

5 June 2003

Dear Shareholder,

As a woolgrower shareholder in a multi-million dollar business funded through a 2 per cent levy on your wool returns, it is vitally important that you are well informed about Australian Wool Innovation Limited's (AWI's) activities. This is the second of the regular letters I am writing to report to you on matters that the AWI Board believes are important, and of which all woolgrower shareholders should be aware.

This letter contains information concerning AWI programs and projects, along with details of findings in a recent review requested by AWI's legal advisers, Minter Ellison, on instructions from the Finance and Audit Committee of the Board into AWI's management systems and processes. This review, conducted by PricewaterhouseCoopers (PwC), has identified a number of issues for further consideration by the Board and its advisers.

#### **Management Consolidation**

First I would like to provide an update on management appointments that will see AWI well positioned to move on from the past and focus on its core business – initiating and investing in wool research and development.

To this end, I am delighted to report to you that we have appointed a new Chief Executive Officer, Dr Len Stephens. Len Stephens came to AWI having been General Manager Livestock Production Innovation with Meat and Livestock Australia (MLA) for the past five years, where a high strike rate of commercial adoption has been his measure of success. The AWI Board think this appointment is ideal and believe that the company will benefit greatly from Dr Stephen's qualifications, experience, and vision.

We are also pleased to have appointed Les Targ, who came with the interim management team, as General Manager Commercial. Les will be applying his experience in finance management and contract negotiation to ensure that all of AWI's operational matters are handled in a professional and thorough manner.

Following these appointments, David Ward and Sas Douglas have retired as Acting Chief Executive Officer and Acting Chief Operating Officer, and will be retained as occasional consultants to help the new management settle in. AWI was extremely fortunate to have the benefit of their expertise during the changeover period last year.

#### **Research and development progress**

AWI's project portfolio has, on the whole, been progressing well. Program highlights include:

- **Wool Genetics Program**

The decision to invest in a wool genetics program that will enable the breeding of superior sheep through investment in new genetic technologies, the identification of problem-specific genes and the application of genetic selection. Extensive industry consultation was undertaken in formulating the strategy guiding this investment.

- **OJD**

The release of an AWI funded report into the feasibility of an OJD framework to guide sheep trade. This report, endorsed by Animal Health Australia, aims to reduce the difficulties presently being encountered in the field of OJD control.

- **Sensory Fabrics**

A 'sensory fabrics' feasibility study to investigate opportunities for use of Australian wool in electronic textiles that can tell where, when and how they are touched. New market opportunities for such innovative fabrics include automotive, healthcare, apparel, aerospace, furnishings, toys and consumer products.

- **Marks and Spencer MOU**

The signing of a two-year Memorandum of Understanding (MOU) between AWI and leading UK retailer Marks and Spencer that provides an additional commercial focus to future R&D investments. This MOU will enable AWI to tap into Marks and Spencer's consumer knowledge and better deliver innovative wool products to the market.

- **In-Shed Lice Detection Test**

A project has been approved for development of an in-shed lice detection test in conjunction with NSW Agriculture and Animal Health Australia.

- **Monthly Market Briefing Service**

Resumption of the Monthly Market Briefing service, free to all AWI shareholders. Call 1800 070 099 to subscribe.

#### *Ad-Hoc Advisory Panels*

A new, industry based consultative process incorporating Research Project Advisory Panels and Open Strategy Forums has also been established to provide woolgrower input into the strategic direction of the company and its programs. This process provides a mechanism through which the Board can obtain shareholder and industry feedback on long term strategic direction while the use of specialist Research Project Panels will provide AWI with expert advice in individual project selection and management.

A specialist advisor database is now being developed from which an individual's expertise will be matched against the scope of the projects to be assessed, and an Advisory Panel formed. Once the panel has provided their advice and the potential new projects assessed, the panel will be disbanded until a progress review is required.

All woolgrowers are encouraged to forward expressions of interest to be included on the specialist advisor database and to participate in the regional consultation forums that will be held later in the year. More details about this process and all of AWI's other research and development areas can be found at [www.wool.com.au](http://www.wool.com.au) or by calling AWI on 1800 070 099.

#### *Shear Express*

The nature of research and development means that not all programs are successful and unfortunately not all of AWI's programs are progressing exactly as expected.

AWI's ambitious and high-risk Shear Express project is encountering some difficulty as it progresses. While the target to deliver a working prototype by September 2003 seems attainable, the costs to achieve this are presently 20 to 30 per cent above initial expectations. The business plan originally put forward was based on very optimistic assumptions. The Shear Express Board is addressing the issues.

