annual volume quoted for was a minimum of 20,000 units for at least four years with an estimated start of production date of July 2004, with an increase in volume by approximately 20,000 units per year over the first four years. The indicative unit pricing was \$1,800 to \$2,000. Based on the quote, minimum annual revenue was expected to be \$36 million.

In his address to the ION AGM on 28 October 2003, ION's managing director stated:

Predicted increase in automotive revenue:

2005 \$140m

2006 \$300m

2007 \$300m

The specific source of the growth was not detailed however the managing director also noted that:

ION has strong 4-speed technology and contracts with Ford and SsangYong to 2007 with expected continuing demand beyond and emerging demand from China.

- 18.10.4 On 27 April 2004, ION issued the April Guidance which stated that an initial contract had been secured by ION to supply 20,000 automotive transmissions into the Chinese market in calendar year 2005 and that, once established, it was expected that strong growth could occur. Prior to the release of the April Guidance, ION had a draft supply agreement (reflecting the agreement in principle reached with SMT) that provided for minimum volumes of 20,000 units from CY 2005 to CY 2009, with an anticipated increase of 20,000 units per calendar year from CY 2006.
- 18.10.5 On 24 June 2004, ION and SMT signed a Supply Agreement (**SMT Supply Agreement**) which provided, amongst other things, that SMT would purchase a minimum of 20,000 4-speed electronic automatic transmissions (and transmission control units) per Contract (calendar) Year, with a minimum of 1,470 units per month, commencing on or about 1 January 2005. The Supply Agreement also gave SMT the option of purchasing units during the six months prior to 1 January 2005 and additional units from 1 January 2005. The yearly supply was forecast to increase by 20,000 units each year from the second calendar year (that is, from 1 January 2006).
- 18.10.6 On 1 July 2004, ION announced the SMT Supply Agreement to the market and noted that it was worth at least \$36 million per year for the next five years (the start date was not specified), which is consistent with the contracted terms. ION also announced that the SMT Supply Agreement involved the production and supply of a contracted minimum number of automatic 4-speed transmissions and control units per year, with further non-binding volume increases anticipated between 2005 and 2009 which could increase the number of transmissions sold up to a maximum volume of 100,000 units per annum.
- 18.10.7 One of ION's employees visited SMT during July 2004 to conduct a calibration/verification exercise for SMT's customers. During the trip he became concerned that the start of production date would be pushed out from January 2005 to April 2005, and that, come

- 1 January 2005, SMT would not order, pay for or take the transmissions produced for it by ION. However, ION's management did not share those concerns at the time, given SMT's contractual obligations under the Supply Agreement, and given that it was not uncommon for new customers to have start up difficulties.
- 18.10.8 By email dated 9 September 2004, ION's management was informed by SMT that it would be asking for significant volume concessions for the first 6 months of 2005, but that SMT still guaranteed the agreed volume over the first two years of the SMT Supply Agreement (ie, 40,000 units). The 'significant volume concessions' were unspecified at that time. Although some of ION's employees were concerned about whether SMT would honour its obligations under the SMT Supply Agreement, ION's management was not similarly concerned, and intended to make SMT honour its commitment. ION's management took the view that delay in start up was not unusual and took comfort from SMT's guarantee of the volume over the first two years of the SMT Supply Agreement. The evidence indicates that it is unlikely that the Board was told specifically about SMT's request on or about 9 September 2004.
- 18.10.9 Following receipt of the request from SMT, ION's management considered various options, such as walking away from the SMT Supply Agreement, enforcing the start of production date, and ensuring that SMT paid even if it did not take units under the SMT Supply Agreement.
- 18.10.10 By 24 September 2004, forecast volume for FY 2005 from SMT had been removed from a forecast prepared at Albury plant level.
- 18.10.11 On and from 28 September 2004, ION continued to correspond with SMT with a view to having SMT honour its obligations under the SMT Supply Agreement. However, it appears that by this date, based on a request by ION's management that SMT purchase 1,500 units before the end of 2004, and do its best to consume 5,000 units between 1 January 2005 and 30 June 2005, ION's management had accepted that SMT would not honour its obligations to take 1,470 units per month for the period from 1 January 2005 to 30 June 2005.
- 18.10.12 In a document prepared by ION (apparently without the involvement of ION's Board or its CFO) entitled 'Revised Presentation to [Purchaser] Business of Driveline Systems' dated 13 October 2004, ION noted, under the heading 'Forecasts Current 04/05' that the supply to SMT had been affected by model delay. Tables attached to the presentation contain forecast volume for SMT for FYs 2006, 2007 and 2008 as 20,000 units per year with a program life of July 2005 to December 2009. The tables which refer to forecast volume for FY 2005 do not include any references to SMT. Based on this presentation, it appears that ION was aware that SMT would not take the minimum units under the Supply Agreement until July 2005, yet still forecast 20,000 units for FY 2006.
- 18.10.13 A Retrenchment Proposal dated 14 October 2004 prepared by ION's management, which was included in the Board Papers for the 25 October 2004 Board meeting, noted that the budgeted FY 2005 volumes for IAS had decreased due to a further softening of the Korean economy and model launch delays in China. SMT was noted as having nil volumes for FY 2005.

- 18.10.14 On 19 October 2004, ION's management wrote to SMT requesting that SMT confirm by 23 October 2004 that it would take 1,500 transmissions by December 2004 with a commitment for a January-June 2005 volume of at least 1,000 transmission units 'thus satisfying ION in terms of contractual commitments' or that ION would take their refusal as a breach of the agreements and therefore consider the SMT Supply Agreement to be null and void. This further demonstrates that by this time ION's management had accepted that SMT would not be taking the minimum units stated under the SMT Supply Agreement for the period from January to June 2005.
- 18.10.15 A report summarising the status of current SMT customers received by ION's management on or about 29 November 2004, states that most of those customers would not be ready for production until April or May 2005.
- 18.10.16 A Board meeting was held on 29 November 2004 at which the managing director's report for October 2004 was tabled. Section 7 of that report includes the following statement:
- Visit to China and Korea - As advised verbally to directors, I spent the week commencing Sunday, 14 November visiting prospective customers for our automotive transmissions in China, and also SsangYong in Korea. The bottom line is I think we have good prospects with Chery in China and somewhat lesser prospects with SAIC and with Brilliance as well as SMT. There is an issue regarding the payment and acceptance of product with SMT and I will discuss these matters more fully with directors at our meeting.
- 18.10.17 By December 2004, the FY 2005 volume requirements for SMT's customers had still not improved and the expected start of production date was April/May 2005.

Other 4/5/6-speed transmissions

- 18.10.18 From about mid 2003, ION began exploring opportunities to supply automatic transmissions to China. According to ION's management, ION was in a unique position to exploit the Chinese market because the market was oriented towards manual transmissions and there were no independent manufacturers of automatic transmissions in China at the time.
- 18.10.19 Aside from SMT, the main prospects in China appeared to be Chery and Brilliance. Management understood that there had been some discussions between BTR and Brilliance before BTR became part of ION, and that Brilliance made contact with ION around mid to late 2003. ION's management began exploring opportunities with Chery from early 2004.
- 18.10.20 On 6 April 2004, ION had an internal sales target of 30,000 6-speed transmissions to 'other' customers for FY 2006 totalling \$55 million. It was thought that supply to China might fill the volume. This was in addition to forecast sales to SMT which were accounted for separately.
- 18.10.21 Between 16 April and 1 May 2004, an ION employee went on a trade mission to China, during which he met with many representatives of Chinese companies. After the trade mission, the ION employee began receiving enquiries directly from Chery and Brilliance.
- 18.10.22 On 26 May 2004, ION's sales target of 30,000 6-speed transmissions to 'other' customers for FY 2006 was also set as a target for FYs 2007 and 2008.

- 18.10.23 Between July and November 2004, there were negotiations between ION and each of Chery and Brilliance about the proposed volume and price of units to be taken by those potential customers. Throughout the discussions, the expected volume, price and start of production for each of Chery and Brilliance fluctuated. There were no contracts in place between ION and each of Chery and Brilliance during this period. In addition, there was as yet no 5/6-speed prototype testing by any of the Chinese manufacturers.
- 18.10.24 As at 27 September 2004, IAS's internal target for sale of 4-speed automatic transmissions for FY 2006 was 2,000 to Chery and 3,960 to Brilliance.
- 18.10.25 ION downgraded the ION Group forecasts in October 2004 to reflect a forecast of 6,000 units to Chery and Brilliance in FY 2006.
- 18.10.26 As at 25 October 2004, quotations had been supplied to Chery for an annual volume of 50,000 units with a start of production of June 2006 and to Brilliance for 50 units in calendar year 2005, 7,000 units in calendar year 2006 and 10,000 units per calendar year from 2007 onwards, with a start of production of December 2005.
- 18.10.27 Revised quotations were to be provided to Brilliance and Chery by 24 November 2004, however, there is no evidence that the revised quotations were provided to them.

19. Altona

19.1 Introduction

- 19.1.1 On 27 May 2002, ION's Board approved a proposal for the establishment of a plant to manufacture engine blocks (ie, the Altona Proposal). The Altona Proposal was driven by Holden's desire to source, from a local supplier, engine blocks for its new V6 engine (which was being produced in Australia).
- 19.1.2 Key terms of the Altona Proposal were as follows:
- (a) capital expenditure of \$91.25 million including land and buildings;
 - (b) manufacture of an initial 200,000 engine blocks per annum for Holden;
 - (c) annual revenue of approximately \$60 million for a period of ten years commencing in January 2006 achieved based on sales to Holden;
 - (d) an expectation that the Altona Proposal would generate an IRR of more than 20% assuming a sale and leaseback of the site; and
 - (e) the use of a manufacturing process for the engine blocks called the Precision Sand Casting Process.
- 19.1.3 The Deed Administrators have investigated various matters relevant to the Altona Project. In particular:
- (a) the circumstances surrounding ION's decisions concerning the plant's start of production capacity and the extent to which there would be expansion capacity (section 19.2 below)

- (b) the capital expenditure forecasts and budgets adopted by ION in relation to the Altona Project, the extent to which those forecasts were disclosed to the financial market and ION's applications for government funding (section 19.3 below);
- (c) the facts concerning Holden's commitment to purchase engine blocks from ION and ION's attempts to secure additional volumes from other vehicle manufacturers (section 19.4 below);
- (d) ION's forecasts in relation to the Altona Project's anticipated revenue, profitability and internal rate of return and the public announcements made by ION in relation to those matters (section 19.5 below).

19.2 Production and expansion capacity

Introduction

- 19.2.1 The Altona Proposal approved by the Board on 27 May 2002 did not specifically refer to the intended production capacity of the plant. However, the financial model which accompanied the Altona Proposal, as well as the evidence of certain of ION's officers and management make it clear that it was intended at this time that the plant was to have a start of production capacity of 200,000 engine blocks per annum.
- 19.2.2 During the course of their investigations, the Deed Administrators have considered whether and, if so, when ION made a decision to increase the Altona plant's capacity from 200,000 to 350,000 engine blocks per annum. The Deed Administrators have also considered ION's decision to construct the plant building at Altona to accommodate an annual capacity of 700,000 engine blocks.
- 19.2.3 Further details concerning the Deed Administrators' investigations in relation to these matters are set out below.

Increase in plant capacity

- 19.2.4 As mentioned above, as part of the Altona Proposal, ION's Board approved a start of production capacity of 200,000 engine blocks per annum. The engine blocks were to be produced using the Precision Sand Casting Process.
- 19.2.5 On 30 October 2002, following the finalisation of the terms of the supply agreement with Holden, ION announced to the market that it had been awarded a contract by Holden for an 'initial demand' of 200,000 engine blocks per annum. It was noted that the plant would be 'modular which will enable expansion to supply further demand'. No specific reference was made at this time to the intended production capacity of the plant.
- 19.2.6 In its half yearly report for six months to 31 December 2002, released on 25 February 2003, ION stated that the plant has 'potential for demand well in excess of its original base load of 200,000 units per annum'.
- 19.2.7 In June/July 2003, a US engineering team who were experts in the Precision Sand Casting Process were appointed by ION to design, purchase and install the equipment for the plant. The team was lead by a US engineer who was appointed by ION to a management position. The US engineering team recognised that the Precision Sand Casting Process required the design, purchase and installation of equipment for a minimum start of production capacity of 350,000 engine blocks per annum. Accordingly, from July 2003 the

US team began designing the plant on the basis of 350,000 engine blocks as the basic capacity of the Precision Sand Casting Process.

19.2.8 The ION Annual Report for 2003 released on 30 September 2003 stated as follows:

Construction will be modular to enable capacity expansion from the initial installed capacity of 200,000 units.

19.2.9 In early October 2003, a member of ION's management was on notice that Holden had been informed by ION that the start of production capacity for the plant was to be 350,000 engine blocks per annum. By November/December 2003, other members of ION's management and one of ION's officers understood that the start of production capacity would be 350,000 engine blocks per annum.

19.2.10 From 4 February 2004, the Board was on notice of the fact that ION intended to implement a start of production capacity of 350,000 engine blocks per annum.

19.2.11 At the February Presentation on 19 February 2004 in Sydney, ION informed investors that the start of production capacity for the plant had increased from 200,000 to 350,000 engine blocks per annum. This is confirmed in a contemporaneous analyst's report which refers to the 'likely unit number' for the plant being higher than 200,000 engine blocks per annum with an additional 150,000 engine blocks per annum 'expected but not committed'.

19.2.12 At a meeting of the Board on 15 March 2004, a financial analysis was presented which examined financial returns based on a production capacity of 200,000 engine blocks versus 350,000 engine blocks. The scenarios based on a production capacity of 350,000 engine blocks per annum produced a higher IRR.

19.2.13 By the time of the Board meeting held on 15 March 2004, the Board, while not having provided formal approval, had acquiesced in the increase to a start of production capacity of 350,000 engine blocks per annum.

Increase in building capacity

19.2.14 The Altona Proposal did not include any details concerning the capacity or expansion capacity of the building which was to accommodate the block plant.

19.2.15 It appears that by late 2003, ION intended to construct the plant building to accommodate 700,000 engine blocks per annum should that be required in the future.

19.2.16 It appears that ION intended the building layout of the plant to be designed so that it could be mirrored, meaning that the Precision Sand Casting Process that was installed could be duplicated within the same building without much added infrastructure. However, any expansion as well as the associated cost would not occur until a later point in time as further capacity was required.

19.3 Capital expenditure

19.3.1 ION's Board adopted four forecasts for capital expenditure to bring the Altona Project to commissioning (collectively, ***Altona Forecasts***). They were as follows:

- (a) A forecast and budget set on 27 May 2002 at \$91.25 million based on a plant capacity of 200,000 engine blocks per annum. This forecast was disclosed to the financial market at \$90 million on 30 October 2002, 30 September 2003 and

28 October 2003. ION did not spend or commit to costs in excess of the \$91.25 million budget in 2002 or 2003.

- (b) A forecast of \$175 million for ION's Hollow Castings division of which the Altona component was \$125 million disclosed to the financial market on 19 February 2004 in the February Presentation. This forecast was based on an increased plant capacity of 350,000 engine blocks per annum. At this point in time the previous budget of \$91.25 million had not been exceeded in terms of costs spent or committed.
 - (c) A forecast of \$125 million was presented to the Board by the CFO on 15 March 2004. ION confirmed the forecast of \$125 million to the financial market on 27 April 2004. At this time, the spend on the Altona Project and commitments were not in excess of \$125 million.
 - (d) A forecast and budget of \$160 million was accepted by the Board on 25 October 2004. While the actual figure of \$160 million was not disclosed, ION disclosed on 26 October 2004 at its AGM that the costs across its capital projects had increased by approximately 15%. At this time, ION's costs on its capital projects had increased by 16% overall. The individual increase in relation to the Altona Project was 27%. By 26 October 2004, ION had not spent in excess of the previous \$125 million forecast although it had committed to capital costs in excess of \$125 million. Indeed, this had been the position since early September 2004, although in late September 2004 ION was exploring ways in which to reduce costs so that they were back in line with the existing \$125 million budget.
- 19.3.2 Other than the Altona Forecasts referred to above, ION management and employees prepared numerous draft budgets, forecasts and models for management purposes in 2003 and 2004. On occasions, these internal working papers incorporated forecasts in excess of the Altona Forecasts. However, none of the internal working papers were presented to ION's Board or approved by the Capital Review Committee.
- 19.3.3 Set out below is a more detailed explanation of the events surrounding the Altona Forecasts and ION's disclosures to the financial market concerning those forecasts.
- 19.3.4 As noted above, on 27 May 2002, ION approved a proposal to develop the Altona engine block manufacturing facility at an estimated capital cost of \$91.25 million.
- 19.3.5 In June 2002, submissions were made for government funding at both State and Commonwealth levels. The Board was informed in August 2002 that funding would not be available at either level of government. On 30 October 2002, ION announced that it had been selected by Holden to establish a new greenfield plant to supply engine blocks and that estimated capital costs for the project would be \$90 million.
- 19.3.6 There were no major developments in relation to forecast capital expenditure for the Altona Project through November 2002 to June 2003. However, during this time ION continued to press for government assistance.
- 19.3.7 In ION's Annual Report of 30 September 2003, ION announced forecast capital expenditure for the Altona Project at \$90 million.

- 19.3.8 In a presentation to the UBS Conference on 20 October 2003, ION announced forecast capital costs for the Altona Project at \$100 million. It was also confirmed that the project would be funded through a project funding vehicle in the form of an unsecured CBA facility.
- 19.3.9 On 28 October 2003, ION announced the estimated capital costs for the Altona Project at \$90 million in a presentation by the managing director to ION's AGM.
- 19.3.10 By the end of January 2004, payments and commitments on the Altona Project had not exceeded \$91.25 million.
- 19.3.11 On 4 February 2004, the Board requested a reassessment of capital expenditure and revenue for the Altona Project to be presented at their March meeting.
- 19.3.12 The 2003 half year results presentation of 19 February 2004 (ie, the February Presentation) included a capital figure for ION's Hollow Castings division of \$175 million. Two internal revenue and capital expenditure forecasts dated 11 and 17 February 2004 appear to have supported the \$175 million Hollow Castings figure disclosed in the February Presentation (with some minor adjustments). The first forecast of 11 February 2004 incorporated capital expenditure of \$126 million for Altona, \$44.707 million for Wingfield and \$6.240 million for Hollow Castings with an overall total capital expenditure of \$176.947 million. The second forecast of 17 February 2004 incorporated capital expenditure of \$129.900 million for Altona (with \$2 million included for maintenance), \$44.004 million for Wingfield and \$6.240 million for Hollow Castings with an overall capital expenditure of \$180.144 million.
- 19.3.13 A figure of \$125 million for Altona Project capital expenditure was presented orally to investors and market analysts at the half year results presentation on 19 February 2004. A JP Morgan report titled 'ION Limited – 1H04 Result – The Leap of Faith is Too Great', issued the same day also noted that capital costs for Altona had increased from the original \$90 million to \$100 - \$105 million, not including land and buildings to be funded on balance sheet by ION (at \$20 million).
- 19.3.14 On 15 March 2004, ION's CFO presented a report to the Board in which the estimated capital cost for the Altona Project was forecast at \$125 million. Although the \$125 million was not minuted as the reforecast Altona budget, ION's Board adopted the forecast.
- 19.3.15 The increase in costs from the previously approved limit of \$91.25 million was attributed to the increase in production capacity to 350,000 engine blocks per annum and the increase in the plant building size to allow for the production of 700,000 engine blocks (should further customer contracts be obtained). Approximately \$4 million of additional costs related to commissioning costs which were not allowed for in the Altona Proposal of May 2002.
- 19.3.16 A financial model was circulated internally on 20 April 2004 in which forecast capital costs for the Altona Project were recorded as \$127.9 million for the 'Feb release' and \$125 million for the 'April release'. The financial model appears to have been the basis for ION's announcement of 27 April 2004 in the April Guidance, that the revised capital cost forecast for the Altona Project was \$125 million. This figure included land and buildings. It was stated in the April Guidance that this figure was in line with previous guidance.
- 19.3.17 The May IM recorded estimated capital costs for the Altona Project at \$125 million.

