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BH/CG/JB

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Dear Sirs

2005 Audit of Magellan Aerospace (UK) Ltd

In order to carry out our duties and responsibilities as auditors, Ernst & Young is required by International Standard on Auditing (UK and Ireland) 260 "*Communication of audit matters with those charged with governance*" ("ISA 260"), to write to you setting out the following matters in respect of the audit of the above named company.

Our fieldwork is complete and we anticipate issuing an unqualified opinion.

Qualitative aspects of accounting practices and financial reporting

The following key audit and accounting issues were discussed and agreed at our closing audit meeting with Shawn Smith, John Dekker, Phil Underwood and Brian Little on 10th February 2006. Further discussions have been held with Shawn Smith following this date to resolve issues raised in this meeting and to complete the statutory accounts process. Any significant matters discussed have been included below.

Company Issues:

- **Prior Year Adjustment in UK statutory accounts to 31 December 2005** – During the preparation of the UK statutory accounts it was noted that an incorrect balance had been included in the calculation of the negative goodwill in the 2004 statutory accounts. The balance related to those Mayflower creditors (ransom creditors) that Magellan Aerospace (UK) Ltd (MALUK) had agreed to pay on the purchase of Mayflower. In accordance with UK GAAP these amounts should have been accounted for as a current period cost in the 2004 accounts and not included as a fair value adjustment on the acquisition which was the correct accounting for group reporting under Canadian GAAP. In the 2004 accounts an adjustment was made to charge these creditors to the 2004 profit & loss account. However in error this was only for part of the balance. A prior year adjustment has therefore been required to ensure that the remaining balance was correctly charged to the profit and loss account in the prior period. This has also impacted the amortisation of the negative goodwill for the prior period. The net impact has been a reduction in profit for the prior period of £691k.
- **Inventory Provisions** – At the closing meeting held on 10th February 2006 ("the closing meeting") it was noted that the audit of inventory provisions was in progress. Significant further investigations were performed following the closing meeting. EY raised several challenges to MALUK management in relation to both slow moving stock provisions and provisions to ensure that stock was recorded at the lower of cost and net realisable value (NRV).

- Slow Moving Stock Provision: MALUK policy required 50% provision for any product that had not moved for 6 months and 100% provision for any product that had not moved for 12 months. This policy was considered by EY to provide a potential issue that if a large volume of product was being held but with only very low usage, no provision would exist against the potential excess. The slow moving provision was therefore challenged based on recent historic usage compared to the volume of stock held. MALUK management reviewed the significant items that arose from this challenge and considered them in light of future orders and other known usage for the inventory. This produced a reduction in the value of the original challenge. However MALUK did concur that some increase to their original provisions were required.
- Net Realisable Value: MALUK had not completed detailed calculations to consider the NRV of the inventory held as at 31 December 2005. We understand that this was due to a lack of time following on from other priorities that were being focused on regarding inventory costing leading up to the year end. We challenged the carrying value of the stock at cost based on the most recent sales price data available in January and February 2006. MALUK considered the appropriateness of the carrying value of the inventory in light of this and agreed that additional provisions were required to ensure that the inventory was correctly held at the lower of cost and NRV.

It is noted that at the time of the group reporting some of the further investigation above was not complete and that a judgement was made by EY Canada based on information provided on the work performed to date by EY UK as to the appropriate level of audit difference to be discussed with Magellan Aerospace Corporation for inclusion in the group financial statements. The level of these audit differences that were actually posted to the group financial statements was agreed between EY Canada and Magellan Aerospace Corporation.

For the UK statutory accounts further detail testing was performed to ensure that the Inventory provision to be included in the financial statements for the year ended 31 December 2005 was correct. As discussed above this has led to an increase in the level of the inventory provisions by £1,437k.