#### *Other Shearing Technologies*

While the Board recognises that Shear Express is a substantial investment in one technology, we welcome and encourage additional, new technologies. We wish to ensure that woolgrowers have access to any other potential shearing developments and are moving to achieve this.

#### *Global Pipeline Study*

The Global Wool Pipeline Study, concluded in November 2002, has also fallen short of a number of key targets. Our expectation that this project would substantially advance commercial understanding of the pipeline has not been met in full and further analysis is now underway to ensure this information is suitable for business use.

#### *AWI Mid-year Review*

Major changes to the AWI Board were brought about at AWI's Annual General Meeting last October by a number of shareholders standing for election on the basis that there had been inadequate corporate governance by the previous Board.

As the new Chairman, I promised to investigate AWI Board processes, management practices and financial controls and report to shareholders the findings of this review. Accordingly, on instructions from the Finance and Audit Committee of the AWI Board, AWI's legal advisers, Minter Ellison, engaged PricewaterhouseCoopers (PwC) to investigate these issues. The findings of PwC, which are summarised below, are to be read subject to the disclaimer appearing on the last page of this letter.

The investigation covered the period between 1 July 2001 and 29 January 2003 and has identified the following:

##### *1. Unusual or poorly substantiated payments*

PwC identified several examples of payments to directors, employees and vendors which, based on information and material provided to PwC, are unusual, or have not been adequately explained, or are not sufficiently supported by documentation. The total amount of these payments is approximately \$270,000 and includes:

- the payment to a senior executive of AWI of remuneration referable to his position as a director of Shear Express despite a resolution of that company noting that he would not seek such remuneration;
- the advance payment of directors' fees to several directors which have not been repaid, despite resignations during the period covered by the advance payment;
- a payment to a former director for reimbursement of travel costs which may not have been incurred by that director;
- a contract providing for payment of \$55,000 to a consultant which is adequately supported by documentation, but for which there is no evidence of actual services provided;
- payments totalling \$44,000 made to a consultant in circumstances where the performance of services to support this amount is unsubstantiated; and
- termination payments to employees that have not adequately been explained and may be excessive in reference to their period of employment.

##### *2. Potential inconsistencies with Statutory Funding Agreement ('SFA') made with the Commonwealth of Australia*

There are examples of payments made by AWI which may be inconsistent with the SFA. These payments include donations and sponsorship contributions to charities including the NSW Sports Council for the Disabled and organisations such as Charles Sturt University and the Royal Society of the Arts.

### 3. Project management issues

A number of examples of payments (including advance payments) to employees, consultants and contractors were identified regarding projects which were poorly documented or exhibited weaknesses in standard controls and procedures. These payments include:

- an advance payment of \$500,000 to a sole trader in regard to the production of a film for the wool industry; advance payments totalling \$404,560 to a wool awards consultancy;
- the award of significant and lucrative consultancy contracts to an individual consulting group; and
- the payment of bonuses to senior staff which were not referred to the Finance and Audit Committee of AWI for approval.

#### Recommendations

PwC has gathered available evidence in relation to these transactions and the payments above and referred this evidence to Minter Ellison for the purpose of obtaining legal advice. This includes advice concerning:

- potential recoveries of funds paid to employees, former directors, contractors and suppliers;
- requests for substantiation of payments;
- any inconsistencies with the SFA; and
- any other legal issues.

PwC has also recommended that a controls review be undertaken which would concentrate on issues such as employee benefits, payment approvals, project management, tendering and other potential risk areas. These controls are being put in place.

PwC also reported on a preliminary basis to the Board on two further matters of concern raised by the Board. The first relates to projects commenced and payments made in the absence of signed contracts. The second is the allocation by AWI's management to specific projects of costs which might instead have been treated as overheads. Below is a selection of relevant points from the matters PwC reported.

#### Review of project approvals, contracts and related payments

- PwC identified 34 projects with a total value of \$14,342,846 that were approved prior to 1 December 2002, without executed contracts in place as at that date.
- Payments of approximately \$3,430,000 were made prior to 1 December 2002 and payments of approximately \$1,549,000 made between 1 December 2002 and 31 March 2003 on these projects (total payments were \$4,979,036).
- PwC identified a further 34 projects with a total value of approximately \$8,265,000 where they were unable to determine the project approval date, however, it appears likely that the projects were approved before 1 December 2002. These projects did not have signed contracts in place as at 1 December 2002.
- During the performance of their review work, PwC identified a number of control weaknesses.
- PwC consider the improved project control procedures put in place by the new Board and management to be prudent and appropriate, noting that management must ensure that the procedures are enforced.

