NOTES TO THE COMBINED FINANCIAL STATEMENTS

History of the spin-off In November 2003, the Management Board and the Supervisory Board of Bayer AG decided to demerge the main areas of the chemical and polymer operations of the Bayer Group, which have in the meantime been combined in the LANXESS Group. One of the alternatives for implementing this demerger was a spin-off in accordance with the German Company Transformation Act (UmwG). The relevant areas of the chemical and polymer operations of the Bayer Group would in this case be transferred to LANXESS AG by means of a spin-off and takeover. In July 2004, the Bayer Management Board decided to carry out the demerger in the form of a spin-off.

In contrast to the products in the remaining core areas of the Bayer Group's business, the products in the LANXESS portfolio consist primarily of products that have reached a higher level of maturity in the markets. Compared with the remaining core areas of the Bayer Group's business, the areas in which the LANXESS Group operates have lower barriers to market entry and lower growth rates. The trend towards smaller margins requires the establishment of lean structures of low complexity and the systematic optimization of plants and processes. The Bayer Management Board is of the opinion that the spin-off of the LANXESS Group represents a basis that enables the necessary measures to be taken more systematically, while the structures and processes can also be optimized to satisfy the particular requirements of the chemical and polymer operations.

To this end, the interests Bayer AG held in LANXESS Deutschland GmbH and LANXESS AG as well as other assets and liabilities were spun off and taken over on the basis of the spin-off and takeover contract of 22 September 2004.

The spin-off of the chemical and polymer operations of the Bayer Group that are combined in the LANXESS Group was carried out in two stages.

In a first, preparatory stage, almost all of the domestic business operations of the LANXESS Group were transferred from Bayer Chemicals Aktiengesellschaft and Bayer MaterialScience Aktiengesellschaft to Bayer AG in the form of a spin-off and takeover in accordance with § 123, paragraph 2, number 1, of the UmwG in return in each case for one share in LANXESS Deutschland GmbH, which was still a wholly owned subsidiary of Bayer AG at this time. The spin-offs were made with economic effect from 1 July 2004. Both of the spin-offs took effect on 30 September 2004 when they were entered in the commercial register of Bayer MaterialScience Aktiengesellschaft and Bayer Chemicals Aktiengesellschaft.

The main chemical and polymer operations outside Germany were transferred to LANXESS Deutschland GmbH and its subsidiaries in legally different ways in the individual countries, on the basis of the local legal rules. The relevant parties generally made arrangements at the economic level as if the transfers were made with effect from 1 July 2004.

Certain parts of the operations of the Bayer service companies were transferred to LANXESS Deutschland GmbH and its subsidiaries, too. LANXESS Deutschland GmbH has held a 40% interest in Bayer Industry Services GmbH & Co. OHG with economic effect from 1 July 2004 as well.

LANXESS Deutschland GmbH also acquired ownership of almost all of the land it uses in Germany on the basis of a notarized land purchase contract of 30 December 2004 between Bayer AG and LANXESS Deutschland GmbH. The land purchase contract became legally effective on 29 January 2005, at the end of the calendar day following the entry of the spin-off between Bayer AG and LANXESS AG in the commercial register of Bayer AG.

Separation from the Bayer Group in the form of a spin-off and takeover in accordance with § 123, paragraph 2, number 1, of the UmwG was carried out in a second stage. As the legal entity making the transfer, Bayer AG transferred all the shares in LANXESS Deutschland GmbH as well as certain other parts of its assets in their entirety to LANXESS AG as the legal entity making the takeover.

The transfer was made in return for the granting of all the LANXESS AG ordinary shares with no nominal value in the name of the bearer to the shareholders of Bayer AG. One LANXESS AG share in the name of the bearer was issued for every ten shares in Bayer AG. The Extraordinary Shareholders' Meetings of Bayer AG and LANXESS AG approved the spin-off and takeover contract on 17 November 2004 and 21 December 2004 respectively. The spin-off took legal effect on 28 January 2005 on being entered in the commercial register of Bayer AG kept by Cologne Court.

Corporate structure and segmentation The chemical and polymer operations of the Bayer Group that have been combined in the LANXESS Group consist essentially of strategic business units of the Bayer Group responsible for managing their own affairs. They include in particular the operations of what used to be the Bayer Chemicals subgroup, with the exception of H.C. Starck GmbH and Wolff Walsrode AG as well as the polymer operations Rubber Chemicals, Semi-Crystalline Products, Styrenics, BR/

Butyl, Technical Rubber Products and Fibers. The “Blends” reporting unit in the “Styrenics” operations was not transferred; this unit is remaining in the Bayer Group. The equity interests held by Bayer Chemicals AG in DyStar Holding Inc., DyStar Textilfarben GmbH, GE Bayer Silicones GmbH & Co. KG and GE Bayer Silicones Verwaltungs-GmbH, which are included in the Bayer Combined Financial Statements at equity, were not allocated to the chemical and polymer operations combined in the LANXESS Group.

In addition to the transfer of the operating units allocated, certain general functions (service functions and corporate center functions combined in a separate organizational unit), which provided services for the transferred polymer and chemical operations in the past, were also included in the LANXESS Group.

Parts in particular of the following functions were transferred from Bayer Business Services GmbH: business consulting, development of IT-based systems, development and support of research systems, procurement, law & patent services and HR recruiting services. In the case of Bayer Industry Services GmbH & Co. OHG, the plant-oriented engineering and maintenance services functions were in particular transferred, while the functions taken over from Bayer Technology Services GmbH were especially parts of the engineering, plant service, process analysis engineering, building services and construction planning functions. Part of the accounting operations attributable to the LANXESS Group was transferred from Euroservices Bayer GmbH – a subsidiary of Bayer Business Services GmbH – too. Service functions were transferred to the LANXESS Group in various countries outside Germany as well.

The LANXESS Group consists of 17 operating business units, which are organized in four segments (Performance Chemicals, Chemical Intermediates, Performance Rubber and Engineering Plastics) on the basis of the operating control system and the internal reporting structure in accordance with the IFRS requirements. With reference to the operations transferred, a comparison is given below between the reporting structure of the LANXESS Group and the previous reporting structure of the Bayer Group.

2003 ↓ / 2004 →		Subgroup/Segment	LANXESS			
Subgroup	Segments	Business divisions* / Reporting groups	Performance Rubber	Engineering Plastics	Chemical Intermediates	Performance Chemicals
Polymers	Plastics/Rubber	Thermoplastic Polymers		Semi-Crystalline Products, Styrenics (ABS/SAN) (new: Styrenic Resins)		
Polymers	Plastics/Rubber	Rubber Polymers	BR/Butyl (new: Polybutadiene Rubber, Butyl Rubber), Technical Rubber Products			Rubber Chemicals (new: Rubber Chemicals and RheinChemie)
Polymers	Polyurethane/Lacquer Raw Materials/Fibers	Coating Materials/Fibers		Fibers		
Chemicals	Chemicals	Industrial Chemicals			Basic Chemicals, Inorganic Pigments	Ion Exchange Resins
Chemicals	Chemicals	Custom Manufacturing			Fine Chemicals	
Chemicals	Chemicals	Functional Chemicals				Functional Chemicals (new: Material Protection Products and Functional Chemicals)
Chemicals	Chemicals	Process Chemicals				Textile Processing Chemicals, Leather, Paper

* after spin-off: segments

Basis for financial statement reporting Since the Bayer Group did not prepare any separate financial statements for the business operations of the LANXESS Group before the spin-off and the LANXESS Group was not a separate reporting unit in the past, what are described as the Combined Financial Statements of the LANXESS Group for the 2003 and 2004 fiscal years have been based on the consolidated reporting of the Bayer Group. The relevant provisions in the agreements concluded to form the LANXESS Group determine which business operations are allocated to the LANXESS Group. The assets and liabilities transferred to the LANXESS Group were recognized and valued in the Combined Financial Statements in accordance with the standards issued by the International Accounting Standards Board (IASB), London, in effect as of the closing date of the financial statements.

The purpose of the Combined Financial Statements is to present the spun-off business operations in the reporting in such a way as if the LANXESS Group had already existed in the past in the structure specified for the spin-off. To do this, the spun-off operations were allocated to the LANXESS Group and were presented for the 2003 and 2004 fiscal years in such a way that assets and liabilities including expenses and income that were necessary to carry out the business operations and/or were incurred in connection with them are included. Central costs that were not allocated directly to the transferred operations in the past but were incurred in connection with these business operations were taken into account accordingly in this context. The same applies to services provided by the Bayer AG corporate center, at which the main management and control functions were carried out for the LANXESS Group in the past, such as board office, corporate development, industrial & environmental affairs, treasury, tax, corporate controlling, accounting, communications, law & intellectual property and human resources. To this end, expenses based on the pro rata historical costs amounting to € 24 million in the 2003 fiscal year and € 22 million in the 2004 fiscal year were shown in the Combined Financial Statements.

For the preparation of the Combined Financial Statements, additional assumptions and estimates have to be made that have an impact on the assets and liabilities included in the balance sheets, on the income and expenditure and on the contingent liabilities. The actual figures may differ from the estimates. The Combined Financial Statements presented here do not therefore necessarily reflect the asset situation, financial position and profitability that would have been the case if the LANXESS Group had already existed as an independent group since 1 January 2002 and the transactions between LANXESS and Bayer companies on which they are based had therefore been carried out between independent companies. The fact that the LANXESS Group was not an independent unit in the past restricts the information value of the Combined Financial Statements for the reasons outlined here. For the same reasons, it is not claimed that a forecast about the future development of the business operations combined in the LANXESS Group can be made on the basis of the Combined Financial Statements.

Determination of the Combined Financial Statements

The business transferred is defined fundamentally on the basis of the structures of Bayer Group reporting and thus on the reporting units in this system. Differing allocations of individual products below this level were not taken into account as a result.

The financial statements of the companies incorporated in the Combined Financial Statements are based on consistent accounting and valuation principles. Items based on tax regulations are not included in the Combined Financial Statements. The individual financial statements of the equity interests are prepared with the same qualifying date as the Combined Financial Statements. Group reporting in the Combined Financial Statements is in million euros (€ million). The income statement was prepared by the cost of sales method. Individual items in the income statement and the balance sheet are combined to improve clarity; they are explained in the notes. In accordance with IAS 1 (Presentation of Financial Statements), a distinction is made in balance sheet presentation between non-current and current liabilities. Liabilities and provisions are considered to be current when they are due in less than one year. Taxes on income were allocated according to the contributions to earnings made by the company parts transferred to the LANXESS Group in every period shown. The actual tax balance of the LANXESS Group in future does, however, depend on the legal structure and tax strategies of the independent LANXESS Group.

The Combined Financial Statements include not only all the business operations of the legal entities (share deals) that already existed in the past but also the individual company parts (asset deals) transferred, including the transferred services.

Business operations of already existing legal entities (share deals) 34 companies (previous year: 34 companies) that contained exclusively LANXESS business were included in the Combined Financial Statements in the 2004 fiscal year. The shares in these companies were already transferred to LANXESS Deutschland GmbH or one of its direct or indirect subsidiaries. The individual companies were included in the Combined Financial Statements on the basis of their financial statements for the 2003 and 2004 fiscal years, so that only the internal Group transactions between the rest of the Bayer Group and the LANXESS Group needed to be investigated and, if necessary, reclassified.

At six of the companies, assets accounted for by the LANXESS business that were transferred from companies with business operations which mainly continue to be part of the Bayer organization were also transferred (see the section entitled 'Transferred business operations (asset deals)' for details about the procedure adopted here.

A further four companies with business operations that are mainly attributable to the LANXESS Group were also included on the basis of their historical individual financial statements, although the company parts/business operations attributable to the remainder of the Bayer Group were transferred to a new or already existing Bayer company.

Transferred business operations (asset deals) 20 companies (previous year: 18 companies) are included in the Combined Financial Statements in the 2004 fiscal year that were created exclusively by means of a transfer of the assets attributable to the LANXESS business. Particularly close attention was given here to the fact that transactions with the corporate operations remaining in the Bayer Group now had to be presented as external Group relationships. In this context, separate historical financial statements were also prepared for the transferred company parts which were included in the Combined Financial Statements.

The allocation of assets and liabilities necessary in this context was based on the following criteria. The assets and liabilities transferred in accordance with the relevant agreement were allocated to the business operations on the basis of the use made of them and the source of them. The LANXESS Group receives appropriate rights to use fixed and current assets that were not legally transferred to the LANXESS Group but are needed for the business operations of the LANXESS Group even so. To the extent that the assets transferred to the LANXESS Group are still needed to continue the operations that remain part of the Bayer Group, the LANXESS Group grants appropriate rights of use to the Bayer Group; this is particularly the case with the land and buildings that are used jointly.

Liabilities relating to individual parts of companies, e.g. trade payables, prepayments and bills payable, were allocated essentially on the basis of responsibility, i.e. in which corporate area the liability was incurred. Generally, provisions were also recognized on the basis of accountability. This also applies to provisions for environmental issues and restructuring measures. For information about pensions and other retirement benefits, see 'Pensions and similar commitments' in the same section. Financial liabilities were allocated as outlined in 'Capital structure'.

Tax assets and liabilities that were established before the spin-off generally remain in the Bayer Group and were not shown in the Combined Financial Statements of the LANXESS Group, unless the transaction on which they were based was clearly attributable to a corporate area of the Group and the specific national tax legislation concerned allows the transfer of tax assets to different taxpayers.

Deferred taxes were determined in the Combined Financial Statements with respect to temporary differences between the values included for assets and liabilities in commercial and tax balance sheets. The calculation is based on the tax rates anticipated in the individual countries at the time of realization. They in turn are based on the statuory rates in effect or enacted as of the balance sheet date and may differ from the actual tax rates that would have applied if the corporate areas of the LANXESS Group had in actual fact operated as separate companies in the period indicated.

Like the assets and liabilities, income and expenses were allocated on a causal basis. In the case of functional areas that are used jointly, such as sales and research and development, expenses were charged by the principle of main use. In the case of services that are used jointly (power plants, laboratories, production facilities and storage buildings), services and the charges made for them are recorded in what are known as term sheets. This means that account is taken in the preparation of the historical financial data of the LANXESS Group of the principle of what is known as the “costs of doing business”, where it has to be taken into consideration that these amounts allocated to the LANXESS Group reflect the expenses and income that would have been incurred/generated for the LANXESS Group as an entity of the Bayer Group.

Service and agency companies Separate historical financial statements were also prepared for consolidation purposes for services from seven Bayer service companies that have provided services for the LANXESS Group up to now.

The LANXESS Group will be taking advantage of the existing sales network of the Bayer Group on the basis of commercial agent and independent dealer contracts in countries where there were no appropriately extensive chemical and polymer operations of the Bayer Group to transfer to the LANXESS Group. The costs incurred in the past were included in the Combined Financial Statements in these cases. The so-called agency companies continue to be included in the Group financial statements of Bayer AG.

