

**Working together  
to meet the challenges ahead**

**Financial statements and  
management report**

**DEUTZ AG 2007**

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## Financial statements and management report

### DEUTZ AG 2007

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# Management report of DEUTZ AG

## INTRODUCTION

### Segment disposal has significant impact on annual financial statements

The reporting structure of DEUTZ AG has been adapted to reflect the new DEUTZ Customised Solutions segment, which was created in 2006. This new segment primarily comprises all air-cooled engine series activities, together with those involving liquid-cooled engines with a capacity greater than eight litres. In 2006, these activities formed part of the Compact Engines segment; from the first quarter of 2007, DEUTZ Customised Solutions has been reported as an individual segment. The comparative figures for 2006 have been restated accordingly.

In addition, the disposal of DEUTZ Power Systems had a significant effect on the net assets, financial position and results of operations of DEUTZ AG.

In addition, since the first quarter of 2007, we have stopped reporting revenue for the Marine application segment as a separate item. Instead, figures for Marine (including prior-year comparative figures) are included in the Other application segment.

## STRUCTURE AND OPERATING ACTIVITIES

### Organisational structure

Independence and decades of engine expertise – these are our defining features: DEUTZ is a non-captive manufacturer of engines, primarily diesel-powered engines. Its activities are divided into two segments: Compact Engines and DEUTZ Customised Solutions.

DEUTZ AG is the executive and operating parent company in the DEUTZ Group, which also comprises various German and international subsidiaries. These subsidiaries are companies with sales and service functions. DEUTZ customers are supported by eleven distribution companies, nine sales offices and approximately 700 sales and service partners in more than 130 countries around the world.

### Diesel engines up to 500kW for an extensive range of applications

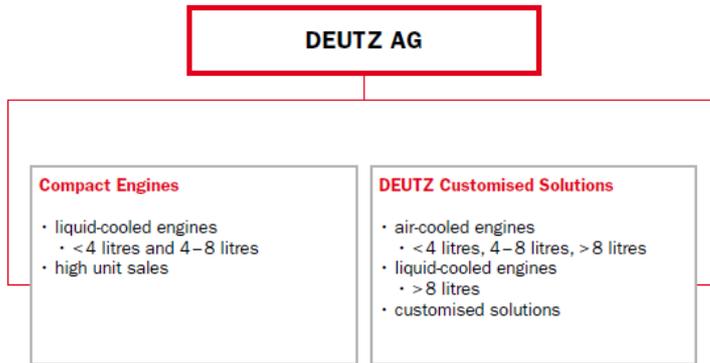
In its two segments, DEUTZ AG focuses on value creation processes involving the development, design, production, sales and service of liquid-cooled and air-cooled engines. The product range includes engines with air, water and oil cooling systems and engine outputs up to 500kW. The engines are targeted at a number of applications, classified into application segments, as follows:

- Mobile Machinery: construction equipment, material handling equipment, ground support equipment, mining equipment
- Automotive: commercial vehicles (trucks, buses), rail vehicles
- Stationary Equipment: generators, pumps, compressors
- Agricultural Machinery: tractors and other agricultural equipment
- Miscellaneous: Includes marine equipment.

The product range is complemented by comprehensive service support, which is continuously expanded and tailored to customer requirements. An extensive global network comprising subsidiaries and authorised dealers provides customer support services including supply of spare parts, repairs, and servicing and maintenance of the supplied engines.

**DEUTZ – the engine company**

Independent engine manufacturer of compact diesel engines (up to 500 kW)  
for on-road and non-road applications



**Market and competitive environment**

Diversity is one of our strengths: DEUTZ supplies customers in different industries and, as a result, has a diversified customer base.

The market is divided into captive manufacturers, which produce equipment and vehicles as well as their own engines, and non-captive manufacturers, whose core competence is specifically the production of engines. DEUTZ is a non-captive manufacturer.

According to our own calculations, the size of the market relevant to DEUTZ in 2007 was around two million engines. DEUTZ has a strong international position in this non-captive market with a market share of around 14 per cent. In the last few years, DEUTZ has entered into strategic alliances to open up additional potential that was previously the preserve of the captive market. For example, DEUTZ has entered into alliances with the Volvo Group in Sweden for four to eight-litre engines to be used in commercial vehicles, construction machinery and gensets, and with the SAME DEUTZ-FAHR Group in Italy for agricultural machinery engines. The year under review saw the establishment of a further partnership: DEUTZ entered into a joint venture at Dalian in China with FAW Jiefang for the manufacture and sale of four to eight-litre engines. These engines are not included in the calculation of market share.

In various market segments, DEUTZ faces competitors whose range of services and applications is in part comparable with that offered by DEUTZ.

Application segment	Application	Main competitors
<b>Mobile Machinery</b>	Construction equipment Material handling equipment Ground support equipment	Kubota (J), Yanmar (J), Perkins (UK)
<b>Automotive</b>	Trucks Buses Railcars	Cummins (USA), Caterpillar (USA), Navistar (USA), Isuzu (J)
<b>Stationary Equipment</b>	Generators Pumps Compressors	Perkins (UK), Cummins (USA), Kubota (J)
<b>Agricultural Machinery</b>	Tractors Harvesters Forestry equipment	Perkins (UK), Yanmar (J), Kubota (J), Deere & Company (USA)

## Ambitious objectives

DEUTZ AG is pursuing the ambitious but realistic objective of winning additional market shares, particularly in Asian markets. At the same time, it is aiming to generate a further long-term improvement in the operating EBIT margin and in return on capital employed (ROCE). To achieve this, the priority is on continuous improvement of the product mix and simultaneous expansion of high-margin services.

## STRATEGIC OBJECTIVES

The strategic objectives of DEUTZ AG are as follows:

- To become one of the top three suppliers in the global market for four to eight-litre engines
- To double unit sales of engines with a capacity of up to four litres
- To consolidate its position as an international market leader in air-cooled engines
- To expand its range of services so that services account for 20 per cent of revenue.

### Expansion on leading market position

In 2007, we continued to expand on our market position: we increased unit sales of four to eight-litre engines to 114,117 units, an increase of 38.5 per cent. A significant contributing factor was the new commercial-vehicle engine for Volvo: although production of this engine had started in 2006, 2007 was the first full year of production. Unit sales of engines with a capacity of up to four litres rose by 13.1 per cent to 110,618 engines, whereas unit sales of air-cooled engines were slightly below the 2006 level at 29,138 units. Overall, we therefore managed to expand our market share from 12 per cent to over 14 per cent. Our service revenue in 2007 increased by around €25 million to €176.0 million; service revenue thereby accounted for 12.2 per cent of the Company's revenue. Despite the growth in the service business, the proportion of revenue accounted for by service revenue fell slightly compared with 2006 because of the disproportionate growth in new-engine business, particularly with major equipment manufacturers. However, the sharp rise in unit sales of new engines over the last few years will ultimately lead to higher service revenue in the future. In the year under review, we were also able to add 16 new service partners in markets where we are experiencing strong growth. These new partners will strengthen our service network in future, contributing to the growth in revenue and corresponding profits. Seven of these new service partners are in Russia, four in Africa and five in south-eastern Europe.

### Presence in Asian growth regions

With the establishment of the DEUTZ (Dalian) Engine Co. Ltd. (DEUTZ Dalian) joint venture, we will significantly expand our presence in the emerging Asian markets, thereby sharing in the market growth in this region, particularly in China. Activities will focus on the supply of four to eight-litre engines based on DEUTZ technology to the FAW Group and international DEUTZ customers in Asia. Components manufactured in Dalian will also be used in DEUTZ assembly plants in Germany; we also want to use our local presence to develop the supply of components from local manufacturers for use in our German production facilities.

## ECONOMIC ENVIRONMENT

Business performance in the DEUTZ Group is being driven primarily by continually increasing global industrialisation and simultaneous growing demand for environmentally friendly equipment and vehicles. The market for diesel engines is characterised by continuing development towards increasingly efficient, but at the same time more economical, quieter engines with lower emissions. This is not least the result of more stringent legal requirements regarding permissible emissions. The capacity to meet increasing customer requirements for efficient, service-friendly engines also demonstrates the competitiveness of the Company. The same also applies to our innovative strength, i.e. our ability to ensure that engine systems continue to be developed on an ongoing basis.

### Global economy in 2007: slowing growth<sup>1)</sup>

The global economy grew by 4.7 per cent in 2007. However, the pace of growth eased off as a result of the mortgage crisis and credit crunch in the USA, which then also hit Europe in the second half of the year. As in 2006, the growth continued to be driven by Asia (excluding Japan): in the year under review, gross domestic product in this region increased by over 9 per cent. In contrast, the USA could only manage economic growth of around 2 per cent. Countries in the euro zone still managed growth of 2.7 per cent; in this case, the economy was driven by exports and capital investment in house building. In Germany, gross domestic product increased by 2.5 per cent in 2007. Compared with the excellent year in 2006, it therefore lost some momentum, the strong euro causing a fall in export demand.

### Strong growth in key industries

The DEUTZ customer base is concentrated particularly in the construction equipment, agricultural machinery and commercial vehicles industries. All three sectors registered strong growth in 2007 with a corresponding positive impact on DEUTZ.

### 2007: boom year for engineering and commercial vehicles<sup>1)</sup>

The German Engineering Federation (VDMA) raised its growth forecast several times during the course of 2007. At the end of the year, production volume had risen to €181 billion, an increase of 11 per cent – making 2007 another record year for German engineering. Double-digit growth rates were registered primarily by the industrial plant, turbines, engines and pump sectors.

There were also positive trends in the construction industry across Europe: experts at EUROCONSTRUCT, the network of research institutes and consulting organisations in the construction and property sector from 15 countries in western Europe and four countries in central and eastern Europe, reported growth of around 2.5 per cent for the construction industry. This growth had an indirect impact on the construction equipment sector, which is important to DEUTZ.

There was also positive growth in the commercial-vehicles sector in 2007, evidenced by registrations of commercial vehicles over 3.5 tonnes (excluding buses and coaches). According to the European Automobile Manufacturers' Association (ACEA), 428,482 vehicles were registered across the whole of Europe, 5.1 per cent more than in 2006. Western Europe accounted for 87 per cent of this total. Central and eastern Europe also saw very dynamic growth of around 39 per cent.

### German agricultural machinery industry grows by 17 per cent<sup>1)</sup>

In 2007, the global agricultural machinery industry saw growth in both production and revenue. Revenue in the German agricultural machinery industry reached €6.1 billion, an increase of 16.7 per cent. Half of the revenue was accounted for by tractors, the other half by other agricultural equipment. The critical period in this surprisingly high growth was the fourth quarter. In the last three months of the year, revenue increased by a further 37 per cent, although a record figure had already been achieved in the equivalent period in 2006.

In the year under review, the driving force behind the business of German manufacturers was again demand from abroad – exports accounted for 74 per cent of revenue. This was reflected in a year-on-year increase of 24 per cent in revenue from abroad. France was once again the most important market outside Germany, accounting for 15 per cent of total exports. The second-largest export market is now Russia. However, there was also a very significant increase in revenue from most of the new European Union (EU) countries, such as Poland and Hungary. In addition, there was an effect from generally good economic conditions in important western European markets, such as the United Kingdom. Exports to the USA fell by 9 per cent, primarily owing to the change in exchange rates.

<sup>1)</sup> Global economic data: Deutsche Bank Research  
Industry data: German Engineering Federation (VDMA), EUROCONSTRUCT,  
European Automobile Manufacturers' Association (ACEA),  
VDMA Agricultural Machinery

## DEUTZ AG BUSINESS PERFORMANCE

### Growth as a challenge

In 2007, DEUTZ AG again increased unit sales and revenue – and significantly beyond the planned increase. This presented a huge challenge for both our own components production capability and our suppliers. The strong demand temporarily caused material bottlenecks and, subsequently, higher logistics costs. To continue to expand capacity as fast as possible, we invested heavily in our production and assembly facilities and in suppliers. In 2007, we also achieved the targeted full utilisation of assembly capacity, assembling over 30,000 engines in the new TCD 2013 4V series. In addition, the planned relocation of air-cooled engine production from Cologne to Ulm was completed on schedule at the start of 2007; following expansion, the Ulm facilities now have a total capacity of 35,000 engines.

Following the issue of all the necessary official approvals, the joint venture between DEUTZ and FAW Jiefang commenced operations on 1 August 2007. Currently, the fledgling joint venture is producing engines primarily for the local Chinese market; these engines are mainly used in commercial vehicles. The greatest challenge at the new facilities in China is the start-up at the new plant for the manufacture of licensed DEUTZ engines, including localisation of parts procurement and the integration of the joint venture into the existing structures covering the group of DEUTZ production sites.

### Sharp increase in new orders

New orders at DEUTZ AG were up by 20.8 per cent: new orders in 2007 amounted to €1,470.7 million compared with €1,217.9 million in 2006. Demand for compact engines was particularly strong: at €1,130.7 million, new orders were up significantly on 2006, a rise of 24.4 per cent. DEUTZ Customised Solutions also saw an increase of 10.1 per cent, with orders rising to €340.0 million. As at 31 December 2007, orders on hand stood at €275.3 million (2006: €247.8 million), which provided us with a very good cushion to start the New Year.

### Further high level of growth in unit sales

There was equally positive growth in unit sales. Total unit sales at DEUTZ AG were 284,331 units, a year-on-year increase of 21.3 per cent. The increase was particularly strong outside Germany, where unit sales rose to 223,314, an increase of 29.1 per cent. Demand in Germany remained close to the level of 2006 at 61,017 units.

As far as the individual segments were concerned, there was a particularly strong increase in unit sales in Compact Engines: in this segment, 250,735 engines were sold in 2007, equating to an increase of 26.0 per cent. In DEUTZ Customised Solutions, unit sales were almost at the same level as in 2006 at 33,596 units; the segment therefore exceeded budget by just under 6 per cent.

Analysed on a regional basis, there was a particularly sharp rise in unit sales in the Asia-Pacific region to 15,458 units (up 58.0 per cent), which was the result of an increase in supplies of engines to Chinese customers. However, this trend will ease off because the region will be supplied increasingly in the future by the joint venture. There was also significant expansion in the Europe/Middle East/Africa region, where sales reached 212,844 units, a rise of 24.9 per cent. The increasing volume of transport combined with a rise in the requirement for mobility led to more capital investment in infrastructure, particularly in the major cities of eastern Europe. For DEUTZ, this resulted in an appreciable increase in demand from manufacturers of buses, trucks and construction equipment. There was also a positive effect from the high level of construction activity in southern Europe, which gave a boost to unit sales of engines for construction equipment, and from long-term infrastructure projects for the decentralisation of energy supply in the Middle East, which stimulated demand for gensets. Despite the economic downturn in the second half of the year, unit sales in the USA exceeded our expectations with the result that the 56,029 engines sold in the Americas region was higher than the figure achieved in 2006 (54,212).

### Business outside Germany drives revenue growth

The revenue figures reflect the excellent figures for new orders and unit sales: revenue climbed from €1,103.0 million in 2006 to €1,443.1 million in 2007, a significant increase of 30.8 per cent. Of this revenue, 76.7 per cent was generated outside Germany. The performance of the individual segments varied considerably, again reflecting the unit sales figures: whereas there was a sharp 40.1 per cent rise in revenue in Compact Engines to €1,137.4 million, DEUTZ Customised Solutions saw a comparatively moderate increase in revenue of 4.9 per cent to €305.7 million, although this increase exceeded our original expectations and was therefore encouraging.

Viewed on a regional basis, growth was higher outside Germany than within Germany. Revenue from customers outside Germany rose by 37.8 per cent, whereas the figure within Germany was 12.1 per cent. Relatively speaking, the Asia-Pacific region recorded the sharpest increase of all the regions with revenue of €113.7 million (an increase of 58.8 per cent) – the result of the increase in supplies of engines and parts to China. Revenue from customers in the Europe/Middle East/Africa region grew by 34.0 per cent to €1,155.4 million. North America experienced a slight gain of 2.8 per cent to €174.0 million. Within the Europe/Middle East/Africa region, which accounted for the greatest proportion of revenue, growth in Europe was particularly strong, both in absolute and relative terms, as a result of the commercial-vehicle engines supplied to Volvo. The commercial-vehicle engine series went into production in 2006, with 2007 being the first full year of production. Revenue in Europe rose over the year by a substantial 51.7 per cent to €740.3 million. A substantial increase in business with new customers in

the commercial vehicles, agricultural machinery and construction equipment industries in eastern Europe also had a positive impact.

#### Further improvement in operating profit

	2007	2006
€ million		
<b>Revenue</b>	<b>1,443.1</b>	<b>1,103.0</b>
EBIT	66.6	37.0
Net interest income/expense	-14.3	-16.4
<b>Profit from ordinary activities</b>	<b>52.3</b>	<b>20.6</b>
Net extraordinary expense	119.5	12.0
<b>Net income before taxes</b>	<b>171.8</b>	<b>32.6</b>
Other taxes	-0.6	-0.7
Income taxes	-18.0	-2.2
<b>Net loss/income</b>	<b>153.2</b>	<b>29.7</b>
Profit carried forward	7.7	-21.6
Addition to the legal reserve	-4.1	-0.4
Addition to the other retained earnings	-74.6	0.0
<b>Accumulated income</b>	<b>82.2</b>	<b>7.7</b>

In 2007, DEUTZ was able to significantly increase operating profit from €37.0 million to €66.6 million. The Compact Engines and DEUTZ Customised Solutions segments contributed to this with operating profit of €41.8 million, an increase of 48.2 per cent. The start-up losses incurred by DEUTZ AG for DEUTZ Dalian in the Compact Engines segment amounted to €2.5 million. Overall, the EBIT margin improved considerably to 4.6 per cent (2006: 3.4 per cent).

The Other segment reported an operating profit of €24.8 million as a result of the collection of dividends from a subsidiary outside Germany and the reversal of impairment losses on receivables from a foreign equity investment.

Profit from ordinary activities was €52.3 million. Including the extraordinary item of €119.5 million from the disposal of DEUTZ Power Systems (2006: €12.0 million), and after taxes, this produced a net income of €153.2 million (2006: €29.7 million). After taking into account profit of €7.7 million brought forward, an addition to the legal reserve of €4.1 million and an addition to the other revenue reserves of €74.6 million, the accumulated income before appropriation of profit was €82.2 million. The result is that DEUTZ AG is in a position to pay a dividend for the first time in over 20 years.

Given the level of operating profit, the Board of Management is proposing a distribution to the shareholders of a dividend of €0.20 per share. The Board of Management is also proposing payment of a further special dividend, also of €0.20 per share, from the gain on the disposal of DEUTZ Power Systems. The Board of Management is therefore proposing a total dividend of €0.40 per share. On this basis, an amount of €48.0 million will be distributed from the accumulated income for 2007.

