



The board of directors of AviChina Industry & Technology Company Limited presents its report of the directors together with the audited financial statements of the Group for the year ended 31st December 2006.

## BUSINESS OF THE GROUP

The Group is principally engaged in the research, development, manufacture and sale of automobiles and civil aviation products.

## RESULTS

The results of the Group for 2006 are set out in the Consolidated Income Statement on page 59 of the Annual Report.

## SHARE CAPITAL

In 2006, there were no changes in the share capital of the Company.

The Company's capital structure as at 31st December 2006 was as follows:

Class of shares	Number of shares as at 31st December 2006	Percentage of total number of shares in issue as at 31st December 2006 (%)
Domestic shares	2,963,808,000	63.83
Overseas listed foreign invested shares (H shares)	1,679,800,500	36.17
Total	<u>4,643,608,500</u>	<u>100</u>



## SHAREHOLDINGS OF SUBSTANTIAL SHAREHOLDERS

As at 31st December 2006, pursuant to the register kept under Section 336 of the Securities and Futures Ordinance (the "SFO"), shareholders holding more than 5% equity interests in the Company and associated corporations were as follows:

Name of Shareholders	Class of shares	Number of shares	Percentage of shareholdings to the same class of shares	Percentage of shareholdings to share capital in issue	Nature of shares held
AVIC II	Domestic shares	2,835,305,636	95.66%	61.06%	Long position
EADS	H shares	232,180,425	13.82%	5%	Long position
The Hamon Investment Group Pte Limited	H shares	86,788,000	5.17%	1.87%	Long position
The Northen Trust Company	H shares	119,056,000	7.09%	2.56%	Lending Pool

Save as disclosed above, as at 31st December 2006, the Company had not been notified of any interests and short positions in 5% or more than 5% of shares and underlying shares of the Company which had been recorded in the register kept under section 336 of the SFO.

## PURCHASE, SALE AND REDEMPTION OF SHARES

Neither the Company nor any of its subsidiaries has purchased, sold or redeemed any of the Company's shares for the year ended 31st December 2006.

## PRE-EMPTIVE RIGHTS

There are no provisions for pre-emptive rights under the Company's Articles of Association and the laws of the People's Republic of China.

## DESIGNATED DEPOSITS AND OVERDUE FIXED DEPOSITS

As at 31st December 2006, the Group had not placed any designated deposits or overdue fixed deposits that could not be collected by the Group upon maturity.

## FIXED ASSETS

Details of fixed assets of the Company are set out in note 15 to the financial statements.

## RESERVES

Details of movement in reserves of the Group for the year ended 31st December 2006 are set out in the Consolidated Statement of Changes in Equity and note 37 to the financial statements.



## DISTRIBUTABLE RETAINED EARNINGS

As at 31st December 2006 the Company had no distributable retained earnings.

## MAJOR CUSTOMERS AND SUPPLIERS

During the period of this report, the Group's total purchases from the five largest suppliers accounted for 6.36% of the Group's total purchases, of which purchases from the largest supplier accounted for approximately 1.85% of the Group's total purchases. The Group's sales to the five largest customers accounted for 25% of the Group's total sales, of which, sales to the largest customer accounted for 12.74% of the Group's total sales.

Purchases of aviation segment from the five largest suppliers accounted for 16.20% of the total purchases in the Group's aviation segment, of which, purchases from the largest supplier accounted for 8.23% of the total purchases in the Group's aviation segment. Sales in the aviation segment to the five largest customers accounted for 54.88% of the total sales in the Group's aviation segment, of which, sales to the largest customer accounted for 48.88% of the total sales in the Group's aviation segment.

Purchases of automobile segment from the five largest suppliers accounted for 22.08% of the total purchases in the Group's automobile segment, of which, purchases from the largest supplier accounted for 1.64% of the total purchases in the Group's automobile segment. Sales in the automobile segment to the five largest customers accounted for 19.10% of the total sales in the Group's automobile segment, of which, sales to the largest customer accounted for 5.47% of the total sales in the Group's automobile segment.

During the period of this report, save for the connected transactions with AVIC II Group, as disclosed in the section of Connected Transactions in this annual report, none of the directors, their associates or any shareholder holding more than 5% in the share capital of the Company has any interest in the above major suppliers and customers.

## SUBSIDIARIES AND ASSOCIATES

Details of subsidiaries and associates are set out in note 43 to the financial statements.

## WELFARE PLANS AND SOCIAL INSURANCE FOR STAFF

Details of the welfare plans and social insurance for staff are set out in note 13 to the financial statements.

Up to 31st December 2006, the Group has 549 retired employees, all of them have participated in the basic social pension plans in various provinces in accordance with the government policies of the PRC. Basic pension funds are being paid from the social plan funds.