Pensions and other post-employment benefits The presentation of the pension commitments in the Combined Financial Statements and the commitments that were transferred was based on separate actuarial reports for the qualifying dates of 31 December 2003 and 31 December 2004, which in turn were based on lists of the employees (being) transferred to the LANXESS Group. This means that the commitments were determined mainly at the individual employee level; historical allocation per employee via allocation keys was only made in exceptional cases.

With reference to the pension rights of employees who had already retired before 1 July 2004 or who had left the company with vested rights before this date, there are specific national or company rules that are explained below regarding the main LANXESS Group pension schemes in Germany, the USA and Canada.

As far as Germany is concerned, it was specified in the agreements concluded to form the Group that all the pension commitments to active employees who were allocated to the LANXESS Group on 1 July 2004 pass to the LANXESS Group. All the commitments to employees who left the company with vested rights up to 1 July 2004 remain at the same time with the Bayer Group.

The commitments in the USA, on the other hand, were allocated on the basis of the existing pension plans. In the case of plans that include the commitments not only to active employees but also to former employees and that could be allocated economically to the LANXESS Group, the commitment was transferred completely to the LANXESS Group. Plans were also allocated in which only the commitments to the active employees were transferred, whereas the remaining commitments remain with the Bayer Group, similar to the rule in Germany. In another category of plans, all of the pension commitments remained with Bayer.

In Canada, not only the rights of active employees but also the commitments to retired employees and former employees with vested rights were transferred to the LANXESS Group.

Capital structure Liquidity and financial debt are not allocated to any business units in the Bayer Group; instead of this, they are controlled centrally at company or Group level.

A funding structure was calculated for 2003 and 2002 on the basis of the net debt planned for the LANXESS Group at the time of the spin-off and taking the free cash flow expected in 2004 into account. The net debt target was presented on the assumption that additional external loan capital was obtained by LANXESS Deutschland GmbH. Interest expenses in 2003 are based on the market interest rates for industrial bonds in the lower investment grade range. The interest rates were computed by averaging the rates charged on a short-term instrument and on a five-year instrument. The proportion of funding required in non-euro currencies was taken into account by including a risk premium. The interest expenses for the first six months of the 2004 fiscal year were determined in accordance with the above-mentioned procedure. In the second six months of 2004 the interest expenses recorded by the individual Group companies in their account preparation were included in the Combined Financial Statements.

Funding at the time of the spin-off When the majority of the chemical operations and some of the polymer operations of the Bayer Group were combined in LANXESS Deutschland GmbH and its direct and indirect subsidiaries, financial debt was concentrated as far as possible and economically advisable at LANXESS AG and/or LANXESS Deutschland GmbH. On 10 December 2004, LANXESS AG, LANXESS Deutschland GmbH and LANXESS Corporation, Pittsburgh/Pennsylvania, USA, arranged a credit line of € 1.5 billion with an international bank syndicate led by Bank of America, Citigroup Global Markets Ltd., Commerzbank Aktiengesellschaft and Deutsche Bank AG. Planned uses of these funds included the repayment of financial liabilities to the companies in the Bayer Group transferred in the course of the establishment of the LANXESS Group after the spin-off took effect. The credit line includes a tranche of € 0.5 billion designed to be a revolving credit line with a term of 364 days that can be extended by a period of 364 days in each case on multiple occasions with the approval of the banks. The credit line also consists of two more revolving tranches with a term up to December 2009, totalling € 1.0 billion.

An asset-backed commercial paper programme with a funding range of up to € 200 million was arranged, too. Financial leasing contracts relating to the LANXESS Group that existed at the time of the spin-off were transferred to the LANXESS Group companies directly or indirectly via subleasing contracts. The LANXESS Group will be obtaining funding via local bank loans as well in countries with highly regulated capital markets, such as China.

Another element of the funding of the LANXESS Group is a mandatory convertible bond payable to the bearer with a nominal value of € 200 million and a term until 15 September 2007 that was issued to Bayer AG by LANXESS AG on 15 September 2004. The conversion right exists from 20 July 2005 to 20 July 2007 with a conversion obligation at the end of the term. The convertible bond is provided with an interest deferral right and is subordinated to more senior, not subordinated receivables held by other creditors of LANXESS AG. LANXESS AG has in the meantime exercised the interest deferral right.

It is not out of the question that the LANXESS Group will take advantage of the favorable market conditions at the present time to issue a corporate bond with a standard market volume and a medium to long term in 2005. The inflowing funds would be used to repay bank loans and thus lead to a further diversification of the maturity structure of the financial debt.

The net debt of the LANXESS Group in the form of financial debts to the Bayer Group (including the convertible bond), bank liabilities, financial leasing less cash and cash equivalents and excluding pension provisions amounted to about € 1.1 billion on 31 December 2004. In October 2004, the rating agency Standard & Poor's gave LANXESS AG a BBB– (investment grade) rating with a stable outlook for its credit standing. Standard & Poor's issues a BBB rating, when the debtor concerned is capable enough of meeting its financial commitments but it is more likely that unfavorable economic conditions or changes in circumstances will lead to a reduction in the debtor's capacity to meet its financial commitments. The minus sign indicates the position in this category.

Effects of new accounting standards Since 2002, IFRS has been the abbreviation for all the accounting standards issued by the International Accounting Standards Board (IASB), thus replacing the older abbreviation IAS (which stood for International Accounting Standards). The abbreviation "IAS" is still used as a prefix for individual accounting standards that the IASB published before this terminology change was made.

In February 2004, the IASB approved the International Financial Reporting Standard (IFRS) 2, Share-Based Payment, about the accounting rules for share-based payment transactions, including the granting of share subscription rights to employees. IFRS 2 specifies the corporate accounting rules for share-based payment transactions and requires their inclusion in the income statements and balance sheets. IFRS 2 has to be applied for fiscal years that begin on or after 1 January 2005.

In March 2004, the IASB published IFRS 3, Business Combinations, which is replacing IAS 22, which had applied up to then. IFRS 3 stipulates that all business combinations have to be accounted for by the purchase method – application of the pooling of interests method is not allowed. Identifiable assets and liabilities have to be included with their fair value at the time of acquisition. Contrary to the previous rules, goodwill may not be amortized on a scheduled basis any more; instead of this, it has to be subjected to annual impairment tests. IFRS 3 has to be applied in the case of all business combinations with contracts signed on or after 31 March 2004. With respect to goodwill or intangible assets that have been acquired in the context of a business combination which took place before 31 March 2004, the standard has to be applied for the first time from the next fiscal year starting after 31 March 2004.

In March 2004, the IASB approved IFRS 4, Insurance Contracts. This standard has to be applied to practically all insurance contracts that lead to an insurance commitment for a company as well as to all reinsurance contracts that a company has concluded. IFRS 4 has to be applied for fiscal years that start on or after 1 January 2005.

In March 2004, the IASB approved IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations. IFRS 5 stipulates that assets which are to be sold must be included at the lower of the book value on the one hand and their fair value less selling costs on the other hand. The standard also specifies when business units of a company must be classified as discontinued operations. IFRS 5 has to be applied from 1 January 2005 onwards.

In March 2004, the IASB published a supplement to the International Accounting Standard (IAS) 39, Financial Instruments: Recognition and Measurement, which issues instructions about fair value hedge accounting to protect a portfolio against interest rate risks. The supplement simplifies the implementation of IAS 39 by making it easier to use fair value hedge accounting to protect a portfolio against interest rate risks than in previous versions of the standard. The relevant changes to IAS 39 have to be applied to fiscal years that start on or after 1 January 2005. This supplement does, however, have to be applied earlier, if the revised versions of IAS 39 (revised in 2003) and IAS 32, Financial Instruments: Disclosure and Presentation (revised in 2003) are applied earlier.

In connection with the approval of IFRS 3 in March 2004, the IASB revised IAS 36, Impairment of Assets, and IAS 38, Intangible Assets, too. It is specified that goodwill and intangible assets with an indefinite useful life have to be subjected to at least annual impairment tests. If there are circumstances that make it reasonable to assume that impairment has taken place, additional impairment tests have to be carried out in the course of the year as well. The reversal of an impairment loss recognized for goodwill is not allowed. Intangible assets for which it cannot be determined specifically how long they will generate cash inflows for the company are treated as if their useful life were unlimited. Scheduled depreciation of such assets is not allowed; instead of this, they are subject to the same impairment tests as goodwill. The revised standards have to be applied for goodwill and intangible assets that result from business combinations from 31. March 2004 onwards and for other goodwill and all intangible assets for fiscal years that start on or after 31 March 2004.

In May 2004, the International Financial Reporting Interpretations Committee ("IFRIC") published the IFRIC Interpretation 1 (Changes in Existing Decommissioning, Restoration and Similar Liabilities). The interpretation covers the procedure to be adopted in the case of changes in decommissioning, restoration and similar liabilities that have been capitalized in the acquisition or production costs of property, plant or equipment and have at the same time been included as a provision. According to this interpretation, the amounts stated in the financial statements have to be adjusted not only when there are changes in the anticipated flows of funds and discounting rates but also when the liability increases in the course of time. IFRIC 1 applies to fiscal years that start on or after 1 September 2004. The LANXESS Group is currently in the process of determining how application of the standard will affect the asset situation, financial position and profitability of the Group.

In November 2004, the IFRIC published an amendment to SIC-12 (Consolidation Special Purpose Entities). This amendment includes equity compensation plans in the area covered by SIC-12. This means that a company which outsources the establishment of a share-based payment system to a trust fund (or a comparable company) is required to consolidate this fund when control can be exercised, if IFRS 2 (Share-Based Payment) is applied. Post-employment benefit plans and all other long-term benefits due to employees are no longer covered by SIC-12 in future, on the other hand. Logically enough, treatment of them in the financial statements is covered by the standard IAS 19 (Employee Benefits). The change applies to fiscal years that start on or after 1 January 2005. The LANXESS Group is not working on the assumption that application of this standard will have any major impact on the asset situation, financial position and profitability of the Group.

In November 2004, the IFRIC issued the IFRIC Interpretation 2 (Members' Shares in Cooperative Entities and Similar Instruments). The interpretation specifies under what circumstances interests in cooperatives must be classified as equity or liabilities. The interpretation applies for fiscal years that start on or after 1. January 2005. The LANXESS Group is not working on the assumption that application of this standard will have any major impact on the asset situation, financial position and profitability of the Group.

In December 2004, the IASB published a limited amendment to the standard IAS 39 (Financial Instruments: Recognition and Measurement) relating to the inclusion of financial assets and liabilities for the first time. The change includes a transitional arrangement for the retrospective application of the regulations for day one profit recognition. In contrast to the previous version of IAS 39 (of 31 March 2004), the amended standard gives companies an option that facilitates the switch to day one profit recognition and makes sure there is convergence between the IASB standards and the US regulations. The changes apply for fiscal years that start on or after 1 January 2005 as well as for earlier years when IAS 39 and IAS 32 (in the versions of 31 March 2004 in each case) have been applied in these fiscal years. The LANXESS Group is currently in the process of determining how application of the amended standard will affect the asset situation, financial position and profitability of the Group.

In December 2004, the IASB issued an amendment to IAS 19 (Employee Benefits). The amendment creates an additional option, which enables actuarial gains and losses from defined benefit pension commitments to be recognized immediately. The option is comparable to the rule in the British standard FRS 17 (Retirement Benefits), which provides for the recognition of all actuarial gains and losses outside the income statements in the form of a statement of equity movements ("statement of total recognized gains and losses"). The amendment also stipulates (a) that a contract between a multi-employer plan and the employers participating in it, in which it is specified how a surplus is to be distributed and how a deficit is to be funded, must be shown in the balance sheets, (b) how defined benefit pension commitments have to be stated in the individual financial statements of the companies participating in the plan and (c) what additional publication commitments the companies are required to meet. The amendment applies for fiscal years that start on or after 1. January 2006. The LANXESS Group is currently in the process of determining how application of the amended standard will affect the asset situation, financial position and profitability of the Group.

In December 2004, the IFRIC published the IFRIC Interpretation 3 (Emission Rights), This interpretation stipulates that emission rights as intangible assets must be stated at their fair value. IFRIC 3 applies for fiscal years that start on or after 1 March 2005. The LANXESS Group is currently in the process of determining how application of the standard will affect the asset situation, financial position and profitability of the Group.

In December 2004, the IFRIC published the IFRIC Interpretation 4 (Determining Whether an Arrangement Contains a Lease). IFRIC 4 stipulates what contracts must be disclosed as leasing contracts in accordance with the accounting rules of IAS 17 (Leases). IFRIC 4 applies for fiscal years that start on or after 1. January 2006. The LANXESS Group has already complied with this standard prematurely and applies the interpretation in its current financial statements. Application of the standard did not have any material impact on the asset situation, financial position and profitability of the Group.

In December 2004, the IFRIC published the IFRIC Interpretation 5 (Rights to Interests Arising From Decommissioning, Restoration and Environmental Rehabilitation Funds). This interpretation stipulates how capital inflows from funds are to be treated that have been established to cover costs of decommissioning, restoration and similar commitments. IFRIC 5 applies for fiscal years that start on or after 1 January 2006. The LANXESS Group is currently in the process of determining how application of the standard will affect the asset situation, financial position and profitability of the Group.

Principles applied in preparation of the Combined Financial Statements

Consolidation principles Capital consolidation is carried out in accordance with IAS 22 2003 (Business Combinations) and IFRS 3 2004 (Business Combinations) by offsetting the book values of equity interests against the pro rata revalued equity of the subsidies at the time of their acquisition. Identifiable assets and liabilities are included at their fair values. The difference is recognized as goodwill and is amortized on a scheduled basis. In accordance with IFRS 3, goodwill resulting from business combinations that are agreed on or after 31 March 2004 is no longer amortized on a scheduled basis; instead of this, it is subjected to an annual impairment test. The hidden reserves and charges that are identified are updated in subsequent consolidation in accordance with the corresponding assets and liabilities.

The write-ups and write-downs of shares in Group companies made in the individual financial statements in the fiscal year are reversed in the Combined Financial Statements.

Profits and losses, sales, expenses and income within the Group and the receivables and payables between consolidated companies are eliminated.

The impact on taxes on income of consolidation entries that affect earnings is taken into account and deferred taxes are included.

Jointly managed units are consolidated on a pro rata basis applying the same principles.

The Combined Financial Statements include the business transactions attributable to the LANXESS Group and the relevant business operations. Subsidiaries and joint ventures that individually and together have an insignificant impact on the asset situation, financial position and profitability are not consolidated. They are included in the Combined Financial Statements with the lower of their historical acquisition costs or fair values.

Equity interests on which the LANXESS Group exerts a major influence – generally on the basis of a shareholding of between 20% and 50% – are valued by the equity method, on the other hand. The acquisition costs of equity interests that are valued by the equity method are increased or reduced annually by the pro rata equity movements. When equity interests are included for the first time by the equity method, balances from initial consolidation are treated in accordance with the principles of full consolidation. Bayer Industry Services GmbH & Co. OHG is the only company valued by the equity method in the Combined Financial Statements in the 2004 fiscal year (previous year: –).

Currency translation All the receivables and payables in foreign currencies in the individual financial statements that form the basis for the Combined Financial Statements are valued at the exchange rate on the balance sheet date, irrespective of whether hedging has been carried out or not. Forward transactions that have the purpose – from the economic point of view – of hedging exchange rates are stated at their fair values.