- 19.3.18 On 18 June 2004 at the Capital Review Committee meeting, management requested a \$4 to \$7 million increase for commissioning for the Altona Project. This figure was rejected by the Capital Review Committee and the approved ION capital expenditure for the Altona Project remained at \$125m. The potential for government funding was also discussed at this meeting.
- 19.3.19 It appears there were further internal discussions in July 2004 relating to strategies that might be used to secure government funding. This ultimately led to a meeting between ION and the Victorian Government which took place on 17 August 2004. This meeting was of a preliminary nature and details of the specific sums sought and the proposed terms of any funding arrangement were not canvassed at this stage.
- 19.3.20 Capital expenditure for the Altona Project was recorded in the August Update (in an attached term sheet) at \$126 million.
- 19.3.21 In August 2004, ION appointed an independent engineer (ie, Williams) to review all major capital projects (including the Altona Project) in order to obtain a definitive estimate for ION's capital projects.
- 19.3.22 On or around 6 September 2004, an ION employee prepared a revised Altona Project forecast for discussion at a 'special budget review' meeting which estimated capital expenditure at \$145.03 million. The revised figure was rejected by management. Neither the CFO nor any member of the Board was present at this meeting.
- 19.3.23 The minutes of the 16 September 2004 Capital Review Committee meeting record the current estimate for capital expenditure at \$145 million with a note that the number was a draft number and not to be made public. The figure was prepared on the basis that it was a working estimate only, which was subject to receipt of the independent consultant's views. It was not a figure which was put to the Board for consideration.
- 19.3.24 The MOFA was executed on 16 September 2004. Clause 1.1 of the MOFA states that the cost to develop the Altona block plant would be \$126 million.
- 19.3.25 On 17 September 2004, the CFO signed a funding notice indicating that forecast capital expenditure for the Altona Project had not exceeded \$126 million. This was on the basis that there was no new information which had come to the CFO's attention indicating the capital expenditure for Altona had exceeded \$126 million. The CFO has said that he did not attend the 16 September 2004 Capital Review Committee meeting and it is apparent that at this point in time ION's Board was not on notice of the forecast figures in excess of \$126 million to complete the Altona Project or the state of commitments in relation to it.
- 19.3.26 At a Board meeting on 22 September 2004, the Williams Status Report was tabled. As mentioned above, the Williams Status Report was stated as being for the week ended 17 September 2004 and was provided to ION on 19 September 2004. The Williams Status Report estimated capital costs to complete the Altona Project in the sum of \$151.646 million and noted that real cost savings would be difficult to achieve given the advanced state of existing commitments. ION did not revise its forecast of \$125 million at this time up to \$151.646 million but rather scheduled a workshop on 30 September 2004 to look at ways of reducing the consultant's estimate.

- 19.3.27 The Board did not consider the Williams Status Report to be the final and definitive assessment of the costs to complete the Altona Project.
- 19.3.28 On 24 September 2004, ION issued the September Announcement stating that work on its major capital projects was continuing in line with recent plans. However, it was stated that ION had sought independent advice to review the costs to completion of the capital projects (with completion of the review expected by November 2004).
- 19.3.29 On 30 September 2004, a block project workshop took place. The workshop was headed by Williams and was attended by various members of ION's management, including the CFO. The agenda for the workshop included an item concerning capital expenditure reductions and set out a list of potential cost reduction mechanisms. At the workshop, the potential for capital expenditure reductions was discussed and following the workshop the various mechanisms identified were assigned for action to specific members of the Altona Project team.
- 19.3.30 A capital report (as at 30 September 2004) was prepared for Williams' use by an ION employee in which forecast capital costs for the Altona Project were reported in the sum of \$151.4 million. In the capital report as at 30 September 2004, \$97.9 million was recorded as committed (including \$51.7 million recorded as spent) and \$53.5 million as future commitments with an estimated final cost of \$151.4 million.
- 19.3.31 On 19 October 2004, a further funding notice was signed by the CFO certifying forecast capital expenditure for the Altona Project at \$126 million. At the time of the signing of the 19 October 2004 funding notice, the CFO's view was that cost reduction initiatives such as use of operating leases and reduction of commissioning costs could reduce the overall capital expenditure on the Altona Project back to \$125 - \$130 million and that it was these initiatives that were being investigated by Williams.
- 19.3.32 On 21 October 2004, the Final Williams Report was issued which forecast capital costs for the Altona Project at \$160 million. In the report, Williams advised that the most likely cost to complete the facility to reach a design throughput of 350,000 units per annum would be \$155 million. Williams recommended that ION's Board allow a further \$5.0 million to bring the confidence level in achieving required outcomes to the ninety percentile range. In summary, Williams advised that the Board should make provision of \$160 million to complete the project with a high level of confidence.
- 19.3.33 The increase in costs from the previous budget of \$125 million was the result of various adjustments to planned manufacturing processes and equipment sourcing, due to customer requirements as well as process improvements. It was also identified at this time that installation costs had been previously underestimated for Altona by approximately \$8 million.
- 19.3.34 The Final Williams Report was provided to the Banks on 21 October 2004.
- 19.3.35 The Final Williams Report was incorporated in the Board papers for the Board meeting of 25 October 2004. In relation to the Final Williams' Report, the managing director's report for that Board meeting stated that 'our currently approved capital expenditure authorisations are in excess of \$40m short of the dollars we expect to be needed to complete these projects'. Although the \$160 million figure was not minuted as the

reforecast Altona Project budget, the Board appears to have adopted the forecast at this meeting.

- 19.3.36 On 26 October 2004, ION held its AGM for 2004. The Chairman's address referred to the receipt by the Board of an external consultant's report increasing the previous allowances on major investments by approximately 15%. No specific announcement was made in relation to the reforecast costs for the Altona Project of \$160 million. At this time, ION's estimated costs on its capital projects had increased by 16% overall. The individual increase in relation to the Altona Project was 27%.

19.4 Customer contracts and volumes

- 19.4.1 On 30 April 2002, ION signed a Memorandum of Understanding with Holden in relation to the supply of engine blocks (ie, the Holden MOU). In the MOU, Holden acknowledged that it was interested in purchasing 100% of its engine blocks from ION commencing in 2006. The MOU did not refer to volume.
- 19.4.2 As mentioned above, on 27 May 2002, the Board approved the Altona Proposal. The Altona Proposal did not refer to the actual plant capacity or the anticipated volume from Holden. However, the financial model which accompanied the Altona Proposal, as well as the evidence of certain of ION's management and officers, make it clear that the Altona Proposal was based on a volume of 200,000 units per annum from Holden.
- 19.4.3 Between April 2001 and September 2002, ION submitted a series of quotes to Holden for the supply of engine blocks by ION. Those quotes included estimated volumes of between 165,000 and 200,000 engine blocks per annum, with the last three quotes (submitted in December 2001, May 2002 and August 2002) each referring to estimated volumes of 200,000 units per annum. On 24 October 2002, Holden confirmed in writing that it agreed to a 10 year supply commitment with cost downs of 1% per year.
- 19.4.4 Throughout the life of the Altona Project, the start of production date for the Altona plant was estimated to be 2005/2006.
- 19.4.5 At a series of Board meetings throughout 2002, the Board was advised of strong and increasing interest from Ford in purchasing engine blocks from ION. While it appears that the potential for engine block business from Ford was increasing during this period, it was recognised within ION that it would have taken some years to obtain a contract with Ford as this customer would have first required ION to prove that its engine block plant was viable. On 30 October 2002, ION issued a market update entitled 'ION Limited Wins Contract from Holden Ltd to Establish Light Weight Aluminium Engine Block Plant' in which it was stated that:

ION Limited advises that it has been selected by Holden Ltd to establish a new 'greenfield' light weight aluminium engine block plant to supply engine blocks for Holden's new High Feature V6 engine. Start up is scheduled for 2006. Initial demand will be 200,000 blocks per annum.

...

The plant will be modular which will enable expansion to supply further demand. Prospects of further business are promising.

- 19.4.6 In the half yearly report for six months to 31 December 2002, released to the market on 25 February 2003, ION included the following commentary in relation to the Altona plant:
- The plant, due to commence production in 2006, has potential for demand well in excess of its original base load of 200,000 units per annum.
- 19.4.7 ION's 2003 Annual Report, released on 30 September 2003, noted the following:
- Construction will be modular to enable capacity expansion from the initial installed capacity of 200,000 units.
- 19.4.8 On 20 October 2003, ION gave a presentation to the UBS Conference (ie, the UBS Presentation). The UBS Presentation contained the following commentary in relation to the Altona Project:
- Process patented by ION- Strong future opportunities for expansion above 200,000 initial base demand from Holden.
-
- Product: HF V6 Cylinder Blocks
- Start of Production: 2005
- Contract period: 10 years
- Market: Australia
- Initial volumes (Units) Per Annum: Large Bore 120,000; Small Bore 65,000.
- 19.4.9 On 28 October 2003, the CEO made the following statement at ION's AGM:
- Block Plant- Team assembled in Cleveland; prototypes produced to specification.
- Acknowledgement by customer and other interested parties in Europe and North America.
- 19.4.10 As noted above, as at 28 October 2003 ION's US engineering team had already been assembled in Cleveland. In addition, by 28 October 2003, ION had produced prototypes which complied with Holden specifications.
- 19.4.11 During 2003, ION had discussions with and/or submitted quotations to the following potential customers for the Altona plant:
- (a) Lotus/Proton:
- (i) An ION internal memorandum dated 18 March 2003 referred to a quote to Lotus for 60,000 to 70,000 engine blocks per annum.
- (ii) In July and September 2003, ION's Board was advised of potential business from Lotus/Proton in the range of 100,000 to 150,000 units per annum.
- (b) DaimlerChrysler Germany:
- In September 2003, ION quoted to DaimlerChrysler Germany for the supply of engine blocks. The request for quotation provided by DaimlerChrysler Germany was based on 200,000 or 250,000 units per annum. ION's Board was informed of the quote to DaimlerChrysler Germany in October 2003 and December 2003.

- (c) DaimlerChrysler US:
- While potential volume of 230,000 units per annum from DaimlerChrysler US was referred to in an ION internal document dated 20 November 2003, the evidence in relation to any request for quotation from DaimlerChrysler US is scant. It appears that DaimlerChrysler US did provide ION with a target price per engine block and that ION considered the target price was too low. ION's Board was first advised of potential business from DaimlerChrysler US in October 2003.
- (d) Suzuki:
- (i) In November 2003, there was discussion within ION about potential volume from Suzuki of 100,000 units per annum. According to ION's management, Suzuki were looking at building a high feature V6 engine under licence from General Motors. The supply contract with Suzuki was to come through Holden so that they could leverage ION for cost savings based on higher volumes. However, at this time the discussions were preliminary in nature and were predominantly between General Motors and Suzuki.
- (ii) ION's Board was advised of the potential business from Suzuki in December 2003.
- 19.4.12 In a market announcement dated 19 February 2004, made in connection with the release of ION's half year results to 31 December 2003 (ie, the February Announcement) ION stated in relation to the Altona plant that:
- Quotations for potential export customers in addition to Holden are proceeding.
- 19.4.13 Throughout 2004, ION appears to have focused on obtaining business from the following potential customers for the Altona plant.
- (a) Lotus/Proton
- (i) The Board was advised in February 2004 of potential demand of 75,000 units per annum from Lotus/Proton. It appears that ION formally began quoting to Lotus/Proton in April 2004.
- (ii) An ION internal review document dated 19 March 2004 reveals that ION was confident of selling to Lotus/Proton, however, not until the second year of the Altona plant, following commissioning.
- (b) DaimlerChrysler Germany
- In February and April 2004, ION's Board was advised of the continuing interest of DaimlerChrysler Germany at a volume of 250,000 units per annum. Revenue from sales to DaimlerChrysler Germany was incorporated in a financial model dated 17 February 2004 which appears to have supported revenue projections announced at the 2003 Half-Year Results Presentation of 19 February 2004.

- (c) Suzuki
- The managing director's report for the Board meeting on 4 February 2004 stated that there was potential volume of 100,000 units per annum from Suzuki. Suzuki's interest was described as a 'firm enquiry'.
- 19.4.14 In addition, in early 2004, DaimlerChrysler US indicated a willingness to visit the Altona site when the plant was up and running. The potential for volume from DaimlerChrysler US of 230,000 units was also referred to in presentations to government dated 18 March 2004 and 17 August 2004.
- 19.4.15 At a Board meeting on 15 March 2004, ION's CFO presented a review of the capital expenditure for the Altona Project. The review contained a financial model for the Altona plant entitled '*Likely Scenario*' which was based on the Altona plant achieving a capacity of 350,000 units in year 4 of its operation. At the time of the 15 March 2004 Board meeting others within ION were confident that ION could obtain contracts for an additional 150,000 units per annum sooner, and therefore considered that a ramp up to 350,000 units in year 4 was unnecessarily conservative and could be brought forward.
- 19.4.16 The April Guidance released on 27 April 2004 contained the following commentary in relation to the Altona plant:
- ION has firm long term contracts to supply Holden with ... engine blocks for Holden's new High Feature V6 engine currently being manufactured at Fishermans Bend.
- 19.4.17 On 4 May 2004 ION made the following statement in a market release:
- All plants are being built against long term supply agreements. It is revenue from these new contracts and other "brownfield investments" for differentials and 6-speed transmissions, when introduced, which will provide future success and profitability.
- 19.4.18 On 28 May 2004, ION informed the Banks in the May IM that it expected to fill the Altona plant capacity of 350,000 units per annum by the end of the third year of its operation.
- 19.4.19 On 25 June 2004, a meeting took place between ION, Holden and senior visiting executives from General Motors (US) during which a presentation was given on the status of the Altona plant. At this meeting the plant capacity of 350,000 blocks per annum was discussed and it was made clear that Holden had factored this capacity into their future planning, indicating that there was potential for demand beyond the initial 200,000 units.
- 19.4.20 The August Update, provided to prospective lenders on 5 August 2004, contained the following commentary in relation to the Altona plant:
- [T]he base case assumes that the incremental rise in production and associated sales from 200K units to 350K units per annum is achieved by the end of the third year
- 19.4.21 On 24 September 2004, ION made the following comment in relation to customer contracts for the Altona plant in a market update:
- Whilst all projects are backed by major customer contracts and should provide good long term shareholder value, there is significant greenfield drag in the construction and then ramp up of each of these facilities which will moderate company profitability in the interim, particularly in view of having multiple overlapping projects.

19.5 Profitability forecasts

- 19.5.1 On 27 May 2002, the Board approved Altona based upon a financial assessment which included the following:
- (a) total capital expenditure of \$91.25 million to be financed through an 'off-balance sheet' financing arrangement with payment of costs to be deferred until July 2006;
 - (b) production capacity of 200,000 engine blocks per annum based on Holden's expected volume requirements pursuant to the MOU of 30 April 2002, with the potential to expand beyond this initial volume should further customers be obtained; and
 - (c) annual revenue of approximately \$60 million at full capacity of 200,000 engine blocks per annum, based on an initial engine block price of \$292
- (the **May 2002 Altona Assessment**).
- 19.5.2 The May 2002 Altona Assessment reflected an IRR of 18.9%, increasing to 21.7% assuming a sale and leaseback of the site with scope for further improvement subject to receipt of government funding.
- 19.5.3 A revised financial analysis of Altona which projected an IRR of 21.9% was also tabled at the Board meeting of 26 August 2002.
- 19.5.4 ION informed the financial market on 30 October 2002 that Altona would achieve revenue of \$60 - \$65 million and meet its corporate benchmark IRR of 20%.
- 19.5.5 During 2003, in its 2003 Annual Report, in the UBS Presentation and in the managing director's address for the 2003 AGM, ION stated that its projects would either exceed or meet its corporate benchmark IRR of 20%.
- 19.5.6 ION also made two revenue announcements for Altona in 2003. At the UBS Conference, ION stated that annual revenue for Altona would be \$60 million and in the managing director's address for the 2003 AGM, ION stated that annual revenue for Altona would be \$65 million. The two forecasts are consistent with what ION knew at the time in relation to potential volume and block prices.
- 19.5.7 In 2003 various dates were proposed for Altona start of production ranging from mid 2005 to early 2006.
- 19.5.8 ION announced a forecast total sales revenue for IAG for FY 2006 and FY 2007 in the February Presentation. Those figures were based on the IAG February 2004 Forecast (referred to in paragraph 25.7.10 below). For FY 2006 the IAG February 2004 Forecast included revenue from the sale of 75,000 engine blocks to DaimlerChrysler and 200,000 engine blocks to Holden at a unit price of \$320, with total revenue of \$88 million. For FY 2007, revenue was forecast from the sale of 150,000 engine blocks to DaimlerChrysler and 220,000 engine blocks to Holden at a unit price of \$320, with total revenue of \$118.4 million.
- 19.5.9 In March 2004, ION's CFO recalculated the IRR for Altona (the **March 2004 Altona Assessment**). The March 2004 Altona Assessment was based upon:
- (a) total capital expenditure of \$125 million;

- (b) production capacity of 350,000 engine blocks per annum with a plant building sized to accommodate the production of 700,000 engine blocks per annum should further customers be obtained;
 - (c) construction and commissioning of the plant to be completed by June 2005 with alternate ramp up dates to full production capacity of 350,000 engine blocks; and
 - (d) annual revenue of approximately \$98.7 million at a full capacity of 350,000 engine blocks per annum.
- 19.5.10 The CFO presented the March 2004 Altona Assessment to the Board at its meeting of 15 March 2004. The March 2004 Altona Assessment reflected a restated IRR of:
 - (a) 18.6% (assuming full capacity was reached in Year 2);
 - (b) 16.6% (assuming full capacity was reached in Year 3); and
 - (c) 15.8% (assuming full capacity was reached in Year 4).
- 19.5.11 ION's CFO considered the most likely scenario for Altona was a progressive ramp up to full capacity of 350,000 engine blocks in Year 4. There is evidence from some members of ION's management that it could take two years and at the most three to four years from contract signing to start of production with a new customer and that certain customers would only consider ION as a potential supplier once Altona had been commissioned. By contrast, ION's CEO as well as a senior member of ION's management were confident that customers could be obtained for 350,000 engine blocks per annum and that a ramp up to full capacity in Year 4 was unnecessarily conservative. There is no evidence that the Board formally adopted any one of the various ramp up scenarios at its March 2004 Board meeting as the most likely forecast.
- 19.5.12 In the course of completing the March 2004 Altona Assessment, ION's CFO made a number of amendments to the May 2002 Altona Assessment used to calculate the IRR. One amendment which materially impacted the calculated IRR of Altona was an amendment to the timing of the initial capital outlay. Specifically, ION's CFO included the initial capital outlay in Year 0 rather than Year 1.
- 19.5.13 As previously noted, the May 2002 Altona Assessment was based on an 'off balance sheet' financing arrangement designed to defer the initial capital outlay of Altona by approximately 12 months. Consistent with this arrangement, the May 2002 Altona Assessment reflected the initial capital outlay (including associated financing costs) at the end of Year 1 as compared to traditional discounted cash flow analysis techniques which ordinarily include the initial capital outlay in Year 0.
- 19.5.14 Notwithstanding some modification to the financing arrangements for Altona in late 2003, it remained the case up to the appointment of the Administrators in December 2004 that the initial capital outlay (and associated debt drawdown) for Altona was to be deferred by approximately 12 months via the Altona V6 project finance vehicle provided by CBA. Accordingly, the Deed Administrators have concluded that in preparing the March 2004 Assessment, it would have been acceptable for the purposes of the discounted cash flow analysis, for ION's CFO to have retained the placement of capital outlay in Year 1. Had this been the case, the March 2004 Altona Assessment would have reflected a restated IRR of:

- (a) 21.4% (assuming full capacity was reached in Year 3); or
- (b) 19.5% (assuming full capacity was reached in Year 4).
- 19.5.15 Further, had ION's CFO also adjusted the March 2004 Altona Assessment to reflect a sale and leaseback of the site, which continued to be an option for ION at this time, the March 2004 Altona Assessment would have reflected a restated IRR of:
- (a) 24.4% (assuming full capacity was reached in Year 3); or
- (b) 22.1% (assuming full capacity was reached in Year 4).
- 19.5.16 A revenue forecast for Altona was not disclosed in the April Guidance of 27 April 2004, although it was stated that ION's sales revenue was forecast to increase by more than 20% in FY 2006. The April Model supporting the April Guidance now excluded the DaimlerChrysler units from its FY 2006 revenue forecast. The April Model forecast 151,000 Holden units for FY 2006 at \$282 per engine block.
- 19.5.17 The May IM and August Update provided by ION to prospective lenders did not incorporate a specific revenue forecast for Altona, although they both incorporated a revenue forecast for ION consolidated for FY 2004 to FY 2008. The May 2004 and August 2004 models which supported the ION consolidated revenue forecasts contained in the May IM and the August Update forecast revenue for Altona as follows:

Altona May IM and August Update forecast

\$m	FY 2005	FY 2006	FY 2007	FY 2008
Sales revenue	-	42.6	56.6	80.6
EBIT	16.7	7.1	11.7	19.7
EBITDA	16.7	10.7	18.7	28.7

- 19.5.18 The FY 2006 forecast assumed the same revenue for Altona as forecast in April 2004. The FY 2007 forecast assumed approximately 200,000 engine blocks at \$282 per block and the FY 2008 forecast may have factored in production of approximately 280,000 engine blocks.
- 19.5.19 ION's Board was informed in July 2004 that Altona could be commissioned by August 2005.
- 19.5.20 As previously noted, on 17 September 2004, Williams (ION's independent engineer) completed his first report in relation to ION's capital projects (ie, the Williams Status Report). The Williams Status Report, which was provided to ION on 19 September 2004 and tabled at its Board Meeting of 22 September 2004, estimated capital costs for Altona at \$151.646 million and noted that Altona would be commissioned by mid-June 2005.
- 19.5.21 On 24 September 2004, ION issued a market update (ie, the September Announcement) in which it said that work on Altona was continuing broadly in line with recent plans and that independent engineering advice had been sought to review the costs to completion of all projects. ION stated that it expected the review to be completed by November 2004.
- 19.5.22 ION's Annual Report of 30 September 2004 recorded that ION would commence start up, trialling and pre-production in the latter part of CY 2005 and stated that both IES and IAG

- were forecast to grow in FY 2005 and beyond as revenues from major capital projects under construction achieved expected returns. ION also stated that three capital projects (including Altona) were pivotal to ION's future and that strong demand and long term supply agreements would augur well for strong cash flow and sustained profitable future growth.
- 19.5.23 On 21 October 2004, the Final Williams Report was provided to ION which forecast capital costs for Altona at \$160 million. Williams found that the most likely cost to complete Altona, based upon a production capacity of 350,000 engine blocks per annum was \$155 million with a further contingency of \$5 million.
- 19.5.24 As ION explained to its financiers on 1 November 2004, with the exception of service and installation costs of \$8 million (which were not included in the original \$125 million estimate), the balance of the additional costs could be attributed to changes in the plant's processes and equipment sourcing strategies designed to minimise commissioning risks following the experience with the Wingfield plant in early 2004.
- 19.5.25 Had the additional service and installation costs of \$8 million been included in the March 2004 Assessment (as restated for the placement of capital outlay in Year 1 and allowing for a sale and leaseback of the site), Altona would have produced an IRR of:
- (a) 22.2 % (assuming full capacity reached in Year 3); or
 - (b) 20.0 % (assuming full capacity reached in Year 4).
- 19.5.26 However, had ION undertaken a revised financial assessment of Altona as at October 2004:
- (a) based on a capital expenditure of \$151 million (excluding from Williams' figure of \$160 million, the \$5 million contingency and \$4 million for a heat treatment oven the costs of which may have been recouped from Holden); and
 - (b) restated for the placement of capital outlay in Year 1 and allowing for a sale and leaseback of the site;
- the restated IRR would have reduced to:
- (c) 18.2% (assuming full capacity was reached in Year 3); or
 - (d) 16.3% (assuming full capacity was reached in Year 4).
- 19.5.27 Financial summaries prepared by ION's CFO on 28 October 2004 incorporated a breakdown of EBITDA across various business units, including Altona. The EBITDA forecast for Altona was driven mainly by ACIS revenue of \$13.4 million in FY 2005, \$2.0 million in FY 2006 and \$13.0 million in FY 2007. The EBITDA for FY 2006 was \$8.7 million less than the EBITDA forecast in May and August 2004 for FY 2006 and the EBITDA for FY 2007 was \$5.7 million less than forecast in May and August 2004 for FY 2007.
- 19.5.28 There is no evidence as to the basis upon which the EBITDA for Altona forecast in October 2004 had reduced by comparison with forecasts in May and August 2004. It has been suggested by the CFO that volume could have been slower or the starting date for production could have been later.

- 19.5.29 On 10 November 2004, ION announced that commissioning start up for Altona would be in late 2005 with volume production in 2006.

20. Wingfield

20.1 Introduction

- 20.1.1 In 2001, ION was awarded a contract from Holden to produce alloy components for Holden's new HF V6 engine, namely cylinder heads, inlet manifolds and oil pans. The revenue from this contract was estimated at \$64 million in the first year of operation, and \$75 million per annum thereafter.
- 20.1.2 When the contract was awarded, ION did not have the capacity or specialised facility to make these parts, which prompted the need to design and construct a new plant. At a meeting of ION's Board held on 27 May 2002, the Board approved an investment proposal for the purchase and development of a greenfield site at Wingfield, South Australia (ie, the Wingfield Project). The capital cost for the project was estimated in the proposal at \$38 million.
- 20.1.3 The investment proposal approved in May 2002 contained an estimated IRR of 48% for the project, comfortably exceeding ION's hurdle rate of 20%.
- 20.1.4 The timetable for completion of the Wingfield Project set out in the initial proposal was:
- | | |
|----------------------------|--------------|
| Board approval | May 2002 |
| Building completion | January 2003 |
| Plant commissioning | January 2004 |
| Start of volume production | March 2004 |
- 20.1.5 The Wingfield plant was designed as a continuous flow metal casting process. This differed from ION's usual process of manufacturing its cast metal products in batches (as it did, for example, at North Plympton).
- 20.1.6 In October 2003 ION announced a second stage to the development of the Wingfield site which would further increase the plant's capacity.
- 20.1.7 Commissioning commenced at Wingfield in late 2003, when ION began testing the production lines. It quickly became apparent that there were engineering and production problems with the plant.
- 20.1.8 These technical problems caused ION to miss its original targets for completion of commissioning. Between October 2003 and February 2004, ION revised its estimate of commencement of production from the April-June quarter 2004 to 1 July 2004. Later, in April 2004, ION again revised the date when it estimated full production would commence at Wingfield, delaying it until January 2005.
- 20.1.9 In addition to delaying the commencement of full production, the problems at the plant required significant additional capital and operational expenditure, which caused extensive operating losses and a revaluation write-down.

- 20.1.10 Further details concerning these matters are set out in sections 20.2 to 20.4 as follows.
- (a) Section 20.2 deals with the circumstances surrounding the commissioning and production problems at Wingfield, their effect on commencement of full production and the increasing manning levels required. Also covered in this section is the extent to which ION made disclosures to the financial market about these matters.
 - (b) Section 20.3 addresses ION's increasing capital expenditure forecasts for Wingfield, the public announcements made about those forecasts, the extent of commissioning and start-up costs and the accounting treatment for those costs.
 - (c) Section 20.4 considers the forecast profitability of Wingfield and the impact on those forecasts of the ongoing engineering and production problems at the plant.

20.2 Production and plant operation

- 20.2.1 As mentioned above, the proposal put to the Board on 27 May 2002 stated that commissioning of Wingfield would occur in January 2004 and volume production would commence in March 2004.
- 20.2.2 The financial analysis presented to the Board in support of the investment proposal included assumptions that ION would earn a gross profit margin of 24% and an EBIT margin of 22% on recurring annual revenue of \$75 million. ION assumed it would achieve similar margins to its North Plympton factory. However, it did not prepare detailed estimates of the cost to produce each of the parts to be manufactured. By December 2004, ION had not been able to achieve its forecast margins, rather it produced parts at Wingfield at a significant loss as set out in section 20.4 below.
- 20.2.3 In June 2003 ION decided to relocate the manufacturing of cylinder heads for Proton from its North Plympton plant to Wingfield. Production of the Proton components commenced at Wingfield in early 2004.
- 20.2.4 By October 2003, ION expected that Wingfield would be commissioned in the April-June quarter 2004. The UBS Presentation on 20 October 2003 contained a slide which stated:
- Wingfield
 - Expenditure completed. Initial commissioning on schedule
 - Revenue to commence in April – June quarter 2004
 - Capital cost: \$53m approx
- 20.2.5 A further slide in the presentation, with respect to Wingfield, stated:
- Capability:
- ...
- Wingfield will deliver on time and on budget
- 20.2.6 At the 28 October 2003 AGM, when referring to Wingfield, the chairman stated:
- In the three years to June 2007, ION expects to double its revenue and maintain its earnings relativity to revenue...The first delivery against this vision will be the commissioning of the Wingfield plant in April – June Quarter 2004 ...
- 20.2.7 The managing director's address at the 2003 AGM was made in a question and answer format. A question was posed as follows:

Q.

ION has two major Greenfield projects. The Wingfield plant to be fully commissioned in Apr-June 04, and the Altona Block Plant to be commissioned in April 05. Greenfield drag could cause a reduction in return on capital. Commissioning problems could occur.

A.

...

- Wingfield will be fully contributing from June 04.

...

- Commissioning of Wingfield is proceeding to plan with some revenue to commence from November. The products are not new – the plant is new and advanced in capability, capacity and reliability. ION is very confident of outcomes as is Holden.

20.2.8 The following question was also posed:

Q.

ION has significant capital expenditure planned over next two years. Management will be stretched. Can they deliver these projects on time and to forecast?

A.

...

- Wingfield – on budget, on time, will deliver April – June Qtr 04. An example of intellectual property held – 30 years of cylinder head manufacture. Capital expenditure \$53m. This is Stage I.

...

20.2.9 When these statements were made in October 2003, the Wingfield plant's construction was well advanced, but it had not reached the point where testing had been done by manufacturing products in significant volumes.

20.2.10 In December 2003 test production runs at full production rate commenced at Wingfield as part of the commissioning process. It soon became apparent that there were engineering and production problems with the plant.

20.2.11 In late January 2004, a new plant manager was appointed (a secondee from the Kentucky plant with 30 years in the foundry industry and previous plant start up experience). At the 4 February 2004 Board meeting, ION's Board was told that there were problems with the commissioning of Wingfield and that 'the process had some flaws, capable of correction'. It was reported that the new plant manager (who had been involved for just 8 days at this time) had both identified shortcomings and planned corrective actions. In the managing director's report for this meeting, it was noted that 'management understand extremely well that there can be no alternative to successful plant start-up'. Also at this meeting the Board became aware that it was likely that the building at Wingfield would need to be extended as it appeared that 'original concepts underestimated space and capacity requirements...'. Early estimates put the cost of this work at in excess of \$5 million. This later became part of the Stage 2 works costed at \$15 million. ION's management thought that if customer forecasts were accurate, cylinder head capacity would be exceeded by the end of 2004.

- 20.2.12 On 19 February 2004, ION released its half year results to 31 December 2004 and made the February Announcement. With reference to Wingfield, the February Announcement stated:
- Completion on time and on budget Stage I of the Wingfield, South Australian cylinder head plant. Commissioning has commenced and is running to plan. The commissioning includes the introduction of six new products for Holden, Bosch and Proton with an initial annual revenue from 1 July 2004 in excess of \$70.0m per annum.
- 20.2.13 At this time, ION had won contracts to produce manifolds for Bosch where Holden was the end user (two products), cylinder heads for Holden and Proton (three products) and oil pans for Holden. Wingfield was being commissioned for the manufacture of cylinder heads for Proton in February 2004, with commissioning for manifolds and oilpans estimated to commence by the end of March 2004. Cylinder head production for Holden had not commenced by December 2004.
- 20.2.14 By this time, although ION's management accounts show that some revenue from the plant had commenced in January 2004, the estimate for commencement of full production was now July 2004.
- 20.2.15 On 26 February 2004 two of ION's directors visited Wingfield and a report to ION's Board (dated 29 February 2004) was subsequently prepared outlining the problems at the plant.
- 20.2.16 The Wingfield plant had been planned as a high volume continuous casting process, whereby parts being produced would flow sequentially from one process to another. This was a different method compared with ION's existing North Plympton plant, where castings were manufactured in batches. ION was not able to make the new Wingfield process work as intended. This was described as follows in the memorandum to the Board dated 29 February 2004:
- We have allowed a flow process to be installed that does not flow. To put it simply as I can we have processes in a line that can be represented by A, B, C, D, and E.....we have no buffer between them so when, say, C stops so does A, B, D and F. Then if C starts but, say, B stops then as you might guess they all stop. There are enough permutations and combinations of ABCDE that the plant as designed never ran. They have implemented manual intervention and we will need to modify the flow with capital.
- 20.2.17 The same memo attributed the cause of these difficulties to bad design and implementation.
- 20.2.18 To overcome the production difficulties, the continuous flow processes were uncoupled. This required significant manual intervention and greatly increased the manning levels required, which was detrimental to the plant's profitability.
- 20.2.19 By February 2004 ION was aware that Holden's cylinder head requirements could potentially be greater than the original estimate of 1,200 units (600 sets) per day. This potential demand was forecast to exceed the cylinder head capacity, which would become fully utilised by November 2004. As noted below, Stage 2 was intended to address this.
- 20.2.20 A review of the business case for Wingfield was undertaken and a report was provided to the Board for its 15 March 2004 Board meeting (the **March 2004 Business Case**). This review was based on the assumption that the plant would be commissioned by 1 June 2004.

20.2.21 On 27 April 2004, ION released the April Guidance which relevantly stated:

Wingfield, the South Australian Greenfield site, is on track for full commissioning in July 2004 and full production from January 2005, when the major customer is planned to move to a single supply source. This rapid start-up plan includes six new products for three customers. The complexity of the manufacturing plan has caused some process and production challenges which we are addressing... On current estimates, the completed cost will be \$74 million, an overrun of approximately \$6 million or 9% compared with previous guidance.

20.2.22 A document titled 'Assumptions... EBIT Market Update Walkthrough – 19 April' identifies the assumptions underlying the April Guidance. Compared with the March 2004 Business Case it halved forecast sales from Wingfield for the period July 2004 to December 2004.

20.2.23 In April 2004, the production of Proton parts was moved back to North Plympton as a result of the manufacturing problems at Wingfield.

20.2.24 The managing director's report to the Board for June 2004, dated 16 July 2004, noted that:

Since the 27 April there has been a significant struggle to meet initial customer demands accompanied by significant over-spend in terms of poor yields and serious dislocation of the manufacturing process and excessive labour costs.

20.2.25 The commissioning phase of the Wingfield Project required higher manning levels than had been anticipated due to the manual intervention required in the production process. Additional layers of inspection were put in place to ensure quality standards were being met, because the plant was experiencing difficulty in producing castings of an acceptable quality.

20.2.26 ION revised its forecasts of the number of personnel required at Wingfield as follows:

Personnel forecast

Date of forecast	Headcount
May 2002	80
November 2003	154
March 2004	148

20.2.27 The actual manning levels required exceeded these forecasts. Specifically, in May 2004, the headcount was 190 people and by November 2004 this had risen to 391 people.

20.2.28 Notwithstanding these high levels of manual intervention, the Wingfield plant's yield during this period was lower than budget (yield being the ratio of acceptable parts to total parts produced). In the March 2004 Business Case, the plant had been expected to produce a yield of 92.5% in the first year and 95% thereafter. The actual yield rate for total production in May 2004 was 59.4%. This increased to 82% by November 2004, but remained significantly below the target rate, notwithstanding the large increase in personnel.

20.2.29 By July 2004, ION was aware that Holden's desire was to increase the demand for cylinder heads from 600 sets per day to potentially 900 to 1,200 sets per day in line with the capacity of Holden's engine plant.

- 20.2.30 By late July 2004 an internal review process had identified a further six month delay in reaching full production at Wingfield (ie, June 2005) and this was reported to the Board at its meeting on 21 July 2004.
- 20.2.31 In relation to Wingfield, the August Update (dated 5 August 2004) stated:
- the issues at Wingfield have resulted in an inability to reach the required production rates as originally forecast.
- ...
- In the short term, ION will apply additional labour to support the ramp up of the production process and the reworking of some of the capital elements, with the introduction of lean manufacturing techniques thereafter to support efficiencies.
- 20.2.32 In the August Announcement released on 24 August 2004, ION commented that:
- Commissioning difficulties at the new Wingfield facility have led to a delayed start-up and additional capital expenditure to support customer requirements.
- 20.2.33 An IAG presentation to ION's Board on 22 September 2004 states:
- Wingfield – Difficulties in getting production to customer anticipated levels with the consequence being higher labour than anticipated, material usage, airfreight and consumable usage.
- ...
- Wingfield plant will be close to full production by Mar/Apr 2005.
- 20.2.34 In late September 2004, while volume production at Wingfield was improving, financial performance was still hampered by excessive labour costs and low yield. On 24 September 2004, ION made a further ASX announcement (ie, the September Announcement). With regard to Wingfield, the September Announcement stated:
- Wingfield operating performance continues to improve whilst its cost of operation relative to output is still adverse as we still have a way to move up the performance curve at the casting plant.
- 20.2.35 On 25 October 2004 a status report on the Wingfield Project was presented to the Board. The report stated that:
- (a) the second building phase was proceeding as planned;
 - (b) in relation to the expansion of cylinder head production to 700 sets per day, the layout and timing plan had been agreed and capital expenditure approval was awaited;
 - (c) production volume for Bosch manifolds was 'in control' although quality improvement was being hampered by equipment reliability. This also resulted in a lower yield at 65%;
 - (d) there were no problems with the production of VZ oil pans which were in full production with yield at 85%; and
 - (e) Proton were impressed by the improvement in productivity and quality of the products manufactured at Wingfield, as were Lotus.

- 20.2.36 The chairman's address to shareholders at the 26 October 2004 AGM noted in regard to Wingfield:

In the case of our new operations such as Wingfield, we have previously noted the difficulties during construction and commissioning. Enormous effort has been directed at correcting these problems. All of the employees associated with this plant have worked tirelessly to overcome the shortcomings while meeting customer demands. The Board thanks them for their effort.

Not all problems at Wingfield are behind us but current performance and future projections indicate we are on the right track.

- 20.2.37 Actual yields for total production for the period May 2004 to November 2004 were as follows:

Production yields	
Month 2004	Actual yield
May	59.4%
June	66.8%
July	72.7%
August	67.1%
September	78.0%
October	76.7%
November	82.0%

As mentioned above, according to the March 2004 Business Case, planned yield rates were 92.5% in the first year and 95% thereafter.

- 20.2.38 By November 2004 ION had not yet commenced full production of Holden's parts. Holden continued to purchase cylinder heads from another supplier. The plant was operating at full capacity, on three shifts per day, with more than double the planned head count, however it had not achieved the forecast volumes, and was incurring heavy losses as described in section 20.4 below.

- 20.2.39 Wingfield plant commissioning had not been completed at the time of the appointment of the Administrators on 7 December 2004.

