# Bayer AG
# Financial Statements 2004

# Management Report

## Change in corporate structure

Fiscal 2004 was the first full year in which Bayer AG concentrated solely on performing its function as a management holding company. The CropScience business area was hived down from Bayer AG and placed into a legally independent company in 2002. All of the remaining business and service areas were similarly hived down to separate legal entities in 2003.

In the Spin-Off and Acquisition Agreement dated September 22, 2004, Bayer AG as the transferor company and LANXESS AG as the transferee company agreed that the assets and liabilities of Bayer AG allocable or allocated to LANXESS be spun off to LANXESS AG. The Extraordinary Stockholders' Meetings of Bayer AG and LANXESS AG approved the Agreement on November 17, 2004 and December 21, 2004, respectively. Upon its entry into the commercial register for Bayer AG on January 28, 2005, the spin-off took legal effect retroactively from July 1, 2004; the effects of the spin-off are reflected in the Bayer AG Financial Statements as of December 31, 2004.

## Sales and earnings performance

Through the transformation of Bayer AG from a parent corporation with manufacturing and sales activities to a management holding company without business operations of its own, the volume and composition of its sales and operating result have changed fundamentally.

Of the €233 million in net sales (2003: €5,224 million) recognized in the income statement, the leasing of real estate on the German sites of Bayer AG to the hived-down operating business areas and service areas accounted for €139 million. The remaining sales of €94 million resulted from additional services performed almost exclusively for other Bayer Group companies, primarily in Germany. With only negligible exceptions, the sales revenues were generated in Germany.

After €184 million in cost of goods sold, of which depreciation and tax write-downs on the leased real estate accounted for €68 million, gross profit amounted to €49 million or 21 percent. The operating result was negative at minus €216 million, primarily due to administration expenses of €173 million as a result of Bayer AG's function as a holding company, and to charges of €87 million for the preparation and implementation of the spin-off, including the stock-market listing of LANXESS.

The non-operating result – which is comprised of income and expenses from investments in affiliated companies, interest income and expense, and other non-operating income and expenses – increased by €558 million to €508 million (2003: minus €50 million).

Income from investments in affiliated companies (net) was practically unchanged year on year at €435 million (2003: €437 million). While Bayer AG had to assume losses of €857 million on aggregate in 2003 under existing profit and loss transfer agreements, profit transfers in 2004 from companies with such agreements had a net €368 million positive effect, to which our subgroup management companies made the largest contributions. From Bayer Chemicals AG and Bayer MaterialScience AG alone – which together incurred write-downs of €263 million on property, plant and equipment in the previous year – we received €414 million and €343 million higher profit transfers, respectively. Bayer CropScience AG and Bayer HealthCare AG also improved their earnings by €124 million and €87 million, respectively. There was a negative trend in other income from affiliated companies, which comprises dividend payments from Bayer Group companies that do not have profit and loss transfer agreements with Bayer AG. This income was down from €1,329 million in the previous year to €38 million in 2004. Of the previous year's figure, however, €1,285 million consisted of a dividend payment by Bayfin GmbH out of retained earnings. Write-downs of investments in affiliated companies were relatively insignificant at €10 million (2003: €75 million), while net gains from the sale of investments in affiliated companies – after losses on such transactions were offset – remained steady at €39 million (2003: €40 million).

While interest income was up by a modest €7 million to €545 million (2003: €538 million), interest expenses grew considerably by €82 million to €748 million (2003: €666 million). Net interest expense thus rose by €75 million to €203 million (2003: €128 million). With interest rates practically unchanged from the previous year, the increase occurred mainly because liabilities to subsidiaries were higher on average during the year.

Of considerable benefit to earnings was the balance of the other non-operating income and expense, which was boosted by exchange gains. Following a €310 million net exchange loss in the previous year, a net exchange gain of €285 million was recorded in 2004. This was due mainly to the fact that, for the first time, derivative financial instruments are recognized together with the respective underlyings as closed positions and exchange losses are only recognized if they are not matched by gains. A further positive effect of €109 million resulted from the fact that following the hive-down of the operating business areas from Bayer AG, the company no longer incurred expenses for the interest component of pension obligations to retirees and former employees with vested rights. On the other hand, the previous year's figure contained a one-time gain of €61 million on sales of interest rate swaps. The balance of other non-operating income and expense improved by €635 million to €276 million (2003: minus €359 million).

Bayer AG recorded pre-tax income for 2004 of €292 million. The stated income tax expense of €18 million relates to other tax periods and foreign withholding taxes. Bayer AG had net income of €274 million. After an €836 million decline in assets as a result of the LANXESS spin-off and a €964 million transfer out of retained earnings, the balance sheet profit amounted to €402 million.

