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Group Management Report

The LANXESS Group

Business and strategy The LANXESS Group is a globally operating chemicals enterprise with a portfolio ranging from basic, specialty and fine chemicals to polymers. The partly low margin level has made it essential to evolve lean, uncomplicated structures, and to systematically optimize plants and processes.

To raise profitability to the level typical of other companies in the industry, LANXESS has adopted a strategic package with four phases: performance improvements, targeted restructuring, portfolio adjustments and acquisitions. In the past fiscal year, we implemented measures in all four phases and acquired a company for the first time in our history as an independent enterprise. An additional aim is selective organic growth in profitable markets.

The segments in brief Organizationally, the LANXESS Group is divided into four segments: Performance Rubber, Engineering Plastics, Chemical Intermediates and Performance Chemicals.

The **Performance Rubber** segment combines all the Group's activities in synthetic rubber production. Here LANXESS offers a broad portfolio of innovative products, many of which are international leaders. The segment comprises the Butyl Rubber, Polybutadiene Rubber and Technical Rubber Products business units, and has production sites in Dormagen, Leverkusen and Marl, Germany; Zwijndrecht, Belgium; La Wantzenau and Port Jérôme, France; Sarnia, Ontario, Canada; and Orange, Texas, United States. Its products have applications in areas ranging from tires and other automotive components to construction materials, leisure equipment, machinery and chewing gum.

LANXESS's **Engineering Plastics** segment makes it one of the world's most important suppliers of polymers. This segment's business units are Lustran Polymers (formerly Styrenic Resins) and Semi-Crystalline Products, and its production sites are located in Dormagen, Hamm-Uentrop and Krefeld-Uerdingen, Germany; Antwerp, Belgium; Tarragona, Spain; Addyston, Ohio, and Bushy Park, South Carolina, in the United States; Katol, Moxi and Nandesari, India; Map Ta Phut, Thailand; and Wuxi, China. The plastics that LANXESS produces are particularly used in household appliances, the automotive industry, electrical engineering, electronics, and medical equipment.

The operations that LANXESS combines in its **Chemical Intermediates** segment make it one of the world's leading suppliers of basic and fine chemicals and inorganic pigments. The business units in this segment are Basic Chemicals, Saltigo (formerly Fine Chemicals) and Inorganic Pigments, and its production sites are in Brunsbuettel, Dormagen, Leverkusen and Krefeld-Uerdingen, Germany; Branston, Staffordshire, United Kingdom; Vilassar de Mar, Spain; Baytown, Texas, and Burgettstown, Pennsylvania, in the United States; Porto Feliz, Brazil; Shanghai, China; and Sydney, Australia. These products are used in such diverse sectors as agrochemicals, construction, dyes and pharmaceuticals.

The **Performance Chemicals** segment embraces the Group's application-oriented specialty chemicals operations. The business units in this segment are Material Protection Products, Functional Chemicals, Leather, Rhein Chemie, Rubber Chemicals and Ion Exchange Resins. It has numerous production sites: in Mannheim, Leverkusen, Krefeld-Uerdingen, Dormagen, Brunsbuettel and Bitterfeld, Germany; Antwerp, Belgium; Filago, Italy; Merebank, Newcastle, Isithebe and Rustenburg, South Africa; Birmingham, New Jersey, Bushy Park, South Carolina, and Chardon, Ohio in the United States; Lerma, Mexico; Zárate, Argentina; Wuxi, Weifang, Tongling and Qingdao, China; Thane and Madurai, India; and Toyohashi, Japan. Its varied products are used in disinfectants, dyes, wood preservatives, the food and beverage industry, water treatment, the leather industry, and more.

Organization LANXESS AG functions largely as a management holding company. Each business unit has global responsibility for its own operations. They are complemented by group functions with international responsibility for providing services.

LANXESS GmbH is a wholly owned subsidiary of LANXESS AG, and in turn controls the other subsidiaries and affiliates both in Germany and elsewhere.

The following are the principal companies wholly owned by LANXESS directly or indirectly:

- LANXESS Deutschland GmbH, Leverkusen, Germany: production and sales, all segments
- LANXESS Corporation, Pittsburgh, Pennsylvania: production and sales, all segments
- LANXESS Elastomères S.A.S., Lillebonne, France: production and sales, Performance Rubber
- LANXESS Holding Hispania, S.L., Barcelona, Spain: holding company, all segments
- LANXESS Inc., Sarnia, Ontario, Canada: production and sales, Performance Rubber
- LANXESS International SA, Fribourg, Switzerland: sales, all segments
- Lanxess N.V., Antwerp, Belgium: production and sales, Engineering Plastics and Performance Chemicals
- LANXESS Rubber N.V., Zwijndrecht, Belgium: production and sales, Performance Rubber
- Rhein Chemie Rheinau GmbH, Mannheim, Germany: production and sales, Performance Chemicals
- SALTIGO GmbH, Leverkusen, Germany; production and sales, Chemical Intermediates

We initiated or carried out the following major changes in the segments during 2006:

In the Leather business unit, we completed the first acquisition in our history as an independent enterprise, acquiring the 50% interest in Chrome International South Africa Ltd. (CISA) in Newcastle, South Africa, held by the Dow Chemical Group. We are now the sole owner of the world's most modern sodium dichromate and chromic acid plant. The transaction took legal and economic effect on February 1, 2007.

Effective February 28, 2006, we divested the Fibers business unit of the Engineering Plastics segment. Two other divestments related to the Performance Chemicals segment. We sold the Paper business unit of this segment effective March 31, 2006, while the Textile Processing Chemicals business unit was divested at the end of fiscal 2006.

The Fine Chemicals business unit of the Chemical Intermediates segment has been operating independently since April 2006 as SALTIGO GmbH, a wholly owned subsidiary of LANXESS Deutschland GmbH.

Value management and control system To achieve its strategic goals, the LANXESS Group needs concrete controlling parameters against which it can measure the success of its efforts. Such assessments are founded on a reliable, readily understandable financial and controlling information system. LANXESS is constantly working to improve the information provided by the Accounting and Controlling group functions, through consistent reporting of projected, expected and actual data.

The key controlling parameter for the LANXESS Group and the individual segments at present is EBITDA (earnings before interest, taxes, depreciation and amortization) pre exceptionals. It is calculated from EBIT by adding back depreciation and amortization relating to operations, leaving out any exceptional items. Each operating decision or achievement is measured in both the short and the long term by how it affects EBITDA. We aim to improve our profitability, measured as the EBITDA margin (pre exceptionals), to the level of our competitors by 2009. In 2006, this was between 12% and 14%. We also set profitability targets for our business operations. All LANXESS business units are expected to achieve an EBITDA margin pre exceptionals of at least 5% in 2009.

To monitor working capital, we use two key performance indicators: DSI (days of sales in inventories) and DSO (days of sales outstanding). These represent inventories and receivables, respectively, in relation to sales after adjustment for portfolio effects. Another important performance indicator is business free cash flow, which indicates the business units' direct contributions toward generating cash. It is calculated for the operating units by a simplified cash flow method.

As previously announced, we introduced two additional controlling parameters – return on capital employed (ROCE) and the net debt ratio – in the reporting year. ROCE is a profitability ratio that indicates how effectively we utilize our employed and tied-up capital, and is calculated as the ratio of EBIT pre exceptionals to capital employed. Capital employed can be derived from balance sheet data; it is defined as total assets less deferred tax assets and interest-free liabilities. Interest-free liabilities comprise provisions (not including provisions for pensions), tax liabilities, trade payables, and material items included under "other liabilities." The net debt ratio is defined as the total of current and noncurrent financial liabilities, less liquid assets, divided by EBITDA pre exceptionals. Both controlling parameters are used exclusively at Group level.

Value Management and Control System		2005	2006
EBITDA pre exceptionals	€ million	581	675
EBITDA margin pre exceptionals	%	8.1	9.7
Capital employed	€ million	2,578	2,640
ROCE	%	12.9	15.9
Days of sales in inventories (DSI)	Days	53.8	56.1
Days of sales outstanding (DSO)	Days	53.6	49.5
Net financial liabilities	€ million	680	511
Net debt ratio		1.2x	0.8x
Investment ratio	%	3.5	3.8

Thanks to a disproportionate increase in EBIT pre exceptionals and an only slight increase in capital employed, our ROCE improved from 12.9% in 2005 to 15.9% in 2006. Our net debt ratio also improved due to a significant reduction in net debt and to the growth in business during the year measured as EBITDA pre exceptionals.

Expenditures for property, plant and equipment are subject to rigorous capital discipline, and focus systematically on those product areas with the greatest potential for success. We have defined 4% of sales as a sustainable and appropriate investment ratio for the Group. Capital expenditures last year were just below this level but will be slightly higher in 2007, at or slightly above €300 million.

Business Conditions

The economic environment 2006 was characterized by sustained strong expansion of the global economy, which grew by 3.8% and therefore somewhat more than our forecast of 3.5%.

As expected, this robust growth rate was supported above all by the Asia-Pacific region and here especially by China, India and other East Asian countries. In addition to the significant rise in consumer demand, investments in this booming region were also increased strongly again. Especially in the first quarter, the United States remained a major driver of the global upswing, but has noticeably lost impetus since the spring due to weaker economic performance. Two factors in particular were responsible for this development: the end of the real estate boom and the restrictive monetary policy of the U.S. Federal Reserve from the spring onward. The economic upturn in Japan also slowed perceptibly due to flatter production growth and a decline in public-sector investment. By contrast, the economies of the European markets that are of importance to German industry continued to consolidate their gains. The main impetus came from trade with European countries, and deliveries to the euro zone and the new E.U. member states expanded considerably.

During the course of the year, the U.S. dollar dropped sharply in value against the euro. This development was accompanied by a strong increase in volatility. At the end of 2006, the euro was worth around $1.32, up 11.9% from a year earlier. The main reasons for this decrease were inflation expectations and uncertainty about the further course of U.S. monetary policy. The average value of the euro for the year was around $1.26, which was what we had anticipated.

Prices of raw materials climbed strongly again during 2006 on account of the dynamic global economy. The price of oil reached a new high of around US$74.00 per barrel in September due to the political tensions in the Middle East. The fact that there were no major hurricanes and that both the Middle East situation and the confrontation with Iran cooled led in December to a drop in the price of oil to around US$58 per barrel. The expected fluctuations on the commodities markets were also reflected in consumer prices.

GDP and Chemical Production in 2006

Change vs. prior year in % (projected)	Gross domestic product	Chemical production
Americas	3.5	3.1
NAFTA	3.3	2.9
Latin America	4.8	4.2
EMEA	3.2	4.5
Germany	2.7	3.7
Western Europe	2.6	4.2
Central/Eastern Europe	5.4	12.7
Asia-Pacific	4.9	6.3
Japan	2.0	(0.9)
Greater China	9.2	12.7
India	8.5	7.3
World	**3.8**	**4.7**

The chemical industry The upswing in the chemical industry that began in 2003 continued in 2006. Global production increased by around 4.7% in 2006 and, like general economic growth, slightly exceeded our forecast of 4%. The Asian markets accounted for a disproportionate share of this growth, underscoring the ongoing trend toward local production.

As anticipated, the chemical industry in the NAFTA region bounced back from its noticeable slump in 2005 to post more dynamic growth of 3%. At 4.5%, growth in chemical production in Europe was much higher than we had anticipated a year earlier. The new E.U. member states in central and eastern Europe saw the highest production growth, although they started from a low base. As in 2005, exports were the main driver for the European chemical industry's growth.

Evolution of major user industries The automotive industry performed robustly in 2006, as expected, with global production growing 4.1%. The main growth drivers here were the Asia-Pacific region with China and India, which posted impressive growth rates of 22.3% and 17.2% respectively. Central and eastern Europe also contributed substantially to this positive trend with growth of 6.7%. As in 2005, growth was less vigorous in the industry's main markets in North America and western Europe. The reasons for this were still high fuel prices and the resulting decline in purchasing power, as well as consumers' continued reluctance to spend.

The performance of the construction industry was positive overall with growth at 5%, up two percentage points from the previous year. By far the largest gains were posted in India, China and Latin America. The momentum for the construction industry's growth in Asia-Pacific and Latin America derived from the dynamic economic expansion in both of these regions. Growth in the European construction industry was driven above all by the new markets in central and eastern Europe.

With growth of 8%, the electrical and electronics industries posted by far the strongest expansion in 2006, which in fact slightly exceeded our positive forecast of 7%. This robust growth was global, bypassing only Latin America and, to a certain degree, Japan.

In the tire industry, the trend of shifting production to emerging nations continued in 2006. The downturn in the NAFTA region accelerated at a surprising rate and was only marginally offset by a slight increase in production in Latin America. The decline continued in Germany and elsewhere in western Europe as well. Expansion of 6% in the Asia-Pacific region was driven primarily by China with growth of 14%.

The apparel industry performed unexpectedly well in 2006, with world production growing by 3.5%. As in the previous year, performance was uneven across the various regions. The industry posted very high growth rates in the Asia-Pacific region, again principally in India and China. This underscores the importance of expanding markets in Asia and the increase in production capacities in emerging nations. Additional impetus came from Latin America, and central and eastern Europe. However, the EMEA (Europe, Middle East, Africa) region experienced a downturn overall, mainly due to a decline in production in Germany and elsewhere in western Europe. The textile industry in North America also reported negative growth rates, although the pace of this downward trend was much slower than in 2005.

Evolution of Major User Industries in 2006

Change vs. prior year in % (projected)	Automotive	Construction	Electrical	Tires	Textiles, Apparel, Leather
Americas	(1.2)	6.0	9.0	(4.3)	0.0
NAFTA	(2.6)	5.0	9.0	(5.9)	(1.0)
Latin America	6.3	12.0	3.0	1.6	3.0
EMEA	3.0	3.5	8.0	0.2	(2.0)
Germany	1.0	4.0	8.5	(2.5)	(5.0)
Western Europe	(1.3)	3.5	7.5	(1.7)	(3.0)
Central/Eastern Europe	6.7	8.5	7.0	1.4	(1.0)
Asia-Pacific	9.2	6.0	8.0	6.0	9.0
World	**4.1**	**5.0**	**8.0**	**1.5**	**3.5**

The Legislative Environment On December 13 and 18, 2006, the Regulation concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) was adopted by the European Parliament and the European Council of Environment Ministers respectively. This concluded the process lasting several years of reforming European chemicals legislation. The regulation enters into force on June 1, 2007.

In contrast to previous European chemicals law, REACH is based on the principle of individual responsibility. Any person (manufacturer or importer) placing chemicals on the market is responsible for those chemicals and must himself procure the data necessary for evaluating their safety. Based on these data, instructions must be provided for the safe handling of these substances along the entire value chain. REACH covers all chemicals produced in quantities of one or more tons per year. The scope of the data required for registration depends on the quantity of the chemical produced.

Since the technical guidelines for implementing this regulation are still being compiled, the precise consequences for LANXESS cannot yet be determined at this time. Please see the Risk Report for further information.

Business Performance of the LANXESS Group

- Sales adjusted for portfolio effects up slightly from previous year
- LANXESS achieves earnings target: EBITDA pre exceptionals climbs €94 million, to €675 million
- EBITDA margin pre exceptionals up from 8.1% in 2005 to 9.7%
- Exceptional items for portfolio adjustments and restructuring measures pull down operating result
- First-time net income of €197 million
- LANXESS pays first dividend

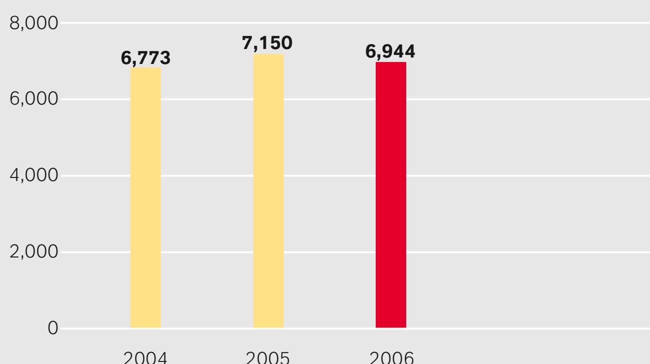
Summary of the fiscal year In 2006, the LANXESS Group improved its operating result before depreciation and amortization (EBITDA) pre exceptionals by €94 million, or 16.2%, to €675 million. A favorable market environment, particularly in Germany and the Asia-Pacific region, improvements in efficiency, and our restructuring successes contributed substantially to this result. Higher costs for raw materials and energy were again passed on to customers through price increases wherever possible. The EBITDA margin rose by 1.6 percentage points to 9.7%. We therefore achieved our objective of significantly increasing our EBITDA margin pre exceptionals to between 9% and 10% as announced in fall 2004. This is also a successful step toward attainment of our new Group objectives, which are explained in greater detail in the Outlook section. Pressure was put on our operating result (EBIT) by exceptional charges for the portfolio adjustments and further restructuring measures undertaken during the fiscal year. As a result of the systematic optimization of our financing structure, our financial result improved by 38.6%. The net income for the Group amounted to €197 million compared with last year's loss of €63 million. It is planned that our stockholders benefit from the company's greatly improved earnings situation in the form of a dividend. The Management Board and Supervisory Board will propose distribution of a dividend of €0.25 per LANXESS share for the first time at the Annual Stockholders' Meeting to be held on May 31, 2007.

Key Financial Data	2005	2006	Change
€ million			in %
Sales	7,150	6,944	(2.9)
Gross profit	1,613	1,540	(4.5)
EBITDA pre exceptionals	581	675	16.2
EBITDA margin pre exceptionals	8.1%	9.7%	–
EBITDA	341	638	87.1
Operating result (EBIT) pre exceptionals	332	421	26.8
Operating result (EBIT)	28	376	*
Financial result	(145)	(89)	38.6
Income (loss) before income taxes	(117)	287	*
Net income (loss)	(63)	197	*
Earnings per share (€)	(0.75)	2.33	*

* change of more than 100%

Sales and earnings

Sales Sales by the LANXESS Group met expectations in fiscal 2006, amounting to €6,944 million. In the previous year, we announced we would systematically pursue our "price before volume" strategy coupled with only moderate growth in sales in our continuing operations. The decline in sales by 2.9% compared to the previous year was exclusively due to portfolio adjustments and unfavorable currency effects, particularly in the case of the U.S. dollar. Adjusted for the sale of the Fibers and Paper business units and the Rhein Chemie subsidiary iSL-Chemie GmbH and the unfavorable currency effects, the LANXESS Group saw a slight increase in sales of 1.2%. The positive price effects of €289 million, or 4.0%, more than compensated for the decrease in volume of €197 million, or 2.8%. As far as selling markets were concerned, Germany and the Asia-Pacific region posted very pleasing growth in a favorable economic environment. In the EMEA region (Europe, Middle East, Africa), excluding Germany,



sales growth was less dynamic than in the previous year, whereas sales in the Americas adjusted for portfolio and currency effects remained at last year's level.

Effects on Sales	2006
Approximate data	in %
Price	4.0
Volume	(2.8)
Currency	(0.4)
Portfolio	(3.7)
	(2.9)

This development reflected our strategy of selective sales growth. Another influencing factor were the higher prices imposed in some areas of the business to pass on increased raw material costs.

Sales by Segment	2005	2006	Change	Contribution to Group sales in %
€ million			in %	in %
Performance Rubber	1,678	1,776	5.8	25.6
Engineering Plastics	1,737	1,708	(1.7)	24.6
Chemical Intermediates	1,535	1,533	(0.1)	22.1
Performance Chemicals	1,977	1,812	(8.3)	26.0
Other/Consolidation	223	115	(48.4)	1.7
	7,150	**6,944**	**(2.9)**	**100.0**

The Performance Rubber segment posted a price-driven rise in sales. The decline in sales in the Engineering Plastics and Performance Chemicals segments resulted from portfolio adjustments. The Chemical Intermediates segment was able to maintain the same high level of sales as in 2005.

Gross profit Compared to the previous year, the cost of sales decreased by 2.4% to €5,404 million, due both to portfolio measures and increases in efficiency. Against these were higher prices for raw materials and energy. Gross profit declined by 4.5% to €1,540 million. Our gross profit margin was 22.2%, nearly matching the prior-year figure of 22.6%. To varying degrees, the continued strong increases in raw material and energy prices were passed on to the market by the segments. Especially in those areas in which stiff competition was an obstacle to implementing the necessary price increases in full, the earnings situation was stabilized by the productivity improvements achieved. The sale of the loss-making Fibers business unit and the low-margin Paper business unit as well as the success of our extensive restructuring measures in fiscal 2005 and 2006 had a positive effect on gross profit.

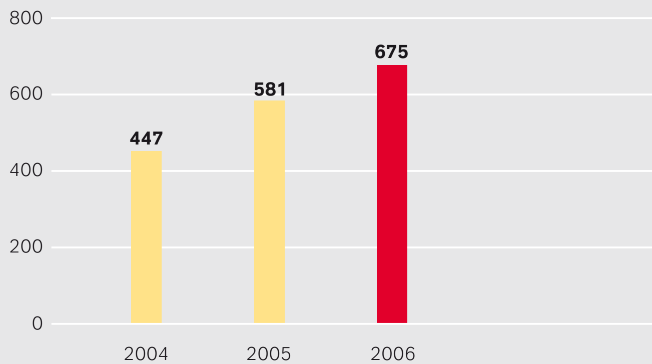
EBITDA and operating result (EBIT) Despite only a slight decline in business volume, selling costs and general administrative expenses decreased by 11.2% and 10.9% respectively in 2006 due to portfolio effects and the systematic reduction in fixed costs in sales and administration.

