NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

General Information The consolidated financial statements of the LANXESS Group as of December 31, 2005 have been prepared in accordance with the International Financial Reporting Standards as adopted by the European Union (E.U.) and the additional requirements of Article 315a paragraph 1 of the German Commercial Code (HGB). The prior-year figures have been determined according to the same principles.

The consolidated financial statements comprise the income statement, balance sheet, cash flow statement, statement of changes in stockholders' equity and the notes, which include the segment data.

The consolidated financial statements of the LANXESS Group are presented in euros (€). Amounts are stated in millions of euros (€ million) except where otherwise indicated. Assets and liabilities are classified in the balance sheet as current or non-current. In some cases, a detailed breakdown by maturity is given in the notes.

The income statement is drawn up by the cost-of-sales method.

The fiscal year for these consolidated financial statements is the calendar year.

The annual financial statements of LANXESS AG and the consolidated financial statements of the LANXESS Group, to which the auditors, PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Cologne, have issued an unqualified opinion, are published in the Federal Gazette (Bundesanzeiger) and filed with the Commercial Register at the Cologne District Court under the number HRB53652.

The consolidated financial statements of the LANXESS Group for fiscal 2005 were drawn up by the Management Board of LANXESS AG and cleared for submission to the Supervisory Board on March 21, 2006. It is the responsibility of the Supervisory Board to examine the consolidated financial statements and declare whether or not it approves them.

Transition from Combined Financial Statements to the Consolidated Financial Statements of the LANXESS Group as of December 31, 2005 These consolidated financial statements of the LANXESS Group constitute the first mandatory financial reporting in accordance with commercial and stock corporation law since the spin-off from Bayer AG on January 28, 2005. For the previous year, voluntary Group statements (Combined Financial Statements) were prepared. Since the spin-off was accomplished by way of a carve-out, the financial reporting for 2005 is required to be based on the fictitious assumptions that the LANXESS Group already existed at the start of the previous year, i.e. on January 1, 2004, and that the chemicals business and parts of the polymers business of the Bayer Group had previously been transferred to it. The consolidated financial statements of the LANXESS Group as of December 31, 2005 therefore contain comparative figures for 2004. The assets and liabilities transferred to the LANXESS Group are accounted for by the predecessor accounting method at the amounts at which they were carried by the Bayer Group at the date of the spin-off.

The combined financial statements as of December 31, 2004 were derived from the consolidated financial statements of the Bayer Group in order to provide a historical record of LANXESS's financial data ahead of the spin-off. The preparation of the Combined Financial Statements required the use of estimates and assumptions affecting the classification and valuation of assets, liabilities, income and expenses. The information value and the comparability of the Combined Financial Statements are limited by the fact that the LANXESS Group was not a unified and independent enterprise during fiscal 2004. The transition from the Combined Financial Statements to the consolidated financial statements of the LANXESS Group entailed a number of adjustments, which are outlined below.

As a result of the transition from the Combined Financial Statements – on which calculations had to be based prior to the spin-off – to consolidated Group statements, the stockholders' equity of the LANXESS Group decreased by €245 million because of adjustments to deferred taxes that are not recognized in income.

The need for these adjustments arose from the fact that – in compliance with tax regulations – the consolidated Group statements have to reflect the amount of loss carryforwards attributable to the operations that were actually spun off, and this differed from the amount previously assigned to LANXESS on the basis of origin for purposes of the Combined Financial Statements. Changes in deferred taxes recognized for temporary differences also had an effect.

In addition, changes in the accounting treatment of the Bayer Pensionskasse (pension fund) by the LANXESS Group resulted in a one-time €58 million reduction in stockholders' equity. From January 31, 2005 the Bayer pension fund has been treated as a defined contribution plan and is no longer recognized as a defined benefit plan. Further details of the post-employment benefit systems are given in Note [27].

Including further effects amounting to €9 million, stockholders' equity decreased by a total of €294 million.

Minority interest in stockholders' equity as of December 31, 2005 reflects the related currency translation adjustments for the first time. This reduces minority interests by €20 million compared with the amount reported in the Combined Financial Statements as of December 31, 2003 and December 31, 2004, and increases stockholders' equity before minority interests by the same amount.

Impact of New Accounting Standards Since 2002 the accounting standards issued by the International Accounting Standards Board (IASB) have been referred to as International Financial Reporting Standards (IFRS) in place of the previous term, International Accounting Standards (IAS). However, standards published by the IASB prior to that date continue to be referred to as IAS.

Accounting standards that had to be applied for the first time in 2005 As a result of its Improvements Project the IASB withdrew the option previously permitted by IAS 1 of classifying assets and liabilities on the balance sheet by maturity or in order of liquidity. From fiscal 2005, IAS 1 prescribes classification by maturity. This change was applied for the first time in the consolidated financial statements of the LANXESS Group for 2005. In connection with this change, deferred items no longer need to be presented separately. The previous year's figures have been restated accordingly.

In February 2004, the IASB issued IFRS 2 on accounting for share-based compensation plans. IFRS 2 had no material impact on the Group's financial position, results of operations or cash flows.

In March 2004, the IASB issued IFRS 3 to replace the previously valid IAS 22. IFRS 3 stipulates that all business combinations are to be accounted for by the purchase method of accounting. Identifiable assets and liabilities are recognized at their fair value at the date of acquisition, and goodwill may no longer be amortized but must be tested annually for impairment. IFRS 3 had no material impact on the Group's financial position, results of operations or cash flows.

In March 2004, the IASB adopted IFRS 4, which is applicable for virtually all insurance contracts under which an entity has an insurance liability, and all reinsurance contracts that it holds. IFRS 4 had no material impact on the Group's financial position, results of operations or cash flows.

In March 2004, the IASB issued IFRS 5, which specifies that assets held for sale must be recognized at the lower of the carrying amount and their fair value less costs to sell. It also specifies when an entity's operations are to be classified as discontinued operations. IFRS 5 had no material impact on the Group's financial position, results of operations or cash flows.

In March 2004, the IASB published an amendment to IAS 39 concerning the recognition of fair value hedges used to hedge a portfolio against interest rate risks. The amendment simplifies the implementation of IAS 39 by enabling fair value hedge accounting to be used for this purpose more readily than before. The related changes to IAS 39 had no material impact on the Group's financial position, results of operations or cash flows.

In connection with the adoption of IFRS 3 in March 2004, the IASB also revised IAS 36 and IAS 38. Goodwill and other intangible assets with an indefinite useful life now have to be tested for impairment at least once a year. If circumstances suggest that an asset could be impaired, impairment tests must be carried out more frequently. Further, the reversal of impairment losses on goodwill is prohibited. Where there is no foreseeable period for which an intangible asset is expected to generate cash inflows for an entity, it is treated as having an indefinite useful life. Such assets may not be amortized but are instead subject to the same impairment tests as goodwill. The revised standards had no material impact on the Group's financial position, results of operations or cash flows.

In May 2004, the International Financial Reporting Interpretations Committee (IFRIC) issued Interpretation IFRIC 1. This addresses accounting for changes in cash outflows and discount rates, and increases resulting from the passage of time in existing decommissioning, restoration, and similar liabilities that have been recognized both as part of the cost of an item of property, plant and equipment and as a provision. IFRIC 1 had no material impact on the Group's financial position, results of operations or cash flows.

In November 2004, the IFRIC released an amendment to the Standing Interpretation Committee's interpretation SIC-12. This amendment removes SIC-12's scope exception for equity compensation plans, thereby requiring an entity that controls an employee benefit trust (or similar entity) set up for the purpose of a share-based payment arrangement to consolidate that trust upon adopting IFRS 2. Now excluded from the scope of SIC-12, however, are not only post-employment benefit plans but also other long-term employee benefit plans, whose accounting treatment is prescribed by IAS 19. This change had no material impact on the Group's financial position, results of operations or cash flows.

In November 2004, the IFRIC issued Interpretation IFRIC 2, which specifies when members' shares in cooperative entities should be classified as financial liabilities or equity. This interpretation had no material impact on the Group's financial position, results of operations or cash flows.

In December 2004, the IASB issued a limited amendment to IAS 39 on the initial recognition of financial assets and financial liabilities. The amendment provides transitional relief from retrospective application of the "day 1" gain and loss recognition requirements. It allows, but does not require, companies to adopt an approach to immediate gain and loss recognition that is easier to implement than under the previous version of IAS 39. The change had no material impact on the Group's financial position, results of operations or cash flows.

Newly issued accounting standards LANXESS has not yet applied accounting standards or interpretations issued by the IASB that are mandatory only for fiscal years beginning after January 1, 2005, except where explicit reference is made to their early adoption.

In December 2004, the IASB issued an amendment to IAS 19. This amendment allows the option of immediately recognizing actuarial gains and losses from defined benefit pension obligations without affecting the income statement. Other features of the amendment include (1) clarification that a contractual agreement between a multi-employer plan and participating employers that determines how a surplus is to be distributed or a deficit funded will give rise to an asset or liability, (2) accounting requirements for group defined benefit plans in the separate or individual financial statements of entities within a group, and (3) additional disclosure requirements. The amendment is effective for annual periods beginning on or after January 1, 2006. The LANXESS Group is currently evaluating the impact the amendment to the standard will have on the Group's financial position, results of operations and cash flows.

In December 2004, the IFRIC issued Interpretation IFRIC 5. The interpretation addresses how to account for an interest in a fund established to meet the costs of the decommissioning or environmental rehabilitation. IFRIC 5 is to be applied for annual periods beginning on or after January 1, 2006. The LANXESS Group is currently evaluating the impact the standard will have on the Group's financial position, results of operations and cash flows.

In April 2005, the IASB issued an amendment to IAS 39 to permit the foreign currency risk of a highly probable forecasted intragroup transaction to qualify as a hedged item in consolidated financial statements, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect the consolidated financial statements. The amendment also specifies that if the hedge of a forecasted intragroup transaction qualifies for hedge accounting, any gain or loss that is recognized directly in equity in accordance with the hedge accounting rules in IAS 39 must be reclassified into profit or loss in the same period or periods during which the hedged transaction affects consolidated profit or loss. The amendment comes into effect on January 1, 2006. The change is not expected to have any material impact on the Group's financial position, results of operations or cash flows.

In June 2005, the IASB published a further amendment to IAS 39. It sets out conditions for the option of measuring financial assets and liabilities at fair value through profit or loss (the "fair value option"). The LANXESS Group did not make use of the fair value option in fiscal 2005.

In August 2005, the IASB issued IFRS 7. This fundamentally restructures disclosure requirements for financial instruments and combines them all in a single standard. It replaces IAS 30 with regard to disclosure requirements for banks and other financial institutions. The section of IAS 32 relating to disclosure requirements has been transferred to IFRS 7 and revised at the same time. IFRS 7 requires the disclosure of information on the importance of financial instruments for the company's financial position and results of operations and contains new requirements on the reporting of risks associated with financial instruments. IFRS 7 is to be applied from January 1, 2007 by all companies that hold financial instruments. The LANXESS Group is currently evaluating the impact the standard will have on the Group's reporting.

Also in August 2005, the IASB adopted amendments to IAS 39 and IFRS 4 relating to financial guarantees. The amendments are intended to clarify whether financial guarantee contracts should be recognized in accordance with IAS 39 or IFRS 4. The IASB defines a financial guarantee contract as one requiring the issuer to make pre-determined payments if a specified debtor defaults on his payment obligations to the holder. The amendment is effective for annual periods beginning on or after January 1, 2006. The LANXESS Group does not expect the first-time application of this standard to have a material impact on its financial position, results of operations or cash flows.

In September 2005, the IFRIC issued Interpretation IFRIC 6. This interpretation relates to the E.U. Directive on the disposal of electrical and electronic equipment by manufacturers and addresses when a provision has to be recorded for such obligations. IFRIC 6 is to be applied for annual periods beginning on or after December 1, 2005. The LANXESS Group does not expect this standard to have a material impact on the Group's financial position, results of operations or cash flows.

In November 2005, the IFRIC issued Interpretation IFRIC 7, which clarifies how the comparative amounts in an entity's financial statements should be restated as required by IAS 29 when the economy of the country whose currency is the entity's functional currency becomes hyperinflationary. It also provides guidance on how deferred tax items in the opening balance sheet should be restated. The LANXESS Group is currently evaluating the impact this interpretation will have on the Group's financial position, results of operations and cash flows.

Consolidation Methods Capital consolidation is performed according to IFRS 3. All business combinations are accounted for by the purchase method. The cost of acquisition is stated by the acquirer as the aggregate of the fair values, at the date of exchange, of the assets given, liabilities incurred or assumed, and any equity instruments issued by the acquirer in exchange for control of the acquiree plus any costs directly attributable to the business combination. Identifiable assets and liabilities are included at their fair values. Any difference to the purchase price is recognized as goodwill and tested annually for impairment – or more frequently where events or changes in circumstances indicate a possible impairment. Negative goodwill is expensed after re-examining the purchase price allocation for possible errors.

Intragroup sales, profits, losses, income, expenses, receivables and payables are eliminated.

Joint ventures are included by proportionate consolidation according to the same principles.

By contrast, investments in material entities in which the LANXESS Group exerts significant influence, generally through an ownership interest between 20% and 50%, are accounted for by the equity method. The cost of acquisition of such investments is adjusted annually by the percentage of any change in its stockholders' equity corresponding to LANXESS's percentage interest in the company. Any goodwill arising from the first-time inclusion of companies at equity is accounted for in the same way as goodwill relating to fully consolidated companies. The only company included at equity in fiscal 2005 was Bayer Industry Services GmbH & Co. OHG.

Currency Translation In the financial statements of the individual consolidated companies, all foreign currency receivables and payables are translated at closing rates, irrespective of whether they are hedged. Forward contracts that, from an economic point of view, serve as a hedge against fluctuations in exchange rates are stated at fair value.

The financial statements of foreign entities are prepared in their respective functional currencies in accordance with IAS 21. By far the majority of foreign companies are financially, economically and organizationally autonomous and their functional currencies are therefore the local currencies. The assets and liabilities of these companies are translated at closing rates while income and expense items are translated at average rates for the year.