## Proposal for distribution of the profit

The Board of Management and Supervisory Board will propose to the Annual Stockholders' Meeting on April 29, 2005 that the balance sheet profit of €402 million be used to pay a dividend of €0.55 per share (730,341,920 shares) on the capital stock of €1,870 million entitled to the dividend for 2004.

## Asset and capital structure

Total assets of Bayer AG declined by €313 million, or 1.2 percent, in 2004, to €25.5 billion (2003: €25.8 billion). The spin-off of assets to LANXESS AG, which took effect on July 1, 2004, diminished total assets by €839 million. Adjusted for this effect, assets grew by €526 million, or 2.0 percent.

Noncurrent assets shrank by €223 million, or 1.3 percent, to 17.6 billion (2003: 17.8 billion). In line with Bayer AG's function as a holding company, they consisted primarily of investments, which, at €17.1 billion (2003: €17.3 billion), accounted for 67 percent of total assets as in the previous year. While property, plant and equipment showed a slight increase of €19 million, investments decreased by €242 million. Capital measures ahead of the LANXESS spin-off, as well as the spin-off itself, led to a €315 million net reduction in the value of investments in subsidiaries. There were net additions of €23 million to investments in affiliated companies. Loans increased by €50 million through the grant of profit-participating capital to Bayer-Pensionskasse VVaG.

In 2004, as in the previous year, current assets of Bayer AG, at €7.9 billion (2003: €8.0 billion) including deferred charges, accounted for 31 percent of total assets. Current assets were down by €90 million compared to 2003. Liquid assets, including marketable securities, declined by €400 million year on year to €1.3 billion (2003: €1.7 billion). However, receivables from subsidiaries and other receivables increased by €206 million and €104 million, respectively. Among other items, the increase contains an amount of €200 million from a convertible bond placed by LANXESS AG with Bayer AG on September 15, 2004. In connection with the LANXESS spin-off, receivables of €100 million were transferred to LANXESS AG.

Receivables from subsidiaries amounted to €5.9 billion (2003: €5.7 billion) on December 31, 2004. Along with intragroup liabilities of €9.0 billion (2003: €8.3 billion), they reflect Bayer AG's special function with regard to Group financing. Other receivables came to €0.8 billion (2003: €0.7 billion).

Liabilities grew by €0.7 billion to €18.0 billion (2003: €17.3 billion), with provisions accounting for €3.0 billion (2003: €3.2 billion) and other liabilities for €15.0 billion (2003: €14.1 billion).

Of the €235 million, or 7.4 percent, decline in provisions, €204 million related to provisions for exchange rate risks, for which – as already explained – losses from the valuation of currency items were matched by gains from opposite transactions. Provisions for pensions and other post-employment benefits fell by €55 million due to a decline in obligations to retirees and former employees with vested pension rights in connection with the hive-downs of the business and service areas.

Other liabilities rose by €0.9 billion, of which €0.7 billion resulted from an increase in allocation of funds to subsidiaries. After offsetting against intragroup receivables, net liabilities increased by €0.5 billion. External financial debt, particularly from increased utilization of commercial paper and European Medium Term Note programs, rose by €0.3 billion, while miscellaneous liabilities fell by €0.1 billion.

Stockholders' equity shrank by €0.9 billion compared to December 31, 2003. An increase of €274 million out of 2004 net income was offset by a decrease of €365 million due to the dividend payment for 2003 and, in particular, a net decline of €836 million as a result of the spin-off of assets and liabilities to LANXESS AG. Equity coverage of total assets fell by 3.3 percentage points to 29.5 percent (2003: 32.8 percent). The LANXESS spin-off accounted for 2.2 percentage points of this decline.

## Employees

Following Bayer AG's successfully completed transformation in 2003 into a management holding company and the related hive-down of business operations into legally independent companies, the number of employees amounted to 590 at the beginning of 2004. During the year, the workforce declined by 42 to 548. The decrease included 40 employees who transferred to LANXESS AG as a result of the spin-off. The average number of employees for 2004 amounted to 560 (2003: 19,398). Personnel expenses came to €88 million (2003: €1,302 million).

## Risk Management

Risk management is an integral part of all decisions and business processes in the Bayer Group. The management structure, the planning system, and the detailed reporting and information systems, in particular, form the basis for the organizational integration of risk management into business processes.