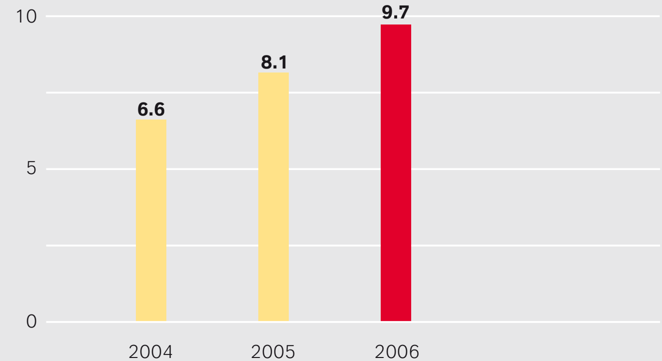
Research and development costs were down 13.9%, to €87 million. Thus R&D costs represented 1.3% of sales, which is around the prior-year level.

Other operating expenses less other operating income dropped substantially from €336 million to €57 million. In the prior year, this item included significant exceptional charges of €304 million relating in particular to restructuring and portfolio measures, and expenses for settlements relating to antitrust investigations. In fiscal 2006, exceptional charges amounted to €45 million, most of which was attributable to restructuring and portfolio measures.

EBITDA Pre Exceptionals by Segment	2005	2006	Change
€ million			in %
Performance Rubber	214	248	15.9
Engineering Plastics	66	103	56.1
Chemical Intermediates	211	245	16.1
Performance Chemicals	212	220	3.8
Other/Consolidation	(122)	(141)	(15.6)
	581	**675**	**16.2**

Since the LANXESS Group began doing business independently, all operating segments have turned in a consistently positive performance. In fiscal 2006, the segments again increased their EBITDA pre exceptionals. The Performance Rubber and Chemical Intermediates segments leveraged their strong market positions





and generated double-digit percentage increases in earnings. The favorable chemical industry environment contributed to this result, as did the successful implementation of efficiency-enhancing programs. The latter were key factors in the jump in earnings of more than 50% in the Engineering Plastics segment, and the sale of the loss-making Fibers business unit also had a positive effect. Earnings performance of the Performance Chemicals operations varied, but the segment posted overall growth of 3.8%.

The operating result amounted to €376 million and was therefore €348 million higher than the prior-year figure of €28 million, which was significantly impacted by exceptionals.

The 2006 operating result (EBIT), which was substantially higher than a year earlier, nevertheless contains exceptionals totaling €45 million, all of which are included in the other operating result. €42 million of this charge related particularly to the additional package of measures to enhance the LANXESS Group's competitiveness, and were mostly the result of global, cross-segment restructuring programs and portfolio adjustments. Additional exceptional charges of €3 million went for settlements related to antitrust investigations.

The total exceptional charges of €304 million for 2005 mainly included expenses for restructuring measures and portfolio adjustments, expenses for settlements related to antitrust investigations and impairments of non-current assets.

Reconciliation of EBIT to Net Income (Loss)	2005	2006	Change
€ million			in %
Operating result (EBIT)	**28**	**376**	*
Loss from investment in associate	(35)	(16)	54.3
Net interest expense	(41)	(23)	43.9
Other financial income and expenses – net	(69)	(50)	27.5
Financial result	**(145)**	**(89)**	**38.6**
Income (loss) before income taxes	**(117)**	**287**	*
Income taxes	63	(85)	*
Income (loss) after taxes	**(54)**	**202**	*
of which:			
Minority interests	9	5	(44.4)
Net income (loss)	(63)	197	*

* change of more than 100%

Financial result The financial result came in at minus €89 million in 2006, compared to minus €145 million for the prior year. The success of our efforts to optimize the capital and financing structure of the LANXESS Group is evident in the significant improvement in net interest expense. The loss from the at-equity valuation of the company's interest in Bayer Industry Services GmbH & Co. OHG (BIS) amounted to €16 million. In addition, there was a slight deterioration in the balance of exchange gains and losses compared to 2005. The expenses for the repurchase and resale of the mandatory convertible bond issued in September 2004 also impacted the other financial result in the prior year.

Income before income taxes Income before income taxes increased by €404 million to €287 million as the result of the higher operating result and improved financial result.

Income taxes The pre-tax income resulted in tax expenses of €85 million, compared to the previous year's tax credit of €63 million. The tax rate was 29.6%.

Net income/Earnings per share After deductions of €5 million for minority interests, the LANXESS Group recorded net income of €197 million in 2006. The net loss of €63 million in 2005 was due largely to exceptional charges. Minority interests amounted to €9 million in 2005. Earnings per share were €2.33 in 2006, compared to minus €0.75 the year before.

Proposal on the utilization of profit In 2006, LANXESS AG's balance sheet profit amounted to €82 million. The Management Board and Supervisory Board will therefore propose to the Annual Stockholders' Meeting on May 31, 2007, that €21 million of this be allocated to retained earnings and that a dividend of €0.25 per share be paid. If this distribution proposal is approved by the stockholders, the total dividend payout will amount to €21 million. A proposal will be made to carry the remaining amount forward to new account.

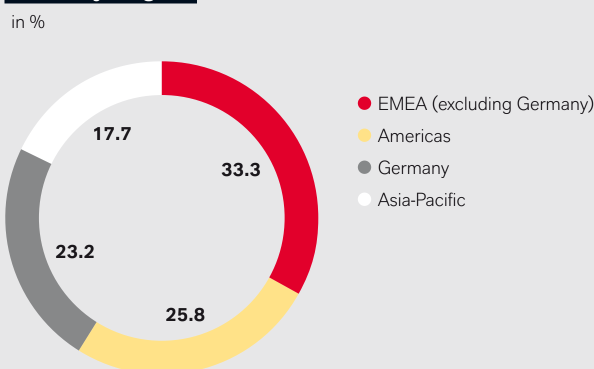
Performance by Region

Sales by Market	2005		2006		Change
€ million	€ million	in % of sales	€ million	in % of sales	in %
EMEA (excluding Germany)	2,494	34.9	2,312	33.3	(7.3)
Germany	1,538	21.5	1,614	23.2	4.9
Americas	1,928	27.0	1,788	25.8	(7.3)
Asia-Pacific	1,190	16.6	1,230	17.7	3.4
	7,150	**100.0**	**6,944**	**100.0**	**(2.9)**

In the **EMEA** region (Europe, Middle East, Africa), excluding Germany, sales were down 7.3% from the previous year, to €2,312 million. Adjusted for portfolio and currency effects, this figure was 3.7% lower. The slight decrease in sales resulted mainly from the conscious decision to forego low-margin business. Sales in the Performance Rubber and Performance Chemicals segments grew, while the other segments saw sales drop. Markets in eastern Europe developed well, while business in Africa and the Middle East remained stable. Sales in France and Belgium in part significantly exceeded prior-year levels, whereas business in the U.K. and Italy did not perform as well as in 2005. The EMEA region (Europe, Middle East, Africa), excluding Germany, accounted for 33.3% of Group sales, compared to 34.9% in 2005.

Sales by Region

in %



In **Germany**, LANXESS sales grew 4.9% from the previous year, to €1,614 million. Adjusted for portfolio measures, sales increased by 8.1%. All segments improved sales substantially due to robust development of the German economy. The Performance Rubber and Engineering Plastics segments posted double-digit percentage growth in sales. Germany's share of total sales was 23.2%, compared to 21.5% in 2005.

LANXESS sales in the **Americas** region remained at around last year's level, adjusted for portfolio and currency effects. After portfolio and currency effects, sales shrank by 7.3% to €1,788 million. The Performance Rubber and Performance Chemicals segments achieved a slight improvement in sales, whereas the Engineering Plastics and Chemical Intermediates segments failed to match prior-year performance. In the United States, adjusted sales remained constant despite slightly weaker economic growth, whereas in Canada, sales were down marginally. Latin America saw sales growth of 3.9%, with Brazil and Mexico contributing particularly to this positive development. The Americas region accounted for 25.8% of total sales, down from 27.0% in 2005.

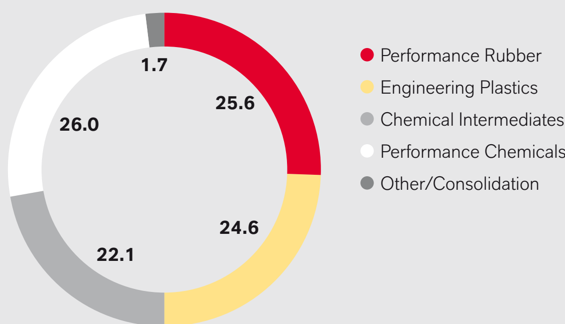
Sales in the **Asia-Pacific** region amounted to €1,230 million in fiscal 2006, up 3.4% from the previous year. Adjusted for currency effects and the business units divested, the increase in sales was 6.3%. All segments performed well, with the Performance Rubber and Engineering Plastics segments reporting above-average growth rates. The drivers of this growth were the Chinese and Indian markets, where substantial double-digit increases in sales were recorded. Business was also especially strong in Hong Kong, Thailand and the Philippines. The withdrawal from agency business in the Chinese market reduced sales there. The Asia-Pacific region's share of total sales rose from 16.6% to 17.7%.

Segment Data

- Performance Rubber: Strong market position underscored
- Engineering Plastics: Broad-based improvements
- Chemical Intermediates: Earnings stable at a high level
- Performance Chemicals: Portfolio effects take hold

Sales by Segment

in %



Performance Rubber	2005		2006		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	1,678		1,776		5.8
EBITDA pre exceptionals	214	12.8	248	14.0	15.9
EBITDA	171	10.2	246	13.9	43.9
Operating result (EBIT) pre exceptionals	151	9.0	180	10.1	19.2
Operating result (EBIT)	108	6.4	178	10.0	64.8
Capital expenditures*	75		89		18.7
Depreciation and amortization	63		68		7.9
Number of employees (December 31)	3,119		2,967		(4.9)

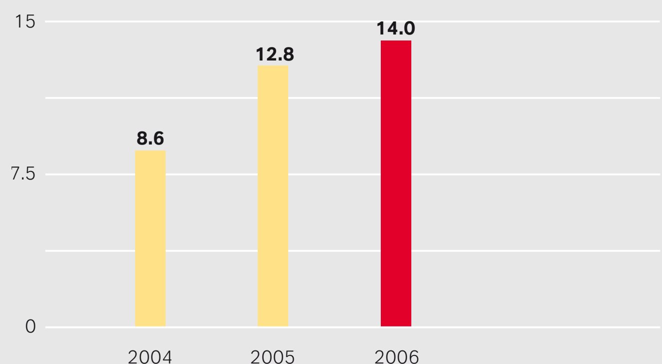
* intangible assets and property, plant and equipment

In 2006, the **Performance Rubber** segment increased sales again over the previous year's high level by 5.8% to €1,776 million. Substantial price increases of 10.2% more than offset the 3.8% decline in volumes and the marginal negative currency effect of 0.6%. Price increases in all of the segment's business units served to pass on the in part considerably higher costs of raw materials to the market. In the Butyl Rubber business unit, the large inventories held by our customers and a strike at a major customer prevented further volume growth. However, the business unit maintained its market position. As expected, the Polybutadiene Rubber business unit reported a decline in volumes in the Americas region. With the start of a market consolidation process, we adjusted production capacities at the U.S. site in Orange, Texas, in early 2006. However, the business unit was unable to match the sales of the previous year due to the difficult market environment in the United States. Volumes in the Technical Rubber Products business unit remained at the previous year's level.

The segment's EBITDA pre exceptionals jumped by 15.9%, to €248 million, with cost containment and efficiency enhancements also helping to improve earnings throughout the segment. In the Butyl Rubber business unit, plant consolidation and process optimization measures were initiated at the site in Zwijndrecht, Belgium, while at the facility in Sarnia, Ontario, Canada, we completed certain capacity expansion activities. In addition to the above-mentioned capacity adjustments in the United States, the Polybutadiene Rubber business unit also modified the production units at Port Jérôme, France, to manufacture the product grades required by the market. Nonetheless, this business unit's earnings remained below the prior-year level due to the adverse demand situation. The restructuring and cost-cutting measures that were initiated in the Technical Rubber Products business unit during 2005 became fully effective in 2006, helping compensate for the rise in energy prices and contributing to a significant improvement in earnings. The EBITDA margin pre exceptionals for the segment as a whole improved 1.2 percentage points, to a pleasing 14.0%.

EBITDA Margin of Performance Rubber

in %



Exceptionals in this segment, at €2 million, related to expenditures for the aforementioned settlements in the context of antitrust investigations involving the Technical Rubber Products business unit. Provisions for such settlements gave rise to exceptional charges of €43 million in the previous year.

Engineering Plastics	2005		2006		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	1,737		1,708		(1.7)
EBITDA pre exceptionals	66	3.8	103	6.0	56.1
EBITDA	66	3.8	103	6.0	56.1
Operating result (EBIT) pre exceptionals	33	1.9	70	4.1	**
Operating result (EBIT)	10	0.6	70	4.1	**
Capital expenditures*	45		63		40.0
Depreciation and amortization	56		33		(41.1)
Number of employees (December 31)	3,479		2,814		(19.1)

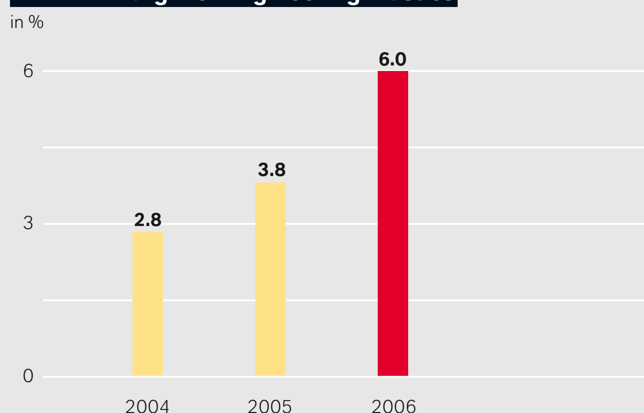
* intangible assets and property, plant and equipment
** change of more than 100%

In the **Engineering Plastics** segment, portfolio adjustments led to a decline in sales of 1.7%, to €1,708 million. Adjusted for the sales of the Fibers business unit that was divested in the first quarter, the segment's sales were up slightly from the previous year. Price increases of 4.4% compensated for adverse volume effects of minus 1.6% and negative exchange rate effects of 0.4%.

In the Lustran Polymers (formerly Styrenic Resins) business unit, we continued to pursue our value-oriented growth strategy and consciously forego unprofitable sales, which depressed volumes. However, the price increases implemented were enough to compensate for this reduction in volumes. In the high-growth Indian and Chinese markets, the business unit saw a satisfactory increase in business volume, particularly in the case of ABS plastics. This development was fostered by the commissioning of additional production capacities in India. The markets served by the Semi-Crystalline Products business unit were characterized by high levels of demand, especially in Europe and the Asia-Pacific region. Further positive impetus was provided by the commissioning of a new compounding plant for the manufacture of Durethan® and Pocan® in Wuxi, China. The business unit's volumes exceeded the high levels of the previous year. Higher raw material costs were passed on to the market through higher prices.

Earnings in the Engineering Plastics segment jumped 56.1% to €103 million based on EBITDA pre exceptionals. In both business units of this segment, raising prices to pass on increases in raw material and energy prices had a positive effect. The Lustran Polymers business unit benefited from the successes achieved by changing strategy and initiating restructuring measures. The focus on higher-margin business improved earnings here. The consolidation of European production facilities for ABS specialties in Tarragona, Spain, also improved cost structures, as did the plant consolidations in Dormagen, Germany, and Brazil, which are proceeding according to schedule. To further strengthen our focus on the European ABS specialties business, we sold our Lustran SAN plastics product line in Europe and South America to BASF AG, Ludwigshafen, Germany, in May 2006. The production capacities freed up by this sale are now being used exclusively to produce ABS specialties. The temporary production stoppage in Tarragona due to fire damage had no sustained negative impact on earnings. Production facilities in the Semi-Crystalline Products business unit enjoyed very high levels of utilization all year, while the additional capacities in China made further contributions to earnings. The sale of the loss-making Fibers business to Asahi Kasei Fibers effective February 28, 2006 led to a further improvement in this segment's earnings. The EBITDA margin pre exceptionals jumped to 6.0% from 3.8% in 2005.

EBITDA Margin of Engineering Plastics
in %



This segment did not report any exceptional items in 2006. In the previous year, the segment's operating result was diminished by impairment losses of €14 million in the Lustran Polymers business unit and €9 million in the Fibers business unit.

Chemical Intermediates	2005		2006		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	1,535		1,533		(0.1)
EBITDA pre exceptionals	211	13.7	245	16.0	16.1
EBITDA	211	13.7	245	16.0	16.1
Operating result (EBIT) pre exceptionals	143	9.3	181	11.8	26.6
Operating result (EBIT)	129	8.4	181	11.8	40.3
Capital expenditures*	59		45		(23.7)
Depreciation and amortization	82		64		(22.0)
Number of employees (December 31)	3,353		3,658		9.1

* intangible assets and property, plant and equipment

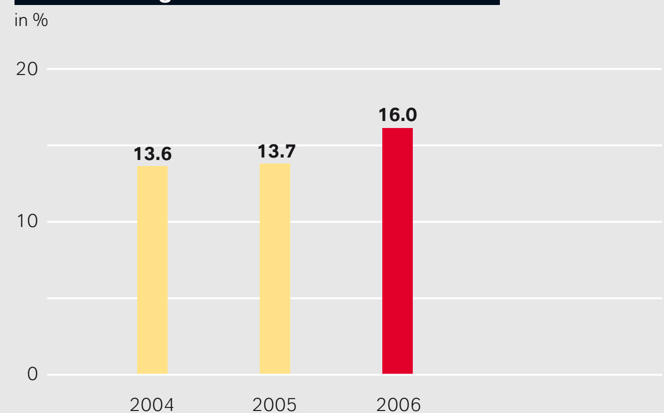
In 2006, sales by the **Chemical Intermediates** segment were nearly unchanged from the prior year at €1,533 million. Price increases of 1.0% compensated for an equally large decline in volumes. Negative currency effects of 0.1% were insignificant in this regard.

The Basic Chemicals and Inorganic Pigments business units implemented price increases to pass on rises in the cost of raw materials and energy. In the Saltigo (formerly Fine Chemicals) business unit, prices and volumes declined due to weaker demand for agrochemicals and specialty chemicals activities. The diminished demand from the agrochemicals market is explained by the dry weather during the year and the resulting reduced need for fungicides. Improvements in pharmaceutical intermediates and active ingredients, due in part to promising projects with new customers, could not fully offset this development. In the Inorganic Pigments business unit volumes increased thanks to buoyant demand for construction, coating and plastics applications.

EBITDA pre exceptionals in this segment improved by 16.1%, to €245 million, primarily because of much higher earnings in the Saltigo and Inorganic Pigments business units. The earnings generated by the Basic Chemicals business unit also remained high. Implementation of the restructuring measures initiated in 2005 enabled the Saltigo business unit to reduce fixed costs in all areas of operation. These measures included the closure of unprofitable facilities and, most importantly, a clearer positioning of this unit in the market for exclusive custom syntheses. The reductions in fixed costs helped compensate for higher raw material prices and improved earnings. On account of the strong project-oriented nature of this business, sales and earnings in the Saltigo business unit are always subject to a certain degree of volatility. Earnings in the Inorganic Pigments business unit were boosted by a positive demand situation and correspondingly high capacity utilization, coupled with the consolidation of production facilities. As part of our restructuring program, we closed our U.S. site at New Martinsville, West Virginia, in 2006. Customers are now supplied from Burgettstown, Pennsylvania, or directly from Krefeld-Uerdingen, Germany, and Porto Feliz, Brazil.

EBITDA Margin of Chemical Intermediates

in %

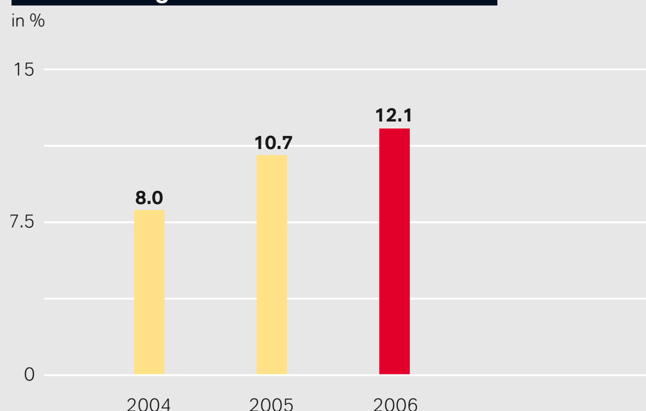


The EBITDA margin pre exceptionals for the segment as a whole improved 2.3 percentage points, to 16.0%.

In 2006, this segment did not report any exceptional items. The exceptionals included in the segment's operating result in the previous year comprised impairment losses of €14 million for the Saltigo business unit.

Performance Chemicals	2005		2006		Change
	€ million	in % of sales	€ million	in % of sales	in %
Sales	1,977		1,812		(8.3)
EBITDA pre exceptionals	212	10.7	220	12.1	3.8
EBITDA	184	9.3	219	12.1	19.0
Operating result (EBIT) pre exceptionals	146	7.4	156	8.6	6.8
Operating result (EBIT)	118	6.0	155	8.6	31.4
Capital expenditures*	61		55		(9.8)
Depreciation and amortization	66		64		(3.0)
Number of employees (December 31)	4,743		3,891		(18.0)

* intangible assets and property, plant and equipment



Sales in the **Performance Chemicals** segment dropped 8.3% from the prior year, to €1,812 million, due to portfolio effects. Adjusted for the divestment of the Paper business unit and Rhein Chemie subsidiary iSL-Chemie GmbH, sales were up slightly by 1.7%. This was due to positive price and volume effects of 1.6% and 0.6% respectively, with a small negative currency effect of minus 0.5%. All business units except Rubber Chemicals raised prices or maintained them at last year's levels. The price increases allowed the business units to pass on the higher costs of raw materials and energy. The Material Protection Products and Leather business units posted pleasing sales growth. The former likewise increased volumes, also of its cold sterilization agent Velcorin®. The Leather business unit benefited especially from its strong market position in the Asia-Pacific region where price increases were implemented successfully. The two production facilities in Wuxi, China, that were completed in 2005, also contributed to this development. In the Rubber Chemicals business unit, sales dipped because of stronger competition and the closure of production facilities by customers, coupled with the associated drop in demand.