Goodwill arising from acquisitions of foreign entities is translated at the closing rate, regardless of the date of acquisition.

Since stockholders' equity (excluding derivative financial instruments) is translated at historical rates, the differences arising on translation at closing rates are shown separately as a currency translation adjustment in the statement of changes in stockholders' equity.

If a company is deconsolidated, the relevant exchange differences are reversed and recognized in income.

Where the operations of a company outside the euro zone are essentially integrated into those of LANXESS AG, the functional currency is the euro. In these cases, currency translation is carried out using the temporal method and recognized in income.

The exchange rates for major currencies against the euro changed as follows:

Exchange rates		Dec. 31, 2004	Dec. 31, 2005	2004	2005
1 €		Closing rate		Average rate	
Argentina	ARS	4.05	3.57	3.66	3.64
Brazil	BRL	3.62	2.76	3.64	3.04
Canada	CAD	1.64	1.37	1.62	1.51
China	CNY	11.27	9.52	10.29	10.20
Japan	JPY	139.65	138.90	134.40	136.86
Mexico	MXN	15.23	12.59	14.04	13.57
United Kingdom	GBP	0.71	0.69	0.68	0.68
United States	USD	1.36	1.18	1.24	1.24

Recognition and Valuation Principles

Sales and other operating income Sales are recognized at the time the goods are delivered to the customer or the services are rendered, and are reported net of sales taxes and deductions. Revenues from contracts that contain customer acceptance provisions are only recognized when customer acceptance occurs or the contractual acceptance period has expired. Allocations to provisions for rebates to customers are recognized in the period in which revenue recognition legally occurs. Payments relating to the sale or licensing of technologies or technological expertise are recognized in income as soon as the relevant agreements have become effective, provided that all rights and obligations relating to the technologies concerned are relinquished under the contract terms. However, if rights to the technologies continue to exist or obligations resulting from them still have to be fulfilled, the payments received are recorded in line with the actual circumstances. Revenues such as license fees, rental payments, interest income or dividends are recognized according to the same principles.

Research and development expenses According to IAS 38, research costs cannot be capitalized, whereas development costs have to be capitalized if, and only if, specific narrowly defined conditions are fulfilled. Development costs must be capitalized if it is sufficiently certain that the future economic benefits to the company will cover not only the usual production, selling and administrative costs but also the development costs themselves. There are also several other criteria relating to the development project and the product or process being developed, all of which have to be met to justify asset recognition. No development costs were capitalized in 2005 or 2004.

Income taxes This item comprises the income taxes paid or accrued in the individual countries, plus deferred taxes. In the Combined Financial Statements for fiscal 2004, income taxes were allocated on the basis of the transferred units' contributions to earnings. Computation is based on local tax rates.

Intangible assets Acquired intangible assets with a definite useful life are recognized at cost and amortized over their useful lives. The amortization period varies from 3 years for software to 20 years for concessions, industrial property rights, similar rights and assets and licenses to such rights and assets. Write-downs are made for impairment losses. Write-backs are made if the reasons for previous years' write-downs no longer apply. Such write-backs (reversals of impairment losses), however, must not cause the net carrying amounts of the assets to exceed either the amortized cost at which they would have been recognized if the write-downs had not been made or their recoverable value. The lower of these two amounts is recognized. Amortization for 2005 has been allocated as appropriate to the cost of sales, selling expenses, research and development expenses or general administration expenses. Intangible assets with an indefinite useful life are not amortized. They are tested at least annually for impairment.

Goodwill, including that arising from capital consolidation, is capitalized and tested annually for impairment – or more frequently where events or changes in circumstances indicate a possible impairment. In compliance with IAS 36, write-downs of goodwill are determined by comparing the goodwill to the discounted cash flows expected to be generated by the assets to which it can be ascribed. Write-downs of capitalized goodwill are included in other operating expenses. The reversal of impairment losses on goodwill is not permitted. Goodwill is not amortized.

Self-created intangible assets are not normally capitalized. However, the costs incurred at the application development stage of in-house software development are an exception to this rule. These costs are amortized over the useful life of the software from the date it is placed in service.

Property, plant and equipment Property, plant and equipment is carried at the cost of acquisition or construction less depreciation for wear and tear. Write-downs are made for impairments that go beyond normal depreciation and are expected to be permanent. In compliance with IAS 36, impairment losses are measured by comparing the carrying amounts to the discounted cash flows expected to be generated by the assets in the future. Where it is not possible to allocate future cash flows to specific assets, the impairment loss is assessed on the basis of the discounted cash flows for the cash-generating unit to which the asset belongs. Write-downs are reversed if the reasons for them no longer apply.

The cost of self-constructed property, plant and equipment comprises the direct cost of materials, direct manufacturing expenses, appropriate allocations of material and manufacturing overheads, and an appropriate share of the depreciation and write-downs of assets used in construction. It also includes the shares of expenses for company pension plans and discretionary employee benefits that are attributable to construction.

If the construction phase of property, plant or equipment extends over a long period, the interest incurred on borrowed capital up to the date of completion is capitalized as part of the cost of acquisition or construction.

Expenses for repairing property, plant and equipment are charged to income. They are capitalized retroactively as acquisition or construction costs if they will result in future economic benefits and can be accurately determined.

When assets are shut down, sold, or abandoned, the difference between the net proceeds and the net carrying amount is recognized as a gain or loss in other operating income or expenses.

The following depreciation periods, which are based on the estimated useful lives of the respective assets, are applied throughout the Group:

Buildings	20 to 50 years
Outdoor infrastructure	10 to 20 years
Plant installations	6 to 20 years
Machinery and equipment	6 to 12 years
Laboratory and research facilities	3 to 5 years
Storage tanks and pipelines	10 to 20 years
Vehicles	5 to 8 years
Computer equipment	3 to 5 years
Furniture and fixtures	4 to 10 years

In accordance with IAS 17, leased assets where all substantive risks and opportunities arising from ownership are transferred (finance leases) are capitalized at the lower of their fair value or the present value of the minimum lease payments at the date of addition. The leased assets are depreciated over their estimated useful lives except where subsequent transfer of title is uncertain, in which case they are depreciated over their estimated useful life or the lease term, whichever is shorter. The future lease payments are recorded as financial liabilities.

Financial instruments Financial instruments are contracts that give rise simultaneously to a financial asset for one party and a financial liability for the other. Under IAS 32, financial instruments include primary instruments, such as trade receivables or payables and financial assets or liabilities, as well as derivative financial instruments that are used to hedge risks arising from changes in currency exchange and interest rates. Further details of financial instruments are given in Note [39].

Financial assets Investments in affiliated companies and the equity instruments included in non-current assets are classified as held-to-maturity investments or available-for-sale financial assets and recognized in compliance with IAS 39 at amortized cost or fair value. Where evidence exists that such assets may be impaired, they are written down as necessary on the basis of an impairment test. Write-downs are reversed if the reasons for them no longer apply.

Investments in companies included at equity (associates) are recognized at the amounts corresponding to LANXESS's shares in their equity in accordance with IAS 28.

Loans receivable that are interest-free or bear low rates of interest are carried at present value; other loans receivable are carried at amortized cost.

Derivative financial instruments and hedging transactions In accordance with IAS 39, the LANXESS Group recognizes derivative financial instruments as assets or liabilities at their fair value on the balance sheet date. Gains and losses resulting from changes in fair value are recognized in income. Where foreign currency derivatives or commodity swaps used to hedge future cash flows from pending business or forecasted transactions qualify for hedge accounting under this standard, changes in the value of such instruments are recognized separately in stockholders' equity until the underlying transactions are realized and thus do not affect the income statement. The amounts recognized in this separate equity item are subsequently released to other operating income/expenses or cost of sales, as appropriate, when the hedged transaction is recognized in the income statement. Any portion of the change in the fair value of such derivatives deemed to be ineffective with regard to the hedged risk is recognized directly in the income statement as other operating income or expense. Changes in the fair value of interest rate derivatives used to hedge non-current liabilities with variable interest rates are also recognized in stockholders' equity with no impact on income, provided that they qualify for cash flow hedge accounting.

Inventories In accordance with IAS 2, inventories encompass assets held for sale in the ordinary course of business (finished goods and trade goods), assets in the process of being manufactured for sale (work in process) and assets consumed during the production process or the rendering of services (raw materials and supplies). In accordance with IAS 2, inventories are valued by the weighted-average method and recognized at the lower of cost or net realizable value, in other words, the estimated normal selling price less the estimated production costs and selling expenses.

The cost of production comprises the direct cost of materials, direct manufacturing expenses and appropriate allocations of fixed and variable material and manufacturing overheads, where these are attributable to production.

It also includes expenses for company pension plans, corporate welfare facilities and discretionary employee benefits that can be allocated to production. Administrative costs are included where they are attributable to production.

In view of the production sequences characteristic of the LANXESS Group, work in progress and finished goods are grouped together.

Receivables and other assets Receivables comprise trade receivables and other assets. They are recognized at amortized cost. Any necessary write-downs are based on the probability of default.

Non-current assets and liabilities held for sale Assets are recognized as held for sale if it is sufficiently probable that they can be disposed of in their current condition. Such assets may be individual non-current assets, groups of assets (disposal groups) or complete business entities. A disposal group may also include liabilities if these are to be divested together with the assets as part of the transaction.

Assets and disposal groups classified as held for sale are no longer depreciated. They are recognized at the lower of fair value less costs to sell or the carrying amount.

Deferred taxes In accordance with IAS 12, deferred taxes arise from temporary differences between the carrying amounts of assets or liabilities in the accounting and tax balance sheets, from consolidation measures and from realizable tax loss carryforwards. Deferred taxes are calculated at the rates which – on the basis of the statutory regulations in force, or already enacted in relation to future periods, as of the closing date – are expected to apply in the individual countries at the time of realization.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced by the amount unlikely to be realizable due to lack of future taxable income. Deferred tax assets on loss carryforwards are recognized if it seems sufficiently certain that the carryforwards can be utilized.

Further explanations concerning income taxes are given in the section on recognition and valuation principles.

Provisions Other provisions are valued in accordance with IAS 37 and, where appropriate, IAS 19 using the best estimate of the extent of the obligation. Non-current portions of material provisions are discounted to present value if the extent and timing of the obligation can be assessed with reasonable certainty. If the projected obligation alters as the time of performance approaches (interest effect), the related expense is recognized in other financial expense. Further details of pension provisions are given in Note [27]. When calculating pension provisions, the portion of the net actuarial gain or loss to be recognized in the income statement is determined by the corridor method.

If the projected obligation declines as a result of a change in the estimate, the provision is reversed by the corresponding amount and the resulting income is recognized in the cost of sales, selling expenses, research and development expenses or general administration expenses, as appropriate.

Personnel commitments mainly include annual bonus payments, long service awards and other personnel costs. Reimbursements to be received from the German government under the phased early retirement program are recorded as receivables and recognized in income as soon as the criteria for such reimbursements are fulfilled.

Provisions for trade-related commitments mainly comprise those for rebates.

The LANXESS Group also records provisions for current or pending legal proceedings where the resulting expenses can be reasonably estimated. These provisions include all estimated fees and legal costs and the cost of potential settlements. The amounts of such provisions are based upon information and cost estimates provided by the Group's legal advisers. The provisions are regularly reviewed (at least once a quarter) together with the Group's legal advisers and adjusted if necessary.

Liabilities Current liabilities are recognized at repayment or redemption amounts. Non-current liabilities and financial obligations that are not the hedged item in a permissible hedge accounting relationship are carried at amortized cost.

Liabilities under finance leases are recognized at the fair value of the leased asset at the inception of the lease or the present value of the minimum lease payments, whichever is lower. Thereafter the minimum lease payments are divided into financing costs and the portion representing repayment of the principal.

Cash flow statement The cash flow statement shows how the liquidity of the LANXESS Group was affected by cash inflows and outflows during the year. The effects of acquisitions, divestments and other changes in the scope of consolidation are eliminated. Cash flows are classified by operating, investing and financing activities in accordance with IAS 7. The cash and cash equivalents recognized in the cash flow statement comprise cash, checks, bank balances and securities with original maturities of up to three months. The cash flow statement is supplemented by a reconciliation of cash and cash equivalents at the end of the year to the liquid assets stated in the balance sheet. The effects of changes in exchange rates and changes in the scope of consolidation are shown separately.

Global impairment testing: procedure and impact In the LANXESS Group, non-current assets are tested for impairment by comparing the residual carrying amount of each cash-generating unit to the recoverable amount.

The LANXESS Group defines its cash-generating units as the business units, since these are the next financial reporting level below the segments. However, if there is reason to suspect impairment of non-current assets below business-unit level, such assets are also tested for impairment and written down where necessary and the write-downs are recognized in income.

The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use. If the carrying amount of a cash-generating unit exceeds the recoverable amount, an impairment loss is recognized. The fair value less costs to sell is the best estimate of the price that would be obtained by selling the cash-generating unit to a third party at the time of valuation less the estimated selling costs. The value in use is defined as the present value of future cash flows based on the continuing use of the asset and its retirement at the end of its useful life.

The value in use is calculated from a forecast of future cash flows based on the LANXESS Group's current long-term planning. This planning is founded upon past experience and the Management Board's estimates of expected market conditions, including assumptions regarding future raw material prices, cost of sales, selling expenses, research and development expenses, general administration expenses and exchange rates.

The present value of future cash flows is calculated by discounting them using the weighted average cost of capital. The weighted average cost of capital is calculated using capital market models. It comprises the average cost of debt and equity financing weighted at market value, taking into account the specific business risks to which the LANXESS Group is exposed. The cost of capital after taxes used in these calculations is 6.0%.

Any impairment losses are allocated by first writing down the goodwill of the strategic business unit concerned. For this purpose, goodwill is allocated among the strategic business units on the basis of use before the impairment test. Any remaining amount is allocated among the other assets of the strategic business unit on the basis of their net carrying amounts at the closing date.