As the parent of a global group of companies, Bayer AG is exposed to a wide variety of risks in the course of its worldwide activities. Even before Germany's "Law on Corporate Supervision and Transparency" came into force on May 1, 1998, Bayer AG operated an effective system for identifying, communicating and dealing with risks at an early stage. The principles behind that system are spelled out in the Risk Management Guidelines valid throughout the Bayer Group. The goal is to identify the potential risks associated with our activities as early as possible by recording them in a central database, evaluate them according to set criteria, assess the possible quantitative and qualitative consequences of their occurrence, and take suitable measures to mitigate them. The various processes and instruments used, depending on the respective risk profile, are constantly being improved, supplemented and optimized in line with statutory requirements.

Reporting plays a key role in monitoring the economic risks of our everyday business. It must ensure that the business performance of individual Group companies is described and explained according to uniform guidelines. In addition to the data on which external reports are based, internal reports are produced each month to ensure that the Board of Management and the various management levels are fully alerted to possible risks in a timely fashion. Corporate accounting and controlling functions support these activities and work to increase the responsiveness and efficiency of the reporting system. Our risk management system is supported by monitoring and control mechanisms based on established standard software. These mechanisms are the subject of continuous improvement and are adjusted to changes in circumstances.

The internal audit department examines at regular intervals the risk management system's efficiency and functionality. Additionally, our external auditors regularly evaluate the system's functionality and brief the Board of Management and the Supervisory Board on the results of these evaluations. The Audit Committee of the Supervisory Board consults regularly on risk management.

As the parent company of a global enterprise with a diverse business portfolio, Bayer AG is exposed to numerous legal risks, particularly in the areas of product liability, patent disputes, tax assessments, competition and antitrust law, and environmental matters. 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 insurers' compensation payments and could significantly affect our revenues and earnings. Where legal risks relate to past events, we record the necessary provisions in the balance sheet and regularly review their appropriateness.

Legal proceedings currently considered to involve material risks to Bayer AG, either directly, or indirectly through subsidiaries, are outlined below. The litigation referred to does not necessarily represent an exhaustive list.

Over the course of the Lipobay/Baycol litigation, Bayer has been named as a defendant in approximately 14,660 cases worldwide (more than 14,550 of them in the United States). As of February 18, 2005, the number of Lipobay/Baycol cases pending against Bayer worldwide was 6,191 (6,111 of them in the United States, including several class actions). The decrease in the number of U.S. cases is attributable to various reasons, including voluntary dismissals by plaintiffs, dismissals based on settlements and court-ordered dismissals, such as for failure to satisfy procedural requirements. Several courts had entered orders requiring plaintiffs alleging injury from Baycol to furnish medical evidence of such injury according to a court-imposed schedule, and numerous cases have been dismissed for failure to provide such evidence. As of February 18, 2005, Bayer had settled 2,938 Lipobay/Baycol cases worldwide without acknowledging any liability and resulting in settlement payments of approximately US$ 1.114 billion. Bayer will continue to offer fair compensation to people who experienced serious side effects while taking Lipobay/Baycol on a voluntary basis and without concession of liability. After more than three years of litigation we are currently aware of fewer than 100 pending cases in the United States that in our opinion hold a potential for settlement, although we cannot rule out the possibility that additional cases involving serious side effects from Lipobay/Baycol may come to our attention. In addition, there could be further settlements of cases outside of the United States. In the 2003 fiscal year, Bayer recorded a €300 million charge to the operating result – exceeding the expected insurance coverage of approximately US$ 1.2 billion – taking into consideration expenses already incurred and quantifiable expenses expected in the future to be incurred in connection with the Lipobay/Baycol litigation risk. Further insurers have since acceded to the agreement concluded in the spring of 2004 under which the insurers have withdrawn the reservation of rights customary in these cases. Negotiations with one remaining insurer are ongoing. A €47 million charge to the operating result was recorded in 2004 in light of settlements already concluded or expected to be concluded and anticipated defense costs.