EBITDA pre exceptionals improved 3.8%, to €220 million, due mainly to the strong performance of the Material Protection Products, Leather and Ion Exchange Resins business units. The sale of the Paper business unit to Finland's Kemira Group in 2006 had a positive impact on the segment's performance. In the Rubber Chemicals business unit, earnings were diminished by the expenses involved in the launch of the new production joint venture, Anhui Tong Feng Shengda Chemical Co. Ltd. This company, based in Tongling, China, will enable us to further expand LANXESS's strong position in the Chinese rubber chemicals market. The Textile Processing Chemicals business unit was sold at the end of 2006. The segment's EBITDA margin pre exceptionals increased by 1.4 percentage points to 12.1%.

The segment's operating result was hampered by €1 million in the context of antitrust investigations already referred to above in the Rubber Chemicals business unit. In the previous year, such settlements led to exceptional charges of €28 million.

The exceptional items of €42 million reported by the **Other/ Consolidation** segment related mainly to restructuring measures and portfolio adjustments initiated in fiscal 2006, as did the previous year's exceptional items of €196 million. The expenses for restructuring measures and portfolio adjustments mainly comprise costs for headcount reductions, impairment charges, closures or partial closures of facilities, and the preparation of corporate transactions. Included in these expenses are impairment losses of €8 million, compared to €27 million in 2005. As in the prior year, restructuring and portfolio expenses are included in the Other/Consolidation segment because they relate to a Group-wide, cross-segment program of asset consolidations, process improvements and portfolio adjustments initiated by the Board of Management, and it is therefore not possible to allocate them properly among the operating segments.

Financial Condition

Balance sheet structure

- Net financial debt significantly reduced
- Equity ratio improved further
- Total assets down from previous year due to portfolio adjustments

Balance Sheet Structure	Dec. 31, 2005		Dec. 31, 2006		Change
	€ million	in %	€ million	in %	in %
Assets					
Non-current assets	1,835	42.3	1,730	41.1	(5.7)
Current assets	2,506	57.7	2,475	58.9	(1.2)
Total assets	**4,341**	**100.0**	**4,205**	**100.0**	**(3.1)**
Equity and liabilities					
Equity (including minority interest)	1,256	28.9	1,428	34.0	13.7
Non-current liabilities	1,576	36.3	1,554	37.0	(1.4)
Current liabilities	1,509	34.8	1,223	29.0	(19.0)
Total equity and liabilities	**4,341**	**100.0**	**4,205**	**100.0**	**(3.1)**

Total assets were down €136 million, or 3.1%, from the previous year, primarily because of portfolio adjustments in fiscal 2006. Please see the Notes to the Consolidated Financial Statements for more detailed information about assets and liabilities disposed of during the divestments. A decline in non-current assets on the assets side of the balance sheet stands against a decrease in current liabilities on the equity and liabilities side. The equity ratio improved 5.1 percentage points, to 34.0%.

Adjusted for portfolio measures, intangible assets and property, plant and equipment remained almost unchanged from the prior year. Deferred tax assets declined, as did the value of the interest in Bayer Industry Services GmbH & Co. OHG, which is included at equity, due to the loss posted by this company.

Non-current assets accounted for 41.1% of total assets, compared to 42.3% in 2005.

Current assets remained at around the prior-year level with a minimal slip of 1.2%. Inventories shrank by €21 million, or 2.0%. After adjustment for currency and portfolio effects, higher raw material prices yielded a slight increase in inventories. The low level of the previous year was also influenced by problems in obtaining deliveries from a raw material supplier. As a result, days of sales in inventories (DSI) rose marginally in fiscal 2006. Trade receivables were down by €141 million, or 13.2%, from the previous year. However, they remained virtually unchanged when adjusted for portfolio and currency effects. The days of sales outstanding (DSO) improved again against the previous year.

On the equity and liabilities side, equity, including minority interest, increased €172 million, or 13.7%, from the year before, due mainly to the net income recorded. The equity ratio came in at 34.0%, compared to 28.9% for the prior year. Further details of changes in equity are provided in the Statement of Changes in Equity and the Notes to the Consolidated Financial Statements.

Non-current liabilities remained close to last year's level with a slight drop of 1.4%, accounting for 37.0% of total equity and liabilities. They include the €500 million Euro Benchmark Bond issued in fiscal 2005, which strengthened Group financing for the long term. Provisions for pensions and other post-employment benefits were up €23 million, or 4.6%, from the year before.

Current liabilities decreased €286 million, or 19.0%, to €1,223 million, largely because of utilization of the restructuring provisions set up in the previous year, reduced trade payables and the repayment of short-term liabilities to banks.

Net financial debt, defined as financial liabilities less cash and cash equivalents, came to €511 million as of December 31, 2006. This represents a substantial €169 million, or 24.9%, decrease from the previous year. The reduction is primarily the consequence of strict capital discipline, stable operating cash flow and net income.

The Group's key balance sheet ratios are as follows:

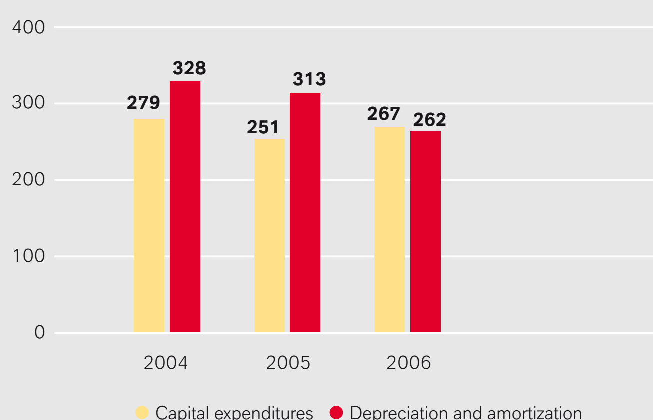
Ratios		2005	2006
in %			
Equity ratio	Equity* / Total assets	28.9	34.0
Non-current asset ratio	Non-current assets / Total assets	42.3	41.1
Asset coverage I	Equity* / Non-current assets	68.4	82.5
Asset coverage II	Equity* and non-current liabilities / Non-current assets	154.3	172.4
Funding structure	Current liabilities / Total liabilities	48.9	44.0

* including minority interest

Capital expenditures LANXESS makes selective capital expenditures to increase its international competitiveness, focusing on profitable businesses with attractive growth opportunities. Funds are allocated to individual segments in keeping with strategic targets. As a rule, capital expenditures are financed out of the cash flow from operating activities, or if these funds are insufficient, from other cash and credit lines available. Additionally, capital expenditure projects are also pursued as part of production and other joint ventures with international partners.

Capital Expenditures vs. Depreciation and Amortization

€ million



In 2006, capital expenditures for property, plant and equipment and for intangible assets came to €267 million, compared to €251 million the year before. Thus capital expenditures were level with depreciation and amortization, which came to €262 million. Depreciation and amortization included €8 million in impairments, which were reported as exceptionals. The prior year's depreciation and amortization was €313 million, including impairments of €67 million, €64 million of which were classified as exceptionals.

Capital expenditures focused primarily on measures to replace or maintain facilities or to enhance plant availability, and projects to improve equipment safety, improve quality or comply with environmental protection requirements. About 60% of the capital expenditures in 2006 were to preserve existing facilities, while the rest were for expansion or efficiency improvement measures.

In regional terms, about 39% of 2006 capital expenditures for property, plant and equipment in 2006 were made in Germany, about 20% in the EMEA region outside Germany, about 32% in the Americas, and about 9% in Asia. The figure for the Americas nearly doubled compared to the previous year. This is attributable to capital expenditures for expanding our butyl rubber production facilities in Canada.

Capital expenditures in the Performance Rubber segment, at €89 million (2005: €75 million), exceeded depreciation and amortization of €68 million. As in the previous year, expenditures served to expanding the capacity of the Butyl Rubber business unit's facilities in Sarnia, Ontario, Canada. Moreover, the Technical Rubber Products business unit invested significantly in chloroprene rubber (CR) production at the Dormagen site with the goal of expanding capacities and further improving process reliability.

In the Engineering Plastics segment capital expenditures came to €63 million, an increase of 40% over the previous year's spending of €45 million. This was significantly higher than the level of depreciation and amortization, which amounted to €33 million. In Tarragona, Spain, targeted capital expenditures were made in ABS production in support of the clear strategy of making Tarragona the hub of LANXESS's ABS operations for Europe and Latin America. In the Semi-Crystalline Products business unit, expenditures related to expanding polyamide 6 production at the Krefeld-Uerdingen site in Germany.

The Chemical Intermediates segment made capital expenditures of €45 million (2005: €59 million). These were less than depreciation and amortization, which amounted to €64 million. In Leverkusen, Germany, the Saltigo business unit initiated expansion of an existing complex compliant with cGMP (current Good Manufacturing Practice) to manufacture products for the pharmaceutical industry.

Capital expenditures in the Performance Chemicals segment, at €55 million (2005: €61 million), were slightly below depreciation and amortization of €64 million. Major expenditures related to the relocation of the hydrazine hydrate production plant from the Baytown, Texas, site in the United States to Weifang, China, which was completed in 2006. The Rhein Chemie business unit completed work on a service and technology center at its headquarters in Mannheim.

Among the major individual projects for 2006 were:

Segment	Description
Performance Rubber (BU: Butyl Rubber)	Expansion of butyl rubber production in Sarnia, Canada
Performance Rubber (BU: Technical Rubber Products)	Expansion of chloroprene rubber (CR) capacities in Dormagen, Germany
Engineering Plastics (BU: Lustran Polymers)	Expansion of ABS production in Tarragona, Spain
Engineering Plastics (BU: Semi-Crystalline Products)	Expansion of polyamide 6 production in Krefeld-Uerdingen, Germany
Chemical Intermediates (BU: Saltigo)	Expansion of an existing facility that complies with cGMP (current Good Manufacturing Practice) for the pharmaceuticals industry in Leverkusen, Germany
Performance Chemicals (BU: Functional Chemicals)	Joint venture for hydrazine hydrate in Weifang, China

Liquidity and capital resources

Financial condition

- Operating cash flow burdened by one-time payments
- Capital expenditures for property, plant and equipment financed out of operating cash flow
- Sound basis established for growth and restructuring cash-outs in 2007
- Term of syndicated credit line successfully extended

The cash flow statement shows cash inflows and outflows by type of business operation.

Cash Flow Statement	2005	2006	Change
€ million			
Income (loss) before income taxes	(117)	287	404
Depreciation and amortization	313	262	(51)
Other items	322	(22)	(344)
Net cash provided by operating activities before change in working capital	**518**	**527**	**9**
Change in working capital	106	(118)	(224)
Net cash provided by operating activities	**624**	**409**	**(215)**
Net cash used in investing activities	**(246)**	**(207)**	**39**
Net cash used in financing activities	**(319)**	**(164)**	**155**
Change in cash and cash equivalents from business activities	59	38	(21)
Cash and cash equivalents as of December 31	136	171	35

Cash provided by operating activities before changes in working capital improved slightly in 2006 compared to the year before. While income before taxes increased substantially and depreciation and amortization was €51 million below the previous year's figure, operating cash flow was impacted by significant one-time payments resulting from the utilization of provisions established in 2005 for restructuring, antitrust cases and higher bonus payments. In the prior year, the increase in other items included the corresponding allocations to provisions. They did not therefore result in cash outflows, and thus did not affect operating cash flow in 2005.

The change in working capital compared to December 31, 2005 resulted in a cash outflow of €118 million. Taking into account portfolio and currency effects, the increase in trade receivables and especially in inventories resulted from higher raw material prices and growth in business volume. In addition, the previous year's inventories were unusually low due to the problems in obtaining deliveries from a raw material supplier and production bottlenecks associated with Hurricane Rita. Moreover, an extension of payment terms with BIS was settled. Adjusted for these effects, working capital approximately matched the level of the previous year.

Cash used in investing activities in 2006 was less than in the previous year, at €207 million. Expenditures for property, plant and equipment and for intangible assets were up €16 million, or 6.4%, to €267 million and thus at the upper end of the range budgeted for 2006. Sales of property, plant and equipment brought in cash of €13 million, compared to €8 million the year before. The LANXESS Group received cash inflows of €104 million from the sale of companies and business units in 2006. The compensation paid for the prior-year loss of BIS and investments in securities led to expenditure on financial assets of €78 million.

Cash used in financing activities for 2006 came to €164 million, compared to €319 million in 2005. Most of this outflow resulted from a net loan repayment of €124 million. Interest expenses and other financial disbursements resulted in cash outflows of €39 million. The prior-year figure of €76 million included items such as payments associated with the June 2005 repurchase and resale of the convertible bond.

Cash and cash equivalents came to €171 million on the reporting date, €35 million, or 25.7%, above the prior-year figure of €136 million.

Financing of the LANXESS Group On the reporting date, the LANXESS Group had unutilized liquidity reserves amounting to approximately €1.6 billion comprising cash, committed credit lines and an asset-backed securities program. This significant liquidity reserve ensures the Group's solvency at all times and is evidence of LANXESS's good overall financial flexibility.

At the core of this liquidity reserve is a credit line of €1.25 billion agreed with an international syndicate of banks. This credit line was extended for a further year during 2006, so that the agreement now expires in October 2011. All of the banks in the syndicate consented to the extension, representing the successful exercise of the first of two extension options. The next date for further extension of the credit line is October 2007.

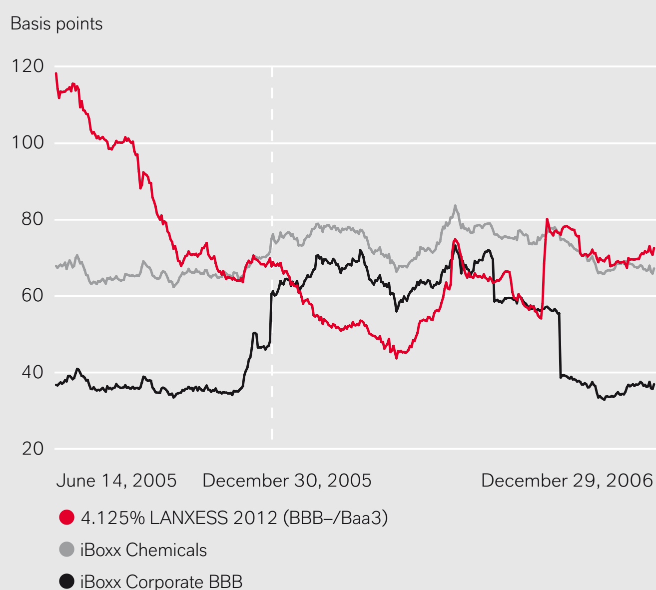
LANXESS's excellent liquidity enabled it to reduce the asset-backed securities program with an initial volume of €200 million implemented by LANXESS Deutschland GmbH in 2004. During 2006, the program was utilized to a maximum of €50 million. As a rule, the sale of receivables to raise liquidity is recognized in the consolidated balance sheet, which is why this transaction is considered to be on-balance sheet financing. LANXESS had not utilized this program by the reporting date.

No additional financing-related transactions were entered into during 2006.

In 2005, we issued a bond with a volume that qualified it as a benchmark bond for inclusion in the major European bond indices. It was issued with a seven-year maturity and a 4.125% annual interest coupon by LANXESS Finance B.V., an indirectly wholly owned subsidiary of LANXESS AG. The bond is guaranteed by LANXESS AG and received investment-grade ratings of BBB– from Standard & Poor's and Baa3 from Moody's Investor Services. The bonds are traded on the Luxembourg Stock Exchange under the securities identification code A0E6C9.

Bond performance – evolution of credit spread An important indicator for corporate bonds, apart from the absolute change in price, is the relative valuation of the risk specific to the issuer in comparison to a reference interest rate. This valuation is expressed in what is known as the "credit spread." The chart below shows the evolution of the credit spread of the LANXESS bond in comparison to the interest-rate swap curve. Following outstanding prior-year performance, the spread at times developed in significant variance to the market in comparison to both to LANXESS's own BBB rating class and to other chemical companies. The announcement by the Board of Management that LANXESS is also considering options for external growth led the bond markets to price in the event risk, which resulted in an increase in the credit spread. At the end of 2006, the LANXESS credit spread traded at the same level as the iBoxx Index for BBB-rated corporate bonds.

Bond Performance – Evolution of Credit Spread



Ensuring a healthy balance sheet and financing structure is an expression of the forward-looking and prudent financial strategy pursued by LANXESS. In the same context is the strategic corporate objective formulated by the Supervisory Board and the Board of Management of maintaining an investment-grade rating in the BBB range. Among other things, this ensures flexible access to capital markets. In 2006, signals from the rating agencies were mostly positive. For example, Fitch included LANXESS in its rating universe in May 2006, issuing an initial BBB flat rating with stable outlook. This was one level higher than the existing ratings from Standard & Poor's and Moody's. In June 2006, Moody's confirmed its Baa3 rating, at the same time upgrading the outlook from stable to positive. Standard & Poor's also confirmed its BBB– rating in May 2006, but its upgrade to a positive outlook was subsequently downgraded again to stable in September 2006. Standard & Poor's justified this move with the assumption that LANXESS in the future would use the financial scope provided by the BBB– rating for external growth.

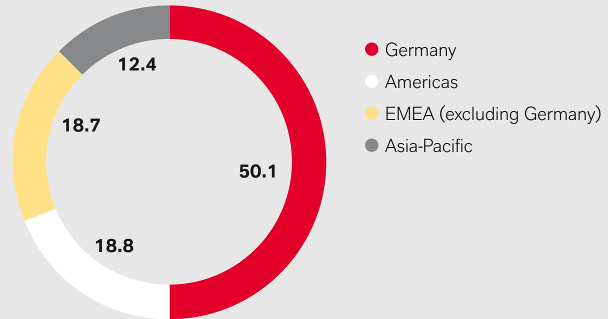
Employees As of December 31, 2006, the LANXESS Group had a total of 16,481 employees. This was 1,801 fewer than a year earlier, due primarily to the restructuring measures and the divestment of the Fibers, Paper and Textile Processing Chemicals business units. The employees of these business units were no longer included as of the reporting date.

As of December 31, 2006, the LANXESS Group employed 3,083 individuals in the EMEA region (not including Germany), compared to 3,290 the year before. The number of employees in Germany declined from 9,410 to 8,263, which most clearly reflects the effects of the abovementioned changes. Staff in the Americas region was down from 3,694 in the previous year to 3,094. The increase in the number of employees in the Asia-Pacific region from 1,888 to 2,041 reflects our expanding activities in the high-growth Asian markets.

Personnel expenses totaled roughly €1,136 million, or 16.4% of sales, down 14.8% from the previous year. Wages and salaries, at €877 million, accounted for most of this figure. Social security contributions were €177 million, while pension plan expenses totaled €78 million, and social assistance benefits came to €4 million.

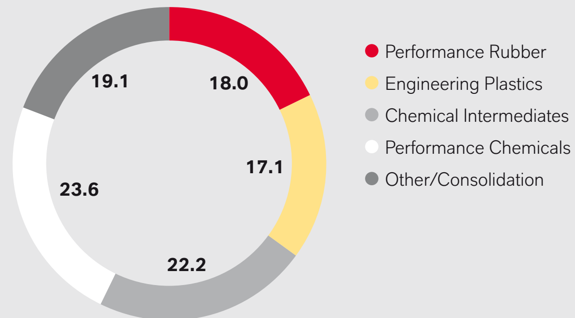
Employees by Region

in %



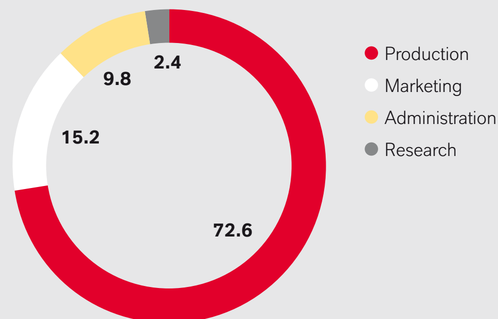
Employees by Segment

in %



Employees by Functional Area

in %



Compensation Report The structure of the compensation system for the members of the Management Board is determined and regularly reviewed by the Supervisory Board in line with proposals from its Human Resources Committee. This Committee is responsible for determining appropriate compensation for individual Management Board members on the basis of criteria that include, in particular, the duties of the individual Management Board member, his personal performance, and the LANXESS Group's economic situation, performance, and future outlook.

In addition to a market-oriented annual base salary that is broadly in line with that paid by comparable companies, their compensation contains two variable components based on LANXESS's short-term and long-term performance.

The fixed compensation comprises the annual base salary and remuneration in kind, consisting mainly of the tax value of perquisites such as the use of a company car. The aggregate amount of these components came to €2.047 million in 2006.

The short-term, performance-based component is called the Short Term Incentive (STI), which is based on the Group's attainment of defined EBITDA targets and is equivalent to the annual base salary in the event of 100% target attainment. The maximum amount payable is 150% of the annual base salary. The aggregate amount of the performance-based STI payments amounted to €2.333 million in 2006.

The long-term, performance-based component of the compensation system is the Long Term Incentive Program (LTIP), which is divided into three tranches for the years 2005 to 2007. The LTIP comprises the Stock Performance Plan (SP) and the Economic Value Plan (EVP). The first award from the LTIP is made after three years, provided defined conditions are satisfied.

The SP is linked to the performance of LANXESS stock against a reference index, the Dow Jones STOXX 600 Chemicals^{SM}. The EVP is an incentive oriented toward an increase in the economic value of LANXESS. The reference for all three tranches is the business plan for 2005 through 2007. The requirement for participation in the LTIP is a prior personal investment in LANXESS shares, which are subject to a five-year lock-up period.

For more information, particularly regarding the valuation parameters applied, please see Note (21) to the Financial Statements.