The following impairment losses were recognized on the non-current assets of the LANXESS Group for fiscal 2004 and 2005:

Impairment losses	2004	2005
€ million		
Goodwill	**20**	**–**
of which Performance Rubber	–	–
of which Engineering Plastics	–	–
of which Chemical Intermediates	–	–
of which Performance Chemicals	20	–
Intangible assets, excluding goodwill	**–**	**–**
Property, plant and equipment	**48**	**64**
of which Performance Rubber	–	–
of which Engineering Plastics	21	23
of which Chemical Intermediates	27	14
of which Performance Chemicals	–	–
Corporate Center, Services, Non-Core Business, Reconciliation	–	27
Total	**68**	**64**

Impairment losses were recognized in full in the income statement under other operating expenses and reflected in the segment reporting under the expenses of the respective segments.

The impairment write-downs of €37 million in the Engineering Plastics and Chemical Intermediates reporting segments in 2005 were partly attributable to as yet unsatisfactory performances by individual business units and the resulting decreases in their value in use. These were mainly based on the expectation of adverse external factors such as higher raw material costs that cannot be passed on to customers to the necessary degree. A further factor is that volume growth is likely to be restricted by tougher competition and global overcapacities. Further impairment losses of €27 million were identified mainly as a result of comparing the carrying amounts of the assets of units earmarked for portfolio measures to the fair values determined from existing contracts.

Estimation Uncertainties Preparation of consolidated financial statements in accordance with IFRS entails forward-looking assumptions and estimates that invariably affect the valuation of assets and liabilities, income and expenses and contingent liabilities.

All assumptions and estimates used in the consolidated financial statements are based on management's expectations as of the closing date. Information that could alter these estimates is reviewed continually and may result in an adjustment to the carrying amounts of the respective assets and liabilities.

In particular, the recognition and the measurement of provisions are greatly influenced by assumptions as to the probability of utilization and the underlying discount rate. Changes in the discount rate used for a provision may make significant remeasurement necessary.

The results of impairment tests are also materially affected by estimates and assumptions. Management's expectations indirectly affect the valuation of assets and goodwill.

In the impairment tests on assets in fiscal 2005, assumptions were made about the future cash flows expected to be generated by certain cash-generating units and the discount rate after taxes used to calculate the present value of such cash flows. If the actual cash flows or discount rates in subsequent periods differ from these assumptions, write-downs may be necessary. An increase of one percentage point in the discount rate or a 10% change in the expected future cash flows would not have caused the recoverable amounts of the cash-generating units to fall below their carrying amounts and thus would not have altered the impairment losses recognized in the fiscal year.

Defined benefit pension plans also necessitate actuarial computations and valuations. The section on provisions for pensions and other post-employment benefits contains information on the assumptions on which the actuarial calculations and estimates were based (see Note [27]).

To assess the impact of changes in material assumptions on the level of provisions, the LANXESS Group performed sensitivity analyses on the other provisions recorded as of December 31, 2005. These analyses involved varying the probability of an event occurring, the discount rate and the amount of the provision.

The LANXESS Group believes that the variations on which the above analyses were based would not have a material impact on the level of provisions reported in the consolidated financial statements.

The LANXESS Group endeavors to minimize short-term fluctuations in its net income by hedging interest rate and currency risks. In the long term, however, it is possible that changes in exchange rates and/or interest rates could adversely affect earnings. As of December 31, 2005 it is estimated that a general increase of one percentage point in interest rates would have reduced the Group's income before income taxes by €2 million.

As part of the spin-off from the Bayer Group, LANXESS took over structures and circumstances that in future are subject to appraisal by the tax authorities. Although the LANXESS Group believes it has presented all relevant facts correctly and in compliance with the law, it is possible that the tax authorities may reach different conclusions in individual cases.

When these consolidated financial statements were prepared, there was no reason to expect any major change in the underlying estimates, so the LANXESS Group does not currently expect any major adjustment in carrying amounts in 2006.

Companies Consolidated

Changes in the scope of consolidation The consolidated financial statements of the LANXESS Group include the parent company LANXESS AG along with all of its material domestic and foreign subsidiaries. Two companies were consolidated for the first time in the second quarter of 2005. LANXESS Finance B.V., Ede, Netherlands, was established on June 6, 2005 in connection with the issue of the Euro Benchmark Bond to operate as a financing and service company within the LANXESS Group. Since April 1, 2005 the Perlon monofil activities of Dorlastan Fibers & Monofil GmbH have been concentrated at Perlon-Monofil GmbH (formerly 1. BCheV GmbH).

LANXESS Kautschuk GmbH and LANXESS Belgien GmbH were merged into LANXESS Deutschland GmbH in 2005. The assets of LANXESS Europe GmbH & Co. KG were transferred to LANXESS Europe GmbH. Since both these transactions exclusively comprised asset transfers between fully consolidated companies, they did not affect the consolidated financial statements. Novochem 2000 S.A. and iSL-Chemie GmbH & Co. KG were divested and thus deconsolidated. These transactions had no material impact on the consolidated financial statements. The assets of both companies together at the dates of deconsolidation accounted for less than 1% of the total assets of the Group. The acquisition price totaled €20 million and is due in the first quarter of 2006.

On December 31, 2005, LANXESS AG had 58 fully consolidated companies. As in the previous year, International South Africa (Pty) Ltd. was included by proportionate consolidation, while Bayer Industry Services GmbH & Co. OHG was included at equity.

Other information on companies consolidated The principal consolidated companies are listed in the following table:

Company name and headquarters	Interest held (%)
Germany	
LANXESS Buna GmbH, Marl	100
LANXESS Deutschland GmbH, Leverkusen	100
LANXESS Distribution GmbH, Cologne	100
LANXESS Europe GmbH, Langenfeld	100
RheinChemie Rheinau GmbH, Mannheim	100
EMEA (excluding Germany)	
LANXESS (Pty.) Ltd., Isando, South Africa	100
LANXESS B.V., Ede, Netherlands	100
LANXESS Chemicals, S.L., Barcelona, Spain	100
LANXESS Elastomères S.A.S., Lillebonne, France	100
LANXESS Emulsion Rubber S.A.S., La Wantzenau, France	100
LANXESS Finance B.V., Ede, Netherlands	100
LANXESS International SA, Fribourg, Switzerland	100
LANXESS Limited, Newbury, U.K.	100
LANXESS N.V., Antwerp, Belgium	100
LANXESS Rubber N.V., Zwijndrecht, Belgium	100
LANXESS S.r.l., Milan, Italy	100
LANXESS Styrenics, S.L., Barcelona, Spain	100
Americas	
LANXESS Corporation, Pittsburgh, Pennsylvania, U.S.	100
LANXESS Inc., Sarnia, Ontario, Canada	100
LANXESS Industria de Produtos Quimicos e Plasticos Ltda., Sao Paulo, Brazil	100
LANXESS S.A., Buenos Aires, Argentina	100
LANXESS S.A. de C.V., Mexico City, Mexico	100
Asia-Pacific	
LANXESS (Thailand) Company Ltd., Rayong, Thailand	100
LANXESS (Wuxi) Chemicals Co. Ltd., Wuxi, China	100
LANXESS ABS Limited, Vadodara, India	51
LANXESS Hong Kong Ltd., Hong Kong, China	100
LANXESS International Trading Shanghai Co. Ltd., Shanghai, China	100
LANXESS K.K., Tokyo, Japan	100
LANXESS Pte. Ltd., Singapore, Singapore	100
LANXESS PTY Ltd., Homebush Bay, Australia	100

A list of the LANXESS Group's ownership interests is deposited with the Commercial Register at the Local Court of Cologne under No. HRB53652 and is also available directly from LANXESS AG on request.

In fiscal 2005 the 40% interest in Bayer Industry Services GmbH & Co. OHG allocated to LANXESS effective July 1, 2004 was included at equity.

As in the previous year, the joint venture Chrome International South Africa was included by proportionate consolidation in accordance with IAS 31 on the basis of LANXESS's 50% interest. The effect of this joint venture on the Group balance sheet and income statement is as follows:

	Dec. 31, 2004	Dec. 31, 2005		2004	2005
€ million			€ million		
Non-current assets	31	30	Income	16	21
Current assets	4	6	Expenses	(21)	(22)
Provisions	(1)	(1)			
Financial liabilities	(44)	(45)			
Other liabilities	(1)	(2)			
Net assets	**(11)**	**(12)**	**Income after taxes**	**(5)**	**(1)**

Notes to the Income Statement

(1) Sales Sales in 2005 showed a year-on-year increase of €377 million, or 5.6%, to €7,150 million. Overall, the positive impact of prices and exchange rates offset the negative impact of volumes. After adjustment for currency effects, sales were up 5.1%. Revenues are derived primarily from the sale of self-manufactured products and trade goods.

A breakdown of sales is provided in the table of key data by segment and region.

(2) Research and development expenses Because of their special importance in the LANXESS Group, research and development expenses are recognized separately alongside the mandatory information on cost of sales, selling expenses and general administration expenses.

(3) Other operating income

Other operating income	2004	2005
€ million		
Income from hedging with derivative financial instruments	9	40
Income from the reversal of provisions	14	15
Gains from the sale of non-current assets	4	4
Income from the reversal of write-downs on receivables and other assets	2	2
Miscellaneous operating income	78	94
	107	**155**

(4) Other operating expenses

Other operating expenses	2004	2005
€ million		
Expenses for allocations to restructuring provisions	–	144
Expenses relating to antitrust litigation	33	71
Expenses for impairment write-downs, excluding goodwill	48	64
Expenses for hedging with derivative financial instruments	–	21
Write-downs of trade receivables and other current assets	15	19
Losses from the sale of non-current assets	6	3
Amortization of acquired goodwill	27	0
Miscellaneous operating expenses	76	169
	205	**491**

Global impairment charges resulted in additional other operating expenses of €64 million in fiscal 2005 (2004: €68 million). The miscellaneous operating expenses for fiscal 2005 also included expenses for portfolio adjustments.

(5) Operating result (EBIT) The reconciliation of the segment results to EBIT for the LANXESS Group is provided in the segment reporting (Note [41]).

In the consolidated financial statements of the LANXESS Group, the interest portion of non-current provisions – including those for funded pension obligations – is recognized entirely in the financial result. The same applies to the return on plan assets. Recognition of the amortization of actuarial gains and losses depends on whether the change in actuarial assumptions relates to the pension obligations themselves or to the plan assets. If the assumptions about pension obligations alter, for example, if the rate of increase in employees' remuneration differs from predictions, the relevant income or expense is recognized in the appropriate operating expense item(s) and thus in the operating result. However, income or expense arising because the actual amounts vary from the actuarial assumptions on which plan assets are valued continue to be recognized in the financial result.

(6) Income/loss from investments in affiliated companies – net The components of this item are as follows:

Income/loss from investments in affiliated companies	2004	2005
€ million		
Loss from company included at equity	(4)	(35)
Income from other affiliated companies	2	3
	(2)	**(32)**

(7) Net interest expense This item comprises:

Net interest expense	2004	2005
€ million		
Income from other securities and loans constituting financial assets	1	1
Other interest and similar income	2	6
Interest and similar expenses	(49)	(48)
	(46)	**(41)**

Finance leases are capitalized under property, plant and equipment in compliance with IAS 17. The interest portion of the lease payments, amounting to €4 million (2004: €5 million), is included in interest expense.

(8) Other financial income and expenses – net
This item comprises:

Other financial income and expenses – net	2004	2005
€ million		
Interest portion of interest-bearing provisions	(33)	(32)
Net exchange gain (loss)	2	(6)
Miscellaneous financial expenses	(1)	(34)
Miscellaneous financial income	1	0
Total	**(31)**	**(72)**

Miscellaneous financial expenses partly comprise the cost of the early repurchase of the mandatory convertible bond.

(9) Income taxes This item comprises the income taxes paid or accrued in the individual countries, plus deferred taxes. In 2004 income taxes were allocated to the business units being transferred to LANXESS on the basis of their contributions to earnings.

A tax rate of 39.6% is used to calculate deferred taxes for the German companies. This is derived from a corporation tax rate of 25.0% plus a solidarity surcharge of 5.5%, after adjusting for trade tax. Deferred taxes for foreign companies are based on local tax rates.

The breakdown of income taxes by origin is as follows:

Income taxes by origin	2004	2005
€ million		
Current taxes	(44)	(56)
Deferred taxes resulting from		
temporary differences	(15)	115
loss carrryforwards	72	4
Income taxes	**13**	**63**

The deferred tax assets and liabilities are allocable to the various balance sheet items as follows:

Deferred tax assets	Dec. 31, 2004		Dec. 31, 2005	
€ million	Deferred tax assets	Deferred tax liabilities	Deferred tax assets	Deferred tax liabilities
Intangible assets	22	5	18	7
Property, plant and equipment	102	253	29	169
Financial assets	0	4	0	3
Inventories	12	12	10	4
Receivables	2	56	3	74
Other assets	20	12	9	12
Pension provisions	12	10	18	7
Other provisions	31	2	92	2
Liabilities	38	1	79	1
Loss carryforwards	233	–	49	–
	472	**355**	**307**	**279**
of which non-current	370	272	114	186
Set-off*	(300)	(300)	(204)	(204)
	172	**55**	**103**	**75**

* Under IAS 12 deferred tax assets and liabilities should, under certain conditions, be offset if they relate to income taxes levied by the same tax authority.

The change in deferred taxes is shown in the table.

Change in deferred taxes	
€ million	
Deferred taxes as of January 1, 2005	**117**
Tax income reflected in the income statement	119
Changes in scope of consolidation	2
Taxes included in stockholders' equity	
Migration effects due to spin-off from the Bayer Group	(245)
Change in accounting treatment of Bayer Pensionskasse	38
Other	2
Translation differences	(5)
Deferred taxes as of December 31, 2005	**28**

Some deferred tax assets relate to tax jurisdictions where losses were recorded in previous years. In this respect, the LANXESS Group has taken customary and feasible tax strategies into consideration.