The financial statements of units in foreign countries are translated into euros in accordance with IAS 21 (The Effects of Changes in Foreign Exchange Rates), applying the concept of the functional currency. In the majority of the equity interests this is the national currency, because these companies manage their business independently at the financial, economic and organizational level. Assets and liabilities are therefore translated at the exchange rate on the balance sheet date, whereas expenses and income are translated at the average annual rate.

If foreign companies are integrated in the business operations of Bayer AG to a large extent, the euro is considered to be the functional currency. Translation in these cases is by the time-based method with recognition in income. In accordance with this, property, plant and equipment, intangible assets, equity interests and securities held as fixed assets as well as the relevant depreciation charges are translated at the average exchange rates in the year of addition, all the other balance sheet items at the relevant year-end exchange rates and the expenses (except for depreciation) and income at the average exchange rates in the year under review.

The differences from the exchange rates on the qualifying date are shown separately in equity as a currency translation adjustment.

Currency translation adjustments were made for the transferred company shares in preparation of the Combined Financial Statements, too. It was assumed in this context that the ratio of the assets and liabilities transferred to the LANXESS Group to the net assets of the transferring Bayer company reflects the corresponding share of the currency translation adjustment.

When Group companies are deconsolidated, the relevant currency translation adjustment is reversed and recognized in income.

The euro exchange rates of major currencies changed as follows:

		2003	2004	2003	2004
1 €		Closing rate		Average rate	
Argentina	ARS	3.70	4.05	3.33	3.66
Brazil	BRL	3.66	3.62	3.47	3.64
Great Britain	GBP	0.70	0.71	0.69	0.68
Japan	JPY	135.05	139.65	130.96	134.40
Canada	CAD	1.62	1.64	1.58	1.62
Mexico	MXN	14.18	15.23	12.22	14.04
Switzerland	CHF	1.56	1.54	1.52	1.54
USA	USD	1.26	1.36	1.13	1.24

Accounting and valuation principles

Sales and other operating income Sales – after deduction of taxes and price reductions – are included at the time of delivery to the customer or rendering of the service. If the contractual agreements are that business transactions do not take effect until the customer has issued an appropriate acceptance statement, the relevant sales are not realized until the acceptance statement has been received or the deadline for submission of it has passed. Expenses incurred in connection with the formation of provisions for customer discounts are taken into account in the period in which sales are realized in accordance with the legal conditions. Payments relating to the sale or licensing of technologies or technological know-how are recognized in earnings immediately – as soon as the relevant agreements come into force – when all the rights and obligations with regard to the technologies concerned are transferred, on the basis of the contractual rules. If, on the other hand, rights continue to be held to the technology or if contractually agreed obligations still have to be met, the payments received are allocated according to the actual arrangements in each individual case. Income such as royalties, rental income, interest income or dividends are also allocated appropriately.

Research and development costs IAS 38 (Intangible Assets) specifies that research costs cannot be capitalized and development costs can only be capitalized if certain, precisely outlined conditions are met. According to these conditions, capitalization is always necessary when it is sufficiently certain that the development activity will lead to inflows of funds in future that cover the relevant development costs, too, in addition to the normal costs. All of a number of different additional criteria have to be met with respect to the development project and the product or process that is being developed. These conditions were not met either in the 2004 fiscal year or in the 2003 fiscal year.

Income Tax The taxes on income paid or owed in the individual countries as well as deferred taxes are shown as taxes on income. They were allocated according to the contributions to earnings of the company areas transferred. The calculation was based on national tax rates. The assumption applied in the case of the German LANXESS companies was not being included in the Bayer AG single tax entity. Losses carried forward were therefore allocated on a pro rata basis in accordance with this assumption and the basic principle followed in preparation of the Combined Financial Statements. The actual tax balance of the LANXESS Group in future depends on the legal structure and tax strategies of the LANXESS Group as an independent company. The domestic tax losses carried forward, which are being transferred to the LANXESS Group in accordance with § 15, paragraph 4, of the German Transformation Tax Act (UmwStG) and can exploited under the conditions of the general rules stipulated in § 8, paragraph 4, of the German Corporation Tax Act (KStG), have a particular impact on this, too. The LANXESS Group assumes that the domestic tax losses carried forward that are actually transferred will be considerably lower than the amounts allocated for the purposes of the Combined Financial Statements as per 31 December 2004. It is also expected as a result of the transition from the Combined Financial Statements as per 31 December 2004 to actual financial statements in the 2005 fiscal year that there will be a substantial reduction in the deferred taxes relating to differences in the timing of entries. Both of these factors have no effect on earnings but reduce equity.

Intangible assets Intangible assets acquired in return for payment are included at their acquisition costs. They are subject to scheduled depreciation in accordance with their useful life. Depreciation of intangible assets – not including the amortization of goodwill – is on a straight-line basis over a period of 3 to 15 years. Permanent reductions in value are accounted for by impairment charges. If the reasons for the impairment no longer apply, appropriate write-ups are made, that may not exceed the current book values. Scheduled depreciation in the fiscal year was allocated to the costs of the relevant functional areas.

Goodwill – from capital consolidation, too – is capitalized in accordance with IAS 22 2003 (Business Combinations) and is amortized on a straight-line basis over its probable useful life up to a maximum of 20 years. In accordance with IFRS 3 2004 (Business Combinations), goodwill resulting from business combinations arranged on or after 31 March 2004 is no longer amortized on a scheduled basis.

Goodwill is subject to regular impairment tests; appropriate impairment charges are made as and when necessary. In accordance with IAS 36 (Impairment of Assets), these impairments are determined on the basis of comparisons with the discounted anticipated future cash flows that are generated by use of the assets to which the relevant goodwill amounts are attributable. Amortization of capitalized goodwill is included in other operating expenses.

Intangible assets that are created internally are not capitalized. Development costs that are incurred with internally developed software during the application development phase are capitalized in the Group, however. Depreciation of these costs over the anticipated useful life starts with the first use of the software.

Property, plant and equipment Property, plant and equipment are valued at acquisition or production costs, less scheduled depreciation due to use. Impairments that go beyond the depreciation through actual use and are likely to be permanent are allowed for by making unscheduled depreciation charges. In accordance with IAS 36 (Impairment of Assets), such impairments are determined on the basis of comparisons with the discounted anticipated future cash flows of the relevant assets. If no future inflows of funds of their own can be attributed to these assets, the impairments are checked on the basis of the flows of funds of the relevant cash-generating unit. Appropriate write-ups are made when the reasons for the impairments no longer apply.

The production costs of internally created property, plant and equipment include not only the direct costs but also appropriate shares of the necessary material and production overheads. They include production-based depreciation and the pro rata costs of the company pension scheme and the voluntary fringe benefits provided by the company.

If the construction phase for items of property, plant and equipment extends over a lengthy period of time, the interest incurred on borrowed capital up to the date of completion is capitalized as part of the acquisition or production costs.

Costs of repairing property, plant and equipment are charged to income. They are capitalized if the costs lead to an expansion of or major improvement to the asset in question.

Property, plant and equipment are depreciated by the straight-line method, unless depreciation on a decreasing balance is necessary because of the actual use. Depreciation in the fiscal year was allocated to the costs of the relevant functional areas.

When property, plant and equipment are shut down, sold or abandoned, the profit or loss from the difference between the proceeds of sale and the residual book value is included in other operating income/expenses.

Scheduled depreciation is based on the following useful lives, which apply throughout the Group:

Buildings	20 to 50 years
Outdoor infrastructure	10 to 20 years
Plant installations	6 to 20 years
Machines and equipment	6 to 12 years
Laboratory and research equipment	3 to 5 years
Storage tanks and pipelines	10 to 20 years
Vehicles	5 to 8 years
Computer equipment	3 to 5 years
Fixtures and fittings	4 to 10 years

In accordance with IAS 17 (Leases), leased property, plant and equipment that, economically speaking, must be classified as asset purchases with long-term financing (financial leases) are included in the financial statements when they are acquired at the lower of their fair value or the present values of the leasing payments. Scheduled depreciation is carried out over the economic useful life. If it is uncertain whether title to the leased asset will be transferred at a later date, the term of the leasing contract is used as the basis if it is shorter. The payment commitments resulting from the future leasing charges are included in the financial statements as financial liabilities.

Investments Equity interests and securities held as fixed as-sets are classified as held-to-maturity or available-for-sale and are stated at amortized cost or fair value in accordance with IAS 39 (Financial Instruments: Recognition and Measurement). If there are signs of a reduction in value, an impairment test is carried out and the reduction in value is taken account of by making an impairment charge. Appropriate write-ups are made when the reasons for impairment charges no longer apply.

The equity interests valued by the equity method are included with their pro rata equity in accordance with the book value method.

Loans made interest-free or at low interest rates are stated with the present value, while the other loans are carried at amortized costs.

Financial instruments Financial instruments are economic transactions based on contracts that involve a right to funds. In accordance with IAS 32 (Financial Instruments: Disclosure and Presentation), they on the one hand include such original financial instruments as trade receivables and payables or financial receivables and financial payables. On the other hand, they also include derivative financial instruments that are used to hedge the risks represented by changes in exchange rates and interest rates. The entire financial instruments item is explained in greater detail in note (35).

Inventories In accordance with IAS 2 (Inventories), the inventories item shows the assets that are kept for sale in normal business operations (finished products and goods), that are in the process of being produced for sale (work in progress) or that are consumed in the course of production or the provision of services (raw, auxiliary and general materials). The inventories are valued at the lower of the acquisition or production costs (determined by the average method) and their net sales value, i.e. the proceeds of sale that can be achieved in normal business operations less the estimated production and sales costs.

The production costs include not only the direct costs but also appropriate shares of the fixed and variable material and production overheads that are needed, to the extent that they are incurred in connection with the production process.

The costs of the company pension scheme, company social facilities and voluntary fringe benefits provided by the company are also included, to the extent that they can be allocated to the production area. Administration costs are included to the extent that they are accounted for by the production area.

In view of the production characteristics of the LANXESS Group, work in progress and finished products are shown combined.

Other receivables and assets The other receivables and assets are stated at amortized costs. Write-downs, which are determined on the basis of the probable risk of default, are made where necessary.

Deferred taxes Deferred taxes are calculated in accordance with IAS 12 (Income Taxes). Deferred taxes are determined with respect to temporary differences between the values included for assets and liabilities in commercial and tax balance sheets, consolidation operations and realizable losses carried forward within the framework of the Bayer Group. The calculation is based on the tax rates anticipated in the individual countries at the time of realization. They in turn are based on the statutory rates in effect or enacted as of the balance sheet date.

When the deferred taxes from losses carried forward were being determined, a reduction was always made when it did not appear to be certain enough that it will actually be possible to use the losses carried forward from the point of view of the Bayer Group.

Since the losses carried forward actually transferred to the LANXESS Group within the framework of the spin-off are considerably lower than the amounts determined for the purposes of the Combined Financial Statements, it must be assumed that there will be a substantial reduction in the deferred taxes formed in this context.

We refer to the relevant information provided about the taxes on income in the section about the accounting and valuation principles.

Provisions The other provisions are valued in accordance with IAS 37 (Provisions, Contingent Liabilities and Contingent Assets) and, if necessary, IAS 19 (Employee Benefits), too, on the basis of the best possible estimate of the size of the commitment. To the extent that provisions are not due until more than one year and it is possible to estimate the payment amounts and times reliably, the relevant present value of the non-current part is determined by discounting. Details on pension provisions are provided in note (26).

If a change in estimates leads to a reduction in the size of the commitment, the provision is released to the appropriate extent and the income is credited to the functional areas that were originally involved in the formation of the provision.

The personnel provisions primarily include special annual payments, payments made to employees in connection with certain anniversaries and miscellaneous personnel costs. Reimbursements that can be expected from the German employment authorities in connection with the implementation of the part-time working scheme for older employees are included in receivables as soon as the conditions for these reimbursements have been met. The provisions relating to transactions with customers include in particular provisions concerning discount commitments.

The LANXESS Group also forms provisions for current or probable legal disputes, when they can be evaluated reasonably. These provisions cover all the estimated fees and legal costs as well as possible settlement costs. The size of the provisions are determined on the basis of information and cost estimates provided by the company's legal advisors. Such provisions are reviewed and adjusted regularly on at least a quarterly basis together with the company's legal advisors.

Liabilities Current liabilities are included with their repayment or redemption amount. Non-current liabilities as well as financial liabilities that do not represent the basic business transaction in a hedging context that meets the requirements of accounting rules are stated at amortized costs. Liabilities from financial leasing contracts are shown with the present value of the future lease payments.

Deferred income Grants made by third parties to promote investment are shown as deferred income and are released to income over the useful life of the relevant assets, in accordance with IAS 20 (Accounting for Government Grants and Disclosure of Government Assistance).

Cash flow statement The cash flow statement shows how the cash and cash equivalents of the LANXESS Group changed in the course of the year under review by inflows and outflows of funds. The effects of acquisitions, divestments and other changes in the companies consolidated are eliminated in this context. In line with IAS 7 (Cash Flow Statements), a distinction is made between flows of funds from operating, investing and financing activities. The cash and cash equivalents shown in the cash flow statement include cash on hand, cheques and bank balances. They also include securities originally due within up to three months. The cash flow statement is supplemented by reconciliation with the cash and cash equivalents shown in the balance sheets.

The amounts reported by the foreign subsidiaries are generally translated at average annual exchange rates. Like in the balance sheets, the cash and cash equivalents are, however, translated at the exchange rate on the qualifying date. The impact of changes in the exchange rate on cash and cash equivalents is shown separately.

Global impairment tests: procedure and effects When assets are subjected to impairment tests within the LANXESS Group, the residual book values of the individual cash-generating units are compared with their recoverable amount, i.e. the higher of the net selling price and its value in use.

In accordance with the definition of a cash-generating unit, the strategic business units are used as cash-generating units. They represent the next reporting level below the reporting segments.

In the cases in which the book value of the cash-generating unit is higher than its recoverable amount, there is an impairment loss amounting to the difference. The goodwill of the strategic business unit concerned is amortized by the amount determined in this way in a first stage. Any remaining amount is divided up pro rata among the other assets of the strategic business unit concerned on the basis of the residual book values of each individual asset on the closing date for the financial statements.

The calculation of the value in use is based on the present value of the future payment, which is expected in view of the continued use by the strategic business unit and its disposal at the end of its useful life. The anticipated payments are based on the current, long-term planning of the Bayer Group.

Capital costs are calculated at Bayer as the average of equity and liabilities, weighted by the relevant fair values (WACC = Weighted Average Cost of Capital). The equity costs correspond to the yield expectations of the Bayer shareholders and are based on capital market information. The financing conditions of the ten-year Bayer corporate bond are used to determine the liability costs. In order to take account of the different yield/risk profiles of the different emphases in the operations, individual capital costs after taxes on income are calculated for the Bayer subgroups in the framework of the valued-oriented Group control procedures (value management system). These costs amount to 6.0% for LANXESS. This interest rate is converted into a capital cost rate before tax, which is used to discount the estimated payment transactions.

