

Directors' Report

The Directors present their annual report and the audited consolidated financial statements for the year ended 31st December, 2006.

Principal Activities

The principal activities of the Group is the manufacture and sales of diesel engines and related parts. The principal activities of its associates and subsidiaries are set out in notes 53 and 88 to the consolidated financial statements, respectively.

Results and Appropriations

The results of the Group for the year ended 31st December, 2006 are set out in the consolidated income statement on page 47.

The Board has resolved that it will not propose a final dividend for the Company for 2006 until the Merger (as hereinafter defined) is completed. After the completion of the Merger (as hereinafter defined), the Board will meet again to consider proposing a final dividend (if any) for the Company for 2006 for the consideration and approval by the 2006 annual general meeting of the Company. For details concerning the agreement between the Company and Torch Automobile Group Co., Limited ("TAGC") on profit distribution, please refer to the section headed "I. The Merger Proposal — 3. Merger Agreement — Others" in the "Letter from the Board" contained in the circular of the Company dated 12th November, 2006.

Subsidiaries

Particulars of the Group's subsidiaries as at 31st December, 2006 are set out in note 37 to the consolidated financial statements.

Share Capital

Details of the share capital of the Company are set out in note 28 to the consolidated financial statements.

Property, Plant and Equipment

Details of movements during the year in the property, plant and equipment of the Group are set out in note 15 to the consolidated financial statements.

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Distributable Reserves

The amount of the Company’s reserves available for distribution to shareholders as at 31st December, 2006, calculated in accordance with the profit as reported under the relevant accounting principles and financial regulations applicable to companies established in the People’s Republic of China (the “PRC”) or Hong Kong Financial Reporting Standards, whichever is less, was approximately RMB1,250.4 million.

Merger and Acquisition

Acquisition of 濰柴動力 (濰坊) 投資有限公司 (Weichai Power (Weifang) Investment Co., Ltd.) (“Weifang Investment”)

On 12th May, 2006, the Company entered into conditional sale and purchase agreements to acquire 55% equity interest in Weifang Investment, as a result of which the Company’s interest therein was increased from 45% to 100%, for a consideration of RMB684,750,000. Weifang Investment is an investment holding company whose principal asset is approximately 28.12% equity interest in 湘火炬汽車集團股份有限公司 (Torch Automobile Group Co., Ltd.) (“TAGC”), a company listed on the Shenzhen Stock Exchange. TAGC and its subsidiaries were are in the manufacture and sale of heavy trucks and related parts and components.

The acquisition of Weifang Investment was approved by the shareholders of the Company at its annual general meeting on 30th June, 2006. Details of the acquisition were set out in the circular of Company dated 14th June, 2006.

Merger with TAGC

On 12th November, 2006, the Company entered into an agreement (the “Merger Agreement”) with TAGC in respect of the merger of the Company and TAGC and the issue of new A shares by the Company (which will be listed on the Shenzhen Stock Exchange upon completion of the Merger) (“Weichai A Shares”) to the shareholders of TAGC (other than Weifang Investment) at the ratio of one Weichai A Share to 3.53 shares of TAGC held by such shareholders of TAGC (the “Merger”). The Merger will be accompanied by a cash alternative to the shareholders of TAGC who elected not to receive in whole (or in part) the Weichai A Shares at the rate of RMB5.05 per share of TAGC. The Company itself will not be a provider of such cash alternative, which shall be arranged by the sponsors to the listing of the Weichai A Shares.

After the completion of the Merger, (i) the shares of TAGC will be cancelled; (ii) TAGC’s assets will be absorbed into and its liabilities assumed by the Company; (iii) TAGC will be deregistered and will cease to exist; and (iv) the Weichai A Shares will be listed on the Shenzhen Stock Exchange while the H shares of the Company will continue to be listed on The Stock Exchange of Hong Kong Limited (the “Stock Exchange”).

The Merger and the Merger Agreement were approved by the shareholders of the Company and TAGC at the extraordinary general meeting on 29th December, 2006. Further details of the Merger and the Merger Agreement were set out in the section headed “I. The Merger Proposal” in the “Letter from the Board” contained in the circular of the Company dated 12th November, 2006.