Deferred tax assets of €49 million (2004: €233 million) are recognized on the €125 million (2004: €591 million) in tax loss carryforwards that represent income likely to be realized in the future.

The reduction in loss carryforwards utilizable for tax purposes from €591 million to €125 million is principally attributable to the fact that the tax loss carryforwards transferred to LANXESS AG at the time of the spin-off from Bayer AG were €461 million lower than the amount allocated to LANXESS AG in the combined financial statements as of December 31, 2004. The difference was recognized in stockholders' equity and thus had no effect on income.

Deferred taxes have not been recognized for €89 million of tax loss carryforwards that can theoretically be utilized over more than one year.

The actual tax income for 2005 was €63 million (2004: €13 million). This figure differed by €17 million (2004: €5 million) from the expected tax income of €46 million (2004: €8 million) that would result from applying the tax rate for LANXESS AG.

The following table shows a reconciliation of expected tax income to reported tax income:

Reconciliation to reported tax income	2004	2005
€ million		
Loss before income taxes	(20)	(117)
Income tax rate of LANXESS AG	39.6%	39.6%
Theoretical tax income	8	46
Tax difference due to differences between local tax rates and the theoretical tax rate	(1)	17
Reduction in taxes due to tax-free income		
Utilization of off-balance-sheet loss carryforwards	–	13
Other	–	3
Increase in taxes due to non-deductible items		
Amortization of goodwill	(1)	–
Other	–	(21)
Other tax effects	7	5
Actual tax income	**13**	**63**
Effective tax rate	65.0%	53.8%

(10) Other taxes Other taxes amounting to €42 million (2004: €39 million) are included in the cost of sales, selling expenses, research and development expenses or general administration expenses. These are mainly taxes related to property, as well as taxes on electricity and other utilities.

(11) Earnings per share Earnings per share for fiscal 2005 are derived from the Group net loss of €63 million and the number of shares in circulation on December 31, 2005 following the spin-off in January and the exercise of conversion rights under the mandatory convertible bond during the year. The calculation is based on the 84,620,670 shares admitted to trading on the Frankfurt Stock Exchange. Further information on equity instruments that could dilute earnings per share in the future is contained in Note [25].

(12) Cost of materials The cost of materials was approximately €3.6 billion (2004: approx. €3.5 billion), comprising purchased materials plus/minus changes in inventories and expenses for purchased utilities and fuels. Since the Bayer Group did not prepare separate financial statements for what are now the LANXESS operations before it decided to spin them off, the cost of materials in 2004 has been derived from the consolidated reporting for the Bayer Group. The cost of materials stated for 2004 does not necessarily reflect the amount that would have been reported if the LANXESS Group had prepared consolidated financial statements for 2004.

(13) Personnel expenses Personnel expenses increased by €131 million from €1,202 million to €1,333 million in 2005, mainly as a result of restructuring. The personnel expenses shown here do not contain the interest portion of the allocation to personnel-related provisions, especially pension provisions. This is included in the financial result as other financial expense (see Note [8]).

Personnel expenses include wages and salaries totaling €1,040 million (2004: €906 million) and social expenses of €293 million (2004: €296 million), of which €104 million (2004: €105 million) were pension expenses. The above statement regarding the limited information value of the figures for cost of materials in 2004 also applies to personnel expenses.

(14) Employees The number of employees as of December 31, 2005, classified by corporate functions, was as follows:

Employees by functional area	Dec. 31, 2004	Dec. 31, 2005
Marketing	3,460	2,797
Production	13,711	13,266
Research	670	583
Administration	1,818	1,636
	19,659	**18,282**

On December 31, 2005 the LANXESS Group had 18,282 employees compared with 19,659 on December 31, 2004. In the Combined Financial Statements as of December 31, 2004, some 600 employees in the marketing functions of Bayer companies were allocated to the LANXESS Group for statistical purposes because they worked in agency business for LANXESS. As of the date of the spin-off, these individuals were no longer assigned to LANXESS.

Notes to the Balance Sheet

(15) Intangible assets Changes in intangible assets in 2005 were as follows:

Changes in intangible assets in 2004				
€ million	Concessions, industrial property rights, similar rights and assets, and licenses to such rights and assets	Acquired goodwill	Advance payments	Total
Gross carrying amounts on December 31, 2003	268	137	15	420
Exchange differences	(6)	(1)		(7)
Changes in scope of consolidation				0
Acquisitions				0
Capital expenditures	4			4
Retirements	(4)	(108)		(112)
Transfers	15		(12)	3
Gross carrying amounts on December 31, 2004	**277**	**28**	**3**	**308**
Accumulated amortization and write-downs on Dec. 31, 2003	(221)	(99)	(1)	(321)
Exchange differences	5	1		6
Changes in scope of consolidation				0
Amortization and write-downs in 2004	(12)	(27)		(39)
of which write-downs		(20)		(20)
Write-backs				0
Retirements	3	108		111
Transfers				0
Accumulated amortization and write-downs on Dec. 31, 2004	**(225)**	**(17)**	**(1)**	**(243)**
Net carrying amounts on December 31, 2004	**52**	**11**	**2**	**65**

Changes in intangible assets in 2005				
€ million	Concessions, industrial property rights, similar rights and assets, and licenses to such rights and assets	Acquired goodwill	Advance payments	Total
Gross carrying amounts on December 31, 2004	277	28	3	308
Exchange differences	14	3		17
Changes in scope of consolidation	(1)			(1)
Acquisitions				0
Capital expenditures	6		2	8
Retirements	(20)	(7)	(1)	(28)
Transfers	5	(5)		0
Gross carrying amounts on December 31, 2005	**281**	**19**	**4**	**304**
Accumulated amortization and write-downs on Dec. 31, 2004	(225)	(17)	(1)	(243)
Exchange differences	(13)			(13)
Changes in scope of consolidation	1			1
Amortization and write-downs in 2005	(20)			(20)
of which write-downs	(2)			(2)
Write-backs				0
Retirements	17	7		24
Transfers	(2)	2		0
Accumulated amortization and write-downs on Dec. 31, 2005	**(242)**	**(8)**	**(1)**	**(251)**
Net carrying amounts on December 31, 2005	**39**	**11**	**3**	**53**

(16) Property, plant and equipment Changes in property, plant and equipment in 2005 were as follows:

Changes in property, plant and equipment in 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 Dec. 31, 2003	1,363	5,529	184	207	7,283
Exchange differences	(18)	(66)	(4)		(88)
Changes in scope of consolidation					0
Acquisitions					0
Capital expenditures	20	47	6	202	275
Retirements	(117)	(208)	(19)	(1)	(345)
Transfers	28	167	29	(227)	(3)
Gross carrying amounts on Dec. 31, 2004	**1,276**	**5,469**	**196**	**181**	**7,122**
Accumulated depreciation and write-downs on Dec. 31, 2003	(1,041)	(4,521)	(169)	(1)	(5,732)
Exchange differences	13	54	4		71
Changes in scope of consolidation					0
Depreciation and write-downs in 2004	(27)	(192)	(12)	(27)	(258)
of which write-downs	(2)	(26)	(1)	(27)	(56)
Write-backs					0
Retirements	109	190	17	2	318
Transfers	2		13	(15)	0
Accumulated depreciation and write-downs on Dec. 31, 2004	**(944)**	**(4,469)**	**(147)**	**(41)**	**(5,601)**
Net carrying amounts on Dec. 31, 2004	**332**	**1,000**	**49**	**140**	**1,521**

Changes in property, plant and equipment in 2005					
€ million	Land and buildings	Technical equipment and machinery	Other fixtures, fittings and equipment	Advance payments and assets under construction	Total
Gross carrying amounts on Dec. 31, 2004	1,276	5,469	196	181	7,122
Exchange differences	41	194	7	9	251
Changes in scope of consolidation	(12)	(28)	(1)		(41)
Acquisitions					0
Capital expenditures	16	41	6	180	243
Retirements	(36)	(171)	(11)	(2)	(220)
Transfers	17	152	11	(180)	0
Gross carrying amounts on Dec. 31, 2005	**1,302**	**5,657**	**208**	**188**	**7,355**
Accumulated depreciation and write-downs on Dec. 31, 2004	(944)	(4,469)	(147)	(41)	(5,601)
Exchange differences	(24)	(155)	(5)		(184)
Changes in scope of consolidation	10	26	1		37
Depreciation and write-downs in 2005	(38)	(225)	(14)	(16)	(293)
of which write-downs	(7)	(40)	(2)	(16)	(65)
Write-backs					0
Retirements	34	167	10	1	212
Transfers	(2)	(36)	(1)	39	0
Accumulated depreciation and write-downs on Dec. 31, 2005	**(964)**	**(4,692)**	**(156)**	**(17)**	**(5,829)**
Net carrying amounts on Dec. 31, 2005	**338**	**965**	**52**	**171**	**1,526**

Capitalized property, plant and equipment includes assets with a total net value of €46 million (2004: €36 million) held under finance leases. The gross carrying amounts of these assets at the closing date totaled €108 million (2004: €89 million).

These assets are mainly machinery and technical equipment with a carrying amount of €20 million (gross amount: €72 million; 2004: carrying amount €18 million, gross amount €66 million) and buildings with a carrying amount of €26 million (gross amount: €36 million; 2004: carrying amount €17 million, gross amount €23 million). In the case of buildings, either the present value of the minimum lease payments substantially covers their fair value, or title passes to the lessee on expiration of the lease.

Property, plant and equipment also includes assets of secondary importance leased to other parties under operating leases. However, if under the relevant agreements the lessee is to be regarded as the economic owner of the assets and the lease therefore constitutes a finance lease as defined in IAS 17, a receivable is recognized in the balance sheet in the amount of the discounted future lease payments.

(17) Investment in associate The following tables show the main income statement and balance sheet items for the company included in the consolidated statements using the equity method:

	2004	2005
€ million		
Sales	1,707	1,656
Loss from associate included at equity	**(4)***	**(35)**

* Relates to the second half of 2004 only

	Dec. 31, 2004	Dec. 31, 2005
€ million		
Stockholders' equity		
Assets	1,009	1,095
Liabilities	772	973
	237	122
Adjustment of LANXESS's interest and equity valuation	(193)	(100)
Associate included at equity	**44**	**22**

(18) Investments in other affiliated companies This item contains interests in other affiliated companies totaling €4 million (2004: €4 million).

The other investments classified as available-for-sale financial assets contain non-listed equity instruments whose fair values could not be reliably determined. These are therefore recognized in the financial statements as of December 31, 2005 at amortized cost of €4 million (2004: €4 million).

(19) Non-current and current financial assets

Financial assets	Dec. 31, 2004			Dec. 31, 2005		
€ million	Non-current	Current	Total	Non-current	Current	Total
Securities	3	0	3	3	0	3
Loans to other affiliated companies	25	0	25	23	0	23
Other loans	9	0	9	9	0	9
Leasing receivables	16	1	17	13	2	15
Loans receivable	0	0	0	0	7	7
Receivables from derivative financial instruments	0	23	23	0	28	28
	53	**24**	**77**	**48**	**37**	**85**

Accounts receivable of €15 million (2004: €17 million) relate to lease agreements in which the other party, as lessee, is to be regarded as the economic owner of the leased assets (finance leases).

The leasing receivables are due as follows:

Leasing receivables			
€ million	Lease payments	Interest portion	Leasing receivables
2006	3	1	2
2007	3	1	2
2008	3	1	2
2009	3	1	2
2010	3	1	2
After 2010	7	2	5
	22	**7**	**15**

(20) Other non-current assets Other non-current assets are carried at amortized cost less write-downs. No write-downs were made in 2005.

Other non-current assets comprise:

Other non-current assets	Dec. 31, 2004	Dec. 31, 2005
€ million		
Receivables from pension obligations	113	59
Other receivables	16	20
	129	**79**

(21) Inventories Of the €1,068 million in inventories carried as of December 31, 2005 (2004: €1,151 million), €19 million (2004: €29 million) are reflected at their net realizable value.

Inventories comprised the following:

Inventories	Dec. 31, 2004	Dec. 31, 2005
€ million		
Raw materials and supplies	211	205
Work in process, finished goods and trade goods	939	862
Advance payments	1	1
	1,151	**1,068**

Write-backs of inventories totaled €3 million in 2005.

Write-downs of inventories were as follows:

Write-downs of inventories	Dec. 31, 2004	Dec. 31, 2005
€ million		
Balance at beginning of year	(56)	(63)
Additions charged as expenses	(25)	(25)
Exchange differences	1	(1)
Reversals/utilization	17	22
Balance at end of year	**(63)**	**(67)**

(22) Trade receivables Trade receivables are stated after write-downs of €31 million (2004: €26 million) for amounts unlikely to be recovered.

All trade receivables – totaling €1,065 million (2004: €1,137 million) – are due within one year. Trade receivables of €4 million (2004: €4 million) related to other affiliated companies and €1,061 million (2004: €1,133 million) to other customers.

Changes in write-downs of trade receivables and other current assets are as follows:

Write-downs of trade receivables and other current assets	Dec. 31, 2004	Dec. 31, 2005
€ million		
Balance at beginning of year	(22)	(26)
Additions charged as expenses	(12)	(19)
Exchange differences	1	(1)
Reversals/utilization	7	12
Balance at end of year	**(26)**	**(34)**

(23) Other current assets Other receivables and other assets are carried at amortized cost, less write-downs of €3 million (2004: €1 million).

They comprise:

Other current assets	Dec. 31, 2004	Dec. 31, 2005
€ million		
Claims for tax refunds	73	102
Payroll receivables	1	1
Other receivables	131	97
	205	**200**

(24) Liquid assets

Liquid assets	Dec. 31, 2004	Dec. 31, 2005
€ million		
Marketable securities and other instruments	0	3
Cash and cash equivalents	72	133
	72	**136**

Financial instruments with original maturities of up to three months are recognized under cash and cash equivalents in view of their high liquidity.