With respect to the fixed assets of the LANXESS Group, the following impairment losses were made for the 2003 and 2004 fiscal years:

Impairment losses	2003	2004
€ million		
Goodwill	**80**	**20**
of which Performance Rubber	–	–
of which Engineering Plastics	–	–
of which Chemical Intermediates	8	–
of which Performance Chemicals	72	20
Intangible assets, excluding goodwill	**84**	**–**
of which Performance Rubber	3	–
of which Engineering Plastics	54	–
of which Chemical Intermediates	1	–
of which Performance Chemicals	26	–
Property, plant and equipment	**824**	**48**
of which Performance Rubber	130	–
of which Engineering Plastics	302	21
of which Chemical Intermediates	322	27
of which Performance Chemicals	70	–
Total	**988**	**68**
of which Performance Rubber	133	–
of which Engineering Plastics	356	21
of which Chemical Intermediates	331	27
of which Performance Chemicals	168	20

The large write-downs that needed to be made in the 2003 fiscal year were attributable to negative economic developments in various areas of the business. They were due essentially to an expected intensification of disadvantageous external factors, such as a continuing unfavorable pricing environment, particularly higher raw material costs that it is only possible to recover from customers to a limited extent. Another reason was lower volume growth because of a tougher competitive situation, which needs to be seen in the context of global capacity underutilization, too. Lower economic growth expectations as well as sustained unfavorable exchange rate developments were further factors.

Changes in the Group Since the business of the LANXESS Group was only run to a limited extent in independent legal entities in the past and was managed instead to a large extent in joint legal entities together with other businesses of the Bayer Group, the Combined Financial Statements were based on the Bayer Group consolidated reporting system.

In addition to LANXESS AG, the Combined Financial Statements in the 2004 fiscal year include 34 companies (previous year: 34 companies) with operations that consist exclusively of business relevant to LANXESS.

LANXESS company	Bayer company in the past
Germany	
GVW Garnveredelungswerke GmbH, Goch	GVW Garnveredelungswerke GmbH, Goch
LANXESS Distribution GmbH, Cologne	Bayer Distribution Service GmbH, Cologne
RheinChemie Rheinau GmbH, Mannheim	RheinChemie Rheinau GmbH, Mannheim
Dorlastan Fibers & Monofil GmbH, Dormagen	Bayer Faser GmbH, Dormagen
LANXESS Kautschuk GmbH, Dormagen	Bayer Kautschuk Gesellschaft mit beschränkter Haftung, Dormagen
LANXESS Buna GmbH, Marl	Bayer Buna GmbH, Marl
Borchers GmbH, Langenfeld	Borchers GmbH, Langenfeld
IAB Ionenaustauscher GmbH Bitterfeld, Greppin	IAB Ionenaustauscher GmbH Bitterfeld, Greppin
LANXESS Europe GmbH & Co. KG, Leverkusen	Bayer Industrieprodukte GmbH & Co. KG, Leverkusen
ISL-Chemie GmbH & Co. KG, Kürten	ISL-Chemie GmbH & Co. KG, Kürten
DUBAY Polymer GmbH, Hamm	DUBAY Polymer GmbH, Hamm
PharmAgro GmbH, Leverkusen (only 2003)	PharmAgro GmbH, Leverkusen (only 2003)

LANXESS company	Bayer company in the past
Rest of Europe	
LANXESS Rubber N.V., Belgium	Bayer Rubber N.V., Belgium
LANXESS Elastomeres S.A.S, France	Bayer Elastomeres S.A., France
LANXESS Emulsion Rubber S.A.S., France (from 2004 onwards)	Bayer Elastomeres S.A., France
Borchers France S.A., France	Borchers France S.A., France
Sybron Chemical Industries Nederland B.V., Netherlands	Sybron Chemical Industries Nederland B.V., Netherlands
EUROPIGMENTS S.L., Spain	EUROPIGMENTS S.L., Spain
LANXESS Chemicals S.L., Spain	Bayer Chemicals S.L., Spain
Novochem 2000 S.A., Spain	Novochem 2000 S.A., Spain
LANXESS Limited, Great Britain	W. Hawley & Son Ltd., Great Britain
LANXESS B.V., Netherlands	Bayer Tanatex B.V., Netherlands
Sybron Chemicals Holdings B.V., Netherlands	Sybron Chemicals Holdings B.V., Netherlands
Sybron Chemicals International Holdings Ltd., Great Britain	Sybron Chemicals International Holdings Ltd., Great Britain
Sybron Kimyasal Ürünler Ticaret Limited Sirketi, Turkey (only 2003)	Sybron Kimyasal Ürünler Ticaret Limited Sirketi, Turkey (only 2003)
North America	
Rhein Chemie Corporation, USA	Rhein Chemie Corporation, USA
Sybron Chemical Holdings Inc., USA	Sybron Chemical Holdings Inc., USA
Far East/Oceania	
LANXESS Shanghai Pigments Co. Ltd., China	Bayer Shanghai Pigments Co. Ltd., China
LANXESS (Wuxi) Chemical Co. Ltd., China	Bayer Wuxi Leather Chemical Co. Ltd., China
Rhein Chemie (Qingdao) Co. Limited, China	Rhein Chemie (Qingdao) Co. Limited, China
LANXESS India Private Limited, India	Bayer Speciality, India
Rhein Chemie Japan Ltd., Japan	Rhein Chemie Japan Ltd., Japan
LANXESS K.K., Japan	Bayer Chemicals Japan Ltd., Japan
LANXESS Yaxing Chemical (Weifang) Company Ltd., China (from 2004 onwards)	–
Latin America/Africa/Middle East	
LANXESS Mining (Proprietary) Limited , South Africa	Bayer Holding (Pty) Ltd., South Africa
Chrome International South Africa (Pty) Ltd., South Africa	Chrome International South Africa (Pty) Ltd., South Africa

Four more companies, which have had business operations in the past that can be allocated mainly to the LANXESS Group, were also included on the basis of their individual financial statements, although the parts of the companies/business operations that can be allocated to the remainder of the Bayer Group were transferred to a new or existing Bayer company.

LANXESS company	Bayer company in the past
LANXESS Pty. Ltd., Australia	Bayer Chemicals Pty. Ltd., Australia
LANXESS ABS Limited, India	Bayer ABS Limited , India
Sybron Chemicals Inc., USA	Sybron Chemicals Inc., USA
LANXESS International Trading (Shanghai) Co. Ltd., China	Bayer International Trading (Shanghai) Co. Ltd., China

In the case of six of the above-mentioned companies, assets accounted for by the LANXESS business were also included which were transferred from companies that have business operations which are mainly staying with Bayer.

LANXESS company	Bayer company
	(legal entity carrying out the transfer)
LANXESS Europe GmbH & Co. KG, Leverkusen	Bayer Polymers Customer Services GmbH, Neuss
LANXESS B.V., Netherlands	Bayer B.V., Netherlands
LANXESS Limited, Great Britain	Bayer UK Limited, Great Britain
LANXESS Pty. Ltd. , Australia	Bayer Australia Limited, Australia
LANXESS India Private Limited, India	Bayer (India) Limited, India Bayer Polychem India Limited, India
LANXESS K.K., Japan	Bayer Ltd., Japan

20 companies (previous year: 18 companies) were in addition included in the Combined Financial Statements for the 2004 fiscal year that were established exclusively by transferring the assets that can be allocated to the LANXESS business. The number of companies also includes the seven Bayer service companies, which provided services for the LANXESS Group in the past.

LANXESS company	Bayer company
	(legal entity carrying out the transfer)
Germany	
LANXESS Deutschland GmbH, Leverkusen	Bayer MaterialScience AG, Leverkusen Bayer Chemicals AG, Leverkusen Bayer Business Services GmbH, Leverkusen Bayer Technology Services GmbH, Leverkusen Bayer MaterialScience S.r.l., Milan
LANXESS Accounting GmbH, Leverkusen	Euroservices Bayer GmbH, Leverkusen
LANXESS Belgien GmbH, Leverkusen (from 2004 onwards)	Bayer MaterialScience AG, Leverkusen
Rest of Europe	
LANXESS N.V., Belgium	Bayer Antwerpen N.V., Belgium Bayer International Comm. V., Belgium Bayer S.A.-N.V., Belgium Bayer International S.A., Belgium
LANXESS S.A.S., France	Bayer S.A.S., France
LANXESS S.r.l., Italy	Bayer S.P.A., Italy
LANXESS International S.A., Switzerland	Bayer International, Switzerland
LANXESS Holding Hispania, S.L., Spain	Bayer Hispania, S.A., Spain
LANXESS Styrenics S.L., Barcelona, Spain	Bayer Polimeros S.L., Barcelona
North America	
LANXESS Inc., Canada	Bayer Inc., Canada
LANXESS Corp., USA	Bayer Polymers LLC, USA Bayer Chemicals Corporation, USA Bayer Corporate and Business Services LLC, USA
Dorlastan Fibers LLC, USA	Bayer Polymers LLC, USA
Far East/Oceania	
LANXESS Hong Kong Ltd., Hong Kong	Bayer China Company Limited, Hong Kong Bayer Polymers, Hong Kong
LANXESS Chemical (Shanghai) Company Limited, China	Bayer China Ltd., China
LANXESS Pte. Ltd., Singapore	Bayer South East Asia Pte. Ltd., Singapore
LANXESS (Thailand) Co. Ltd., Thailand	Bayer Thai Company Limited, Thailand
Latin America/Africa/Middle East	
LANXESS S.A., Argentina	Bayer S.A., Argentina
LANXESS, S.A. de C.V., Mexico	Bayer de Mexico, S.A. de C.V., Mexico
LANXESS Industria de Produtos Quimicos e Plasticos Ltda., Brazil	Bayer S.A., Brazil
LANXESS (Pty) Ltd., South Africa	Bayer (Proprietary) Limited, South Africa

In the 2004 fiscal year, 10 companies (previous year: 9 companies) of minor overall importance to the asset situation, financial position and profitability of the Group were not consolidated.

The following companies are involved here:

LANXESS company	Capital interest
	%
Suberit Kork GmbH, Mannheim	100
LANXESS Europe Geschäftsführungs GmbH, Leverkusen	100
ISL-Chemie Geschäftsführungs GmbH, Leverkusen	100
Mineracao Comisa Ltda., Brazil	100
Comercial Andinas Ltda., Chile	99.5
Mineracao Cromina Ltda., Brazil	100
Sybron Chemicals UK Ltd., Great Britain	100
Sybron Chemicals (Shanghai) Ltd., China (only 2003)	100
1. BCh eV GmbH, Leverkusen	100
Rustenburg Chrome Mine Holdings (Pty) Ltd., South Africa (from 2004 onwards)	100
PharmAgro GmbH, Leverkusen (from 2004 onwards)	100

In the 2004 fiscal year, the 40% interest in Bayer Industry Services GmbH & Co. OHG, which was acquired with economic effect from 1 July, was valued by the equity method.

LANXESS company	Capital interest
	%
Bayer Industry Services GmbH & Co. OHG	40

There are also eight (previous year: eight) associated or other companies of minor importance to the asset situation, financial position and profitability of the Group. The following companies are involved here:

LANXESS company	Capital interest
	%
ARG Verwaltungs GmbH, Duisburg	16.67
ARG mbH & Co. KG, Duisburg	16.90
Treuhandgemeinschaft Deutscher Chemiefasererzeuger GmbH, Frankfurt	12.60
Studiengesellschaft Kohle mbH, Mülheim	4.50
Quimidroga Plasticos, S.A., Barcelona	40.00
Indaver N.V., Antwerp	0.44
Elemica Inc., Delaware, USA	9.48
Hidrax Ltda., Brazil	39.00

In the 2004 fiscal year, Chrome International, South Africa, was consolidated on a pro rata basis as a joint venture in accordance with IAS 31 (Financial Reporting of Interests in Joint Ventures). The joint venture had the following impact on the assets, liabilities, income and expenses of the Group:

	2004		2004
€ million		€ million	
Non-current assets	31	Income	16
Current assets	4	Expenses	–21
Pension provisions	0		
Other provisions	–1		
Financial liabilities	–44		
Other liabilities	–1		
Net assets	**–11**	**Net loss**	**–5**

No acquisitions were made in the 2003 and 2004 fiscal years. The business with organic pigments was sold to Sun Chemicals Group, USA, for € 46 million in the 2003 fiscal year. The purchase price was offset by asset disposals of € 41 million as well as transaction and other costs of € 5 million.

Notes to the combined income statement

(1) Sales Sales in 2004 were a total of € 458 million or 7.3% higher than in 2003 at € 6,773 million. There are both price and volume reasons for this increase. The negative change in exchange rates of € –172 million (–2.7%) had an opposite effect.

The targeted structure of the LANXESS Group on 1 July 2004 was reflected in the Combined Financial Statements. Transactions completed in the period from 1 January 2002 onwards relating to individual product groups – essentially the sale of the organic pigment business in 2003 – are, however, taken into account in the Combined Financial Statements at the time when they took economic effect.

Sales and their breakdown by segments can be found in the summary on pages 62/63.

(2) Research and development expenses In view of their particular importance, the research and development expenses are shown separately in the LANXESS Group in addition to the mandatory indication of costs of goods sold, selling expenses and general administration expenses.

(3) Other operating income

Other operating income	2003	2004
€ million		
Income from the release of provisions	11	14
Recognition of exchange rate hedges	11	9
Gains from sales of property, plant and equipment	0	4
Income from the reversal of write-downs of receivables and other assets	1	2
Miscellaneous operating income	34	78
	57	**107**

Adjustment of the impairment expenses of the previous year led to income of € 29 million, which is included in the miscellaneous operating income.

(4) Other operating expenses

Other operating expenses	2003	2004
€ million		
Amortization and impairment of acquired goodwill	–97	–27
Write-downs of trade receivables	–3	–15
Losses from the disposal of property, plant and equipment	–5	–6
Expenses from impairment write-downs, excluding goodwill	–908	–48
Miscellaneous operating expenses	–85	–109
	–1,098	**–205**

In the 2004 fiscal year, the global write-downs required led to additional expenses in the other operating expenses of € 68 million (previous year: € 988 million). Provisions of € 40 million for environmental protection and of € 20 million for legal disputes were made that are included in the miscellaneous operating expenses.

(5) Operating result (EBIT) A breakdown of the operating result by segments and regions can be found on pages 62/63.

In the context of the accounting for defined benefit pension plans, the balance of all the expenses and income was recorded in the operating result in the Bayer Group financial statements up to and including 31 December 2003. The consequence of this was that interest costs for funded pension obligations representing the increase in the present value of a defined benefit obligation in a period and the expected return on plan assets were shown in the operating result. Only the interest costs for unfunded pension obligations were recorded within the financial result.