Issue of Debentures

On 23rd January, 2007, the Company issued certain short-term debentures in an aggregate principal amount of RMB900 million without guarantee. The said debentures are zero coupon with a face value of RMB100 each and priced and issued at a discount at RMB96.31 each with a maturity period of 365 days from 25th January, 2007. The proceeds from the said issue of debentures will be used as working capital of the Company for its production and operational needs. For details of the said issue of debentures and its results, please refer to the announcements of the Company dated 17th January, 2007 and 29th January, 2007, respectively.

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Directors and Supervisors

The Directors and Supervisors of the Company during the year and up to the date of this report were:

Executive Directors:

Tan Xuguang (*Chairman and CEO*)

Xu Xinyu

Sun Shaojun

Zhang Quan

Non-Executive Directors:

Yeung Sai Hong

Chen Xuejian

Yao Yu

Li San Yim

Liu Huisheng (appointed on 30th June, 2006)

Zhang Fusheng

Julius G. Kiss

Han Xiaoqun

Tong Jingen (resigned on 30th June, 2006)

Independent Non-Executive Directors:

Zhang Xiaoyu

Koo Fook Sun, Louis

Fang Zhongchang

Supervisors:

Sun Chengping

Wang Yong

Jiang Jianfang

Directors' and Supervisors' Service Contracts

Each of the executive Directors has entered into a service contract with the Company which commenced from 18th December, 2005 and is to end on 17th December, 2008.

The term of appointment of each of the non-executive Directors and Supervisors is from 18th December, 2005 to 17th December, 2008, except Tong Jingen who resigned with effect from 30th June, 2006 and Liu Huisheng who was appointed on 30th June, 2006 at the annual general meeting for the period from 30th June, 2006 to 17th December, 2008.

Each of the independent non-executive Directors has a fixed term of appointment commencing from the date of his appointment by the shareholders of the Company and ending on the conclusion of the next annual general meeting of the Company. At the annual general meeting, each of the independent non-executive Directors will offer himself for

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re-election for a term ending (i) on the next annual general meeting of the Company (“Next AGM”); or (ii) on the conclusion of the extraordinary general meeting (if any) of the Company convened prior to the Next AGM at which he is re-appointed as independent non-executive Director for a term beyond the conclusion of the Next AGM (whichever is the earlier). The term of appointment of each Independent Non-Executive Directors of the Company is from 18th December, 2005 to 17th December, 2008.

The Company has received, from each of the Independent non-executive directors, an annual confirmation of his independence pursuant to Rule 3.13 of the Rules Governing the Listing of Securities on the Stock Exchange (the “Listing Rules”). The Company considers all of the independent non-executive Directors independent.

Directors’ and Supervisors’ Interests in Shares and Underlying Shares

As at 31st December, 2006, the interests of the Directors, Supervisors and their associates in the shares and underlying shares of the Company and its associated corporations, as recorded in the register maintained by the Company pursuant to Section 352 of the Securities and Futures Ordinance (“SFO”), or as otherwise notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies (“Model Code”), were as follows:

Name of Director	Capacity	Number of domestic shares or foreign shares held	Percentage of the issued share capital of the Company
Tan Xuguang	Beneficial owner	4,300,000 (Note 1)	1.3%
Xu Xinyu	Beneficial owner	1,000,000 (Note 1)	0.3%
Sun Shaojun	Beneficial owner	1,000,000 (Note 1)	0.3%
Zhang Quan	Beneficial owner	1,000,000 (Note 1)	0.3%
Liu Huisheng	Beneficial owner	600,000 (Note 1)	0.2%
Yeung Sai Hong (Note 3)	Held by controlled corporation	23,500,000 (Note 2)	7.1%
Li San Yim (Note 4)	Held by spouse and controlled corporation	21,500,000 (Note 1)	6.5%
Julius G. Kiss (Note 5)	Held by controlled corporation	10,750,000 (Note 2)	3.3%
Name of Supervisor			
Wang Yong	Beneficial owner	350,000 (Note 1)	0.1%