The number of stock-based compensation rights issued in 2006 and their corresponding fair values at the time of issue are as follows:

Stock Performance Plan	Number of option rights	Fair values
		in €
Dr. Axel C. Heitmann	360,000	406,800
Dr. Ulrich Koemm	281,400	317,982
Dr. Martin Wienkenhöver	240,000	271,200
Matthias Zachert	240,000	271,200
	1,121,400	**1,267,182**

On termination of their employment contracts, the members of the Management Board receive benefits under the company pension plan. These benefits are paid when the beneficiary reaches age 60 or if the beneficiary is permanently unable to work. They are paid to surviving dependents in the event of the beneficiary's death.

The new pension plan set up in 2006 for Dr. Axel C. Heitmann, Dr. Martin Wienkenhöver and Matthias Zachert is a cash balance plan stipulating a basic benefit of 25% of their respective annual base salary. Moreover, Management Board members must themselves pay an amount from deferred compensation amounting to 12.5% of the STI, which is matched by LANXESS. From the date of entitlement, 70% of the accumulated capital is paid out in a lump sum. The remaining 30% is converted to a pension benefit. Claims arising from provisions in place before the new pension plan was established are granted as vested rights. If the employment relationship ends before the beneficiary reaches age 60, the company shall pay certain additional benefits up to a defined ceiling.

LANXESS has set up provisions for the future claims of Management Board members. The service costs recognized in the 2006 annual financial statements for this purpose totaled €4.841 million. Most of this amount is attributable to the modification of the pension plan.

The following table shows details of the compensation paid to individual Management Board members:

Compensation of the Management Board	Short-term compensation			Long-term compensation	Pensions		
in € '000	Base salary	Variable component	Total	Stock Performance Plan and Economic Value Plan	Service costs	Annual pension benefits from date of entitlement	Capital from interest
Dr. Axel C. Heitmann	670	749	1,419	523	1,757	192	390
Dr. Ulrich Koemm	502	586	1,088	408	664	202	0
Dr. Martin Wienkenhöver	437	499	936	348	1,221	144	260
Matthias Zachert	438	499	937	348	1,199	68	260
	2,047	**2,333**	**4,380**	**1,627**	**4,841**	**606**	**910**

The members of the Management Board receive indemnification should their employment contracts be terminated by the company for defined reasons such that they would leave the company before reaching age 60. In such cases, the contractually agreed annual base salary and the STI continue to be paid for the remaining duration of the employment contract or, following its expiration, for 12 months, assuming 100% target attainment. In addition, a new placement budget is made available and a monthly transition benefit amounting to 50% of the Management Board member's monthly base salary is paid for a period not to exceed 48 months and only until the Management Board member has reached age 60. Any non-compete payments and, under certain defined conditions, income from other employment are offset against the settlement payments.

In the event of a material change of control over the company, the Management Board members have the right to claim benefits if their employment contracts are terminated mutually or expire within 12 months after the event causing the change of control, or if the Management Board member himself ends the employment relationship because of a material change in his position. This can, for example, include a change in the strategy of the company or a change in the responsibilities of the Management Board member. Benefits in the event of a change of control correspond to the aforementioned benefits in connection with contract termination initiated by the company, with the exception that the monthly transition benefit is paid for 60 months and only until age 60.

As part of the new five-year Management Board contracts signed with Dr. Axel C. Heitmann and Matthias Zachert effective July 1, 2007, the severance indemnity agreement and change-of-control provisions were extended. The terms depend on the respective circumstances and, in addition to contractual compensation for the remaining term of the employment contract or transition benefits, also include settlement payments amounting to up to two times the annual base salary plus the STI. The severance indemnity agreement and change of control provisions described for Dr. Heitmann and Mr. Zachert are also applicable for Dr. Rainier van Roessel, who was appointed to the Management Board on January 1, 2007.

In the event of a Management Board member's death during his active service period, compensation will continue to be paid to his surviving dependents in the month of death and for an additional six months. This payment is based on the contractually agreed base compensation component.

No additional benefits have been pledged to any Management Board member in the event of termination of their employment. In 2006, no member of the Management Board received benefits or corresponding commitments from third parties in respect of their duties as Management Board members.

In 2006, no loans were granted to members of the Management Board.

Reporting Pursuant to Article 315 Paragraph 4 of the German Commercial Code Pursuant to Article 315 Paragraph 4 Nos. 1 to 9 of the German Commercial Code, we hereby make the following declarations:

1. As in the previous year, the capital stock of the Group parent company LANXESS AG amounted to €84,620,670 as of December 31, 2006, and is composed of 84,620,670 no-par bearer shares. The rights and obligations arising from the shares are governed by the German Stock Corporation Act.
2. We are not aware of any restrictions affecting voting rights or the transfer of shares. However, participants in employee stock plans are subject to a lock-up period on disposal of their shares.
3. No direct or indirect equity investments in the capital of LANXESS AG exceeding 10% of total voting rights were reported to LANXESS AG.
4. No shares carry special rights granting control authority.

5. Employees hold a direct interest in the capital of LANXESS AG through employee stock programs. There are no restrictions on directly exercising the control rights arising from these shares.
6. Article 84 of the German Stock Corporation Act and Article 31 of the German Codetermination Act apply to the appointment and dismissal of Management Board members. Articles 179 et seq. of the German Stock Corporation Act apply to amendment to the articles of association. The articles of association of LANXESS AG do not contain any provisions deviating from these regulations.
7. On May 31, 2006, the Annual Stockholders' Meeting of LANXESS AG authorized the Management Board to purchase a total of 10% of the company's capital stock for any legal purpose through November 30, 2007. The Management Board can decide whether to acquire shares on the stock exchange or via a public purchase offer. Moreover, pursuant to Article 4 Paragraph 2 of LANXESS AG's articles of association, the Management Board is authorized to increase the company's capital stock with the approval of the Supervisory Board once or several times through August 30, 2009, by way of the issue of new no-par shares against cash or non-cash contributions up to a total amount of €36,517,096.
8. The employment contracts between the company and the members of the Management Board of LANXESS AG contain agreements subject to the condition of a change of control. These are outlined in detail in the Compensation Report in this Management Report. In addition, the terms of the €500 million Euro Benchmark Bond issued by LANXESS Finance B.V. in 2005 contain a change-of-control clause which gives bondholders the right to redeem the bond should certain events occur that affect its rating. The bond was guaranteed by LANXESS AG.
9. The employment contracts between the company and the members of the Management Board of LANXESS AG contain compensation agreements applicable in the event of a takeover bid. These are also outlined in detail in the Compensation Report in this Management Report.

Procurement and Production

Procurement LANXESS uses a centrally managed global procurement organization to ensure a reliable supply of materials and services. Global procurement teams coordinate with the business units to pool requirements. A global procurement network enables them to leverage purchasing synergies, so that LANXESS can move efficiently in the market and exploit price advantages. LANXESS systematically applies best-practice processes. These include e-procurement tools, such as e-catalogs and electronic marketplaces, many of which are integrated into the company's internal IT systems. About 30% of all items ordered are now handled through e-procurement.

Procuring petrochemical raw materials is a significant priority at LANXESS. The biggest suppliers here in 2006 included BP, Chevron Phillips, Dow, Exxon Mobil, Huntsman, Ineos, Lyondell, Nova Chemicals, Repsol, Siam Styrene, Shell Chemicals and Total. Other important suppliers of basic inorganic and organic chemicals are BASF, Bayer, Degussa, European Oxo, Ineos and Polimeri.

Among the most important petrochemical raw materials by far for our production operations are 1,3-butadiene, styrene, cyclohexane, acrylonitrile, C4 raffinate 1, toluene, isobutylene and benzene. The basic chemicals ammonia, aniline, chlorine, caustic soda, and sulfur are also important, as are ferrous raw materials. In all, petrochemical raw materials accounted for a purchasing volume of about €1.6 billion in fiscal 2006 (previous year €1.5 billion), or around 50% of total raw materials expenses for the LANXESS Group.

Production LANXESS is one of Europe's major producers of chemical and polymer products. Our production facilities can make anywhere from very small batches of custom-synthesized products to basic, specialty and fine chemicals and polymers in quantities of several thousand tons.

Each of the Group's production facilities is organizationally assigned to an individual business unit. The most important production sites are at Leverkusen, Dormagen and Krefeld-Uerdingen, Germany; Antwerp, Belgium; Bushy Park, South Carolina, and Addyston, Ohio, United States; Sarnia, Ontario, Canada; and Wuxi, China. LANXESS also has other production sites in Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, India, Italy, Japan, Mexico, South Africa, Spain, Thailand, the United Kingdom and the United States.

In the past fiscal year, we invested €267 million, primarily in maintaining and expanding our production capacities, especially in Sarnia, Ontario, Canada; and Dormagen, Leverkusen and Krefeld-Uerdingen, Germany. New production facilities were opened in Tongling and Wuxi, China, and in Madurai, India. In other cases, we relocated production capacities to other sites. For example, we moved a hydrazine hydrate plant from the United States to China and ABS plastics production units from Dormagen, Germany, to Tarragona, Spain.

We experienced two temporary production outages at two sites last year. In early January, we were forced to cut back butyl rubber production in Sarnia due to supply problems. In mid-March, we were able to lift our force majeure declaration. Then in August, ABS plastics production in Tarragona was brought to a partial halt after a fire. However, the affected plants were quickly repaired.

As part of our restructuring measures, the plants at Trenton, New Jersey, and New Martinsville, West Virginia, in the United States and the facility in Camaçari, Brazil, were closed.

Sales Organization and Customers

Sales organization LANXESS sells its products all over the world, to several thousand customers in more than 140 countries across all continents. LANXESS's long-standing customer base includes leaders in each of its user industries. Our well-established customer relationships are especially extensive in Europe and North and South America. To meet our customers' needs, we have set up very flexible marketing and sales structures. Sales are managed through 39 legal entities owned by LANXESS itself, 31 Bayer sales agencies, and independent sales partners throughout the world. Additionally, orders worth some €1.5 billion, or 21.6% of total sales, were processed via e-business in 2006. This capability is provided by the LanxessONE Internet tool and the ELEMICA Web portal for chemical products. Compared to the previous year, the share of total sales accounted for by e-business rose by 3.4 percentage points.

To keep as close as possible to customers and ensure they receive individual support, the LANXESS business units each manage their own sales organizations. Another competitive advantage for LANXESS is provided by our 47 production sites in 17 countries. Wherever possible, customers are supplied from production sites in the same region, saving both time and money.

Selling costs for fiscal 2006 came to 11.0% of LANXESS Group sales, compared to 12.1% for the previous year.

Customers Because of its many products and lines of business, LANXESS has business relationships with a vast range of customers all over the world. They need an individualized, well-focused approach, which we are able to provide because our sales organizations are managed through the business units. Individual marketing strategies are reviewed on the basis of customer satisfaction surveys.

LANXESS serves the following industries: tires, automotive supply, chemicals, plastics, electronics, agrochemicals, pharmaceuticals, food, textiles, water treatment, and furniture.

Shares of Sales by Industry Sector	2006
in %	
Chemicals	> 15
Automotive, construction, electrical/electronics, life science, tires	5–15
Leather/shoes, textiles, apparel	< 5
Others	~ 15

The LANXESS Group's top five customers accounted for about 11% of total sales in fiscal 2006. The decline of this share by approximately three percentage points compared with 2005 underscores that we have broadened our customer base and further reduced our dependence on individual key accounts. 14 (2005: 18) customers accounted for sales of between €20 million and €50 million. About 24,000 (2005: 15,000) customers contributed sales of up to €100,000.

The number of customers in each segment varied widely, as in the past year. The Performance Rubber segment again had some 2,000 customers in 2006, while Engineering Plastics had about 4,000. Chemical Intermediates significantly expanded its customer base to 8,000, adding 1,000 to the 2005 figure. The number of customers served by Performance Chemicals increased by 3,000 on the prior year, to 17,000. Each segment includes all customer groups and sales volumes. However, one customer may do business with more than one segment.

The comparatively low sales per customer in the Performance Chemicals segment, as well as its broad customer base, reflect the way in which its business often involves custom-tailored solutions in specialty chemistry. The substantially lower number of customers in the Performance Rubber segment, which generates relatively high sales, is likewise typical of the synthetic rubber products business. This extensive customer base means that no segment can be considered dependent on just a few customers.

Research and Development Our research and development activities continue to focus on optimizing and further developing our existing operations and technologies. New products are developed only in selected business areas offering a good chance for success. Thus, innovations can be specifically developed for our markets and applications and offered to customers within a short time.

LANXESS research and development units worldwide had about 400 employees as of December 31, 2006 (compared with about 600 the previous year). We have research and development units worldwide at our sites in Leverkusen, Dormagen and Krefeld-Uerdingen, Germany; Sarnia, Ontario, Canada; Wuxi, China; and Moxi, India.

In 2006, we conducted approximately 120 research and development projects, around 90 of which aimed to develop new products or improve existing ones. Thirty projects were concerned with optimizing chemical processes to reduce costs, improve yields or increase capacities. Roughly 85% of the research and development projects started in 2006 are scheduled to reach the market or technical implementation stages by the end of 2007.

The results of our research and development work are protected by patents, where this is expedient. In the course of 2006, we submitted 103 priority applications worldwide. As of December 31, 2006, the full patent portfolio includes 1,400 patent families covering approximately 8,300 property rights.

LANXESS does not conduct fundamental research. Instead, nearly all business units enter project-specific R&D partnerships with external partners to leverage expertise not available in-house for innovative product development. In 2006, a total of 33 major R&D partnerships were established, 13 of which were with universities, 13 with suppliers or customers, and 7 with research institutes.

An example of a successful research and development project involving universities is the development of Therban® AT, a new product line by the Technical Rubber Products business unit. The University of Waterloo (Toronto, Ontario, Canada), the University of Zurich (Switzerland) and the Munich University of Technology participated in the development of this product. In August 2006, Therban® AT received the DKG (German Rubber Society) award for outstanding innovations in the rubber industry. The new manufacturing process underlying this product is based on the principle of metathesis, the discovery of which received the Nobel Prize in Chemistry in 2005. Due to its modified chemical structure, Therban® AT has special rheological properties that provide our customers with significant processing advantages, at the same time substantially broadening the range of applications for this type of high-performance elastomer.

Most of the LANXESS Group's research and development expenditures are in the Saltigo, Semi-Crystalline Products, Butyl Rubber and Technical Rubber Products business units. In 2006, these accounted for 51% of the Group's total research and development spending (compared with 46% in 2005).

Organizationally, the LANXESS Group's research and development units are assigned to the individual business units. This approach is intended to ensure that development activities are always closely allied to the business units' own strategies, markets and customers. For example, business units with a large proportion of commodities (products in very mature markets), such as Basic Chemicals, concentrate on constantly improving their production facilities and processes (process optimization). Other business units, such as Material Protection Products, Semi-Crystalline Products and Leather, focus their R&D activities more on optimizing products and product quality, and developing new products to meet market requirements and customers' special needs. There is also a Board initiative to coordinate research and development work across business unit boundaries, thereby promoting especially innovative products from an overall LANXESS perspective and coordinating the exchange of R&D expertise and staff among business units.

Research and development in the **Performance Rubber** segment is conducted mainly by the Butyl Rubber and Technical Rubber Products business units. Butyl Rubber develops products such as novel types of butyl rubber with a broader spectrum of applications and improved mechanical properties. As outlined above, Therban® AT is an important and successful result of the Technical Rubber Products business unit's research and development activities. However, the main focus of research is still on optimizing existing products and further improving processes in terms of both costs and ecology.

Research and development activities in the **Engineering Plastics** segment concentrate on identifying and developing new areas of application for existing products, as well as further updating these products for this purpose. A current focus of the Semi-Crystalline Products business unit is the development of flame-retardant, halogen- and antimony-free polyamides and polyesters that comply with the stricter statutory regulations recently introduced. These innovative products can be used in all areas of the electronics industry, as well as in household appliances. In developing this new generation of flame-retardant products, particular emphasis was placed on excellent mechanical and rheological performance, as well as outstanding flame-resistant properties.

The market launch of this new product line is already successfully underway and is expected to be expanded steadily through the advanced product and application development activities.

In the **Chemical Intermediates** segment, R&D work is concentrated mainly in Saltigo's custom manufacturing sector, which develops processes for customers' specific intermediates as a service and manufactures the resulting products. Development services are an integral part of Saltigo's portfolio. The customers for these services are primarily pharmaceutical companies, manufacturers of agrochemicals, and companies that market chemical specialties such as electronic chemicals, fragrances and flavorings. The Basic Chemicals business unit's development work focuses mainly on further optimizing existing production processes. Product development is limited to a few promising growth segments, such as the biofuels market. This business unit has developed the Baynox® product line of stabilizers for biodiesel, which it brought to market in December 2006. Inexpensive vegetable oils in particular oxidize very rapidly on exposure to air. Baynox® is a highly effective stabilizer which prolongs the storage stability of biodiesel based on such oils. We anticipate a successful market launch for Baynox®, particularly in the leading soybean-growing countries such as the United States and Brazil.

In the **Performance Chemicals** segment, the emphasis is on applications development to optimize products. One current goal of the Ion Exchange Resins business unit is the development of anion exchangers with excellent thermal stability for use in fuel cells. With a view to accessing this attractive growth market, the business unit is experimenting with variations of existing products.

LANXESS's total research and development expenditures in 2006 amounted to €87 million, or 1.3% of sales, compared with €101 million, or 1.4% of sales, in 2005. This decline is attributable in part to portfolio measures implemented in fiscal 2006.

Corporate Responsibility

Corporate values LANXESS's guiding principles are characterized to a great extent by ethical values. The company's objective is sustainable, forward-looking development, which sensibly combines the demands of economy, ecology and society through responsible care – in short: sustainable development. This issue is therefore firmly anchored in our organization, requiring all employees to act responsibly in respect of people, the environment and capital. In practice, this means that we always apply our high sustainable business standards in making entrepreneurial decisions.

Our Corporate Compliance Guideline is a code of legal compliance and responsible conduct that is binding on all LANXESS employees and expresses a commitment to act in accordance with the law, apply the principles of responsible care and demonstrate ethical conduct. It contains guidance on issues such as competition; occupational, product and plant safety; environmental protection and interactions with other people.

The great importance we assign to protecting nature and the environment is manifested in our company's voluntary commitment to the principles of sustainable development and in our global implementation of a standardized environmental management system in accordance with ISO 14001. Furthermore, LANXESS is one of the signatories to the international Responsible Care® Charter that was adopted by the International Council of Chemical Associations as a significant step toward sustainable development.

Our activities have already resulted in several awards. Moreover, LANXESS features in the FTSE4Good sustainability index. This index lists companies which have performed particularly well in the areas of environmental protection, human rights and social standards.

In 2006, the LANXESS Group for the first time honored outstanding achievements in three categories: environmental protection; occupational, plant, process and product safety; and communication. The Global HSE Award, with prizes of €10,000, €5,000 and €2,500, went to teams from Belgium (1st place), Germany (2nd place) and Thailand (3rd place).

Committees The Management Board established the Compliance Committee to implement the Corporate Compliance Guideline. This Committee handles all referrals concerning compliance violations, with the goal of correcting any illegal conduct by LANXESS employees that may occur. The Compliance Committee includes the heads of the Law and Intellectual Property, Human Resources, Technical Services and Procurement group functions and the head of Internal Auditing as the LANXESS Compliance Officer.

The HSEQ Committee steers all management processes required to ensure and further improve environmental and health protection, safety, product stewardship and quality. The committee includes all heads of business units and group functions and is headed by a Management Board member. It initiates all necessary HSEQ directives and programs for LANXESS, defines HSEQ objectives for the medium and long terms, and continually reviews the effectiveness of the management system and reporting on Responsible Care and sustainable development. The programs initiated are implemented worldwide with support from global and regional HSEQ units and are regularly tracked by means of internal audits.

HSEQ management system In fiscal 2005, we initiated a comprehensive global process of aligning and controlling the HSEQ management system in order to ensure that the same environmental and safety standards are applied at all LANXESS locations throughout the world. These standards are regularly reviewed in compliance checks. We completed this process at the end of fiscal 2006. Our quality and environmental policies were revised, and global responsibilities were assigned in LANXESS directives that are binding at all our sites. Moreover, we established a global reporting system for HSEQ indicators, introduced a worldwide information network and internationalized the performance review process.

A further priority is the comprehensive certification of our facilities. At the end of fiscal 2006, around 81% of our key sites had been certified at least according to ISO 9001 or ISO 14001. We plan to have completed certification of all our major sites by the end of 2007.

Occupational safety Occupational safety is a key issue at LANXESS. The Safety Master Plan systematically identifies and corrects weak points in every organizational unit. Even after concluding the Thousand-Day Program to improve occupational safety in October 2005, we continue to track the key performance indicators. The accident rate per million work hours was 2.9 for 2006, a reduction of 63% compared to the baseline figure at the starting date.

Environmental protection As LANXESS sees it, conserving natural resources – for example, through the most efficient possible use of raw materials and energies – and identifying further potential for reducing emissions and waste is an ongoing mission, an inherent part of our ecological obligations to which we must apply our expertise. The continuous improvement of environmental performance is a key corporate goal.

We are concerned that our products in all segments must be environmentally compatible. As early as the development stage, we consider ways that a product can be disposed of safely. LANXESS views product stewardship as our responsibility to continually improve product safety for the sake of both people and the environment. For this reason, we expressly support the protection goals of E.U. chemicals policy, implementation of the REACH regulation, and the international Responsible Care® Charter. A healthy balance must be achieved between safe production and use of chemicals and the competitiveness of the chemical industry in Europe.

It is not yet possible to separately report consolidated environmental protection spending for all LANXESS subsidiaries and affiliates worldwide. However, in the future we will report transparently about the progress of our environmental protection activities. For LANXESS Deutschland GmbH, expenditures for waste disposal, water protection, noise abatement, clean air and other environmental protection measures came to 5.1% of total operating costs in 2006, compared with 4.9% the previous year.