### CONNECTED TRANSACTIONS

#### Continuing Connected Transactions

The Group has engaged in several continuing connected transactions with AVIC II Group (AVIC II and its subsidiaries, together referring to as AVIC II Group, is a connected person of the Company as AVIC II is the controlling shareholder of the Company), joint venture partners (who are connected persons of the Company as they hold at least 10% interests in the subsidiaries of the Company) and non-wholly owned subsidiaries of the Company (who are connected persons of the Company as AVIC II or its associates has not less than 10% interests in them). The waivers granted by the Stock Exchange for those connected transactions expired on 31st December 2005. The Company submitted relevant resolutions at the general meeting held on 19th December 2005 for approvals of its independent shareholders on extending the terms of previous continuing connected transactions, new continuing connected transactions and newly proposed relative annual caps for those transactions for financial years from 2006 to 2008.

In 2006, the approved continuing connected transactions of the Company are as follows:

1. On 26th August 2005, the Company entered into a supplemental agreement with AVIC II to renew the terms of the product and ancillary services mutual supply agreement ("Mutual Supply Agreement") for a further term of three years expiring on 31st December 2008, whereby the AVIC II Group has agreed to provide certain products and services to the Group and the Group has agreed to provide certain products and services to AVIC II Group.
2. On 26th August 2005, the Company entered into a supplemental agreement with AVIC II to renew the terms of the comprehensive services agreement ("Comprehensive Services Agreement") for a further term of three years expiring on 31st December 2008, whereby AVIC II Group has agreed to provide certain social welfare and logistics services to the Group.
3. On 2nd October 2003, the Company entered into a land use rights leasing agreement ("Land Use Rights Leasing Agreement") with AVIC II whereby the AVIC II Group has agreed to lease to the Group 48 pieces of lands, with an aggregate area of approximately 2.9 million square metres at the annual rent of approximately RMB37.6 million. The lands are used by the Group as workshops, warehouses, administrative office and ancillary facilities. The term of the lease is 20 years.
4. On 26th August 2005, the Company entered into a supplementary agreement for the properties leasing agreement ("Properties Leasing Agreement") with AVIC II whereby the AVIC II Group has agreed to lease to the Group certain properties with an aggregate gross floor area of approximately 111,000 square metres ("Rented Properties") at an annual rent of approximately RMB24 million. Similarly, the Company has agreed to lease to the AVIC II Group certain properties with an aggregate gross floor area of approximately 36,000 square meters ("Leased Properties") at an annual rent of approximately RMB1.1 million. The Rented Properties are built on leased lands and used by the Group as workshops, warehouses and ancillary facilities. The Leased Properties are used by AVIC II as workshops, warehouses and ancillary facilities.
5. On 26th August 2005, the Company entered into a supplementary agreement with AVIC II to renew the terms of the technology cooperation framework agreement ("Technology Cooperation Agreement") for a further term of three years expiring on 31st December 2008, whereby the AVIC II Group has agreed to transfer or grant a licence to the Group to use certain existing technologies required for the Group's business in connection with the production of aircraft and automobiles. The agreement has also provided for future cooperation between the AVIC II Group and the Group in respect of development of new technologies.



6. On 30th June 1999, Dongan Engine entered into a technology transfer agreement (“Mitsubishi Technology Transfer Agreement”) with Mitsubishi, a connected person by virtue of it being a substantial shareholder of Dongan Engine, whereby Mitsubishi has agreed to grant to Dongan Engine licence to use the industrial properties rights, patent and technology documents relating to engines, gearboxes and the respective assemblies, parts and components.
7. As part of the joint venture establishment agreement of Dongan Engine dated 16th June 1998, the CKD spare parts supply agreement between Dongan Engine and Mitsubishi (“Mitsubishi CKD Agreement”) states that Dongan Engine agrees to purchase CKD spare parts and components from Mitsubishi.
8. On 26th August 2005, the Company and its subsidiaries entered into a supplementary agreement to renew the term of the internal connected transaction agreement (“Internal CT Agreement”) for a further term of three years expiring on 31st December 2008, which set out the general principles of the transactions between the Company (or its wholly-owned subsidiaries) and the non-wholly owned subsidiaries of the Company and transactions between the non-wholly owned subsidiaries of the Company. Dongan Engine and Hafei Auto are both parties engaging in transactions according to the Internal CT Agreement.
9. On 2nd June 2005, the Group entered into Agusta Agreement with Agusta S.p.A., a connected person by virtue of it being a substantial shareholder of Jiangxi Changhe-Agusta Helicopter Co., Ltd. (“Changhe Agusta”, a joint venture established by the Group and Agusta S.p.A.), whereby Agusta S.p.A. agrees to provide to Changhe Agusta parts and components for manufacturing helicopters and assistance in manufacturing, assembling and selling helicopters.
10. On 24th December 2003, 21st March 2005 and 24th December 2003, Changhe Suzuki entered into three licence agreements (“Suzuki Licence Agreement”) with Suzuki, a connected person by virtue of it being a substantial shareholder of Changhe Suzuki, namely Liana Licence Agreement, New Model Technology Transfer Agreement and K Series Licence Agreement, whereby Suzuki agrees to grant Changhe Suzuki licence to use Suzuki’s technologies in manufacturing, assembling and selling Lianas, new models, K series engines, gear boxes and relevant parts and components and to use relevant patents, brands and technologies, provide technical assistance, and supply relevant parts and components.
11. Hafei Auto entered into Mitsubishi Joint Development Agreement with Mitsubishi, whereby Mitsubishi agrees to give assistance to Hafei Auto in developing automobile products with Mitsubishi’s technologies and grant Hafei Auto licence to use certain Mitsubishi’s automobile technologies, information and patents.
12. Hafei Auto entered into Mitsubishi Hafei Parts and Components Contract with Mitsubishi, whereby Hafei Auto agrees to purchase CKD spares and parts from Mitsubishi so as to use Mitsubishi’s technologies in manufacturing automobiles.