Bayer is a defendant in numerous product liability lawsuits relating to phenylpropanolamine (PPA). The first PPA lawsuits were filed after the U.S. Food and Drug Administration recommended in the fall of 2000 that manufacturers voluntarily cease marketing products containing this active ingredient. Since that time, Bayer and other manufacturers of PPA-containing products, along with several retailers and distributors, have been named in numerous lawsuits in the United States. Following the dismissal or withdrawal of many of these lawsuits, fewer than 850 cases remain pending against Bayer. Bayer is the sole defendant in approximately 550 cases and co-defendant together with other former manufacturers of PPA-containing products in approximately 300 cases. The majority of these cases are still at an early stage. Further dismissals are therefore possible, particularly should plaintiffs fail to comply with court orders requiring the submission of causative evidence. Currently, approximately 290 appeals have been filed by some of the plaintiffs whose suits were dismissed in the first instance on the grounds of procedural deficiency. Two PPA cases against Bayer have gone to trial so far. In the first case, in October 2004, a Texas jury awarded a plaintiff damages amounting to US$ 400,000. Bayer will appeal this decision. In the second case, in February 2005 in Utah, the jury returned a verdict in Bayer's favor. To date, the company has settled several cases without acknowledging liability. Based on the relatively small number of pending cases in which adequate factual records have been developed to permit a meaningful assessment, a provision taking into account existing insurance coverage was established in 2004 in the Group balance sheet for those cases where Bayer is considering settlement. This provision, in the amount of €16 million, is for possible settlements and further defense costs. It remains impossible, however, to reasonably estimate potential liability with respect to the balance of the pending PPA cases, so no provision has been recorded for them.

Bayer intends to vigorously defend the Lipobay/Baycol and PPA litigation. Since the existing insurance coverage is exhausted, it is possible – depending on the future progress of the litigation – that Bayer could face further payments that are not covered by the accounting measures already taken. We will regularly review the possibility of further accounting measures depending on the progress of the litigation.

Thirty-nine putative class action lawsuits, one individual lawsuit and one consumer protection group lawsuit against Bayer involving the medication Cipro® have been filed since July 2000 in the United States. The plaintiffs are suing Bayer and other companies also named as defendants, alleging that a settlement to end patent litigation reached in 1997 between Bayer and Barr Laboratories, Inc. violated antitrust regulations. The plaintiffs claim the alleged violation prevented the marketing of generic ciprofloxacin as of 1997. In particular, they are seeking triple damages under U.S. law. Bayer believes that it has meritorious defenses and will vigorously defend the litigation. Bayer believes the plaintiffs will not be able to establish that the settlement with Barr was outside of the scope of Bayer's valid Cipro® patent, which patent has been the subject of a successful re-examination by the U.S. Patent and Trademark Office and of successful defenses in U.S. Federal Courts.

Risks also exist in connection with investigations by the E.U. Commission and the U.S. and Canadian antitrust authorities for alleged anticompetitive conduct involving certain products in the rubber field. In two cases Bayer AG has already reached agreements with the U.S. Department of Justice to pay fines, amounting to US$ 66 million for antitrust violations relating to rubber chemicals and approximately US$ 5 million for those relating to acrylonitrile-butadiene rubber. Both these agreements have received court approval and the respective amounts have since been paid. Provisions of €50 million were established in 2003 for risks arising out of the E.U. Commission's investigation, although a reliable estimate cannot yet be made as to the actual amount of any fines. Bayer Corporation has reached agreement with the U.S. Department of Justice to pay a fine of US$ 33 million for antitrust violations in the United States relating to adipic-based polyester polyols. This fine, for which a provision has been established in the Group balance sheet, requires court approval. A similar investigation is pending in Canada, but it is not currently possible to estimate the amount of any fine that may result. A number of civil claims for damages have been filed in the United States, and a few in Canada, against Bayer AG and some of its subsidiaries. These lawsuits, involving allegations of unlawful collusion on prices for certain rubber and polyester polyol product lines, are still at a very early stage. The financial risk associated with all of the above litigation (with the exception of those criminal proceedings in which fines have already been imposed), including the financial risk of private claims for damages, is currently not quantifiable. The company expects that, in the course of the above-mentioned regulatory proceedings and civil damages suits, significant expenses will become necessary that may be of material importance to the company. In the United States, civil actions are also pending involving allegations of unlawful collusion on prices for polyether polyols and other raw materials for urethane products. These lawsuits are also at a very early stage. Under the Spin-Off and Acquisition Agreement with LANXESS, 30 percent of the provisions established for risks arising out of investigations into alleged anticompetitive conduct involving rubber products were transferred to LANXESS. According to the terms of the agreement, LANXESS' liability in this regard is limited to €100 million.

Business risks also include those pertaining to acquisitions, capital expenditures and research and development activities. These future-oriented activities are vital to the continued existence of the Group, yet they also harbor risks because of the related uncertainties. We control and mitigate operating risks by exercising due diligence prior to such activities and by tracking their progress. For example, we investigate whether budgets can be adhered to, whether original forecasts can be met, and whether additional financial or technological risks are likely to emerge.