Idea management When LANXESS employees have good ideas for improving work processes, safety and environmental protection, or preventing mistakes, those ideas pay off. An idea management system encourages suggestions for improvements to ensure that LANXESS will constantly be provided with new ways to improve cost-effectiveness, occupational safety and environmental protection. During 2006, employees submitted 2,256 suggestions, around 440 of which related to occupational safety and environmental protection. Total savings of €3.3 million were achieved as a result. In the future, our idea management activities will continue to contribute substantially to LANXESS's success thanks to a simplified, IT-based processing system and an attractive, performance-based bonus system.

Risk Report

Risk management Risk management is important for LANXESS because business activity necessarily entails risks as well as opportunities. The LANXESS Group's success is significantly dependent on identifying both opportunities and risks and actively managing them. Effective risk management is therefore a core element in safeguarding the company's existence for the long term and ensuring its successful future development.

LANXESS's risk management approach is based on clearly defined business processes, the precise assignment of responsibilities throughout the Group, and reporting systems that ensure the timely provision of the information required for decision-making to the Management Board or other management levels. LANXESS views risk management as an integral part of corporate controlling. Risk management is incorporated into business processes primarily through the company's organizational structure, its planning, reporting and communication systems, and a body of detailed management regulations and technical standards. Various committees and other bodies discuss and monitor opportunities and risks.

At LANXESS, the business units each conduct their own operations, for which they have global profit responsibility. Group functions support the business units by providing financial, legal, technical and other centralized services. Complementing this global alignment of the business units and group functions, the country organizations ensure the required proximity to markets and the necessary organizational infrastructure.

In line with this division of duties, LANXESS has assigned responsibility, i.e. defined the risk owners, for the following:
- risk identification and analysis,
- risk prevention (measures taken to avoid, minimize or diversify risk),
- risk monitoring and
- risk mitigation (measures to minimize damage upon occurrence of a risk event).

Risk transfer transactions (hedging transactions or insurance) are entered into and managed centrally at LANXESS via the Treasury group function.

In connection with the decentralized organization of its risk management, LANXESS has established a central risk database to which the risk owners contribute structured data about identified risks. To this end, standardized risk categories have been defined for the Group along with parameters for probabilities of occurrence and damage levels. The central risk database therefore provides an overview of LANXESS's risk landscape as typical for the industry. The Management Board receives a regular report on any material changes to this risk database from the head of the Internal Auditing group function. There is also provision for immediate internal reporting on specific risk issues such as significant corporate compliance violations. In 2006 there was no cause for immediate reporting of this kind on significant risks at LANXESS. In addition to the standard risk reporting system required by the German Law on Corporate Control and Transparency, LANXESS has a hierarchical reporting system for appraising potential opportunities and risks and making them known to the Management Board.

To supplement the central risk database, corporate planning is another core element of opportunity and risk management at LANXESS. During the planning process, information about developments expected in the future is collected and mapped across the Group. Forecasts are prepared and those risks and opportunities considered relatively likely to materialize are presented as worst-case/best-case scenarios. Certain Management Board meetings are dedicated to discussing corporate planning and the associated opportunities and risks. Each fiscal year, the annual plan is adjusted and monitored by regularly recording current expectations. Significant and strategic opportunities and risks are systematically analyzed and evaluated by the Corporate Development group function with the goal of ensuring that the Group is pursuing the correct long-term strategy.

LANXESS's risk management principles are laid down in a Group directive. Risk management also includes preventing illegal conduct by our employees. To this end, we obtain extensive legal advice concerning business transactions and obligate employees by means of our compliance code to observe the law and to act responsibly. A Compliance Committee promotes and monitors adherence to these compliance guidelines. Its work is supported by compliance officers who have been appointed for each country in which LANXESS has a subsidiary. The Compliance Committee reports directly and regularly to the Management Board.

Monitoring of risk management and of LANXESS's internal control system (ICS) by means of process-independent testing is part of the risk management system. Within the Group, the Internal Auditing group function is tasked with overseeing both the functionality of the internal control and monitoring system and compliance with organizational safeguards. Planning of audits (selection of audit subjects) and audit methods applied by this group function are correspondingly aligned with risks. In addition, the risk management system is evaluated by the auditor as part of the audit of the annual financial statements. In the course of exercising its duties under the articles of association, the Supervisory Board also exercises control functions, including regular monitoring of the functioning of the risk management system by its Audit Committee.

LANXESS considers the motivation of its employees to be a key factor in exploiting opportunities. For this reason, we highly value a corporate culture which fosters the search for and implementation of new possibilities. One component of this effort is providing a financial bonus for ideas submitted via the company's idea management system.

LANXESS has acknowledged that managing the company necessarily involves managing risk. Steps have been taken to ensure that potential risks or opportunities relevant to the attainment of corporate goals are fully identified and quantified at an early stage. Preventive measures and safeguards minimize the probability that risks will materialize and limit their potentially adverse effects. The management of opportunities and risks is one of LANXESS's goals and therefore constitutes an integral part of decision-making processes.

Risks of future development

Market risks LANXESS is exposed to the general economic and political opportunities and risks of the countries and regions in which its companies operate. As a chemicals enterprise, LANXESS is subject to economic risks and the risks typical of this industry sector. The volatility and cyclicality of the global chemical and polymer markets and their dependence on developments in customer industries harbor opportunities and risks with respect to LANXESS's business volume. LANXESS anticipates future growth to come from a continuing increase in demand on Asian markets, particularly in China and India. If the general business environment in this region should deteriorate due to economic or other factors, one of LANXESS's key growth drivers could be weakened or eliminated.

LANXESS's risk profile is influenced by structural changes in markets, such as the entry of new suppliers, particularly those based in emerging economies; the migration of customers to countries with lower costs; and product substitution or market consolidation trends of the kind already occurring in some sectors, particularly rubber. LANXESS counters such trends by restructuring operations to achieve a sharper focus and arrive at a product portfolio with which it can operate successfully for the long term. At the same time, LANXESS systematically manages costs.

On the procurement side, the principal risk lies in the volatility of raw material and energy prices. LANXESS mitigates this type of procurement risk by entering into long-term supply contracts for most raw materials and agreeing price escalation clauses with customers. LANXESS also hedges this risk in some cases via derivatives transactions where liquid futures markets are available for raw materials and energy. To guard against possible supply bottlenecks due to factors such as the failure of an upstream operation at a networked site, LANXESS pursues an appropriate inventory strategy and lines up alternative sources of supply.

Corporate strategy risks LANXESS plans to continue with its restructuring and its realignment toward strategic core businesses, as well as participating in industry consolidation through active portfolio management, including partnerships, divestments and acquisitions, as well as possible changes in the investment, facility and product portfolios. The success of these decisions is naturally subject to forecasting risk, associated on the one hand with predicting future market developments and on the other hand with making assumptions about the feasibility of planned measures. For example, the entry into or exit from a business segment could be based on profitability or growth expectations that prove to be unrealistic over time. LANXESS mitigates this risk by carefully and systematically processing decision-making information. During this process, the business units affected and the Management Board receive support from the Corporate Development group function and, if necessary, also from the Mergers and Acquisitions group function and possibly from external consultants. The preparatory work for investments that exceed a specified significance threshold is the responsibility of the relevant business units. After review by an Investment Committee set up for this purpose, this information is presented to the Management Board for a decision. This procedure ensures that investments are in line with our corporate strategy and satisfy our profitability and security requirements.

Financial risks Changes in the euro exchange rate, particularly against the U.S. dollar, can affect LANXESS's results. At LANXESS, payment flows in various currencies are documented, monitored and managed centrally for the entire Group. This enables LANXESS to offset the various foreign exchange effects of procurement and sales activities, and the foreign currency balances of the individual LANXESS companies, against one another. The goal is to hedge the residual amounts with derivative financial instruments. LANXESS only hedges foreign currency items that have arisen from the company's core businesses or are considered highly likely to arise. Long-term changes in currency parities can negatively or positively affect competitiveness in relation to suppliers outside the euro zone.

The risk of interest rate changes is centrally managed by the Treasury group function for the entire LANXESS Group. The majority of the company's debt was raised at fixed terms. Possible interest rate shifts in the coming years will therefore only have a limited effect on LANXESS. The Treasury group function also verifies customers' creditworthiness in close cooperation with our sales departments to minimize the default risk.

Due to our existing liquidity reserves, including a largely undrawn five-year credit line of €1.25 billion, and our financial structure, which has improved significantly since LANXESS's founding, we have not identified any liquidity risks (see "Financial Condition"). This assessment is supported by the investment-grade ratings assigned to LANXESS by external rating agencies. In the event of possible acquisitions in the future, LANXESS is willing to accept only a temporary rating downgrade to slightly below investment grade (BB+ or BB), if financing these acquisitions necessitates this. Even with such a rating, we anticipate being able to ensure sufficient liquidity.

Legal risks Companies in the LANXESS Group are parties to various litigations. The outcome of individual proceedings cannot be predicted with assurance due to the uncertainties always associated with legal disputes. To the extent necessary in light of the known circumstances in each case, LANXESS has set up risk provisions for the event of an unfavorable outcome of such proceedings.

Taking into account existing provisions and insurance, as well as agreements reached with third parties in respect of liability risks arising from legal disputes, the company currently estimates that none of these proceedings will materially affect the future earnings of the LANXESS Group.

In our reporting in previous years, we referred to heightened risks relating to certain antitrust proceedings brought against Bayer AG by regulatory authorities or civil courts in the United States, Canada and Europe with respect to businesses that were transferred to LANXESS AG or its subsidiaries. In connection with the spin-off of LANXESS AG from the Bayer Group, LANXESS AG and Bayer AG agreed on specific rules with regard to these

proceedings. These rules provided that LANXESS AG had to bear part of such liabilities vis-à-vis Bayer AG, limited to a maximum of €100 million. This amount has now been exhausted. Still open are possible additional liabilities of LANXESS AG in respect of defense costs and proportionate reimbursement of additional taxes that may be payable if the tax deductibility of expenses is restricted.

Production and environmental risks Although LANXESS applies high technical and safety standards to the construction, operation and maintenance of production facilities, interruptions in operations, including those due to external factors, such as natural disasters or terrorism, cannot be ruled out. These can lead to explosions, the release of materials hazardous to health, or accidents in which people, property or the environment are harmed. In addition to systematically monitoring compliance with quality standards aimed at avoiding such stoppages or accidents, LANXESS is also insured against the resulting damage to the extent usual in the industry.

Possible tightening of safety, quality and environmental regulations or standards can lead to additional costs and liability that are beyond the control of LANXESS. Particularly noteworthy in this regard is the implementation of the E.U. Regulation concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH). In addition to direct costs that could arise due to additional measures necessary to comply with these standards, market structures could change to LANXESS's disadvantage as a result of a shift by suppliers and customers to regions outside Europe.

LANXESS is responsible for numerous sites and landfills in which chemicals have been produced or stored for periods that in some cases exceed 140 years. The possibility cannot be ruled out that pollution occurred during this time that has not been discovered to date. LANXESS is committed to the Responsible Care initiative and actively pursues environmental management. This includes constant monitoring and testing of the soil, groundwater and air. Sufficient provisions have been set up within the scope permitted by law for necessary containment or remediation measures in areas with identified contamination.

LANXESS's product portfolio includes substances that are classified as hazardous to health. In order to prevent possible harm to health, LANXESS systematically tests the properties of its products and draws its customers' attention to the risks associated with their use. We have also arranged for adequate product liability insurance.

Other risks In the course of the spin-off from Bayer, LANXESS acquired structures and circumstances that will in the future be subject to assessment by the tax authorities. Even if LANXESS believes that all circumstances have been reported correctly and in compliance with the law, the possibility cannot be ruled out that the tax authorities may come to a different conclusion in individual cases.

The provision of correct information at the correct time to the correct addressee is one of LANXESS's success factors. LANXESS is dependent on its integrated IT systems to manage this information. In order to ensure constant availability of its data, LANXESS maintains data back-up systems, mirrored databases, anti-virus and access restriction systems, along with other state-of-the-art security and monitoring tools.

LANXESS's activities depend on its employees. With regard to human resources risks, industrial actions in some countries resulting from disputes about the implementation of restructuring measures or in connection with negotiations concerning future collective pay agreements cannot be ruled out. We counter this risk by fostering open communication with our employees and their representatives.

In Germany, key units of the LANXESS Group are subject to an employment pact that precludes dismissals for operational reasons before December 31, 2007, and expires at the end of 2007.

Overall risk Based on an overall evaluation of risk management information, we have not identified any sufficiently likely risks or risk combinations that would jeopardize the continued existence of LANXESS.

Subsequent Events The acquisition of the 50% interest in Chrome International South Africa Ltd. (CISA) in South Africa from former joint venture partner the Dow Chemical Group took legal and economic effect on February 1, 2007. This transaction gives us sole ownership of the sodium dichromate production facility at the Newcastle site, South Africa.

Also in February 2007, the hydrazine hydrate production facility in Weifang, China, had to be shut down after operating problems. The stoppage is expected to last several months. As a result, we have declared force majeure to our customers in the Asia-Pacific region. We currently estimate that this situation will diminish EBITDA pre exceptionals by a medium single-digit million figure.

Outlook

Expected changes in business conditions

Future economic environment In 2007, we expect the global economy to continue growing well, although at a slightly slower pace than in the previous year. As in 2006, global economic growth will be driven mainly by Asia's emerging economies, particularly India and China, and by central and eastern Europe. We also anticipate that Latin America will contribute substantially to ongoing growth of the global economy. Germany's robust economic performance in 2006 led us to make a slight upward adjustment to our forecasts. Nonetheless, growth in Germany is expected to again be well below the international average.

Expected Growth in GDP	2007	2008	2009–2012
Change vs. prior year in % (projected)	Gross domestic product		
Americas	2.6	3.3	3.2
NAFTA	2.3	3.2	3.0
Latin America	4.7	4.3	4.1
EMEA	2.7	2.6	2.5
Germany	1.8	1.7	1.7
Western Europe	1.9	1.9	1.9
Central/Eastern Europe	5.2	5.1	4.6
Asia-Pacific	4.6	4.6	4.3
Japan	1.9	2.1	1.6
Greater China	8.2	7.6	7.2
India	7.7	7.6	7.1
World	**3.2**	**3.5**	**3.3**

While we believe that the prices of raw materials will remain at the prior-year level in the first quarter of 2007, a slight decrease is likely to begin in the second or third quarter. However, prices are expected to remain highly volatile, in part as a consequence of market participants' continued uncertainty about the reliability of future supplies. In the case of energy prices, we forecast an increase in the cost of steam and natural gas in Germany and North America.

LANXESS's business projections assume an average exchange rate of about US$1.30 to the euro. Significant short-term fluctuations from this projected figure will be hedged.

Future performance of the chemical industry In view of the ongoing upswing in the global economy, we believe that the chemical industry will also continue on its robust growth path in 2007. For this reason, we have not changed our growth forecast of 4% for worldwide chemical production. However, in line with the situation in the global economy, we expect the pace of growth in all regions to slow slightly compared to last year. Asia, and especially China, will still be the market with the greatest growth potential in 2007.

Expected Growth in Chemical Production	2007	2008	2009–2012
Change vs. prior year in % (projected)	Chemical production		
Americas	2.5	2.5	2.5
NAFTA	2.0	2.0	2.5
Latin America	3.5	3.5	3.0
EMEA	3.0	3.0	3.0
Germany	3.0	3.0	2.5
Western Europe	3.0	3.0	3.0
Central/Eastern Europe	5.0	6.0	5.0
Asia-Pacific	6.0	6.0	6.0
Japan	1.0	1.0	1.5
Greater China	11.0	10.0	9.0
India	8.5	8.0	7.5
World	**4.0**	**4.0**	**4.0**

* rounded to 0.5%

Future evolution of selling markets We also expect the key selling markets for LANXESS products to perform in line with the global economy in 2007. Across all industry segments, we anticipate continued growth at a slightly slower pace compared to 2006. Only the tire industry is expected to develop against this trend and post stronger growth than in 2006. We again anticipate that the electrical and electronics industries will provide strong impetus in 2007, which is reflected in the continued positive trend in Asia. In contrast, the automotive industry is expected to be a significantly weaker growth driver than we forecast in 2005, due to a slowdown in the Asian market.

Expected Evolution of Major User Industries

Change vs. prior year in % (projected)	Automotive			Construction			Electrical			Tires			Textiles, Apparel, Leather		
	2007	2008	2009 –2012	2007	2008	2009 –2012	2007	2008	2009 –2012	2007	2008	2009 –2012	2007	2008	2009 –2012
Americas	0.5	1.5	2.0	0.0	2.5	3.0	5.0	4.0	5.0	(3.0)	0.0	0.0	0.0	0.0	0.0
NAFTA	0.0	1.0	2.0	(1.0)	2.0	2.0	5.0	4.0	5.0	(5.0)	2.0	(1.0)	(1.0)	0.0	0.0
Latin America	5.5	3.5	2.5	6.0	5.5	4.5	4.5	5.0	4.5	5.0	6.5	3.5	2.0	2.0	2.0
EMEA	0.5	3.5	3.5	2.5	2.5	2.5	5.5	4.5	4.0	2.0	3.0	3.0	(1.0)	(1.0)	(1.0)
Germany	(2.0)	0.0	2.5	1.5	1.5	1.5	5.5	4.5	3.5	(1.0)	(1.0)	(1.0)	(3.0)	(3.0)	(3.0)
Western Europe	(3.0)	0.0	2.0	2.0	2.0	1.5	5.0	4.0	3.5	0.0	0.0	0.0	(2.0)	(2.0)	(2.0)
Central/Eastern Europe	11.5	10.5	3.0	7.5	5.5	4.5	6.0	7.0	7.0	3.5	4.0	3.0	0.0	1.0	2.0
Asia-Pacific	3.0	6.0	4.5	4.5	4.0	3.0	7.0	6.5	6.0	5.5	5.0	5.0	7.5	7.5	7.0
World	**1.5**	**4.0**	**3.5**	**2.5**	**3.0**	**3.0**	**6.0**	**5.0**	**5.0**	**2.5**	**3.0**	**3.5**	**3.5**	**4.0**	**4.0**

* rounded to 0.5%

Future focus of the LANXESS Group Future opportunities for the LANXESS Group derive from the economic environment and company-specific factors described below.

In the current fiscal year, global economic growth is expected to remain robust, with impetus again coming particularly from Asia (especially China and India). LANXESS is well positioned worldwide, and in recent years, we have also systematically expanded our market position in the key growth market of Asia. Our presence in the relevant markets enables us to benefit from advantageous and dynamic economic environments in the individual regions. Nevertheless, the continued growth of the Asian market means this region will remain significant to LANXESS's future business focus.

The successful transformation of the Group in recent years has enabled us to react more quickly to global market changes today and to sharpen our focus our business on market and industry trends. We are thus able to further reinforce and expand our activities and positions in various markets. We will continue to drive forward the transformation of the Group in order to further boost efficiency, expand our portfolio of leadership businesses, and improve our ability to respond more quickly to changing markets.

For that reason, we will hold steady to our course, based on our four-phase strategy (short-term measures to improve performance, targeted restructuring, portfolio management, acquisitions). Following the successful implementation of the first three phases of the strategy, we entered into the fourth phase in fall 2006 and from now on will consider focused acquisitions in the chemical industry. It is conceivable that LANXESS might acquire individual small or medium-sized chemical operations, as well as chemical companies or divisions of chemical companies that have thus far been unable to optimally develop their potential. We consider such acquisitions to be an opportunity to reinforce or supplement our portfolio and to use our expertise in transformation processes for the good of the company and its stockholders.

LANXESS will actively participate in the consolidation of the chemical industry, create additional value and further improve the long-term perspectives of the company.

Product portfolio LANXESS's presence in all key customer industries is ensured by its broad portfolio of leading, high-demand products for important growth sectors. These include halobutyl rubber for high-performance tires and Durethan® for hybrid components used to achieve weight reductions in automotive engineering. We aim to leverage the opportunities provided by the consistent optimization of our product portfolio and access new future-oriented segments with innovative developments. For example, LANXESS produces antioxidants as additives to improve the storage stability and usability of biodiesel.

The broad diversification of its product portfolio makes LANXESS independent from any one product or process. In that regard, no product or process innovations are expected in 2007 that would individually have a significant influence on the LANXESS Group's performance. Instead, opportunities in procurement, production and sales will derive from the continuous improvement of a large number of products, processes and structures. LANXESS will systematically pursue this optimization process with an eye to market requirements.

Research and development LANXESS's application-oriented research and development activities focus on improving product characteristics and maximizing customer benefits. Examples include improving the thermal stability and flow properties of plastics, developing alternatives to heavy metals in material protection products, and enhancing the biodegradability of ingredients. Product formulations will also be optimized, and new customer-oriented formulations will be developed. Another important aspect is the ongoing review of production methods to reveal any still unused potential for enhancing efficiency and cutting costs.

Roughly 85% of the research and development projects started in 2006 are scheduled to reach the market or technical implementation stages by the end of 2007.

As a contribution to our organic growth initiative, we will launch further growth-oriented research and development projects in the medium term. Additional resources will be needed for this purpose so we plan to increase research and development expenditures by approximately 10% to 15% in 2007.

Expected financial condition We keep the capital and financing structures of the Group under constant review. At present, no additional measures are planned in the aftermath of the refinancing transactions of 2006, which also safeguard the Group's liquidity for the long term. We intend to finance planned capital expenditures out of current cash flow and have sufficient lines of credit available to cover any additional need for financial resources.

We have defined 4% of sales as a sustainable and appropriate investment ratio for the Group. Capital expenditures last year were just below this level but will be slightly higher in 2007, at or just above €300 million. The Performance Rubber segment will be one focus of our spending, with additional production capacity increases planned in the Butyl Rubber business unit in 2007.

Moreover, in the Saltigo business unit of the Chemical Intermediates segment, we plan to establish a state-of-the-art multifunctional plant complex for cGMP-compliant (current Good Manufacturing Practice) production, processing and purification of APIs (active pharmaceutical ingredients) and intermediates. Capital expenditures of around €10 million will enable us to significantly increase cGMP capacities by mid-2007.