## Report of the Board

Proposed annual caps for financial years 2006, 2007 and 2008 of respective continuing connected transactions are set out as follows:

Agreements	Proposed annual Caps RMB million		
	Financial year ended 31st December		
	2006	2007	2008
<b>1 Mutual Supply Agreement</b>			
(a) Annual expenditures of the Group	<b>3,000</b>	3,500	4,000
(b) Annual revenues of the Group	<b>5,400</b>	7,000	8,500
<b>2 Comprehensive Services Agreement</b>			
Annual expenditures of the Group	<b>180</b>	200	220
<b>3 Land Use Rights Leasing Agreement</b>			
Annual expenditures of the Group	<b>38</b>	38	38
<b>Properties Leasing Agreement</b>			
(a) Annual expenditures of the Group	<b>24</b>	24	24
(b) Annual revenues of the Group	<b>1.1</b>	1.1	1.1
<b>4 Technology Cooperation Agreement</b>			
(a) Annual expenditures of the Group	<b>33</b>	36	40
(b) Annual revenues of the Group	<b>22</b>	24	27
<b>5 Mitsubishi Technology Transfer Agreement</b>			
Annual expenditures of the Group	<b>8</b>	14	17
<b>Mitsubishi CKD Agreement</b>			
Annual expenditures of the Group	<b>36</b>	86	0
<b>6 Internal CT Agreement</b>			
(i) Annual expenditures of Dongan Engine and Hafei Auto	<b>2,700</b>	3,200	3,800
(ii) Annual revenues of Dongan Engine and Hafei Auto	<b>500</b>	550	600
(iii) Annual guarantees provided by subsidiaries of the Group to Hafei Auto	<b>2,000</b>	2,000	2,000
<b>7 Agusts Agreement</b>			
Annual expenditures of the Group	<b>78</b>	117	117
<b>8 Liana Licence Agreement, New Model Technology Transfer Agreement and K Series Licence Agreement</b>			
Annual expenditures of the Group	<b>1,105</b>	2,070	2,121
<b>9 Mitsubishi Joint Development Agreement</b>			
Annual expenditures of the Group	<b>41</b>	38	53
<b>Mitsubishi Hafei Parts and Components Contract</b>			
Annual expenditures of the Group	<b>30</b>	95	135



As to Mitsubishi Technology Transfer Agreement and Mitsubishi CKD Agreement, the approved annual caps of those two transactions for the year 2006 were RMB8,000,000 and RMB36,000,000 respectively. However, the actual expenditures related to those two transactions rose up to RMB31,000,000 and RMB186,000,000 respectively, both exceeded the approved annual caps. The excesses were caused by the expansion of Dongan Engine's business resulted in a significant increase in the output of engines. The Company will further review its management on the Group's connected transactions and re-comply with requirements on announcement and independent shareholders' approvals relating to the revision of the annual caps in accordance with applicable requirements under Chapter 14A of the Listing Rules.

The Board (including independent non-executive directors) has reviewed the above continuing connected transactions and confirmed that they had been entered into under the following conditions:

- (a) The transactions were entered into in the ordinary and usual course of business of the Group;
- (b) The transactions were entered into: i) on normal commercial terms; or ii) in accordance with the relevant agreements governing such transactions, on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole; and iii) where there is no available comparison for the purpose of determining whether (i) above is satisfied, on terms that no less favorable to the Company than terms available to or from (as appropriate) independent third parties; and
- (c) The aggregated amounts of the transactions have not exceeded the respective annual caps as set out above, except those related to the Mitsubishi Technology Transfer Agreement and the Mitsubishi CKD Agreement as disclosed above.