## BUSINESS PERFORMANCE IN THE COMPACT ENGINES SEGMENT

### Strong growth in Compact Engines

The Compact Engines business generated strong growth throughout the year under review, which was mainly attributable to the first full year of production for the commercial-vehicle engine manufactured for Volvo. A further reason was the positive economic climate, which stimulated demand for engines for construction equipment, material-handling equipment and tractors. This resulted in a corresponding increase in new orders to €1,130.7 million, a rise of 24.4 per cent.

### Unit sales up 26 per cent

Unit sales rose significantly to 250,735 engines, an increase of 26.0 per cent. The upward trend was particularly marked in four to eight-litre engine series, where sales reached 140,117 units (2006: 101,159 units), an increase of 38.5 per cent. The growth in sales of engines in this particular class was attributable specifically to the commercial-vehicle engine launched in 2006; in the first full year of production there was almost a fourfold increase in unit sales of this engine. However, even engines with a smaller capacity of under four litres saw an increase in unit sales of 13.1 per cent, with total unit sales in this category reaching 110,618 engines (2006: 97,821).

### Revenue growth in the Automotive application segment

Excellent unit sales also led to a significant rise in segment revenue to €1,137.4 million, a year-on-year increase of 40.1 per cent. The increase was particularly noticeable in the Automotive application segment. As a result of the significant revenue generated by the commercial-vehicle engines, Automotive revenue was around €238 million, almost three times higher than in 2006 when full production of these engines was started. Within the Compact Engines segment, the largest revenue contributor was the Mobile Machinery application segment, which again generated double-digit revenue growth of 35 per cent, driven primarily by the high demand for construction and material handling equipment. In addition, revenue generated by engines in the Stationary Equipment application segment, such as gensets, compressors and pumps, saw an encouraging increase of around 18 per cent. Service revenue also continued to grow significantly, up 21.2 per cent on 2006. Apart from the contribution from the very successful spare-parts business, this was also the outcome of numerous intensive marketing activities undertaken by the service organisation: foremost among these activities was the 'Service 20%' programme, which included projects on a global basis to win market share, expand the DEUTZ lubricants business and increase price differentiation in the spare-parts business.

### Successful start-up for the DEUTZ Dalian joint venture

The first few months of 2007 focused on developing the necessary organisational structures and management processes for the joint venture, the agreement on which had been signed in December 2006.

In the period from August to December 2007, DEUTZ Dalian – currently there are just under 2,000 employees at the facilities – produced over 42,000 engines, of which 3,000 were based on DEUTZ technology. This generated revenue of over €80 million.

We signed initial supply agreements with DEUTZ customers active in China. It had also been decided that, in the start-up year of the joint venture, we would increase crankcase production for four to eight-litre engines from 50,000 to 60,000 units. This additional capacity is scheduled to come on stream in the second half of 2009. All current and future capital expenditure will be financed either by the joint venture's own resources or by loans taken out locally.

## BUSINESS PERFORMANCE IN THE DEUTZ CUSTOMISED SOLUTIONS SEGMENT

### Order volume at a high level

In DEUTZ Customised Solutions, new orders over the entire year increased by 10.1 per cent to €340.0 million and thereby exceeded our expectations. Although unit sales of engines were 5.0 per cent down on 2006, the figure was significantly above budget: 33,596 units were sold in 2007 (2006: 35,362). Despite the fall in unit sales, the high proportion of engines with a capacity greater than eight litres meant that revenue grew by 4.9 per cent to €305.7 million.

However, performance varied from one application segment to another. Whereas revenue from Stationary Equipment engines dropped by 26.0 per cent owing to a downturn in project business and a fall in the US business caused by the strong euro, revenue in the Automotive application segment rose by 23.0 per cent, with revenue in the Mobile Machinery application segment also growing by 14.8 per cent. The Agricultural Machinery application segment saw excellent growth of 63.7 per cent: in the year under review, a significant number of engines were built in advance for several customers, the reason being that the Stage III A/Tier 3 emissions standard for engines with outputs of between 37kW and 75kW was due to come into force on 1 January 2008. Service revenue also rose: the increase of 13.2 per cent was specifically the result of the volume of Xchange business involving reconditioned exchange parts and engines. The Xchange business experienced a strong rate of growth of 15.3 per cent. We also

achieved a significant expansion in the spare-parts business.

## NET ASSETS AND FINANCIAL POSITION

As a result of the disposal, the investments in affiliated companies and real estate holdings attributable to DEUTZ Power Systems were no longer carried on the balance sheet as at 31 December 2007.

### Financial management centrally organised

Financial management of DEUTZ AG is the responsibility of the finance department. This responsibility primarily comprises management of the lines of credit required by the Company, cash pooling and any necessary foreign exchange hedging. Centralised cash pooling ensures optimum use of cash. Foreign currency surpluses are largely hedged naturally by the use of purchasing agreements. The risk in residual or foreseeable currency surpluses is hedged by the head office finance department in accordance with internal guidelines.

### US private placement with a total value of US\$ 274 million completed

With the issue of notes (bonds) as part of a private placement in the United States, DEUTZ has put in place long-term, non-bank-based financing with maturities of five, seven and ten years. The bondholders are institutional investors in the US. With the placement in the early summer of 2007 – that is, before the mortgage crisis in the US – DEUTZ AG tapped into a very receptive capital market: the bonds, initially worth US\$ 150 million, were more than three times oversubscribed and were therefore raised to US\$ 274 million (equivalent to €203.15 million). The average coupon was 5.4 per cent. Interest payments and the repayment of the principal in US dollars are hedged over the entire maturity of the bonds by cross-currency swaps in euros. In other words, there is no risk to DEUTZ AG from changes in the exchange rate between US dollars and the euro. There are currently no other material financial liabilities denominated in foreign currency.

The proceeds have been used for the joint venture in China, the payment of compensation for the surrender of vested company pension rights and the repayment of outstanding bank debt. Current lines of credit with banks are largely unused; all are unsecured. We do not expect to see a deterioration in our terms of credit in the future.

### Optimum receivables management by means of factoring

Over the last few years, factoring – the sale of receivables – has steadily become increasingly important. We make use of these opportunities to sell receivables in order to optimise our receivables management. As at 31 December 2007, the volume of receivables sold under factoring agreements was around €87 million (2006: €106 million). The average volume in 2007 was over 12 per cent lower than in 2006.

### Pension reserves reduced by one-off payments

For historical reasons, there has been a substantial imbalance at DEUTZ AG between the number of employees and the number of beneficiaries of vested company pension rights: at the end of 2006, there were three such beneficiaries for every active employee. The majority of retirees or pension beneficiaries only had a maximum monthly pension entitlement of €200. Given this background, a voluntary one-off compensatory payment seemed to us to be a promising option that would allow us, to the extent permitted by the law, to encourage surrender of these vested pension rights – especially as such compensation payments would be exempt from personal tax and social security obligations for many of our pension recipients.

DEUTZ circulated a compensation offer to just under 13,000 pension beneficiaries – more than 7,000 pension beneficiaries and active employees accepted the offer. As a result, the ratio of pension beneficiaries to active employees at the end of 2007 was two to one. DEUTZ AG's pension reserves were also reduced accordingly by around €69.6 million.

### Convertible bond issued in 2004 almost completely converted

Of the original issue of 19,792,998 convertible bonds, 839,263 were still outstanding at the end of 2007. Since the outstanding volume represented less than 10 per cent of the original issue, we made use of the provision in the terms of the bond to call the bond. The effective date for redeeming the bond was 7 March 2008, although up to 3 March bondholders still had the option to exchange one convertible bond for one DEUTZ share. On 19 November 2007, DEUTZ notified holders that it intended to redeem a further 1,194 convertible profit-sharing rights with an effective date of 22 May 2008.

### Covenants provide evidence of investment-grade rating

Currently, none of the rating agencies has set a credit rating for DEUTZ AG. However, the covenants imposed on DEUTZ in connection with the US private placement are equivalent to those imposed on companies classified as investment grade by rating agencies or by the National Association of Insurance Commissioners (NAIC) in the US. These covenants are defined by key performance indicators based on the ratio of net debt to equity, net debt to

EBITDA (before one-off items), and EBITDA (before one-off items) to net interest income/expense. Net debt includes all current and non-current interest-bearing financial liabilities (loans, bonds, notes, finance lease liabilities less any existing cash and cash equivalents).

#### Disposal of DEUTZ Power Systems increases liquidity

DEUTZ Power Systems was sold on 30 September 2007. This gave rise to cash inflows at DEUTZ of €293.2 million. Together with the current credit facilities, this means that DEUTZ AG has sufficient funding available to cover capital expenditure, any acquisitions and the further expansion of the Compact Engines business.

#### Changes to balance sheet structure

There were significant changes to the balance sheet of DEUTZ AG as at 31 December 2007 compared with the corresponding balance sheet as at 31 December 2006. These changes were mainly attributable to the disposal of investments in affiliated companies and real estate holdings associated with the sale of DEUTZ Power Systems on 30 September 2007. The balance sheet no longer shows these items, while most of the sale price received is included under cash and cash equivalents.

#### Increase in total assets

As at 31 December 2007, the total assets of DEUTZ AG had risen to €1.235.1 million, an increase of €328.8 million (36.3 per cent) on the equivalent figure for 31 December 2006. The derecognition of DEUTZ Power Systems assets worth approximately €133 million was more than offset by two items: firstly, the purchase price received for the sale of DEUTZ Power Systems which, after debt repayments, increased cash and cash equivalents by approximately €261 million; and secondly, by the addition of financial assets worth €57.8 million for the 50 per cent share in the DEUTZ Dalian joint venture.

#### Working capital grows along with business volume

As at 31 December 2007, working capital (the total of inventories and trade receivables less trade payables) amounted to €104.6 million, an increase of €75.7 million on the working capital as at 31 December 2006. This includes an increase in inventories of €40.1 million to support the high level of orders on hand. The rise of €26.8 million in trade payables was also a result of the high level of orders. Trade receivables rose €62.4 million year on year due to the positive business performance, particularly in the fourth quarter.

#### Equity ratio up four percentage points

The realignment of DEUTZ AG has also significantly altered the structure of the equity and liabilities side of the balance sheet: equity increased to €494.5 million (2006: €322.3 million) primarily owing to the high level of net income, which included the effect of the disposal of DEUTZ Power Systems, and owing to the conversion of bonds and profit-sharing rights. The equity ratio was 40.0 per cent (before dividend distribution), a year-on-year increase of 4.4 percentage points.

#### Further increase in ROCE

To avoid distortions caused by the high level of cash and cash equivalents in 2007, we have amended our definition of return on capital employed (ROCE) used hitherto in line with the standard definition: henceforward, this key figure will be the ratio of EBIT before one-off items to capital employed, comprising the asset side of the balance sheet (average figures) less cash and cash equivalents and less trade payables and other current liabilities.

The increase in earnings and a roughly constant amount of capital employed led to a rise in ROCE to 9.1 per cent (2006: 5.1 per cent).

#### Surrender of vested company pension rights in return for compensatory payment reduces pension reserves

Pension reserves decreased by €67.1 million to €160.1 million compared with the end of December 2006; above all, the critical factor in this was the settlement of vested company pension rights.

#### Net financial position positive for the first time

Following implementation of the US private placement in 2007, we used this opportunity to bring our existing definition of net financial debt into line with the standard definition used by capital markets. Previously, this key debt figure was derived from bank debt less cash and cash equivalents. The key figure now known as 'net financial position' represents existing cash and cash equivalents less all current and non-current interest-bearing financial liabilities in the form of loans, bonds, notes and finance lease liabilities. Given the high level of cash inflows resulting from the significant proceeds in connection with the disposal of DEUTZ Power Systems, we ended the year under review with a positive net financial position of €90.1 million (2006: negative figure of €15.3 million).

## Cash flow statement (condensed)

	2007	2006
€ million		
EBIT (before extraordinary result)	66.6	37.0
Cash flow from operating activities before payment of compensation for vested company pension rights	8.0	81.2
Payment of compensation for vested company pension rights	-69.6	0.0
Cash flow from operating activities	-61.6	81.2
Cash flow from investing activities	156.9	-54.9
Cash flow from financing activities	166.1	-30.3
<b>Change in cash and cash equivalents</b>	<b>261.4</b>	<b>-4.0</b>

Cash flow from operating activities was minus €61.6 million, a decrease of €142.8 million compared with 2006. Essentially, the change is attributable to the non-operating payments of €69.6 million in compensation for the surrender of vested company pension rights. Furthermore, the expansion of working capital as a consequence of the increased business volume resulted in higher cash outflows.

The sale of DEUTZ Power Systems after deduction of transaction costs resulted in cash inflows for DEUTZ AG of €279.5 million. Further cash inflows of €14.2 million arose from the legacy effects of the disposal of the Marine Service business. After deduction of the capital expenditure (which was higher than in 2006) and an investment of around €58 million in the DEUTZ Dalian joint venture in China, the positive cash flow from investing activities was €156.9 million (2006: minus €54.9 million).

Cash flow from financing activities amounted to €166.1 million (2006: minus €30.3 million). This includes the proceeds of €203 million from the US bond placement.

## CAPITAL EXPENDITURE

### Volume of capital expenditure influenced by investment in China and expansion of capacity

In 2007, total capital expenditure amounted to €126.9 million (2006: €70.8 million). This includes approximately €58 million paid for the 50 per cent share in the DEUTZ Dalian joint venture in China. In addition, we invested €55.1 million in property, plant and equipment (2006: €56.9 million) and €11.6 million (2006: €13.5 million) in intangible assets.

### Further increase in capacity for compact engines

Overall, capital expenditure in the Compact Engines segment was considerably higher than in 2006 at €119.6 million (2006: €66.1 million). Apart from the Chinese joint venture, the focus of this capital expenditure was on projects to expand capacity. These projects included the TCD 2013 4V engine series for commercial-vehicle and industrial applications, the 2011 series for industrial applications and the expansion of capacity at our production and assembly facilities in Cologne. Numerous machining centres, lathes, grinding machines and milling machines were purchased, allowing us to expand the production of crankcases, camshafts, crankshafts, conrods and cylinder heads. There was also a considerable amount of capital expenditure on tools to be used by suppliers.

### Investment in the future and in the environment

In DEUTZ Customised Solutions, capital expenditure of €7.3 million (2006: €4.7 million) was used to expand this segment into a centre of competence for air-cooled diesel engines. The funds were used to support both pioneering and environmentally oriented projects, such as an innovative paint facility in which only environmentally friendly water-based paint is used, new test rigs, a new goods-inward area and modified infrastructure and energy supplies. Finally, the new logistics centre came into operation in September. The centre comprises a high-bay storage facility, a small-parts store and a dispatch hall.

### Depreciation, amortisation expense and impairment losses above 2006 level

The depreciation/amortisation expense and impairment losses of DEUTZ AG were higher in 2007 than in 2006, amounting to €63.5 million (2006: €56.0 million). Since 2005, capital expenditure has been significantly in excess of depreciation, amortisation and impairment losses, reflecting the objective of stronger growth and the associated expansion of capacity.

## RESEARCH AND DEVELOPMENT

### Core competence: diesel engines

We – and our engines – are driven by technological progress. We have firm research and development goals related to the reduction of emissions, optimisation of fuel consumption, the reduction of engine noise and the achievement of the highest possible advances in efficiency.

Within DEUTZ AG, 388 people (2006: 361) at the Cologne site in Germany and at the Dursley site in the UK are employed on the development of diesel engines. In the year under review, R&D expenditure amounted to €52.1 million (2006: €51.5 million). €43.6 million of this expenditure was attributable to the Compact Engines segment (2006: €43.0 million) and €8.5 million to the DEUTZ Customised Solutions segment (2006: €8.5 million). Given a level of expenditure similar to that in 2006 in absolute terms and a disproportionate increase in revenue, the ratio of R&D expenditure to revenue fell to 3.6 per cent, a drop of 1.1 percentage points on 2006.

In the year under review, 66 per cent (2006: 70 per cent) of R&D expenditure was accounted for by new engine development and engine refinement, 23 per cent (2006: 22 per cent) by customer applications and support for engine series production, and the remaining 11 per cent (2006: 8 per cent) by research and preliminary development.

A feature of development in 2007 was again the further reduction in emissions values for our engines by means of internal exhaust gas recirculation. The primary aim was to ensure that, by the start of 2008, production of various engine variants had been modified to ensure compliance with the III A/Tier 3 standard for engines with outputs of 37kW to 75kW.

### Successful production start-ups

In 2007, the most important production start-ups for engine series complying with the Stage III A/Tier 3 standard for engines with outputs of 75kW to 130kW were the engine series with four-valve technology, the DEUTZ common-rail injection system and cooled external exhaust gas recirculation, and those variants with mechanical injection and internal exhaust gas recirculation. Depending on customer requirements and the emissions standard, designs were further optimised in the application. We found the first practical tests carried out by trade publications very encouraging: the 2012 and 2013 series achieved outstanding results in terms of both engine characteristics and fuel consumption when tested in tractor applications.

### Innovative engine designs: biofuels and hybrid drive systems

Whilst one side of research and development work at DEUTZ is the optimisation of proven drive designs, the other side is pioneering work on the development of new types of engines. In the case of the latter, one of the key areas of research and development activities has been the DEUTZ Natural Fuel Engine, an engine in the TCD 2012 series that has been developed to run on rapeseed oil and has now been certified. We successfully showcased this innovative engine for the first time at the Agritechnica trade fair in November 2007: the German Agricultural Society (DLG) awarded this engine the silver medal for 'outstanding innovation in the field of drive technology'.

The hybrid drive is a further focus of research and development activities. DEUTZ used the opportunity of the bauma trade fair in April 2007 to present the first construction equipment hybrid drive in the world; the drive was installed in a wheel loader. We have now also started development of a production model, which we are planning to have ready for presentation at bauma in 2010.

What exactly is the hybrid design? The design combines a diesel engine with an electromotor and an electrical energy storage capability. The advantage is the more powerful torque provided by the combination of diesel engine and electromotor. In addition, the engine is automatically stopped when idle; it also regains kinetic energy on braking.

The advantages for customers are obvious: lower operating costs as a result of lower fuel consumption and therefore also lower carbon dioxide emissions – to the benefit of the environment, too. However, there are also advantages from increased efficiency, a reduction in the size of the internal combustion engine and more comfort as a result of the reduction in idle running.