In the Engineering Plastics segment, we will invest in the Durethan® product line of the Semi-Crystalline Products business unit, mainly in Krefeld-Uerdingen, Germany, and Wuxi, China.

Expected results of operations In fall 2006, LANXESS announced new earnings targets. We aim to increase our profitability, measured by our EBITDA margin pre exceptionals, to the level of our competitors in 2009. In 2006, this was between 12% and 14%. In order to reach this goal, we also intend to improve our EBITDA pre exceptionals compared to 2006 and bring our EBITDA margin closer to the level of our competitors in 2007. To this end, we will continue to pursue our cost-efficiency initiatives and further improve our margins by optimizing pricing. Adjusted for portfolio effects, we anticipate moderate sales growth in 2007.

Between 2004 and 2006, we reduced the proportion of businesses with an EBITDA margin pre exceptionals of below 5% from approximately 40% to around 20%. We will further pursue this strategy, and our target for 2009 is not to have any businesses with an EBITDA margin pre exceptionals of below 5%.

Earnings in the Performance Rubber segment will be supported by savings from restructuring measures and higher butyl and chloroprene rubber sales volumes.

In the Engineering Plastics segment, the consolidation of all activities of the Lustran Polymers business unit at one site in each region will have a positive effect on earnings, as will cost reductions in toll manufacturing and Durethan® and Pocan® production in the Semi-Crystalline Products business unit.

Ongoing productivity enhancements and our move into fast-expanding high-quality segments in growth markets are key factors in the success of the Chemical Intermediates segment. These measures will help LANXESS remain competitive against new Asian rivals in 2007.

In the Performance Chemicals segment, our focus is also on developing our position in the Asian markets by offering high-quality products. The portfolio adjustments already implemented are expected to improve margins in this segment. However, the absolute level of EBITDA pre exceptionals will be held back by the absence of earnings contributions from the divested Textile Processing Chemicals and Paper Chemicals business units. EBITDA pre exceptionals is also likely to be impaired by the declaration of force majeure for the hydrazine hydrate plant in Weifang, China.

Summary of Group's projected performance In 2009, we aim to achieve an EBITDA margin pre exceptionals that is close to average levels for our industry. In 2006, this figure was between 12% and 14%. Against the backdrop of these goals, we expect our EBITDA margin to grow faster than the average of our competitors over the next three years. In addition to this clearly defined profitability goal for the Group as a whole, we also set profitability targets for our business operations. In 2009, all LANXESS business units are expected to achieve an EBITDA margin pre exceptionals of at least 5%.

In 2007, we anticipate the general economic environment to remain favorable for our business development and expect an increase in the Group operating result. Adjusted for portfolio changes, we forecast moderate sales growth in 2007.

We will propose our first dividend payment of €0.25 for 2006 in recognition of our stockholders' loyalty. In the medium term, if we achieve the earnings targets we have set for the current and future fiscal years, we plan to further increase the dividend paid to stockholders. However, we reserve the right to give priority to targeted capital expenditures if internal or external growth opportunities arise.

LANXESS Group

Income Statement

	Note	2005	2006
€ million			
Sales	[1]	**7,150**	**6,944**
Cost of sales		(5,537)	(5,404)
Gross profit		**1,613**	**1,540**
Selling expenses		(863)	(766)
Research and development expenses		(101)	(87)
General administration expenses		(285)	(254)
Other operating income	[2]	155	243
Other operating expenses	[3]	(491)	(300)
Operating result (EBIT)		**28**	**376**
Loss from investment in associate		(35)	(16)
Interest income		7	10
Interest expense		(48)	(33)
Other financial income and expense		(69)	(50)
Financial result	[4]	**(145)**	**(89)**
Income (loss) before income taxes		**(117)**	**287**
Income taxes	[5]	63	(85)
Income (loss) after taxes		**(54)**	**202**
of which attributable to minority stockholders		9	5
of which attributable to LANXESS AG stockholders (net income (loss))		(63)	197
Earnings per share (€)	[6]	**(0.75)**	**2.33**

LANXESS Group

Balance Sheet

	Note	Dec. 31, 2005	Dec. 31, 2006
€ million			
ASSETS			
Intangible assets	[9]	53	41
Property, plant and equipment	[10]	1,526	1,465
Investment in associate	[11]	22	5
Investments in other affiliated companies	[12]	4	4
Non-current financial assets	[13]	48	37
Deferred taxes	[5]	103	84
Other non-current assets	[14]	79	94
Non-current assets		**1,835**	**1,730**
Inventories	[15]	1,068	1,047
Trade receivables	[16]	1,065	924
Current financial assets	[13]	37	113
Other current assets	[17]	200	220
Liquid assets	[18]	136	171
Current assets		**2,506**	**2,475**
Total assets		**4,341**	**4,205**
EQUITY AND LIABILITIES			
Capital stock and capital reserves		889	889
Other reserves		748	685
Net income (loss)		(63)	197
Accumulated other comprehensive loss		(335)	(368)
Equity attributable to minority interest		17	25
Equity	[19]	**1,256**	**1,428**
Provisions for pensions and other post-employment benefits	[20]	497	520
Other non-current provisions	[21]	302	271
Non-current financial liabilities	[22]	644	632
Non-current tax liabilities		26	38
Other non-current liabilities		32	36
Deferred taxes	[5]	75	57
Non-current liabilities		**1,576**	**1,554**
Other current provisions	[21]	401	354
Current financial liabilities	[23]	172	50
Trade payables	[24]	694	602
Current tax liabilities		27	36
Other current liabilities	[25]	215	181
Current liabilities		**1,509**	**1,223**
Total equity and liabilities		**4,341**	**4,205**

LANXESS Group

Statement of Changes in Equity

€ million	Capital stock and capital reserves	Other reserves	Net income (loss)	Accumulated other comprehensive loss		Equity attributable to LANXESS AG stock-holders	Equity attributable to minority interest	Total
				Currency translation adjustment	Derivative financial instruments			
Dec. 31, 2004	**836**	**896**	**(12)**	**(375)**	**6**	**1,351**	**14**	**1,365**
Dividend payments						0	(2)	(2)
Allocation to retained earnings		(12)	12			0		0
Exchange differences				41		41	1	42
Transfer of LANXESS AG net loss	(158)	158				0		0
Other changes in equity	211	(294)			(7)	(90)	(5)	(95)
Net loss			(63)			(63)	9	(54)
Dec. 31, 2005	**889**	**748**	**(63)**	**(334)**	**(1)**	**1,239**	**17**	**1,256**
Dividend payments						0	(1)	(1)
Allocation to retained earnings		(63)	63			0		0
Exchange differences				(33)		(33)	2	(31)
Other changes in equity					0	0	2	2
Net income			197			197	5	202
Dec. 31, 2006	**889**	**685**	**197**	**(367)**	**(1)**	**1,403**	**25**	**1,428**

LANXESS Group

Cash Flow Statement

	Note	2005	2006
€ million			
Income (loss) before income taxes		**(117)**	**287**
Depreciation and amortization		313	262
Loss from investment in associate		35	16
Gains on retirements of property, plant and equipment		(1)	(2)
Financial losses		72	21
Income taxes paid		(25)	(68)
Change in inventories		141	(83)
Changes in trade receivables		121	15
Changes in trade payables		(156)	(50)
Changes in other assets and liabilities		241	11
Net cash provided by operating activities	[33]	**624**	**409**
Cash outflow for additions to intangible assets, property, plant and equipment		(251)	(267)
Cash outflows for financial assets		(8)	(78)
Cash inflow from sales of intangible assets, property, plant and equipment		8	13
Cash inflows from divestments of subsidiaries and other businesses, less divested cash		(5)	104
Interest and dividends received		10	21
Net cash used in investing activities	[33]	**(246)**	**(207)**
Dividend payments to minority stockholders		(2)	(1)
Proceeds from borrowings		666	18
Repayments of borrowings		(907)	(142)
Interest paid and other financial disbursements		(76)	(39)
Net cash used in financing activities	[33]	**(319)**	**(164)**
Change in cash and cash equivalents from business activities		**59**	**38**
Cash and cash equivalents as of January 1		72	136
Other changes in cash and cash equivalents		5	(3)
Cash and cash equivalents as of December 31	[33]	**136**	**171**

Notes to the Consolidated Financial Statements

General Information The consolidated financial statements of the LANXESS Group as of December 31, 2006 have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union (E.U.) and the additional requirements of Article 315a paragraph 1 of the German Commercial Code (HGB). All of the IFRSs issued by the IASB that were valid when these consolidated financial statements were prepared and have been applied by LANXESS AG herein have been adopted by the European Commission for use in the European Union. The consolidated financial statements therefore comply with the IFRS as a whole. The prior-year figures have been determined according to the same principles.

The consolidated financial statements comprise the income statement, balance sheet, statement of changes in equity, cash flow statement, 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 electronic Federal Gazette (Bundesanzeiger).

The consolidated financial statements of the LANXESS Group for fiscal 2006 were drawn up by the Management Board of LANXESS AG and cleared for submission to the Supervisory Board on March 5, 2007. It is the responsibility of the Supervisory Board to examine the consolidated financial statements and declare whether or not it approves them.

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 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 in exchange for control of the acquiree plus any costs directly attributable to the business combination. The cost of acquisition is compared to the fair value of the acquired assets and liabilities. 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 reexamining the purchase price allocation for possible errors.

Intragroup, profits, losses, sales, 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 an entity (associate) is adjusted annually by the percentage of any change in its equity corresponding to LANXESS's percentage interest in the entity. 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.

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, irrespective of the date of acquisition.

Since 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, 2005	Dec. 31, 2006	2005	2006
1 €		Closing rate		Average rate	
Argentina	ARS	3.57	4.04	3.64	3.86
Brazil	BRL	2.76	2.82	3.04	2.73
China	CNY	9.52	10.28	10.20	10.01
United Kingdom	GBP	0.69	0.67	0.68	0.68
Japan	JPY	138.90	156.93	136.86	146.04
Canada	CAD	1.37	1.53	1.51	1.42
Mexico	MXN	12.59	14.28	13.57	13.69
United States	USD	1.18	1.32	1.24	1.26

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 2006 or 2005.

Income taxes This item comprises the income taxes paid or accrued in the individual countries, plus deferred taxes. Computation is based on local tax rates.

Income tax liabilities comprise obligations relating to the respective fiscal year and any obligations relating to previous years.

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 2006 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 annually for impairment, or more often if events or a change in circumstances indicates a possible decline in their value.

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. Any write-downs of capitalized goodwill are included in other operating expenses. IFRS does not permit write-backs of impairment charges on goodwill. Goodwill is not amortized.

The costs incurred for in-house software development at the application development stage are capitalized and amortized over the expected 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 property, plant or equipment is sold, 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.

In the case of leasing contracts that do not include the transfer of all substantive risks and benefits arising from ownership (operating leases), the lessee recognizes the lease payments as current expenses.

Financial instruments Financial instruments are contracts that give rise simultaneously to a financial asset for one party and a financial liability or equity instrument 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, raw material prices and interest rates. Further details of financial instruments are given in Note [32].

Investments in affiliated companies and the equity instruments included in non-current assets are classified as “available-for-sale” and recognized at fair value in accordance with IAS 39, except where it is not possible to ascertain their fair value reliably. In this case they are carried at amortized cost. 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 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 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 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, which is the estimated selling price in the ordinary course of business 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. Only the amount likely to be realizable due to future taxable income is recognized. Deferred tax assets on loss carryforwards are recognized if it seems sufficiently certain that the carryforwards can be utilized. Further information is given in the section on income taxes above.

Provisions Other provisions are valued in accordance with IAS 37 and, where appropriate, IAS 19 and IFRS 2, 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 [20]. 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, payments under long-term compensation programs, 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 maturities of up to three months from the date of acquisition

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 business units as cash-generating units. However, if there is reason to suspect impairment of non-current assets below business-unit level, such assets are also tested for impairment, and any impairment loss is recognized in income as an asset write-down.

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 fair value less costs to sell 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.

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 proportionately among the other assets of the strategic business unit on the basis of their net carrying amounts at the closing date.

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

Changes in Recognition and Valuation Principles The International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRIC) have adopted a number of new accounting standards which became mandatory in fiscal 2006 and were first applied by the LANXESS Group in this year.

In December 2004, the IASB adopted amendments to IAS 19. These principally comprise:
- Introduction of an option of immediately recognizing actuarial gains and losses from defined benefit pension obligations without affecting the income statement.
- Clarification of the balance sheet and income statement presentation of multi-employer pension plans.
- Additional information to be provided in the notes.

Application of the amendments to IAS 19 has only affected the extent and format of the information provided in the notes. The LANXESS Group has not altered the method of recognizing actuarial gains and losses.

Under the previous rules on hedging transactions involving financial instruments, only an external transaction could be recognized as the underlying. An amendment to IAS 39 issued in April 2005 permits the use of hedge accounting for intragroup foreign currency transactions under certain circumstances. The main conditions for this are that the underlying transaction will affect the consolidated income statement and that the transaction currency is not the functional currency of the entity entering into the transaction. This change had no material impact on the Group's financial position, results of operations or cash flows.

The following accounting standards had to be applied for the first time in 2006 but are not of significance for the LANXESS Group:

- IFRS 6 Exploration for and Evaluation of Mineral Resources
- Amendment to IAS 21 (The Effects of Changes in Foreign Exchange Rates – net investment in a foreign operation)
- Amendment to IAS 39 (fair value option)
- Amendments to IAS 39 and IFRS 4 (financial guarantees)
- IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
- IFRIC 6 Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment

New Standards and Interpretations Issued but not yet Mandatory The LANXESS Group has not yet applied further accounting standards and interpretations that have been issued by the IASB and IFRIC but were not mandatory for 2006. Application of some of these accounting standards is contingent upon their adoption by the E.U.

In August 2005 the IASB issued IFRS 7 and a related amendment to IAS 1. IFRS 7 fundamentally restructures disclosure requirements for financial instruments and combines them all in a single standard. IFRS 7 and the amendment to IAS 1 are applicable from January 1, 2007. Since they relate only to disclosure obligations, their first-time application will have no material impact on the financial position, results of operations or cash flows of the LANXESS Group.

In November 2005, the IFRIC issued Interpretation IFRIC 7, which clarifies individual aspects of accounting for hyperinflationary economies. IFRIC 7 is to be applied for annual periods beginning on or after March 1, 2006. Since none of the companies in the LANXESS Group uses a hyperinflationary currency as its functional currency, IFRIC 7 is not of relevance for the LANXESS Group.

In January 2006, the IFRIC issued Interpretation IFRIC 8, which specifies that IFRS 2 is also applicable for agreements under which an entity receives few, if any, specifically identifiable goods or services as consideration for equity instruments granted. IFRIC 8 is to be applied retrospectively for annual periods beginning on or after May 1, 2006. The LANXESS Group does not expect this interpretation to have a material impact on the Group's financial position, results of operations or cash flows.

In March 2006, the IFRIC issued Interpretation IFRIC 9, which requires that an assessment of whether an embedded derivative is to be separated from the host contract must be made when an entity first becomes party to the contract. Subsequent reassessment is only permitted if there is a change in the terms of the contract that significantly modifies the cash flows under the contract. IFRIC 9 is to be applied retrospectively for annual periods beginning on or after June 1, 2006. This interpretation has no practical relevance for the LANXESS Group at present.

In July 2006, the IFRIC issued Interpretation IFRIC 10. This states that an impairment loss recognized in interim statements in respect of goodwill or an investment in an equity instrument or financial asset carried at cost shall not be reversed in subsequent periods. This interpretation is to be applied for annual periods beginning on or after November 1, 2006. The LANXESS Group does not expect this interpretation to have a material impact on the Group's financial position, results of operations or cash flows.

In November 2006, the IFRIC issued Interpretation IFRIC 11, which contains information on the treatment of share-based payment transactions where an entity receives goods or services in return for its own equity instruments. It is to be applied retrospectively for fiscal years beginning on or after March 1, 2007. The LANXESS Group does not expect this interpretation to have a material impact on the Group's financial position, results of operations or cash flows.

In November 2006, the IFRIC also issued Interpretation IFRIC 12 concerning the recognition and valuation of the rights and obligations of operators under service concession arrangements. This interpretation is to be applied for annual periods beginning on or after January 1, 2008. Since it only applies to concessions granted to private-sector companies to operate public service infrastructure, IFRIC 12 is not relevant for the LANXESS Group.

In November 2006, the IASB issued IFRS 8. The main change compared to IAS 14, which currently defines segment reporting, is the application of the management approach, whereby the identification of reporting segments is based on internal controlling. This interpretation is to be applied for annual periods beginning on or after January 1, 2009. The LANXESS Group is currently evaluating the impact the standard will have on the Group's reporting.

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 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. For further information see Note [21].

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

In the impairment tests on assets in fiscal 2006, 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% reduction in the expected future cash flows would have caused an impairment loss of around €24 million.

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 [20]).

The LANXESS Group performed sensitivity analyses on all provisions existing as of December 31, 2006 in compliance with the IFRS. These involved calculating the impact on earnings of variations the parameters used, especially the probability of an event occurring, discount rate and absolute level of risk.

The outcome of these sensitivity analyses shows that variations in the assumptions described above would not have a material impact on the level of provisions reported in the consolidated financial statements for the LANXESS Group.

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, 2006 it is estimated that a general increase of one percentage point in interest rates would not have had a material impact on Group income before income taxes.

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.

Other major estimates are used to assess the useful lives of intangible assets and property, plant and equipment, the probability of collecting receivables and other assets, the valuation of inventories and the ability to realize tax claims and deferred tax assets recognized for temporary differences and tax loss carryforwards.

Up to the time these consolidated financial statements were prepared, no circumstances had become known that would necessitate a major change in such estimates.

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.

The activities of the Saltigo business unit (formerly the Fine Chemicals business unit) were hived down from LANXESS Deutschland GmbH to SALTIGO GmbH (formerly Dritte LXS GmbH) with effect from January 1, 2006. GVW Garnveredelungswerke GmbH was merged into LXS Dormagen Verwaltungs-GmbH (formerly Dorlastan Fibers GmbH). Since these transactions exclusively comprised the transfer of assets between consolidated companies in the LANXESS Group, they had no impact on the assets and liabilities reflected in the consolidated financial statements.

LANXESS Korea Limited, Seoul (South Korea) and LANXESS (Shanghai) Trading Co. Ltd., Shanghai (China) were consolidated for the first time. The newly established Korean company is responsible for the LANXESS Group's business in Korea. LANXESS (Shanghai) Trading Co. Ltd. is a new distribution company for LANXESS products in China. Dorlastan Fibers LLC, Goose Creek (U.S.) and LANXESS B.V., Ede (Netherlands) were deconsolidated in 2006 as a result of divestment. These transactions had no material impact on the consolidated financial statements.

On December 31, 2006, LANXESS AG had 56 fully consolidated companies. As in the previous year, Chrome International South Africa (Pty.) Ltd., Newcastle, South Africa, was included in the financial statements as of December 31, 2006 by proportionate consolidation. The 40% stake in Bayer Industry Services GmbH & Co. OHG was included by the equity method as in 2005 (see Note [11]).

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
Rhein Chemie Rheinau GmbH, Mannheim	100
SALTIGO GmbH, Leverkusen	100
EMEA (excluding Germany)	
LANXESS (Pty.) Ltd., Isando, South Africa	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
Lustran Polymers, S.L., Tarragona, Spain	100
Americas	
LANXESS Corporation, Pittsburgh, Pennsylvania, U.S.	100
LANXESS Inc., Sarnia, Ontario, Canada	100
LANXESS Industria de Produtos Quimicos e Plasticos Ltda., São 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 published in the electronic Federal Gazette (Bundesanzeiger) and is also available directly from LANXESS AG on request.

As in the previous year, the joint venture Chrome International South Africa (Pty.) Ltd. was included by proportionate consolidation in accordance with IAS 31 on the basis of LANXESS's 50% interest. The following amounts pertaining to this joint venture are taken into account in the consolidated financial statements of the LANXESS Group:

	Dec. 31, 2005	Dec. 31, 2006		2005	2006
€ million			€ million		
Non-current assets	30	22	Income	21	24
Current assets	6	9	Expenses	(22)	(22)
Non-current liabilities	(46)	(39)			
Current liabilities	(2)	(1)			
Net assets	**(12)**	**(9)**	**Income after taxes**	**(1)**	**2**

Divestment of subsidiaries and other businesses The divestment of the Fibers business unit effective February 28, 2006, the Paper business unit effective March 31, 2006 and the Textile Processing Chemicals business unit effective December 31, 2006 altered the structure of the Group as follows:

Divestment of Subsidiaries and Other Businesses	2006
€ million	
Non-current assets	14
Current assets	170
of which cash and cash equivalents	9
Non-current liabilities	(26)
Current liabilities	(24)
Realized sale price	138

Notes to the Income Statement

(1) Sales Sales of €6,944 million (2005: €7,150 million) comprise principally goods sold less discounts and rebates. Sales are deemed to have been realized as soon as delivery has been effected or the service has been rendered. This is normally the case when the material risks and benefits associated with ownership of the goods pass to the purchaser. In addition, it must be sufficiently certain that the economic benefits will be obtained and it must be possible to determine the costs reliably.

A breakdown of sales and the change in sales by segment and region is given in the segment data (cf. Note [34]).

(2) Other operating income

Other Operating Income	2005	2006
€ million		
Income from non-core business	31	141
Income from hedging with derivative financial instruments	40	31
Income from the reversal of provisions	15	18
Income from the reversal of write-downs on receivables and other assets	2	6
Gains from the sale of non-current assets	4	4
Miscellaneous operating income	63	43
	155	**243**

(3) Other operating expenses

Other Operating Expenses	2005	2006
€ million		
Expenses for non-core business	25	136
Expenses for allocations to restructuring provisions	144	39
Expenses for hedging with derivative financial instruments	21	20
Write-downs of trade receivables and other current assets	19	10
Expenses for impairment write-downs, excluding goodwill	64	8
Expenses relating to antitrust litigation	71	3
Losses from the sale of non-current assets	3	2
Miscellaneous operating expenses	144	82
	491	**300**

The other operating expenses include expenses for portfolio adjustments.