In the course of its business, Bayer AG is exposed to foreign exchange and interest rate risks, which it hedges principally by using derivative financial instruments. It mainly uses over-the-counter (OTC) instruments, particularly forward rate contracts, currency options, interest rate swaps, and interest and principal currency swaps. Their use is generally confined to hedging the operating business and the related investments and financing transactions. The main objective is to reduce fluctuations in cash flows and earnings associated with changes in interest rates and foreign exchange rates.

There is a risk that the value of derivative financial instruments could decline as a result of fluctuations in related parameters such as exchange rates or interest rates. Where derivatives are used as hedges, possible declines in their value are offset by contrary movements in the value of the hedged transactions.

Where derivatives have a positive fair value, there is a credit or default risk arising from the fact that the counterparties may not be able to meet their obligations. To minimize this risk, all transactions are executed with banks of high credit standing. We also impose limit on the volume of business in derivative financial instruments transacted with individual parties.

The future success of our business depends on the dedication, motivation and skills of our employees. We must be capable at all times of attracting suitably qualified technical and managerial personnel, successfully integrating them into our operations and ensuring that they stay with us over the long term.

With this goal in mind, we offer our employees in-house education and training opportunities, as well as performance-oriented remuneration systems. To ensure that our employees act responsibly from both a professional and a legal point of view within their respective fields of work, we have promulgated a worldwide legal compliance program. Supported by thorough training, this behavioral code obligates employees to observe the relevant laws and regulations. Complying with the rules at all times and monitoring the way employees handle risks are among the basic duties of all managers and supervisors throughout the Group. Binding guidelines, instructions and manuals are distributed throughout the enterprise to help ensure that our employees act consistently and safely.

In addition to the risks described above, further risks could exist for our business that we are currently unaware of or currently regard as negligible.

## Outlook

With the spin-off and successful stock-market listing of LANXESS in January 2005, Bayer is now concentrating on the growth-oriented, innovation-driven health care, nutrition and high-tech materials businesses, as announced in the previous year. By strategically aligning itself to its core competencies, Bayer will invest more heavily in growth areas and innovative technologies in order to achieve leadership roles, or expand already strong market positions, in these attractive markets.

We expect to further improve the Bayer Group's operating performance in 2005, targeting an increase of more than 5 percent in currency- and portfolio-adjusted Group sales from continuing operations, to over €25 billion. We are confident that our operating result from this business before special items – as determined according to the International Financial Reporting Standards (IFRS) – will improve by roughly 20 percent year on year.

For the performance of its function as a management holding company, Bayer AG anticipates operating expenditures in line with those of 2004. Earnings will be increased by the absence of €87 million in one-time charges in connection with the LANXESS spin-off that diminished the operating result in 2004. A further positive effect in 2005 will be provided by income of approximately €180 million from the sale to LANXESS Deutschland GmbH of real estate used by LANXESS, which took place after the spin-off. Earnings of Bayer AG will also be affected by the balance of interest income and expense and by income and expense from investments in affiliated companies. If the earnings situation in the Bayer Group improves as expected, we expect to substantially increase net income of Bayer AG as a result of higher dividend income from subsidiaries.

## Subsequent Events

Upon its entry into the commercial register for Bayer AG on January 28, 2005, the spin-off of LANXESS AG from Bayer AG took legal effect retroactively from July 1, 2004. The spin-off is taken into account in Bayer AG's financial statements for 2004. The sale of real estate used by LANXESS at the Leverkusen, Dormagen, Uerdingen and Brunsbüttel sites to LANXESS Deutschland GmbH on January 29, 2005, will be reflected in the financial statements for 2005.

# Auditor's Report

We have audited the annual financial statements, together with the accounting system, and the management report of Bayer Aktiengesellschaft, Leverkusen, Germany, for the financial year from January 1 to December 31, 2004. The maintenance of the books and records and the preparation of the annual financial statements and management report in accordance with German commercial law are the responsibility of the Board of Management of Bayer AG. Our responsibility is to express an opinion on the annual financial statements, together with the accounting system, and the management report based on our audit.

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

Our audit has not led to any reservations.

In our opinion, the annual financial statements give a true and fair view of the net assets, financial position and results of operations of the Company in accordance with German generally accepted accounting principles. On the whole the management report provides a suitable understanding of the Company's position and adequately presents the risks of future development.