20.3 Capital expenditure and commissioning and start-up costs

- 20.3.1 The original investment proposal for Wingfield, approved by the Board in May 2002, authorised a capital outlay of \$38 million. By the time Administrators were appointed, the capital expenditure committed or approved in respect of Wingfield had increased to \$109.8 million, of which \$93 million had been incurred.

- 20.3.2 The increase in Wingfield capital expenditure reflected a combination of the following:

- (a) approved increases in the scope of the project;
- (b) capital expenditure increases which had not been anticipated at the outset, such as the expenditure required to bring machining in-house, which were commercially justified by anticipated revenue increases or reduced production costs; and

- (c) unanticipated costs reflecting a combination of higher than expected commissioning costs, rectification work to enable the plant to function as planned, and inaccurate forecasting (a large proportion of these cost overruns or under budgeted costs were written off in 2004).

Further details of these matters are set out below.

- 20.3.3 Part of ION's method of evaluating new projects was to calculate an IRR, which is a discounted cash flow methodology. As mentioned above, ION required the IRR of new projects to meet a hurdle of 20% at the time of project approval.
- 20.3.4 The original estimate of \$38 million in capital expenditure for Wingfield equated to an IRR of 48% (with scope for improvement to in excess of 60% with a sale and leaseback of the plant).
- 20.3.5 In November 2002 the Board approved further capital expenditure to bring the machining of cylinder heads in-house, rather than outsourcing it to a third party as had originally been proposed. This was to be at a cost of approximately \$12.86 million and resulted in a total authorised capital expenditure for the Wingfield Project of \$50.86 million, with an improved base case IRR of 53.4% (not including a sale and leaseback).
- 20.3.6 However, ION's calculations of estimated IRR excluded costs such as commissioning, working capital funding, and research and development. Furthermore, the IRR calculations were prepared on the basis that the Wingfield plant was to be funded by project specific funding, with debt recognition delayed until the plant's completion. Some time prior to October 2003, ION decided not to proceed with this funding structure for the Wingfield Project.
- 20.3.7 ION's IRR calculations also assumed that the Wingfield plant would generate gross profit margins of 24% on sales, as set out at paragraph 20.2.2 above. This was predicated on the Wingfield plant being able to operate as planned, however, as subsequent events showed, the plant did not achieve forecast yields, manning levels or profit.
- 20.3.8 The Deed Administrators have restated the November 2002 IRR for Wingfield to reflect the following items that should have been included in the original IRR calculation:
 - (a) recognition of the capital outflow a year earlier (to reflect ION self funding the project from inception);
 - (b) research and development costs;
 - (c) working capital funding requirements;
 - (d) commissioning costs;
 - (e) the benefit of ACIS revenue; and
 - (f) removal of the project specific financing cost of \$5 million (as the project was now being funded from existing facilities).

On this restated basis, the Wingfield Project's IRR (on the November 2002 base case) would have been 30%, thereby continuing to exceed the hurdle rate of 20%. Similarly, the restated IRR as at May 2002 also produces an IRR exceeding ION's hurdle rate, at 26%.

- 20.3.9 ION's decision in June 2003 to relocate the manufacturing of cylinder heads for Proton from North Plympton to Wingfield involved capital expenditure of \$1.8 million.
- 20.3.10 In October 2003 ION stated in the UBS Presentation that the capital expenditure estimate of \$53 million related to Stage 1 of the Wingfield Project, and that it was intended to increase the scope of the project by means of a Stage 2, to cost an estimated \$10 million, bringing the total project cost to \$63 million. The UBS Presentation also confirmed that the Wingfield Project was being funded from existing facilities.
- 20.3.11 The purpose of Stage 2 was to increase Wingfield's production capacity. This was necessary for two reasons. First, the relocation of manufacturing of Proton cylinder heads from North Plympton to Wingfield absorbed the bulk of the excess capacity initially planned for Wingfield. As a result, it became apparent that Wingfield would reach its full capacity for cylinder head production earlier than expected. Secondly, expansion of Wingfield would allow ION to cope with increases in future customer demand.
- 20.3.12 At a Board meeting on 4 February 2004, ION's directors were informed that \$15 million was required in respect of Stage 2, bringing the total capital expenditure estimate to \$68 million. As noted in the March 2004 Wingfield financial model mentioned below, the breakdown of the \$15 million was as follows:
- (a) resolving capacity constraints - \$10.5 million;
 - (b) relocation of AWD production from North Plympton to Wingfield - \$1.47 million; and
 - (c) capitalised interest costs - \$3.2 million.
- 20.3.13 On 19 February 2004, ION disclosed to the market in the February Presentation that the total capital cost of the project had increased to \$68 million (being the approved costs for Stage 1 of \$53 million combined with the additional costs for Stage 2, of \$15 million).
- 20.3.14 Had ION modelled the increase in capital outlay to \$68 million along with the adjustments noted in paragraph 20.3.8 above, the Wingfield Project's IRR would have fallen to 20.4%.
- 20.3.15 For the purposes of the Board meeting on 15 March 2004, ION's CFO submitted a new Wingfield financial model to the Board which reflected the capital outflow in Year 0, and included research and development costs, working capital, commissioning costs, and ACIS revenue. This produced an IRR of 14.6%, or 15% assuming reduced product losses from Year 3. The March 2004 financial model assumed capital expenditure of \$74 million¹⁶ (the increase of 8.8% from \$68 million reflected the inclusion of \$6.2 million in commissioning costs). The capital outflow in the financial model included a finance cost of \$3.2 million, which although forming part of the overall capital expenditure estimate, ought to have been excluded from the IRR calculation. Had the finance cost been excluded, this would have resulted in an IRR of 15.6%, or 15.9% assuming reduced product losses from Year 3. Further, had ION's CFO also adjusted the March 2004 model to reflect a sale and leaseback of the site, which continued to be an option for ION at this time, the March 2004 assessment would have reflected a restated IRR of:

¹⁶ Excluding research and development costs.

- (a) 18.3% (assuming reduced product losses from year 3 in accordance with ION's own assumptions in March 2004); or
 - (b) 17.9% (ignoring reduced product losses).
- 20.3.16 As part of the preparation of the April Model, the capital expenditure figure for Wingfield was confirmed at \$74 million.
- 20.3.17 The April Guidance dated 27 April 2004 stated:
- ... On current estimates, the completed cost will be \$74 million, an overrun of approximately \$6 million or 9% compared with previous guidance.
- The capital cost referred to in this market announcement included the \$68 million noted above plus commissioning costs of \$6.2 million which had been capitalised.
- 20.3.18 From April to June 2004 commissioning costs continued to accumulate as a result of the ongoing engineering and production difficulties being experienced at the plant. Commissioning costs of \$14.9 million had accumulated by July 2004, exceeding the April estimate by \$8.7 million and taking the total capital expenditure estimate from \$74 million to \$82.7 million.
- 20.3.19 The managing director's report tabled at the Board meeting held on 16 June 2004 is dated 10 June 2004. Concerning Wingfield, the report noted:
- Commissioning costs continue to accumulate (currently \$13.1m). Realistic commissioning costs will be assessed and following Board Approval, the excess will be written off in accounts to 30 June 2004 [sic] as 'non-recurring one-off costs'.
- 20.3.20 The Light Metal Castings report tabled at the Board meeting held on 16 June 2004 is dated 8 June 2004. It notes, regarding Wingfield:
- We continue to reflect the Wingfield plant as still being in commissioning phase and therefore all costs, excluding internal rent to head office, airfreight and local freight, are capitalised. For the month of May, a total of \$2.7m was capitalised into project costs....
- 20.3.21 In July 2004 an additional \$8.5 million of capital expenditure was required to rectify the ongoing production difficulties, bringing the total estimated capital cost to complete Wingfield to \$102 million at 30 July 2004 (including research and development costs).
- 20.3.22 In late July 2004 the estimated capital cost of Wingfield was reviewed and a decision was made to write-off \$36.1 million from the carrying value of the Wingfield Project (or approximately \$25 million after tax). The write-off comprised the following amounts:
- (a) pre-production costs - \$14.9 million;
 - (b) research and development costs incurred prior to 30 June 2003 - \$8.5 million;
 - (c) fixed asset write-downs - \$11.5m; and
 - (d) initial operating losses capitalised - \$1.2 million.
- 20.3.23 As far as the Deed Administrators are aware, ION did not recalculate the IRR at this time. Had it done so, the IRR would have fallen materially below 20%.
- 20.3.24 In July 2004, ION's auditors agreed that ION should expense the \$14.9 million of pre-production costs and noted ION's intention to record these as a 'significant item' in the annual accounts for the financial year ended 30 June 2004 due to both the quantum of

these costs and the fact that they were predominantly incurred as pre-production start up costs. ION's auditors also requested the remaining write-offs be disclosed as a 'significant item'.

- 20.3.25 The Wingfield write-off (net of tax) was disclosed to the market as a 'significant item' in the results for the financial year ended 30 June 2004. The announcement dated 24 August 2004 which accompanied the results (ie, the August Announcement) relevantly stated:

...

Commissioning difficulties at the new Wingfield facility have led to a delayed start-up and additional capital expenditure to support customer requirements.

Reappraisal of asset carrying values, including research and development (refer Significant Items)

...

SIGNIFICANT ITEMS

...A further review of asset carrying values, particularly Wingfield as well as research and development, has led to an increase in post tax significant items (excluding the impact of tax consolidation credit) from \$23 million to \$48.5 million, the majority of which is non-cash in nature.

...A review of the Wingfield project led to further significant items of \$19.4m after tax and comprised initial operating losses and pre-production expenses together with a reassessment of the carrying value of fixed assets. A further review of the carrying value of research and development led to an additional \$6.1m after tax write-off.

- 20.3.26 An Ord Minnett analyst's report issued on 24 August 2004, following the August Announcement noted:

In our view, what the write-off reflects is the extent to which ION got pre-production R&D associated with Wingfield wrong.

- 20.3.27 In the MOFA, executed on 16 September 2004, the estimated cost of completion of Wingfield was stated to be \$79 million. This appears to have been made up of the \$102 million figure mentioned above less pre-production costs (\$14.9 million) and research and development costs (\$8.5 million) which had been written off.

- 20.3.28 A Wingfield Project capital expenditure progress report for the period ended 30 September 2004 increased the estimate of capital expenditure required to complete the Wingfield Project from \$102 million to \$107.6 million. The net increase in expenditure related to:

- (a) \$10 million required to commission the HF V6 cylinder head production; less
- (b) \$4.4 million for scope changes, which were to be recovered from Holden.

- 20.3.29 The increase was first reported to the Capital Projects Committee meeting on 14 October 2004 and subsequently to the Board on 25 October 2004.

- 20.3.30 On 21 October 2004 ION received the Final Williams Report. The report estimated the final capital cost of Wingfield at \$109.8 million, including an allowance of a \$2 million contingency.

- 20.3.31 As mentioned in section 12.3 above, at the 26 October 2004 AGM the chairman's address referred to an increase of 15% on previous capital expenditure allowances for all major investments. This included the Wingfield Project which had a stand-alone increase of 6.8% from \$102.8 million to \$109.8 million.
- 20.3.32 A summary of the capital expenditure that ION had estimated to be spent in the purchase, construction and commissioning of the Wingfield plant as at 30 November 2004, prior to the write-off of \$36.1 million, was as follows:

Wingfield capital expenditure	
\$m	30 November 2004
Phase 1	38
In-house machining	12.9
Relocation of Proton	1.8
Phase 2	15
Research and development	8.5
Commissioning costs	17.4
Production improvements	8.5
HF V6 cyclinder head production	10
Scope changes	(4.4)
Contingency	2
Total estimated expenditure	109.7

- 20.3.33 At 30 November 2004, the actual amount spent at Wingfield amounted to \$91.6 million.

20.4 Actual and forecast profitability

- 20.4.1 During its commissioning, in the period leading up to the appointment of the Administrators in December 2004, the financial performance of the Wingfield plant was considerably worse than ION had anticipated, which reflected the operational difficulties detailed in section 20.2 above. Numerous revisions were made to profit forecasts, however ION was not able to achieve those forecasts. Substantial losses were incurred throughout this period.
- 20.4.2 The original forecasts used for the purposes of assessing the viability of the project were based on broad assumptions. Detailed product or process costings had not been prepared. The capex proposal submitted to the Board in May 2002, and the subsequent update in the March 2004 Business Case, were based on the following assumptions:

Wingfield capital expenditure		
	May 2002 capex proposal	March 2004 business case
Revenue for the first full year (\$m)	75	68
EBIT/sales margin	22%	18%

- 20.4.3 ION began to manufacture products at Wingfield in saleable quantities from January 2004. The management accounts for the year ended 30 June 2004 included detailed profit and loss accounts and forecasts for Wingfield.

- 20.4.4 Wingfield's results, reported by ION in its management accounts for the year ended 30 June 2004, and their comparison to budget, were as follows:

Wingfield financial results for the year ended 30 June 2004

\$'000	Actual	Budget
Total revenue	3,110	6,765
Gross margin	(6,568)	1,564
Overheads	(6,383)	306
Depreciation and amortisation	(185)	(1,872)
Trading EBIT	-	(2)

- 20.4.5 As set out above, the financial performance during the first period of commissioning recorded a breakeven result in line with the budget. However, this does not reflect the entire cost of commissioning Wingfield, for the following reasons:
- (a) ION classified a proportion of its Wingfield operating costs as capital expenditure during the year ended 30 June 2004, amounting to \$14.9 million of additional costs; and
 - (b) a further portion of Wingfield's costs were classified as restructuring costs, amounting to \$1.2 million for the period to 30 June 2004.
- 20.4.6 The commissioning costs that were classified as capital expenditure were subsequently written off as explained at paragraph 20.3.22 above.
- 20.4.7 For the year ended 30 June 2005, a detailed monthly budget was prepared for Wingfield, and was completed in early August 2004.
- 20.4.8 Although production volumes increased from July 2004, ION was not able to achieve its profit budget. Sales volumes achieved were close to budget, however the cost of production continued to be significantly higher than expected, reflecting the production difficulties described above.
- 20.4.9 From 1 July 2004, ION accounted for a portion of the higher than budgeted production costs at Wingfield as restructuring costs, and classified these restructuring costs as significant items. This was a change of treatment from the preceding financial year when commissioning costs had been capitalised. The extent of these restructuring costs is noted below in paragraph 20.4.11.

- 20.4.10 The results of operations at Wingfield for the 5 months ended 30 November 2004 were as follows:

Wingfield results for the 5 months ended 30 November 2004

\$'000	Actual	Budget
Total revenue	11,988	13,169
Costs of goods manufactured	(10,840)	(14,086)
Gross margin	1,148	(917)
Overheads	(3,694)	(1,920)
EBITDA	(2,586)	(2,837)
Depreciation and amortisation	-	(968)
Trading EBIT	(2,586)	(3,805)
Restructuring costs	(13,062)	-
EBIT	(15,648)	(3,805)

- 20.4.11 When it became apparent that ION would not be able to achieve its FY 2005 budget, new forecasts were prepared. A summary of the revised forecasts prepared in September 2004, October 2004 and November 2004 is set out below:

Wingfield annual forecast for the year ended 30 June 2005

\$'000	Date of forecast preparation			
	Sep-04 Version 1*	Sep-04 Version 2*	Oct-04	Nov-04
Sales revenue	49,041	46,364	49,273	45,576
ACIS revenue	7,677	7,505	7,636	1,893
Other revenue	578	578	365	95
Total revenue	57,296	54,447	57,274	47,564
Actual gross margin/(loss) per ION	4,771	2,104	(1,372)	2,858
Overheads	(5,776)	(5,776)	(6,773)	(10,614)
Actual EBITDA	(1,005)	(3,672)	(8,145)	(7,756)
Depreciation and amortisation	(2,977)	(2,817)	(2,851)	(2,837)
Trading EBIT	(3,982)	(6,489)	(10,996)	(10,593)
Restructuring costs	(4,304)	(4,304)	(6,814)	(14,039)
EBIT	(8,286)	(10,793)	(17,810)	(24,632)

* Two versions of a forecast prepared as at September 2004 were discovered in ION's books and records

- 20.4.12 A comparison of these revised forecasts with the actual results for each month demonstrates that ION was not able to accurately predict its losses at Wingfield, and tended to underestimate the costs involved in operating the plant. For example, the updated forecast prepared in October reflected restructuring costs for FY 2005 of \$6.8 million. Actual restructuring costs of \$9.5 million had been incurred by 31 October 2004.
- 20.4.13 In addition to budgets prepared for the year ended 30 June 2004 and 30 June 2005, ION prepared longer term forecasts. The earliest versions of these longer term forecasts (prepared in 2002 and 2003) lacked detail. In March 2004 ION began to separately estimate the cost of production at Wingfield (rather than assuming average gross profit margins consistent with the North Plympton plant).

- 20.4.14 The forecasts for sales revenue to be achieved at Wingfield were relatively consistent, once the March 2004 Business Case had been completed. A summary of the forecast sales revenues is set out below:

Wingfield sales revenue forecast					
\$'000	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Date of forecast					
May 2002	-	64,093	75,000	65,679	65,679
November 2002	-	62,770	62,770	62,770	62,770
October 2003	6,000	60,000	66,000	72,600	n/a
February 2004	4,937	57,738	76,512	80,704	n/a
March 2004 Business Case Review *	-	54,265	67,912	63,958	63,284
April 2004 ASX release	4,235	40,291	63,067	n/a	n/a
May 2004	4,200	40,300	63,100	63,100	63,100
August 2004	3,100	31,300	63,100	63,100	63,100

* November 2002 financial model and March 2004 Business Case financial model shows first full year as FY 2004; however we have assumed it should be the year ended 30 June 2005.

The consistency of sales revenue forecasts reflects the relative certainty of selling prices and sales volumes, presuming ION could make enough saleable product (which had not been achieved by December 2004).

- 20.4.15 The forecast profitability of Wingfield was considerably less certain than sales revenue. A summary of ION's forecasts for EBITDA is tabulated below:

Wingfield EBITDA forecast					
\$m					
Date of forecast	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
May 2002	-	16.8	19.3	17.1	17.1
September 2003	20.5	20.4	20.4	20.4	20.3
March 2004 Business Case*	n/a	15.4	21.3	19.5	19.0
April 2004 ASX release**	(7.3)	10.3	20.7	n/a	n/a
May 2004**	(8.6)	10.3	20.8	20.8	20.8
August 2004**	(16.6)	(0.8)	13.0	12.2	12.2
29 October 2004**	(16.6)	(13.8)	9.0	9.0	n/a
1 December 2004 update**	(16.6)	(21.8)	9.0	9.0	9.0

* March 2004 Business Case shows the year ended 30 June 2004 as first full year of trading. We have assumed this is incorrect and that the year ended 30 June 2005 is the first full year.

** EBITDA includes any known or forecast capitalised commissioning costs or significant items.

- 20.4.16 The Deed Administrators have included ION's forecast restructuring costs or capitalised start up costs within the EBITDA forecasts set out above. It is therefore apparent that a substantial improvement in performance would have been required to achieve the profit forecasts for years subsequent to 30 June 2005. By December 2004, the operational performance of the Wingfield plant had not reached the point where it was evident that profitable operations could be achieved. As explained at section 20.2, production yields

and manning levels were significantly worse than required, and continued to reflect significant technical production difficulties.

20.4.17 As noted in section 20.3 above, by August 2004, ION had disclosed that significant unplanned pre-production costs incurred for the financial year ended 30 June 2004 had been written off. Costs of a similar type and magnitude continued to be incurred, although these were classified as restructuring costs (as described above). In the early months of the FY 2005, ION made several statements regarding the continued difficulties at Wingfield.