(4) Financial result The components of this item are as follows:

Financial Result	2005	2006
€ million		
Loss from investment in associate	**(35)**	**(16)**
Interest income	7	10
Interest expense	(48)	(33)
Net interest expense	**(41)**	**(23)**
Dividends and income from other affiliated companies	3	11
Interest portion of interest-bearing provisions	(32)	(39)
Net exchange loss	(6)	(13)
Miscellaneous financial expenses	(34)	(9)
Other financial income/expense – net	**(69)**	**(50)**
Financial result	**(145)**	**(89)**

Finance leases are capitalized under property, plant and equipment in compliance with IAS 17. The interest portion of the lease payments, amounting to €3 million (2005: €4 million), is included in interest expense.

In 2005 miscellaneous financial expenses included the cost of the early repurchase of a mandatory convertible bond.

(5) Income taxes This item comprises the income taxes paid or accrued in the individual countries, plus deferred taxes.

As in the previous year, an aggregate income tax rate of 39.6% is used to calculate the expected tax expense of the Group and deferred taxes for the German companies. This is derived from a corporation tax rate of 25.0%, plus the impact of a 5.5% solidarity surcharge on the corporation tax rate, after adjustment 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	2005	2006
€ million		
Current taxes	(56)	(87)
Deferred taxes resulting from		
temporary differences	115	17
loss carrryforwards	4	(15)
Income taxes	**63**	**(85)**

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

Deferred Taxes	Dec. 31, 2005		Dec. 31, 2006	
€ million	Deferred tax assets	Deferred tax liabilities	Deferred tax assets	Deferred tax liabilities
Intangible assets	18	7	14	3
Property, plant and equipment	29	169	19	130
Financial assets	0	3	3	6
Inventories	10	4	13	5
Trade receivables	3	19	54	27
Other assets	9	67	8	85
Pension provisions	18	7	17	34
Other provisions	92	2	83	0
Liabilities	79	1	72	0
Loss carryforwards	49	–	34	–
	307	**279**	**317**	**290**
of which non-current	114	186	87	174
Set-off*	(204)	(204)	(233)	(233)
	103	**75**	**84**	**57**

* 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	2005	2006
€ million		
Deferred taxes as of January 1	**117**	**28**
Tax income reflected in the income statement	119	2
Changes in scope of consolidation	2	(1)
Taxes included in equity		
Migration effects due to spin-off from the Bayer Group	(245)	–
Change in accounting treatment of Bayer Pensionskasse	38	–
Other	2	(1)
Translation differences	(5)	(1)
Deferred taxes as of December 31	**28**	**27**

As of December 31, 2006, equity was reduced by €2 million (2005: €1 million) through the recognition of deferred taxes without affecting the income statement.

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 €34 million (2005: €49 million) are recognized on the €113 million (2005: €125 million) in tax loss carryforwards that represent income likely to be realized in the future.

Deferred taxes have not been recognized for €86 million (2005: €89 million) of tax loss carryforwards that can theoretically be utilized over more than five years.

The actual tax expense for 2006 was €85 million (2005: tax income of €63 million). This figure differed by €29 million (2005: €17 million) from the expected tax expense of €114 million (2005: expected tax income of €46 million) that would result from applying the tax rate for LANXESS AG.

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

Reconciliation to Reported Tax Income	2005	2006
€ million		
Income (loss) before income taxes	(117)	287
Income tax rate of LANXESS AG	39.6%	39.6%
Theoretical tax income (expense)	46	(114)
Tax difference due to differences between local tax rates and the theoretical tax rate	17	15
Reduction in taxes due to tax-free income		
Utilization of off-balance-sheet loss carryforwards	13	16
Other	3	23
Increase in taxes due to non-deductible items	(21)	(21)
Other tax effects	5	(4)
Actual tax income (expense)	**63**	**(85)**
Effective tax rate	53.8%	29.6%

(6) Earnings per share Earnings per share were €2.33 in fiscal 2006 (2005: minus €0.75), calculated by dividing Group net income of €197 million (2005: Group net loss of €63 million) by the 84,620,670 shares listed for trading on the Frankfurt Stock Exchange. The number of shares is unchanged from the previous year. Since there are currently no equity instruments outstanding that could dilute earnings per share, basic and diluted earnings per share are identical. Further information on equity instruments that could dilute earnings per share in the future is contained in Note [19].

LANXESS AG reported a balance sheet profit of €81.9 million for fiscal 2006. The Management Board and Supervisory Board are proposing a dividend of €0.25 per share. If the stockholders approve this proposal at the Annual Stockholders' Meeting, the total dividend payment will be €21.2 million. Of the remaining €60.7 million of the balance sheet profit, it is proposed that €20.7 million be allocated to retained earnings and the remainder be carried forward to the new accounting period.

(7) Cost of materials The cost of materials was approximately €3.9 billion (2005: approx. €3.6 billion), comprising purchased materials adjusted for changes in inventories and expenses for purchased energy and fuels.

(8) Personnel expenses Personnel expenses declined by €197 million in fiscal 2006 from €1,333 million to €1,136 million, mainly because the previous year's figure contained higher expenses relating to restructuring and because the number of employees declined in 2006. 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 (see Note [4]).

Personnel expenses include wages and salaries totaling €877 million (2005: €1,040 million) and social expenses of €259 million (2005: €293 million), of which €78 million (2005: €104 million) were pension expenses.

Notes to the Balance Sheet

(9) Intangible assets Changes in intangible assets were as follows:

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)
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)
Retirements	17	7		24
Transfers	(2)	2		0
Accumulated amortization and write-downs on December 31, 2005	**(242)**	**(8)**	**(1)**	**(251)**
Net carrying amounts on December 31, 2005	**39**	**11**	**3**	**53**

Changes in Intangible Assets in 2006				
€ 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, 2005	281	19	4	304
Exchange differences	(9)	(1)		(10)
Changes in scope of consolidation				0
Capital expenditures	4		6	10
Retirements	(44)			(44)
Transfers	4		(4)	0
Gross carrying amounts on December 31, 2006	**236**	**18**	**6**	**260**
Accumulated amortization and write-downs on Dec. 31, 2005	(242)	(8)	(1)	(251)
Exchange differences	7	1		8
Changes in scope of consolidation				0
Amortization and write-downs in 2006	(20)			(20)
of which write-downs				0
Retirements	44			44
Transfers	(1)		1	0
Accumulated amortization and write-downs on December 31, 2006	**(212)**	**(7)**	**0**	**(219)**
Net carrying amounts on December 31, 2006	**24**	**11**	**6**	**41**

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

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 December 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)
Capital expenditures	16	41	6	180	243
Retirements	(36)	(171)	(11)	(2)	(220)
Transfers	17	152	11	(180)	0
Gross carrying amounts on December 31, 2005	**1,302**	**5,657**	**208**	**188**	**7,355**
Accumulated depreciation and write-downs on December 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)
Retirements	34	167	10	1	212
Transfers	(2)	(36)	(1)	39	0
Accumulated depreciation and write-downs on December 31, 2005	**(964)**	**(4,692)**	**(156)**	**(17)**	**(5,829)**
Net carrying amounts on December 31, 2005	**338**	**965**	**52**	**171**	**1,526**

Changes in Property, Plant and Equipment in 2006

€ million	Land and buildings	Technical equipment and machinery	Other fixtures, fittings and equipment	Advance payments and assets under construction	Total
Gross carrying amounts on December 31, 2005	1,302	5,657	208	188	7,355
Exchange differences	(29)	(123)	(6)	(8)	(166)
Changes in scope of consolidation	(24)	(144)	(2)	(1)	(171)
Capital expenditures	16	61	6	174	257
Retirements	(44)	(323)	(19)	(2)	(388)
Transfers	27	121	20	(168)	0
Gross carrying amounts on December 31, 2006	**1,248**	**5,249**	**207**	**183**	**6,887**
Accumulated depreciation and write-downs on December 31, 2005	(964)	(4,692)	(156)	(17)	(5,829)
Exchange differences	16	94	5		115
Changes in scope of consolidation	23	144	3	1	171
Depreciation and write-downs in 2006	(34)	(177)	(30)	(1)	(242)
of which write-downs	(5)	(2)	(3)	(1)	(11)
Retirements	37	308	18		363
Transfers	0	(14)	1	13	0
Accumulated depreciation and write-downs on December 31, 2006	**(922)**	**(4,337)**	**(159)**	**(4)**	**(5,422)**
Net carrying amounts on December 31, 2006	**326**	**912**	**48**	**179**	**1,465**

Capitalized property, plant and equipment includes assets with a total net value of €34 million (2005: €46 million) held under finance leases. The gross carrying amounts of these assets at the closing date totaled €103 million (2005: €108 million).

These assets are mainly machinery and technical equipment with a carrying amount of €19 million (gross amount: €80 million; 2005: carrying amount €20 million, gross amount €72 million) and buildings with a carrying amount of €15 million (gross amount: €23 million; 2005: carrying amount €26 million, gross amount €36 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.

(11) 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: Bayer Industry Services GmbH & Co. OHG.

	2005	2006
€ million		
Sales	1,656	1,708
Loss from associate included at equity	**(35)**	**(16)**

	Dec. 31, 2005	Dec. 31, 2006
€ million		
Equity		
Assets	1,095	1,012
Liabilities	973	958
	122	54
Adjustment of LANXESS's interest and equity valuation	(100)	(49)
Associate included at equity	**22**	**5**

The €17 million (2005: €22 million) reduction in the carrying amount of this investment is calculated from the equity-method loss after adjusting for a €18 million reduction in the value of cash flow hedges (2005: €6 million increase), recognized directly in the associate's equity, and the impact of the pro rata loss assumption of €17 million (2005: €7 million).

(12) Investments in other affiliated companies This item contains interests in other affiliated companies totaling €4 million (2005: €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, 2006 at amortized cost of €4 million (2005: €4 million).

(13) Non-current and current financial assets

Financial Assets	Dec. 31, 2005			Dec. 31, 2006		
€ million	Non-current	Current	Total	Non-current	Current	Total
Securities	3	0	3	1	0	1
Loans to other affiliated companies	23	0	23	17	0	17
Other loans	9	0	9	8	0	8
Leasing receivables	13	2	15	11	2	13
Investment receivables	0	0	0	0	39	39
Loans receivable	0	7	7	0	25	25
Receivables from derivative financial instruments	0	28	28	0	47	47
	48	**37**	**85**	**37**	**113**	**150**

Investment receivables mainly comprise a German treasury note (Bundesschatzanweisung) while loans receivable comprise a promissory note. Both have an effective interest rate of 3.7%.

Accounts receivable of €13 million (2005: €15 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
2007	3	1	2
2008	3	1	2
2009	3	1	2
2010	3	1	2
2011	3	1	2
After 2011	4	1	3
	19	**6**	**13**

(14) Other non-current assets Other non-current assets are carried at amortized cost less write-downs. No write-downs were necessary in 2005 or 2006.

This item comprises:

Other Non-current Assets	Dec. 31, 2005	Dec. 31, 2006
€ million		
Receivables from pension obligations	59	71
Other receivables	20	23
	79	**94**

(15) Inventories Of the €1,047 million in inventories carried as of December 31, 2006 (2005: €1,068 million), €197 million are reflected at their fair value less costs to sell.

Inventories comprised the following:

Inventories	Dec. 31, 2005	Dec. 31, 2006
€ million		
Raw materials and supplies	205	212
Work in process, finished goods and trade goods	862	835
Advance payments	1	0
	1,068	**1,047**

Write-downs of inventories were as follows:

Write-downs of Inventories	Dec. 31, 2005	Dec. 31, 2006
€ million		
Balance at beginning of year	(63)	(67)
Additions charged as expenses	(25)	(12)
Exchange differences	(1)	2
Reversals/utilization	22	23
Balance at end of year	**(67)**	**(54)**

No write-backs of inventories were recorded in 2006 (2005: €3 million).

(16) Trade receivables Trade receivables are stated after write-downs of €22 million (2005: €31 million) for amounts unlikely to be recovered.

All trade receivables – totaling €924 million (2005: €1,065 million) – are due within one year. Trade receivables of €12 million (2005: €4 million) related to other affiliated companies and €912 million (2005: €1,061 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, 2005	Dec. 31, 2006
€ million		
Balance at beginning of year	(26)	(34)
Additions charged as expenses	(19)	(10)
Exchange differences	(1)	1
Changes in scope of consolidation	0	1
Reversals/utilization	12	18
Balance at end of year	**(34)**	**(24)**

(17) Other current assets Other receivables and other assets are carried at amortized cost, less write-downs of €2 million (2005: €3 million).

They comprise:

Other Current Assets	Dec. 31, 2005	Dec. 31, 2006
€ million		
Claims for tax refunds	102	67
Payroll receivables	1	1
Other receivables	97	152
	200	**220**

(18) Liquid assets

Liquid Assets	Dec. 31, 2005	Dec. 31, 2006
€ million		
Cash and cash equivalents	133	171
Marketable securities and other instruments	3	0
	136	**171**

Securities with maturities of up to three months from the date of acquisition are recognized under cash and cash equivalents in view of their high liquidity.

(19) 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 in one or more installments up to a total of €36,517,096 (authorized capital). This resolution on authorized capital was entered in the Commercial Register on February 25, 2005. Stockholders must normally 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.

Under a resolution adopted at the Annual Stockholders' Meeting on May 31, 2006, the Management Board is authorized to repurchase up to 10% of the company's capital stock up to November 30, 2007. The shares acquired on the basis of this authorization, together with treasury stock acquired by the company on any other basis and still held by the company, may not at any time exceed 10% of the company's capital stock. This authorization had not been utilized as of year-end 2006.

The capital stock and capital reserves are unchanged from the previous year at €84,620,670 and €804,777,491 respectively.

The other reserves principally contain retained earnings amounting to €527 million in 2006 (2005: €590 million).

Minority stockholders' interests consisted mainly of interests in the 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 Rhein Chemie Ltd., Qingdao (China).

(20) Provisions for pensions and other post-employment benefits Most employees in the LANXESS Group are entitled to retirement benefits on the basis of statutory regulations or contractual agreements. These are provided through both defined-contribution and defined-benefit plans.

In the case of defined-contribution plans, the company pays contributions into separate pension funds. These contributions are included in the function expenses and thus in the operating result. Once the contributions have been paid, the company has no further payment obligations. In fiscal 2006 these expenses totaled €75 million (2005: €81 million) for the Group, including €44 million (2005: €46 million) in employer's contributions to the state pension plan in Germany.

The pension plan financed through the Bayer Pensionskasse is also reflected in the annual financial statements as a defined-contribution plan. The above amounts include contributions of €15 million (2005: €15 million) to this pension fund.

The Bayer Pensionskasse is a legally independent 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 to account for the Bayer Pensionskasse as a defined-benefit plan in accordance with IAS 19. Therefore, the Bayer Pensionskasse is accounted for as a defined-contribution plan and not as a defined-benefit 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 are not assumed by the Bayer Pensionskasse are accounted for by LANXESS as a separate defined-benefit plan.

Statutory pension plans mainly comprise an obligation to pay a lump sum when employment ends. The amount depends principally on years of service and final salary.

Pension plans based on contractual agreements generally comprise lifelong benefits payable in the event of death or disability or when the employee reaches a certain age. Benefits are normally based on remuneration and years of service.

Alongside retirement benefits, pension and other post-employment benefit obligations include the obligation of Group companies in America to reimburse healthcare costs for retirees.

Most pension plans in Germany are financed via provisions while pension plans in other countries are generally financed through external pension funds.

The provisions for pensions and other post-employment benefits recognized on the balance sheet reflect the present value of the defined benefit obligation on the reporting date, taking into account expected future benefit increases, less the fair value of external plan assets on the reporting date, after adjustment for accumulated unrecognized actuarial gains and losses, unrecognized past service cost and unrealizable plan assets. The defined benefit obligation is reviewed regularly – at least every three years – by an independent actuary using the projected unit credit method. Comprehensive actuarial valuations are undertaken annually for all major pension plans. The discount rates used to compute present value normally correspond to the yields on high-quality corporate bonds with the same maturities.

Pension provisions and pension expense are calculated using the 10% corridor method, in other words, actuarial gains and losses exceeding 10% of the defined benefit obligation or fair value of plan assets are recognized in the income statement over the average remaining service life of the workforce. Past service cost is recognized in income over the period until pension rights become vested.

In 2006 expenses for defined-benefit plans amounted to €79 million (2005: €79 million). With the exception of interest cost, the expected return on plan assets and a part of the amortization of actuarial gains and losses, these expenses are recognized in the operating result.

The costs for the plans comprise the following:

	2005	2006	2005	2006
€ million	Pension obligations		Other post-employment obligations	
Current service cost	28	29	19	11
Past service cost	6	4	(5)	0
Interest cost	43	43	8	8
Expected return on plan assets	(27)	(29)	0	0
Amortization of actuarial gains/losses	6	10	2	1
Plan curtailments and settlements	(1)	1	0	1
	55	**58**	**24**	**21**

The reconciliation of the defined benefit obligation to the net amounts of assets and provisions recognized on the balance sheet is as follows:

	Dec. 31, 05	Dec. 31, 06	Dec. 31, 05	Dec. 31, 06
€ million	Pension obligations		Other post-employment obligations	
Defined benefit obligation (funded)	**449**	**400**	**0**	**1**
External plan assets	**(396)**	**(395)**	**0**	**(1)**
Underfunding/overfunding	**53**	**5**	**0**	**0**
Defined benefit obligation (unfunded)	**468**	**474**	**156**	**147**
Unrecognized past service cost	0	0	2	2
Unrecognized actuarial gains/losses	(222)	(168)	(22)	(14)
Asset limitation	3	3	0	0
Net recognized liability	**302**	**314**	**136**	**135**
Amounts shown in the balance sheet				
Receivables from pension obligations	(59)	(71)	0	0
Provisions for pensions and other post-employment benefits	361	385	136	135
Net recognized liability	**302**	**314**	**136**	**135**

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

€ million	Dec. 31, 2005	Dec. 31, 2006
Provisions for pensions and other post-employment benefits	497	520
Other non-current assets	(59)	(71)
Net recognized liability	**438**	**449**

The reconciliation of the defined benefit obligation to plan assets is as follows:

	Dec. 31, 05	Dec. 31, 06	Dec. 31, 05	Dec. 31, 06
€ million	Pension obligations		Other post-employment obligations	
Defined benefit obligation				
Benefit obligations at beginning of the year	1,310	917	134	156
Current service cost	28	29	19	11
Interest cost	43	43	8	8
Employee contributions	2	2	–	–
Plan changes	6	4	(2)	0
Plan settlements	(584)	–	–	–
Actuarial gains/losses	96	(19)	(5)	(4)
Translation differences	67	(40)	16	(10)
Benefits paid	(47)	(35)	(14)	(14)
Acquisitions/divestments	(2)	(27)	–	–
Plan curtailments	(2)	0	–	1
Benefit obligation at end of the year	**917**	**874**	**156**	**148**
Fair value of plan assets				
Plan assets at beginning of the year	925	396	0	0
Actual return on plan assets	27	29	0	0
Actuarial gains/losses	17	16	0	0
Acquisitions/Divestments	(9)	(15)	–	–
Plan settlements	(620)	–	–	–
Translation differences	63	(36)	0	1
Employer contributions	38	38	14	14
Employee contributions	2	2	–	–
Benefits paid	(47)	(35)	(14)	(14)
Plan assets at end of the year	**396**	**395**	**0**	**1**

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 2005.

The actuarial gains and losses computed in fiscal 2006 relate to changes in actuarial assumptions and experience adjustments. The actuarial gains and losses are assigned to the following categories.

	Dec. 31, 05	Dec. 31, 06	Dec. 31, 05	Dec. 31, 06
€ million	Pension obligations		Other post-employment obligations	
Difference between expected and actual return on plan assets	17	16	0	0
Experience adjustment	4	11	12	3
Adjustment for changes in valuation assumptions	(100)	8	(7)	1
Net actuarial gain/loss for the year	**(79)**	**35**	**5**	**4**

The actual return on plan assets was €45 million in 2006 (2005: €44 million).

The following weighted parameters were used to define the benefit costs and liability:

	Dec. 31, 05	Dec. 31, 06	Dec. 31, 05	Dec. 31, 06
in %	Pension obligations		Other post-employment obligations	
Interest rate	4.7	5.0	4.9	5.1
Expected salary increases	2.9	3.1	2.8	2.8
Expected pension increases	1.2	1.3	–	–
Expected return on plan assets	6.9	7.5	7.3	7.9
Expected increase in the cost of medical care	–	–	8.5	8.5
Expected long-term increase in the cost of medical care	–	–	4.8	5.2

The Heubeck reference tables 2005 G form the biometric basis for the computation of pension obligations in Germany. Current national biometric assumptions are used to compute benefit obligations at other Group companies. Employee turnover rates are estimated on the basis of age and gender.

It is expected that the long-term cost increase for medical care will take place within about three years.

Assuming all other parameters remain unchanged, a one percentage increase or decrease in the assumptions relating to the expected long-term increase in medical costs would raise or reduce the present value of the defined benefit obligation by €6 million. The cost of healthcare plans would thus rise or decline by €1 million.

Plan assets to cover pension obligations are comprised as follows:

	Dec. 31, 2005	Dec. 31, 2006
in % of plan assets		
Equities	52.8	54.3
Fixed-income securities	40.6	36.4
Real estate	0.5	0.5
Other	6.1	8.8
	100.0	**100.0**

The expected return on every category of plan assets was calculated on the basis of generally available and internal capital market reports and forecasts. The expected return on fixed-income securities is based on the maturity of the portfolio and the yields on the reporting date. The expected return on equities reflects the long-term return expectations for the underlying equity portfolio.