Essen, March 3, 2005

PwC Deutsche Revision
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

P. Albrecht
(Wirtschaftsprüfer)

V. Linke
(Wirtschaftsprüfer)

# Statements of Income

€ million

| | Note | 2003 | 2004 |
|---|---|---|---|
| **Net sales** | [1] | **5,224** | **233** |
| Cost of goods sold | | (4,204) | (184) |
| **Gross profit** | | **1,020** | **49** |
| | | | |
| Selling expenses | | (573) | (16) |
| Research and development expenses | | (202) | – |
| General administration expenses | | (306) | (173) |
| Other operating income | [2] | 122 | 27 |
| Other operating expenses | [3] | (135) | (103) |
| **Operating result** | | **(74)** | **(216)** |
| | | | |
| Income from investments in affiliated companies – net | [4] | 437 | 435 |
| Interest expense – net | [5] | (128) | (203) |
| Other non-operating income (expense) – net | [6] | (359) | 276 |
| **Non-operating result** | | **(50)** | **508** |
| | | | |
| **Income (loss) before income taxes** | | **(124)** | **292** |
| | | | |
| Income taxes | [7] | (61) | (18) |
| | | | |
| **Net income (loss)** | | **(185)** | **274** |
| | | | |
| Decline in assets due to the spin-off | | – | (836) |
| | | | |
| Allocation from retained earnings | | 550 | 964 |
| | | | |
| **Balance sheet profit** | | **365** | **402** |

# Balance Sheets

€ million

| | Note | Dec. 31, 2003 | Dec. 31, 2004 |
|---|---|---|---|
| Assets | | | |
| **Noncurrent assets** | | | |
| Intangible assets | [14] | 0 | 38 |
| Property, plant and equipment | [15] | 485 | 466 |
| Investments | [16] | 17,334 | 17,092 |
| | | **17,819** | **17,596** |
| **Current assets** | | | |
| Receivables and other assets | | | |
| Trade accounts receivable | [17] | 30 | 28 |
| Receivables from subsidiaries | [18] | 5,661 | 5,867 |
| Other receivables and other assets | [19] | 604 | 730 |
| | [20] | **6,295** | **6,625** |
| Marketable securities | [21] | 114 | 10 |
| Cash and cash equivalents | | 1,547 | 1,251 |
| | | **7,956** | **7,886** |
| | | | |
| **Deferred charges** | [22] | **62** | **42** |
| | | **25,837** | **25,524** |
| | | | |
| Stockholders' equity and liabilities | | | |
| **Stockholders' equity** | [23] | | |
| Capital stock | | 1,870 | 1,870 |
| Capital reserves | | 2,942 | 2,942 |
| Other retained earnings | | 3,290 | 2,326 |
| Balance sheet profit | | 365 | 402 |
| | | **8,467** | **7,540** |
| **Special item with an equity component** | [24] | **86** | **25** |
| | | | |
| **Provisions** | | | |
| Provisions for pensions and other post-employment benefits | [25] | 2,591 | 2,536 |
| Other provisions | [26] | 572 | 392 |
| | | **3,163** | **2,928** |
| **Other liabilities** | | | |
| Debentures | [27] | 5,340 | 5,360 |
| Liabilities to banks | | 37 | 39 |
| Trade accounts payable | [28] | 36 | 35 |
| Payables to subsidiaries | [29] | 8,286 | 8,951 |
| Miscellaneous liabilities | [30] | 417 | 643 |
| | [31] | **14,116** | **15,028** |
| | | | |
| **Deferred income** | | **5** | **3** |
| | | **25,837** | **25,524** |

# Notes to the Financial Statements

## Changes in corporate structure

All the former operating units of Bayer AG were carved out in 2003 with the exception of the CropScience business area, which had already been hived down into a legally separate company in 2002. The Health-Care, MaterialScience and Chemicals business areas together with Industry Services, Business Services and Technology Services were hived down from Bayer AG on different dates during 2003. Since October 1, 2003 Bayer AG has therefore been a management holding company without any business operations of its own. This limits the comparability of the figures shown in the income statements for 2004 and 2003.

The assets and liabilities of Bayer AG allocable or allocated to LANXESS were transferred to LANXESS AG effective July 1, 2004. As a consequence, the balance sheet of Bayer AG as of December 31, 2004 no longer contains the assets and liabilities relating to the LANXESS business area. The following table shows the assets and liabilities transferred to LANXESS as of July 1, 2004:

| Assets | July 1, 2004 |
|---|---|
| € thousand | |
| **Noncurrent assets** | |
| **Property, plant and equipment** | |
| Furniture, fixtures and other equipment | 11 |
| **Investments** | |
| Investments in Group companies | 738,839 |
| Other loans | 70 |
| | **738,909** |
| | **738,920** |
| **Current assets** | |
| **Receivables and other assets** | |
| Receivables from Group companies | 100,000 |
| Other assets | 36 |
| | **100,036** |
| | **838,956** |

| Stockholders' Equity and Liabilities | July 1, 2004 |
|---|---|
| € thousand | |
| **Stockholders' equity** | **836,248** |
| **Provisions** | |
| Provisions for pensions and other post-employment benefits | 2,023 |
| Miscellaneous provisions | 685 |
| | **2,708** |
| | **838,956** |

## Accounting policies

The financial statements of Bayer AG are prepared in accordance with the German Commercial Code (Handelsgesetzbuch) and Stock Corporation Act (Aktiengesetz).