#### Emissions legislation requires exhaust-gas aftertreatment

Further statutory reductions in emissions limits will be introduced, for example, through the implementation of emissions standards III B in Europe and Interim Tier 4 in the USA from 2011. As a consequence, the development of exhaust-gas aftertreatment systems is becoming increasingly important for DEUTZ. Under these emissions standards, it is no longer possible to achieve a further reduction in emissions from within the engine alone – for non-road applications (as is currently already standard in the case of some on-road applications), it is necessary to use exhaust-gas aftertreatment systems.

We have systematically accelerated the development of basic principles in the areas of injection, supercharging, combustion and exhaust-gas aftertreatment. In mid-2007, DEUTZ began development of production engines that comply with the next stage of emissions standards. These engines use SCR (selective catalytic reduction) systems to reduce nitrogen oxide. This development is able to make use of our experience in manufacturing such engines for on-road applications (commercial-vehicle engines). In addition, special filter systems are required for the soot particles arising in the combustion of diesel fuel. In this regard, we have many years of experience, particularly from our retrofitting business. We have already developed an electronically controlled burner system for the regeneration of the filter element that is sometimes required.

#### DEUTZ Customised Solutions: first end-customer product

Apart from the preliminary development of engines to comply with the next stage of emissions standards, a key area of development in the DEUTZ Customised Solutions segment was the provision of support for the production start-up of engines complying with the Stage 3 emissions standard. In addition, the focus in 2007 was also on the successful completion of the development of the first end-customer product: a genset with the product name ADG (air-cooled diesel genset) based on an air-cooled engine. The first practical tests have confirmed our high expectations: the ADGs are particularly robust, durable and low-maintenance – like all air-cooled DEUTZ engines, they are particularly suitable for use in extreme conditions (dust, heat, cold). Even the noise values far exceeded our expectations. Production start-up is planned for the first half of 2008.

#### Over 300 industrial property rights

The culture of innovation at DEUTZ is also mirrored in the industrial property rights owned by the Group. In 2007, patent applications were filed for a total of 36 inventions, of which 29 were in Germany and seven elsewhere. At the end of 2007, DEUTZ held a total of 305 patent applications, patents and utility models, of which 172 were in Germany and 133 elsewhere.

## PROCUREMENT

#### High level of demand leads to supply bottlenecks

The strong growth of DEUTZ AG in conjunction with the general boom in the German economy meant that the procurement of raw materials and components was under some strain in 2007: there were supply bottlenecks, particularly in the first half of the year, creating significant challenges for materials planning and supply chain management. The particular materials affected by bottlenecks were cast parts, cooler packages, injection systems and valves. The situation was relieved from the middle of the year by expansion in both suppliers' and our own capacity and by increased cooperation with reserve suppliers. However, we were also able to make use of the production opportunities provided by the joint venture in China. This all enabled us to improve procurement processes in the second half of the year and gradually scale back the special logistics measures we had introduced.

In the year under review, we again stepped up collaboration with suppliers: DEUTZ AG entered into an agreement with the global market leader for injection systems that secures the long-term supply of high-quality mechanical injection systems to meet our increasing requirements. We also renewed our long-standing partnerships with leading manufacturers of valves for air admission and venting in engines: the objective is to establish very long-term and innovation-oriented alliances. Finally, we increased the number of our suppliers of grey cast-iron cylinder crankcases to provide us with more security of supply.

#### Price rises in key raw materials

Steel scrap is the main material used by iron foundries and the market for steel scrap is the most important raw materials market as far as DEUTZ AG is concerned. In 2007, steel scrap prices were 9 per cent higher than in 2006 on average. Average prices for non-ferrous metals, such as copper and aluminium, fell slightly.

#### Foundry products account for over one third of the cost of materials

Significant items in the cost of materials are foundry products, fuel injection equipment and measurement and control devices. In the year under review, foundry products accounted for 28 per cent of the cost of materials, followed by fuel injection equipment, which accounted for around 16 per cent. Measurement and control devices together accounted for more than 7 per cent of the cost of materials. Other important material subcategories are generators and starters, turned parts, sheet metal parts, DIN and standard parts, together with forged parts.

## PRODUCTION

The unit sales figures show that we had a record year: following a year-on-year unit sales increase in 2006 of 21 per cent, unit sales increased again in 2007 by 21.3 per cent, with the number of engines sold rising from 234,342 to 284,331.

#### Further increase in assembly and production of engines in Cologne

The Cologne plants in Germany, comprising mechanical fabrication at Cologne-Deutz, Cologne-Kalk and Herschbach, together with assembly at Cologne-Deutz and Cologne-Porz, produced a total of 251,384 engines in 2007 (2006: 198,266), representing an increase of 27 per cent on 2006. The number of employees in production and assembly over the same period rose from 1,247 to 1,336, an increase of over 7 per cent.

The factors that made this record level of production possible included the introduction of three-shift operation at the principal assembly plant for industrial engines. At the same time, we also increased productivity: average production line output per hour in 2007 was 42 engines, compared with 40 engines previously. This equates to an increase of over 5 per cent.

2007 saw the first full year of production for the new 2013 4V engine series. This engine, which first went into production in 2006, is produced in an assembly hall specially constructed for this purpose in 2005 and is primarily used in commercial-vehicle applications. Output figures mirrored this ramp-up in production: in 2006 only 8,277 units were produced, whereas output in 2007 was 31,544 engines from two-shift operation, almost a fourfold increase.

#### Continuous improvement process increases productivity

There were also a number of organisational changes in 2007: the Company brought together the Cologne plants under one production management structure – with the objective of continuing to increase productivity and at the same time securing output. To this end, a new uniform concept was introduced as part of the continuous improvement process (CIP). This concept defines the steady streamlining of manufacturing processes as the most important and urgent task of each individual manager. However, CIP is not restricted to management – it applies to every individual employee in the Company. The success of the concept is impressive: productivity at the principal assembly plant rose by approximately 5 per cent. This was achieved even though there were sometimes bottlenecks in the supply of parts.

#### Ulm: more production, more employees

We also ramped up production at the Ulm facilities in 2007. The assembly of air-cooled engines had only been relocated from Cologne to Ulm at the start of the year – since then a total of 31,308 engines have been produced at the site, of which 27,656 units were air-cooled engines and 3,652 units were liquid-cooled engines in engine series with a capacity greater than eight litres. In 2006, total production stood at just 5,173 engines, of which air-cooled series accounted for 1,270. The headcount was increased accordingly: by the end of 2007, the number of employees at the site was 542 (2006: 407).

#### DEUTZ Dalian: the Company's most important joint venture

Strategically, the most important of all our joint ventures is the DEUTZ Dalian joint venture, which commenced operations in August 2007. Over the whole of 2007, its production facilities manufactured over 100,000 engines, of which over 42,000 were produced in the period August to December. Of the latter, 3,000 engines were assembled in the new plant with DEUTZ technology.

Our Argentinian joint venture, DEUTZ AGCO Motores S.A. (DAMSA), produced over 3,000 engines in 2007 for the local market.

#### High level of quality

Our products are subject to ongoing quality control – ultimately, a sustained high level of product quality is one of the outstanding factors in our success. Quality is measured on the basis of the additional costs that arise from rejects, defects or goodwill repairs and replacements. However, these costs are a purely internal measure; they cannot be compared with competitors because there is no benchmark and are therefore not published.

#### Health and safety: better than the industry as a whole

The rate of notifiable accidents per thousand employees is an important key indicator in evaluating accidents in the Company. The efficiency of health and safety management systems, and in particular the success of improvement measures, can be measured on the basis of this value. In the last few years, the number of workplace accidents per thousand employees at DEUTZ AG has regularly been below the figure supplied by the engineering employers' liability insurance association, the figure used as the benchmark in the industry. In 2007, there were 39 accidents notifiable in accordance with this method (2006: 38). This figure is approximately 15 per cent lower than the industry average determined by our accident insurers.

## EMPLOYEES

#### Another substantial increase in employee numbers

DEUTZ AG is on a growth trajectory – this is also mirrored in the headcount trend. Overall, the Company employed 3,841 people in 2007, an increase of 339, or 9.7 per cent, on the figure for 2006. There were 2,891 employees in Cologne and 542 in Ulm. In the period under review, an average of 366 persons were employed under temporary employment agreements, representing an increase of 118 over 2006. Headcount was increased in response to the growing demand for manpower as a result of the sharp expansion in production.

At the end of 2007, the Compact Engines segment employed 3,119 people (2006: 2,887), while the DEUTZ Customised Solutions segment had 722 employees (2006: 615). The increase in personnel numbers in the Compact Engines segment was concentrated in the Cologne production and assembly facilities and was the result of the significant growth in the production programme. The headcount growth in DEUTZ Customised Solutions is attributable to the expansion of the Ulm facilities to become the competence centre for air-cooled engines.

#### Training is the future

As a forward-looking company with a long-term future we are always thinking about tomorrow. For this reason, we added more training and apprenticeship places in 2007 and now have 174 trainees and apprentices (2006: 159 trainees and apprentices) in future-oriented technical and commercial vocations, for example in industrial technology, electronics and business administration. The trainee ratio rose slightly year on year and is now 4.5 per cent (2006: 4.5 per cent).

In recognition of its commitment to the training of young people, DEUTZ was given a training award in 2007 by the German Federal Employment Agency for its contribution to initial training. This award was for the high technical standard, the significant personal commitment of the trainers and the 15 years of cooperation with IN VIA e.V. in Cologne. In cooperation with IN VIA, an association under the auspices of the German Caritas organisation, and the German Federal Employment Agency, we have over this period prepared 430 young people in our training workshop and production facilities for vocational training. The target group is made up of young people who have left school with few educational qualifications and who lack social skills. 330 participants have gone on to find a training place, of whom 100 are now employed by DEUTZ. There are 38 participants in the current year group.

#### Further acceleration in professional development

We have now reached the fourth 'generation' in our trainee programme. Under this programme, we offer professional development opportunities in the Company for young, very well educated graduates. In the year under review, DEUTZ offered four more university graduates the opportunity to take part in a 16-month trainee programme. The trainees are supported by personal mentors and work on four different projects, each lasting four months, in different areas of the business. In this way, we offer potential managers the opportunity to take on responsibility at an early stage. One of the projects takes place at a Company site outside Germany. This enables the trainees to gain new professional and cultural experience and also improve their language skills. In return, DEUTZ AG is able to access new internationally oriented employees and continue to expand the strategic internationalisation of the Company. For these very reasons, we have for many years been paying close attention to the right mix of cultural, academic and personal backgrounds. With the regular presentation of their results to the Board of Management, the trainees learn to hold discussions and communicate with management.

All trainees to date have successfully completed the programme. DEUTZ AG has been able to offer permanent positions to 19 of the 24 trainees that have participated in the programme to date (including the current year group).

At our Ulm plant, we are also developing a skilled workforce, capable of meeting the challenges that lie ahead. In Ulm, we offer school leavers with the German *Abitur* the opportunity to study for a bachelor of engineering degree on a sandwich course operated by DEUTZ in cooperation with the Heidenheim University of Cooperative Education.

#### Ulm: changes create jobs

At the start of 2007, large-scale structural changes were imminent at the Ulm site. First, the air-cooled engine series were relocated to Ulm from Cologne-Deutz at the start of the year. Then in September, a state-of-the-art, fully automatic high-bay storage facility came into operation at the site. To support these changes, around 110 new employees with a variety of skills were taken on during the course of the year. Given a rate of unemployment in the Ulm area of significantly below 3 per cent, this represented a particular challenge, especially as regards the recruitment of managers and employees with specialist skills.

#### Reorganisation of employee skills development

Within the context of a realignment of the HR department, we carried out a detailed review of personnel development processes and tools. Our objective is to ensure that employees are better prepared for the challenges of the future and that valuable managers and specialists are encouraged to remain with the Company by offering them systematic career progression and succession planning. This also includes efforts to face up to the demographic challenge: we have therefore analysed the age structure of our workforce and taken action to ensure that employees can be replaced promptly by successors with the right skills and qualifications.

#### Performance-related remuneration

The salaries of around 7 per cent of employees include variable components based on the achievement of a combination of corporate and personal targets. Depending on the employment contract, up to 33 per cent of remuneration is linked to company and personal performance.

## ENVIRONMENT

#### Innovations to combat global warming and climate change

Over the last few years, there has been a significant increase in environmental awareness among many people. As a manufacturer of engines, DEUTZ feels under a particular obligation to commit to long-term environmental protection – so that the environment can be maintained intact for future generations.

Firstly, we carry out intensive research and development in the field of environmentally friendly drives, thereby bringing together perfectly our own core competence and environmental objectives. More information on our innovative drive units, the hybrid drive and the rapeseed-oil-powered engine, can be found in the section on research and development on page 13 of this annual report.

Secondly, we have also espoused the cause of sustainable environmental protection in many other areas. For example, with the well thought-out energy-saving heating design in the new administrative building almost 80 per cent of the heat will be taken from the production areas. DEUTZ is also making further advances in the avoidance of waste. Since the start of 2007, a yearly total of around 400 tonnes of sludge contaminated with oil is no longer burnt, but is reprocessed so that it can be used again in other industrial processes as a basic oil. In this way, DEUTZ is making an important contribution to reducing its carbon footprint.

#### Certified environmental management system

The importance enjoyed by environmental protection at DEUTZ is documented, not least, by our environmental protection management system in accordance with DIN EN ISO 14001, which covers all environmentally relevant processes in the business. The system ensures that these processes are monitored, analysed and evaluated on an ongoing basis and that systematic improvements are introduced as required. At the end of 2007, the environmental protection management system was audited by an independent expert from DNV Zertifizierung und Umweltgutachter GmbH, Essen, Germany, who confirmed that the system complies with the international ISO 14001 standard. Since then, the certification has also been extended to cover the Cologne site's own fire service, which is also officially recognised by the German authorities. In addition, eco-audits have already been carried out several times at the Cologne-Porz and Cologne-Kalk facilities, each time ending with certification in accordance with DIN/ISO 14001.

DEUTZ AG's total expenses for environmental protection activities, including health and safety, amounted to €5.7 million in 2007. This compares with €5.4 million in 2006.

## DEPENDENCY REPORT

The Board of Management of DEUTZ AG has submitted a report for the year ended to the Supervisory Board as required under section 312 of the German Stock Corporation Act (AktG). This report covers the relationships between the companies in the DEUTZ Group and the SAME DEUTZ-FAHR Group. The Board of Management issued the following concluding statement:

"For all the legal transactions and activities stated, our company received an appropriate consideration for each legal transaction in accordance with the circumstances known to us at the time the transactions were conducted or the activities carried out and was not disadvantaged as a result of measures that were taken."

## DISCLOSURES PURSUANT TO SECTION 289 (4) GERMAN COMMERCIAL CODE (HGB)

### Composition of the issued capital

The issued capital (share capital) of DEUTZ AG amounted to €306,992,504.46 at the end of 2007 (2006: €292,270,841.53) and was divided into 120,085,030 (2006: 114,326,416) no-par-value bearer shares.

### Direct or indirect investments representing more than 10 per cent of voting rights

At the end of 2007, SAME DEUTZ-FAHR Holding & Finance B.V., Amsterdam, Netherlands, held a direct investment in DEUTZ AG representing 42.5 per cent of voting rights. Via SAME DEUTZ-FAHR Holding & Finance B.V., the following companies and individuals held an indirect investment in DEUTZ AG equivalent to the same percentage:

- SAME DEUTZ-FAHR Group S.p.A., Treviso, Italy
- Intractor B.V., Amsterdam, Netherlands
- Belfort S.A., Luxembourg, Luxembourg
- Messrs Vittorio, Aldo and Francesco Carozza and Ms Luisella Carozza-Cassani.

## LEGAL PROVISIONS AND STATUTE PROVISIONS REGARDING THE APPOINTMENT AND REMOVAL OF MEMBERS OF THE BOARD OF MANAGEMENT AND REGARDING CHANGES TO THE STATUTES ACCORDING TO ARTICLES 7 (1) AND 7 (2) OF THE STATUTES OF DEUTZ AG:

"(1) The Board of Management shall comprise at least two members.

(2) The Supervisory Board shall determine the number of members of the Board of Management and the allocation of responsibilities. It may draw up and issue rules of procedure."

As far as the appointment and removal of members of the Board of Management are concerned, sections 84, 85 German Stock Corporation Act (AktG) and section 31 German Codetermination Act (MitbestG) also apply.

According to article 14 of the Statutes of DEUTZ AG:

"The Supervisory Board may change the wording but not the spirit of the Statutes."

Sections 179, 133 AktG also apply in the case of changes to the Statutes.

The authority of the Board of Management is derived from the legal provisions and from the rules of procedure laid down by the Supervisory Board.

### Authority of the Board of Management, in particular with regard to share issue or buyback

Pursuant to article 4 (5) of the Statutes of DEUTZ AG, the Board of Management is authorised, subject to the consent of the Supervisory Board, in the period up to 21 June 2011 to increase the issued capital through the issue of new no-par-value shares against cash or non-cash contributions on one or more occasions up to a total amount of €120,000,000. Capital increases against non-cash contributions may not exceed a total of €80,000,000.

### Further disclosures

There are no restrictions affecting voting rights or the transfer of shares.

No bearers of shares have any special rights conferring authority to control the Company.

Numerous employees have direct shareholdings in DEUTZ AG. There are no restrictions affecting the direct exercise of rights of control in connection with these shares.

Material agreements at DEUTZ AG that are subject to a condition requiring a change of control in the event of a takeover bid

In July 2007, by means of a private placement with US institutional investors, DEUTZ AG issued notes (bonds) with a total value of approximately US\$ 274 million. The notes had various terms of issue and maturities of five, seven and ten years. Under the terms of issue for these notes, holders can demand premature redemption if there is a change of control in the Company and, within a specified period after this change of control, any rating for the notes or other financial liability of the Company or of the controlling person with a residual maturity of at least five years

a) is withdrawn, or

b) is downgraded from investment grade to non-investment grade, or

c) if the notes or the financial liabilities have a non-investment grade rating at the time of the change of control, is not upgraded to investment grade.

A change of control is deemed to have taken place if, at an Annual General Meeting, a third party (or third parties acting jointly) elect(s) new shareholder representatives to all the shareholder positions on the Supervisory Board of DEUTZ AG or, at two successive Annual General Meetings of DEUTZ AG, a third party (or third parties acting jointly) control(s) more than 50 per cent of the votes represented at the meeting or acquire(s) more than 50 per cent of the issued capital in DEUTZ AG. However, this does not apply to control in the sense described if this control is acquired by AB Volvo or by companies controlled by AB Volvo or by the (indirect) shareholders of SAME DEUTZ-FAHR Holding & Finance B.V., providing these shareholders are members of the Carozza family, or by companies controlled by these shareholders. If DEUTZ AG needed to repay a considerable proportion of the notes in the event of a change of control, it would need to raise the necessary funds some other way in the short term.