(25) Stockholders' equity At the Extraordinary Stockholders' Meeting of LANXESS AG on September 15, 2004 the Management Board was authorized until August 30, 2009 to increase the company's capital stock, with the approval of the Supervisory Board, by issuing new no-par shares against cash or non-cash contributions by a total of €36,517,096 on one or more occasions (authorized capital). This resolution on authorized capital was entered in the Commercial Register on February 25, 2005. Stockholders essentially have to be granted subscription rights to any authorized capital issued. However, with the approval of the Supervisory Board, the Management Board is authorized to exclude subscription rights for stockholders in certain circumstances.

The Annual Stockholders' Meeting of LANXESS AG on June 16, 2005 authorized an increase of up to €20,000,000 in the capital stock through the issue of up to 20,000,000 new no-par bearer shares. This contingent capital was used to grant shares to holders of the convertible bond issued by LANXESS AG under a resolution adopted at the Stockholders' Meeting of September 15, 2004, upon exercise of conversion rights or fulfillment of the mandatory conversion obligation.

Capital increase from contingent capital On July 20, 2005, following the bondholder's exercise of its right to convert the mandatory convertible bond, the capital stock of LANXESS AG was increased from the contingent capital by €11,586,478 to €84,620,670 through the issuance of 11,586,478 no-par bearer shares, each representing €1 of the capital stock. These new shares, which are entitled to any dividends from January 1, 2005 onward, were admitted to trading on German stock exchanges on July 22, 2005. As a result of the stock issue, capital reserves increased by €199 million.

Capital reserves The spin-off balance sheet prepared in connection with the spin-off of LANXESS AG from Bayer AG contained the assets and liabilities allocated to LANXESS AG for purposes of its commercial accounts as of July 1, 2004. Insofar as the net assets exceeded the capital stock shown in the spin-off balance sheet as of July 1, 2004, they were recognized as capital reserves in accordance with the Spin-off and Acquisition Agreement. In 2005 the capital reserves were increased by the exercise of the conversion rights under the mandatory convertible bond. €158 million was transferred from the capital reserve of LANXESS AG to offset the loss carryforward and net loss. The capital stock and capital reserves of LANXESS AG amounted to €889 million as of December 31, 2005.

Other reserves The other reserves mainly contain retained earnings amounting to €748 million (2004: €896 million).

(26) Minority stockholders' interest Minority stockholders' interests in fiscal 2004 and 2005 consisted mainly of interests in the stockholders' equity of LANXESS ABS Ltd., Vadodara, India; DUBAY GmbH, Hamm, Germany; EUROPIGMENTS S.L., Vilasar de Mar, Barcelona, Spain; LANXESS Yaxing Chemicals Company Ltd., Weifang, China; and RheinChemie Ltd., Qingdao, China. Regarding the recognition of exchange differences relating to minority stockholders' interests in equity, please see the section headed "Transition from the Combined Financial Statements to the Consolidated Financial Statements of the LANXESS Group as of December 31, 2005".

(27) Provisions for pensions and other post-employment benefits Group companies provide retirement benefits for most of their employees, either directly or by contributing to independently administered funds.

The way these benefits are provided varies according to the legal, fiscal and economic conditions of each country. The benefits are generally based on the employees' remuneration and years of service. The obligations relate both to existing retirees' pensions and to pension entitlements of future retirees.

The presentation of the pension obligations in the combined financial statements and the obligations to be transferred was based on separate actuarial reports for the periods ended December 31, 2004 and December 31, 2005, which in turn were based on lists of the employees to be transferred or already transferred, respectively, at the closing dates. The obligations were determined on an individual basis, except that, as of December 31, 2004, they were allocated in certain cases by way of distribution keys for specific employee groups.

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

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

In the case of defined contribution plans, the company pays contributions to publicly or privately administered pension insurance plans on a mandatory, contractual or voluntary basis. Once the contributions have been paid, the company has no further payment obligations.

The regular contributions constitute expenses for the year in which they are due and as such are included in the function expenses, and thus in the operating result. In 2005, these expenses totaled €81 million (2004: €47 million), including €46 million in employer's contributions to the statutory pension plan in Germany. The year-on-year increase was partly attributable to the change in the accounting treatment of the Bayer Pensionskasse VvaG (Bayer pension fund).

The legally independent Bayer Pensionskasse is a private insurance company and is therefore subject to the German Law on the Supervision of Private Insurance Companies. Since the obligations of the participating entities are not confined to payment of the contributions for the respective fiscal year, the Bayer Pensionskasse constitutes a defined-benefit multi-employer plan and therefore would normally have to be accounted for proportionately as a defined-benefit plan.

The Bayer Pensionskasse is financed not on the principle of coverage for individual benefit entitlements, but on the actuarial equivalence principle, based on totals for the whole plan. This means that the sum of existing plan assets and the present value of future contributions must be at least equal to the total future benefits payable under the plan. The LANXESS Group is therefore exposed to the actuarial risks of the other participating entities in the Bayer Pensionskasse and thus has no consistent or reliable basis for allocating the benefit obligation, plan assets and costs. It also has no access to the information it would need in order to account for the Bayer Pensionskasse as a defined benefit plan in accordance with IAS 19. Therefore, as of January 28, 2005, the Bayer Pensionskasse is no longer accounted for as a defined benefit plan, but as a defined contribution plan.

The Bayer Pensionskasse makes any pension adjustments in accordance with Article 16 of the German Occupational Pensions Improvement Act (BetrAVG) insofar as the necessary funds are made available to it. Pension adjustment obligations that have not been assumed by the Bayer Pensionskasse are accounted for by LANXESS as a separate defined benefit plan.

Since the change in the accounting treatment of the Bayer Pensionskasse by the LANXESS Group is a result of the spin-off from the Bayer Group, the resulting €58 million impact is offset against stockholders' equity without affecting the income statement.

All other retirement benefit systems are defined benefit plans, which may be either unfunded, i.e. financed by provisions, or funded, i.e. financed through pension funds. In 2005, expenses for defined benefit plans amounted to €55 million (2004: €47 million). These net periodic costs – except for the interest portion, the expected return on plan assets and the share of the amortization of actuarial losses that is attributable to the plan assets – are included in the function expenses.

Provisions are also set up under this item for the obligations of Group companies, particularly in the United States, to provide health care to their retirees. Early retirement and certain other benefits provided to retirees are also included in pension provisions since they are similar in character to pension obligations. Like pension obligations, they are determined in accordance with IAS 19. In 2005, provisions for other post-employment benefits amounted to €136 million (2004: €114 million). Changes were made to the basic conditions for the plan covering health care costs in the United States in 2004. These changes essentially require employees participating in the plan to assume a greater share of the costs through higher copayments and proportionate contributions. In addition, a ceiling was introduced for the annual contributions payable by companies. Under IAS 19, these changes constitute a plan amendment that thus reduces the past service cost. In addition to the resulting €8 million impact, plan amendments in connection with the spin-off from the Bayer Group reduced other post-employment benefit obligations by €22 million. Net expense of €24 million for the other post-employment benefits was recorded in 2005 (2004: €14 million). This comprises €19 million (2004: €13 million) in current service cost, €8 million (2004: €6 million) in interest cost, €2 million (2004: €2 million) in amortization of actuarial losses, and €5 million (2004: €7 million) in income from subsequent adjustments of benefit entitlements.

The costs for the plans comprise the following:

€ million	2004 Pension obligations	2005 Pension obligations	2004 Other post-employment obligations	2005 Other post-employment obligations
Current service cost	30	28	13	19
Past service cost	5	6	(5)	(5)
Interest cost	48	43	6	8
Expected return on plan assets	(41)	(27)	–	–
Amortization of actuarial gains/losses	10	6	2	2
Plan curtailments and settlements	(5)	(1)	(2)	–
	47	**55**	**14**	**24**

The pension provisions for defined benefit plans are calculated in accordance with IAS 19 by the projected unit credit method. The future benefit obligations are valued by actuarial methods on the basis of the best estimate of the relevant parameters. Funds and benefit obligations are valued on a regular basis at least every three years. For all major plans, comprehensive actuarial valuations are performed annually.

Benefits expected to be payable after retirement are spread over each employee's entire period of employment, allowing for future changes in remuneration.

€ million	Dec. 31, 04 Pension obligations	Dec. 31, 05 Pension obligations	Dec. 31, 04 Other post-employment obligations	Dec. 31, 05 Other post-employment obligations
Defined benefit obligation				
Benefit obligations at beginning of the year	1,118	1,310	146	134
Current service cost	30	28	13	19
Interest cost	48	43	6	8
Employee contributions	7	2	–	–
Plan changes	2	6	(30)	(2)
Plan settlements	1	(584)	–	–
Actuarial gains/losses	119	96	10	(5)
Translation differences	(5)	67	(5)	16
Benefits paid	(28)	(47)	(3)	(14)
Acquisitions/mergers/migration	16	–	–	–
Divestments	–	(2)	–	–
Plan curtailments	2	(2)	(3)	–
Benefit obligation at end of the year	**1,310**	**917**	**134**	**156**
Fair value of plan assets				
Plan assets at beginning of the year	812	925	–	–
Actual return on plan assets	71	44	–	–
Acquisitions/mergers/migration	18	–	–	–
Divestments	–	(9)	–	–
Plan settlements	2	(620)	–	–
Translation differences	(4)	63	–	–
Employer contributions	47	38	3	14
Employee contributions	7	2	–	–
Benefits paid	(28)	(47)	(3)	(14)
Plan assets at end of the year	**925**	**396**	**0**	**0**
Funded status	**(385)**	**(521)**	**(134)**	**(156)**
Unrecognized past service cost	0	0	(4)	(2)
Unrecognized actuarial gains/losses	323	222	24	22
Asset limitation	(129)	(3)	–	–
Net recognized liability at year end	**(191)**	**(302)**	**(114)**	**(136)**
Amounts shown in the balance sheet				
Receivables from pension obligations	113	59	–	–
Provisions for pensions and other post-employment benefits	(304)	(361)	(114)	(136)
Net recognized liability	**(191)**	**(302)**	**(114)**	**(136)**

€468 million (2004: €353 million) of the defined benefit pension obligation relates to unfunded obligations while €449 million (2004: €957 million) relates to funded benefit obligations. The defined benefit obligation for other post-employment benefits totals €156 million (2004: €134 million) and relates entirely to unfunded plans.

For the funded pension plans, total overfunding of individual plans amounts to €14 million (2004: €19 million) while underfunding amounts to €66 million (€51 million).

The amounts relating to plan settlements stated in the reconciliation of pension obligations and plan assets from January 1, 2005 to December 31, 2005 relate to the change in the accounting treatment of the Bayer Pensionskasse in the fiscal year.

The adjustments, as yet unrecognized in the income statement, represent the difference between the defined benefit obligation – after deducting the fair value of plan assets – and the net liability recognized in the balance sheet. They arise mainly from actuarial gains or losses caused by differences between actual and previously assumed trends in employee remuneration. Plan assets in excess of the obligation are reflected in other receivables, subject to the asset limitation specified in IAS 19. In accordance with IAS 19, the amounts reflected in the balance sheet will be recognized in the income statement over the expected average remaining working lives of existing employees. The portion of the net actuarial gain or loss to be recognized in the income statement is determined by the corridor method. Under this method, actuarial gains and losses on pension obligations and plan assets are netted. That portion of the net amount that exceeds the higher of 10% of the benefit obligations or 10% of plan assets at the end of the prior year is recognized in income in equal installments over the average remaining working lives of the active workforce.

All defined benefit plans necessitate actuarial computations and valuations. The following weighted parameters were used:

	Dec. 31, 04	Dec. 31, 05	Dec. 31, 04	Dec. 31, 05
in %	Pension obligations		Other post-employment obligations	
Interest rate	5.5	4.7	5.4	4.9
Expected salary increases	3.1	2.9	2.7	2.8
Expected pension increases	1.3	1.2	–	–
Average employee turnover (depending on age and gender)	*	*	*	*
Expected return on plan assets	7.3	6.9	–	–
Expected increase in the cost of medical care	–	–	8.5	8.5
Expected long-term increase in the cost of medical care	–	–	4.7	4.8

* empirical values

It is expected that the long-term cost increase for medical care will take place within about four years. The expected return on plan assets is determined from published and internal capital market reports and forecasts for each asset class.

The following table shows the impact of a change in these parameters, assuming the other parameters remain unchanged, on the defined benefit obligation at the end of fiscal 2005 and the benefit expense in 2006:

Pensions		
€ million	Benefit obligations 2005	Benefit expense following year
Change in discount rate		
Increase of 0.25 percentage points	(41)	2
Decrease of 0.25 percentage points	42	(2)
Change in expected salary increases		
Increase of 0.5 percentage points	22	1
Decrease of 0.5 percentage points	(21)	(1)
Change in expected cost of medical care		
Increase of 0.5 percentage points	61	2
Decrease of 0.5 percentage points	(60)	(2)
Change in expected return on plan assets		
Increase of 0.5 percentage points	–	(2)
Decrease of 0.5 percentage points	–	2

Other post-employment benefits		
€ million	Benefit obligations 2005	Benefit expense following year
Change in discount rate		
Increase of 0.25 percentage points	(9)	0
Decrease of 0.25 percentage points	9	0
Change in expected salary increases		
Increase of 0.5 percentage points	6	0
Decrease of 0.5 percentage points	(6)	0
Change in expected cost of medical care		
Increase of 1 percentage point	9	0
Decrease of 1 percentage point	(8)	0

At year end, plan assets to cover pension obligations were comprised as follows:

	Fair value	
	€ million	in %
Equities	209	52.8
Fixed-income securities	161	40.6
Real estate	2	0.5
Other	24	6.1
	396	**100.0**

The net recognized liability is reflected in the following balance sheet items:

	Dec. 31, 2004	Dec. 31, 2005
€ million		
Provisions for pensions and other post-employment benefits	(418)	(497)
Other non-current assets	113	59
Net recognized liability	**(305)**	**(438)**

Changes in provisions for pensions and other post-employment benefits were as follows:

Provisions for pensions and other post-employment benefits							
€ million	Jan. 1, 2005	Changes in scope of consolidation	Exchange differences	Allocations	Utilization	Reversals	Dec. 31, 2005
Provisions for pensions and other post-employment benefits	418	(2)	13	101	(28)	(5)	497

(28) Other non-current and current provisions

These comprise:

Other provisions	Dec. 31, 2004			Dec. 31, 2005		
€ million	Non-current	Current	Total	Non-current	Current	Total
Personnel-related provisions	150	93	243	135	127	262
Provisions for restructuring	0	5	5	66	81	147
Provisions for transactions with customers	0	64	64	0	90	90
Provisions for environmental protection	74	14	88	70	17	87
Miscellaneous provisions	6	49	55	31	86	117
	230	**225**	**455**	**302**	**401**	**703**

Changes in provisions in 2005 were as follows:

Changes in provisions in 2005							
€ million	Jan. 1, 2005	Change in scope of consolidation	Exchange differences	Allocations	Utilization	Reversals	Dec. 31, 2005
Personnel	243	–	5	142	(115)	(13)	262
Restructuring	5	–	2	144	(4)	–	147
Transactions with customers	64	–	1	80	(42)	(13)	90
Environmental protection	88	–	8	5	(13)	(1)	87
Miscellaneous	55	1	1	113	(35)	(18)	117
Total	**455**	**1**	**17**	**484**	**(209)**	**(45)**	**703**

€175 million (2004: €159 million) of the other provisions had maturities of longer than five years.