In the LANXESS Combined Financial Statements, the interest costs are shown completely, i.e. also in the case of funded pension obligations, in the financial result, with retroactive effect in accordance with the procedure adopted by the Bayer Group from the 2004 fiscal year onwards. The same applies to the return on plan assets. With respect to the amortization of actuarial gains and losses, a distinction has to be made between whether the expenses arising from changes in actuarial assumptions result from the pension obligation or the plan assets. If the assumptions with respect to the pension obligation change, e.g. because of a change in wage and salary increases, the relevant expenses or income must be allocated to the operating function costs and therefore reduce or increase the operating result. Income or expenses arising from a change in the actual values compared with the actuarial assumptions in the context of valuation of the plan assets continued to be shown in the financial result.

(6) Result from investments The result from investments can be broken down as follows:

Result from investments	2003	2004
€ million		
Loss from investments in affiliated companies	0	–2
of which from companies included at equity € –4 million (2003: € 0 million)		
Income from profit transfer agreements	2	0
of which from affiliated companies € 0 million (2003: € 0 million)		
Write-downs of investments	–17	0
	–15	**–2**

(7) Interest expense – net The interest income and expense consists of:

Interest expense – net	2003	2004
€ million		
Income from other securities and loans included in investments	0	1
Other interest and similar income	12	2
of which from affiliated companies € 0 million (2003: € 0 million)		
Interest and similar expenses	–66	–49
of which to affiliated companies € 0 million (2003: € –1 million)		
	–54	**–46**

In accordance with IAS 17 (Leases), finance lease contracts are shown in property, plant and equipment, while the interest of € 5 million (previous year: € 5 million) included in the leasing payments is shown in the interest balance.

No interest was incurred in the financing of major investment projects during the construction phase.

(8) Other financial expenses and income The other financial expenses and income can be broken down as follows:

Other financial expenses and income	2003	2004
€ million		
Interest portion of interest-bearing provisions	–23	–33
Currency translation balance	–18	2
Miscellaneous financial expenses	–2	–1
Miscellaneous financial income	1	1
	–42	**–31**

(9) Income tax The taxes on income paid or owed in the individual countries as well as deferred taxes are shown as income tax. They were generally allocated according to the contributions to earnings of the business units transferred. The calculation was based on national tax rates. The assumption applied in the case of the German LANXESS companies was not being included in the Bayer AG. Losses carried forward were therefore consolidated in accordance with tax assessment and the basic principle followed in preparation of the Combined Financial Statements allocated on a pro rata basis.

The fact that the LANXESS Group was not an independent unit in the past restricts the information value of the taxes shown here. The actual tax result of the LANXESS Group in future depends on the legal structure and tax strategies of the LANXESS Group as an independent company. The domestic tax losses carried forward, which are being transferred to the LANXESS Group in accordance with § 15, paragraph 4, of the German Transformation Tax Act (UmwStG) and may be used under the conditions of the general rules stipulated in § 8, paragraph 4, of the German Corporation Tax Act (KStG), have a particular impact on this, too. The taxes on income shown here, including the deferred tax income, reflect the situation within the Bayer Group.

On the basis of their source, the income tax can be broken down as follows:

Income tax	2003	2004
€ million		
Loss before income tax		
Germany	–816	–100
Other countries	–592	80
	–1,408	**–20**
Income taxes paid or owed		
Germany	–11	–3
Other countries	23	–41
	12	**–44**
Deferred taxes		
From temporary differences	258	–15
From losses carried forward	142	72
	400	**57**
	412	**13**

The deferred tax expenses decreased by € 10 million in the previous year because of changes in the tax rates.

The deferred tax amounts are due to the individual balance sheet items as follows:

Deferred tax amounts	31.12.2003		31.12.2004	
€ million	Deferred tax assets	Deferred tax liabilities	Deferred tax assets	Deferred tax liabilities
Intangible assets	45	1	22	5
Property, plant and equipment	129	300	102	253
Investments	–	–	–	4
Inventories	12	13	12	12
Receivables	3	14	2	56
Other current assets	0	17	20	12
Pension provisions	26	14	12	10
Other provisions	52	2	31	2
Liabilities	42	0	38	1
Losses carried forward	167	–	233	–
Valuation allowance for losses carried forward	–2	–	0	–
	474	**361**	**472**	**355**
of which non-current	364	316	370	272
Set-off*	–304	–304	–300	–300
	170	**57**	**172**	**55**

* According to IAS 12 (Income Taxes), deferred tax assets and liabilities should, under certain conditions, be offset, provided they relate to the same tax authority.

€ 2 million in deferred tax assets were eliminated in the 2003 fiscal year due to changes in the scope of the companies consolidated.

The existing tax losses carried forward can be used as follows:

Tax losses carried forward	31.12.2003	31.12.2004
€ million		
Within one year	4	2
Within two years	–	–
Within three years	–	–
Within four years	–	–
Within five or more years	416	589
	420	**591**

Deferred tax assets of € 233 million (2003: € 165 million) were recognized with respect to the amount of € 591 million (2003: € 420 million) of the total losses carried forward that are probably realizable. This led to deferred tax income of € 72 million (2003: € 142 million). The actual utilization of domestic losses carried forward is determined by the general rules of § 8, paragraph 4, of the German Corporation Tax Act (KStG). The LANXESS Group assumes that the domestic tax losses carried forward that are actually transferred will be considerably lower than the amounts allocated for the purposes of the Combined Financial Statements as per 31 December 2004. This will have no effect on earnings but will reduce equity.

The actual tax income of € 13 million in 2004 (previous year: € 412 million) differed by € 6 million (previous year: € 105 million) from the theoretical tax income of € 7 million (previous year: € 517 million), which would be the result of application of a weighted expected average tax rate to the earnings before tax of the legal entities and the spun-off business operations. This average rate is calculated from the tax rates expected for the individual Group companies and was 35.2% in 2004 (previous year: 36.7%).

The reasons for the difference between the expected and actual tax income in the Group can be summarized as follows:

	2003		2004	
	€ million	%	€ million	%
Theoretical tax income (+)	517	100	7	100
Increase in tax because of expenses that are not tax-deductible				
Scheduled goodwill amortization	–6	–1	–1	–14
Unscheduled goodwill amortization due to impairments	–29	–6	–	–
Other expenses relating to impairments	–57	–11	–	–
Other tax effects	–13	–2	7	100
Actual tax income (+)	**412**	**80**	**13**	**186**
Effective tax rate in %	29.3		65.0	

(10) Other taxes The other taxes of € 39 million (previous year: € 70 million) are included in the costs of goods sold, selling expenses, research expenses and general administration expenses. These are mainly taxes related to property, as well as taxes on electricity and other utilities.

(11) Minority interest The minority interest in income amounts to € 5 million (previous year: € 2 million). Losses attributable to minority interests were not made in 2004 (previous year: € 1 million).

(12) Earnings per share Due to the convertible bond issued in September 2004, there were option rights for the first time on 31 December 2004. The undiluted and diluted earnings per share were determined for the 2003 and 2004 fiscal years on the basis of the net income (loss) divided by the number of shares. 73,034,192 shares were taken as the basis for the undiluted earnings per share for the 2003 and 2004 fiscal years. The diluted earnings per share for the 2004 fiscal year were determined on the basis of 86,358,642 shares. In accordance with the specifications of IAS 33, the net income (loss) was adjusted to take account of the lower interest expenses.

(13) Costs of materials The costs of materials amounted to approx. € 2.6 billion (previous year: approx. € 2.4 billion). Since the Bayer Group did not prepare any separate financial statements for the business operations of the LANXESS Group before the decision was taken to spin them off, the costs of materials were based on Bayer Group reporting. The costs of materials shown here do not necessarily reflect the expenses that would have been incurred if separate reporting had already been carried out for the LANXESS Group on 1 January 2002. The central Group service functions, which were transferred to the operating units, may in particular lead to shifts between the primary and secondary costs in future.

(14) Personnel expenses Personnel expenses were € 160 million lower in 2004 at € 1,117 million, with changes in the exchange rates reducing the relevant expenses by € 29 million. Amounts due to the accrued interest for personnel provisions, particularly pension provisions, are not included as personnel expenses. They are shown as part of the financial result and the other financial expenses (see note [8]).

The personnel expenses include wages and salaries of € 850 million (previous year: € 932 million) as well as social security contributions and similar expenses of € 267 million (previous year: € 345 million), € 86 million of which are accounted for by pension expenses (previous year: € 141 million). The limitation on the information value of the costs of materials apply accordingly to the personnel expenses.

(15) Employees The breakdown of the number of employees on 31 December 2004 by the operating functional areas was as follows:

Employees by operating functional areas	2003	2004
Marketing	3,648	3,460
Technology	14,213	13,711
Research	887	670
Administration	1,675	1,818
	20,423	**19,659**

Notes to the balance sheet

(16) Intangible assets Changes in intangible assets in 2004 were as follows:

Changes in intangible assets 2004 € million	Concessions, industrial property rights and similar rights and assets as well as licences to such rights and assets	Acquired goodwill	Advance payments	Total
Gross carrying amounts on 31.12.2003	268	137	15	420
Exchange differences	–6	–1	–	–7
Changes in the scope of consolidation	–	–	–	–
Acquisitions	–	–	–	–
Capital expenditures	4	–	–	4
Retirements	–4	–108	–	–112
Transfers	15	–	–12	3
Gross carrying amounts on 31.12.2004	**277**	**28**	**3**	**308**
Accumulated amortization and write-downs on 31.12.2003	–221	–99	–1	–321
Exchange differences	5	1	–	6
Changes in the scope of consolidation	–	–	–	–
Amortization and write-downs	–12	–27	–	–39
of which unscheduled	–	–20	–	–20
Reversals	–	–	–	–
Retirements	3	108	–	111
Transfers	–	–	–	–
Accumulated amortization and write-downs on 31.12.2004	**–225**	**–17**	**–1**	**–243**
Net carrying amounts on 31.12.2004	**52**	**11**	**2**	**65**

The assets of the foreign companies are translated into euros at the beginning and end of the year using the exchange rates on these dates, whereas all the changes during the year are translated at average annual rates. This translation method is also applied as a fundamental rule for goodwill and revaluation amounts created by acquisitions at companies outside the euro zone. The exchange rate adjustments resulting from the differences in translation are shown separately.

(17) Property, plant and equipment The property, plant and equipment item developed as follows in 2004:

Changes in property, plant and equipment 2004

€ million	Land and buildings	Technical equipment and machinery	Other fixtures, fittings and equipment	Advance payments and assets under construction	Total
Gross carrying amounts on 31.12.2003	1,363	5,529	184	207	7,283
Exchange differences	–18	–66	–4	–	–88
Changes in the scope of consolidation	–	–	–	–	–
Acquisitions	–	–	–	–	–
Capital expenditures	20	47	6	202	275
Retirements	–117	–208	–19	–1	–345
Transfers	28	167	29	–227	3
Gross carrying amounts on 31.12.2004	**1,276**	**5,469**	**196**	**181**	**7,122**
Accumulated depreciation and write-downs on 31.12.2003	–1,041	–4,521	–169	–1	–5,732
Exchange differences	13	54	4	–	71
Changes in the scope of consolidation	–	–	–	–	–
Depreciation and write-downs	–27	–192	–12	–27	–258
of which unscheduled	–2	–26	–1	–27	–56
Reversals	–	–	–	–	–
Retirements	109	190	17	2	318
Transfers	2	–	13	–15	–
Accumulated depreciation and write-downs on 31.12.2004	**–944**	**–4,469**	**–147**	**–41**	**–5,601**
Net carrying amounts on 31.12.2004	**332**	**1,000**	**49**	**140**	**1,521**

The currency translation principles explained in the section about intangible assets are applied here accordingly.

Assets of € 36 million (previous year: € 53 million) that are used on the basis of finance lease contracts are included in the property, plant and equipment shown in the financial statements; their gross value on the balance sheet date amounted to € 89 million (previous year: € 126 million).

What these assets essentially involve are technical equipment and machinery and buildings with a book value of € 18 million and a gross value of € 66 million (previous year: book value of € 38 million and gross value of € 107 million) and a book value of € 17 million and a gross value of € 23 million (previous year: book value of € 13 million and gross value of € 18 million). In the case of the buildings, the present value of the future minimum lease payments covers substantially all of the costs of the acquisition or title.

The property, plant and equipment also include rented/leased products of minor importance leased to other parties, provided the lease does not constitute a finance lease as defined by IAS 17 (Leases) on the basis of the contracts concluded. However, if the lessee is to be regarded as the economic owner, a receivable is capitalized in the current assets that amounts to the discounted future lease payments.

(18) Investment Changes in investments in 2004 were as follows:

Changes in investments 2004

€ million	Shares in affiliated companies	Loans to subsidiaries	Investments in affiliated companies: Associated companies	Investments in affiliated companies: Other companies	Loans to other affiliated companies	Other securities	Other loans	Total
Gross carrying amounts on 31.12.2003	5	–	0	18	34	3	–	60
Exchange differences	–	–	–	–	–	–	–	–
Changes in the scope of consolidation	–	–	–	–	–	–	–	–
Changes in fair value	–	–	–	–	–	–	–	–
Acquisitions	–	–	–	–	–	–	–	–
Other additions	–	–	48	1	–	–	–	49
Valuation at equity	–	–	–4	–	–	–	–	–4
Retirements	–	–	–	–	–	–	–	–
Transfers	–	–	–	–	–9	–	9	–
Gross carrying amounts on 31.12.2004	**5**	**–**	**44**	**19**	**25**	**3**	**9**	**105**
Accumulated write-downs on 31.12.2003	–3	–	–	–17	–	–	–	–20
Exchange differences	–	–	–	–	–	–	–	–
Changes in the scope of consolidation	–	–	–	–	–	–	–	–
Write-downs in 2004	–	–	–	–	–	–	–	–
Write-ups	–	–	–	–	–	–	–	–
Retirements	–	–	–	–	–	–	–	–
Transfers	–	–	–	–	–	–	–	–
Accumulated write-downs on 31.12.2004	**–3**	**–**	**–**	**–17**	**–**	**–**	**–**	**–20**
Net carrying amounts on 31.12.2004	**2**	**–**	**44**	**2**	**25**	**3**	**9**	**85**

The currency translation principles explained in the section about intangible assets are applied here accordingly.

(19) Inventories € 29 million (previous year: € 25 million) of the inventories of € 1,151 million (previous year: € 1,096 million) available on 31 December 2004 were stated at their net realizable value.

The inventory breakdown is as follows:

Inventories	31.12.2003	31.12.2004
€ million		
Raw materials and supplies	185	211
Work in progress, finished goods and goods purchased for resale	909	939
Advance payments	2	1
	1,096	**1,151**

The inventory write-downs developed as follows:

Inventory write-downs	31.12.2003	31.12.2004
€ million		
Balance at the beginning of the year	–62	–56
Additions charged to expenses	–34	–25
Exchange differences	1	1
Deductions/utilization	39	17
Balance at the end of the year	**–56**	**–63**

(20) Trade receivables Trade receivables include write-downs of € 26 million (previous year: € 22 million), which were necessary because of the probable risk of default.

€ 1,130 million (previous year: € 990 million) of the total trade receivables are due within one year and € 7 million (previous year: –) are due after one year. € 4 million (previous year: € 3 million) of the trade receivables were from associated companies and € 1,133 million (previous year: € 987 million) were from other customers. There were trade receivables of € 107 million (previous year: € 75 million) from companies in the Bayer Group, which represent third parties from the point of view of the LANXESS Group. There were no trade receivables from affiliated companies in either the 2003 fiscal year or the 2004 fiscal year.