The bilateral credit facilities agreed by DEUTZ AG are mostly subject to a change-of-control clause. Under this clause, the banks would be permitted in the event of a change of control and in the event of a resulting deterioration in the risk situation to tighten their lending terms or, if it proved impossible to reach an agreement on new terms, to terminate the loan agreement.

DEUTZ AG has no indemnification agreements with members of the Board of Management or employees that would come into force in the event of a takeover bid.

Explanatory statement by the Board of Management in connection with sections 289 (4) and 315 (4) HGB

The disclosures contained in the management report and group management report pursuant to sections 289 (4) and 315 (4) HGB relate to arrangements that may be significant in the success of any public takeover bid for DEUTZ AG. It is the opinion of the Board of Management that these arrangements are normal for publicly traded companies comparable with DEUTZ AG. Insofar as the terms of the private placement regarding a change of control link the premature repayment of the notes, among other things, to the withdrawal, downgrading or failure to achieve an upgrading in the rating of financial liabilities, the Board of Management hereby draws attention to the fact that DEUTZ AG currently does not hold any financial liabilities that are rated.

## REMUNERATION REPORT

Salaries of the members of the Board of Management: fixed, variable and long-term components

Total Board of Management remuneration for 2007 at DEUTZ AG was €3.4 million. The remuneration paid to the individual members of the Board of Management comprises fixed, variable and long-term performance-related components. The variable component of the remuneration is also performance-related and depends on the trend in performance indicators such as revenue, EBIT margin, ROCE and net financial position in the Group. In 2007, the Company launched a long-term incentive (LTI) plan for the Board of Management and the top level of senior management. Under this plan, virtual stock options are issued to senior executives to reward them for their sustained contribution to the Company's success. Before they receive stock options, those eligible must invest some of their own capital in DEUTZ shares. The stock options include the right to receive a cash payment at the end of a lock-up period of three years, providing the performance of DEUTZ shares meets the criteria specified in the plan. Under these criteria, the price of DEUTZ shares on the exercise date either must be 30 per cent above the defined reference price – the weighted average price of DEUTZ shares in the three months prior to the option grant date – or must have outperformed the Prime Industrial index by 30 per cent. Further information on remuneration can be found on page 48 of this annual report.

#### Remuneration of the Supervisory Board

The remuneration of the Supervisory Board is fixed by section 15 of the Statutes of the Company. This stipulates that the members of the Supervisory Board of DEUTZ AG receive a fixed annual remuneration of €12,500. They also receive a fee of €1,000 for each Supervisory Board meeting they attend and are reimbursed for their out-of-pocket expenses. Furthermore, each member of the Supervisory Board is paid a fixed amount of €2,000 for each percentage point by which the dividend exceeds 4 per cent of the Company's paid-up share capital; this amount is payable proportionately for fractions of percentage points. The chairman of the Supervisory Board receives double these amounts, and his deputy one-and-a-half times.

The chairmanship and membership of Supervisory Board committees are remunerated separately in accordance with the German Corporate Governance Code. DEUTZ also pays each member of a committee a fee of €1,000 for each committee meeting they attend. The chairman of a committee is entitled to twice this sum, his deputy to one-and-a-half times the amount. In addition, we reimburse the members of the Supervisory Board for any VAT they incur in connection with the performance of their mandate. Further information on the remuneration paid to the Supervisory Board can be found on page 49 in the notes to the financial statements.

## OVERALL ASSESSMENT OF 2007

#### Multiple upward forecast adjustments

Orders, unit sales and revenue all significantly exceeded the forecasts made at the start of the year. For this reason, we twice made an upward adjustment to our revenue forecast during the course of the year. Although we forecast growth of between 6 and 10 per cent initially, we were able to raise this forecast during the course of the year to 25 to 30 per cent. The actual revenue growth achieved of 31 per cent was above our forecast band. We also significantly exceeded our expectations in unit sales of engines. At the start of the year we were predicting sales of 269,000 engines, but the actual figure of over 284,300 engines sold was right in the middle of the revised target range of 280,000 to 290,000 engines – and this gain was hard earned. In order to ensure that we were seen as a reliable partner by our customers, we did our utmost to meet customer engine requirements, which turned out to be significantly greater than originally planned, even though this meant higher costs for us in the short term (logistics, production) owing to capacity bottlenecks both in our plants and at suppliers.

#### Exceptional factors increase costs

In 2007, costs were influenced by various exceptional factors. These included the start-up of production for engines between 75 and 130kW complying with the III A/Tier 3 emissions standards, the first full year of production for the Euro IV TCD 2013 engine and the ramp-up in production of the new engine series with capacities below four litres. There was also an impact from the commencement of production of air-cooled engines at the Ulm plant – production had been relocated there from Cologne at the start of the year – and from bottlenecks in the supply of parts.

These factors had an adverse impact on our EBIT margin. Nevertheless, the actual increase to 4.6 per cent (2006: 3.4 per cent) means that we have made a great deal of progress.

#### Encouraging key financials

The key financials also continued to improve in 2007. The excellent operating profit, the proceeds from the disposal of DEUTZ Power Systems and the conversion of bonds all contributed to an increase in the equity ratio to a level of around 40 per cent (before dividend distribution) – well above our earlier target of 25 per cent. This capital structure means that we are extremely well equipped to meet the challenges of the future. The growth in net income combined with asset management activities also improved ROCE in the year under review. We believe that the figures we have managed to achieve for the working capital ratio and ROCE are a huge success, especially as we have also undertaken significant expansion of the business at the same time. These figures represent an excellent starting point for further advances. The substantial proceeds from the disposal of DEUTZ Power Systems meant that, for the first time, we were able to report a positive net financial position, the figure as at 31 December 2007 being around €90 million.

#### First dividend distribution in over 20 years

Not least, we have achieved our long-term objective: to restore DEUTZ AG's ability to pay dividends based on 2007 performance onwards. For the first time in over 20 years we will be distributing a dividend to our shareholders.

## EVENTS AFTER THE REPORTING PERIOD

In mid-February, DEUTZ received notification of a threat of legal proceedings by an American customer claiming damages of more than US\$ 40 million. The action, which has only been justified in general terms, is without substance in the opinion of the Company because the engines were used in a manner contrary to instructions and liability for consequential loss is contractually excluded. A provision has been recognised in the annual financial statements to cover the risk in connection with the litigation.

On 22 February 2008, the American subsidiary of DEUTZ AG was also notified of a new action to be brought against the Company for the recovery of damages of an unspecified amount for alleged damage to health caused by asbestos. This action is being brought by two private persons against a total of more than 100 companies.

## RISK REPORT

### Risk management system: identifying both risks and opportunities

The changes in markets and economic conditions are ongoing and dynamic. Companies must act fast and respond even faster if they want to be successful over the long term. Systematic risk management is an important prerequisite, especially against the background of increasingly complex corporate structures and growing internationalisation.

DEUTZ AG itself operates in a variety of industries and regions worldwide and manages its business through a number of organisational units: the operating segments of the Group's parent company, subsidiaries, sales offices and authorised dealers. This organisational structure presents the Company with a large number of opportunities, but also gives rise to business-specific risks.

Our objective is to generate profits on a sustained basis and to increase these profits significantly over the years in order to develop the Company and secure its future. It is therefore essential to identify and assess business risks at an early stage and take corrective action where required. Since 1998, DEUTZ has therefore had an appropriate risk management system as required by the law.

A system of this kind is an important prerequisite for the success of a business. It raises employee awareness of existing and potential risks and heightens their sense of responsibility; it also provides them with support in identifying, analysing and communicating risks in good time and in taking effective corrective action where required.

The DEUTZ risk management system meets the requirements of the German Control and Transparency of Companies Act (KonTraG). The basic principles, monitoring standards, personnel responsibilities, functions and procedures in the risk management system have been identified by the Board of Management of DEUTZ AG and have been set out and defined in a manual that is continually updated in the light of new knowledge. A systematic reporting structure in conjunction with the Risk Management Committee ensures that all major risks are documented and communicated, and that appropriate corrective action is taken and documented at an early stage.

Normally – and this was the case in 2007 – risk inventories take place four times a year. These risk inventories are carried out in all functions and areas of the Company and in the main subsidiaries to identify whether new risks have arisen in respect of short-term and medium-term planning and whether and how any corrective action approved has affected or continues to affect risks already identified. The Risk Management Committee assesses the risks and makes proposals to the Board of Management, which then decides on appropriate measures to prevent or minimise the risk. In addition, risk officers and their employees are under an obligation to make ad-hoc reports independently of the regular reporting requirements if any new material risks arise or if there is an increase in the threat from known risks.

The Group's internal audit department and the independent auditors carry out an audit of risk management at DEUTZ AG each year to assess whether the system is functioning efficiently. The findings of the audits carried out in 2007 confirmed that the risk management system was functioning efficiently. As in prior years, suggested improvements, whether from the internal audit department, the independent auditors or from the Risk Management Committee, were implemented promptly.

#### Sales risks

In 2007, DEUTZ continued to minimise sales risks as far as possible.

In addition to the alignment of our development activities with our product strategies, close alliances with key customers such as Volvo and SAME DEUTZ-FAHR are also of considerable importance in enabling us to achieve our sales targets. Equally important is the further expansion of our market position in the Asia growth region. In August 2007, DEUTZ (Dalian) Engines Co. Ltd., a joint venture between DEUTZ AG and FAW Jiefang Automotive Co. Ltd., commenced operations in the northern Chinese city of Dalian. This joint venture provides DEUTZ with significantly better access to the fast-growing domestic market in China and lower-cost production facilities in the wider Asian market, which is extremely price sensitive.

New product developments incorporating the efficient use of energy resources also provide us with some security against future sales risks. In cooperation with the construction equipment manufacturer Atlas Weyhausen, we have become the first engine manufacturer to develop a hybrid drive design for construction equipment delivering improved performance with simultaneous fuel savings of up to 20 per cent. The hybrid drive is planned to be ready for production by 2010. This innovative technology was demonstrated publicly for the first time in spring 2007 at bauma, the world's largest trade fair for construction equipment held in Munich, Germany. At Agritechnica, the world's largest agricultural equipment trade fair held in Hannover, Germany, in the autumn, DEUTZ then became the first engine manufacturer to exhibit yet another new technology: the DEUTZ Natural Fuel Engine®, the production version of which can be run on rapeseed oil, a renewable fuel. Whereas the rapeseed-oil-powered engine is meeting short-term and medium-term market requirements, the hybrid drive is already anticipating market developments in the medium term and long term.

With customers distributed across a number of regions and industries, the sales structure of DEUTZ is well diversified. However, a critical factor influencing the success of DEUTZ in its markets is the trend in markets served by DEUTZ customers, and DEUTZ itself has no influence over these markets.

#### Production risks

In order to avoid mistakes in planning and capital expenditure, the necessary production capacity is planned using different timescales: over a number of years in medium-term planning generated once a year, for the following financial year in the context of budget planning (which is then updated monthly for the next twelve months on a rolling basis) and weekly by means of operating production planning with unit sales forecasts for the individual engine series and types. In the last few years, a rationalisation of production and a focus on core competences has also reduced the risk of under-utilising capacity. In addition, the Company is well equipped for the forecast growth in production: specific expansion of capacity, particularly at Cologne in Germany and Zafrá in Spain, the future procurement of core components from DEUTZ Dalian in China, and the allocation of supplementary production to externally contracted manufacturers will ensure reliable production output in future.

#### IT risks

In the year under review, DEUTZ AG continued the systematic development of its information and communication technology infrastructure and the range of applications used in line with the Company's strategic objectives. The Company's hardware and software technologies and systems continue to be updated by DEUTZ in close cooperation with external service providers. Further subsidiaries and associates of DEUTZ AG were integrated into existing DEUTZ processes and systems. Strategic business processes are handled using mySAP ERP 2005, which is proven software. To minimise the operating risk in DEUTZ's SAP system, we migrated in 2006 to an IT system with high-availability adaptive computing technology. The system is operated by the service provider on the basis of the principles in the current version of the de facto ITIL (IT Infrastructure Library) standard and is audited annually in accordance with the requirements of SAS 70 (Statement on Auditing Standard 70) issued by the American Institute of Certified Public Accountants. The strategy to consolidate information and communication technology will also be continued in 2008; the key area of development will be the integration of the equity investments in the Asia-Pacific region into DEUTZ's SAP system.

#### Organisational risks

Organisational risks are risks that arise from inadequate or non-harmonised organisational structures, processes, communication and information flows, procedures and guidelines. At DEUTZ, special central units therefore provide support to the individual operating units so that such risks are avoided. Centralisation of functions and services for all locations and segments ensures the application of standardised processes throughout the Company. This is also supported by appropriate Company-wide guidelines. All operating levels, including subsidiaries outside Germany, are integrated into a detailed planning, control and reporting system. The core elements of the system are: revolving short-term and medium-term plans, monthly budget/actual analyses, quarterly forecasts and regular review/planning meetings. This early-warning system ensures that management is in a position to instigate any necessary corrective action promptly.

Since 2006, a risk analysis has been added to medium-term planning. Worst-case and best-case scenarios are developed from the results of these analyses and reported to the Supervisory Board.

With the disposal of more subsidiaries in 2007, we were able to bring about a further reduction in the complexity of the Group and the time and effort required to manage it. This includes the disposal of DEUTZ Power Systems GmbH & Co. KG with its subsidiaries. We also continued the process of selling strategically unnecessary investments begun in 2004. As a result, corporate processes have become simpler, more transparent, less expensive and also less prone to risk.

#### Human resources risks

In a technology-oriented international company like DEUTZ, highly skilled employees are indispensable and irreplaceable as the basis for a successful business.

There are various risks in this regard: not keeping the skills of managers and specialist personnel up-to-date; not being able to recruit additional personnel quickly enough to meet the requirements of growth; and not being able to appoint suitably qualified managers and specialist employees to relevant posts. We counter these human resources risks by specifically analysing the skills and qualifications we need from our current and future employees and using this analysis to draw up appropriate measures targeting the development of individual managerial and technical capabilities. In addition, we offer our employees professional development opportunities both in Germany and abroad and demanding responsibilities in the various areas of the business. These activities allow us to align the capabilities of our employees with the growing requirements of the market on an ongoing basis and also to enhance employee loyalty to the Company by promoting personal success.

The systematic analysis of our demographic structure, together with targeted, proactive succession planning and skills development, prevents problems in recruiting personnel for managerial and technical positions that become available as existing employees reach retirement age. A focus of our activities in this regard is the development of suitable young managerial talent: each year, young, highly qualified management trainees with an international outlook are recruited to our internationally oriented management trainee programme, where the participants are groomed for later managerial responsibility.

#### Quality risks

We operate a central quality management system delivering quality assurance across all plants and segments of the business: sources of defects are systematically analysed, our own production processes optimised and the risks in production start-ups minimised. At the same time, central quality management also ensures there is a substantial reduction in warranty risks. In addition, DEUTZ has defined uniform standards for the selection of suppliers and uses process audits to achieve continuous improvement in supplier quality. Over the past few years, these quality activities have led to a significant reduction in the costs of errors and defects.

The basic principles of quality management are clearly set out in a quality management manual. The manual is broken down into three parts. The first part, 'Quality policy', describes the overall quality principles and definitions. The second part provides information on the most important quality processes. The third part explains the continuous improvement process and provides employees with information on numerous methods and systems for controlling and improving product and process quality. The manual is also available in an interactive online version on DEUTZ's intranet.

#### Financial risks

Annual financial planning and regular analysis of variances during the course of the year minimise our financial risks. A weekly rolling forecast is produced showing the cash inflows and outflows for the subsequent four weeks. Financial management in the Group is the responsibility of DEUTZ AG as the parent company. Head office cash pooling ensures optimum use of cash in the Group. The central finance department is also responsible for managing the investment of available cash and the arrangement of lines of credit or other financing to cover financing requirements in accordance with internal financing guidelines. DEUTZ AG has sufficient existing credit facilities with leading banks, although the use of these facilities is currently minimal.

With the issue of notes with a total value of US\$ 274 million under the US private placement during the year under review, we were able to open up broadly based financing from institutional investors in the US independently of the banks. The coupon is fixed for the entire maturity of the individual tranches (between five and ten years). Where interest payments and the repayment of the principal are due in US dollars, these payments are hedged over the entire term to maturity.

We protect ourselves against the risk from bad debts by constant IT-supported monitoring and regular analysis of receivables and their breakdown. The Company minimises the risk in its receivables to a large extent by the use of credit insurance. Exchange-rate risks are monitored under a centralised currency management system and reduced by the use of hedging transactions. DEUTZ is also taking specific action to increase the volume of purchasing in US dollars; this enables the company to counteract exchange rate risks from sales invoiced in US dollars.

#### Pension risks

Even after the surrender of over 7,300 vested company pension rights in 2007 in return for a compensatory payment, we still have a significant number of defined pension benefit obligations. The amount of these obligations is subject to certain risks arising specifically in connection with changes in life expectancy, the future amount of pension adjustments and the movement in interest rates on capital markets.

#### Procurement risks

It is not possible to fully rule out procurement risks caused by market bottlenecks and unforeseen price increases, particularly in the procurement of components, primary materials and services from third parties. We counter these risks by carrying out intensive supplier management based on procurement tools and key performance indicators, and by monitoring the market, which is becoming increasingly globally oriented. This is supported throughout the world by local implementation of procurement and logistics offices that make use of the infrastructure in DEUTZ subsidiaries outside Germany: these offices enable the Group to ensure a high level of quality and delivery performance, and at the same time to benefit from advantageous labour costs in growth markets.

Besides these global activities, there are three cornerstones to our procurement strategy for strategic components and parts for which supply is critical: long-term supplier relationships and supply agreements, increased dual sourcing and, where appropriate, allocation of production to subcontractors. These cornerstones amount to a proven strategy that allows us largely to minimise risk and secure capacity, thus actively supporting our continuing growth.

In the case of components with an aluminium content, price escalation clauses have been agreed with our suppliers based on market prices for aluminium. Our aluminium requirement for a full financial year is 9,600 tonnes. In the middle of 2007 we entered into raw-material swaps to hedge our exposure in respect of 3,000 tonnes of this aluminium. Exposure in respect of a further 3,300 tonnes was hedged in this way at the start of 2008. The price of aluminium is relatively volatile and has been subject to enormous increases over the last few years.

#### Legal risks

Existing and imminent legal disputes are recorded and analysed on an ongoing basis; they are assessed in terms of their legal and financial impact and covered by an appropriate amount added to ongoing risk provisioning.