The Company's auditors have reviewed the relevant transactions, and have confirmed in a letter to the Directors stating that:

- (a) The transactions have received the approval of the Board;
- (b) The pricing of the transactions are in accordance with the relevant pricing policies of the Group;
- (c) The transactions have been entered into in accordance with the relevant agreements governing the transactions;
- (d) The aggregate amounts of the transactions have not exceeded the respective annual caps as set out above, except those related to the Mitsubishi Technology Transfer Agreement and the Mitsubishi CKD Agreement as disclosed above.





### One-off Connected Transactions

1. *Disposal of equity interests in Beijing Wisewell Avionics Technology Co., Ltd. ("Wisewell")*

On 28th April 2006, the Company entered into an agreement with AVIC II to transfer the 51% equity interests in Wisewell to AVIC II. As each of the percentage ratios (as defined in the Listing Rules, other than the profits ratio) for the disposal was below 0.1%, the transaction was exempted from complying with the requirements under Chapter 14A of the Listing Rules relating to reporting, announcement and achieving independent shareholders' approval.

2. *Transfer of equity interests in Beijing Fangzheng Dongan Lanthanide New Material Co., Ltd ("Fangzheng Dongan")*

On 16th June 2006, Dongan Motor, a subsidiary of the Company, and Harbin Dongan Engine (Group) Co., Ltd. ("Dongan Group") a subsidiary of AVIC II who is the controlling shareholder of the Company, entered into an agreement, pursuant to which Dongan Motor agreed to transfer the 27% equity interests in Fangzheng Dongan to Dongan Group for a total cash consideration of RMB10 million. As each of the percentage ratios (as defined in the Listing Rules, other than the profits ratio) for the transaction was more than 0.1% but below 2.5%, the agreement is only subject to the reporting and announcement requirements under Chapter 14A of the Listing Rules. Details of this transaction have been set out in the Connected Transaction Announcement issued by the Company on 21st June 2006.

### CORPORATE GOVERNANCE

Details of corporate governance adopted by the Company are set out in the section of "Corporate Governance Report" of the Annual Report.

### PUBLIC FLOAT

Based on the information that is available to the Company and within the knowledge of the Board, as at the date of this report, there is a sufficient public float of more than 25% of the Company's issued shares as required under the Listing Rules.

### AUDITORS

The financial statements for this year have been audited by PricewaterhouseCoopers. In the forthcoming annual general meeting, a resolution for the re-appointment of PricewaterhouseCoopers as the international auditor of the Company for the financial year of 2007 will be presented.

### CHANGE OF DIRECTORS, SUPERVISORS AND SENIOR MANAGEMENT

Change of Directors, Supervisors or senior management within relevant period are set out in the section "Change of Directors, Supervisors and Senior Management" under the Chairman's Statement of the Annual Report.

### SERVICE CONTRACTS OF DIRECTORS AND SUPERVISORS

Each of the Directors (except the independent non-executive directors) and Supervisors has entered into service contract with the Company. None of the Directors and Supervisors has entered into service contracts which are not terminable by the Company within one year without payment of compensation (other than statutory compensation).





## DIRECTORS' AND SUPERVISORS' INTERESTS IN CONTRACTS

During the year, none of the Directors or Supervisors had a material interest, directly or indirectly, in any contract of significance to which the Company or its subsidiaries was a party.

## THE INTERESTS OF DIRECTORS, SUPERVISORS AND CHIEF EXECUTIVES IN THE SECURITIES OF THE COMPANY

As at 31st December 2006, interests of the Directors, Supervisors and chief executives of the Company in the shares of the Company and its associated corporations (within the meaning of Part XV of the SFO), which are required to be recorded and kept in the register pursuant to section 352 of the SFO, or which were notified to the Company and the Stock Exchange pursuant to the Model Code were as follows:

Name of Company or its associated corporation	Name of Director/ Supervisor/ chief executive	Number and class of securities held	Capacity in holding interest	Type of interests held	Approximate % of shareholding in the same class of securities
Dongan Motor	Tan Ruisong	6,844 A Shares	Beneficial owner	Long position	0.0015%

Except to those disclosed above, as at 31st December 2006, none of the Directors, Supervisors and chief executive of the Company had interests or held short position in shares of the Company and/or shares, relative shares and/or securities of its associated corporations (within the meaning of Part XV of the SFO), which are required to be recorded and kept in the register pursuant to section 352 of the SFO and be notified to the Company and the Stock Exchange pursuant to Part XV, Part 7 and Part 8 of the SFO.

## REMUNERATION OF DIRECTORS, SUPERVISORS AND SENIOR MANAGEMENT

Details of remuneration of the existing Directors, Supervisors and senior management are set out in note 14 to the financial statements.

## MANAGEMENT CONTRACTS

No contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.