The total receivables write-downs developed as follows:

Receivables write-downs	31.12.2003	31.12.2004
€ million		
Balance at the beginning of the year	–25	–22
Additions charged to expenses	–3	–12
Exchange differences	1	1
Deductions/utilization	5	7
Balance at the end of the year	**–22**	**–26**

(21) Other receivables and other assets Other receivables and other assets are generally carried at amortized costs less write-downs of € 1 million (previous year: € 3 million).

They can be broken down as follows:

Other receivables and other assets	31.12.2003	31.12.2004
€ million		
Loan receivables	256	0
Pension assets in excess of obligations	89	113
Claims for tax refunds	28	73
Lease payments receivable	20	17
Receivables from derivative financial instruments	4	23
Receivables from employees	2	1
Other receivables	155	136
	554	**363**

Interest receivables from loans essentially include interest to be received after the balance sheet date.

There were no other receivables from other affiliated companies in the 2004 fiscal year (previous year: € 1 million). Other receivables from companies belonging to the Bayer Group, which have to be classified as third parties from the point of view of the LANXESS Group, totalled € 51 million (previous year: € 332 million). There were no receivables from associated companies.

€ 126 million of the other receivables and other assets had a residual term of more than one year (previous year: € 107 million).

Receivables from leases in which the customers must be considered the economic owners of the assets leased (finance leases) amounted to € 17 million (previous year: € 20 million).

The total lease payments are due as follows:

Lease payments			
€ million	Lease payments	Interest included	Leasing receivable
2005	1	0	1
2006	1	0	1
2007	1	0	1
2008	1	0	1
2009	1	0	1
After 2009	12	0	12
	17	**0**	**17**

(22) Cash and cash equivalents

Cash and cash equivalents	31.12.2003	31.12.2004
€ million		
Securities and promissory notes	0	0
Cheques, cash on hand, bank balances	13	72
	13	**72**

Securities originally due within up to three months are shown in the "Cheques, cash on hand, bank balances" item because of their highly liquid character.

(23) Prepaid expenses € 8 million of the total amount of the prepaid expenses item are likely to be used in 2005 (previous year: € 13 million).

(24) Equity As has already been explained in the "Basis for financial statement reporting" section, the Combined Financial Statements of the LANXESS Group for the 2003 and 2004 fiscal years were based on the Bayer Group reporting system. The spun-off operations were allocated to the LANXESS Group for the 2003 and 2004 fiscal years in this context. In accordance with the assumptions, the net debt assigned as per 30 June 2004 in line with the funding structure for 2003 and 2004 was taken into account on this basis for the cash and cash equivalents and equity/liability structure in the Combined Financial Statements of the LANXESS Group.

On the basis of the assumptions, the total equity therefore represents a difference between assets and liabilities determined from the spun-off business operations, including the allocation of net debt for the 2003 and 2004 fiscal years, which were combined in the LANXESS Group, less the accumulated contributions to earnings and other changes in equity of the combined business operations.

It can be assumed that the equity of the LANXESS Group will decrease with the transition from the Combined Financial Statements to actual financial statements in the 2005 fiscal year, since the actually transferred domestic tax losses carried forward will be considerably lower than the amounts allocated for the purposes of the Combined Financial Statements as per 31 December 2004 and since – in addition – a substantial reduction in the deferred tax items attributable to temporary differences is expected as a result of the transition.

(25) Minority interests The minority interests in the 2003 and 2004 fiscal years related essentially to the external interests held in the equity of LANXESS ABS Ltd., India, Novochem, Alcantarilla, DUBAY GmbH, Hamm, EUROPIGMENTS S.L., Spain, and RheinChemie, China.

(26) Provisions for pensions and other post-employment benefits The LANXESS Group provides retirement benefits for most employees, either directly or by paying contributions to independently administered funds.

The Group benefits vary according to the legal, tax and economic situation in the country concerned and are generally based on the employees' length of service and pay. The commitments consist not only of pensions that are already being paid but also of rights to pension payments in future.

The presentation of the pension obligations in the Combined Financial Statements and the obligations transferred was based on separate actuarial reports for the periods ending 31 December 2003 and 31 December 2004, which in turn were based on lists of the employees transferred on the qualifying date for the financial statements. The obligations were determined mainly at the individual employee level; allocation via allocation keys was only made in exceptional cases as per 31 December 2003.

Specific national or company rules govern the pension rights of employees who had already retired before 1 July 2004 or who had left the company with vested rights before this date.

Retirement benefits are provided under both defined contribution and defined benefit plans.

In the case of the defined contribution plans, the company pays contributions to public or private pension insurance organizations on the basis of legal or contractual rules or on a voluntary basis. Once the company has paid the contributions, it has no more payment obligations.

The current contribution payments are shown as expenses incurred in the year in question in the functional costs and thus in the operating result; in the 2004 fiscal year, they amounted to a total for the Group of € 47 million (previous year: € 51 million).

All the other retirement benefit plans are defined benefit plans, with a distinction being made between unfunded and funded pension plans. Total expenses in connection with defined benefit plans in 2004 amounted to € 47 million (previous year: € 58 million), which are included in the functional costs, except for the interest costs incurred, the expected return on plan assets and that share of the amortized actuarial losses that is attributable to the plan assets.

In view of their pension character, the commitments entered into by the US Group companies with respect to the medical expenses incurred by their employees after they retire are in particular shown in the pension provisions, too. For health care costs, the valuation is based on the assumption that they will increase at an annual rate of 5% in the long term. Early retirement benefits and other old-age pension benefits provided when employment contracts are terminated that have the character of an obligation similar to a pension are a further element of the pension provisions. Like pension obligations, these obligations amounting to € 114 million (previous year: € 129 million) are determined in accordance with the international standards. In the 2004 fiscal year, there were changes to the general conditions of the medical expenses plan in the USA, which involve the employees participating in the plan paying a larger proportion of the costs in the form of higher deductibles and shares of the contribution payments. A maximum limit on the annual contribution payments to be paid by the companies was also introduced. In accordance with IAS 19, the changes involve a plan adjustment, which therefore reduces the expenses for pension rights earned in previous years. In addition to the effect of € 8 million attributable to this, the other post-employment benefit obligation is reduced by € 22 million as a result of plan changes in the context of the spin-off of the LANXESS operations from the Bayer Group. In total, the expenses relating to other post-employment benefit obligations amount to € 14 million for the 2004 fiscal year (previous year: € 63 million). They are made up of expenses of € 13 million (previous year: € 57 million) for service costs incurred in 2004, interest costs of € 6 million (previous year: € 5 million), amortization of actuarial losses of € 2 million (previous year: € 1 million) and € 7 million (previous year: –) gained from subsequent adjustments of pension entitlements.

The costs for the pension plans can be broken down as follows:

	31.12.03	31.12.04	31.12.03	31.12.04
€ million	Pension obligations		Other post-employment benefit obligations	
Service cost	38	30	57	13
Past service cost	2	5	–	–5
Interest cost	61	48	5	6
Expected return on plan assets	–51	–41	–	–
Amortization of actuarial losses (+)/gains (–)	8	10	1	2
Plan curtailments and settlements	–	–5	–	–2
	58	**47**	**63**	**14**

The pension provisions for the defined benefit pension plans are determined by the projected unit credit method in accordance with IAS 19 (Employee Benefits). In this method, the future benefit obligations are valued by applying actuarial methods and a conservative assessment of the relevant influencing factors. Pension funds and obligations are valued at regular intervals. A period of three years is not exceeded in this context; comprehensive actuarial reviews are made every year in the case of all significant funds.

The pension benefit payments that can be expected after retirement on the basis of a dynamic assessment are spread out over the entire service life of the employees, with future changes in income being taken into account, too.

The legally independent Bayer-Pensionskasse VvaG (Bayer Pensionskasse) is a private insurance company and is therefore subject to German insurance supervision legislation. Bayer guarantees the contractual commitments of the Bayer Pensionskasse. For the purposes of IFRS accounting, the Bayer Pensionskasse is therefore classified as a defined benefit plan.

The capital investment policy of the Bayer Pensionskasse is based not only on compliance with the general specifications of supervisory legislation but also on the risk structure resulting from the commitments that have been entered into. The Bayer Pensionskasse has developed a strategic portfolio profile that is in line with the risks, taking this basis and the development of the capital market into account. This investment strategy focusses primarily on strict downside risk management and less on absolute yield maximization. It can be expected that the investment policy defined in this way will enable a return on capital to be generated that guarantees the long-term fulfilment of the commitments.

Actuarial calculations and estimates are essential in all defined benefit pension plans. Alongside assumptions about life expectancy, the following calculation parameters play a role, which depend on the economic situation in the country concerned:

	31.12.2003	31.12.2004
in %	Parameters used	
Interest rate	5.50% to 6.25%	4.50% to 6.00%
Expected income development	2.75% to 4.25%	2.25% to 4.30%
Expected pension development	1.25% to 2.75%	1.00% to 2.50%
Average employee turnover (depending on age and sex)	Past experience	Past experience
Expected return on plan assets	6.25% to 8.25%	5.25% to 8.25%

The early retirement benefit obligations are calculated according to the anticipated medium-term requirements, applying an interest rate of 3.25% (previous year: 3.50%).

	31.12.03	31.12.04	31.12.03	31.12.04
€ million	Pension obligations		Other post-employment benefit obligations	
Defined benefit obligation				
Benefit obligations at the beginning of the year	1,007	1,118	90	146
Service cost	38	30	57	13
Interest cost	61	48	5	6
Employee contributions	10	7	–	–
Plan changes	2	2	–	–30
Plan settlements	–	1	–	–
Actuarial gains (–)/losses (+)	31	119	8	10
Translation differences	–3	–5	–7	–5
Pension benefits paid	–28	–28	–7	–3
Acquisitions/mergers/migration	–	16	–	–
Divestments	–	–	–	–
Plan curtailments	–	2	–	–3
Benefit obligation at the end of the year	**1,118**	**1,310**	**146**	**134**
Fair value of plan assets				
Plan assets at the beginning of the year	748	812	–	–
Actual return on plan assets	42	71	–	–
Acquisitions/mergers/migration	–	18	–	–
Divestments	–	–	–	–
Plan settlements	0	2	–	–
Translation differences	1	–4	–	–
Employer contributions	39	47	7	3
Employee contributions	10	7	–	–
Pension benefits paid	–28	–28	–7	–3
Plan assets at the end of the year	**812**	**925**	**0**	**0**
Funded status	**–306**	**–385**	**–146**	**–134**
Unrecognized past service costs	1	0	–	–4
Unrecognized transition obligation	–	–	–	–
Unrecognized actuarial gains (–)/losses (+)	243	323	17	24
Asset limitation	–128	–129	–	–
Net recognized liability at the end of the year	**–190**	**–191**	**–129**	**–114**
Amounts shown in the balance sheet				
Prepaid benefit assets	89	113	–	–
Provisions for pension and other post-employment benefits	–279	–304	–129	–114
Net recognized liability	**–190**	**–191**	**–129**	**–114**

€ 353 million (previous year: € 283 million) of the defined benefit obligation for pensions relate to unfunded benefit obligations, while € 957 million (previous year: € 835 million) relate to funded benefit obligations. The defined benefit obligation for other post-employment benefits is completely unfunded and amounts to € 134 million (previous year: € 146 million). Pension benefit obligations amounting to € 16 million and associated plan assets of € 18 million were migrated in the course of the spin-off of the LANXESS operations from the Bayer Group.

The funded pension plans are overfunded by € 19 million (previous year: € 60 million) and underfunded by € 51 million (previous year: € 83 million).

Adjustment amounts between the defined benefit obligations – after deduction of the fund assets – and the provision that have not yet been charged to earnings are mainly due to actuarial gains or losses in connection with employee turnover and deviations between actual income trends as well as asset developments and the assumptions when the calculations were made.

If the fund assets exceed the relevant obligation, the excess amount is included in other receivables and other assets, taking into account the asset limitation specified in IAS 19 (Employee Benefits). The amounts included in the balance sheet are recognized in earnings over the expected average remaining service time of the active employees, in line with IAS 19. What is known as the corridor method is applied when determining the proportion of the actuarial gains and losses that affect earnings.

The net commitment stated in the balance sheet is included in the following items:

	2003	2004
€ million		
Provisions for pensions and other post-employment benefits	–408	–418
Other assets	89	113
Net recognized liability	**–319**	**–305**

The provisions for pensions and similar commitments developed as follows in the balance sheets:

€ million	1.1.2004	Change in the scope of consolidation	Currency effects	Allocations	Utilization	Reversal	31.12.2004
Provision for pensions and other post-employment benefits	408	–	–4	72	–50	–8	418

(27) Other provisions

The individual provisions are as follows:

Other provisions	31.12.2003		31.12.2004	
€ million	Total	Of which due within less than one year	Total	Of which due within less than one year
Personnel provisions	234	73	243	93
Provisions/transactions with customers	40	32	64	64
Provisions for environmental protection	42	4	88	14
Tax provisions	22	11	26	18
Provisions for restructuring	21	21	5	5
Miscellaneous provisions	46	12	55	49
	405	**153**	**481**	**243**

The provisions developed as follows in 2004:

Development of provisions 2004							
€ million	1.1.2004	Change in the scope of consolidation	Currency effects	Allocations	Utilization	Reversal	31.12.2004
Personnel	234	–	–1	117	–94	–13	243
Transactions with customers	40	–	–1	57	–28	–4	64
Environmental protection	42	–	–2	52	–3	–1	88
Tax	22	–	–	20	–14	–2	26
Restructuring	21	–	–	3	–8	–11	5
Others	46	–	–	42	–13	–20	55
Total	**405**	**–**	**–4**	**291**	**–160**	**–51**	**481**

Participation programmes The Bayer Group introduced an participation programme consisting of three different plans for different groups of employees for the first time in 2000. What is involved in the case of members of the Management Board of Bayer AG and staff at the top management levels is a share option plan, while there is a share incentive plan for the middle management and a share participation plan for the rest of the management and the employees covered by collective agreements. The condition for participation in the share option plan, the share incentive plan and module 1 of the share participation plan is in each case a personal investment in Bayer shares, which then have to be kept in a special deposit.

On the condition that the employees do not sell their shares throughout the term of the share incentive plan and the share participation plan, the company makes incentive payments by a system with certain timing and volume specifications. In module 2 of the share participation plan, the employees have the opportunity to buy Bayer shares for a reduced price. To the extent that the commitments from the employee participation programmes exist towards employees of the LANXESS Group, these commitments were transferred to the LANXESS Group.