On this basis, the management of DEUTZ AG can take appropriate action promptly and, where appropriate, recognise any necessary accounting provisions. Company-wide standards such as the 'General terms and conditions of business', sample contracts for various uses and implementation provisions in the form of organisational guidelines reduce the level of new legal risks at DEUTZ. The Legal Affairs Department and, if necessary, external lawyers are also regularly consulted for projects and the finalisation of contracts that fall outside the scope of the standards developed for day-to-day business.

In the year under review, we again managed to scale back the risks from litigation, in particular by the disposal of DEUTZ Power Systems. The claim by the Greek tax authorities against a Greek subsidiary of DEUTZ AG for supplementary tax payments and penalties amounting to a total of €35 million is still pending. There are also two legal actions brought by private persons against the American subsidiary of DEUTZ AG alleging damage to health caused by asbestos. In the year under review, two further American asbestos-related actions were concluded: one of the cases was dismissed; in the other case, we reached a settlement.

#### Future tax risks

The year under review saw the start of an external tax audit covering the tax assessment periods 2002 to 2005. We have not yet received the tax auditor's report. As things stand, the Company is not expecting any material risks.

#### Overall assessment of risk situation

There are no risks that, in themselves or in combination with other risks, have jeopardised or could jeopardise DEUTZ AG as a going concern in the year under review or thereafter.

## OUTLOOK

### Growth slackens<sup>1)</sup>

Following several outstanding years, global economic growth will settle down at a slightly lower level in 2008. Nevertheless, a growth rate of 3.8 per cent is still expected with a slight increase in economic risk: there is still some uncertainty, primarily in connection with the effects of the problems on financial markets and also as a result of possible further increases in the price of oil and raw materials. In addition, the mortgage crisis in the US has not yet come to an end and there could be a further noticeable slowdown in the US economy. The construction industry and consumer spending in particular could be hit by the fall in property values. However, capital expenditure outside the housing sector remains robust and sustained export growth is expected to provide further support for the American economy with the result that gross domestic product in the US is likely to grow by 1.6 per cent in 2008.

The prospects for Asia remain outstanding: with the exception of Japan, economic growth is forecast at 8.0 per cent. China continues to be the driving force with growth of 10.0 per cent, even though restrictive economic measures and a resulting weakening in capital expenditure growth are causing a slight cooling-off in the Chinese economy. Overall, the Asian economies, which are strongly dependent on exports to the US and therefore on the US economy, will ease off a little, but at a high level.

In the euro zone, the sustained strength of the euro – experts are predicting an exchange rate of US\$ 1.36 to €1.00 at the end of 2008 – will act as a brake on the economy, particularly in terms of exports. Gross domestic product is forecast to grow at approximately 1.6 per cent. In Germany, the upturn is likely to continue in 2008, but will be adversely affected by factors such as the increase in the oil price and the strong euro. Economic growth will be stimulated within Germany, particularly by strong domestic demand, primarily from consumers: gross domestic product is expected to rise by around 2.0 per cent in 2008. However, the strong euro will depress exports; there will also be an easing-off in capital expenditure, despite the sharp increases seen in 2007.

### Economic forecasts until 2009<sup>1)</sup>

In 2009, the forecast is for global growth of 4.2 per cent. A slight recovery is predicted for the USA, where the growth rate is forecast at 2.6 per cent. Asia (excluding Japan) will again generate growth of 8.0 per cent, consolidating at the level achieved in 2008, but still the strongest growth rate anywhere in the world. The forecast for growth in the countries of the euro zone is around 1.9 per cent, with Germany continuing to experience an uptrend with growth of 2.1 per cent.

### Industry perspective

For DEUTZ, economic growth in certain engineering-related industries is particularly important: these industries include the construction equipment industry, especially in Europe and the US, and the commercial-vehicles sector of the automotive industry, in which the 3.5 tonne to 16 tonne vehicles segment in Europe is particularly relevant for DEUTZ, as is increasingly the Chinese market owing to the DEUTZ Dalian joint venture. DEUTZ is also dependent on growth in the agricultural machinery industry, especially in Europe.

### Continuing boom in commercial vehicles<sup>1)</sup>

The commercial-vehicle boom in Europe is forecast to continue in 2008, driven by demand from central and eastern Europe. This demand is being stimulated by increasing mobility and logistics requirements. The largest global manufacturers of trucks also include Volvo, our alliance partner and largest customer for commercial-vehicle engines. As in 2007, Volvo is endeavouring to generate further growth in 2008. Demand in the European commercial-vehicles market is expected to grow by between 5 and 10 per cent in 2008.

<sup>1)</sup> Global economic data: Deutsche Bank Research

Industry data: German Engineering Federation (VDMA), EUROCONSTRUCT, VDMA Agricultural Machinery

#### Agricultural machinery on the up<sup>1)</sup>

The growth in the global population that needs to be fed, increasingly sophisticated consumer habits, climate change and the use of renewable resources are central issues that impact on the growth in demand and on the development of the global agricultural machinery industry. The basic conditions as far as agricultural policy in Europe is concerned are fixed until 2013 – until then, we are only likely to see minor adjustments in the current subsidy policy.

Global tractor production, which rose in both 2006 and 2007, is expected to continue to grow in 2008 and 2009. Manufacturers in the European Union – first and foremost in Germany and Italy – are the strongest players in the global market. As far as DEUTZ is concerned, the European agricultural machinery market, specifically the market for tractor engines, is particularly important. The upturn in the market will continue in 2008, especially in western Europe, because capital expenditure on agricultural equipment is benefiting from increasing farming incomes and better opportunities resulting from new operating models. The current market is dominated by four major manufacturers, each with several brands. Two of these well-known manufacturers have been key customers of DEUTZ for many years.

#### Engineering: slackening in the rate of growth<sup>1)</sup>

In 2008, the German engineering industry will grow at a slower rate. The German Engineering Federation (VDMA) is predicting that production will rise in real terms by 5 per cent. The order cushion will cover at least six months; currently 92 per cent of capacity is utilised. However, in the US, the most important export market for German engineering companies, there is now a downturn in demand, although this can be offset by deliveries to other export markets. Further problems could arise if there is a continuing rise in the value of the euro, since 75 to 80 per cent of German engineering output is export-oriented.

#### Moderate growth in the construction industry<sup>1)</sup>

EUROCONSTRUCT, the European trade association, is predicting that growth in 2008 will be just 1.8 per cent (2007: 2.5 per cent) for the housing, commercial and public-sector property, and civil engineering sectors. The critical factor is that there is expected to be a significant contraction in the housing sector in 2008, whereas the strongest stimulus is expected to come from civil engineering.

#### Statutory regulations: emissions standards come into force

Growth and unit sales of engines are strongly influenced by statutory provisions on emissions. These provisions lay down stringent requirements to be met by producers. From 1 January 2008, the Stage III A emissions standard for non-road applications in the 37kW to 75kW engine class became mandatory in the countries of the European Union (EU). From the same date, the Tier 3 standard came into force in the US for engines of 37kW to 75kW and Interim Tier 4 for engines of 19kW to 56kW. From January 2011, further emissions standards, depending on engine output class, will gradually come into force in the EU and in the US in the period up to 2014/2015.

For on-road applications, the Euro V emissions standard will come into force from 1 October 2009 in the EU.

#### Stability in raw material prices, collective pay agreements and US dollar exchange rate

Changes in the prices of steel scrap, copper and aluminium have a significant impact on our cost of materials. We anticipate that prices in 2008 will be maintained at the high level experienced in 2007. A further basic assumption is that, following the end of the current binding collective pay agreement in October 2008, there will be further pay increases for the remainder of the financial year equivalent to those in the previous agreements. We have hedged over 70 to 80 per cent of our exposure to movements in exchange rates for the US dollar; this does not take into account natural hedging, whereby we use US dollar revenue for component procurement denominated in US dollars.

#### Further growth in new orders, revenue and employee numbers

We predict that both new orders and revenue will increase by 10 to 15 per cent in 2008. Our underlying assumption is that the Compact Engines segment will achieve double-digit growth, and the DEUTZ Customised Solutions segment single-digit growth. In 2008, DEUTZ will expand in all regions, with the exception of North America; the distribution of revenue among the regions will be similar to that of 2007. This means that there will be a drop in the proportion accounted for by the Americas. However, the increase in the revenue in the DEUTZ Dalian joint venture means that there will be a reduction in the revenue in Asia. The number of employees is expected to rise slightly: we are predicting that there will be just under 4,200 employees at the end of 2008.

<sup>1)</sup> Global economic data: Deutsche Bank Research

Industry data: German Engineering Federation (VDMA), EUROCONSTRUCT, VDMA Agricultural Machinery

#### Unit sales up again

In 2008, unit sales are expected to grow at 10 per cent, thereby exceeding 300,000 engines with no significant changes in the product mix. Unit sales of air-cooled engines are predicted to decline at the same rate as the previous year. Given the purchases planned by some of our key customers, we are forecasting that unit sales of engine series with capacities greater than four litres will rise sharply compared with 2007.

#### Further increase in operating profit

Operating profit is expected to see a further improvement in 2008, with the EBIT margin reaching around 5 per cent. The tax rate will be below 15 per cent. Double-digit growth is forecast in both absolute and percentage terms for profit from ordinary activities.

#### Capital expenditure continues to be financed from the Company's own resources

In 2008, capital expenditure will amount to around €98 million (property, plant and equipment and intangible assets); over 85 per cent of this figure will be accounted for by the Compact Engines segment and around 15 per cent by the DEUTZ Customised Solutions segment. In the current circumstances, there are no plans to raise any financing in connection with the planned capital expenditure. Of this capital expenditure, around 22 per cent will be used for the expansion of capacity and around 24 per cent for replacement investment. Over 10 per cent in each segment will be invested in the development of new products, the refinement of existing engines and in structural changes. These figures do not include strategic capital expenditure, such as the DEUTZ Dalian joint venture. Any such expenditure in 2008 would be financed from the available funds.

The greatest proportion of this capital expenditure (over 39 per cent) will go to the Cologne-Porz site; around 15 per cent will be invested in Cologne-Deutz (mechanical fabrication). However, close cooperation with our suppliers is playing an increasingly important role: over 26 per cent of the funds will be dedicated to new tools for our suppliers.

#### Research and development for the future

Our future success is critically dependent on the innovative capabilities of our developers and on our ability to turn technological requirements into products that can be used in practice. Our culture of technical innovation therefore remains one of the key elements in our success. In 2008, DEUTZ will consequently allocate over €80 million to research and development – around 5 per cent of forecast revenue. A high priority will be given to the systematic further development of our products for the III B emissions standard in Europe and Interim Tier 4 standard in the US, both due to come into force from 2011 onwards. Our efforts will be concentrated primarily on reducing emissions within the engines themselves and by the use of exhaust-gas aftertreatment systems.

#### Up to 120,000 engines from Dalian

In 2008, we will continue to focus on the smooth start-up of DEUTZ engine production at the new plant and – associated with this – on securing the supply of materials from local suppliers. Our intention is also to develop supplier relationships so that they can supply parts to meet the requirements of the German assembly plants. We will also continue to expand the production capacity for cylinder heads and crankcases at DEUTZ Dalian to meet the requirements of the joint venture itself and those of the German assembly plants.

To date, the organisation and processes have been primarily oriented around the commercial-vehicle engines business; in the course of 2008 these structures will be expanded and modified to include non-road applications, such as engines for construction equipment. At the same time, we intend to build up marketing and distribution of DEUTZ engines 'made in China' so that we can secure and gain a further share of the Chinese market.

The DEUTZ Dalian joint venture is forecast to manufacture approximately 100,000 to 120,000 engines in 2008. We are expecting sales of 80,000 to 100,000 units for engines with local technology. The new plant, manufacturing engines with DEUTZ technology, is expected to achieve unit sales of around 20,000 engines.

In the first full financial year of the joint venture, which is still the start-up phase for the project, we are expecting the contribution to net income to be a moderate negative single-digit million euro amount.

#### Outlook for 2009

We are also forecasting a further increase in new orders and revenue for 2009, although the growth rates will be lower than in 2008: we are expecting a single-digit growth rate, but close to 10 per cent. We intend to continue to improve operating profit in both segments, resulting in a slight increase in the EBIT margin. This includes the achievement of break-even at DEUTZ Dalian.

Capital expenditure will again be around €95 million; R&D expenditure will be maintained at a high level, similar to the amount allocated in 2008.

This management report includes certain statements about future events and developments, together with disclosures and estimates provided by the Company. Such forward-looking statements include known and unknown risks, uncertainties and other factors that may mean that the actual performances, developments and results in the Company or those in sectors important to the Company are significantly different (especially from a negative point of view) from those expressly or implicitly assumed in these statements. The Board of Management cannot therefore make any warranty with regard to the statements made in this management report. The Company gives no undertaking that it will update forward-looking statements to bring them into line with future developments.

# Annual financial statements DEUTZ AG

## BALANCE SHEET

<b>Assets</b>	Note	31/12/2007	31/12/2006
€ million			
<b>Expenses for the expansion of operations</b>		<b>20.8</b>	<b>31.1</b>
Intangible assets		29.6	29.1
Property, plant and equipment		280.1	303.7
Financial assets		181.9	164.6
<b>Fixed assets</b>	1	<b>491.6</b>	<b>497.4</b>
Inventories	2	149.3	109.2
Receivables and other assets	3	271.6	229.5
Cash and cash equivalents	4	298.1	36.7
<b>Current assets</b>		<b>719.0</b>	<b>375.4</b>
Prepaid expenses	5	3.7	2.4
<b>Total assets</b>		<b>1,235.1</b>	<b>906.3</b>
<b>Equity and liabilities</b>			
Issued capital		307.0	292.3
Additional paid-in capital		26.2	21.9
Retained earnings			
Legal reserve		4.5	0.4
Other retained earnings		74.6	0
Accumulated income		82.2	7.7
<b>Equity</b>	6	<b>494.5</b>	<b>322.3</b>
Profit-sharing rights	6	0.0	0.0
Provisions	7	320.9	339.3
Other liabilities	8	419.7	244.7
<b>Total equity and liabilities</b>		<b>1,235.1</b>	<b>906.3</b>

## INCOME STATEMENT

	2007	2006
€ million		
Revenue	1,443.1	1,103.0
Change in inventories	13.1	9.1
Other own work capitalised	0.4	0.2
<b>Total output</b>	<b>1,456.6</b>	<b>1,112.3</b>
Other operating income	78.9	74.2
Cost of materials	-1,043.2	-771.2
Staff costs	-237.0	-211.4
Depreciation, amortisation and impairment	-63.5	-56.0
Other operating expenses	-138.6	-120.9
Net investment income	13.4	10.0
Net interest income (expense)	-14.3	-16.4
<b>Profit from ordinary activities</b>	<b>52.3</b>	<b>20.6</b>
Net extraordinary expense	119.5	12.0
Income taxes	-18.0	-2.2
Other taxes	-0.6	-0.7
<b>Net income</b>	<b>153.2</b>	<b>29.7</b>
Profit carried forward	7.7	-21.6
Additions to legal reserves	-4.1	-0.4
Additions to other retained earnings	-74.6	0.0
<b>Accumulated income</b>	<b>82.2</b>	<b>7.7</b>

## Notes to the financial statements

### STATEMENT OF CHANGES IN FIXED ASSETS

	Gross figures Acquisition and production costs								Gross figures Depreciation, amortisation and impairment							Net figures	
	1/1/2007	Additions	Investment grants	Additions Group companies	Disposals Group companies	Disposals	Reclassifications	31/12/2007	1/1/2007	Additions <sup>1)</sup>	Disposals Group companies	Disposals	Write-ups	Reclassifications	1/12/2007	31/12/2007	31/12/2006
thousand																	
<b>Expenses for the expansion of operations</b>	<b>41,513</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>41,513</b>	<b>10,378</b>	<b>10,378</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>20,756</b>	<b>20,757</b>	<b>31,135</b>
Patents, licences, trademarks and similar rights and assets, including licences for such rights and assets	97,252	11,587	-1,606	0	0	24	253	107,462	68,128	9,695	0	24	0	0	77,799	29,663	29,124
<b>Intangible assets</b>	<b>97,252</b>	<b>11,587</b>	<b>-1,606</b>	<b>0</b>	<b>0</b>	<b>24</b>	<b>253</b>	<b>107,462</b>	<b>68,128</b>	<b>9,695</b>	<b>0</b>	<b>24</b>	<b>0</b>	<b>0</b>	<b>77,799</b>	<b>29,663</b>	<b>29,124</b>
Land, leasehold rights and buildings, including buildings on land owned by others	210,606	2,084	-200	203	0	39,174	73	173,592	47,279	6,402	0	6,640	0	0	47,041	126,551	163,327
Technical equipment and machines	315,485	17,966	-8	597	635	3,843	7,581	337,143	224,359	24,766	26	3,742	0	0	245,357	91,786	91,126
Other equipment, furniture and fixtures	154,259	18,780	-1,256	467	0	14,651	673	158,272	119,030	13,847	0	14,628	0	0	118,249	40,023	35,228
Advances paid and construction in progress	14,046	16,283	-36	0	0	0	-8,580	21,713	0	0	0	0	0	0	0	21,713	14,046
<b>Property, plant and equipment</b>	<b>694,396</b>	<b>55,113</b>	<b>-1,500</b>	<b>1,267</b>	<b>635</b>	<b>57,668</b>	<b>-253</b>	<b>690,720</b>	<b>390,668</b>	<b>45,015</b>	<b>26</b>	<b>25,010</b>	<b>0</b>	<b>0</b>	<b>410,647</b>	<b>280,073</b>	<b>303,727</b>
Investments in affiliated companies	241,387	2,428	0	17,044	0	109,977	0	150,882	116,141	0	0	50,263	0	0	65,878	85,004	125,246
Long-term equity investments	9,291	57,782	0	0	0	0	0	67,073	3,608	0	0	0	0	0	3,608	63,465	5,683
Loans to other long-term investees and investors	41,420	0	0	0	0	5,788	0	35,632	9,100	0	0	5,600	0	0	3,500	32,132	32,320
Other loans	2,108	0	0	0	0	5	0	2,103	796	0	0	0	0	0	796	1,307	1,312
<b>Financial assets</b>	<b>294,206</b>	<b>60,210</b>	<b>0</b>	<b>17,044</b>	<b>0</b>	<b>115,770</b>	<b>0</b>	<b>255,690</b>	<b>129,645</b>	<b>0</b>	<b>0</b>	<b>55,863</b>	<b>0</b>	<b>0</b>	<b>73,782</b>	<b>181,908</b>	<b>164,561</b>
<b>Fixed assets</b>	<b>1,085,854</b>	<b>126,910</b>	<b>-3,106</b>	<b>18,311</b>	<b>635</b>	<b>173,462</b>	<b>0</b>	<b>1,053,872</b>	<b>588,441</b>	<b>54,710</b>	<b>26</b>	<b>80,897</b>	<b>0</b>	<b>0</b>	<b>562,228</b>	<b>491,644</b>	<b>497,412</b>
<b>Total</b>	<b>1,127,367</b>	<b>126,910</b>	<b>-3,106</b>	<b>18,311</b>	<b>635</b>	<b>173,462</b>	<b>0</b>	<b>1,095,385</b>	<b>598,819</b>	<b>65,088</b>	<b>26</b>	<b>80,897</b>	<b>0</b>	<b>0</b>	<b>582,984</b>	<b>512,401</b>	<b>528,547</b>

1) The figure reported for depreciation, amortisation and impairment in the income statement differs by 11.5 million because impairment losses of 11.5 million have been included in net extraordinary expense (Sale DEUTZ Power Systems).