- **Engineering and Head Office Bonus Accruals** – Following the closing meeting MALUK management considered the appropriateness of the bonus accruals that had been accrued throughout 2005 for the Engineering and Head Office divisions. MALUK determined that no constructive obligation existed to pay the bonuses based on performance in 2005. They therefore wrote back the accrued amounts in both divisions totalling £105k. We discussed the appropriateness of this with management and not being aware of any contractual obligation to pay the bonuses accepted managements' position. However we do note that in 2006 bonuses were paid to some of the staff in the engineering division. Management have represented to us that this was a discretionary payment that was agreed in 2006 (and not specifically relating to performance targets met in 2005) and therefore have treated this as a 2006 cost. We have obtained specific representation from the Directors to support the position adopted by MALUK in relation to this.
- **Head Office Ransom Creditors & Group Reporting Opening Reserves Reconciliation** – EY noted in the closing meeting that a balance of £457k was held in the head office balance sheet. It was noted that this was incorrectly posted to the reporting pack to reflect a 2004 UK statutory adjustment. Subsequent to the closing meeting further investigation was performed to ensure that the reserves in the group reporting pack were correctly reconciled. In order to achieve this other adjustments were made with Shawn Smith prior to the submission of the group reporting pack.

- **A380 Sales Reserve Release** – The release of the A380 sales reserve was not specifically discussed in the closing meeting, however during our audit we discussed this with management and were advised that the significant risks that the provision was to cover had reduced and that the provision was no longer required. In the prior year we had obtained specific representation from management on the validity and value of this provision due to the judgemental nature of the provision.
- **Fixed Asset Transfers** – Physical transfer of fixed assets between sites and including the scrapping of some items had taken place prior to the year end but had not been accounted for, although a reconciliation of the movements had been prepared. Accounting for the scrapping of any fixed assets led to a £23k write off. Interdivisional transfers had a nil impact on the company position. This adjustment was agreed.
- **Plant & Machinery Additions** – It was discussed at the closing meeting that replacement parts to manufacturing machinery were being given a 20 year useful life the same as the manufacturing machinery. It was noted that these replacement parts may wear quicker and need replacing at shorter intervals than this. On further investigation the impact on the depreciation charge was not found to be significant based on the current levels of additions but EY advised that this could increase to become significant if further replacement parts were added over time.
- **Warranty Provision** – It was discussed in the closing meeting that the company held a low level of warranty provisions (£11k in structures) at the year end and some had been released in the year. MALUK management has noted that due to the serious nature of any failure in the aerospace industry and the stringent regulations there is little or no warranty work unless there is one off significant failure in which case a provision for this would be made once the event had occurred. Therefore they considered that there was no need for a general warranty provision to be held. From our understanding of the business we have accepted managements' position.

Site Specific Issues

Engineering:

- **Engineering Overhead Adjustment** – During the audit discussions were held between MALUK and EY regarding the inconsistency of absorbing overheads into the stock at the manufacturing divisions but not performing this in the Engineering division. MALUK determined that they would bring the engineering division in line with the rest of the company, their stated accounting policy and UK GAAP and calculated an appropriate overhead absorption as at the year end. This had the impact of increasing WIP by £134k at the time of the group reporting. We reviewed managements' calculations and found these to be materially correct. Following further adjustments that were made for the UK statutory accounts that impact the Work in Progress balance MALUK have reconsidered the calculation and adjusted the total level of the absorption to £84k. We have also obtained specific representation from management on their considerations of the appropriateness of the accounting for this item and the value of overheads absorbed.
- **Engineering Contract Accounting** – At the closing meeting EY noted that they needed to perform further investigations into the accuracy of the company's accounting for engineering contracts. Further investigation was performed subsequent to the closing meeting and it was noted that the accounting did not correctly allocate revenue, costs and profit/loss over the life of the contracts. The net impact of the reworking of the most significant contracts performed with MALUK created an increased cost to the profit & loss

account and led to reassessment of the balance sheet position between WIP, NRC and contract loss provisions. Most significantly the original MALUK calculations has created different margins on the current and deferred (NRC) portions of the contracts. This led to taking a higher margin on the NRC element (with these costs being capitalised first) and a loss on the current portion. As a result the original accounting created contract loss provisions. Allocating the profit margin evenly over the life of the entire contract showed that these provisions were mainly not in a loss making position and therefore the loss provisions should be reversed, however this was offset by the reduction in NRC and WIP balances to similarly accrue costs evenly. It was agreed with management that given the type of contracts that the most prudent basis to assess the percentage completion of the contract was based on the meeting of agreed milestones at which point revenue was then due to the company.