Provisions for environmental protection The LANXESS Group's business is subject to extensive laws and regulations in the countries in which its operations are carried out and it which it owns property. Compliance with laws and regulations about environmental protection can therefore mean that the Group is required to eliminate or minimize the impact of the storage or emission of chemicals at various locations. The effect of some of these laws and regulations is that a company which currently is or in the past was owner of a location or has operated equipment there is made liable to pay compensation for the costs that are incurred in eliminating hazardous substances on or below the surface of a site or in making them harmless. The liability to pay compensation may be irrespective of whether the owner or the equipment operator was aware of the contamination or whether he caused it himself and it does not matter either whether the contamination was legally permissible or not at the time when it was originally caused. Since many of the production locations have already been used for industrial purposes for a long time, it is impossible to specify exactly what impact such laws and regulations will have on the LANXESS Group in future.

As can be expected with companies in the chemical and related industries, there has been contamination of the soil and groundwater at individual locations in the past; such contamination could occur or be discovered at other locations, too. Claims are being made by federal or state regulation authorities in the United States as well as by private organizations and individuals. They involve the restoration of locations and land that the LANXESS Group has acquired ownership of from Bayer AG, at which products were manufactured by third parties in the context of contract production agreements or at which waste from production facilities within the LANXESS Group were treated, stored or disposed of.

There are potential liabilities relating to investigation and restoration costs at a number of locations, e.g. on the basis of the US environmental protection legislation generally known as “Superfund”, the American Federal Resource Conservation and Recovery Act and similar American state laws. At most of the US locations affected, numerous companies – including the LANXESS Group – have been informed that the US environmental protection authorities, state authorities and private individuals are working on the assumption that the companies concerned may be responsible for restoration measures in accordance with the Superfund or similar laws. The LANXESS Group is the only company responsible at other US locations. The proceedings have reached different stages at the individual locations. The restoration process has already been initiated at most locations.

At the end of 2004 and 2003, the LANXESS Group had made total provisions of € 88 million and € 42 million to cover environmental protection commitments. These environmental protection provisions relate primarily to land reclamation, the restoration of contaminated locations and the retrofitting of landfill sites as well as recultivation and water protection measures. The environmental protection provisions are determined by discounting when environmental investigations or restoration measures are probable, the costs can be estimated reliably enough and no future benefits are expected from these measures. Significant factors in compiling the cost estimates are, for example, past experience in comparable cases, reports about environmental measures, the current costs and new developments that influence the costs, our interpretation of the present environmental legislation and regulations, the number and financial situation of the external companies that may also be obliged to reimburse costs at the different locations because of joint liability and the restoration methods that will probably be used.

It is difficult to estimate the future costs of the environmental protection and restoration measures, particularly in view of the many uncertain factors, relating above all to the laws, the regulations and the information that is available about the circumstances in the different countries and at the various locations. Considering this situation and taking its past experience with similar environmental protection incidents into account, the LANXESS Group assumes that the existing provisions are adequate – on the basis of the information available at the present time. Due to the inherent difficulties that are faced in this area when trying to estimate obligations accurately, it cannot be guaranteed that no additional costs above and beyond the provision amounts will be incurred. It is possible that a final settlement of these cases will require additional expenditure above and beyond the existing provisions for a longer period and to an extent that cannot be estimated reasonably. It is, however, assumed that if any such additional amounts were even incurred, they would not have any major impact on the asset situation, financial position and profitability of the Group.

Legal risks The LANXESS Group is involved in a number of legal disputes directly or indirectly via reimbursement commitments to the Bayer corporate operations. As a chemical company with international operations, it currently faces – and could in future continue to face – legal action in the course of its normal business operations, such as in connection with competition and cartel law as well as former waste disposal processes and environmental emissions in relation to chemicals.

The outcome of currently pending and future proceedings cannot be predicted with any certainty, so that court decisions may lead to additional expenses that are not covered either completely or at all by relevant insurance contracts and may have a major impact on the business and profitability of the LANXESS Group. If the LANXESS Group loses in proceedings by which it aims to enforce its patent rights, this could lead to a reduction in future earnings, if other manufacturers are as a result allowed to market products that the LANXESS Group or its predecessors developed.

Law suits and legal proceedings generally raise difficult and complicated legal issues and are subject to great uncertainty. The circumstances of every individual case, the jurisdiction in which the law suit is filed and the applicable law can, for example, vary. When a legal dispute is settled, the LANXESS Group can be obliged to make payments that exceed the provisions it has made and the insurance cover that has been obtained. It is possible that the profitability and cash flow of the LANXESS Group will be affected significantly by the unfavorable outcome of a legal dispute.

With regard to current risks in connection with cartel law, reference is made to the information provided about this in the section about contingent liabilities and other financial commitments (note [33]).

Restructuring expenses € 3 million were spent on restructuring measures in total in 2004. This overall amount consists in particular of compensation for redundancies. Most of the compensation for redundancies and the other expenses in 2004 will lead to payments in 2005.

The provisions for restructuring developed as follows in 2004:

€ million	Severance payments	Other costs	Total
Balance on 1.1.2004	16	5	21
Additions	2	1	3
Utilization	–14	–5	–19
Exchange differences	0	0	0
Balance on 31.12.2004	**4**	**1**	**5**

The other costs essentially include demolition expenses and other charges associated with the abandonment of production facilities.

(28) Financial liabilities The total financial liabilities can be broken down as follows:

Financial liabilities	31.12.2003		31.12.2004	
€ million	Total	Of which due within one year	Total	Of which due within one year
Liabilities to banks	41	3	57	21
Liabilities from leasing contracts	86	9	82	27
Other financial liabilities	1,315	1,221	1,068	1,028
	1,442	**1,233**	**1,207**	**1,076**

The total financial liabilities were due as follows on 31 December 2004:

Year due	
€ million	
2005	1,076
2006	6
2007	28
2008	7
2009	41
2010 and later	49
	1,207

On the basis of the net debt target that was set for the time when the spin-off took legal effect, all the financial commitments that were included in the historical financial statements of what are known as the share deal companies and could be allocated directly were assigned to the LANXESS Group. In line with the assumptions made, external funding was included on the basis of this in order to provide the overall financial resources planned for the LANXESS Group. This external funding has been classified as a current financial liability at the present time. Current financial liabilities totalled € 1,076 million (previous year: € 1,233 million). Their weighted average interest rate was 4.1% (previous year: 4.6%). The convertible bond amounting to € 200 million that was issued to Bayer AG on 15 September 2004 is included in the current financial liabilities. Most of the financial liabilities allocated to the LANXESS Group are either unsecured or have the same priority level.

Liabilities from leasing contracts are included in the balance sheet when the leased assets have been capitalized in the property, plant and equipment item as the economic property of the Group (finance leases). They are included with their present values. Lease payments of € 99 million (previous year: € 116 million) have to be made to the relevant lessors in the subsequent years; interest included in this figure amounts to € 22 million (previous year: € 30 million).

The leasing liabilities are due as follows:

Lease liabilities			
€ million	Lease payments	Interest included	Lease liability
2005	19	4	15
2006	10	3	7
2007	12	3	9
2008	5	3	2
2009	6	2	4
After 2010	47	7	40
	99	**22**	**77**

Lease payments of € 5 million and € 29 million were made on the basis of operating leases in 2004 and 2003.

There were no other financial liabilities to affiliated companies and companies in the Bayer Group.

(29) Trade payables Most of the trade payables were to third parties. As in the previous year, the total amount of € 820 million (previous year: € 574 million) is due within one year.

At the end of 2004, the LANXESS Group and the Bayer Group arranged an extension of the payment period for selected products and services from the Bayer Group to the LANXESS Group with a volume of about € 130 million on a rolling basis until the third quarter of the 2006 fiscal year.

€ 156 million (previous year: € 7 million) of the trade payables were to associated companies, while € 661 million (previous year: € 567 million) were to other suppliers. The trade payables to affiliated companies amounted to € 3 million (previous year: –). The trade payables to companies that belong to the Bayer Group, which have to be classified as third parties by the LANXESS Group, totalled € 168 million (previous year: € 142 million).

(30) Other liabilities The other liabilities are stated at amortized costs.

They can be broken down as follows:

Other liabilities	31.12.2003		31.12.2004	
€ million	Total	Of which due within one year	Total	Of which due within one year
Payroll liabilities	40	39	30	29
Tax liabilities	32	32	43	43
Social security liabilities	15	15	14	14
Accrued interest on liabilities	2	2	7	7
Advance payments received on orders	3	3	2	2
Liabilities from the acceptance of drafts	12	12	19	19
Licence liabilities	–	–	–	–
Miscellaneous liabilities	84	84	75	75
	188	**187**	**190**	**189**

The tax liabilities include not only the amounts that the Group companies are liable to pay but also taxes that are paid to the tax authorities for the account of third parties.

The social security liabilities consist in particular of the social security contributions that still have to be paid.

The miscellaneous liabilities essentially involve guarantee payments, commissions to customers and cost reimbursements.

€ 1 million (previous year: € 2 million) of the other liabilities were to affiliated companies and € 34 million (previous year: € 38 million) to companies belonging to the Bayer Group, that have to be classified as third parties from the LANXESS point of view. The other liabilities to associated companies amounted to € 3 million (previous year: –).

(31) Further information on liabilities € 49 million of the total liabilities were due in more than five years (previous year: € 104 million).

Liabilities amounting to € 257 million (previous year: € 189 million) were secured, € 23 million (previous year: € 22 million) of them by mortgages.

The total liability amount included interest allocations of € 7 million (previous year: € 2 million) for liabilities that are not established legally until after the qualifying date for the financial statements.

(32) Deferred income The deferred income item includes grants from public authorities, a total of € 41 million of which (previous year: € 56 million) were posted on the equity and liabilities side of the balance sheet as per 31 December 2004, while € 16 million (previous year: € 9 million) were released in earnings in the fiscal year.

(33) Contingent liabilities and other financial commitments The contingent liabilities totalled € 11 million on 31 December 2004 (previous year: € 13 million). They are attributable exclusively to commitments to third parties and can be broken down as follows:

	31.12.2003	31.12.2004
€ million		
Bill of exchange commitments	0	1
Guarantees	8	10
Warranty commitments	5	0
	13	**11**

In all these cases, potential future commitments are involved, where the occurrence of the relevant future event would lead to a commitment that is still completely uncertain on the balance sheet date. Companies enter into warranty commitments in many cases in their business operations. They mainly involve commitments requiring companies to guarantee a specific success or a specific performance, in which liability above and beyond the warranty that is standard in the industry is assumed. The guarantee item consists essentially of bank guarantees, in which subsidiaries guarantee bank liabilities of third parties arising from contracts with the LANXESS Group. There is a commitment to pay under the guarantee if the debtor defaults or becomes insolvent.

Alongside the provisions, liabilities and contingent liabilities, other financial commitments consist in particular of leasing and long-term rental contracts.

The minimum amount of undiscounted future lease and rental payments from operating leases amounted to € 40 million (previous year: € 67 million). The relevant payment commitments are due as follows:

Year due	
€ million	
2005	5
2006	6
2007	5
2008	4
2009	9
2010 and later	11
	40

There are commitments of € 47 million (previous year: € 37 million) from orders that have already been placed for investment projects that have been started or are planned (liabilities for purchase orders). All of the relevant payments are due in 2005.

Cooperation has also been arranged with external partners, in which different research projects have been financed or other commitments have been accepted – depending on the fulfilment of certain clearly agreed conditions. Such commitments amounted to less than € 1 million on 31 December 2004 (previous year: € 2 million).

§ 133, paragraph 1, sentence 2, of the German Company Transformation Act (UmwG) stipulates that all the legal entities involved in a spin-off are liable jointly and severally for the liabilities of the legal entity making the transfer that are established when the spin-off takes effect. This means that Bayer AG and LANXESS AG are liable jointly and severally for all the established liabilities of Bayer AG at the time when the spin-off of the LANXESS Group took effect. In accordance with § 133, paragraph 3, of the German Company Transformation Act (UmwG), the liability is limited to five years for the company that was not allocated the liabilities in the spin-off and takeover contract.

It was arranged in the spin-off and takeover contract that Bayer AG exempts LANXESS AG from all legally stipulated joint liability, e.g. on the basis of § 133 of the German Company Transformation Act (UmwG), and joint and several liability for commitments and liabilities that are not to be transferred to LANXESS AG in the context of the spin-off and takeover contract.

Description of the master agreement In a master agreement that was concluded between Bayer AG and LANXESS AG at the same time as the spin-off and takeover contract, Bayer AG and LANXESS AG agreed, among other things, on commitments about the mutual exemption from joint liability for commitments of the other party to the contract and made arrangements about the allocation of liability for product liability commitments, for environmental pollution and for violations of cartel legislation in the relationship between the parties to the contract. The main provisions of the master agreement about these issues are explained below.

Joint liability & joint and several liability Bayer AG and LANXESS AG arranged in the master agreement that Bayer AG exempts LANXESS AG and all the companies affiliated to LANXESS AG from joint liability or joint and several liability for commitments of the Bayer Group resulting from the global implementation of the reorganization of the Bayer Group in 2002 and 2003. Bayer AG also exempted LANXESS AG and all the companies affiliated with LANXESS AG from joint liability or joint and several liability resulting from measures taken to establish the LANXESS Group, to the extent that this liability relates to liabilities that cannot be or have not expressly been assigned to the LANXESS Group. LANXESS AG in turn exempted Bayer AG and all the companies affiliated with Bayer AG from joint liability or joint and several liability resulting from measures taken to establish the LANXESS Group, to the extent that this liability relates to liabilities that can be or have expressly been assigned to the LANXESS Group.

Environmental pollution The master agreement specifies which of the parties to it is liable internally for site-based environmental pollution that was caused or occurred up to the spin-off date (1. July 2004). The fundamental legal consequence of the liability of one of the parties to the contract is that this party to the contract is required to exempt the other party to the contract and the companies affiliated with the other party to the contract completely from any liability under public or private law in relation to authorities or other third parties with respect to environmental pollution of the sites in question. The arrangement about the allocation of liability for environmental pollution essentially establishes liability for the respective party to the contract for the status quo at the sites which it and the companies affiliated with it used on the qualifying date. The liability arrangement also includes individual elements of origination liability. The liability is as a result based on the sites affected in each case and makes certain distinctions, which are presented in simplified form below:

LANXESS AG is basically liable – subject to plans for potential exoneration – for all environmental pollution of what are known as the LANXESS sites. The sites in Germany and other countries used by the LANXESS Group on the qualifying date are essentially what are involved here. Bayer AG, on the other hand, is basically liable – also subject to plans for potential exoneration – for all environmental pollution of what are known as the BAG sites. All the sites owned by Bayer AG and companies affiliated with it or used by Bayer AG and companies affiliated with it (with the exception of the LANXESS sites) are essentially what are involved here. With respect to possible liability for environmental pollution of the sites of miscellaneous third parties, the parties to the contract arranged that LANXESS AG is liable for this environmental pollution when the environmental pollution was caused by a LANXESS site (via the groundwater) and that Bayer AG is liable when the environmental pollution was caused by a BAG site (via the groundwater). The master agreement also makes special arrangements about the allocation of liability for environmental pollution of specific sites (including landfill sites) as well as of liability for environmental pollution arising from certain company purchase contracts.

The master agreement specifies a restriction of the liability of LANXESS AG and companies affiliated with LANXESS AG for environmental pollution to a total of € 350 million, with this maximum liability limit relating – in simplified terms – only to measures that have been ordered, agreed or carried out by the end of 2009. LANXESS AG and the companies affiliated with LANXESS AG otherwise have unlimited liability for environmental pollution.