Notes:

- These are domestic shares of the Company. Domestic shares are ordinary shares issued by the Company, with a Renminbi-denominated par value of RMB1.00 each, which are subscribed for and paid up in Renminbi or credited as fully paid up.
- These are foreign shares of the Company. Foreign shares are ordinary shares issued by the Company, with a Renminbi-denominated par value of RMB1.00 each, which are subscribed for and paid up in a currency other than Renminbi. As at 31st December, 2006, these foreign shares were included in the domestic shares of the Company.

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3. Yeung Sai Hong, a non-executive Director, was directly and indirectly interested in 90% of the issued share capital of Peterson Holdings Company Limited ("Peterson"), which in turn held 23,500,000 foreign shares of the Company.
4. Li San Yim, a non-executive Director, and his spouse, Ni Yinying, were interested in 69.16% and 30.84%, respectively, in the registered capital of 福建龍岩工程機械(集團)有限公司 Fujian Longgong Construction Machinery (Group) Company Limited ("Fujian Longgong") which in turn held 21,500,000 domestic shares of the Company, and therefore Li San Yim was deemed to be interested in these shares of the Company.
5. Julius G. Kiss, a non-executive Director, was indirectly interested in the entire issued share capital of IVM Technical Consultants Wien Gesellschaft m.b.H. ("IVM"), which in turn held 10,750,000 foreign shares of the Company.

Save as disclosed above, none of the Directors, Supervisors, nor their associates had any interests or short positions in any shares or underlying shares of the Company or any of its associated corporations as at 31st December, 2006.

Substantial Shareholders

The register of substantial shareholders maintained by the Company pursuant to Section 336 of the SFO shows that as at 31st December, 2006, the following shareholders had notified the Company of their relevant interests in the issued share capital of the Company.

Name	Capacity	Number of domestic shares (Note 7) or foreign shares (Note 8) held	Percentage of share capital comprising only domestic shares and foreign shares	Number of H shares held (Note 9)	Percentage of share capital comprising only H shares	Percentage of total issued share capital
濰坊柴油機廠 (Weifang Diesel Engine Works) ("Weichai Factory")	Beneficial owner	77,647,900	38.16%	Nil	—	23.53%
山東省國有資產監督管理委員會 State-owned Assets Supervision and Administration of Shandong Province ("Shandong SASAC") (Note 1)	Beneficial owner	77,647,900	38.16%	Nil	—	23.53%
Peterson Holdings Company Limited ("Peterson") (Note 2)	Beneficial owner	23,500,000	11.55%	Nil	—	7.12%
Yeung Sai Hong (Note 2)	Held by controlled corporation	23,500,000	11.55%	Nil	—	7.12%
Tingho Nominees Limited (Note 2)	Held by controlled corporation	23,500,000	11.55%	Nil	—	7.12%
Advantage Investment Corporation Limited (Note 2)	Held by controlled corporation	23,500,000	11.55%	Nil	—	7.12%
Fujian Longgong	Beneficial owner	21,500,000	10.57%	Nil	—	6.52%