#### Review of calculation of overheads and project costs

- Under AWI's previous management, a large percentage of costs were attributed to project expenses, rather than overheads. AWI's current management consider a number of these costs to be overheads, rather than project expenses.
- Based on the actual results to 28 February 2003 and forecast figures for the four months to 30 June 2003, the overheads of AWI, relating to both project overheads and corporate overheads, are estimated to be approximately \$20 million (including current year redundancy costs and bonus payments).

AWI is acting upon the reports from PwC and taking further action where appropriate including:

- Where legally or commercially appropriate, attempts are under way to recover funds paid to former directors, employees, suppliers and contractors;
- Financial controls and delegations have been completely reviewed and tightened;
- Until further notice, all potential projects are to be forwarded to the Board for approval;
- Payments to service providers will not be made before contracts are signed;
- Risk and fraud prevention policies are under development and internal audit procedures have been strengthened;

A number of operational matters have caused the Board further concern. These matters and the appropriate remedial measures are summarised below:

- Certain payments made for assistance and advice in the attempted re-election of previous AWI Directors last year have been identified.  
**Remedy: No AWI payments will be made for re-election campaigning of any Directors in future.**
- A donation of \$500,000 to the Farmhand Appeal, contrary to the Statutory Funding Agreement between AWI and the Federal Government.  
**Remedy: This money was returned to AWI and a clear sponsorship policy has now been implemented.**
- Payment of end-of-year bonuses totalling \$858,820 without any objective criteria.  
**Remedy: A standard human resources and remuneration policy has been formulated and is now being implemented.**
- A payment of \$149,000 made to a staff member upon departure from the company when his term of employment had been only 20 months.  
**Remedy: Further inquiries are in train.**
- Voting entitlements at the last election were at least one, and in some cases, two years out of date.  
**Remedy: At the next Annual General Meeting, voting entitlements will be accurately based on levies paid in the three years to 30 June 2003.**
- For the period 1 July to 31 December 2000, many shareholders' wool tax payments were not included in their voting entitlements because AWI did not have details of levy payments made during the Government Collection System changeover period.  
**Remedy: AWI will contact all woolgrowers to obtain that information in the near future.**
- Staff numbers were reported at the October 2002 Annual General Meeting to be 32. In fact there were 56 staff, comprising 51 employees and 5 full-time contract staff, working for AWI as at 31 October 2002.  
**Remedy: Staff and contractor numbers are now reported on a regular basis to all senior staff and Directors.**
- At the Annual General Meeting in October 2002, the Board reported that the premises owned by AWI at 47 York Street, Sydney were the subject of a lease. In fact, the premises had not been leased and are still vacant.  
**Remedy: AWI is now negotiating to sell the premises.**

Finally, I must say something about company policy. There has been considerable debate about the possibility of AWI being commercially successful to the extent that it could be self-funding. The Board does not believe that this outcome is feasible.

Returns will be generated from successfully commercialised research but will not be enough for AWI to be self-funding. In an organisation such as this there are many programs that, by their very nature, will provide benefits to woolgrower shareholders but will not deliver a direct commercial return. These include investments in programs such as Land, Water and Wool, trade and tariff policy research and AWI's education and extension programs.

The Board is committed to pursuing strong returns on the investment of levy funds but believes the majority of woolgrowers never expected such a self-funding scenario to be possible when AWI was initially established. The Future Directions Task Force Report, which recommended the formation of this new research body, most certainly did not.

In conclusion, I am confident that the right people have been appointed to senior executive positions and that the required processes and policies are now being implemented.

The Board will maintain a close watch on all aspects of the business to ensure the highest standards of corporate governance are achieved and continue to focus on the pursuit of research, development and innovation that will increase the long term profitability of Australian woolgrowers.

Yours faithfully,



The Honourable Ian McLachlan AO

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*For the purposes of conducting our review, reliance was placed on the representations, information and instructions provided to us. We did not seek to verify the accuracy or completeness of the information made available to us, nor did we conduct any procedures in the nature of an audit of the information or assumptions therein in any way, other than has been specifically stated.*

*The review was conducted subject to the provisions and qualifications stated by us, for the use of Minter Ellison, and its client, Australian Wool Innovation Limited ('AWI'). The firm, its partners, its agents and servants specifically deny any liability whatsoever to any other party who may use or rely on the whole, or any part, of the summary of the findings of our review. The summary should not be used for any other purpose without the firm's prior written consent.*

*We stress that the transactions and profiles identified in our review were merely the results of our analysis, and are not necessarily indications that fraud or errors have occurred. The testing we perform cannot detect all cases of fraud and nothing in the summary of our findings appearing in this letter is intended to imply this.*

*Our findings were based on information made available to us up to the date of this letter and we reserve the right to amend our opinions, if necessary, based on factual information that comes to our attention after that date.*