20.4.18 The relevant statements were as follows.

(a) In the September Announcement issued on 24 September 2004, ION stated:

Wingfield operating performance continues to improve whilst its cost of operation relative to output is still adverse as we still have some way to move up the performance curve at this casting plant

(b) In its 2004 Annual Report, published in late September 2004, ION stated:

The first of the plants to be commissioned is Wingfield. Unfortunately, Wingfield was late and had start-up failures which led to additional plant and start-up costs. These costs have been written off at 30 June 2004. This means the carrying value of the plant is at a value believed by directors and management to enable fair economic returns throughout its expected business life.

...

The major capital projects, namely:

- Wingfield, South Australia, cylinder head plant;
 - Altona, Victoria, alloy engine block plant;
 - Kentucky, USA, alloy wheel plant and
 - Albury, NSW, upgrade to manufacture differentials for the Holden VE program
- will provide long term revenue, profitability and powerful cash flow.

These projects are further reviewed in the relevant business unit areas.

...

Pre-production costs at Wingfield of \$16.1m have also been written off.

...

The South Australian, Wingfield cylinder head, manifold and oil pan plant, established to supply engine components for the new Holden High Feature V6 engine, ran late and was a major cause of the aforementioned abnormal costs. While yet to reach its target capacities, the plant is now in production and supplying product on time to customer demand and specification. The complex task of introducing six new products, commissioning a new plant and training a workforce was very demanding and achieved at great cost to and unrelenting demand on ION personnel who persevered and achieved in very difficult circumstances.

...The lessons of Wingfield have been thoroughly absorbed.

...

Wingfield, Kentucky and Altona are pivotal to the future of ION. New facilities, strong demand and long term supply agreements augur well for strong cash flow and sustained profitable future growth ...

...

The delay has brought with it associated project overheads, prolonged commissioning costs and capital overspend. ION has assessed that the capitalised costs of this plant should not be more than \$67.5m, and is therefore writing off as at 30 June 2004 fixed assets of \$11.5m to ensure the capital cost is contained at the properly assessed economic worth.

...

... The manufacture of cylinder heads for the new high feature V6 engine for Holden will commence in late 2004 with ramp up to full production scheduled for January-June 2005.

ION acknowledges that the start-up of Wingfield was disappointing with cost overruns and production delays. However, the recruitment of a quality team and collaboration with expert experienced engineering resources will result in these one-time issues being overcome.

- (c) In his address at the 2004 AGM on 26 October 2004, the chairman stated:

In the case of our new operations such as Wingfield, we have previously noted the difficulties during construction and commissioning. Enormous effort has been directed at correcting these problems. All of the employees associated with this plant have worked tirelessly to overcome the shortcomings while meeting customer demands. The Board thanks them for their effort

Not all problems at Wingfield are behind us but current performance and future projections indicates we are on the right track

- (d) In his address at the 2004 AGM, the CEO stated:

... Wingfield was not properly resourced and we have paid a price there.

This is an area getting close attention from me.

...

In that time [over the last two months] we have:

- ramped output at Wingfield

...

Meanwhile, Wingfield production and quality continue to improve towards our targets but the efficiency is still a long way from where we need to get it to. I'm sure this improvement will continue ...

- (e) In the presentation made on 10 November 2004 to the Citigroup Conference, ION stated in relation to Wingfield:

- In production ramp up
- Incremental capital to go in
- Performance improving after correcting early difficulties.

20.4.19 In the chairman's address at the 2004 AGM on 26 October 2004 the following was said:

We expect that in the half year ended June 2005 we will have a stronger trading profit, and although it is very difficult to reliably forecast a figure at this time, it is estimated that EBITDA will be approximately \$90 million for the full year before significant times.

At that time, ION anticipated significant items of \$22.6 million before tax, which included Wingfield restructuring costs of \$11.8 million. No mention was made at the AGM of the nature and magnitude of the significant items anticipated by ION at this time.

21. North Plympton

21.1 Introduction

21.1.1 ION acquired the Castalloy business located at North Plympton, South Australia in December 1999. North Plympton produced motorcycle wheels, hubs and swing arm parts and accessories for Harley-Davidson and hollow core cast engine components for Holden, Peugeot and Proton. Approximately 60% to 70% of North Plympton's revenue represented sales to Harley-Davidson.

21.1.2 Historically, the North Plympton operations had been profitable, although there was a clear trend of declining performance in the lead up to the Administrators' appointment. Net profit before tax and restructuring costs for the years FY 2000 to FY 2004 was as follows:

FY 2000 - \$2.205 million

FY 2001 - \$13.802 million

FY 2002 - \$11.096 million

FY 2003 - \$7.478 million

FY 2004 - \$2.983 million

21.1.3 The Deed Administrators' investigations in relation to North Plympton have focused on:

- (a) the operational problems at the plant (including EPA issues) and the impact of those problems on profitability (section 21.2 below); and
- (b) the contractual arrangements which were in place in relation to the supply of products to Harley-Davidson (section 21.3 below).

21.2 Operational problems and profitability

21.2.1 In the second half of 2003 ION's Board became aware that North Plympton was experiencing operational problems which were unfavourably impacting operating EBIT.

21.2.2 The operational concerns at North Plympton included:

- (a) excessive use of casual labour;
- (b) high repairs and maintenance costs due to breakdown rather than preventative maintenance;
- (c) poor quality product and high reject rates requiring rework;
- (d) excessive overtime required to deal with rework;

- (e) failure to deliver scheduled demands;
- (f) increased use of airfreight due to delays in production;
- (g) high absenteeism amongst staff; and
- (h) high injury frequency among the workforce due to poor plant layout, excessive stock handling and inadequate preventative, timed maintenance.

These problems had a direct impact on the operating expenses of the business.

- 21.2.3 It was also recognised at this time that North Plympton's costing systems required improvement and steps were taken to address this.
- 21.2.4 In addition, the South Australian EPA had been pressuring ION for some time to reduce the noise and odour emissions from its North Plympton facility. Following a period of consultation with the EPA and local community groups, ION developed a proposed plan to address the environmental concerns. Preliminary costings for the proposed plan were in the order of \$20 to \$25 million. In mid 2003 senior ION management reviewed the proposed plan and the legal imperative for it. A decision was made that the commitments in the proposed plan were not strictly required under the legislation and the costs prohibitive. In those circumstances ION did not proceed with the proposed plan but continued its dialogue with the EPA in an attempt to resolve the EPA issues at the plant.
- 21.2.5 In September 2003, ION implemented a corrective action plan to deal with the operational problems which were impacting on North Plympton's profitability. The corrective action plan included a proposal to reduce staff levels by between 80 to 100 staff by June 2004. A reduction of 100 staff was expected to produce cost savings of \$6.3 million per annum at a one off cost of \$1.9 million.
- 21.2.6 ION had set its budget for FY 2004 in April 2003. By October 2003, management had introduced a monthly rolling forecast. The December 2003 forecast for North Plympton for FY 2004, in contrast to the budget set in April 2003, was as follows:
- (a) April 2003 budget – sales of \$106.882 million with EBIT of \$8.886 million;
 - (b) December 2003 forecast – sales of \$112.718 million with EBIT of \$6.526 million.
- 21.2.7 By January 2004 the planned retrenchment program had been completed, which included both a voluntary and involuntary redundancy component, reducing head count at North Plympton by approximately 100. A further profit improvement program was implemented at this time which primarily focused on the following:
- (a) reducing freight costs;
 - (b) improving production yields;
 - (c) reducing scrap and rework; and
 - (d) reducing subcontract costs.
- However, the reduced workforce meant a loss of experienced staff to assist in improving North Plympton's processes.
- 21.2.8 The February 2004 forecast for North Plympton for FY 2004 was – sales of \$95.558 million with EBIT of \$3.600 million.

- 21.2.9 By March 2004, the forecast for FY 2004 EBIT for North Plympton (as notified to the Board at the March 2004 meeting) was now \$1.629 million.
- 21.2.10 In March 2004, the Board was provided with an extensive report on the environmental issues affecting North Plympton. It was reported that the EPA had been pressing Castalloy for some time to reduce the level of noise and odour emissions from its North Plympton facility. The report noted that negotiations were continuing with the EPA in relation to ION's licence conditions (imposed in November 2003) which required maximum noise and odour conditions to be met by June 2004. Meanwhile, ION had lodged an appeal against a number of the licence conditions.
- 21.2.11 In April 2004, the Board was informed that the revised EBIT forecast for FY 2004 was \$1.224 million (\$7.662 million below budget). The EBIT forecast was stated to be impacted by redundancy costs of \$1.905 million and a \$6 million inventory write-down. It was also noted that a reduction in sales volume for North Plympton reflected the change in invoicing to Harley-Davidson earlier in the year when ION moved to 'just in time' supply and a stock of inventory was created in ION's newly established US warehouse (see section 21.3 below).
- 21.2.12 On 27 April 2004, ION published the April Guidance which did not contain specific forecasts for North Plympton. However, a forecast supporting the April Guidance (ie, the April Model) included the following actual and estimated profit figures for North Plympton:

North Plympton forecast				
\$'000	FY 2003 Actual	FY 2004 Forecast	FY 2005 Forecast	FY 2006 Forecast
Sales	87,659	99,849	111,541	118,596
EBITDA	11,186	9,033	16,292	20,368
Trading EBIT	7,478	3,729	10,553	14,629
EBIT	7,478	1,224	10,553	14,629

- 21.2.13 The reduced sales in FY 2004 were the result of a one-off adjustment due to a change in Harley-Davidson's inventory management strategy. The \$1.224 million forecast EBIT figure for FY 2004 was based on trading EBIT of \$3.729 million reduced by restructuring costs of \$2.505 million (including redundancies).
- 21.2.14 The FY 2005 figures assumed net cost savings in that year totalling \$16.9 million, which included an expected \$6 million annualised savings from staff redundancies, a \$2.5 million saving in one off redundancy costs incurred in FY 2004, a \$4.7 million saving in reduced staff costs (including natural attrition) and overtime, and a saving in air freight of \$1.7 million. In the Deed Administrators' view, some of the forecast cost savings may have been optimistic noting:
- (a) the impact of the redundancy program on the likelihood of subsequent natural attrition and addressing operational issues;
 - (b) the treatment of the \$6 million of annualised labour savings (which were not pro-rated to account for the redundancies program being implemented part way through FY 2004); and

- (c) that the \$6 million of annualised labour savings were expected to be partially offset by up to \$1.5 million of other related costs (which were not allowed for).
- As noted in paragraph 25.7.23 when the April Model forecasts are adjusted to take account of these matters, the forecasts nonetheless remain in line with the April Guidance.
- 21.2.15 As at May 2004, ION was continuing with the implementation of its profit improvement initiatives. A new 'Profit Recovery Plan' was launched with further initiatives for cost savings in targeted areas such as overtime, outsourced operations, airfreight, scrap and rework. At this time ION was aiming to reduce costs in these areas by 50%, representing a saving of \$1.5 million per month.
- 21.2.16 By May 2004 there had been a small improvement in the short term rolling forecast for FY 2004 in contrast to the preceding monthly forecast as follows:
- (a) April 2004 forecast – sales of \$98.854 million with EBIT of \$1.224 million (EBITDA \$3.729 million);
- (b) May 2004 forecast – sales of \$102.861 million with EBIT of \$1.729 million (EBITDA \$4.234 million).
- 21.2.17 In May 2004, the Board was informed that ION had submitted an environment improvement plan to the EPA and that EPA representatives were encouraged by the plan. As a compromise, the EPA agreed to extend the date in the licence for compliance with the specified noise and odour conditions until December 2005. The cost to implement phase 1 of the environmental controls was \$932,896.
- 21.2.18 In late May 2004, ION prepared the May IM which incorporated a forecast for North Plympton which was the same as the forecast underpinning the April Guidance.
- 21.2.19 In June 2004, North Plympton was reported to the Board as a continuing major challenge with sub-standard work flows and environmental issues. It was also reported that North Plympton's FY 2004 actual sales were significantly less than budget expectation with sales impacted by the change in invoicing to Harley-Davidson and reduced volume requirements for Holden and Peugeot.
- 21.2.20 As at 30 June 2004, North Plympton recorded a Trading EBIT of \$2.733 million, and after restructuring costs of \$14.3 million (which had not been provided for in the budget), an EBIT shortfall of approximately \$11.6 million. The restructuring costs (which were one-off transactions) comprised a write-off of research and development costs (as a result of recommendations made by ION's external auditors), a write-down in inventory valuation, redundancy costs and a consumables write-down.
- 21.2.21 By July 2004 officers of ION were aware that it was necessary to revise the EBITDA forecasts for North Plympton contained in the May IM and to provide updated information to prospective lenders. As mentioned above, the earlier forecasts provided to prospective lenders (which were based on the April Model) incorporated figures for North Plympton which assumed certain costs savings would be achieved. This led to the preparation of the August Update. Whilst not separately disclosed, the ION Group forecasts in the August Update, incorporated the following North Plympton forecasts:

- (a) FY 2005 – EBITDA of \$10 million down from the April Model EBITDA of \$16.292 million; and
 - (b) FY 2006 – EBITDA of \$12.3 million down from the April Model EBITDA of \$20.368 million.
- 21.2.22 North Plympton's EBITDA forecast as reported in the August Update had declined by \$6.3 million for FY 2005 and by \$8.07 million for FY 2006 from the May IM. The August Update to financiers stated the reasons for the downgrade was as follows:
- ...earnings over the latter stages of 2004 have been lower than expected principally due to a deterioration in material yields which then led to increases in other costs. The financial forecasts had also envisaged a further step change improvement in performance in 2005. Given the lower than expected performance over the latter stages of 2004, ION considers it prudent to revise the future forecasts downwards accordingly. A series of productivity based programs (focused on die changeovers, scrap, rework, logistics, and a review of outsourcing) are being developed to address the current situation and provide a basis for future improvements.
- 21.2.23 ION's FY 2004 Annual Report issued in September 2004 outlined the EPA issues at the North Plympton plant, stating:
- The consolidated entity's activities are subject to various environmental regulations. Certain conditions relating to odour and noise emissions contained in the licence issued by the South Australian Environment Protection Authority in November 2003 in respect of the ION Automotive North Plympton facility are the subject of appeal proceedings in the South Australian Environment, Resources and Development Court. The parties to those proceedings are engaged in ongoing discussions with a view to reaching an agreed outcome.
- 21.2.24 The Board was informed in late September 2004 that ION had prepared a formal response to the EPA addressing their concerns and specifically challenging a number of suggestions put by the EPA in relation to the achievability of certain odour and noise targets. Phase 1 actions were reported as nearly complete and phase 2 actions costed at \$1.542 million with completion expected in December 2005.
- 21.2.25 The Board was informed at its 22 September 2004 meeting that the performance of North Plympton continued to be negative and that North Plympton recorded a loss for the month of August of \$1.5 million.
- 21.2.26 The North Plympton profit improvement plan was updated on 14 October 2004 at which time it was noted that air freight costs had reduced from \$720,000 in June to \$370,000 in August with September at \$200,000 and October estimated at \$150,000.
- 21.2.27 Management produced a report summarising the position of North Plympton for the purposes of the Board meeting on 25 October 2004. The report noted that, in an effort to improve profitability, an accelerated profit improvement program had been initiated. It also noted that:
- (a) despite customer demand for many products exceeding manufacturing capacity, North Plympton was operating at a significant trading loss each month;

- (b) North Plympton required substantial investment in order to meet environmental compliance standards and workplace hazards were difficult to mitigate against given the configuration of the manufacturing operations;
 - (c) the current structure of the business unit was not profitable;
 - (d) profitability could only be achieved through a complete rationalisation of the site and the process flow; and
 - (e) negotiations should be initiated with Harley-Davidson to secure profitable pricing on wheels and discontinuance of non-profitable product lines.
- 21.2.28 On 26 October 2004, ION held its AGM for 2004. In the chairman's address it was stated that:

North Plympton, our original plant in Adelaide, has suffered from lower demand and management's attention being directed at the start-up of Wingfield. The priority we now have is to refocus on the costs and product mix of this facility and return the plant to the profitability we know we can achieve.

- 21.2.29 On 1 November 2004, ION provided forecasts to the Banks which revealed North Plympton's forecast trading EBITDA had been scaled back from the August Update a further \$1 million for FY 2006 and a further \$2.3 million for FY 2007.

- 21.2.30 There was little tangible evidence of improved performance in the lead up to the appointment of Administrators. Specifically, North Plympton reported Trading EBIT of (\$2.8) million in September 2004 and (\$1.7) million in October 2004.

21.3 Harley-Davidson

- 21.3.1 As mentioned above, ION manufactured and supplied various types of alloy wheels, swing arms and hubs for Harley-Davidson from its North Plympton plant. Prior to August 2003, the parts were supplied pursuant to the terms of an agreement called the Master Supply Agreement.
- 21.3.2 The Master Supply Agreement was executed between Harley-Davidson and Castalloy on 15 September 1999. It was an open ended agreement with no specific contract period, although it could be terminated on the happening of prescribed events. The Master Supply Agreement did not require ION to reduce its price for Harley-Davidson parts on a specific percentage basis each year. There was, however, a continuous improvement term which required ION to implement productivity initiatives with a view to passing on manufacturing cost reductions to Harley-Davidson. The Master Supply Agreement required ION to supply parts to Harley-Davidson in response to orders issued on a monthly basis. There was no onus on ION to be able to respond to short term changes in Harley-Davidson's order schedules.
- 21.3.3 During the period when the Master Supply Agreement was operative, the systems in place in relation to calculating margins on Harley-Davidson products did not enable ION to determine with any degree of confidence what the return was on each Harley-Davidson product. This made it difficult for ION to ascertain with accuracy which Harley-Davidson product was profitable and which Harley-Davidson product was not profitable.