(21) Other non-current and current provisions These comprise:

Other Provisions	Dec. 31, 2005			Dec. 31, 2006		
€ million	Non-current	Current	Total	Non-current	Current	Total
Personnel-related provisions	135	127	262	139	126	265
Provisions for restructuring	66	81	147	60	46	106
Provisions for transactions with customers	0	90	90	0	102	102
Provisions for environmental protection	70	17	87	68	7	75
Miscellaneous provisions	31	86	117	4	73	77
	302	**401**	**703**	**271**	**354**	**625**

€102 million (2005: €175 million) of the other provisions had maturities of more than five years.

Provisions changed as follows in 2006:

Changes in Provisions in 2006							
€ million	Jan. 1, 2006	Change in scope of consolidation	Exchange differences	Allocations	Utilization	Reversals	Dec. 31, 2006
Personnel	262	(1)	(4)	146	(115)	(23)	265
Restructuring	147	0	(3)	39	(52)	(25)	106
Transactions with customers	90	(4)	(1)	86	(61)	(8)	102
Environmental protection	87	(2)	(11)	10	(7)	(2)	75
Miscellaneous	117	0	(1)	44	(77)	(6)	77
Total	**703**	**(7)**	**(20)**	**325**	**(312)**	**(64)**	**625**

Allocations to other provisions include interest of €6 million (2005: €2 million).

Personnel-related provisions – Long-term compensation programs

Long-Term Incentive Program (LTIP) LANXESS AG offers a long term incentive program to members of the Management Board and certain other managers. This program provides for cash payments. Tranches are issued annually on February 1. Departing from this practice, the first of the three annual tranches was granted retroactively as of January 31, 2005. Participation in the LTIP is conditional upon each manager making a personal investment in LANXESS stock, the amount of which depends on his/her base salary. These shares must be held until three years after issue of the third tranche, i.e. January 31, 2010. The first date for potential disbursements under this program is 2008.

The share-based part of the LTIP is the Stock Performance Plan. The other non-share-based component, is the Economic Value Plan outlined below.

Provisions are established for the obligations entered into under share-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. If LANXESS stock performs in line with this index, a payment of €0.75 per right will be made. For each percentage point by which the stock outperforms the index, €0.025 will be paid in addition. The additional payment per percentage point above 10% is €0.05, up to a maximum possible payment of €1.50 per right. Awards to members of the Management Board are basically 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	1.0%
Expected index volatility	13.0%
Correlation between LANXESS stock and the index	53.0%
Risk-free interest rate	3.7%
Total term of program	5 years
Retention period	3 years
Reference share price	
Tranche 1	€15.01
Tranche 2	€26.03
Reference price of the index	
Tranche 1	268.95 points
Tranche 2	348.60 points

The expected volatilities are based on the historical volatility of LANXESS stock and the Dow Jones STOXX 600 Chemicals^{SM} index.

Of the 3,562,416 rights of the first tranche outstanding at the start of the fiscal year, 3,500,731 were still outstanding as of December 31, 2006. The decline was due to the fact that some original participants left the LANXESS Group during the year and therefore forfeited their rights. 3,584,824 rights are still outstanding under the second tranche. Based on the valuation parameters, the value of each right is €1.43 for those issued in the first tranche and €1.08 for those issued in the second tranche. The fair value of the rights is reflected in a provision on a pro rata basis over the retention period. As of December 31, 2006 this provision totaled €4 million (2005: €1 million).

Economic Value Plan Awards under the Economic Value Plan depend on the development of the economic value of the LANXESS Group. If 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.

As of December 31, 2006 this provision totaled €10 million (2005: €3 million). The value of economic value rights is determined on the basis of the expected target attainment.

LANXESS stock plan 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 112,158 LANXESS shares under this program in 2006 (2005: 225,658). These shares must be retained for at least three years. Since there are no further conditions attached to this stock plan, the effect resulting from the discount was expensed immediately. Expense of €2 million was recognized for the stock plan in 2006 (2005: €3 million). 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, 2006 (2005: €2 million). The entitlements of eligible LANXESS employees under these programs cease in 2009.

Provisions for restructuring €52 million of the allocations made to provisions in 2005 was utilized in 2006. €39 million was allocated to provisions for further restructuring programs during the year.

Provisions for restructuring totaled €106 million (2005: €147 million) on December 31, 2006. Of this amount, €70 million (2005: €115 million) comprised provisions for severance payments and other personnel expenses and €36 million (2005: €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.

It cannot be excluded for companies in the chemical and related industries that 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.

The present components of the provisions for environmental remediation costs primarily relate to 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 relating 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 difficulties inherent in estimating liabilities in this area, it is not possible to exclude the possibility that additional costs could be incurred beyond the amounts accrued. It is nevertheless assumed that 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 litigation in the normal course of business and may be again in the future.

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 complex legal issues and are therefore subject to a number of uncertainties. 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 [29]).

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

Non-current Financial Liabilities	Dec. 31, 2005	Dec. 31, 2006
€ million		
Bonds	497	498
Liabilities to banks	63	63
Liabilities under leasing agreements	71	58
Other financial liabilities	13	13
	644	**632**

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, 2006, the maturities of financial liabilities were as follows:

Year Due	
€ million	
2007	50
2008	12
2009	13
2010	14
2011	14
After 2011	579
	682

The weighted average interest rate on financial liabilities in the LANXESS Group was 4.0% (2005: 3.8%).

In September 2006 an international bank consortium extended the €1.25 billion credit facility arranged in 2005 by one year. The conditions for this credit line, which now runs through October 2011, are unchanged. The facility serves the LANXESS Group as a long-term liquidity back-up and is not currently drawn upon.

Information on the fair or market values of financial liabilities is given in Note [32].

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 €75 million (2005: €101 million), including €13 million (2005: €19 million) in interest, are to be made to the respective lessors in future years.

The liabilities associated with finance leases are due as follows:

Leasing Liabilities			
€ million	Lease payments	Interest portion	Leasing liabilities
2007	5	1	4
2008	7	2	5
2009	7	2	5
2010	7	2	5
2011	7	2	5
After 2011	42	4	38
	75	**13**	**62**

Lease payments under operating leases amounted to €10 million in 2006 (2005: €8 million).

(23) Current financial liabilities

Current Financial Liabilities	Dec. 31, 2005	Dec. 31, 2006
€ million		
Liabilities to banks	147	41
Liabilities under leasing agreements	11	4
Other financial liabilities	14	5
	172	**50**

(24) Trade payables Trade accounts are payable mainly to third parties. As in the previous year, the entire amount totaling €602 million (2005: €694 million) is due within one year.

Trade payables of €41 million (2005: €87 million) pertain to other affiliated companies and €561 million (2005: €607 million) to other suppliers.

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

Other Current Liabilities	Dec. 31, 2005	Dec. 31, 2006
€ million		
Payroll liabilities	33	20
Social security liabilities	19	18
Tax liabilities	39	34
Accrued interest liabilities	13	12
Liabilities from derivative financial instruments	31	22
Miscellaneous liabilities	80	75
	215	**181**

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 €2 million (2005: €1 million) to other affiliated companies.

(26) Further information on liabilities €579 million (2005: €607 million) of the liabilities had maturities of more than five years.

Liabilities of €36 million (2005: €32 million) were secured, including €36 million (2005: €32 million) secured by mortgages.

The total amount includes €12 million (2005: €13 million) in accrued interest.

Other Information

(27) Employees The number of employees as of December 31, 2006, classified by corporate functions, was as follows:

Employees by Function	Dec. 31, 2005	Dec. 31, 2006
Marketing	2,797	2,513
Production	13,266	11,956
Research	583	390
Administration	1,636	1,622
	18,282	**16,481**

(28) Assets and liabilities held for sale The consolidated financial statements for the LANXESS Group as of December 31, 2005 contained assets and liabilities classified as held for sale.

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

These were divested with the fibers business as of February 28, 2006 and the paper business as of March 31, 2006. The consolidated financial statements for the LANXESS Group as of December 31, 2006 do not contain any assets or liabilities classified as held for sale.

(29) Contingent liabilities and other financial commitments Contingent liabilities as of December 31, 2006 amounted to €1 million (2005: €7 million). They result entirely from liabilities assumed on behalf of third parties and comprise:

Contingent Liabilities	Dec. 31, 2005	Dec. 31, 2006
€ million		
Bills of exchange	1	0
Guarantees	6	1
	7	**1**

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.

As a personally liable partner in Bayer Industry Services GmbH & Co. OHG, LANXESS may be required to inject further capital into this company in the future.

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 €86 million (2005: €70 million). These payment obligations are due as follows:

Year Due	
€ million	
2007	14
2008	13
2009	12
2010	10
2011	9
After 2011	28
	86

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 (2005: €32 million). €17 million of these payments are due in 2007 and €15 million in 2008.

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 units 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. LANXESS has to pay 30% of the liabilities for these proceedings and Bayer 70%. Reimbursements made by LANXESS AG have now reached the limit set for its liability. In addition to this maximum amount, it is liable for the reimbursement of income tax paid as a result of limited tax deductibility and the proportionate costs of external legal counsel, which are split between LANXESS and Bayer in a ratio of 30:70.

(30) 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 mainly comprise the purchase of site services in the fields of utilities, infrastructure and logistics totaling €423 million (2005: €433 million) from Bayer Industry Services GmbH & Co. OHG. As a result of these transactions, there were trade payables of €41 million (2005: €87 million) pertaining to Bayer Industry Services GmbH & Co. OHG on December 31, 2006.

No material business transactions were undertaken with other associated companies.

(31) Compensation of the Management Board and the Supervisory Board In fiscal 2006 short-term compensation totaling €4,380,000 (2005: €4,233,000) was paid to the members of the LANXESS AG Management Board. This comprised fixed salaries of €2,047,000 (2005: €1,971,000) and bonus payments of €2,333,000 (2005: €2,262,000).

In addition, the members of the Management Board received compensation under the Long Term Incentive Program (LTIP): This gave rise to expense of €1,627,000 (2005: €709,000) comprising €990,000 (2005: €404,000) for the stock-based Stock Performance Plan and €637,000 (2005: €305,000) for the non-stock-based Economic Value Plan. Further details of the components of the LTIP can be found in Note [21].

As in the previous year, the Management Board members were granted 1,121,400 stock-based rights as part of their compensation. The fair value of these rights at the time of granting was €1,267,000 (2005: €886,000).

Details of the compensation system for Management Board members and an individual breakdown of compensation are given in the Compensation Report section of the Group Management Report for fiscal 2006.

Further, in fiscal 2006 service cost of €4,841,000 (2005: €537,000) relating to defined benefit pension plans was incurred for members of the Management Board as part of their compensation package. The increase compared with the previous year reflects an adjustment in pension commitments.

The total remuneration of members of the Supervisory Board was €2,964,000 in 2006 (2005: €650,000). This comprised short-term remuneration components totaling €844,000 (2005: €650,000) and long-term components totaling €2,120,000 (2005: €0). Long-term remuneration components were allocated to the Supervisory Board members for the first time in 2006.

Details of the remuneration system for members of the Supervisory Board and an individual breakdown of the amounts paid are contained in the corporate governance report in the section headed Compensation Report of the Supervisory Board.

No loans were granted to members of the Management Board or the Supervisory Board in fiscal 2006 or 2005.

(32) 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 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, credit risk 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 for the LANXESS Group 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 equity under other comprehensive income/loss. In 2006 equity increased by changes in the fair value of cash flow hedges amounting to €22 million (2005: decrease by €11 million). This includes €11 million released from equity and recognized as a gain in the accounting period following the realization of the underlying transaction (2005: loss of €2 million). Hedging took place through forward contracts and currency options with positive fair values of €38 million (2006: €5 million) and negative fair values of €3 million (2005: €17 million) on December 31, 2006. The total notional value of these hedges was €828 million (2005: €579 million), including €500 million (2005: €434 million) due within one year. In fiscal 2006 a hedging contract concluded to hedge a currency risk in yen was closed out because the underlying transaction was no longer expected to take place. The resultant expense was €2 million.

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.

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 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.

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. However, netting is essentially possible within any master agreements made.

Given the LANXESS Group's customer structure, it is not exposed to any significant country default 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. Market price risks are systematically monitored, analyzed and controlled through financial risk management. The aim is 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 such as for natural gas, fuel oil and gasoline (strategic management). Changes in the fair values of commodity derivatives are recognized in the income statement in other operating income or 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 2006, changes in the value of cash flow hedges impacted equity by €11 million (2005: €4 million). This includes €13 million (2005: €6 million) released from equity and recognized as a loss in the accounting period following the realization of the underlying transaction. Hedges comprised commodity swaps with positive fair values of €0 million on December 31, 2006 (2005: €10 million) and negative fair values of €18 million (2005: €1 million). The total notional value of these hedges was €126 million (2005: €72 million), including €100 million (2005: €56 million) due within one year.

Derivative financial instruments Derivatives with a fair value of €47 million (2005: €28 million) are capitalized in the consolidated financial statements of the LANXESS Group for fiscal 2006. Instruments with a negative fair value totaling €22 million (2005: €31 million) are recognized as liabilities. "Regular way" purchases and sales of financial assets and liabilities 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 exchange contracts	1,266	3	(27)
Currency options	151	2	(3)
Commodity contracts	92	23	(1)
Total	**1,509**	**28**	**(31)**

Derivative Financial Instruments	Dec. 31, 2006		
€ million	Notional value	Positive fair values	Negative fair values
Forward exchange contracts	1,985	41	(3)
Currency options	182	6	(1)
Commodity contracts	126	0	(18)
Total	**2,293**	**47**	**(22)**

The total notional value of commodity swaps contracts was €126 million (2005: €92 million), including €100 million (2005: €76 million) due within one year. Forward contracts and currency options have a combined notional value of €2,167 million (2005: €1,417 million), including €1,839 million (2005: €1,271 million) due within one year.

Bonds 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, 2006 was €498 million (2005: €497 million) and its fair value was €482 million (2005: €504 million).

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

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.

Many 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 methods.

The following interest rates were used to determine fair values:

	Dec. 31, 2005	Dec. 31, 2006
in %		
Euro Benchmark Bond	4.1	4.1
Leasing liabilities	5.0	5.0

(33) Notes to the Cash Flow Statement

Net cash flow provided by operating activities The net operating cash flow of €409 million in 2006 (2005: €624 million) reflects an improvement in the operating result of the LANXESS Group along with cash outflows for restructuring and antitrust proceedings. Alongside income before income taxes of €287 million (2005: loss of €117 million), it includes depreciation and amortization of €262 million (2005: €313 million) and cash outflows of €107 million due to changes in balance sheet items (2005: cash inflow of €347 million). It also includes cash outflows for income taxes totaling €68 million (2005: €25 million).

Net cash used in investing activities Additions to property, plant and equipment resulted in a cash outflow of €267 million in 2006 (2005: €251 million). Proceeds from the divestment of subsidiaries and other businesses led to a cash inflow of €104 million (2005: outflow of €5 million), principally from the sale of the Fibers and Paper business units. Further cash inflows comprised interest receipts of €10 million (2005: €7 million) and dividend receipts of €11 million (2005: €3 million). Cash outflows for financial assets related to the purchase of debt instruments and the pro rata assumption of the loss reported by the associate reflected at equity. The net cash outflow for investing activities was €207 million (2005: €246 million).

Net cash used in financing activities The net cash outflow for financing activities amounted to €164 million (2005: €319 million), including €124 million (2005: €241 million) for the repayment of loans. Interest payments and other financial disbursements led to a further cash outflow of €39 million (2005: €76 million).

Cash and cash equivalents Cash and cash equivalents (cash, checks, bank balances) amounted to €171 million on December 31, 2006 (2005: €136 million). In accordance with IAS 7, this item also includes securities with maturities of up to three months from the date of acquisition.

(34) Segment Reporting

Notes to the segment reporting The valuation principles applied in segment reporting correspond to the recognition and valuation principles used for the consolidated financial statements prepared in accordance with IFRS. 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, 2006 the LANXESS Group comprised the following reporting segments:

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

Other/Consolidation This segment eliminates intersegment items and reflects assets and liabilities not directly allocable to the core segments. These include, in particular, the Corporate Center. The segment also includes the interest in Bayer Industry Services GmbH & Co. OHG, which has an equity value of €5 million and gave rise to an equity-method loss of €16 million.

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. Segment assets do not contain liquid assets or current and non-current financial assets.

Reconciliation of Segment Assets	2005	2006
€ million		
Segment assets	4,039	3,796
Non-current financial assets	26	41
Deferred tax assets	103	84
Current financial assets	37	113
Liquid assets	136	171
Group assets	**4,341**	**4,205**

Segment liabilities basically consist of trade payables, other liabilities and provisions. They do not include current and non-current financial liabilities and income tax liabilities.

Reconciliation of Segment Liabilities	2005	2006
€ million		
Segment liabilities	2,141	1,964
Non-current financial liabilities	644	632
Deferred tax liabilities	75	57
Current financial liabilities	172	50
Income tax liabilities	53	74
Group liabilities	**3,085**	**2,777**

Capital expenditures made by the segments mainly comprised additions to intangible assets, property, plant and equipment.

All depreciation, amortization and write-downs in fiscal 2005 and 2006 were recognized directly in income.

In fiscal 2006, the core segments reported non-cash expenses of €173 million. Of these, €27 related to Performance Chemicals, €19 million to Engineering Plastics, €69 million to Chemical Intermediates and €58 million to Performance Chemicals. The main non-cash expenses comprised allocations to provisions and write-downs of inventories and receivables.

Allocations to provisions in the Other/Consolidation segment included provisions for non-cash expenses totaling €27 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. Overall non-cash expenses of €172 million were allocated to the Other/Consolidation segment.

Segment and region data

Business Segments	2005	2006	2005	2006	2005	2006
€ million	Performance Rubber		Engineering Plastics		Chemical Intermediates	
External sales	1,678	1,776	1,737	1,708	1,535	1,533
Intersegment sales	2	0	22	29	88	94
Segment/Group sales	1,680	1,776	1,759	1,737	1,623	1,627
Segment result/EBIT	108	178	10	70	129	181
Segment assets	1,033	1,060	775	794	840	824
Capital expenditures	75	89	45	63	59	45
Depreciation and amortization	63	68	33	33	66	64
Write-downs			23		16	
Segment liabilities	408	347	353	300	262	360
Employees (December 31)	3,119	2,967	3,479	2,814	3,353	3,658
Employees (average for the year)	3,079	3,007	3,507	2,865	3,551	3,663

Geographical Regions	2005	2006	2005	2006	2005	2006
€ million	EMEA (excluding Germany)		Germany		Americas	
External sales by market	2,494	2,312	1,538	1,614	1,928	1,788
Segment assets	831	785	1,870	1,792	1,054	947
Capital expenditures	63	54	117	105	47	85
Employees (December 31)	3,290	3,083	9,410	8,263	3,694	3,094

	Performance Chemicals		Other/ Consolidation		LANXESS	
	2005	2006	2005	2006	2005	2006
	1,977	1,812	223	115	7,150	6,944
	23	19	(135)	(142)	0	0
	2,000	1,831	88	(27)	7,150	6,944
	118	155	(337)	(208)	28	376
	1,065	887	326	231	4,039	3,796
	61	55	11	15	251	267
	66	59	18	27	246	251
		5	28	6	67	11
	461	410	657	547	2,141	1,964
	4,743	3,891	3,588	3,151	18,282	16,481
	4,824	4,293	3,632	3,160	18,593	16,988

	Asia-Pacific		LANXESS	
	2005	2006	2005	2006
	1,190	1,230	7,150	6,944
	284	272	4,039	3,796
	24	23	251	267
	1,888	2,041	18,282	16,481

(35) Subsequent events The acquisition of a 50% interest in Chrome International South Africa Ltd. (CISA) in South Africa from our previous joint venture partner Dow Chemical Group took legal and economic effect on February 1, 2007. We are now the sole owner of the sodium dichromate production operations at Newcastle, South Africa.

In February 2007 we had to halt production of hydrazine hydrate at our facility in Weifang, China following an operational incident. The standstill is expected to last several months. We have therefore declared a state of force majeure to our customers in the Asia-Pacific region. At present we estimate that this will diminish EBITDA pre exceptionals by an amount in the mid-single-digit million euro range.

(36) Audit fees The LANXESS Group recognized audit fees of €8,118,000 (2005: €6,121,000) as expenses in 2006. Of this amount, €2,784,000 (2005: €3,408,000) relates to the auditing of financial statements, €1,504,000 (2005: €665,000) to audit-related services and other audit work, and €3,830,000 (2005: €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 €5,188,000 (2005: €3,551,000), of which €1,135,000 (2005: €1,208,000) was for auditing the financial statements, €1,145,000 (2005: €665,000) for audit-related services and other audit work, and €2,908,000 (2005: €1,678,000) for other services rendered to Group companies.

(37) 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.

(38) 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:

Erste LXS GmbH, Leverkusen
IAB Ionenaustauscher GmbH Bitterfeld, Greppin
LANXESS Accounting GmbH, Leverkusen
LANXESS Buna GmbH, Marl
LANXESS Deutschland GmbH, Leverkusen
LANXESS Distribution GmbH, Cologne
LANXESS Europe GmbH, Leverkusen
LXS Dormagen Verwaltungs-GmbH
(formerly Dorlastan Fibers GmbH), Dormagen
Perlon-Monofil GmbH, Dormagen
PharmAgro GmbH, Cologne
Rhein Chemie Rheinau GmbH, Mannheim
SALTIGO GmbH, Leverkusen
Suberit Kork GmbH, Mannheim
Zweite LXS GmbH, Leverkusen

Leverkusen, March 5, 2007

LANXESS Aktiengesellschaft, Leverkusen

The Management Board

Dr. Axel C. Heitmann   Dr. Ulrich Koemm

Dr. Rainier van Roessel   Dr. Martin Wienkenhöver   Matthias Zachert

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, 2006. The preparation of the consolidated financial statements and the management report in accordance with the IFRSs, as adopted by the EU, 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 Board of Managing Directors. 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). These 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 Board of Managing Directors, 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 EU, 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 5, 2007

PricewaterhouseCoopers
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

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