Bournemouth & Poole:

- **Bournemouth Overhead Absorption Calculation** - At the closing meeting it was discussed that EY considered that the overhead absorption rate was potentially too high due to the calculations used to arrive at an hourly rate. The impact of this was in our opinion to overvalue inventory by £106k. Subsequent to the closing meeting this was further discussed with Shawn Smith who considered our challenges and has however determined that he is satisfied with the original calculation. We note that this is a relatively subjective area and that any difference includes an element of judgement. Based on the grounds of materiality we are therefore willing to accept managements' position. The unadjusted audit difference has however been included on the management letter of representation.
- **Bournemouth Stock Ledger Differences** – EY noted in the closing meeting that the General Ledger did not agree with the Stock Ledger. The £42k difference was required to write off to cost of sales. This adjustment was agreed.
- **Reclassification of Bournemouth Admin Costs to Cost of Sales** – EY noted in the closing meeting that during our testing various costs (totalling £380k) included within admin costs related to production and should therefore be included within cost of sales. Subsequent to the meeting this was agreed.
- **Bournemouth Thales Accrual** – EY noted at the closing meeting that revenue and costs had been recognised in relation to a Thales project when only the invoice had been raised and no significant work performed. An adjustment was proposed to remove this transaction and reduce revenue and cost of sales by £50k and £33k respectively. This adjustment was agreed.
- **Bournemouth Pensioner's Liability** – It was noted in the closing meeting that Magellan were in process of trying to obtain recompense for this liability from the previous owners of the Moores business. Subsequent to the close meeting Magellan secured a £62k recompense for this liability and hence proposed to reduce the liability by this amount. This adjustment was agreed.
- **Bournemouth Fixed Assets** – Our audit of fixed assets noted that some assets purchased in 2004 and 2005 were being incorrectly depreciated. The impact of this was to increase the depreciation charge by £11k. This adjustment was agreed.
- **Bournemouth Prepayments** – EY noted in the closing meeting that prepayments had been accounted for relating to Titanium and Fabrications price adjustments. These balances were not required and a £24k write off was proposed. This adjustment was agreed.

- **Poole Lease Creditor** – EY noted in the closing meeting that the lease creditor had not been correctly accounted for. To correct the position to the 31 December 2005 the creditor needed to be reduced by £19k. This adjustment was agreed.
- **Bournemouth GKN Claim** – The GKN claim was not discussed at the closing meeting but EY were aware that a claim for approximately £50k had been made against MALUK as at the year end. MALUK management considered it appropriate to raise a provision for £25k. EY accepted managements' position on this and the adjustment was agreed.

Structures:

- **Structures Stock** – EY noted in the closing meeting that the stock listing did not reconcile to the general ledger by £20k. An adjustment was therefore proposed to write off the overstatement to cost of sales. This adjustment was agreed. EY also noted that the calculation of the labour and overhead absorptions in the structures division had not correctly taken account of hours charged at the beginning and end of the period. The impact of this assessed by EY was to increase in the stock value by £20k. As with the Bournemouth overhead calculation following further discussion management were satisfied that their original calculations were materially correct. We note that this is a relatively subjective area and that any difference includes an element of judgement. Based on the grounds of materiality we are therefore willing to accept managements' position. The unadjusted audit difference has however been included on the management letter of representation.

Treatments:

- Treatments WIP – At the closing meeting EY noted that the calculation of Treatments WIP was still being based on a sales less margin approach. Whilst the balance is not particularly significant (£35k) this should be accounted for based on cost. EY also noted that this calculation assumed that WIP was 100% complete. EY noted that this was unlikely to be realistic but that information on the exact stage of completion at the year end was not available. Subsequent to the meeting it was agreed with MALUK management that whilst there could be some reduction in the value of WIP, given the small size of the overall balance and that any adjustment would also only be an estimate and could not be quantified accurately, that based on the grounds of materiality no adjustment should be posted.

Fabrications:

- **Fabrications Depreciation** – At the closing meeting EY noted that depreciation in the Fabrications division had been incorrectly calculated. This led to a proposed £11k increase to depreciation. This adjustment was agreed.
- **Fabrications TB to Pack Differences** – It was noted by EY that the Fabrications division reporting pack did not agree to the underlying TB for all account codes. EY therefore proposed audit differences to ensure that the reporting pack was in line with the audited underlying TB. These adjustments had the net impact of reducing profit by approximately £20k. This was discovered and discussed with management after the closing meeting. The adjustment was agreed.
- **Fabrications Invalid Capitalisation of Costs** – At the closing meeting EY raised some concerns over the capitalisation of costs. Following further investigation and clarification a relatively small value of £12k at the Fabrications site was found to have been incorrectly capitalised. This adjustment was agreed.
- **Fabrications Payroll Accrual** – On the completion of our audit work in the Fabrications division following the closing meeting we noted that an accrual for the week 40 payroll had not been correctly accrued. This adjustment was agreed with MALUK management.