Certain income statement and balance sheet items are combined for the sake of clarity, as explained in the Notes.

The income statement is drawn up by the cost-of-sales method. Research and development expenses are shown separately in the prior-year figures in view of their special importance in the chemical industry. Non-operating income and expenses whose disclosure is not covered by a mandatory item are stated under other non-operating income or expenses.

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

## Recognition and valuation principles

Intangible assets that have been acquired are recognized at cost and amortized on a straight-line basis over their estimated useful lives.

Property, plant and equipment is carried at the cost of acquisition or construction. Assets subject to depletion are depreciated. Write-downs are made for any declines in value that go beyond the depletion reflected in depreciation. Low-value assets are fully depreciated in the year of acquisition. Where permitted under the tax laws, depreciation is made by the declining-balance method at the highest rates possible, switching to the straight-line method as soon as this leads to higher depreciation.

| Useful Life of Property, Plant and Equipment | | | | |
|---|---|---|---|---|
| Factory, commercial and residential buildings | 25 | to | 50 | years |
| Outdoor infrastructure | 10 | to | 20 | years |
| Plant installations | 7 | to | 20 | years |
| Machinery and apparatus | | generally | 10 | years |
| Laboratory and research facilities | | | 5 | years |
| Storage tanks and pipelines | 12 | to | 20 | years |
| Vehicles | | | 5 | years |
| Computer equipment | 3 | to | 4 | years |
| Furniture and fixtures | 4 | to | 10 | years |

The cost of construction 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 of assets used in construction.

Investments in subsidiaries and affiliated companies are carried at cost, less write-downs for any decline in value that is expected to be permanent.

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

Receivables and other assets are stated at nominal value, less any necessary write-downs for amounts unlikely to be recovered.

Where the redemption value of liabilities exceeds their issue price, the difference is capitalized and amortized over the term of the liabilities.

Marketable securities are shown at the lower of cost or market as of the closing date.

Allocations to the special item with an equity component are made at the amounts permitted for tax purposes where tax recognition is subject to their inclusion in the accounting balance sheet.

Provisions for pensions and other post-employment benefits are computed by the actuarial method that takes tax regulations into consideration, based on a statutory discount factor of 6 percent and the life expectancy tables published in 1998.

Other provisions are established to cover all foreseeable risks and uncertain liabilities, based on reasonable estimates of such commitments as of the closing date. Provisions for maintenance are set up for maintenance work that has been deferred until the first three months of the following year. Provisions for expenses pursuant to Article 249, Paragraph 2 of the German Commercial Code are not established.

Other liabilities are carried at nominal or redemption value, whichever is higher.

Foreign currency receivables and payables are translated at the rates at which they were initially recorded or at the current year's closing rates, whichever yield the lower amounts for receivables or the higher amounts for payables. Foreign currency receivables and payables that are hedged are translated at the hedged rates. Cash and cash equivalents and bank balances held in foreign currencies are translated at the rate on the reporting date.

Contingent liabilities arising from sureties and debt guarantees, and amounts pledged as security for other parties' liabilities, are shown at the amounts equivalent to the loans or commitments actually outstanding as of the closing date.

## Notes to the Statements of Income

**[1] Net sales**

Net sales of Bayer AG declined from €5,224 million in 2003 to €233 million in 2004 as a result of the hive-downs of the remaining operating business areas and service areas of Bayer AG into legally separate companies in 2003. Sales now comprise only revenues of €139 million from the rental of real estate belonging to Bayer AG and €94 million from the provision of certain services. The sales recognized for Bayer AG in 2003 comprised amounts of €3,285 million for the MaterialScience business area and €1,076 million for the chemicals business area (before elimination of intragroup business in each case). The 2003 figure also included other sales revenue totaling €1,065 million, with the elimination of intragroup sales between the various business areas at Bayer AG diminishing sales by €202 million.