Product liability The master agreement specifies the allocation of liability for product liability commitments in the internal relationship between the parties to the contract. Only product liability commitments to third parties are meant here and not product liability claims between the parties to the contract. The latter are in fact expressly excluded. The legal consequence of the liability of a party to the contract is that this party to the contract is required to exempt the other party to the contract and the companies affiliated with the other party to the contract from the relevant product liability commitment. The master agreement makes essentially the following distinctions with respect to the allocation of liability:

The LANXESS Group on the one hand and the future Bayer Group on the other hand are each liable fundamentally for all the product liability commitments arising from or in connection with faulty products that were put on the market in the past by their business divisions that were active on the qualifying date or are put on the market up to the effective date. The products put on the market by the individual business divisions are determined, for example, by the "UVP" numbers, which are assigned to every product. With respect to product liability commitments arising from or in connection with faulty products that are put on the market after the effective date, the master agreement refers to the rules of the legal system that applies in each individual case and does not therefore specify any particular contractual rules. The master agreement also makes a special arrangement for faulty products that are put on the market by certain companies, plants, production facilities and equipment that have been sold and assigns product liability to LANXESS AG in these cases. In addition to this, it makes another special arrangement, according to which product liability for certain products, particularly products from the discontinued business areas and business divisions of the Bayer Group allocated to the LANXESS Group, is assigned to LANXESS AG.

Anti-trust violations The master agreement specifies the allocation of liability for violations of anti-trust laws in the internal relationship between the parties to the contract. Anti-trust liabilities are obligations and liabilities relating to the payment of fines and other penalties, commitments to the payment of damages to third parties, including the payment of penal damages, and commitments to third parties about the payment of additional revenues or benefits arising from anti-trust violations.

In the relationship to the Bayer Group, the LANXESS Group is liable for any liabilities arising from anti-trust violations for which the LANXESS operations are responsible. Bayer, in turn, is liable for any liabilities arising from anti-trust violations for which they are responsible. The party that is liable in each case is required to reimburse the other party the necessary funds to meet the cartel commitments.

In addition to this general principle, there are special arrangements for cartel proceedings and civil proceedings in connection with certain products from what used to be the rubber business division, which has been allocated to the LANXESS Group. Bayer AG and some subsidiaries are the subject of investigations under criminal and civil law with respect to these products, particularly in the USA, Canada and Europe. If authorities at least initiated proceedings or a company took action with a cartel authority concerning the initiation of proceedings by 1 July 2004, the internal arrangement is that LANXESS will pay 30% of the liabilities and Bayer 70%.

LANXESS AG's reimbursement commitment is limited to a maximum total of € 100 million, to which the reimbursement of tax damage arising from restrictions on tax deductibility may be added. The reimbursement payments are limited to € 50 million per calendar year.

The reimbursement arrangement also applies to proceedings about which Bayer AG announced on 14 July 2004 that it had reached agreement with the US Department of Justice and which related to accusations of activities that violated cartel legislation in the Rubber Chemicals Business Unit in the years 1995 to 2001. Bayer AG agreed to plead guilty and to pay $ 66 million. This agreement has received court approval and Bayer AG has in the meantime made the payment.

The costs of external assistance with the proceedings are also divided up on the basis of a ratio of 30:70, although these costs are not counted towards the maximum liability limit.

Any anti-trust obligations that have been allocated to the parts of the LANXESS Group resident or operating in the USA are included in the calculation of the maximum liability limits in each case. In view of the special features of the US legal situation, contracts are being concluded about these parts of the LANXESS Group resident or operating in the USA, the provisions of which do not have to coincide with the provisions of the master agreement. Bayer AG and LANXESS AG have, however, undertaken to make sure that the agreements in the USA are adapted according to the fundamental rules of the master agreement if there are major deviations.

(34) Related parties In the course of its business operations, the LANXESS Group buys materials, stocks and services from numerous business partners all over the world. They include ones in which Bayer AG in particular holds interests as well as companies that have connections to members of the Supervisory Board of Bayer AG.

There are business and legal relationships between the remainder of the Bayer Group and the LANXESS Group. These relationships are being maintained after the spin-off has taken effect. They include in particular supply relationships between the Bayer subgroups and the Bayer service companies on the one hand and the LANXESS Group on the other.

On the basis of these supply relationships, the LANXESS Group purchased goods and services with a volume of about € 0.6 billion from companies in the Bayer Group in the 2004 fiscal year. Most of them were product deliveries, for example of chlorine and caustic soda, with the majority of these deliveries being made by the Bayer MaterialScience subgroup. Services (excluding services from Bayer Industry Services GmbH & Co. OHG) were also provided to the LANXESS Group. Large proportions of them were services provided by Bayer Business Services GmbH in the areas of IT systems development & application support, IT infrastructure, HR payroll & pensions and customs & excise. The LANXESS Group received engineering services from Bayer Technology Services GmbH. There were various other services, primarily in the custom manufacturing field and other areas.

The LANXESS Group also purchased site services from Bayer Industry Services GmbH & Co. OHG in the areas of energy, infrastructure, logistics and catering with a volume of € 0.5 billion. The companies in the LANXESS Group supplied goods and services with a volume of about € 0.7 billion to companies in the Bayer Group in the 2004 fiscal year. Most of the deliveries were made to the Bayer Material Science and Bayer Crop Science subgroups.

Where there were no chemical or polymer operations of an appropriate size to be transferred to the LANXESS Group in a particular country, the business with a sales volume of € 0.7 billion was channelled via Bayer companies, mainly on an agency business basis and to some extent as an independent dealer. In contrast to this, only minor use was made of the LANXESS organization to sell Bayer products.

(35) Financial instruments The portfolio of primary financial instruments is shown in the balance sheets. Financial instruments on the assets side are classified in the categories held-for-trading-purposes, held-to-maturity or available-for-sale – in accordance with IAS 39 – and are stated at amortized costs or fair values in line with their classification, with the changes in the fair value of the available-for-sale instruments being recognized in equity. Permanent impairment losses are charged to income. Financial instruments that represent liabilities are stated at amortized costs.

a) Risks and risk management Due to the global corporate alignment of the LANXESS Group, the business operations, results and cash flows are exposed to a number of market risks. Such risks include:

- Currency risks: The LANXESS Group is exposed to fluctuations in the exchange rate between the euro and other major currencies.

- Interest rate risks: The LANXESS Group is exposed to fluctuations in interest rates.

- Credit risks: The LANXESS Group is exposed to credit risk with respect to its transaction partners.

- Raw material price risks: The LANXESS Group is exposed to possible increases in raw material prices.

The above-mentioned risk could have an adverse effect on the profitability and financial position of the LANXESS Group. An outline of the individual risks and risk management within the LANXESS Group is given below.

Currency risk

Since the LANXESS Group carries out business transactions in many different currencies, it is exposed to a number of risks in connection with fluctuations in the relative values of these currencies.

Transaction risk: There are currency risks, i.e. potential reductions in the value of a financial instrument because of changes in the exchange rate, particularly where receivables or liabilities exist or will be created in a different currency than the local currency of the company.

The risks arising from the business operations are determined and analyzed systematically. Decisions about the level of hedging for these risks are taken at regular intervals. Anticipated business is sometimes hedged, too within the framework of these hedging activities. A large proportion of the contractual and foreseeable currency risks are hedged by using derivative financial instruments, the changes in the fair value of which are shown in the income statements or – in the case of cash flow hedges – in the other equity movements. Since the LANXESS Group concludes derivative contracts for most of the currency risks, the Group is of the opinion that a significant increase or a significant decrease in the exchange rate between the euro and other major currencies would not have any material impact on future cash flows in the short term. In the long run, however, these exchange rate fluctuations could have a negative effect on cash flows, if the LANXESS Group were not in a position to absorb these exchange rate fluctuations, e.g. via the pricing of its products in the relevant local currency.

Currency risks from financial transactions are generally hedged 100% , including interest. Particular use is made of interest/currency swaps and forward exchange transactions as hedging instruments.

Securities held as fixed assets and other loans are mainly kept in the currency area of the Group companies making the investment, so that the currency risk is minimized.

Translation risk: Many of the companies in the LANXESS Group are located outside the euro zone. Since the euro is the currency in which the Group prepares its financial statements, the financial statements of these subsidiaries were translated into euros for inclusion in the Combined Financial Statements. Changes in the average exchange rate of the currency of a particular country from period to period can have a major impact on the translation into euros of both the sales and the earnings that are shown in this currency. In contrast to the effect of exchange rate fluctuations where the transaction risk is concerned, the translation risk has no effects on the cash flows of the Group in the local currency.

The LANXESS Group has major assets, liabilities and businesses outside the euro zone that are reported in local currencies. Although their long-term currency risk is estimated and evaluated on a regular basis, foreign exchange transactions are only carried out in view of these risks when consideration is being given to withdrawal from a specific business and if the funds released by this withdrawal are to be repatriated. The LANXESS Group does, however, show the effects of exchange rate fluctuations in the translation of net positions into euros in its equity item.

Interest rate risk

Financial assets and financial liabilities are primarily exposed to an interest rate risk, i.e. possible fluctuations in the overall return produced by a financial instrument due to movements in the market interest rate.

When the risk of interest rate changes is not hedged with financial assets and financial liabilities because of favorable fixed interest rate conditions, hedging via derivative interest rate instruments plays a particularly important role here. Interest rate/interest rate currency swaps can be used in this context.

It was assumed that the targeted net indebtedness for the LANXESS Group would be achieved by the obtainment of central external loan facilities. The interest expenses allowed for in this connection are based on the market interest rates for corporate bonds in the lower investment grade range. The interest rates were computed by averaging the rates charged on a short-term instrument and on a five-year instrument. The proportion of funding required in non-euro currencies was taken into account by including a risk premium. No interest rate derivatives are included in the LANXESS Combined Financial Statements because of this assumption.

Other loans primarily consist of small loans to employees, which are made to a large extent at a fixed interest rate close to the market rate. Since the interest rates are fixed, these loans are in principle exposed to an interest rate risk, but this risk is accepted for overriding reasons, so that no hedging is carried out here. More than three-quarters of the loans to employees have a term of more than five years.

Credit risk

There is a credit risk to the extent that transaction partners do not meet their commitments to the LANXESS Group in transactions involving financial instruments. Since the LANXESS Group does not conclude any master netting agreements with its transaction partners, the total amount of the assets represents the maximum credit risk.

Raw material price risk
The LANXESS Group is exposed to risks associated with changes in market prices with its business operations in the commodity field. In connection with the spin-off, the LANXESS Group is in the process of developing a comprehensive strategy to reduce the relevant risks by means of financial measures, including the use of financial instruments. In order to participate in market fluctuations in this area, derivative financial instrument contracts were concluded in the 2004 fiscal year on the basis of internal assessments of the market. The changes in the fair value of the derivative financial instruments in the commodity field are recognized in the income statement.

b) Derivative financial instruments Derivative financial instruments were only taken into account in preparation of the Combined Financial Statements at the already existing legal entities which had operations that related exclusively to LANXESS business. In this connection, fair values of € 23 million were capitalized in the 2004 fiscal year. Negative fair values of € 3 million were included in liabilities. "Regular-way" purchases and sales of financial assets are included in the accounts in accordance with IAS 39 by applying the settlement day accounting.

Notes to the cash flow statement

(36) Cash inflow from operating activities The cash flow statement begins with the operating result (EBIT). The gross cash flow of € 313 million (previous year: € 223 million) shows the operating surplus of income over expenses before any changes in funds. The changes in working capital were also included in the cash inflow from operating activities of € 311 million (previous year: € 346 million).

In the determination of depreciation and amortization of fixed assets in the 2004 fiscal year for the business units affected by the impairments made as per 31 December 2003, depreciation charges that were capitalized as part of the costs of goods sold of inventories as per 31 December 2003 were allocated to the depreciation and amortization of fixed assets – contrary to the calculation method normally used by Bayer and LANXESS – in order to make a chronologically comparable presentation of the depreciation and amortization.

(37) Cash out-/inflow from investing activities An amount of € 71 million (previous year: € 370 million) was spent in 2004 to acquire property, plant and equipment as well as financial assets. Income totalling € 26 million (previous year: € 65 million) was, on the other hand, generated by the sale of property, plant and equipment and other assets, while interest and dividend income of € 6 million (previous year: € 5 million) was also obtained. The repayment of a short-term loan granted to the Bayer Group in the context of the internal Group financing system led to a cash inflow of € 256 million. € 48 million were spent on acquiring the interest of 40% in Bayer Industry Services GmbH & Co. OHG. The overall cash outflow from investing activities was € 39 million (previous year: € 300 million).

(38) Cash out-/inflow from financing activities There was a cash outflow of € 214 million from financing activities (previous year: € 46 million). Loans were reduced by € 166 million (previous year: inflow of € 23 million). Interest expenses led to a cash outflow of € 48 million (previous year: € 69 million).

(39) Cash and cash equivalents The cash and cash equivalents of € 72 million (previous year: € 13 million) include cheques, cash on hand and bank balances. Securities originally due within up to three months are also included in accordance with IAS 7 (Cash Flow Statements).

Notes to the segment reporting In accordance with the rules of IAS 14 (Segment Reporting), certain financial statements data have to be presented separately by segments and regions and the breakdown has to be based on internal reporting that enables the risks and earnings of the Group to be assessed reliably. The purpose of segmentation is to provide transparency on the profitability and success prospects of the individual operations of the Group.

The LANXESS Group is controlled via strategic business units, which are combined in segments on the basis of the economic features of the business, the nature of the products and production processes, the nature of the customer relationships and the characteristics of the sales organization. Reports were presented about the following segments as per 31 December 2004:

Segments	Operations
Performance Rubber	Special rubber and rubber chemicals for high-quality rubber products, e.g. for use in vehicles, buildings or shoes
Engineering Plastics	Thermoplastics as the basis for high-tech applications in the car, household, leisure and electronics fields
Chemical Intermediates	Basic chemicals as a global commodity supplier, fine chemicals as primary and intermediate products for pharmaceuticals, agrochemicals and special chemicals as well as inorganic pigments for coloring concrete, dispersion inks/paints and lacquers
Performance Chemicals	Material protection products, finishing agents for the leather, textile and paper industries, ion exchangers for water treatment, synthetic elastic Fibers for fashionable clothing and plastic additives, such as flameproofing agents and plasticizers

The allocation to the reporting regions was changed over the previous year in accordance with the future regional breakdown in the LANXESS Group. The figures for the previous year were adapted accordingly. In the new structure, a breakdown is made into the regions EMEA (Europe without Germany, Middle East, Africa), Germany, America and Asia (including Oceania).

In the reconciliation calculation, internal Group items are eliminated and income, expenses, assets and liabilities that cannot be allocated to the segments directly are shown. What are included here are in particular the corporate center, the service companies (including the interest in Bayer Industry Services GmbH & Co. OHG with an equity value of € 44 million and equity earnings of € –4 million) and ancillary businesses.