Other:

- **Brian Little Whistle Blowing Allegations** – We have been made aware of various allegations that have been made by a former employee regarding the accounting for certain positions and transactions. We have noted those below that have an impact on the 2005 UK statutory accounts:
    - A380 provision release in 2005
    - 2005 Head Office and Engineering bonus accruals release in 2005 being a 2006 discretionary cost.
    - The overhead rate applied to Bournemouth inventory.
    - Absorption of direct overheads in Engineering inventory and that only appropriate overheads have been included within this calculation.
    - The level of inventory provisions is appropriate.

  We have included in the items discussed above the consideration of these items during our audit. We understand that further investigation into some these specific items has been performed by PwC who have concluded that the accounting for the items they reviewed was not materially incorrect.

Internal financial controls

Our review of the company's system of internal control is carried out to assist us in expressing an opinion on the accounts of the company as a whole. This work is not primarily directed towards the discovery of weaknesses or the detection of fraud or other irregularities (other than those which would influence us in forming that opinion) and should not therefore be relied upon to show that no other weaknesses exist. Accordingly, we refer only to those matters which have come to our attention during the course of our normal audit work and do not attempt to indicate all possible improvements which a special review might develop.

Whilst we note from our audit approach discussed below we have not sought to place any reliance on the controls in operation at the individual sites during the course of our audit we have noted the following matters to report:

- Information Technology:
    - We acknowledge the implementation of the EFACS system at all manufacturing sites which has been an important move to harmonise the accounting processes for the company. However we would note that there could be further improvements made in the reports produced by the EFACS system at each division so that they are consistently produced and used in the recording and calculating of inventory.
    - We understand that a SAGE accounting system has been implemented in 2006 to replace the spreadsheets that had been used to record transactions in the Head Office and Engineering divisions. We would commend this approach.
- Inventory Provisioning:
    - We would recommend that MALUK review the stock provisioning policy that was originally applied for the 2005 year end audit. In our opinion, as noted above, the sole application of the original policy raised the potential for excessive stock

holdings to not be correctly identified. We are aware that there has been improvement in 2006 regarding the consistency and timely calculation of the inventory provisions.

- Inventory Overhead Rates
  - During our audit we were aware that management had been engaged in updating the overhead absorption rates which are based on an hourly labour rate. We note that this is a key component of the Inventory valuation and would recommend that management regularly review the calculation of the hourly rate and ensure that this remains appropriate.
- Financial Statement Close Process and Accounting Policies
  - We would recommend that, in addition to the Magellan Corporation Accounting Policies, MALUK document the accounting policies and considerations that they will apply to specific transactions within the business so that these can be clearly set out and consistently applied. We would specifically recommend this in relation to Inventory provisioning, engineering contracts, non recurring costs and judgemental provisions.
  - We noted during the audit that improvements could be implemented to the financial statement close process. Our observations specifically relate to:
    - The completion of the divisional Magellan reporting packs from the divisions where we noted some differences between the final TB and the completed reporting pack.
    - We would recommend that the reporting pack should include additional information that allows the head office accounting team to more easily identify specific information. For example, greater detail on the composition of balance sheet and Profit & Loss accounts so that consistent and accurate disclosures can be made for the UK statutory accounts and group reporting.

If you would like us to expand on any of our observations above please contact me at the contact details included on this letter.

Integrity, objectivity and independence

APB Ethical Standard 1 "Integrity, Objectivity and Independence" and ISA 260 requires us to communicate with you on a timely basis on all significant facts and matters that bear upon our independence and objectivity. The aim of these communications is to ensure full and fair disclosure by us to those charged with governance on matters in which you have an interest.

Listed in Appendix A are Ernst & Young's key firm-wide policies and processes to maintain independence and objectivity.

We are not aware of any other relationships between member firms of Ernst & Young International and the Company (or Group) that, in our professional judgment, may reasonably be thought to bear on our independence or the objectivity of the audit engagement team.