- 21.3.4 By July 2003, Harley-Davidson was moving to a more formal basis of dealing with key suppliers and seeking commitments on cost reductions, quality improvement and development of technology. In return for the more formal commitments from suppliers, Harley-Davidson would provide greater certainty concerning its demand.
- 21.3.5 Consistent with this approach, on 14 August 2003 Harley-Davidson presented to ION the 'Harley-Davidson Motor Company Enterprise Wide Cost Imperative' (**ECI**) in which it set out its requirements from suppliers and made it clear that it would be necessary for suppliers to negotiate new agreements with it. In the ECI, Harley-Davidson also stated that it expected a 10 per cent annual increase in unit volumes for the balance of the decade.
- 21.3.6 In keeping with the ECI, in August 2003 ION entered into negotiations with Harley-Davidson to implement the new Harley-Davidson cost imperatives in a revised agreement (the **HD Agreement**). It appears that the terms of the HD Agreement were formally accepted by ION on 13 October 2003.
- 21.3.7 In keeping with the new purchasing philosophy adopted by Harley-Davidson, the HD Agreement required ION to provide a 3% price reduction annually (starting in year one) and required ION to be able to respond to short term changes in Harley-Davidson's supply schedule. Supply was required to be provided on a 'just-in-time' basis. This meant that ION was required to carry inventory and to establish a warehouse in the United States so that it could respond to Harley-Davidson's supply demands more rapidly. The change to 'just-in-time' supply also resulted in a one-off reduction in sales while Harley-Davidson's existing stocks were depleted.
- 21.3.8 It is unlikely that ION could have negotiated a revised agreement in August 2003 with Harley-Davidson that did not incorporate an annual price reduction and 'just-in-time' delivery obligation and that Harley-Davidson may have looked elsewhere in the absence of agreement on the part of ION to the type of terms incorporated in the HD Agreement.
- 21.3.9 The most compelling advantage of the HD Agreement for ION was that Harley-Davidson agreed to purchase from ION until 2010. That commitment demonstrated to ION that Harley-Davidson would not be seeking alternate suppliers and competitive price reductions. It is also apparent that the annual price reduction of 3% (known as 'costdowns') were relatively common by industry standards.
- 21.3.10 ION management considered the HD Agreement had the potential to be profitable despite annual price reductions, subject to resolving operational difficulties at North Plympton. In addition, management considered that there was potential to negotiate price increases towards the end of 2004 on product lines identified as being unprofitable. ION management considered that the key advantage of entering into the HD Agreement was that it required Harley-Davidson to purchase from ION until 2010. However, there is no written evidence of review, analysis, or modelling of financial information for the purpose of determining the financial viability of the HD Agreement at the time ION entered into it.
- 21.3.11 In ION's 2003 Annual Report, released on 30 September 2003, ION announced to the financial market that it exported 350,000 wheels to Harley-Davidson per annum and that Harley-Davidson sales were expected to grow at an average of 10% compound for the

- next five years. ION's records confirm that ION exported more than 350,000 wheels in each of FY 2003 and FY 2004 to Harley-Davidson.
- 21.3.12 In a presentation to the UBS Conference on 20 October 2003 (ie, the UBS Presentation), ION informed the financial market that new business had been secured from Harley-Davidson with their supply agreement extended to 2010. The UBS Presentation stated:
- New Business Secured
- Harley Davidson
 - ION supply agreements extended to 2010.
- 21.3.13 In the UBS Presentation, ION also noted that Harley-Davidson had been a customer since 1984, over three million wheels had been supplied to it, growth was forecast at 10% and that volumes per annum were 300,000 wheels, 200,000 laced hubs and 200,000 swing arms.
- 21.3.14 On 21 January 2004, Harley-Davidson issued a press release in which it stated that it expected to grow its business with a goal to produce 400,000 Harley-Davidson motorcycles in 2007.
- 21.3.15 A press release from Harley-Davidson dated 14 April 2004 entitled 'Harley-Davidson roars into Its Second Century with Another Record Quarter' recorded that:
- The Company's continuing strong performance supports our longer-range objectives to satisfy demand for 400,000 Harley-Davidson motorcycles in 2007 and to deliver an annual earnings growth rate in the mid teens.
- 21.3.16 On 27 April 2004, ION published the April Guidance in which it stated that ION was the principal supplier of castalloy wheels and other accessories to Harley-Davidson and that Harley-Davidson had recently announced record results for the January/March quarter with production of motorcycles forecast to grow from 317,000 in 2004 to 400,000 by 2007.
- 21.3.17 ION supplied Harley-Davidson with 62% of its wheel requirements in 2003. In 2004, ION supplied 58% of Harley-Davidson's wheels.

22. Auckland

- 22.1.1 ION's operations in Auckland, New Zealand comprised the wholly owned subsidiaries of ION Holdings (NZ) Ltd, ION New Zealand Limited, ION Finance NZ Limited and ION Automotive (New Zealand) Limited, the latter being the main operating entity (together **Auckland**).
- 22.1.2 Auckland was established in August 2001 when ION purchased a 76.25% interest in the business from Ford US, acquiring the remaining 23.75% interest from a private equity investor four months later in December 2001.
- 22.1.3 Auckland formed part of the Wheels Division of IAG and manufactured alloy wheels and front cross-members, primarily for sale to Ford in the United States and Australia.
- 22.1.4 Auckland was heavily reliant upon its primary customer, Ford, with contracts in place that were due to expire progressively throughout FY 2007 (Ford Australia) and FY 2008 (Ford

- US). The contracts stipulated that prices would be charged in NZ\$ and determined by a fixed exchange rate. The NZ\$ appreciated favourably during late 2003 which meant that, whilst Auckland was effectively hedged against foreign currency volatility, it's pricing was becoming less competitive due to the appreciating exchange rate resulting in pressure from Ford to reduce prices.
- 22.1.5 In late 2003 Ford informed ION of the planned wind-down in the production of its Taurus model, which accounted for approximately 85% of the Auckland plant's production. Around this time, new contracts were awarded by Ford to ION that were expected to largely replace the lost Taurus model volumes. However, these new contracts no longer provided ION protection from the foreign currency movements.
- 22.1.6 In early 2004 ION commenced plans to produce a portion of its Harley-Davidson volumes from the Auckland plant, with production scheduled to commence in early 2005. However, ION had only run trials of this product by the time of the appointment of the Administrators.
- 22.1.7 It was initially expected that as the Taurus volumes would begin to decrease around February 2004 these would be replaced by volumes under the new contracts which would begin to ramp up from around May 2004, thus resulting in a temporary period of reduced levels of demand with a drop in revenues forecast for FY 2004. The resulting revenue reductions forecast for FY 2004 were appropriately reflected in the IAG February 2004 Forecast.
- 22.1.8 In March 2004, ION was informed that due to launch and production issues experienced by Ford in respect of the replacement models, volumes for the existing model would continue to be low in FY 2004 and launch model volumes would not reach expectations until August 2004. The delay in the replacement volumes, resulting in further revenue reduction in FY 2004, was appropriately reflected in the April Model.
- 22.1.9 The April Model also projected that customer volumes in FY 2005 would return to FY 2003 production levels, which included some Ford volumes that were deemed by management to be uncertain. These volumes accounted for 150,000 units and EBIT of \$5.1 million (9% of total Auckland volumes and 26% of total Auckland EBIT).
- 22.1.10 The customer volumes projected in the April Model for FY 2006 included 170,000 units of uncontracted volumes which represented revenues for this financial year of \$9.8 million and EBIT of \$4.3 million (7.9% and 20% of total Auckland revenue and EBIT respectively).
- 22.1.11 In October 2004 it was recognised within ION that the softening in customer demand was forecast to continue throughout FY 2005. This was attributed to lower Ford volumes and the continued strength of the NZ\$. This reduction in revenues was appropriately reflected in ION's prevailing forecasts (ie, the October 2004 Forecast) by a reduction in EBITDA of \$5.2 million in FY 2005 and (to be conservative) a reduction of \$2.6 million in both FY 2006 and FY 2007.
- 22.1.12 Throughout 2004 Auckland attempted to win business from other customers such as Holden, Land Rover and Lotus and as a result had factored in unsourced volumes into its longer term forecasts (included in FY 2006 and FY 2007). By the time of the Administrators' appointment, quotes had not crystallised into contracts, and Ford Australia and Ford US remained the Auckland plant's primary customers.

23. Kentucky

- 23.1.1 During 2002, ION began formulating a strategy to expand its wheel production capacity and, in particular, to consider establishing a facility in the United States.
- 23.1.2 By late 2002, ION had commenced a review of properties in the United States and by March 2003 a mothballed facility in Warsaw, Kentucky, United States had been identified and a request submitted to ION's Board for the purchase of the property for US\$9 million. The proposal was approved by the Board at the 31 March 2003 Board meeting and the property was purchased in April 2003. It was intended that the facility would manufacture wheels for supply to Ford, with capacity to also supply other customers.
- 23.1.3 On 27 October 2003, ION's Board approved US\$46.3 million in expenditure for the fit-out of the Kentucky facility. This decision appears to have been made on the basis of information provided to ION's Board, including the following:
- (a) estimated total capex of US\$55.3 million (which included the US\$9 million previously spent on the purchase of the land and buildings);
 - (b) estimated capacity of 1.7 million units per annum; and
 - (c) an IRR of +20%.
- 23.1.4 The Deed Administrators have reviewed the methodology utilised by ION to calculate the IRR for the Kentucky Project. While there are aspects of the methodology which the Deed Administrators do not consider to be best practice, a re-statement of the financial model by the Deed Administrators using the appropriate methodology (**Restated Kentucky Model**) still results in an IRR of +20% for the project. In addition, it appears that there were other opportunities, such as for bed plate manufacture or the sale and lease back of plant and equipment, which if taken into account in the project evaluation, would have enhanced the IRR further.
- 23.1.5 The forecasts prepared for the May IM reveal a moderation in the Kentucky Project's earnings from the Restated Kentucky Model (primarily as a result of a more conservative production ramp-up rate and a reduction in average product margins). Using the Restated Kentucky Model, this moderation in earnings meant that by May 2004 the Kentucky Project's forecast IRR had declined to approximately 18.1% (again, not taking into account other potential opportunities to enhance the business case.)
- 23.1.6 Project status reports confirm that the Kentucky Project tracked to plan and budget until late 2004. Specifically, Board papers for the Board meeting held on 22 September 2004 indicate that commissioning costs were anticipated to exceed approved project costs by approximately US\$6 million. At this time ION's management team was assessing other risks and opportunities for the project to determine whether there would be an overall increase in project costs. ION had also engaged an independent engineer (ie, Williams) to assess the required capital outlay to complete its capital projects, including Kentucky.
- 23.1.7 In late October 2004 forecast earnings for the Kentucky Project were scaled back by US\$2 million in both FY 2006 and FY 2007. There is no evidence that there was a change in the expected economics of the plant and this adjustment appears to have been made in the interests of conservatism. At this time the capital expenditure forecast was also

increased by approximately US\$8 million following receipt of the Final Williams Report (including an allowance of US\$3 million as a contingency). This increase was consistent with the information tabled at the 22 September 2004 Board meeting.

- 23.1.8 The Restated Kentucky Model, adjusted for the further moderation in earnings and the increase in capital costs confirmed in the Final Williams Report (not including the US\$3 million contingency), indicates an IRR for the project of approximately 16%. There is no evidence that the additional capital costs ought to have been recognised and included in the original assessment of the project in 2003. In any event, there was still the potential to increase the IRR through the inclusion of other opportunities.
- 23.1.9 At the time of the appointment of the Administrators to ION on 7 December 2004, ION's subsidiaries in the United States were still in the process of completing the Kentucky facility.

24. Energy Services

- 24.1.1 The ION Energy Services Group (ie, IES) was formed from the acquisition of Cootes Holdings Pty Ltd (an oil and gas transport company) in December 2000, Stevenson Transport Pty Ltd (a liquid petroleum and gas distribution company) in June 2003, and Liquip Sales Pty Ltd (a designer and manufacturer of fluid transfer equipment) in December 2003.
- 24.1.2 IES conducted operations in fuel distribution, refuelling services, and fuel equipment manufacture. The distribution operations traded in all of the mainland states of Australia, with the head office of Cootes located in Dandenong, Victoria. The manufacturing facilities of Liquip were located at Smithfield, New South Wales and Sunshine, Victoria.
- 24.1.3 Historically IES was a strong performer and contributed significantly to the ION Group's profitability.
- 24.1.4 No issues have been identified by the Deed Administrators with respect to IES which are relevant to potential claims by ION shareholders.

25. ION's disclosures regarding Financial Outlook

25.1 Background

- 25.1.1 A key aspect of the Deed Administrators' investigations has been to consider and assess the financial forecasts prepared by ION in the period October 2003 to November 2004 and to consider in light of those forecasts the reasonableness of ION's related market disclosures.
- 25.1.2 Market expectations in relation to ION's projected financial performance for the current year (FY 2004), and future years (FY 2005 and beyond) were reset during this period with related announcements made in August 2003, October 2003, February 2004, April 2004, September 2004, and October 2004. While there were no market disclosures between April (when the April Guidance was issued) and September 2004, ION updated its long term forecasts in May and August 2004 as part of its refinancing process.

25.2 Overview

- 25.2.1 Notwithstanding initial deficiencies in ION's short-term forecasting processes, ION's disclosures in relation to the financial outlook for FY 2004 were adequately supported by relevant prevailing information including recent trading performance, forward order guidance provided by customers, the status of and budget for capital projects, the cashflow impact of acquisitions and changes to net working capital requirements, and other relevant financial and non-financial data.
- 25.2.2 ION's reported results for FY 2004 (expressed on a pre-significant item basis) were consistent with the most recent guidance provided in April 2004.
- 25.2.3 The significant items included in ION's reported results for FY 2004 were disclosed on a timely basis by reference to ION's post financial year-end evaluation of major capital projects and asset carrying values conducted in consultation with external auditors.
- 25.2.4 Long term forecasting processes were relatively unsophisticated prior to the appointment of a new CFO in September 2003. At that time the company did not have detailed, integrated long term forecast models incorporating consolidated cashflow/funds flow forecasting. By February 2004, ION's long term forecasting tools and processes had improved, and by April 2004 ION had a comprehensive long term forecast in place.
- 25.2.5 Despite the absence of fully integrated long-term financial forecasting processes, future year revenue and earnings growth predictions made by ION in October 2003 and again in February 2004 were found to be reasonable in the context of approved capital projects, currently contracted revenue based on forward order guidance provided by customers, and identified growth opportunities based largely on quotations already provided to existing and prospective customers. By contrast, the future year revenue and earnings growth predictions made by ION in the April Guidance were supported by a properly constructed fully integrated financial forecast (ie, the April Model). Importantly, the April Model showed a significantly more favourable financial outlook for key financial metrics by comparison to the April Guidance, which provided ION with a degree of 'buffer' as internal forecasts were downgraded over time.
- 25.2.6 Between April 2004 and October 2004 ION did not adequately consider the impact of certain developments on its long term forecasts. However, due mainly to the level of 'buffer' factored into the April 2004 market disclosure, its forecasts remained materially in line with the April Guidance, with some exceptions. Those exceptions included the following (based on the Deed Administrators' restatement of relevant forecasts and assuming a minimum 10% variance level):
- (a) the EPS forecast for FY 2005 which was found to have declined to 21.4 cents per share by the end of May 2004, 11% lower than the April Guidance figure of 24 cents (see paragraph 25.8.6 below);
 - (b) the 10% revenue growth forecast for FY 2005 which was found to have declined to 6.9% by the end of May 2004 (see paragraph 25.8.6 below);
 - (c) the EPS forecast for FY 2005 which was found to have declined further by early August 2004 to 20 cents per share (a reduction against the April Guidance of 17%) (see paragraph 25.8.12 below);

- (d) by early August 2004 the 10% revenue growth forecast for FY 2005 in the April Guidance had declined to 4.6% (see paragraph 25.8.12 below); and
 - (e) by early August 2004 the 20% plus revenue growth forecast for FY 2006 in the April Guidance was down to 15.8% (see paragraph 25.8.12 below).
- 25.2.7 In section 25.5 below, the Deed Administrators set out in detail their assessment of forecasts and market disclosures for the then current year – FY 2004. Long term forecasts and market disclosures for FY 2005 and beyond are dealt with in detail in section 25.6 below.

25.3 Approach to reconstruction of forecasts

- 25.3.1 The Deed Administrators reviewed ION's current year forecasts (FY 2004) and long term forecasts (FY 2005 onwards). When assessing the forecasts, the Deed Administrators considered their appropriateness based on what was known by ION at relevant points in time.
- 25.3.2 The Deed Administrators reconstructed ION's forecasts at various intervals during the relevant period to include the estimated financial impact of various emerging issues as and when those issues ought, in the Deed Administrators' view, to have been taken into account for forecasting purposes.
- 25.3.3 It is noted that when reconstructing ION's forecasts the Deed Administrators did not take into account other favourable conditions which could have mitigated the financial impact of the issues for which negative adjustments were made. For example, it is possible that ION could have initiated broader profit improvement programs or sought to renegotiate terms with suppliers and/or customers if it identified a material decline in its forecasts. Given the speculative nature of these matters, the Deed Administrators formed the view that it was preferable to adjust forecasts only in respect of actual events.

25.4 Events impacting ION's forecasts

- 25.4.1 The key events that impacted ION's current and long term forecasts during the period October 2003 to November 2004 are outlined below. These events will be referred to in this section to explain the changes that were or should have been made to ION's forecasts over that period.
- (a) Event 1 - In November 2003, SsangYong advised ION of anticipated softening in 4-speed transmission volumes for CY 2004. The reduction in forecast volumes for 2004 was attributed by ION's management to a number of factors including depressed economic conditions in South Korea and SsangYong's aim of reducing its parts inventory (**November SsangYong Softening**) (paragraph 18.7.15);
 - (b) Event 2 - In December 2003, ION acquired the Liquip business for \$15.5 million (**Liquip Acquisition**);
 - (c) Event 3 - In late 2003 ION (Auckland) was advised by Ford US of the planned wind-down of the production of the Taurus model by February 2004. Around this time, ION was awarded new contracts from Ford that were expected to largely replace the lost Taurus model volumes, with a short lag between February 2004 and May 2004. In March 2004 ION was informed that volumes for the existing

model would continue to be low in FY 2004 and launch model volumes would not reach expectations until August 2004. (**Ford Taurus Volume Replacement Delay**) (paragraph 22.1.8);

- (d) Event 4 - At a Board meeting on 4 February 2004, ION was informed that Stage 2 of the Wingfield Project would cost an additional \$15 million, bringing the total capital expenditure estimate to \$68 million. A full review of the Wingfield Project was completed in March 2004 and presented to the Board. The review noted an increased total estimated capital spend of \$74 million (primarily incurred by June 2004). The increase related to commissioning costs of \$6 million (**March Wingfield Project Restatement**) (section 20.3);
- (e) Event 5 - At the half-year results presentation on 19 February 2004, ION announced that the anticipated capital cost for the Altona Project had increased to \$125 million from the original \$90 million. This project was forecast to be completed in FY 2005 (**February Altona Project Capex Increase**) (paragraph 19.3.13);
- (f) Event 6 - On about 25 February 2004, SsangYong provided ION with a further downgraded forecast of SsangYong's monthly production levels and supply requirements for 4-speed transmission products in CY2004 (**February SsangYong 4-speed Softening**) (paragraph 18.7.18);
- (g) Event 7 - On 15 March 2004, a number of business case scenarios for the Altona Project were presented to the Board. The likely scenario reflected a more conservative ramp up in revenues in the first 3 years of production and a change in the funding model (**March Altona Project Restatement**) (paragraph 19.4.15);
- (h) Event 8 - Between 15 and 17 March 2004, SsangYong informed ION that the D100 program would require 5/6-speed transmissions from January 2005 onwards – this was instead of, not in addition to, forecast 4-speed volumes and represented a decrease in SsangYong's forecast transmission requirements (**March SsangYong 6-speed Notification**) (paragraph 18.7.20);
- (i) Event 9 - On or about 17 March 2004, SsangYong informed ION's management of further reductions in demand for 4-speed transmissions for FY 2005 and FY 2006 (**March SsangYong Softening**) (paragraph 18.7.21);
- (j) Event 10 - At a meeting with Holden on 7 May 2004, ION was informed that it would not be awarded the transfer case contract. This impacted ION's long term forecasts for the period from FY 2007 (**Holden Transfer Case Loss**) (paragraph 18.9.13);
- (k) Event 11 - On 4 May 2004, SsangYong informed one of ION's senior employees of a further reduction in FY 2005 volumes to 42,840 units per annum. Then, on 12 May 2004, ION became aware that it had not been awarded the 5/6-speed contract for the SsangYong D100 program and that the E100 program was to continue with a 4-speed platform for the time being. The deferral of the 5/6-speed platform meant that the capital expenditure and corresponding ACIS revenue would be postponed from FY 2005 to FY 2006 in ION's forecasts. ION was

supplied with revised volumes for the 4-speed platform. As a second stage, ION and another supplier would participate in the development of a 5/6-speed transmission for use in the E100 program for the export market (from September 2006) and the domestic market (from January 2008) (**SsangYong May Notifications**) (paragraph 18.7.26);

- (l) Event 12 - On 1 July 2004, Ford informed ION that Ford's present revised estimated forecast volumes for 4 speed transmissions for the Copperhead Program (scheduled to commence in approximately September 2005) was approximately 61,175 units per annum (down from an earlier estimate of 75,000 units). It appears that ION may have intended to address this reduction in volume by increasing the transmission unit price previously quoted to Ford (**Ford Copperhead July Volume Reduction**) (paragraph 18.3.16);
- (m) Event 13 - Sometime between late June 2004 and 26 July 2004, ION had become aware of further softening in SsangYong 4-speed requirements for FY 2005 (**SsangYong July Softening**) (paragraph 18.7.32);
- (n) Event 14 - In an email dated 28 July 2004, and circulated amongst certain ION employees, SsangYong's 'current thoughts' were confirmed, being a further downgrade in 4-speed transmissions for FY 2005 (**SsangYong 28 July Softening**) (paragraph 18.7.34);
- (o) Event 15 - By late July 2004, Wingfield and North Plympton were continuing to trade at substandard levels and management decided that an adjustment to ION's long term forecasts was warranted (**Wingfield and North Plympton Forecast Downgrade**) (section 20.3 and paragraph 21.2.21);
- (p) Event 16 - On 9 September 2004, ION's management was informed by SMT that it would be asking for significant volume concessions for the first 6 months of 2005, but that SMT still guaranteed the agreed volume over the first two years of the Supply Agreement (ie, 40,000 units) (**SMT September Volume Concession**) (paragraph 18.10.8);
- (q) Event 17 - At a meeting with Ford on the afternoon of 9 September 2004, two of ION's managers were informed that Ford had selected ZF Lemforder as the supplier of 6-speed transmissions for the Orion Program and that Ford's decision was final. Ford also stated that it had decided to produce 6-speed models from March 2008 and as a result Ford would not continue purchasing 4-speed transmissions from ION beyond March 2008 (**Ford 6-speed Bid Failure**) (paragraph 18.4.37);
- (r) Event 18 - By late September 2004, ION was aware that its bid for Ford's Copperhead transfer case business had been unsuccessful. This impacted ION's long term forecasts for the period from FY 2007 (**Ford Transfer Case Bid Failure**) (paragraph 18.6.4);
- (s) Event 19 - By the end of September 2004, Ford had informed ION that it had not secured differentials business for Ford's Copperhead Program. This had

represented potential revenues of \$60+ million per annum from early 2007 onwards (**Ford Differential Bid Failure**) (paragraph 18.5.17);

- (t) Event 20 - A retrenchment proposal dated 14 October 2004 prepared by ION's management was included in the Board papers for the 25 October 2004 Board meeting. The proposal noted that the budgeted FY 2005 volumes for IAS had decreased due to a further softening of the South Korean economy and model launch delays in China (**IAS Redundancy Program**) (paragraph 18.10.13);
- (u) Event 21 - On 21 October 2004, ION received the Final Williams Report which indicated that the forecast capital expenditure for each of Wingfield, Kentucky and Altona exceeded the estimates contained in the MOFA (**Final Williams Report Capex Increases**) (paragraphs 12.3.74 to 12.3.76);
- (v) Event 22 - During October 2004 ION identified softening demand at the Auckland plant estimated to impact forecast trading EBITDA by \$5.2 million in FY 2005 and \$2.6 million in FY 2006 and FY 2007 (**October Auckland softening**) (paragraph 22.1.11); and
- (w) Event 23 - Continued protracted operational issues at North Plympton and Wingfield lead to a further downgrade in October 2004 of forecast trading EBITDA by \$6.5 million, \$7.3 million, and \$5.5 million for FY 2005, FY 2006, and FY 2007, respectively (**North Plympton and Wingfield October Downgrade**) (sections 21.2 and 20.4).