## STATEMENT OF CHANGES IN EQUITY

	Issued capital	Additional paid-in capital	Retained earnings	Accumulated income	Total
€ thousand					
<b>Balance at 1 January 2006</b>	<b>242,873</b>	<b>15,336</b>	<b>0</b>	<b>-21,562</b>	<b>236,647</b>
Increased through conversion of convertible profit-sharing rights & convertible bonds	49,398	6,586	0	0	<b>55,984</b>
Net profit for 2006	0	0	0	29,673	<b>29,673</b>
Additions to retained earnings	0	0	406	-406	<b>0</b>
<b>Balance at 31 December 2006</b>	<b>292,271</b>	<b>21,922</b>	<b>406</b>	<b>7,705</b>	<b>322,304</b>
Increased through conversion of convertible profit-sharing rights & convertible bonds	14,721	4,306	0	0	<b>19,027</b>
Net loss for 2007				153,207	<b>153,207</b>
Additions to retained earnings	0	0	4,065	-4,065	<b>0</b>
Additions to other retained earnings			74,600	-74,600	<b>0</b>
<b>Balance at 31 December 2007</b>	<b>306,992</b>	<b>26,228</b>	<b>79,071</b>	<b>82,247</b>	<b>494,538</b>

## BASIS OF PRESENTATION

The annual financial statements of DEUTZ AG for the financial year 2007 have been prepared in accordance with the requirements of the German Commercial Code (HGB) (sections 238 et seq., sections 264 et seq.) and the supplementary requirements of the German Stock Corporation Act (AktG).

In the interest of clarity, some items on the face of the balance sheet and the income statement have been aggregated and are reported separately in the notes to the financial statements. The income statement has been prepared using the nature-of-expense method.

## ACCOUNTING POLICIES

### Expenses for the expansion of operations

This item comprises expenses incurred in connection with the development of the Commercial Vehicles market segment. Amortisation is over four years in accordance with section 282 HGB. In the year under review, amortisation on expenses previously capitalised amounted to €10.4 million.

### Fixed assets

**Intangible assets** are recognised at amortised cost over a useful life of three to eight years.

**Property, plant and equipment** are recognised at cost and, if depreciable, take account of depreciation.

Investment grants from customers are deducted from the cost of intangible assets and property, plant and equipment. Additions to property, plant and equipment resulting from Group companies in the amount of €1.3 million were translated using the closing rate applicable on 1 October 2007.

Buildings are depreciated in accordance with tax rules. They are depreciated over their estimated useful life. Movable assets are generally depreciated on a straight-line basis *pro rata temporis* over their typical useful life.

The following useful lives are generally used for depreciation purposes:

	Useful life (years)	Deprecia- tion rate (%)
Buildings and grounds	5 to 40	2.5 to 20
Technical equipment and machines	10 to 20	5 to 10
Other equipment, furniture and fixtures	3 to 10	10 to 33.3

Impairment charges are recognised if the fair value of the assets is lower at the balance sheet date.

**Investments in affiliated companies and long-term equity investments** are recognised at cost less commercially necessary impairment; loans are always recognised at their nominal value. Non-interest-bearing and low-interest **loans** are discounted to their present value.

### Current assets

**Raw materials, consumables and bought-in parts** are recognised at the lower of cost or market price. The cost of purchase is based on weighted average procurement prices. **Work in progress and finished goods** are valued at the cost of conversion, which includes directly attributable costs, a proportion of indirect labour and indirect materials and administration costs that are eligible for capitalisation pursuant to section 255 (2) HGB.

If the realisable selling price less future costs is lower, this amount is recognised. Additional write-downs are applied to cover risks resulting from inventories' period of storage and impaired usability as well as contract-related losses.

Appropriate impairment charges are recognised against **receivables and other assets** to take account of all identifiable commercial and political risks. General write-downs are recognised for non-specific credit risk. Non-interest-bearing receivables with maturities of more than one year are discounted. Foreign-currency receivables falling due within one year are recognised at the spot rates on the balance sheet date. Longer-term receivables are recognised at the hedging rate or at the lower of the rate on the date they were posted or the balance sheet date.

Hedging transactions not associated with longer-term receivables or pending orders on hand are marked to market on the balance sheet date.

### **Provisions for pensions and other post-retirement benefits**

Provisions for pensions are recognised under the tax-based entry-age normal method (section 6a of the German Income Tax Act [EStG]) using the generation mortality tables 2005 G of Prof. Dr Klaus Heubeck with a discount rate of 6 per cent. Financing is based on the minimum pensionable age in accordance with the 1999 German Pension Reform Act (RRG99).

To improve the informative value of the annual financial statements, the accrued interest cost for pension obligations is not recognised as part of staff costs, but as interest expenses.

### **Other provisions**

Appropriate provisions have been recognised for all identifiable risks and contingent liabilities at the balance sheet date.

### **Liabilities**

All liabilities are recognised at their repayment amount. The same rules apply to the valuation of foreign-currency liabilities as described above for foreign-currency receivables.

The convertible bond issued in 2004 had a coupon of 3.95% and matured in 2009. The price of the conversion right determined on the basis of the discounted benefit of the low-interest-bearing nature was transferred to additional paid-in capital. Based on the option provided by section 250 (3) HGB, prepaid expenses were recognised in an equivalent amount and amortised over the term of the bond. In the event of early conversion, the pro rata discount is taken directly to additional paid-in capital.

The Management Board of DEUTZ AG, Cologne, with the consent of the Supervisory Board, cancelled the convertible bond issued in 2004 on 6 February 2008, with effect from 7 March 2008. At 31 December 2007, 839,263 convertible bonds were still outstanding, which equates to 4.2 per cent of the original issue volume. On redemption, bondholders will receive the par value of €3.40 plus accrued interest. Until 3 March 2008, however, bondholders had the option of converting each bond into one DEUTZ share. Of the outstanding 839,263 bonds, 729,321 had been converted into DEUTZ shares by 29 February 2008.

DEUTZ AG issued bonds worth USD 274 million (€203 million) as part of a private placement in the United States and recognised them at cost.

### **Derivative financial instruments**

Derivative financial instruments (currency forwards, currency options, interest-rate swaps) are used exclusively for hedging purposes in the context of operating activities.

Derivative financial instruments (currency forwards, currency options, interest-rate swaps) are used exclusively for hedging purposes in the context of operating activities. The portion of the fair value changes recognised in profit or loss in the amount of €1.6 million was reported in other provisions and is attributable to the measurement of the commodity swap (€0.8 million) and to currency hedging (€0.8 million).

The following derivative financial instruments were reported as at the balance sheet date:

	Notional amount 2007	Notional amount 2006	Fair value 2007	Fair value 2006
€ million				
Currency forwards	57.0	32.3	1.9	0.6
Currency options	0.0	62.1	0.0	0.8
Interest rate swaps	0.0	26.2	0.0	0.6
Cross-currency swap	160.2	0.0	-7.8	0.0
Commodities	7.0	0.0	-0.8	0.0

Bank assessments were used where available to ascertain fair value. The banks calculate the market values using a recognised valuation method (present value method) based on current market interest rates and foreign exchange rates.

## NOTES TO THE BALANCE SHEET AND THE INCOME STATEMENT

### 1. FIXED ASSETS

Fixed assets decreased slightly by €5.8 million compared to the previous year, as detailed below: Intangible assets were impacted by capital expenditures (net of investment grants) of €10.0 million and amortisation and impairment of €9.7 million.

Property, plant and equipment declined by €23.6 million year-on-year. Additions (net of investment grants) in the amount of €53.6 million and additions from Group companies amounting to €1.3 million are offset primarily by the disposal of investment property in connection with the sale of the DEUTZ Power Systems segment in the amount of €32.5 million as well as depreciation and impairment of €45.0 million.

The additions to property, plant and equipment comprised capital expenditure for expanding capacity in Cologne in the Compact Engines segment within the framework of its growth strategy and capital expenditure for both pioneering and environmentally friendly projects in Ulm in the DEUTZ Customised Solutions segment, including our new logistics centre.

Financial assets increased in a total amount of €17.3 million. The additions relate to the acquisition of a shareholding of 50 per cent in the Chinese joint venture DEUTZ Dalian/China (€57.8 million) as well as to foreign Group companies (€19.5 million). The disposals of investments in affiliated companies and other long-term investees and investors in the amount of €59.9 million relate to the sale of the DEUTZ Power Systems segment.

### 2. INVENTORIES

	31/12/2007	31/12/2006
€ thousand		
Raw materials, consumables, bought-in parts and spare parts	103,987	76,500
Work in progress	34,562	24,381
Finished goods	10,378	7,517
	<b>148,927</b>	<b>108,398</b>
Advances paid	2,302	1,945
	<b>151,229</b>	<b>110,343</b>
Advances received for orders	-1,968	-1,107
<b>Total</b>	<b>149,261</b>	<b>109,236</b>

### 3. RECEIVABLES AND OTHER ASSETS

€ thousand	Thereof residual maturity up to 1 year	Thereof residual maturity over 1 year	31/12/2007 Total	31/12/2006 Total
Trade receivables	125,342	0	125,342	62,917
Receivables from affiliated companies	82,599	0	82,599	109,188
Receivables from other long-term investees and investors	3,601	0	3,601	3,397
Other assets	54,448	5,649	60,097	53,918
<b>Total</b>	<b>265,990</b>	<b>5,649</b>	<b>271,639</b>	<b>229,420</b>

Trade receivables account for €44,669 thousand of the total receivables due from affiliated companies and €2,128 thousand of the total receivables from long-term investees and investors (31 December 2008: €59,937 thousand and €2,099 thousand respectively).

### 4. CASH AND CASH EQUIVALENTS

This item comprises cash on hand and credit balances held with banks. The increase results from the sale of the DEUTZ Power Systems segment.

### 5. PREPAID EXPENSES

Prepaid expenses amounting to €3.7 million (2006: €2.4 million) primarily comprise prepaid items for interest, pension payments and other expenses.

### 6. EQUITY

#### Issued capital

At the end of 2007, the issued capital (share capital) of DEUTZ AG amounted to €306,992,504.46 (31 December 2006: €292,270,841.53) and was divided into 120,085,030 no-par-value bearer shares (31 December 2006: 114,326,416).

In 2007, 5,758,434 (2006: 9,339,625) convertible bonds and 18 (2006: 998,317) convertible profit-sharing rights were converted into a total of 5,758,614 (2006: 19,322,795) no-par-value shares in DEUTZ AG.

#### Notifications under the German Securities Trading Act

The German Securities Trading Act (WpHG) obliges investors whose share of voting rights in listed companies reaches certain thresholds to notify the company accordingly. We have been notified of the following shareholdings:

AB Volvo (publ), SE-40508 Gothenburg, Sweden, notified pursuant to sections 21 (1) and 24 of the WpHG that its shareholding in DEUTZ AG fell below the 10 per cent threshold on 23 October 2003 and now amounts to 7.09 per cent of the voting rights.

SAME DEUTZ-FAHR Group S.p.A., V. le Cassani 14, 24047 Treviglio (BG), Italy, notified pursuant to sections 21 (1) and 24 of the WpHG that the shareholding of SAME DEUTZ-FAHR Holding & Finance BV, Herengracht 548, 1017 CG Amsterdam, Netherlands, in DEUTZ AG exceeded the 25 per cent threshold on 2 July 2004 and now

amounts to 29.90 per cent of the voting rights. These voting rights are attributable to SAME DEUTZ-FAHR Group S.p.A. pursuant to section 22 (1) number 1 of the WpHG.

In a letter dated 6. June 2006, INTAL INTERNATIONAL S.A., Luxembourg, notified the following pursuant to section 21 et seq. of the WpHG:

"The share of voting rights held by SAME DEUTZ-FAHR Holding & Finance B.V., Rokin 55, 1012 KK Amsterdam, Netherlands, in DEUTZ AG exceeded the thresholds of 5 and 10 per cent on 21 November 2003; on 21 November 2003, this share amounted to 14.47 % per cent and is now 38.88 per cent. Pursuant to section 22 (1) sentence 1 number 1 and section 22 (3) WpHG, the voting rights are fully attributable to SAME DEUTZ-FAHR Group S.p.A., V. le Cassani 14, 24047 Treviglio (BG), Italy. As a result, the share of voting rights held by SAME DEUTZ-FAHR Group S.p.A. in DEUTZ AG on 21 November 2003 also exceeded the thresholds of 5 and 10 per cent; on 21 November 2003 this share amounted to 14.47 per cent and is now 38.88 per cent.

We, INTAL INTERNATIONAL S.A., 54, Boulevard Napoleon 1er, 2210 Luxembourg, hereby notify you, pursuant to sections 21 et seq. of the WpHG, in our own name and in the name of, and on the behalf of, the company and individuals specified under (i) and (ii) below that the share of voting rights held in DEUTZ AG by

(i) Intractor B.V., Rokin 55, 1012 KK Amsterdam, Netherlands;

(ii) Messrs Vittorio Carozza, Francesco Carozza and Aldo Carozza and Ms Carozza-Cassani, V. le Cassani 14, 24047 Treviglio (BG), Italy; and

(iii) INTAL INTERNATIONAL S.A., 54, Boulevard Napoléon 1er, 2210 Luxembourg, exceeded the thresholds of 5 and 10 per cent on 21 November 2003, with the share on 21 November 2003 amounting to 14.47 per cent and now standing at 38.88 per cent. These voting rights are fully attributable to the companies and natural persons specified under (i) to (iii) above pursuant to section 22 (1) sentence 1 number 1 and section 22 (3) of the WpHG."

In a further letter dated 6 June 2006, INTAL INTERNATIONAL S.A., Luxembourg, notified the following pursuant to section 21 et seq. of the WpHG:

"The share of voting rights held by SAME DEUTZ-FAHR Holding & Finance B.V., Rokin 55, 1012 KK Amsterdam, Netherlands, in DEUTZ AG exceeded the threshold of 25 per cent on 2 July 2004; on 2 July 2004, this share amounted to 29.90 per cent and is now 38.88 per cent. Pursuant to section 22 (1) sentence 1 number 1 and section 22 (3) WpHG, the voting rights are fully attributable to SAME DEUTZ-FAHR Group S.p.A., V. le Cassani 14, 24047 Treviglio (BG), Italy. As a result, the share of voting rights held by SAME DEUTZ-FAHR Group S.p.A. in DEUTZ AG on 2 July 2004 also exceeded the threshold of 25 per cent; on 2 July 2004, this share amounted to 29.90 per cent and is now 38.88 per cent.

We, INTAL INTERNATIONAL S.A., 54, Boulevard Napoleon 1er, 2210 Luxembourg, hereby notify you, pursuant to sections 21 et seq. of the WpHG, in our own name and in the name of, and on the behalf of, the company and individuals specified under (i) and (ii) below that the share of voting rights held in DEUTZ AG by

(i) Intractor B.V., Rokin 55, 1012 KK Amsterdam, Netherlands;

(ii) Messrs Vittorio Carozza, Francesco Carozza und Aldo Carozza and Ms Carozza-Cassani, V. le Cassani 14, 24047 Treviglio (BG), Italy; and

(iii) INTAL INTERNATIONAL S.A., 54, Boulevard Napoléon 1er, 2210 Luxembourg, exceeded the threshold of 25 per cent on 2 July 2004, with the share on 2 July 2004 amounting to 29.90 per cent and now standing at 38.88 per cent. These voting rights are fully attributable to the companies and natural persons specified under (i) to (iii) above pursuant to section 22 (1) sentence 1 number 1 and section 22 (3) of the WpHG."

In a letter dated 15 November 2006, INTAL INTERNATIONAL S.A., Luxembourg, notified the following pursuant to section 21 et seq. of the WpHG:

"We, INTAL INTERNATIONAL S.A., 54, Boulevard Napoleon 1er, 2210 Luxembourg, hereby notify you, pursuant to sections 21 et seq. of the WpHG, that the share of the voting rights held by INTAL INTERNATIONAL S.A., 54, Boulevard Napoleon 1er, 2210 Luxembourg, in DEUTZ AG on 8 November 2006 fell below the thresholds of 5 per cent, 10 per cent and 25 per cent and now amounts to 0 per cent."

In a letter dated 15 November 2006, Belfort S.A., Luxembourg, notified the following pursuant to sections 21 et seq. of the WpHG:

"We, Belfort S.A., 54, Boulevard Napoléon 1er, 2210 Luxembourg, hereby notify you, pursuant to sections 21 et seq. of the WpHG, that the share of the voting rights held by Belfort S.A., 54, Boulevard Napoléon 1er, 2210 Luxembourg, in DEUTZ AG on 8 November 2006 exceeded the thresholds of 5 per cent, 10 per cent and 25 per cent and is now 40.32 per cent. These voting rights are attributable to us pursuant to section 22 (1) sentence 1 number 1 and section 22 (3) of the WpHG."

In fiscal year 2007, the parent company (DEUTZ AG) did not receive any new notifications in relation to the above.

In fiscal year 2007, DEUTZ AG received the following new notifications.

JPMorgan Chase & Co., 270 Park Avenue, New York, NY 10017, USA, notified, pursuant to section 21 (1) of the WpHG, that the share of voting rights held by JPMorgan Chase & Co. in DEUTZ AG on 27 February 2007, exceeded the threshold of 3 per cent and now amounts to 3.02 per cent. The voting rights are attributable to JPMorgan Asset Management Holdings Inc. pursuant to section 22 (1) sentence 1 numbers 1 and 6 in conjunction with sentence 2 of the WpHG.

JPMorgan Asset Management Holding Inc., 270 Park Avenue, New York, NY 10017, USA, notified, pursuant to section 21 (1) of the WpHG, that the share of voting rights held by JPMorgan Asset Management Holding Inc. in DEUTZ AG on 27 February 2007, exceeded the threshold of 3.00 per cent and now amounts to 3.00 per cent. The voting rights are attributable to JPMorgan Asset Management Holdings Inc. pursuant to section 22 (1) sentence 1 numbers 1 and 6 in conjunction with sentence 2 of the WpHG.