We confirm that in our professional judgment, the Firm is independent within the meaning of regulatory and professional requirements and the objectivity of the audit engagement partner and audit staff has not been compromised.

We consider that our independence in this context is a matter that should be reviewed by both you and ourselves. It is therefore important that you and your Board consider the facts of which you are aware and come to a view. Should you have any specific matters that you wish to discuss, please contact us.

Uncorrected misstatements

We understand that not all of the differences raised in the matters above were adjusted by Magellan Corporation in the preparation of their group accounts for the year ended 31 December 2005. However the decision as to the materiality of these adjustments for this purpose was discussed and agreed between Magellan Aerospace Corporation and EY Canada.

For the purposes of the UK statutory accounts for the year ended 31 December 2005 all audit differences raised in the matters discussed above have been adjusted in the statutory accounts with the exception of the adjustment to the Bournemouth & Structures overhead absorption calculations.

Other matters:

General audit approach and overall scope of the audit. – We have been engaged to perform an audit to enable us to provide an opinion on the UK statutory accounts for the year ended 31 December 2005. We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed. We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

In order to fulfil these obligations we determined that it would be most appropriate to conduct our audit on a substantive basis. We have therefore not sought to place reliance on any controls that you may have in place to process transactions and around the IT systems.

This letter has been prepared for the sole use of the Board of Directors, management and others within the Company. It must not be disclosed to a third party or quoted or referred to without our written consent. No responsibility is assumed by Ernst & Young LLP to any other person.

Finally we would like to take this opportunity to thank your staff for the co-operation we have received throughout our audit. If there are any further matters which you wish to discuss concerning our audit, please do not hesitate to call us.

Yours faithfully

Barbara Hadfield

Barbara Hadfield
Partner
Ernst & Young LLP

Communication to Those Charged with Governance

Appendix A

Ernst & Young LLP (E&Y) has policies and procedures that instil professional values as part of Firm culture and ensures the highest standards of objectivity, independence and integrity are maintained. Listed below are some of the key policies and processes in place within E&Y UK for maintaining objectivity and independence:

Financial interests	The firm prohibits investments in all audit client companies by Ernst & Young partners and technical staff. Our partners and staff are required to confirm their compliance each year with our Firm's independence policies. We track this compliance through a worldwide investment tracking system. New starters are required to confirm their compliance with the firm's independence policies on commencement of their employment.
Training	Our partners and staff are required to undertake regular mandatory training on our independence and ethical policies and processes.
Partner rotation	The Firm has detailed policies on the rotation of the audit engagement partner and, in the case of listed clients: key audit partners, independent partners and "other partners and staff in senior positions".
Consultation	The Firm requires that the audit team consult with a panel of experienced partners on complex accounting and auditing matters.
Ethics	Our global code of conduct provides an ethical framework on which we base our decisions and our actions—as individuals and as members of our global organisation. We have also established the EY/Ethics hotline which will allow any person, inside or outside of Ernst & Young, to report confidentially and anonymously any activity that they believe may involve conduct that is unethical, illegal, in breach of professional standards, or is otherwise inconsistent with our established policies or code of conduct.
Quality reviews	The firm operates a programme under the direction of senior partners that annually assesses compliance with policies and procedures. Over a three year period, a proportion of the work of all audit partners is reviewed. The results of the programme help us to evaluate the firm's quality controls and personnel performance and identify areas for improvement. As with other firms, Ernst & Young's audit practice is subject to annual review by the Audit Inspection Unit (AIU) and the Quality Assurance Directorate (QAD) of the Financial Reporting Council (FRC) for compliance with Audit Regulations. As part of its visits, the AIU/QAD evaluate the system of quality control operated by the firm for its audit practice.
Business relationships	EY UK has implemented a centralised process for the review and pre-approval, by our quality and risk management team, of all new business relationships. A submission must be made and approved for each new business relationship before committing the firm. In addition, all new business relationships must be notified and approved

by the lead audit or client service partner before committing the firm.

Non-audit services

Our audit engagement partners must approve any non-audit services offered to their clients. This allows them to:

- ensure the objectives of the proposed engagement are not inconsistent with the objectives of the audit of the financial statement;
- identify and assess any related threats to our objectivity; and
- assess the effectiveness of available safeguards to eliminate such threats or reduce them to an acceptable level.

Where no satisfactory safeguards exist we do not carry out the non-audit service.