25.4.2 As mentioned above, ION did not adequately consider the impact of some of these developments on its forecasts. In this regard, the various events identified above may be categorised as follows:

- (a) events impacting ION's forecasts for the period disclosed to the market in the April Guidance (ie, FY 2004 to FY 2006) and taken into account in ION's forecasts in a timely manner comprise Events 1, 2, 3, 4, 5, 6, 7, 8, 9, 15, 20, 21, 22 and 23;
- (b) events impacting ION's forecasts for the period disclosed to the market in the April Guidance (ie, FY 2004 to FY 2006) that were not taken into account in ION's forecasts in a timely manner comprise Events 11, 12, 13, 14, and 16; and
- (c) events impacting ION's long term forecasts beyond the period disclosed to the market in the April Guidance (ie, FY 2007 and beyond) and are therefore not relevant to assessing the ongoing accuracy of the statements made in the April Guidance (ie, Events 10, 17, 18 and 19).

25.5 Current year expectations (FY 2004)

25.5.1 The Deed Administrators reviewed the financial forecasts disclosed to the market by ION for FY 2004 between August 2003 and April 2004. ION provided market guidance in relation to its FY 2004 financial projections in August 2003, October 2003, February 2004 and April 2004. The guidance included statements in relation to ION's forecast financial performance and cashflow/net debt position. Each of these is dealt with in turn below.

Financial performance (FY 2004)

- 25.5.2 On 26 August 2003 ION stated in its results announcement for the year ended 30 June 2003 that:

The 2004 earnings are expected to improve by at least 10% [from 2003]....

- 25.5.3 On 20 October 2003, in the UBS Presentation, ION made the following statements in relation to its FY 2004 forecasts:

Earnings prediction 2003/04 financial year already made

	Prediction
Revenue up by not less than 8%	\$733 m
NPAT to increase by not less than 10%	\$58.4 m
EPS to increase by not less than 10%	27.4 c
Return to Shareholders' Funds	25%

are confirmed as achievable based on the sound start to the year and forward expectations

These revenue, profit and EPS figures were repeated in the chairman's address at the 2003 AGM.

- 25.5.4 ION's actual half year results to 31 December 2003 were consistent with the guidance given in October 2003 and the year to date performance indicated a favourable revenue and NPAT position with a sizeable growth in revenue of over 10% from FY 2003. At this time ION had no reason to believe that financial performance for the remainder of the year would be markedly lower than first half performance.

- 25.5.5 ION reaffirmed the October 2003 earnings guidance concurrent with the release of its half year results in February 2004 (ie, the February Announcement), and stated that a profit increase of not less than 10% improvement over 2003 would be achieved. ION stated:

... Steady trading conditions are forecast to continue in the six months to 30 June 2004, and Directors are confident that previous profit guidance of not less than 10% improvement over 2003 will be achieved.

Despite some expected softening in SsangYong demand (Event 1) (with the consequent drop in revenue expectations), as at February 2004, a 10% profit improvement was still achievable given the anticipated trading benefit from the Liquip Acquisition (Event 2).

- 25.5.6 In relation to revenue, the presentation published at the time of the half year results announcement (ie, the February Presentation) did not report a revenue forecast for the ION Group as a whole, instead reporting IAG forecasts only. Total sales revenue for IAG for FY 2004 was shown in the February Presentation as \$520 million. This was down from the \$611 million incorporated in the ION Group revenue prediction of \$733 million disclosed in the UBS Presentation. The lower FY 2004 revenue base was the result of the November SsangYong Softening (Event 1). The Placement Model prepared by ION shortly after the February Announcement indicated ION anticipated a revenue increase of 5.9% for FY 2004 from FY 2003 (compared with the 8% revenue growth guidance provided in the UBS Presentation). This drop in revenue was reflected in the IAG revenue figures included in the February Presentation.

25.5.7 In April 2004, ION revised its FY 2004 guidance downward to reflect the April Model forecasts. Those forecasts took into account the revenue and profit impact of further softening in demand from SsangYong (ie, the February SsangYong 4-speed Softening) (Event 6) and Ford US launch delays affecting the Auckland plant (ie, Ford Taurus Volume Reduction) (Event 3). The April Guidance, issued on 27 April 2004, made the following statements in relation to the FY 2004 outlook:

The forecast to 30 June 2004 based on unaudited management accounts to 31 March 2004, including forward customer supply schedules for the balance of the year, is for a NPAT of approximately \$55m excluding one-off items. The following table outlines forecast trading performance:

TRADING PROFIT (\$M)			
	Forecast 2004	Actual 2003	% Change
EBIT (ii)	86.5	81.0	+6.8%
NPAT (iii)	55.0	53.1	+3.6%
EPS – weighted average	24.0 cents	24.9 cents	-3.6%
DPS (i)	12.0 cents	11.25 cents	+6.7%

- (i) Forecast 2004 final dividend of 6.0 cents per share fully franked.
- (ii) Excludes one-off redundancy costs of \$8.5m (\$6.0m post fax). The comparative EBIT for the six months to 31 December 2003 was \$49.5m.
- (iii) Forecast NPAT excluding one-off items. The comparative NPAT for the six months to 31 December 2003 was \$32.6m. The reported NPAT including all one-off items is expected to be approximately \$55m.

The forecast Trading EBIT is based on forecast total revenue of approximately \$700m.

25.5.8 Relative to ION's previous guidance, the April Guidance reflected deterioration in forecast revenue of 4.5%, a deterioration in forecast net profit of 5.8% and deterioration in forecast EPS of 12.4% from the UBS Presentation. The Deed Administrators' investigations confirm that this deterioration was attributable to events which occurred after the February Presentation and to a lesser extent, the more conservative approach taken in the preparation of the April Model which underpinned the April Guidance.

25.5.9 ION's actual results for FY 2004 (pre-significant items) outperformed the revenue, net profit, and EPS guidance provided in April 2004. This is outlined in the table at paragraph 25.5.21.

25.5.10 As at April 2004, ION's FY 2004 earnings were not expected to be materially impacted by one-off items. In relation to one-off items, the April Guidance stated that ION expected to generate a one-off tax gain of \$23 million and that the gain would be partly offset by restructuring costs (a value of \$6 million post tax), with the treatment of the balance to be assessed by the Board at financial year end.

25.5.11 Contrary to the April Guidance, ION's FY 2004 results were such that the tax consolidation benefit of approximately \$23 million was ultimately fully utilised against other one-off costs and asset write-downs totalling approximately \$69.3 million (pre tax) resulting in a net

impact from one-off items of approximately \$26.5 million (post tax) and a net profit post significant items of \$28.8 million. The year-end adjustments included:

- (a) a \$19.1 million write-down of fixed assets and inventory, primarily at Wingfield;
- (b) redundancy costs of \$8.1 million relating to IAS and North Plympton;
- (c) a \$16.1 million write-off of capitalised pre-production costs (Wingfield); and
- (d) a \$19.3 million write-off of previously capitalised research and development costs (for various business units, including North Plympton and Wingfield).

25.5.12 These adjustments were made by ION post year end in consultation with its auditors and took into account (amongst other things) ION's post commissioning and post year end review of the Wingfield Project. While the necessity for write-offs relating to the Wingfield Project had been flagged with the Board in June 2004, the extent of the one-off adjustments beyond the buffer outlined in the April Guidance was not confirmed until reviewed by the company's auditors during the finalisation of ION's FY 2004 audited accounts.

Cashflow / Net Debt (FY 2004)

25.5.13 ION provided market guidance in relation to its projected FY 2004 year end net debt position in October 2003, February 2004 and April 2004.

25.5.14 In the October 2003 UBS Presentation, ION foreshadowed an expected increase in its year end net debt position of approximately \$40.5 million (to \$186.5 million) well within ION's existing facility limits of approximately \$225 million. This guidance was labelled as 'Indicative' and made no provision for any capital acquisitions. The indicative gearing ratio for FY 2004 was stated in the UBS Presentation as 40%. The Deed Administrators have not located in ION's records any specific forecasts underlying these figures.

25.5.15 Consistent with this forecast, ION stated in the UBS Presentation that:

Capital raising apart from acquisitions appears unnecessary as retention from strong earnings growth and depreciation set to maintain gearing ratios at comfortable bankable levels.

Also, at its AGM in October 2003 ION stated that, although its analysis showed no requirement to 'raise equity in 05', ION may raise equity if it deems appropriate, including to fund acquisitions. Those statements were made in the context of representations that ION's gearing ratio would remain at or below 50%.

25.5.16 In February 2004, ION issued a revised year end net debt guidance showing a forecast increase of approximately \$125 million (to a range of \$265 million to \$275 million), well above ION's existing facility limits of approximately \$225 million. This projection represented an increase in net debt of approximately \$85 million relative to the previous guidance in October 2003. Based on the Deed Administrators' investigations, the increase can be attributed to:

- (a) the \$15.5 million Liquip Acquisition in December 2003;
- (b) a \$27 million net increase in capital expenditure primarily related to the Altona Project; and

- (c) a \$41 million increase in working capital further explained below.
- 25.5.17 Part of the working capital movement can be explained as follows:
- (a) ION had been previously planning to factor Auckland's debtors, however by February 2004 it became clear that it was unable to do so cost effectively (\$13.1 million);
 - (b) in addition to the cash component of the Liquip Acquisition, in December 2003, ION assumed approximately \$4.3 million in lease obligations (treated as debt); and
 - (c) the increase in Altona's capital expenditure announced in February 2004 led to an increase in the ACIS receivable balance (\$3 million).

The cause of the remaining balance of the working capital movement (circa \$20 million) is not known however this represents less than 4% of forecast funds employed and is not an unusual working capital movement for a company of ION's size. Moreover, ION's actual net debt position at the end of FY 2004 was markedly better than anticipated at \$196.3 million.

- 25.5.18 In response to the changed cashflow outlook which emerged by early February 2004, ION raised approximately \$65 million in fresh equity in February 2004 – effectively restoring the net debt projection (post capital raising) at that time to a range of approximately \$200 million to \$210 million, within ION's existing facility limits (allowing for the then proposed capital raising).
- 25.5.19 In the April Guidance, notwithstanding the reduced profit guidance, ION confirmed that its cashflow projection was anticipated to remain in line with the February 2004 guidance and its year end net debt position was forecast at approximately \$209 million (within the range of \$200 million to \$210 million previously provided).
- 25.5.20 ION's audited accounts for FY 2004 reflected a net debt position as at 30 June 2004 of \$196.3 million – below the bottom end of the guidance range due mainly to the timing of capital expenditure payments and a reduced working capital requirement relative to forecast.

Summary for current year (FY 2004)

- 25.5.21 The disclosed forecasts, as well as a comparison to actual results are summarised in the table below.

Actual trading results					Market disclosure FY 2004 forecasts				
	FY 2003 Actual	Dec-03 ¹ (annual'd)	FY 2004 Actual	FY 2003 vs FY 2004	Oct-03	Feb-04 ²	Feb-04 vs Oct-03	Apr-04	Apr-04 vs Oct-03
Revenue	679.0	752.0	711.2	4.7%	733.0	n/a		700.0	(4.5%)
NPAT*	53.1	59.0	55.2	4.0%	58.4	58.4	-	55.0	(5.8%)
EPS*	24.9	27.0	24.1		27.4		-	24.0	(12.4%)
NPAT	53.1	59.0	28.8	(45.8%)	58.4	58.4	-	55.0	(5.8%)
Significant items			26.4						
EPS	24.9	27.0	12.5		27.4			24.0	
Gearing ratio			39.8%		40.0%	50.0%	25.0%	39% - 40%	(3%) - 0%
Net cashflow			(40.7)		(40.5)	(125.0)		(125.0)	
Net debt			196.3		185.5	270.0		209.0	

* Pre significant items

1. Source: 19 February 2004 half year results

2. Numbers expressed pre equity placement

25.5.22 The table above reveals that leaving aside the impact of significant items, the forecasts disclosed to the market in October 2003 and February and April 2004 were not significantly different to the results ultimately reported by the company for FY 2004 and remained broadly in line with the FY 2003 result. The February 2004 data in the table is shown prior to the equity placement, which is reflected in a higher gearing ratio and net debt position.

25.6 Future year expectations - Introduction

25.6.1 In the following sections 25.7 and 25.8, the Deed Administrators comment on relevant aspects of their review and assessment of ION's long term forecasts (FY 2005 onwards) and the market disclosures which were made (or should have been made) by ION in relation to those forecasts.

25.6.2 As noted above, ION's long term forecasting processes were relatively unsophisticated and lacking in detail prior to the appointment of a new CFO in September 2003. From late 2003 the new CFO focussed on improving the company's forecasting methodologies. From February 2004, ION's long term forecasting tools and processes had further developed, and by April 2004 a comprehensive model had been implemented.

25.7 Future year expectations (FY 2005 onwards) - What was said to the market

25.7.1 ION reported on its long term outlook in October 2003 and again in February and April 2004. Its next outlook disclosure was made in late September 2004, followed in October 2004 with a statement limited to its FY 2005 outlook. In this section, the Deed Administrators consider each of ION's outlook disclosures for FY 2005 onwards, made between October 2003 and October 2004 and whether those disclosures were reasonable having regard to the information known to ION at relevant points in time.

October 2003

25.7.2 The following was stated in the UBS Presentation on 20 October 2003:

Indicative Guide of Revenue increases

Guidance for future years indicates:

Automotive

• Revenue increase	04/05	\$140m
	05/06	\$300m
	06/07	\$300m

from known projects, demand growth from existing customers

...

Revenue is expected to double in the next three years producing strong growth in after tax profits.

25.7.3 Those figures were repeated by the managing director at the 2003 AGM.

25.7.4 The chairman also stated the following at ION's 2003 AGM:

ION is a company of consequence which expects to double its revenue by 2007 while sustaining relative profitability to the increase revenue.

In the three years to June 2007, ION expects to double its revenue and maintain its earnings relativity to revenue.

25.7.5 No detailed long term forecasts prepared around October 2003 have been located in ION's records. However, the October 2003 Board papers included a high level income statement and EPS forecast for the years FY 2004 through to FY 2007 (ie, the October 2003 Board Papers Forecast). The information disclosed in the October 2003 market announcements was consistent with this forecast, although the figures disclosed were slightly more conservative. The IAG forecasts incorporated in the October 2003 Board Papers Forecast were described by the managing director in his report for the October 2003 Board meeting as 'realistic to conservative' and based on:

... retention of current business, expansion of sales into China, differential sales to Holden (now won) and Ford Australia, start up of Wingfield from June 2004, Block plant sales to meet Holden demand (other quotes pending), strong sales from Kentucky 2005/06, transfer case sales to Holden and Ford, and the introduction of high pressure die castings.

25.7.6 The October 2003 Board Papers Forecast indicated significant growth in revenue (108% or \$824 million) and net profit (79% or \$48.3 million) between FY 2004 and FY 2007. IAG was forecast to contribute the vast majority (90%) of that revenue growth.

25.7.7 With no detailed assumptions available for review in connection with the October 2003 Board Papers Forecast, the Deed Administrators relied on underlying evidence concerning ION's business units, its committed and expected future projects and the potential for revenue growth from those sources in order to assess the reasonableness of the forecasts for FY 2005 onwards. The October 2003 Board Papers Forecast is supported by the following.

- (a) Over half of the expected revenue growth to FY 2007 (\$740 million) was attributed to the anticipated annual revenue from IAG's major capital projects (once completed) of circa \$540 million by FY 2007. Over half of that revenue was from capital projects already approved by the Board and was in line with that forecast in project approvals.

- (b) ION also forecast organic growth from its existing business which it attributed to retention of current business, expansion of sales into China, potential differential sales to Holden and Ford Australia, start up of Wingfield from June 2004, the development of a transfer case for potential sale to Holden and Ford, and the introduction of high pressure die castings.
- (c) Company records (including correspondence with external parties) which provide support for the projected growth via the existing business and capital projects, and potential growth into new markets, particularly China.
- 25.7.8 While there are no detailed forecasts as at October 2003 available for review by the Deed Administrators, having regard to the matters noted above (and the documentary evidence available), it is apparent that ION was pursuing a number of prospective product lines for future growth at that time, all of which were realistic options. Accordingly, in the Deed Administrators' view, the October 2003 Board Papers Forecast and the corresponding UBS Presentation were a reasonable reflection of ION's potential long term trading outlook at that time.

February 2004

- 25.7.9 The February Presentation included the following revenue forecast (in graphical format) relating to the IAG business unit

IAG revenue forecast				
\$'000	FY 2004	FY 2005	FY 2006	FY 2007
Feb-04	520	620	880	1,160

- 25.7.10 ION prepared a detailed long term forecast in February 2004 for the period to FY 2006 to quantify ION's funding requirements to 30 June 2006 (ie, the Placement Model). In addition, ION prepared detailed revenue and capital expenditure forecasts for IAG at this time (**IAG February 2004 Forecast**). This was the first integrated, comprehensive long term forecast prepared by ION for the period beyond FY 2004.
- 25.7.11 The outlook disclosed to the market in the February Presentation was in line with the IAG February 2004 Forecast and Placement Model.