JPMorgan Chase & Co., 270 Park Avenue, New York, NY 10017, USA, notified, pursuant to section 21 (1) of the WpHG, that the share of voting rights held by JPMorgan Chase & Co. in DEUTZ AG on 19 April 2007, fell below the threshold of 3 per cent and now amounts to 2.92 per cent. The voting rights are attributable to JPMorgan Asset Management Holdings Inc. pursuant to section 22 (1) sentence 1 numbers 1 and 6 in conjunction with sentence 2 of the WpHG.

JPMorgan Asset Management Holding Inc., 270 Park Avenue, New York, NY 10017, USA, notified, pursuant to section 21 (1) of the WpHG, that the share of voting rights held by JPMorgan Asset Management Holding Inc. in DEUTZ AG on 19 April 2007, fell below the threshold of 3.00 per cent and now amounts to 2.90 per cent. The voting rights are attributable to JPMorgan Asset Management Holdings Inc. pursuant to section 22 (1) sentence 1 numbers 1 and 6 in conjunction with sentence 2 of the WpHG.

Fidelity Investments International Limited, Kingswood Fields, Millfield Lane, Lower Kingswood, Tadworth, Surrey, KT20 6RB, UK, notified the following in its letter dated 10 May 2007, pursuant to sections 21 (1) and 22 (1) of the WpHG: "Pursuant to section 21 (1) of the German Securities Trading Act (WpHG), we hereby notify you that the share of the voting rights held by FMR Corp., 82 Devonshire Street, Boston, Massachusetts 02109, USA, in DEUTZ AG exceeded the threshold of 5 per cent on 4 May 2007, and now amounts to 5.05 per cent. This share of the voting rights was attributable to Fidelity Management & Research Company pursuant to section 22 (1) number 1 of the WpHG."

In a letter dated 14 May 2007, Fidelity International Limited, Kingswood Fields, Millfield Lane, Lower Kingswood, Tadworth, Surrey KT20 6RB, UK, corrected its notification of 10 May 2007 as follows:

"Pursuant to section 21 (1) of the German Securities Trading Act (WpHG), we hereby notify you that the share of the voting rights held by FMR Corp., 82 Devonshire Street, Boston, Massachusetts 02109, USA, in DEUTZ AG exceeded the threshold of 5 per cent on 4 May 2007, and now amounts to 5.05 per cent. This share of the voting rights was attributable to Fidelity Management & Research Company pursuant to section 22 (1) number 2 in conjunction with section 22 (1) sentence 2 in conjunction with section 22 (1) sentence 1 number 6 of the WpHG."

Fidelity Investments International Limited, Kingswood Fields, Millfield Lane, Lower Kingswood, Tadworth, Surrey, KT20 6RB, UK, notified the following in its letter dated 14 May 2007, pursuant to sections 21 (1) and 22 (1) of the WpHG:

"Pursuant to section 21 (1) of the German Securities Trading Act (WpHG), we hereby notify you that the share of the voting rights held by FMR Corp., 82 Devonshire Street, Boston, Massachusetts 02109, USA, in DEUTZ AG fell below the threshold of 5 per cent on 11 May 2007, and now amounts to 4.93 per cent. This share of the voting rights was attributable to Fidelity Management & Research Company pursuant to section 22 (1) number 2 in conjunction with section 22 (1) sentence 2 in conjunction with section 22 (1) sentence 1 number 6 of the WpHG."

Fidelity Investments International Limited, Kingswood Fields, Millfield Lane, Lower Kingswood, Tadworth, Surrey, KT20 6RB, UK, notified the following in its letter dated 17 July 2007, pursuant to sections 21 (1) and 22 (1) of the WpHG:

"Pursuant to section 21 (1) of the German Securities Trading Act (WpHG), we hereby notify you that the share of the voting rights held by FMR Corp., 82 Devonshire Street, Boston, Massachusetts 02109, USA, in DEUTZ AG fell below the threshold of 3 per cent on 16 July 2007, and now amounts to 2.98 per cent. This share of the voting rights was attributable to Fidelity Management & Research Company pursuant to section 22 (1) number 2 in conjunction with section 22 (1) sentence 2 in conjunction with section 22 (1) sentence 1 number 6 of the WpHG."

In a letter dated 17 July 2007, Fidelity International Limited, Kingswood Fields, Millfield Lane, Lower Kingswood, Tadworth, Surrey KT20 6RB, UK, corrected its notification of 16 July 2007 as follows:

"Pursuant to section 21 (1) of the German Securities Trading Act (WpHG), we hereby notify you that the share of the voting rights held by FMR Corp., 82 Devonshire Street, Boston, Massachusetts 02109, USA, in DEUTZ AG fell below the threshold of 3 per cent on 16 July 2007, and now amounts to 2.92 per cent. This share of the voting rights was attributable to Fidelity Management & Research Company pursuant to section 22 (1) number 2 in conjunction with section 22 (1) sentence 2 in conjunction with section 22 (1) sentence 1 number 6 of the WpHG."

### **Authorised capital**

The Annual General Meeting held on 22 June 2006 approved a resolution to create new authorised capital. The Board of Management is authorised, subject to the consent of the Supervisory Board, to increase the issued capital on or before 21 June 2011 through the issue of new no-par-value shares against cash and/or non-cash contributions on one or more occasions by up to a total amount of €120,000,000.00. Capital increases against non-cash contributions may not exceed a total of €80,000,000.00.

If the capital is increased against cash contributions, the shareholders must be granted pre-emptive rights. The new shares may be transferred to a bank specified by the Board of Management subject to an undertaking by the bank to offer the shares to shareholders (indirect pre-emptive right). The Board of Management is authorised, subject to the consent of the Supervisory Board, to disapply the pre-emptive rights of shareholders in the following cases:

- for fractional amounts;
- in so far as is necessary to grant holders of bonds with conversion rights, warrants or conversion obligations issued by DEUTZ AG pre-emptive rights to new shares to the extent that would be required if they were to exercise their conversion or option rights or fulfil their conversion obligations;
- if the issue price of the new shares is not significantly below the market price and the shares issued with the disapplication of pre-emptive rights pursuant to section 186 (3) sentence 4 of the German Stock Corporation Act (AktG) in total do not exceed 10 per cent of the issued capital either at the effective date or the exercise date of this authorisation. The aforementioned 10 per cent threshold includes shares that are acquired on the basis of an authorisation granted by the Annual General Meeting and sold during the period of this authorisation pursuant to section 71 (1) no. 8 sentence 5 AktG in conjunction with section 186 (3) sentence 4 AktG. This restriction also includes shares that have been or are to be issued in order to service bonds with conversion rights, warrants or conversion obligations insofar as the bonds were issued during the term of this authorisation with the disapplication of pre-emptive rights in application *mutatis mutandis* of section 186 (3) sentence 4 AktG.

The Board of Management is also authorised, subject to the consent of the Supervisory Board, to disapply pre-emptive rights in cases where the capital increase is made against non-cash contributions in the context of the acquisition of an entity, parts of an entity or investments in an entity.

### **Conditional capital**

**Convertible profit-sharing rights** The Annual General Meeting voted on 29 June 1995, to increase the Company's conditional share capital by DM 50,000,000, by issuing 10,000,000 bearer shares with a par value of DM 5. The increase in conditional capital was to be used to grant conversion rights to the holders of profit-sharing rights issued by the Company at the end of August 1995. The conditional capital will only be increased to the extent that the holders of profit-sharing rights utilise their conversion rights.

**Convertible bonds** The Annual General Meeting voted on 28 June 2001, to increase the Company's conditional share capital by up to €16,600,000. The conditional capital will only be increased to the extent that:

- a) the holders or creditors of conversion rights or warrants attached to the convertible bonds or bonds with warrants issued by DEUTZ AG, or by companies in which DEUTZ AG directly or indirectly holds a majority shareholding, on or before 27 June 2006, exercise their conversion rights or option rights or
- b) the holders or creditors of the convertible bonds issued on or before 27 June 2006 by DEUTZ AG, or by companies in which DEUTZ AG directly or indirectly holds a majority shareholding, who are obliged to exercise their conversion rights, fulfil their conversion obligations.

The new shares carry dividend rights from the beginning of the financial year in which they are issued as a result of the exercise of conversion rights or warrants or the fulfilment of conversion obligations.

The Annual General Meeting voted on 27 May 2004, to increase the Company's conditional share capital by up to € 34,000,000. The conditional capital will only be increased to the extent that

- a) the holders or creditors of conversion rights or warrants attached to the convertible bonds or bonds with warrants issued by DEUTZ AG, or by companies in which DEUTZ AG directly or indirectly holds a majority shareholding, on or before 26 May 2009, exercise their conversion rights or option rights or

b) the holders or creditors of the convertible bonds issued on or before 26 May 2009 by DEUTZ AG, or by companies in which DEUTZ AG directly or indirectly holds a majority shareholding, who are obliged to exercise their conversion rights, fulfil their conversion obligations.

The new shares entitle their holders to a share of the Company's profits from the beginning of the financial year in which they are created through the exercise of conversion rights or option rights, or through fulfilment of conversion obligations.

#### **Additional paid-in capital**

The conversion of convertible bonds into no-par-value shares resulted in an increase of additional paid-in capital of €4.3 million.

#### **Retained earnings**

Retained earnings comprise DEUTZ AG's legal reserve amounting to €4.1 million together with other retained earnings of €74.6 million.

#### **Statement of changes in equity**

The statement of changes in equity is presented on page 32.

#### **Convertible profit-sharing rights**

The Annual General Meeting on 29 June 1995 voted to authorise the Board of Management, with the consent of the Supervisory Board, to issue registered convertible profit-sharing rights with transfer restrictions with a total par value of up to DM 50,000,000, on or before 31 December 1996.

In August 1995, the Board of Management decided, with the consent of the Supervisory Board, to utilise this authorisation and to issue profit-sharing rights with a total par value of DM 50,000,000. The 1,000,000 registered profit-sharing rights with transfer restrictions were issued in the ratio of one for 59 against cash contributions at the issue price of DM 100 for each profit-sharing right with a par value of DM 50.

The profit-sharing rights entitle the holder to an annual dividend payment equal to the dividend paid on shares of the same par value, and to a share of the liquidation proceeds up to the amount of the issue price. If the profit-sharing rights fall due for repayment before this date, only the par value is paid. The holder does not participate in any losses.

The profit-sharing rights do not entitle the holder to attend the Company's Annual General Meeting nor to any voting rights, options on new shares or new profit-sharing rights.

The Company or the holders of profit-sharing rights can terminate the profit-sharing rights with effect from the day after any Annual General Meeting by giving six months' notice; however, the earliest effective termination date is the day after the Annual General Meeting at which the annual financial statements for the financial year ending on 31 December 2006 are presented.

In accordance with Article 7 (1) of the terms & conditions governing its profit-sharing rights, DEUTZ Aktiengesellschaft gave due notice of cancellation of the convertible profit-sharing rights it had previously issued with effect from midnight on the day immediately following the Annual General Meeting at which the adopted annual financial statements for the period ended 31 December 2007 are presented. The announcement of the routine termination of profit-sharing rights was published in the electronic Federal Gazette on 19 November 2007. The profit-sharing rights can be exchanged for shares of DEUTZ AG in the ratio of one to ten. In 2007, 18 profit-sharing rights were converted into 180 no-par-value shares in DEUTZ AG. The profit-sharing rights outstanding at the end of 2007 totalled €30,524.12.

## Provisions

	<b>31/12/2007</b>	<b>31/12/2006</b>
€ thousand		
Provisions for pensions and other post-retirement benefits	160,074	227,160
Provisions for taxes	6,831	5,833
Other provisions	153,975	106,287
<b>Total</b>	<b>320,880</b>	<b>339,280</b>

Provisions for pensions are recognised as liabilities in accordance with German commercial law under the tax-based entry-age normal method (section 6a of the German Income Tax Act [EStG]) using the generation mortality tables 2005 G of Prof. Dr Klaus Heubeck with a discount rate of 6 per cent. Financing is based on the minimum pensionable age in accordance with the 1999 German Pension Reform Act (RRG99).

In financial year 2007, DEUTZ AG offered – where permitted by law – to pay compensation to its pensioners and those with pension entitlements in the form of a one-off payment for their vested company pension rights. A total amount of €69.6 million was paid out.

Provisions for taxes include provisions for the current year in the amount of €6.8 million.

Other provisions cover all identifiable risks and other contingent liabilities. The main items covered are cost of warranties and potential risks, discounts and price reductions, provisions for staff costs and social insurance as well as litigation risks. The provisions also cover commitments relating to the disposal of the DEUTZ Power Systems segment.

Write-downs/provisions for impending losses in relation to orders on hand (firm orders) at the balance sheet date were recognised on the basis of full costs. Valuation of further anticipated engine orders arising from long-term supply agreements or framework agreements on the basis of variable costs did not give rise to the need for additional provisions.

It is not possible to make a meaningful calculation of a potential shortfall in coverage at full costs due to the variable contract structure for long-term supply agreements and framework agreements.

## 7. LIABILITIES

	Thereof residual maturity	Thereof residual maturity	Thereof residual maturity	31/12/2007 Total	31/12/2006 Total
	up to 1 year	1 to 5 years	over 5 years		
<b>€ thousand</b>					
Convertible bonds	2,853	0	0	2,853	22,432
Bond (USPP)	0	40,353	162,884	203,237	0
Liabilities to banks	1,690	270	0	1,960	29,623
Trade payables	170,037	0	0	170,037	143,182
Liabilities to affiliated companies	15,923	0	6,155	22,078	40,031
Liabilities to other long-term investees and investors	0	0	0	0	28
Liabilities arising from taxes	52	0	0	52	3
Liabilities relating to social security	1,049	0	0	1,049	989
Sundry other liabilities	17,798	597	0	18,395	8,387
<b>Total</b>	<b>209,402</b>	<b>41,220</b>	<b>169,039</b>	<b>419,661</b>	<b>244,675</b>

In July 2004, the Board of Management issued a convertible bond for €67.3 million with the consent of the Supervisory Board. This convertible bond pays an annual coupon of 3.95 per cent on its par value of €3.40, has a maturity of five years and falls due for repayment on 22 July 2009. The subscription price was €3.40. Each bond can be converted into one no-par-value share of DEUTZ AG and the bondholder can exercise the conversion right at any time on or before 10 July 2009.

The capital market interest rate (6.5 per cent) and the nominal coupon (3.95 per cent) were determined at the date of issue on 22 July 2004. The difference between both components represents the value of the conversion right, which amounts to €7.2 million, and was allocated to additional paid-in capital. Prepaid expenses were recognised in the same amount and will be amortised in profit or loss over the term of the convertible bond.

A total of 5,758,434 of these bonds were converted into shares in 2007.

The Board of Management of DEUTZ AG, Cologne, with the consent of the Supervisory Board, cancelled the convertible bond issued in 2004 on 6 February 2008, with effect from 7 March 2008. At 31 December 2007, 839,263 convertible bonds were still outstanding, which equates to 4.2 per cent of the original issue volume. On redemption, bondholders will receive the par value of €3.40 plus accrued interest. Until 3 March 2008, however, bondholders had the option of converting each bond into one DEUTZ share. Of the outstanding 839,263 bonds, 729,321 had been converted into DEUTZ shares by 29 February 2008.

DEUTZ AG issued bonds worth USD 274 million (€203 million) as part of a private placement in the United States and recognised them at cost. The placement was completed on 16 July 2007. The bonds – which carry maturities of 5, 7 and 10 years – were purchased by US institutional investors. Around 20 per cent of the total volume was taken up directly in euros (€43.0 million), with the remainder in US dollars (USD 216.1 million) hedged in euros. The bonds have coupons of between 5.22 to 6.12 per cent.

Liabilities to affiliated companies as well as liabilities to other long-term investees and investors include trade payables in an amount of €4,845 thousand (2006: €4,621 thousand).

Liabilities to banks and sundry other liabilities are no longer secured by mortgages (2006: €29.5 million).

The usual industry retention of title arrangements apply to trade payables.

## 8. CONTINGENT LIABILITIES AND OTHER FINANCIAL OBLIGATIONS

### Contingent liabilities

	2007	2006
€ thousand		
Liabilities on endorsed bills of exchange	2,478	3,031
Liabilities on guarantees	40,595	49,565
thereof for affiliated companies	30,682	44,842
Liabilities on warranties	11,174	15,551
thereof for affiliated companies	54	14,001
<b>Total</b>	<b>54,247</b>	<b>68,147</b>

### Other financial obligations

At 31 December 2007, DEUTZ AG had total other financial obligations of €104.3 million (31 December 2006: €67.5 million) that were neither reported on the balance sheet nor included under contingent liabilities. Of that total, €1.7 million (31 December 2006: €1.7 million) was due to affiliated companies.

These obligations relate to leases with a nominal value of €29.6 million, commitments to purchase property, plant and equipment and intangible assets amounting to €39.7 million and commitments to purchase inventories amounting to €35.0 million.

DEUTZ AG's obligations under leases were offset by receivables of €0.3 million (31 December 2006: receivables of €1.0 million).

## 9. PENDING AND POTENTIAL LEGAL DISPUTES

DEUTZ AG is involved in a number of legal disputes and arbitration proceedings, mainly in relation to claims of defective performance, consequential losses resulting from defects and claims for damages.

Provisions have been recognised to cover the risks arising from this litigation.

At present it is not possible to predict the outcome of these pending cases with any degree of certainty. We do not expect them to have a significantly adverse impact on the net assets, financial position or results of operations of DEUTZ AG.

## 10. REVENUE

### Breakdown by segment

	2007	2006
€ million		
Engines	1,057.4	745.7
Services	80.0	66.0
<b>DEUTZ Compact Engines</b>	<b>1,137.4</b>	<b>811.7</b>
Engines	209.7	206.5
Services	96.0	84.8
<b>DEUTZ Customised Solutions</b>	<b>305.7</b>	<b>291.3</b>
<b>Total</b>	<b>1,443.1</b>	<b>1,103.0</b>

### Breakdown by region

	2007	2006
€ million		
<b>Europe/Middle East/Africa</b>	<b>1,155.4</b>	<b>862.2</b>
thereof Germany	335.9	299.6
thereof Europe	740.3	487.9
thereof Africa	35.5	36.9
thereof Middle East	43.7	37.8
<b>Americas</b>	<b>174.0</b>	<b>169.2</b>
<b>Asia-Pacific</b>	<b>113.7</b>	<b>71.6</b>
<b>Total</b>	<b>1,443.1</b>	<b>1,103.0</b>

## 11. CHANGE IN INVENTORIES AND OTHER OWN WORK CAPITALISED

### Change in inventories

	2007	2006
€ thousand		
Inventories as at 1 January	31,897	22,791
Inventories as at 31 December	45,028	31,897
<b>Change in inventories</b>	<b>13,131</b>	<b>9,106</b>

## 12. OTHER OPERATING INCOME

Other operating income comprises, amongst other things, income from other services including cost transfers within the Group for administrative expenses, income from the reversal of provisions, foreign currency gains, income from the reversal of write-downs, write-ups on the investment in a foreign company and miscellaneous operating income.