Share-based payment LANXESS AG offers a long term incentive (LTI) program to members of the Management Board and certain other managers. This program provides for cash payments. The LTI program comprises three annual tranches, the first of which was granted retroactively as of January 31, 2005. Participation in the LTI program is conditional upon the manager's making a personal investment in LANXESS stock, the amount of which depends on his or her base salary. The shares constituting this personal investment cannot be sold for a five-year period.

The share-based part of the LTI program is the Stock Performance Plan.

Provisions are established for the obligations entered into under stock-based compensation programs on the basis of the proportionate fair value of the rights allocated to employees.

Stock Performance Plan Awards under the Stock Performance Plan are based on the performance of LANXESS stock relative to the Dow Jones STOXX 600 Chemicals^{SM} index. Awards to members of the Management Board are normally only made if LANXESS outperforms the benchmark index.

Members of the Management Board and senior managers are entitled to take part in the Stock Performance Plan. Eligibility is contingent upon participation in the Economic Value Plan described below. They may not opt to participate in only the Stock Performance Plan or the Economic Value Plan.

The fair values of obligations under these share-based compensation programs are calculated using a Monte Carlo simulation. This simulates the future return on the stock and the benchmark index and the value of the option rights constituting the expected disbursement. A two-dimensional standard distribution of returns is assumed. The calculation is based on the following parameters:

Parameters	
Expected share price volatility	25.0%
Expected dividend payment	0.0%
Expected index volatility	13.0%
Correlation between LANXESS stock and the index	48.0%
Risk-free interest rate	3.0%
Total term of program	5 years
Retention period	3 years
Reference share price (tranche 1)	€15.01
Reference price of the index (tranche 1)	268.95

The volatility of the stock and its correlation to the index is measured by the development of the stock price and the index since January 31, 2005, when LANXESS AG was first listed on the stock exchange. The values are verified by a comparison with the volatility of German shares in the benchmark index, calculated over a longer period.

3,562,416 stock appreciation rights were issued in the first tranche of the Stock Performance Plan. Based on the valuation criteria, the value of each right issued for the first tranche is €1.18. The fair value of the rights is reflected in a provision on a pro rata basis over the retention period. As of December 31, 2005 this provision totaled €1 million.

Other compensation programs

Economic Value Plan Awards under the Economic Value Plan depend on the development of the economic value of the LANXESS Group. If it the Group's performance is in line with the medium-term operational plan, a 100% award is made under the program.

Members of the Management Board, senior managers and some other managers are eligible to participate in the Economic Value Plan.

Although the Economic Value Plan is not, strictly speaking, a share-based compensation program, it is accounted for analogously to IFRS 2, the value of an economic value right being determined on the basis of the expected target attainment. As of December 31, 2005, provisions for this plan totaled €3 million.

LANXESS Stock Plan 2005 This is an employee stock plan entitling managers at lower levels and non-managerial staff to purchase shares in the company at a 50% discount. Employees acquired a total of 225,658 LANXESS shares under this program in 2005. These shares must be retained for at least three years. Participation in this program does not confer any right to similar benefits in the future.

Bayer AG employee stock programs In the Spin-Off and Acquisition Agreement between Bayer AG and LANXESS AG, Bayer AG transferred obligations under existing Bayer AG stock programs (the Stock Option Program, Stock Incentive Program and Stock Participation Program) to LANXESS AG. These programs relate to shares in Bayer AG. The provisions established for these obligations on the basis of a Monte Carlo simulation amounted to €2 million on December 31, 2005 (2004: €1 million). The entitlements of eligible LANXESS employees under these programs cease in 2009.

Provisions for restructuring €144 million was allocated to provisions for restructuring in 2005. The greater part of the provisions as of December 31, 2005 will be disbursed in 2006.

Provisions for restructuring totaled €147 million on December 31, 2005. Of this amount, €115 million comprised provisions for severance payments and other personnel expenses and €32 million comprised provisions for demolition and other expenses.

Environmental provisions The Group's activities are subject to extensive laws and regulations in the jurisdictions in which it does business and maintains properties. Compliance with environmental laws and regulations may require LANXESS to remove or mitigate the effects of the disposal or release of chemical substances at various sites. Under some of these laws and regulations, a current or previous owner or operator of property may be held liable for the costs of removal or remediation of hazardous substances on, under, or in its property, without regard to whether the owner or operator knew of or caused the presence of the contaminants, and regardless of whether the practices that resulted in the contamination were legal at the time they occurred. As many of the production sites have an extended history of industrial use, it is impossible to predict precisely what effect these laws and regulations will have on the LANXESS Group in the future.

As is typical for companies in the chemical and related industries, soil and groundwater contamination has occurred in the past at certain sites, and might occur or be discovered at other sites. Group companies may be subject to claims brought by national or local regulatory agencies, private organizations or individuals regarding the remediation of sites or areas of land that the LANXESS Group has acquired from companies in the Bayer Group, where materials were produced specifically for third parties under contract manufacturing agreements or where waste from production facilities operated by the LANXESS Group was treated, stored or disposed of.

For instance, a potential liability exists under the U.S. Federal Comprehensive Environmental Response, Compensation, and Liability Act, commonly known as "Superfund," the U.S. Resource Conservation and Recovery Act and related state laws for investigation and remediation costs at a number of sites. At most of the U.S. sites concerned, numerous companies, including the LANXESS Group, have been notified that the U.S. Environmental Protection Agency, state governing body or private individuals consider such companies to be potentially responsible parties under Superfund or related laws. At other sites in the United States, the LANXESS Group is the sole responsible party. The proceedings relating to these sites are in various stages. In most cases remediation measures have already been initiated.

In the Combined Financial Statements of what is now the LANXESS Group for fiscal 2004, prepared for purposes of the spin-off, provisions of €88 million were recognized for environmental remediation. The provisions for such commitments reflected in the consolidated balance sheet of the LANXESS Group as of December 31, 2005 amount to €87 million. The material components of the provisions for environmental remediation costs primarily relate to land reclamation, rehabilitation of contaminated sites, recultivation of landfills, and redevelopment and water protection measures. The provisions for environmental remediation costs are stated at present value where environmental assessments or clean-ups are probable, the costs can be reasonably estimated and no future economic benefit is expected to arise from these measures. Costs are estimated based on significant factors such as previous experience in similar cases, environmental assessments, current cost levels and new developments affecting costs, our understanding of current environmental laws and regulations, the number of other potentially responsible parties at each site and the identity and financial position of such parties in light of the joint and several nature of the liability, and the remediation methods expected to be employed.

It is difficult to estimate the future costs of environmental protection and remediation because of many uncertainties, particularly with regard to the status of laws, regulations and the information available about conditions in the various countries and at the individual sites. Subject to these factors, but taking into consideration experience gained to date regarding environmental matters of a similar nature, LANXESS believes the provisions recorded to be adequate based upon currently available information. However, given the inherent difficulties in estimating liabilities in this area, it cannot be guaranteed that no additional costs will be incurred beyond the amounts accrued. It is possible that final resolution of these matters may require expenditures to be made in excess of established provisions, over an extended period of time and in a range of amounts that cannot be reasonably estimated. It is nevertheless assumed that such additional amounts, if any, would not have a material adverse effect on the Group's financial position, results of operations or cash flows.

Legal risks The LANXESS Group is involved in numerous legal disputes either directly, or indirectly through reimbursement obligations to companies in the Bayer Group under agreements made in connection with the spin-off of the LANXESS Group. As an international chemical company, the LANXESS Group is exposed to a number of legal disputes in the normal course of business and could be exposed to such proceedings in the future, for example in the areas of antitrust law, the disposal of waste, emissions to the environment and the properties of products it manufactures.

The outcome of any current or future proceedings cannot be predicted with certainty. It is therefore possible that legal judgments could give rise to expenses that are not covered, or not fully covered, by insurance and could significantly affect the business operations and revenues and earnings of the LANXESS Group. If, for example, the LANXESS Group loses a case in which it has sought to enforce patent rights, this could reduce future earnings as other manufacturers could be permitted to market products developed by the LANXESS Group or its predecessors.

Legal proceedings normally involve difficult and complicated legal issues and are therefore subject to a number of uncertainties. For example, the circumstances and conditions of each individual case, the jurisdiction in which a claim is filed and thus the applicable law may vary. Upon conclusion of a legal dispute, the LANXESS Group may be required to make payments that exceed reported provisions and existing insurance coverage. The outcome of legal disputes could therefore have a material adverse impact on the results of operations and the cash flow of the LANXESS Group.

For information on current risks relating to antitrust proceedings, please refer to the information on contingent liabilities and other financial commitments (Note [36]).

(29) Non-current financial liabilities Non-current financial liabilities comprise the following:

Non-current financial liabilities	Dec. 31, 2004	Dec. 31, 2005
€ million		
Bonds	0	497
Liabilities to banks	36	63
Liabilities under leasing agreements	67	71
Other financial liabilities	28	13
	131	**644**

In June 2005 the LANXESS Group placed a Euro Benchmark Bond for the first time in the European capital market. This €500 million bond has an annual coupon of 4.125% and a maturity of seven years.

As of December 31, 2005, the maturities of financial liabilities were as follows:

Year due	
€ million	
2006	172
2007	20
2008	6
2009	6
2010	5
After 2010	607
	816

The weighted average interest rate on financial liabilities in the LANXESS Group was 3.8% (2004: 4.1%).

In October 2005 LANXESS replaced the €1.5 billion credit facility arranged with an international bank consortium in December 2004, which comprised a five-year tranche of €1.0 billion and a one-year tranche of €0.5 billion, by a new syndicated credit line of €1.25 billion on better terms. This credit line runs for five years and has two extension options, providing a long-term liquidity back-up.

Information on the fair or market values of financial liabilities is given in Note [39].

Liabilities under lease agreements are recognized in the balance sheet if the leased assets are capitalized under property, plant and equipment as the economic property of the Group (finance leases). They are stated at present values. Lease payments totaling €101 million (2004: €99 million), including €19 million (2004: €22 million) in interest, are to be made to the respective lessors in future years.

The liabilities associated with finance leases mature as follows:

Leasing liabilities			
€ million	Lease payments	Interest portion	Leasing liabilities
2006	14	3	11
2007	10	3	7
2008	9	3	6
2009	8	2	6
2010	8	2	6
After 2010	52	6	46
	101	**19**	**82**

Lease payments in 2005 under operating leases amounted to €8 million (2004: €5 million).

(30) Other non-current liabilities Other non-current liabilities, recognized at amortized cost, totaled €32 million at December 31, 2005 (2004: €36 million).

(31) Current financial liabilities

Current financial liabilities	Dec. 31, 2004	Dec. 31, 2005
€ million		
Liabilities to banks	21	147
Liabilities under leasing agreements	15	11
Other financial liabilities	1,040	14
	1,076	**172**

Current financial liabilities amounted to €172 million (2004: €1,076 million). Details of the maturities of financial liabilities are given in Note [29].

(32) Trade payables Trade accounts are payable mainly to third parties. As in the previous year, the entire amount totaling €694 million (2004: €820 million) is due within one year. Of the €130 million trade payables for which extended payment terms were agreed between the LANXESS Group and the Bayer Group at the end of 2004, €50 million is still outstanding. These are due on a rolling basis in 2007.

Trade payables of €87 million (2004: €156 million) pertain to other affiliated companies and €607 million (2004: €661 million) to other suppliers.

(33) Other current liabilities Other current liabilities are recognized at amortized cost. They comprise:

Other current liabilities	Dec. 31, 2004	Dec. 31, 2005
€ million		
Payroll liabilities	29	33
Social security liabilities	14	19
Tax liabilities	43	39
Accrued interest liabilities	7	13
Advance payments received	2	1
Liabilities from the acceptance of drafts	19	17
Liabilities from derivative financial instruments	2	31
Miscellaneous liabilities	79	62
	195	**215**

Tax liabilities include not only Group companies' own tax liabilities, but also taxes withheld for payment to the authorities on behalf of third parties.

Liabilities for social expenses include, in particular, social insurance contributions that had not been paid by the closing date.

The other liabilities comprise mainly guarantees, commission payments to customers and reimbursements of expenses.

The remaining liabilities include €1 million (2004: €3 million) to other affiliated companies.

(34) Further information on liabilities Liabilities include €607 million (2004: €49 million) with maturities of more than five years.

Liabilities of €32 million (2004: €257 million) were secured, including €32 million (2004: €23 million) secured by mortgages.

The total amount includes €13 million (2004: €7 million) in accrued interest.