IAG forecast					
\$m	FY 2004	FY 2005	FY 2006	FY 2007	Total
February presentation	520.0	620.0	880.0	1,160.0	3,180.0
Placement model	520.0	620.0	850.0	-	
IAG revenue forecast to 2007	522.4	619.7	869.9	1,155.4	3,167.4

- 25.7.12 The IAG February 2004 Forecast included forecast volumes for each major customer and/or product line, enabling the Deed Administrators to undertake an assessment of the forecasts against information contained within company records including: known contracts, correspondence with customers, product developments, potential customer targets, and greenfield project business plans.

- 25.7.13 The Deed Administrators found the assumptions underlying the IAG February 2004 Forecast and the corresponding February Presentation to be reasonable. The forecast assumptions were found to reflect lower revenue targets, and took into account current contracts, approved projects with their updated costings (for example February Altona Project Capex) (Event 5) as well as opportunities being actively pursued by ION at the time (with reasonable corresponding revenues that could potentially arise from such prospects).
- 25.7.14 In summary, the Deed Administrators concluded that the representations made in the February Presentation were reasonable and remained current until the next market disclosure in April 2004 following a number of events occurring in March 2004, namely:
- (a) March SsangYong Softening (Event 9);
 - (b) March SsangYong 6-speed Notification (Event 8);
 - (c) March Wingfield Project Restatement (Event 4); and
 - (d) March Altona Project Restatement (Event 7).
- 25.7.15 As noted above in section 12.3, a forecast review process was already in progress in March 2004 and the above events (so far as they necessitated adjustments to forecasts) were taken into account as part of that process. The review process was finalised in April, culminating in the production of the April Model and the April Guidance disclosure to the market. The Deed Administrators consider that the length of time to complete the forecast review was reasonable given the comprehensive nature of the work being undertaken.

April 2004

- 25.7.16 The April Guidance did not contain detailed long term forecast information, but provided an estimated revenue growth rate and the expected return to shareholders on an EPS basis for FY 2005 and FY 2006, as well as other high level financial measures as outlined below.
- 25.7.17 The April Guidance contained the following statements in relation to long term forecasts:
- 1.4 Profitability – 2004/05 and 2005/06
- Sales revenue in 2004/05 is forecast to increase by 10%, and in 2005/06 by more than 20%.
- These sales revenue forecasts are based on supply contracts held for approximately 93% of the 2004/05 forecast sales revenue and 75% for the 2005/06 year. These sales revenue forecasts are subject to fluctuations to automotive company customer schedules currently held by ION.
- Earnings Per Share are expected to be not less than 24.0 cents in 2004/05 on the enlarged capital base and increasing in 2006.
- 25.7.18 The April Guidance also provided information about ION's forecast gearing ratio and interest cover as follows:

ION April Guidance forecast gearing ratio and interest cover

SM		Jun-04	Jun-05	Jun-06
ND / (ND+NA)*	%	39-40	48-50	50-52
Interest cover	X	7.5-8.0	6.0-6.5	5.0-5.5

* Current accounting and bank covenant treatments allow the debt for the Altona Block Plant project to be classified as a trade creditor until the plant is fully commissioned. This will be included as net debt during the 2006 year. If the Altona Plant funding was included, gearing would be 42-44% and 54-56% for June 04 and June 05 respectively.

- 25.7.19 The April Model was comprehensive and supported by detailed assumptions. These forecasts exposed a downgraded position from the February forecast in the Placement Model as a result of the events that occurred in March outlined above.
- 25.7.20 ION reported its estimated EPS outlook in the April Guidance on a conservative basis relative to its base case forecasts in the April Model. As mentioned above, there was a 'buffer' in the market release whereby ION indicated earnings of not less than 24 cents per share in FY 2005 and increasing in FY 2006, compared to the April Model which indicated a forecast of 27 cents and 32.9 cents per share for each year respectively. Accordingly there was an earnings buffer of 3 cents for FY 2005 and approximately 8.8 cents per share for FY 2006. This is a key consideration when reviewing the need for future market disclosures as ION's internal forecasts were downgraded over time.
- 25.7.21 All other forecast metrics outlined in the April Guidance were materially in accordance with the April Model.
- 25.7.22 The Deed Administrators also reviewed the revenue, EBIT and capital expenditure data for each of ION's business units as reflected in the April Model. The forecasts were found to be reasonable with the exception of the following:
- (a) aggressive profit improvement targets at North Plympton in FY 2005 and FY 2006 (ultimately amended in the August Update as part of the Wingfield and North Plympton Forecast Downgrades); and
 - (b) under estimation of Ford 4-speed Copperhead volumes expected in FY 2006.
- 25.7.23 The Deed Administrators made the above adjustments to the April Model and found that ION's forecast EPS still remained above that disclosed in the April Guidance with a reduction of EPS of approximately 2 cents and 1.5 cents in FY 2005 and FY 2006 respectively. In addition, other financial measures in the restated April Model remained broadly in line with the April Guidance disclosure, namely:
- (a) gearing ratios of approximately 39%, 49%, and 51% for FY 2004 to FY 2006 respectively; and
 - (b) interest cover of circa 5.9 times and 5.3 times for FY 2005 and FY 2006 respectively.

Accordingly, the Deed Administrators found that the disclosures made in the April Guidance in relation to the company's long term outlook were reasonable.

September 2004

- 25.7.24 Following the April Guidance, ION did not make any further disclosures to the market in relation to resetting forecast expectations until 24 September 2004, when it issued the September Announcement stating that it was not possible to predict forward profitability for the then current year (FY 2005). The announcement stated:

At this stage it is not possible to predict forward profitability for the current financial year but a review by the Board, the new Managing Director and senior executives indicates that profit in the December half is likely to be significantly lower than in the previous corresponding period. Profit in the second half of the financial year is expected to be significantly better than in the first half. The poorer outlook in the first half is a function of both revenue and cost issues. There will be increased focus on managing both revenue and costs going forward.

- 25.7.25 In the month following the release of the September Announcement, ION continued to assess the likely change in the company's outlook and to refine its forecasts (particularly in relation to FY 2005), pending a further market announcement.

October 2004

- 25.7.26 A further market announcement was made on 26 October 2004 at ION's 2004 AGM. The chairman's address stated:

As a result of the current market conditions, combined with the delay between the capital expenditure on our growth projects and the associated revenue streams, our immediate profitability has been affected. We expect that for the half year ending December 2004 our PAT from operations will be a modest profit before significant items. Of course any asset sale would generate a material capital profit.

We expect that in the half year ended June 2005 we will have a stronger trading profit, and although it is very difficult to reliably forecast a figure at this time, it is estimated that EBITDA will be approximately \$90 million for the full year before significant items.

- 25.7.27 The above market announcement was supported by a forecast for FY 2005 prepared by ION during October 2004 (**October 2004 Forecast**).
- 25.7.28 The October 2004 Forecast reflected a material deterioration in the outlook for IAS, which now incorporated (in addition to Event 15 already incorporated into the August Update) the impact of the following events each of which post dated preparation of the April Model and the release of the April Guidance:
- (a) the SsangYong 4-speed softening (Events 11, 13 and 14);
 - (b) the deferral of the 5/6-speed project (Event 11);
 - (c) removal of SMT volumes in FY 2005 (arising from the SMT September Volume Concession) (Event 16).
 - (d) North Plympton and Wingfield October Downgrade (Event 23);
 - (e) October Auckland Softening (Event 22);
 - (f) IAS Redundancy Program (Event 20); and
 - (g) Final Williams Report Capex Increases for Wingfield, Kentucky and Altona Projects (Event 21).

- 25.7.29 The implications (if any) of ION not taking into account in its forecasts the impact of these matters prior to October 2004 is dealt with in section 25.8 below.
- 25.7.30 So far as the October 2004 Forecast itself is concerned, based on their detailed review, the Deed Administrators consider that the forecast (covering only the FY 2005 period) incorporated all relevant issues which were known to ION at that time which impacted the company's forecast for that year. The Wingfield component of the forecast is likely to have been somewhat aggressive (refer section 20.4), however the outlook for other business units appear reasonable. The forecast (including IES) included an expected Trading NPAT of \$31.6 m (pre significant items) for FY 2005 which translated to an EPS of just over 12 cents per share. The market disclosure at the 2004 AGM for the FY 2005 forecast EBITDA position (before significant items) of \$90 million was reported on a conservative basis compared to internal forecasts which reflected a Trading EBITDA position of \$95.5 million. ION did not disclose to the market the quantum of anticipated significant items, which represented almost another quarter (before tax) of its disclosed trading EBITDA position at circa \$22 million. The issue of significant items is dealt with further in section 20.4 of this Report.
- 25.7.31 Forecasts for FY 2006 and FY 2007, which incorporated the downgrades listed above as they impacted those years, were subsequently prepared and provided to the Banks on 1 November 2004. No further market announcements were made by ION in respect of the outlook for those years.
- 25.8 Future year expectations (FY 2005 onwards) - Consideration of what was not said to the market**
- 25.8.1 As previously outlined, ION gave no market updates in relation to its long term forecast position between the April Guidance and the September Announcement. The Deed Administrators investigated whether disclosures were required to reposition the market during this period by reference to forecasts prepared by ION in May and August 2004 (ie, the May IM and August Update) and considering ION's known position at each point. These forecasts were prepared for the purpose of seeking finance and are considered in turn below. When assessing the forecasts, the Deed Administrators also produced restated forecasts which included the impact of events which were not taken into account by ION in the preparation of the May IM and August Update.
- 25.8.2 In summary, the Deed Administrators' restated forecasts indicate the following position.

Deed Administrators' restated forecasts

FY 2005					FY 2006				
ION		Variance:	Variance:		ION		Variance:	Variance:	
Forecast	Restated	ION forecast to guidance	restated to guidance	%	Forecast	Restated	ION forecast to guidance	restated to guidance	%
April earnings guidance disclosure									
EPS (cents)	24				24.0 +				
Sales growth	10% increase from FY 2004				20% increase from FY 2005				
Gearing ratio	50% (Range from 48% to 50%)				52% (Range from 50% to 52%)				
Interest cover	6.0 (Range from 6.0 to 6.5)				5.0 (Range from 5.0 to 5.5)				
April model									
EPS (cents)	27.0	24.9	13%	4%	32.9	31.4	37%	31%	
Sales revenue	742.0	742.0	0%	0%	972.0	973.7	9%	9%	
Sales growth	9.8%	9.8%	(2%)	(2%)	30.7%	30.9%	54%	55%	
Gearing ratio	48.0%	49.0%	(4%)	(2%)	50.0%	51.0%	(4%)	(2%)	
Interest cover	6.6	5.9	10%	(2%)	5.5	5.3	10%	6%	
May IM									
EPS (cents)	27.0	21.4	13%	(11%)	31.6	27.5	32%	15%	
Sales revenue	742.0	722.5	0%	(3%)	972.0	880.0	9%	(1%)	
Sales growth	9.8%	6.9%	(2%)	(31%)	30.7%	18.3%	54%	(8%)	
Gearing ratio	49.0%	50.0%	(3%)	0%	51.0%	53.0%	(2%)	2%	
Interest cover	6.6	5.5	10%	(8%)	5.2	4.9	4%	(2%)	
August update									
EPS (cents)	24.7	20.0	3%	(17%)	29.0	24.7	21%	3%	
Sales revenue	733.1	707.0	(1%)	(5%)	971.8	861.0	9%	(4%)	
Sales growth	8.4%	4.6%	(16%)	(54%)	30.7%	15.8%	53%	(21%)	
Gearing ratio	46.6%	48.3%	(7%)	(3%)	48.9%	51.8%	(6%)	0%	
Interest cover	6.5	5.5	8%	(8%)	5.2	4.6	4%	(8%)	

April Model

- 25.8.3 As mentioned above at paragraph 25.7.23, the Deed Administrators' restatement of the forecasts in the April Model indicated that forecast EPS still remained above that disclosed in the April Guidance with a reduction of EPS of approximately 2 cents and 1.5 cents in FY 2005 and FY 2006 respectively. In addition, other financial measures remained broadly in line with the April Guidance disclosure.

May IM

- 25.8.4 On 28 May 2004, ION issued the May IM to existing and prospective lenders, not to the wider market. The forecasts prepared for the April Guidance were incorporated into the May IM almost unchanged, and extended to FY 2008. Accordingly the May IM (as prepared by ION) did not indicate any erosion of the EPS buffer for FY 2005 and FY 2006.

- 25.8.5 The Deed Administrators' investigations revealed that key events arising between the April Guidance and the May IM were not taken into account in the May IM forecast. Accordingly, in addition to the Deed Administrators' adjustments to the April Model (explained in paragraph 25.7.22 above) it was found that the May IM did not take into account that IAS had been advised in May by one of its primary customers, SsangYong, of the issues raised in the SsangYong May Notifications (Event 11). Accordingly, the May IM forecasts were overstated for the period FY 2005 to FY 2006.
- 25.8.6 The Deed Administrators prepared a restated May IM forecast (**Restated May IM**) taking into account not only the adjustments required to the April Model but also the changes in the SsangYong assumptions (Event 11). They found that ION's forecast EPS fell below the estimate disclosed in the April Guidance for FY 2005 to approximately 21.4 cents (a reduction of 11%). The adjusted EPS for FY 2006 was 27.5 cents – a figure consistent with ION's April Guidance of '24 cents per share in FY 2005 and increasing thereafter'. Other financial measures in the Restated May IM (gearing ratio and interest cover) remained materially consistent with the April Guidance (see summary table above), with the exception of the revenue growth guidance of 10% for FY 2005 which was found to have declined to 6.9%.
- August Update**
- 25.8.7 As noted in section 12.3 above, in early August 2004, ION prepared revised forecasts for provision to prospective lenders (ie, the August Update). The need for the August Update arose due to the deterioration in the position of the Wingfield and North Plympton business units which was identified in July 2004 (ie, the Wingfield and North Plympton Forecast Downgrade) (Event 15).
- 25.8.8 The August Update was issued to financiers on 5 August 2004 explaining the various operational issues affecting the Wingfield and North Plympton business units (further detailed in sections 20 and 21 of this Report) and set out revised forecasts reflecting the financial impact of same. Importantly, the August Update represented that the performance of and outlook for the remaining business units remained in line with the May IM. The forecasts for these business units remained unchanged from the May IM.
- 25.8.9 The August Update reflected a large decline in forecast EBITDA for FY 2005 from the May IM by \$15.5 million to \$139.3 million. To avoid an unfavourable change in ION's forecast net debt position and proposed lender covenants, ION removed dividends from its cash forecast in FY 2005 and FY 2006 on the basis that dividend payments would be supported by a fully underwritten DRP or a capital raising. As a result, the August Update forecast (as prepared by ION) remained in line with the April Guidance, with some erosion of the EPS buffer but still above the 24 cent guidance for FY 2005 at 24.7 cents and at 29 cents for FY 2006. As shown in the table above, other financial measures (other than sales growth) remained materially in line with the April Guidance.
- 25.8.10 However, as noted above the August Update incorrectly represented that, other than Wingfield and North Plympton, the outlook for ION's remaining business units was unchanged relative to the May IM. The Deed Administrators have concluded that the August Update should have reported that the outlook for IAS had also changed significantly since the May IM in relation to demand from existing customers for existing

- products and in relation to the ION Group's prospects of securing contracts for new products under development.
- 25.8.11 The additional adjustments required (in addition to those affecting the April Model) included:
- (a) the issues raised in the SsangYong May Notifications (Event 11);
 - (b) the SsangYong July Softening and the SsangYong 28 July Softening (Events 13 and 14); and
 - (c) the Ford Copperhead July Volume Reduction (although it appears that ION may have intended to address this reduction in volume by increasing the transmission unit price previously quoted to Ford, and the impact was not large as ION's forecast already understated Ford Copperhead Volumes) (Event 12).
- 25.8.12 The Deed Administrators prepared a restated August Update forecast (***Restated August Update***) taking into account the accumulation of adjustments required and found:
- (a) ION's forecast EPS for FY 2005 fell below the April Guidance to approximately 20 cents (a reduction against the guidance of 17%);
 - (b) the forecast EPS for FY 2006 remained in line with the April Guidance at approximately 24.7 cents; and
 - (c) other financial measures remained materially consistent with the April Guidance (with the exception of sales growth previously mentioned which declined to 4.6% for FY 2005 and 15.8% for FY 2006).
- 25.8.13 Events impacting ION's forecasts which occurred after 5 August 2004 (the date of the August Update) were as follows:
- (a) SMT September Volume Concession (Event 16). This impacted the FY 2005 forecast but represented under 3% of revenue and in any event was included in the October 2004 Forecast;
 - (b) IAS Redundancy Program (Event 20). This program was agreed by the Board on 25 October 2004 and represented approximately 7% of FY 2005 forecast EBITDA disclosed to the market on 26 October 2004. The cost of the program was included in the October 2004 Forecast;
 - (c) Final Williams Report Capex Increases (Event 21). The capital expenditure increase was disclosed at the October 2004 AGM;
 - (d) October Auckland softening (Event 22). This was included in the October 2004 Forecast and represented approximately 5.4% of revised EBITDA for FY 2005 and less than 2% of FY 2006 and FY 2007 EBITDA;
 - (e) North Plympton and Wingfield October Downgrade (Event 23). This was included in the October 2004 Forecast and represented approximately 6.8%, 5.5%, and 3.2% of the revised forecast EBITDA for FY 2005, FY 2006 and FY 2007 respectively.

25.8.14 Events 10, 17, 18 and 19 did not impact FY 2005 or FY 2006. They did, however, impact subsequent years from FY 2007 and adversely impacted IAG's outlook generally (see section 18.9 and paragraphs 18.4.37, 18.6.4 and 18.5.17).

Annexure 1

Pooled and Non-Pooled Entities

Pooled Entities

The Pooled Entities are:

Core Cast Limited (ACN 097 447 660)
ION Limited (ACN 009 106 272)
ION Automotive Group Limited (ACN 104 279 156)
ION Light Metal Castings Pty Ltd (ACN 104 930 181)
Yollatsac Limited (formerly Castalloy Limited) (ACN 007 528 583)
Yollatsac Manufacturing Pty Ltd (formerly Castalloy Manufacturing Pty Ltd) (ACN 007 838 986)
Yollatsac Wheels Pty Ltd (formerly Castalloy Wheels Pty Ltd) (ACN 007 894 984)
XCTA Pty Ltd (formerly Cootes Transport Pty Ltd) (ACN 010 383 016)
XCTS Pty Ltd (formerly Cootes Tanker Service Pty Ltd) (ACN 004 495 765)
XIAS Pty Ltd (formerly ION Automotive Systems Pty Ltd) (ACN 104 930 109)
XIRC Pty Ltd (formerly I.R. Cootes Pty Ltd) (ACN 004 801 076)
XITMS Pty Ltd (formerly ION Transmissions Pty Ltd) (ACN 099 982 180)
XLC Pty Ltd (formerly Liquip Corp Pty Limited) (ACN 082 859 970)
XLO Pty Ltd (formerly Liquip Overseas Pty Ltd) (ACN 094 440 589)
XLS Pty Ltd (formerly Liquip Sales Pty Limited) (ACN 001 595 222)
XLSE Pty Ltd (formerly Liquip Service Pty Ltd) (ACN 082 859 989)
XLSV Pty Ltd (formerly Liquip Sales (Vict.) Pty Limited) (ACN 005 691 761)
XST Pty Ltd (formerly Stevenson Transport Pty Ltd) (ACN 006 271 352)

Non-Pooled Entities

The Non-Pooled Entities are:

ION Finance Pty Ltd;
ION Holdings Pty Ltd;
ION Investments Pty Ltd;
Thomson & Scougall Industries Pty Ltd; and
XCHO Pty Ltd (formerly Cootes Holdings Pty Ltd).