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Name	Capacity	Number of domestic shares (Note 7) or foreign shares (Note 8) held	Percentage of share capital comprising only domestic shares and foreign shares	Number of H shares held (Note 9)	Percentage of share capital comprising only H shares	Percentage of total issued share capital
Li San Yim (Note 3)	Held by controlled corporation and spouse	21,500,000	10.57%	Nil	—	6.52%
Ni Yinying (Note 3)	Held by controlled corporation and spouse	21,500,000	10.57%	Nil	—	6.52%
濰坊市投資公司 (“Weifang Investment Company”) (Note 4)	Beneficial owner	19,311,550	9.49%	Nil	—	5.85%
深圳市創新投資集團有限公司 (“Shenzhen Chuangxin Investment Group Company Limited”) (Note 5)	Beneficial owner	21,500,000	10.57%	Nil	—	6.52%
深圳市投資管理公司 (“Shenzhen Investment Management Company”) (Note 5)	Held by controlled corporation	21,500,000	10.57%	Nil	—	6.52%
IVM Technical Consultants Wien Gesellschaft m.b.H. (“IVM”) (Note 6)	Beneficial owner	10,750,000	5.28%	Nil	—	3.26%
ADTECH Advanced Technologies AG (“ADTECH”) (Note 6)	Held by controlled corporation	10,750,000	5.28%	Nil	—	3.26%
Julius G. Kiss (Note 6)	Held by controlled corporation	10,750,000	5.28%	Nil	—	3.26%
Fidelity International Limited	Investment manager	Nil	—	12,363,000	9.77%	3.75%
JP Morgan Chase & Co.	Investment manager	Nil	—	11,288,000	8.92%	3.42%
The Capital Group Companies Inc.	Investment manager	Nil	—	10,719,900	8.47%	3.25%
Hansberger Global Investors, Inc.	Investment manager	Nil	—	8,851,000	7.00%	2.68%
Altantis Investment Management Ltd.	Investment manager	Nil	—	6,500,000	5.14%	1.97%
Mirae Asset Global Investment Management Limited	Investment manager	Nil	—	6,335,000	5.01%	1.92%

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Notes:

1. State-owned Assets Supervision and Administration Commission of Shandong Province ("Shangdong SASAC") held the entire registered capital of Weichai Factory. For details, please refer to the announcement of the Company Dated 22nd March, 2006.
2. Yeung Sai Hong, a Non-Executive Director, was beneficially interested in the entire issued share capital of Tingho Nominees Limited, which in turn held 100% of Advantage Investment Corporation Limited, which was interested in 90% of the issued share capital of Peterson.
3. The registered capital of Fujian Longgong was held as to 69.16% by Li San Yim, a Non-Executive Director, and as to 30.84% by Ni Yinying, spouse of Li San Yim, and therefore Ni Yinying was deemed to be interested in these shares of the Company.
4. Weifang Investment Company was a State-owned enterprise.
5. Shenzhen Investment Management Company was interested in approximately 33.73% of the registered capital of Shenzhen Chuangxin Investment Group Company Limited.
6. ADTECH was wholly owned by Julius G. Kiss, a Non-Executive Director, and ADTECH was interested in the entire issued share capital of IVM.
7. Domestic shares are ordinary shares issued by the Company, with a Renminbi-denominated par value of RMB1.00 each, which are subscribed for and paid up in Renminbi or other currencies or credited as fully paid up.
8. Foreign shares are ordinary shares issued by the Company, with a Renminbi-denominated par value of RMB1.00 each, which are subscribed for and paid up in a currency other than Renminbi. As at 31st December, 2006, these foreign shares were included in the domestic shares of the Company.
9. H shares are overseas listed shares in the shares capital of the Company, with a Renminbi-denominated par value of RMB1.00 each and are subscribed for and traded in Hong Kong dollars, and they are currently listed on the Main Board of the Stock Exchange.

Save as disclosed above, the Company has not been notified of any other relevant interests or short positions in the issued share capital of the Company as 31st December, 2006.

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Connected Transactions and Directors' and Supervisors' Interests in Contracts of Significance

During the year, the Group had the following significant transactions with connected persons:

	Notes	RMB'000
Weichai Factory:		
Sales of diesel engines and related parts	(v), (xii)	275,107
Purchase of materials	(v), (xii)	111,146
Warehouse and logistic services fee income	(v), (xii)	796
General services fee paid	(vi), (xii)	8,131
Utility services fee paid	(vii), (xii)	90,071
Sales and warranty period repair services fee income	(viii), (xii)	16,917
Purchases of property, plant and equipment	(ix), (xii)	418
Disposal of property, plant and equipment	(ix), (xii)	39
Rental paid for certain premises, machinery and equipment	(x), (xii)	42,814
Chongqing Weichai Factory (<i>Note i</i>):		
Sales of diesel engines and related parts	(v), (xii)	39,276
Purchase of materials	(v), (xii)	6,232
General services fee paid	(vi), (xii)	7,172
Utility services fee paid	(vii), (xii)	14,012
Rental paid for certain premises, machinery and equipment	(x), (xii)	3,404
Processing services fee paid	(xi), (xii)	63,070
CHDTGL (<i>Note ii</i>):		
Sales of diesel engines and related parts	(v), (xii)	57,764
Purchases of materials	(v), (xii)	3,904
Longgong Fujian (<i>Note iii</i>):		
Sales of diesel engines and related parts	(v), (xiii)	97,355
Longgong Shanghai (<i>Note iii</i>):		
Sales of diesel engines and related parts	(v), (xiv)	429,983
Guangxi Liugong Group (<i>Note iv</i>):		
Sales of diesel engines and related parts	(v)	320,075

Notes:

- (i) 重慶濰柴發動機廠 (Chongqing Weichai Diesel Engine Works) ("Chongqing Weichai Factory") is wholly owned by Weichai Factory.

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- (ii) 中國重型汽車集團有限公司 (China Heavy Duty Truck Group Co., Ltd.) (“CHDTGL”), a state owned enterprise, was the holding company of Weichai Factory and held the entire registered capital of Weichai Factory until 20th March, 2006. On that date, Shandong SASAC issued a document approving the segregation of ownership between CHDTGL and Weichai Factory such that CHDTGL transferred its entire ownership in Weichai Factory to Shandong SASAC for its direct holding. CHDTGL ceased to be a connected person of the Company thereafter.
- (iii) 龍工(福建)機械有限公司 (Longgong Fujian Machinery Company Limited) (“Longgong Fujian”) and 龍工(上海)機械有限公司 (Longgong Shanghai Machinery Company Limited (“Longgong Shanghai”)), wholly owned subsidiaries of China Infrastructure Machineries Holdings Limited (“CIMHL”), a company listed in Hong Kong, in which Li San Yim, a non-executive Director and his spouse, Ni Yingying, have beneficial interest in CIMHL and the Company. Accordingly, Li San Yim was interested in the transaction.
- (iv) 廣西柳工集團有限公司 (Guangxi Liugong Group Company Limited) (“Guangxi Liugong”) is a promoter of the Company and held 1.36% interest in the Company at 31st December, 2006. Guangxi Liugong together with its affiliates are collectively referred as the “Guangxi Liugong Group”.
- (v) These transactions were carried out at market prices or, where no market prices were available, at cost plus a percentage profit mark-up.
- (vi) The general services fee was based on the actual cost incurred plus not more than 20% service charge.
- (vii) The utility services fee was based on the actual usage and with reference to market prices or, where no market prices were available, at actual cost incurred plus not more than 20% service charge.
- (viii) The sales and warranty period repair service fee income was based on 3% on the sales of medium speed diesel engines on behalf of Weichai Factory.
- (ix) These transactions were carried out on terms mutually agreed by the relevant parties.
- (x) Rental for certain land and buildings, machinery and equipment were charged based on a fixed monthly charge.
- (xi) The processing services fee was based on the actual cost incurred plus not more than 20% service charge.
- (xii) Tan Xuguang, the Chairman of the Board and the general manager of Weichai Factory, was interested in the transaction.

Save as disclosed above, no contracts of significance, to which the Company or its subsidiaries, was a party and in which a Director or a Supervisor of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

The Independent Non-Executive Directors have reviewed the continuing connected transactions and have confirmed that the transactions have been entered into by the Company and its subsidiaries in the ordinary course of its business, on normal commercial terms, and in accordance with the terms of the agreement governing such transactions that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

Emolument Policy

The emolument policy of the employees of the Group is set up by the Remuneration Committee on the basis of their merit, qualifications and competence.

The emoluments of the Directors of the Company are decided by the Remuneration Committee, having regard to the Group's operating results, individual performance and comparable market statistics.

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Arrangement to Purchase Shares or Debentures

At no time during the year was the Company or any of its subsidiaries, a party to any arrangements to enable the Directors of the Company to acquire benefits by means of the acquisition of shares in, or debentures of, the Company or any other body corporate.