Other operating income includes income from the reversal of miscellaneous provisions amounting to €11.4 million (2006: €13.5 million) and the reversal of write-downs amounting to €12.9 million (2006: €1.7 million).

## 13. COST OF MATERIALS

	2007	2006
€ thousand		
Cost of raw materials, consumables and purchased merchandise	1,000,744	744,422
Cost of services procured	42,438	26,760
<b>Total</b>	<b>1,043,182</b>	<b>771,182</b>

## 14. STAFF COSTS

	2007	2006
€ thousand		
Wages and salaries	196,248	175,485
Social security contributions and other employee benefits	34,697	32,312
Pensions and other post-retirement benefits	6,036	3,589
<b>Total</b>	<b>236,981</b>	<b>211,386</b>

### Average number of employees during the year

	2007	2006
Non-salaried employees	2,323	2,063
Salaried employees	1,187	1,146
Trainees	161	147
<b>Total</b>	<b>3,671</b>	<b>3,356</b>

## 15. DEPRECIATION AND AMORTISATION

	2007	2006
€ thousand		
Expenses for the expansion of operations	10,378	10,378
Intangible fixed assets	9,695	8,643
Property, plant and equipment	43,472	37,042
<b>Total</b>	<b>63,545</b>	<b>56,063</b>

## 16. OTHER OPERATING EXPENSES

Other operating expenses comprise, in particular, expenses for services, necessary risk provisions for pending transactions and warranties, the cost of rentals and leases, administrative and selling expenses including freight costs and commission, foreign currency losses, and losses and expenses arising from write-downs of current assets excluding inventories.

## 17. NET INVESTMENT INCOME

	2007	2006
€ thousand		
Income from profit transfer agreements	1,490	1,337
Income from long-term equity investments		
in affiliated companies	11,056	8,400
in other companies	822	289
<b>Total</b>	<b>13,368</b>	<b>10,026</b>

## 18. NET INTEREST EXPENSE

	2007	2006
€ thousand		
Income from other securities and lending of financial fixed assets	1,854	1,845
thereof received from affiliated companies	1,782	1,782
Other interest and similar income	12,911	4,978
thereof received from affiliated companies	4,707	4,299
Other interest and similar expenses	-28,988	-23,194
thereof owed to affiliated companies	-2,158	-1,967
<b>Total</b>	<b>-14,223</b>	<b>-16,371</b>

## 19. NET EXTRAORDINARY EXPENSE

	2007	2006
€ thousand		
Extraordinary income	119,515	12,000
<b>Total</b>	<b>119,515</b>	<b>12,000</b>

There is relatively little overlap between the Compact Engines business and the medium-sized and large engines business of DEUTZ Power Systems because of their differing business processes, customer profiles and market conditions. For this reason, the Board of Management decided to sell the DEUTZ Power Systems segment – including its affiliated companies and other long-term investees and investors – to financial investor 3i.

After DEUTZ AG's Supervisory Board and the relevant antitrust regulator had given their approval, the disposal of the gas-engines and diesel-engines business for decentralised power generation (DEUTZ Power Systems) was completed with commercial effect from 30 September 2007.

The agreed purchase price amounts to €337.4 million and includes the shares in the following companies:

- DEUTZ Power Systems GmbH & Co. KG, Mannheim
- DEUTZ Power Systems B.V., Rotterdam/Netherlands
- DEUTZ POWER SYSTEMS IBERIA S.A., Madrid/Spain (formerly: DEUTZ IBERIA S.A., Madrid)
- DEUTZ POWER SYSTEMS ASIA-PACIFIC PTE. LTD., Singapore/Singapore

In addition, material assets that were essential to the business operations of the DEUTZ Power Systems segment, but did not belong to any of the companies being sold, were also sold. Payments of €292.3 million were received from the disposal in the year under review, after deduction of tax payments, one-off expenses and purchase price adjustments.

The gain on disposal is calculated as follows:

	2007
€ million	
<b>Selling price</b>	<b>337.4</b>
Assets and liabilities	-133.1
One-off items	-84.8
<b>Gain on disposal before income taxes</b>	<b>119.5</b>
Income taxes	-9.9
<b>Gain on disposal after income taxes</b>	<b>109.6</b>

At the time of preparation of the 2007 annual financial statements, the sale of DEUTZ Power Systems, including the price adjustment mechanisms stipulated in the sale and purchase agreement, had not yet been completed. Any resulting changes could have either a positive or negative impact on the gain on disposal.

## 20. INCOME TAXES

In 2007 income taxes increased to an amount of €18.0 million, especially due to the sale of DEUTZ Power Systems.

## 21. OTHER INFORMATION

### Corporate governance

In December 2008, the Management Board and the Supervisory Board of DEUTZ AG issued a declaration of compliance with the recommendations of the German Corporate Governance Code government commission as amended on 12 June 2006 and 14 June 2007 pursuant to section 161 of the AktG and made this declaration permanently available to shareholders on the Company's website (<http://www.deutz.com>).

### Auditors' fees

The following fees were recognised as an expense in 2007:

	2007
€ thousand	
Auditing	210
Other advisory and attestation services	119
<b>Total</b>	<b>329</b>

### Total remuneration paid to the Board of Management, former members of the Board of Management, and the Supervisory Board

**Board of Management** The following table shows the breakdown of total remuneration for members of the Board of Management:

	Fixed remuneration	Variable remuneration	Other <sup>1)</sup>	Total	Number of virtual share options granted
€ thousand					
Gordon Riske (until 30 September 2007)	408	548	125	1,081	
Gino Mario Biondi (since 1 September 2007)	150	60	50	260	
Karl Huebser	450	300	433	1,183	
Helmut Meyer	418	305	152	875	60,000
<b>Total</b>	<b>1,426</b>	<b>1,213</b>	<b>760</b>	<b>3,399</b>	<b>60,000</b>

<sup>1)</sup> including payment of life insurance premiums

The share options of Helmut Meyer have a fair value of €203,504.23 on the initial grant date.

Remuneration paid to former members of the Board of Management and their surviving dependants amounted to €1,438 thousand for DEUTZ AG and the Group; a provision of €13,437 thousand has been recognised to cover pension obligations to these persons.

**Supervisory Board** The following table shows the breakdown of total remuneration paid to members of the Supervisory Board:

	<b>Fixed remuneration</b>	<b>Variable remuneration</b>	<b>Meeting attendance fees</b>	<b>Total</b>
€				
Dr Giuseppe Vita Chairman	25,000	46,587	40,000	111,587
Werner Scherer Deputy Chairman	18,750	34,940	33,000	86,690
Gino M. Biondi (former member)	417	766	1,000	2,183
Dr Massimo Bordi	11,910	22,208	9,000	43,118
Prof Klauf-Otto Fruhner	12,500	23,293	11,000	46,793
Reinhold Götz	12,500	23,293	11,000	46,793
Michael Haupt	12,500	23,293	24,000	59,793
Dr Helmut Lerchner	12,500	23,293	11,000	46,793
Helmut Müller	12,500	23,293	11,000	46,793
Karl-Heinz Müller	12,500	23,293	13,000	48,793
Dr Witich Roßmann	12,500	23,293	11,000	46,793
Peter Schwab (former member)	9,375	17,422	10,000	36,797
Prof Dr Marco Vitale	12,500	23,293	6,000	41,793
Egbert Zieher	3,125	4,914	1,000	9,039
<b>Total</b>	<b>168,577</b>	<b>313,181</b>	<b>192,000</b>	<b>673,758</b>

#### **Advances and loans to members of the Board of Management and the Supervisory Board**

As at 31 December 2007 there were no outstanding advances or loans to any members of the Board of Management or the Supervisory Board, nor had any guarantees or other warranties been issued in favour of any such persons.

#### **Shareholdings**

The principal shareholdings of DEUTZ AG are listed in the appendix to the notes to the financial statements on page 51. Full disclosure of shareholdings is published in the electronic German Federal Gazette.

### **Supervisory Board and Board of Management**

Information on the members of the Supervisory Board and the Board of Management, including directorships held at other companies, is given in a separate list on page 55 seq..

Cologne, 29 February 2008

DEUTZ Aktiengesellschaft  
The Board of Management

Dr Helmut Leube

Karl Huebser

Gino Mario Biondi

Helmut Meyer

## SHAREHOLDINGS OF DEUTZ AG

As at 31 December 2007

Ref. No.	Name and registered office of the company	Holding (%)	Equity (€ thousand)	Net income (€ thousand)
1	DEUTZ AG	-	494,538	153,207

### Affiliated companies

#### Germany

2	Unterstützungsgesellschaft mbH der DEUTZ Aktiengesellschaft, Cologne	100.0	-26	0
3	Deutz- Mülheim Grundstücksgesellschaft mbH, Düsseldorf	19.6	-3,032	-160
4	DEUTZ Beteiligung GmbH, Cologne	100.0	21	-9

#### Outside Germany

##### Europe/Africa

5	DEUTZ DITER S.A., Zafra/Spain	100,0	-2,619	1,462
6	DEUTZ DITER COMPONENTES S.A., Zafra/Spain	100,0	18,505	688
7	DEUTZ FRANCE S.A., Gennevilliers/France	100,0	13,571	2,336
8	DEUTZ UK Ltd., Cannock/UK	100,0	3,648	11,503
9	Nlle Ste MAGIDEUTZ S.A., Casablanca/Morocco	100,0	1,331	-87

##### Americas

10	Deutz Corporation, Atlanta/USA	100,0	34,731	-320
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##### Asia-Pacific

11	DEUTZ Asia-Pacific (Pte) Ltd., Singapore/Singapore	100,0	3,037	623
12	Deutz Australia (Pty) Ltd., Braeside/Australia	100,0	5,307	903

### Associates

#### Outside Germany

13	D. D .Power Holdings (Pty) Ltd., Elandsfontein/South Africa	30.0	7,773	3,827
14	DEUTZ AGCO MOTORES S.A., Haedo/Argentina <sup>1)</sup>	50.0	5,370	1,094
15	DEUTZ (Dalian) Engine Co., Ltd., Dalian/China	50.0	105,215	-6,933

## SUPERVISORY BOARD

### **Dr Giuseppe Vita**

Chairman  
Chairman of the Supervisory Board of Axel Springer AG, Berlin

- a) HUGO BOSS AG, Metzingen, Chairman  
Axel Springer AG, Berlin, Chairman  
Vattenfall Europe AG, Berlin
- b) Allianz S.p.A., Milan (former R.A.S. S.p.A.), Chairman  
Gruppo Banca Leonardo, Milan, Italy, Chairman  
Barilla S.p.A., Parma, Italy  
Humanitas S.p.A., Milan, Italy

### **Werner Scherer<sup>1)</sup>**

Deputy Chairman  
Chairman of the Group Works Council Cologne and of the Joint Works Council of DEUTZ AG, Cologne

### **Gino M. Biondi**

(until 12 January 2007)  
Former CEO of SAME DEUTZ-FAHR Deutschland GmbH, Lauingen

### **Dr Massimo Bordi**

CEO of SAME DEUTZ-FAHR Group S.p.A., Treviglio, Italy

- b) SAME DEUTZ-FAHR ITALIA S.p.A., Treviglio, Italy  
SAME DEUTZ-FAHR Group S.p.A., Treviglio, Italy

### **Prof. Klaus-Otto Fruhner**

CEO of K.O.F.-Projektberatung GmbH, Cologne

### **Reinhold Götz<sup>1)</sup>**

Deputy Chief Executive of IG Metall Administrative Office Mannheim, Mannheim

- a) MVV-Energie AG, Mannheim
- b) Stadt Mannheim Beteiligungsgesellschaft mbH, Mannheim  
Sparkasse Rhein-Neckar-Nord, Mannheim

### **Michael Haupt**

Former member of the Group Board of SKF AB, Gothenburg, Sweden

### **Dr Helmut Lerchner**

Management consultant, Aichtal-Rudolfshöhe

- a) ElringKlinger AG, Dettingen/Erms, Chairman

### **Helmut Müller<sup>1)</sup>**

Chairman of the Senior Staff Committee of DEUTZ AG, Cologne

### **Karl-Heinz Müller<sup>1)</sup>**

Deputy Chairman of the Group Works Council of DEUTZ AG, Cologne

**Dr Witich Roßmann<sup>1)</sup>**

Chief Executive of IG Metall Cologne, Cologne

- a) Ford Werke GmbH, Cologne  
Ford Holding Deutschland GmbH, Cologne

**Peter Schwab<sup>1)</sup>**

(until 30 September 2007)

Chairman of the Works Council of DEUTZ Power Systems GmbH & Co. KG, Mannheim

- b) DEUTZ Power Systems GmbH & Co. KG, Mannheim

Prof Dr Marco Vitale

President of Vitale-Novello & Co SRL, Milan, Italy

- b) SAME DEUTZ-FAHR DEUTSCHLAND GmbH, Lauingen  
SAME DEUTZ-FAHR ITALIA S.p.A., Treviso, Italy, Chairman  
SAME DEUTZ-FAHR POLSKA SP.Z.O.O., Melgiew, Poland  
SAME DEUTZ-FAHR KOMBAJNI d.d., Zupanja, Croatia  
BANCA POPOLARE DI MILANO, Milan, Italy  
C. BORGOMEIO & CO. SRL, Rome, Italy  
CONNECT SUD SRL, Palermo, Italy  
PICTET INTERNATIONAL CAPITAL MANAGEMENT, Luxembourg, Luxembourg  
PICTET & C. SIM S.p.A., Turin, Italy  
VINCENZO ZUCCHI S.p.A., Milan, Italy

**Egbert Zieher<sup>1)</sup>**

(since 16 October 2007)

Chairman of the Ulm Works Council of DEUTZ AG, Ulm

<sup>1)</sup> Employee representatives on the Supervisory Board

a) Membership of statutory German supervisory boards within the meaning of section 125 AktG

b) Membership of comparable German or international supervisory bodies within the meaning of section 125 AktG

## **SUPERVISORY BOARD COMMITTEES**

### **Human Resources Committee**

Dr Giuseppe Vita, Chairman  
Werner Scherer, Deputy Chairman  
Michael Haupt

### **Audit Committee**

Michael Haupt, Chairman  
Werner Scherer, Deputy Chairman  
Karl-Heinz Müller  
Dr Giuseppe Vita

### **Arbitration Committee**

(Section 27 (3) German Codetermination Act (MitbestG))

Dr Giuseppe Vita, Chairman  
Michael Haupt  
Werner Scherer  
Peter Schwab (until 30 September 2007)  
Karl-Heinz Müller

### **Nominations Committee**

Dr Giuseppe Vita, Chairman  
Michael Haupt  
Dr Massimo Bordi

## BOARD OF MANAGEMENT

### **Dr Ing Helmut Leube (54)**, Cologne

(since 1 February 2008)

Chairman

Markets

a) KUKA AG, Augsburg

### **Gordon Riske (50)**, Cologne

(until 30 September 2007)

Chairman

Markets

a) Dräger AG, Lübeck

### **Gino M. Biondi (48)**, Brombach

(since 1 September 2007)

Procurement, Logistics

b) DEUTZ (Dalian) Engine Co. Ltd., Dalian, China

### **Karl Huebser (62)**, Overath

Technology

b) DEUTZ DITER S.A., Zafra, Spain, Chairman

DEUTZ DITER COMPONENTES S.A., Zafra, Spain, Chairman

DEUTZ (Dalian) Engine Co. Ltd., Dalian, China

WEIFANG WEICHAI DEUTZ DIESEL ENGINE LTD., Weifang, China

### **Helmut Meyer (58)**, Düsseldorf

Finance, Personnel

b) DEUTZ Corporation, Atlanta/USA, Chairman

DEUTZ Asia-Pacific (Pte) Ltd., Singapore, Singapore, Chairman

DEUTZ (Dalian) Engine Co. Ltd., Dalian, China

DEUTZ UK Ltd., Cannock/UK

a) Membership of statutory German supervisory boards within the meaning of section 125 AktG

b) Membership of comparable German or international supervisory bodies within the meaning of section 125 AktG

# Miscellaneous

## RESPONSIBILITY STATEMENT

"To the best of our knowledge, and in accordance with the applicable accounting principles, the annual financial statements give a true and fair view of the net assets, financial position and results of operations of DEUTZ AG, and the management report presents a true and fair view of the development and performance of the business and the position of DEUTZ AG, together with a description of the principal opportunities and risks associated with the expected development of the DEUTZ AG."

Cologne, 29 February 2008

DEUTZ Aktiengesellschaft  
The Board of Management

Dr Helmut Leube

Karl Huebser

Gino Mario Biondi

Helmut Meyer

## AUDIT OPINION

We have audited the annual financial statements - comprising the balance sheet, the income statement and the notes to the financial statements - together with the bookkeeping system, and the management report of DEUTZ Aktiengesellschaft, Cologne/Germany, for the business year from 1 January to 31 December 2007. The maintenance of the books and records and the preparation of the annual financial statements and management report in accordance with German commercial law are the responsibility of the Company's Board of Directors. Our responsibility is to express an opinion on the annual financial statements, together with the bookkeeping system, and on the management report based on our audit.

We conducted our audit of the annual financial statements in accordance with § 317 HGB ("German Commercial Code") and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer. Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the annual financial statements in accordance with German principles of proper accounting and in the management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Company and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the books and records, the annual financial statements and the management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the accounting principles used and significant estimates made by the Board of Directors, as well as evaluating the overall presentation of the annual financial statements and management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the annual financial statements of DEUTZ Aktiengesellschaft, Cologne/Germany, comply with the legal requirements and give a true and fair view of the net assets, financial position and results of operations of the Company in accordance with German principles of proper accounting. The management report is consistent with the annual financial statements and as a whole provides a suitable view of the Company's position and suitably presents the opportunities and risks of future development.

Düsseldorf, 19 March 2008  
Deloitte & Touche GmbH  
Wirtschaftsprüfungsgesellschaft

signed: Crampton  
Wirtschaftsprüfer  
(German Public Auditor)

signed: Lammers  
Wirtschaftsprüferin  
(German Public Auditor)