(35) Assets and liabilities held for sale The agreements to sell the fibers and the paper chemicals businesses were signed on December 22, 2005 and December 20, 2005, respectively. The consolidated balance sheet as of December 31, 2005 therefore contains assets and liabilities classified as held for sale according to IFRS 5. These assets and liabilities are as follows:

Disposal group	Dec. 31, 2005
€ million	
Property, plant and equipment	17
Inventories	43
Receivables and other assets	54
Provisions	14
Liabilities	6

Other Information

(36) Contingent liabilities and other financial commitments Contingent liabilities as of December 31, 2005 amounted to €7 million (2004: €11 million). They result entirely from liabilities assumed on behalf of third parties and comprise:

Contingent liabilities	Dec. 31, 2004	Dec. 31, 2005
€ million		
Bills of exchange	1	1
Guarantees	10	6
	11	**7**

These are potential future commitments in cases where the occurrence of certain events in the future would create an obligation, the existence of which is uncertain at the balance sheet date. Guarantees comprise mainly bank guarantees where subsidiaries guarantee third parties' liabilities to banks resulting from contractual agreements with the LANXESS Group. A liability to perform under the guarantee arises if the debtor does not settle the liability on time or becomes insolvent.

Apart from provisions, liabilities and contingent liabilities, financial commitments also exist under leasing and long-term rental agreements.

The minimum non-discounted future payments relating to operating leases total €70 million (2004: €40 million). These payment obligations mature as follows:

Year due	
€ million	
2006	9
2007	8
2008	7
2009	7
2010	6
After 2010	33
	70

Financial commitments resulting from orders already placed under purchase agreements relating to planned or ongoing capital expenditure projects for property, plant and equipment total €32 million (2004: €47 million). €31 million of these payments are due in 2006 and €1 million is due in 2007.

Under Article 133 paragraph 1 sentence 1 of the German Transformation Act, all legal entities involved in a spin-off are jointly and severally liable for the obligations of the transferring entity that exist at the date of the spin-off. This means that Bayer AG and LANXESS AG are jointly and severally liable for obligations of Bayer AG that existed when the LANXESS Group was spun off from Bayer. However, under Article 133 paragraph 3 of the Act, each company's liability for the obligations not assigned to it under the Spin-Off and Acquisition Agreement is limited to five years.

The Spin-Off and Acquisition Agreement specifies that Bayer AG shall indemnify LANXESS AG against any legally imposed joint liability, including that under Article 133 of the German Transformation Act, and from joint and several liability for commitments and obligations that were not assigned to LANXESS under the Agreement.

Description of the master agreement In a master agreement concluded between Bayer AG and LANXESS AG at the same time as the Spin-off and Acquisition Agreement, Bayer AG and LANXESS AG agreed, among other things, on commitments regarding mutual exemption from joint liability for commitments of the other party and arrangements regarding the allocation of liability for product liability commitments, environmental contamination and antitrust violations. The main provisions of the master agreement on these issues are outlined below.

Joint liability, and joint and several liability Under the master agreement, Bayer AG must indemnify LANXESS AG and all the companies affiliated with LANXESS AG against joint liability, or joint and several liability, for commitments of the Bayer Group arising from the worldwide realignment of the Bayer Group in 2002 and 2003. Bayer AG must also indemnify 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 such liability relates to commitments that cannot be, or have not expressly been, assigned to the LANXESS Group. LANXESS AG must in turn indemnify 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 such liability relates to commitments that can be, or have expressly been, assigned to the LANXESS Group.

Environmental contamination The master agreement specifies which of the parties is liable vis-à-vis the other party for site-specific environmental contamination that was caused or occurred up to the qualifying date, i.e. the date on which the spin-off is deemed to have taken economic effect (July 1, 2004). The fundamental legal consequence of this arrangement is that the party to whom liability is assigned is required to indemnify the other party and companies affiliated with the other party from all public- or private-law liability to authorities or other third parties with respect to environmental contamination at the sites in question. The arrangement allocating liability for environmental contamination essentially establishes the respective party's liability 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 elements of origination liability. As a consequence, liability is based on the sites affected in each case. In this respect certain distinctions are made, which are briefly explained below.

LANXESS AG is basically liable – subject to opportunities for potential exoneration – for all environmental contamination at what are known as the LANXESS sites. This essentially means the sites in Germany and other countries used by the LANXESS Group on the qualifying date. Bayer AG, on the other hand, is basically liable – again, subject to opportunities for potential exoneration – for all environmental contamination at what are known as the Bayer sites. This essentially means all the sites owned by Bayer AG or companies affiliated with it or used by Bayer AG and companies affiliated with it (with the exception of LANXESS sites). With respect to possible liability for environmental contamination of the sites of other third parties, the agreement provides that LANXESS AG is liable for such contamination if it was caused by a LANXESS site (via the groundwater) and that Bayer AG is liable if such contamination was caused by a Bayer site (via the groundwater). The master agreement also contains special arrangements regarding the allocation of liability for contamination of specific sites (including landfill sites) and for such liability arising from certain corporate acquisition agreements.

The master agreement limits the liability of LANXESS AG and companies affiliates with LANXESS AG for environmental contamination to a total of €350 million, although this maximum relates – to put it simply – 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 contamination.

Product liability The master agreement specifies the allocation of each party's liability vis-à-vis the other party in relation to third-party product liability claims, whereas direct product liability claims by either party against the other are expressly excluded. The legal consequence of allocation of liability to one of the parties is that this party is required to indemnify the other party and the companies affiliated with that party against the relevant product liability commitment. The master agreement essentially makes the following distinctions with respect to the allocation of liability:

The LANXESS Group on the one hand and the Bayer Group on the other hand are each fundamentally liable for all product liability commitments arising from or in connection with defective products that were put on the market in the past by their business divisions that were operational on the qualifying date or were subsequently put on the market prior to the effective date of the spin-off. The products put on the market by individual business units 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 defective products that are put on the market after the effective date of the spin-off, the master agreement refers to the provisions of applicable law and does not therefore contain any particular contractual arrangement. The master agreement also includes a special arrangement for defective products put on the market by certain companies, plants or production facilities that have since been sold and assigns product liability to LANXESS AG in these cases. It also contains another special arrangement, under which product liability with respect to certain products, particularly products from the discontinued business areas and business groups of the Bayer Group that were allocated to the LANXESS Group, is assigned to LANXESS AG.

Antitrust violations The master agreement specifies the allocation of each party's liability for antitrust violations vis-à-vis the other party. Antitrust liabilities are obligations and liabilities relating to the payment of fines and other (secondary) penalties, obligations to pay damages – including penal damages – to third parties, and obligations to third parties to compensate them for revenues or benefits lost as a result of antitrust violations.

The LANXESS Group is liable vis-à-vis the Bayer Group for any obligations arising from antitrust violations for which the LANXESS operations are responsible. Bayer, in turn, is liable vis-à-vis LANXESS for any obligations arising from antitrust violations for which Bayer is responsible. Each party is required to reimburse the other party the amounts required to meet claims arising from antitrust violations.

In addition to this general principle, there are special arrangements for antitrust proceedings and civil proceedings in connection with certain products of the former Rubber Business Group of Bayer, which was allocated to the LANXESS Group. Bayer AG and certain subsidiaries are the subject of investigations under criminal and civil law with respect to these products, particularly in the United States, Canada and Europe. Where authorities had initiated proceedings or a company had taken steps through an antitrust authority to initiate proceedings by July 1, 2004, LANXESS has to pay 30% of the liabilities and Bayer 70%.

LANXESS AG's maximum liability is €100 million, to which reimbursement of income tax paid as a result of limited tax deductibility may be added. Reimbursements are limited to €50 million per calendar year. The costs of external legal counsel are also split in the ratio 30:70, but these costs do not count towards the maximum liability limit. The settlements made by Bayer AG in fiscal 2005 fully exhaust LANXESS AG's maximum liability of €100 million.

Antitrust obligations that have been allocated to parts of the LANXESS Group based or operating in the United States are included in the calculation of the respective liability limits. Due to specific aspects of U.S. law, agreements are being concluded concerning the parts of the LANXESS Group that are based or operating in the U.S., 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 U.S. will be modified to reflect the fundamental rules of the master agreement if there are major deviations.

(37) Related parties In the course of its operations, the LANXESS Group sources materials, inventories and services from a large number of business partners around the world. These include companies in which LANXESS AG has a direct or indirect interest. Transactions with these companies are carried out on an arm's length basis.

Transactions with associated companies included in the consolidated financial statements by the equity method comprised the purchase of site services in the fields of utilities, infrastructure, logistics and catering totaling €433 million (2004: €458 million) from Bayer Industry Services GmbH & Co. OHG.

As a result of these transactions, there were trade payables of €87 million pertaining to Bayer Industry Services GmbH & Co. OHG on December 31, 2005.

No material business transactions were undertaken with other associated companies.

(38) Compensation of the Management Board and the Supervisory Board In fiscal 2005 compensation totaling €4,233,000 was paid to the members of the LANXESS AG Management Board. The breakdown of this amount is as follows:

Total compensation of the Management Board in fiscal 2005

€ '000	Short-term benefits			
	Fixed salary	Fringe benefits	Bonus	Total
Dr. Axel C. Heitmann	592	46	820	1,458
Dr. Ulrich Koemm	469	22	643	1,134
Dr. Martin Wienkenhöver	393	29	396	818
Matthias Zachert	400	20	403	823
Total	**1,854**	**117**	**2,262**	**4,233**

In addition, the members of the Management Board received the following compensation under the Long Term Incentive Program (LTIP):

Stock-based compensation: LTIP tranche 2005

	Long-term incentive plan	
	No. of rights	Fair value €'000
Dr. Axel C. Heitmann	520,000	227
Dr. Ulrich Koemm	406,467	178
Dr. Martin Wienkenhöver	346,667	152
Matthias Zachert	346,667	152
Total	**1,619,801**	**709**

Further, in fiscal 2005 service cost of €537,000 relating to defined benefit pension plans was incurred for members of the Management Board as part of their compensation package.

The total remuneration of the members of the Supervisory Board (fixed compensation and remuneration for membership of committees) amounted to €650,000 in fiscal 2005. Details are given in the corporate governance report.

No loans were granted to members of the Management Board or the Supervisory Board in fiscal 2005.

(39) Financial instruments Primary financial instruments are reflected in the balance sheet. In compliance with IAS 39, asset instruments are categorized as "at fair value through profit or loss," "held to maturity" or "available for sale" and, accordingly, recognized at fair value or amortized cost. Financial instruments that constitute liabilities, are not held for trading and are not derivatives, are carried at amortized cost.

Risks and risk management The global alignment of the LANXESS Group exposes its business operations, earnings and cash flows to a number of market risks. Material financial risks to the Group as a whole are centrally managed. Financial risks chiefly relate to exchange rates, interest rates, possible customer default and raw material prices.

These risks could impair the earnings and financial position of the LANXESS Group. The various risk categories and risk management systems are outlined below.

Financial risks
Currency risk: Since the LANXESS Group undertakes transactions in a numerous currencies, it is exposed to the risk of fluctuations in the relative value of these currencies, particularly the value of the euro against the U.S. dollar.

Currency risks from potential declines in the value of financial instruments due to exchange rate fluctuations (transaction risks) arise mainly when receivables and payables are denominated in a currency other than the company's local currency.

Currency risks relating to operating activities are systematically monitored and analyzed. The level of hedging of such risks is regularly reviewed. In some cases forecasted transactions are also hedged. A substantial proportion of contractual and foreseeable currency risks are hedged using derivative financial instruments. Changes in the fair values of these instruments are recognized in the income statement or in the financial result. Changes in the fair values of cash flow hedges are recognized in stockholders' equity under other comprehensive income/loss. In 2005 stockholders' equity was impacted by changes in the fair value of cash flow hedges amounting to €11 million. This includes €2 million released from stockholders' equity and recognized as a loss in the accounting period following the realization of the underlying transaction. Hedging took place through forward contracts and currency options with positive fair values of €5 million (2004: €6 million) and negative fair values of €17 million (2004: €0 million) on December 31, 2005. The total notional value of these hedges was €579 million, including €434 million due within one year. Since the LANXESS Group concludes derivative contracts for a significant proportion of its currency risks, it believes that, in the short term, a significant rise or fall in the euro against other major currencies would not have any material impact on future cash flows. In the long run, however, these exchange rate fluctuations could have a negative effect on cash flows should the LANXESS Group not be in a position to absorb them, e.g. via the pricing of its products in the relevant local currencies.

Currency risks arising on financial transactions, including interest, are generally fully hedged. The main instruments used are forward contracts.

Securities held and other loans are mainly denominated in the currency used by the Group company making the investment to minimize the currency risk.

Many companies in the LANXESS Group are based outside the euro zone. Since the Group prepares its consolidated financial statements in euros, the annual financial statements of these subsidiaries are translated into euros for consolidation purposes. Changes in the average exchange rate of a currency from one period to the next can materially affect the translation of sales and earnings reported in this currency (translation risk). Unlike transaction risk, translation risk has no impact on Group cash flows in the local currency.

The LANXESS Group has material assets, liabilities and businesses outside the euro zone that report in local currencies. Their long-term currency risk is estimated and evaluated on a regular basis. In view of the risks involved in such cases, however, hedging transactions are only concluded if consideration is being given to withdrawing from a particular business and it is intended to repatriate the funds released by the withdrawal. The LANXESS Group does, however, reflect in stockholders' equity the effects of exchange rate fluctuations on the translation of net positions into euros.

Interest rate risk: Fluctuations in market interest rates can cause fluctuations in the overall return on a financial instrument. Interest rate risk mainly affects financial assets and financial liabilities.

Where financial assets and financial liabilities are exposed to interest rate risk due to variable interest rates, hedging via derivative financial instruments, such as interest rate swaps and cross-currency interest rate swaps, plays a prominent role.

Receivables from employees (see Note [23]) primarily comprise small loans to employees, generally at fixed interest rates close to the market rate. Such loans are exposed to an interest rate risk which, however, is not hedged since it was entered into for specific reasons. More than three quarters of employee loans are for terms exceeding five years.

Credit risk: This arises from the possibility that counterparties could default on their obligations to the LANXESS Group from transactions involving financial instruments. Since the LANXESS Group does not normally conclude master netting arrangements with counterparties, the total amounts of these assets represents the maximum exposure to credit risk.