Purchase, Sale or Redemption of Securities of the Company

During the year, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities.

Pre-Emptive Rights

There are no provisions for pre-emptive rights under the Company's Articles of Association or the laws of the People's Republic of China, which would oblige the Company to offer new shares on a *pro-rata* basis to existing shareholders.

Major Suppliers and Customers

The aggregate sales attributable to the Group's largest customer and the five largest customers accounted for approximately 21% and 53%, respectively, of the Group's total sales for the year.

At 31st December, 2006, Fujian Longgong was a shareholder holding indirectly more than 5% of the Company's share capital. An affiliate of Longgong Fujian, Longgong Shanghai, was one of the Group's five largest customers. All transactions between the Group and the customer concerned were carried out on normal commercial terms.

The aggregate purchase during the year attributable to the Group's five largest suppliers were less than 30% of the Group's total purchases.

Save as disclosed above, at no time during the year did a Director, a Supervisor, an associate of a Director or a shareholder of the Company, which to the knowledge of the Directors, own more than 5% of the Company's share capital, have an interest in any of the Group's five largest suppliers or customers.

Audit Committee

The Audit Committee comprises all three independent non-executive Directors of the Company. The Chairman of the Audit Committee is Mr. Koo Fook Sun, Louis, an independent non-executive Director. Mr. Koo is an experienced investment banker with appropriate professional qualifications or accounting or related financial management expertise as required under Rule 3.10(2) of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules") for the purpose of such appointment.

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Throughout the Period, the Audit Committee discharged its responsibilities, reviewed and discussed the financial results and internal control system of the Company. In accordance with the requirements of Appendix 16 to the Listing Rules, the Audit Committee has reviewed the consolidated financial statements for the Period.

Compliance with Code on Corporate Governance Practices in Appendix 14 of the Listing Rules

During the Period, except for Code A.2.1, the Company was in compliance with the principles and code provisions in the “Code on Corporate Governance Practices” as set out in Appendix 14 to the Listing Rules (the “CG Code”).

Code A.2.1 of the CG Code requires the roles of chairman and chief executive officer to be separate and not be performed by the same individual. Currently, Mr. Tan Xuguang (“Mr. Tan”) serves as the Chairman and Chief Executive Officer of the Company. The Directors believe that vesting such roles in Mr. Tan will allow for more effective planning and execution of business strategies of the Company. As all major decisions are made in consultation with other members of the Board, the Company believes that there is adequate balance of power and authority in place.

Other than the deviation mentioned above, the Board is of the view that the Company has complied with the code provisions of the CG Code throughout the Period. None of the Directors is aware of any information that would reasonably indicate that the Company was not for any time during the Period under review in compliance with the code provisions of the CG Code.

Compliance with the Model Code

During the Period, the Company has adopted a code of conduct regarding securities transactions by Directors on terms no less exacting than the required standard set out in the Model Code for Securities Transaction by Directors of Listed Issuers as set out in Appendix 10 to the Listing Rules (the “Model Code”). Having made specific enquiry of all Directors, the Directors have confirmed that they complied with the required standard set out in the Model Code for the Period under review.

Sufficiency of Public Float

The Company has maintained a sufficient public float throughout the year ended 31st December, 2006.

Donations

During the year, the Group made charitable donations amounting to approximately RMB1,018,000.

Post Balance Sheet Events

Details of significant events (including issue of short-term debentures with principal amount of RMB900 million) occurring after the balance sheet date are set out in note 34 to the consolidated financial statements.

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Auditors

The financial statements have been audited by Deloitte Touche Tohmatsu and a resolution will be submitted to the annual general meeting to re-appoint Messrs. Deloitte Touche Tohmatsu as auditors of the Company.

Approval of the Consolidated Financial Statement

The consolidated financial statements for the period have approved by the Board on 17th April, 2007.

On behalf of the Board

Tan Xuguang

Chairman and CEO

Hong Kong, 17th April, 2007