Raw material price risk: The LANXESS Group is exposed to changes in the market prices of commodities used for its business operations. It is possible that increases in the cost of procuring energy and raw materials can only be passed on to customers to a limited extent and therefore have a material impact on LANXESS's operating result. The financial management of price risks is designed to achieve a deliberate and controlled reduction in the volatility of cash flows and thus the volatility of the company's economic value by making systematic use of derivative financial instruments (strategic management). Changes in the fair values of commodity derivatives are recognized in the income statement in other operating income and expense. Where cash flow hedges qualify for hedge accounting, such changes are recognized in equity under other comprehensive income without impacting earnings until the hedged transaction is realized. In 2005, changes in the value of cash flow hedges increased stockholders' equity by €4 million. This total includes €6 million released from stockholders' equity and recognized in income in the accounting period following realization of the underlying transaction. Hedges comprised commodity swaps with positive fair values of €10 million on December 31, 2005 (2004: €0 million) and negative fair values of €1 million (2004: €0 million). The total notional value of these hedges was €72 million, including €56 million due within one year.

Derivative financial instruments Derivatives with a fair value of €28 million are capitalized in the consolidated financial statements of the LANXESS Group for fiscal 2005 (2004: €23 million). Instruments with a negative fair value totaling €31 million (2004: €2 million) are recognized as liabilities. "Regular way" purchases and sales of financial assets are recorded at the settlement date in compliance with IAS 39.

Derivative financial instruments	Dec. 31, 2005		
€ million	Notional value	Positive fair values	Negative fair values
Forward contracts	1,266	3	(27)
Currency options	151	2	(3)
Commodity contracts	92	23	(1)
Total	**1,509**	**28**	**(31)**

€76 million of the commodity swaps contracts totaling €92 million are due within one year. Forward contracts and currency options have a combined notional value of €1,417 million, €1,271 million of which is due within one year.

On June 21, 2005 LANXESS issued a Euro Benchmark Bond with a maturity of 7 years. The bond has a coupon of 4.125% and the nominal issue volume was €500 million. The carrying amount of the bond as of December 31, 2005 was €497 million and its fair value on this date was €504 million.

Determination of fair value:
The main methods and assumptions used to ascertain the fair value of financial instruments are outlined in the following:

Trade receivables and other receivables:
The fair value of receivables due within one year corresponds to their nominal value. That of all other receivables is determined by discounting them to present value where feasible.

In the case of liabilities to banks, the fair value is the nominal value.

Trade payables and other liabilities:
The fair value of liabilities due within one year corresponds to their nominal value. That of all other liabilities is determined by discounting them to present value where feasible.

The fair value of securities is determined from their market price on the closing date, without taking transaction costs into account.

The Euro Benchmark Bond is actively traded on a liquid market. Its fair value is the price determined and published by the stock market.

The fair value of loans is determined from discounted future interest and repayment installments.

The fair value of liabilities for lease payments is the present value of the net lease payments calculated using the market rate for comparable leasing agreements.

Most of the derivative financial instruments used by LANXESS are traded in an active, liquid market. The fair value of forward contracts is derived from their trading or listed price using the "forward method". Currency options are valued using the asset pricing model derived from Black & Scholes. The fair value of commodity swaps is also derived from their trading or listed price using the "forward method". If no market price is available, the value is determined using recognized capital market pricing models.

The following interest rates were used in the determination of fair values:

	Dec. 31, 2004	Dec. 31, 2005
in %		
Euro Benchmark Bond	–	4
Leasing liabilities	5	5

(40) Notes to the cash flow statement

Net cash provided by operating activities The cash flow statements start from income before income taxes. The net operating cash flow of €624 million (2004: €311 million) takes account of changes in net current assets and other balance sheet items totaling €378 million (2004: minus €2 million) and depreciation and write-downs of €313 million (2004: €328 million). It also includes cash outflows for income taxes of €56 million, compared with €45 million in 2004.

Net cash used in investing activities Additions to property, plant and equipment and intangible assets in 2005 resulted in a cash outflow of €251 million (2004: €279 million). Sales of property, plant and equipment and other assets led to a cash inflow of €8 million (2004: €26 million) while the cash inflow from interest and dividend income was €10 million (2004: €6 million). The net cash outflow for investing activities was €241 million (2004: €39 million).

Net cash used in financing activities The net cash outflow for financing activities amounted to €319 million (2004: €214 million). The reduction in net borrowings resulted in a cash outflow of €241 million (2004: inflow of €166 million). Interest expense and other financial payments led to a further cash outflow of €76 million (2004: €48 million).

For further details of the exercise of conversion rights under the mandatory convertible bond by the bondholder, which had no impact on cash flows, and the resulting €211 million increase in stockholders' equity can be found in Note [25].

Cash and cash equivalents Cash and cash equivalents (cash, checks, bank balances) amounted to €136 million on December 31, 2005 (2004: €72 million). In accordance with IAS 7, this item also includes securities with original maturities of up to three months.

(41) Segment Reporting

Notes to the segment reporting In accordance with IAS 14, a breakdown of certain financial statement data is given by business segment and geographical region. The segments and regions are the same as those used for internal reporting, allowing a reliable assessment of risks and returns in the Group. The aim is to provide users of the financial statements with meaningful information regarding the profitability and future prospects of the Group's activities.

On December 31, 2005 the LANXESS Group comprised the following reporting segments:

Segments	Operations
Performance Rubber	Special-purpose rubber and rubber chemicals for high-quality rubber products, e.g. for use in vehicles, construction and footwear
Engineering Plastics	Thermoplastics for high-tech applications in the automotive, household, leisure and electronics sectors.
Chemical Intermediates	Global supplier of commodity and fine chemicals as starting products and intermediates for pharmaceuticals, agrochemicals, specialty chemicals, and inorganic pigments for the coloring of concrete, emulsion paints and coatings.
Performance Chemicals	Material protection products, finishing agents for the leather, textile and paper industries, ion exchange resins for water treatment and plastics additives such as flame retardants and plasticizers.

The reporting regions are those into which LANXESS's activities are organized: EMEA (Europe excluding Germany, Middle East, Africa), Germany, Americas, and Asia-Pacific.

Segment assets principally comprise property, plant and equipment, intangible assets, inventories and trade receivables. Liquid assets and deferred tax assets, in particular, are excluded.

Segment liabilities basically consist of trade payables, other liabilities and provisions, while financial liabilities and deferred tax liabilities, in particular, are excluded.

Departing from the presentation in the 2004 Annual Report, corporate costs are no longer allocated among the business segments. As of fiscal 2005 they are instead reported collectively under a segment named “Corporate Center, Services, Non-Core Business, Reconciliation”, facilitating a comparison of performance across LANXESS’s operating segments. The figures already published for 2004 have been restated accordingly.

All depreciation, amortization and write-downs in fiscal 2005 were recognized directly in income.

In 2005 segment earnings were reduced by expenses totaling €71 million relating to antitrust proceedings. Of this amount, €43 million related to the Performance Rubber segment and €28 million to Performance Chemicals. €19 million / €13 million of the respective amounts had no cash impact in 2005.

Allocations to provisions in the Corporate Center, Services, Non-Core Business, Reconciliation segment included those for non-cash expenses totaling €144 million in connection with the Group-wide restructuring program. These expenses are allocated to this segment because the Group-wide restructuring program mainly comprises headcount adjustments at Group companies, especially in central functions. Thus the allocation of these expenses to the operating segments would not correctly reflect their origin.

The reconciliation eliminates intersegment items and reflects income, expenses, assets and liabilities not allocable to the segments. These include, in particular, the Corporate Sector, the service companies (including the interest in Bayer Industry Services GmbH & Co. OHG, which has an equity value of €22 million and gave rise to an equity-method loss of €35 million) and non-core businesses.

SEGMENT AND REGION DATA

Business segments	2004	2005	2004	2005	2004	2005
€ million	Performance Rubber		Engineering Plastics		Chemical Intermediates	
External sales	1,431	1,678	1,722	1,737	1,487	1,535
Intersegment sales	4	2	20	22	89	88
Segment/Group sales	1,435	1,680	1,742	1,759	1,576	1,623
Segment result/EBIT	50	108	12	10	89	129
Segment assets/total assets	1,075	1,033	850	775	954	840
Capital expenditures	76	75	45	45	89	59
Depreciation and amortization	61	63	40	33	91	66
Write-downs			(3)*	23	22**	16
Segment/Group liabilities	428	408	397	353	235	262
Employees (December 31)	3,163	3,119	3,652	3,479	3,819	3,353
Employees (average for the year)	3,081	3,079	3,655	3,507	3,939	3,551

* Includes €21 million in write-downs and €24 million in write-backs.
** Includes €27 million in write-downs and €5 million in write-backs.

Geographical regions	2004	2005	2004	2005	2004	2005
€ million	EMEA (excluding Germany)		Germany		Americas	
External sales by market	2,419	2,494	1,610	1,538	1,757	1,928
Segment assets/total assets	984	913	2,197	2,008	1,083	1,100
Capital expenditures	59	63	152	117	58	47
Employees (December 31)	3,717	3,290	10,098	9,410	3,920	3,694

	2004	2005	2004	2005	2004	2005
	Performance Chemicals		Corporate Center, Services, Non-Core Business, Reconciliation		LANXESS	
	1,910	1,977	223	223	6,773	7,150
	20	23	(133)	(135)	0	0
	1,930	2,000	90	88	6,773	7,150
	9	118	(101)	(337)	59	28
	1,083	1,065	615	628	4,577	4,341
	57	61	12	11	279	251
	75	66	22	18	289	246
	20			28	39	67
	624	461	1,528	1,601	3,212	3,085
	5,140	4,743	3,885	3,588	19,659	18,282
	5,011	4,824	4,356	3,632	20,042	18,593

	2004	2005	2004	2005
	Asia-Pacific		LANXESS	
	987	1,190	6,773	7,150
	313	320	4,577	4,341
	10	24	279	251
	1,924	1,888	19,659	18,282

(42) Subsequent events Following the conclusion of an agreement in December 2005 to sell the fibers business to the Japanese company Asahi Kasei Fibers, approval for the sale was granted by the antitrust authorities in January 2006 and the transaction took legal and economic effect on February 28, 2006.

The agreement concluded, also in December 2005, to sell the paper chemicals activities to the Kemira Group of Finland was approved by the antitrust authorities in February 2006 and the transaction is expected to be completed on March 31, 2006.

In January 2006 the LANXESS Group was forced to cut back production of butyl rubber at its site in Sarnia, Canada, due to prolonged absence of deliveries from a raw material supplier, and to declare force majeure. It was able to lift this declaration on March 13, 2006 following delivery of the raw materials required for production.

(43) Audit fees The LANXESS Group recognized audit fees of €6,121,000 as expenses in 2005. Of this amount, €3,408,000 relates to the auditing of financial statements, €665,000 to audit-related services and other audit work, and €2,048,000 to other services rendered to Group companies. The fees for financial statements auditing comprise all fees, including incidental expenses, paid or still to be paid with respect to the audit of the consolidated financial statements of the Group and the issuance of an opinion thereon, as well as for the audit of the legally prescribed financial statements of LANXESS AG and its subsidiaries. Fees paid to the auditor of the consolidated financial statements of the LANXESS Group comprised €3,551,000, of which €1,208,000 was for auditing the financial statements, €665,000 for audit-related services and other audit work, and €1,678,000 for other services rendered to Group companies.

(44) Declaration of Compliance pursuant to Article 161 Stock Corporation Act A Declaration of Compliance with the German Corporate Governance Code has been issued pursuant to Article 161 of the German Stock Corporation Act and made available to stockholders.

(45) Exemptions under Article 264 paragraph 3 German Commercial Code The following German subsidiaries made use of some of the disclosure exemptions granted in Article 264 paragraph 3 of the German Commercial Code:

Dorlastan Fibers GmbH, Dormagen
Erste LXS GmbH, Leverkusen
GVW Garnveredlungswerke GmbH, Goch
IAB Ionenaustauscher GmbH, Greppin
LANXESS Accounting GmbH, Leverkusen
LANXESS Buna GmbH, Marl
LANXESS Deutschland GmbH, Leverkusen
LANXESS Distribution GmbH, Cologne
LANXESS Europe GmbH, Leverkusen
Perlon-Monofil GmbH, Dormagen
PharmAgro GmbH, Cologne
RheinChemie Rheinau GmbH, Mannheim
Saltigo GmbH, Leverkusen
Suberit Kork GmbH, Mannheim
Zweite LXS GmbH, Leverkusen

AUDITOR'S REPORT

We have audited the consolidated financial statements prepared by the LANXESS Aktiengesellschaft, Leverkusen, comprising the income statement, balance sheet, statement of changes in equity, cash flow statement and the notes to the consolidated financial statements, together with the group management report for the business year from January 1 to December 31, 2005. The preparation of the consolidated financial statements and the management report in accordance with the IFRSs, as adopted by the E.U., and the additional requirements of German commercial law pursuant to § (Article) 315a Abs. (paragraph) 1 HGB ("Handelsgesetzbuch": German Commercial Code) are the responsibility of the parent company's Management Board. Our responsibility is to express an opinion on the consolidated financial statements and the management report based on our audit.

We conducted our audit of the consolidated financial statements in accordance with § 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer (Institute of Public Auditors in Germany) (IDW) and additionally observed the International Standards on Auditing (ISA). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and in the management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of the companies included in consolidation, the determination of the companies to be included in consolidation, the accounting and consolidation principles used and significant estimates made by the company's Management Board, as well as evaluating the overall presentation of the consolidated financial statements and the management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion based on the findings of our audit the consolidated financial statements comply with the IFRSs, as adopted by the E.U., the additional requirements of German commercial law pursuant to § 315a Abs. 1 HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these provisions. The management report is consistent with the consolidated financial statements and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development.

Cologne, March 22, 2006

PricewaterhouseCoopers
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

(P. Albrecht) (J. Sechser)
German Public Auditor German Public Auditor