Germany accounted for virtually all of the €231 million in sales generated in 2004.

**[2] Other operating income**

| | 2003 | 2004 |
|---|---|---|
| € million | | |
| Gains from retirements of noncurrent assets | 1 | 4 |
| Income from the sale of trademarks and know-how | 20 | – |
| Reversals of unutilized provisions | 43 | 10 |
| Miscellaneous income | 58 | 13 |
| | **122** | **27** |

The revenues from sideline operations are offset against the corresponding cost of goods sold to more clearly reflect the earnings position. This resulted in net operating income of €1 million, while in fiscal 2003 the net result was an expense of €16 million, which was recognized in other operating expenses.

**[3] Other operating expenses**
Included in other operating expenses are those for allocations to provisions, write-downs and retirements of accounts receivable, losses on retirements of noncurrent assets, and donations. €87 million of the other operating expenses for 2004 was incurred in connection with the carve-out of LANXESS AG and preparations for its stock-market listing.

Allocations to the special item with an equity component pursuant to Article 6b of the German Income Tax Act (Einkommensteuergesetz) resulted in expenses of €1 million (2003: €1 million).

**[4] Income from investments in affiliated companies – net**

| | 2003 | 2004 |
|---|---|---|
| € million | | |
| Dividends and similar income | 1,329 | 38 |
| *of which €38 million (2003: €1,327 million) from subsidiaries* | | |
| Income from profit and loss transfer agreements | 268 | 792 |
| *of which €792 million (2003: €268 million) from subsidiaries* | | |
| Expenses from profit and loss transfer agreements | (1,125) | (424) |
| *of which €424 million (2003: €1,125 million) to subsidiaries* | | |
| Write-downs of investments in affiliated companies | (75) | (10) |
| Gains from the sale of investments in affiliated companies | 40 | 46 |
| Losses from the sale of investments in affiliated companies | – | (7) |
| | **437** | **435** |

The dividends and similar income of €38 million originates entirely from foreign subsidiaries. In 2003, €1,279 million related to domestic affiliates and €50 million to foreign affiliates.

Write-downs of investments in affiliated companies mainly include €7 million for Lion Bioscience AG. A write-down of €75 million on the investment in CuraGen Corporation, United States, was expensed in 2003.

Gains from the sale of investments in affiliated companies consist mainly of €21 million from the divestment of LANXESS Distribution GmbH to LANXESS Deutschland GmbH and €17 million from the liquidation of Bayer Trading Pte Ltd., Singapore. In 2003 this item mainly consisted of €31 million from the sale of Bayer's interest in the PolymerLatex Group to Soros Private Equity Investors, United States.

**[5] Interest expense – net**

| | 2003 | 2004 |
|---|---|---|
| € million | | |
| Income from other securities and loans included in investments | 12 | 3 |
| Other interest and similar income | 526 | 542 |
| *of which €233 million (2003: €236 million) from subsidiaries* | | |
| Interest and similar expenses | (666) | (748) |
| *of which €220 million (2002: €172 million) to subsidiaries* | | |
| | **(128)** | **(203)** |

€8 million of the other interest and similar income from subsidiaries originates from companies in the LANXESS Group. €5 million of the interest expense to subsidiaries relates to LANXESS.

**[6] Other non-operating income (expense) – net**

| | 2003 | 2004 |
|---|---|---|
| € million | | |
| Interest portion of the allocation to personnel-related provisions | (193) | (167) |
| Interest portion of the allocation to personnel-related provisions assigned to subsidiaries | 76 | 159 |
| Miscellaneous non-operating expenses | (312) | (19) |
| Miscellaneous non-operating income | 70 | 303 |
| | **(359)** | **276** |

The interest portion of allocations to personnel-related provisions, calculated on the basis of actuarial assumptions, was assigned proportionately to the subsidiaries hived down from Bayer AG in 2002 and 2003. This was agreed with these subsidiaries in the respective hive-down and transfer agreements and relates to retirees whose pensions continue to be paid by Bayer AG and to former employees with vested pension rights.

Currency translation resulted in a net exchange gain of €285 million in 2004. This is recognized in miscellaneous non-operating income. The net exchange loss of €310 million in 2003 is recognized in miscellaneous non-operating expenses. In 2004, for the first time, derivative financial instruments are recognized together with the respective underlyings as closed positions. This differs from the practice in 2003. Unrealized losses are only recognized if they are not offset by corresponding unrealized gains.

As well as exchange gains, the miscellaneous non-operating income includes gains of €8 million (2003: €6 million) from the sale of securities. In 2003 it also included a gain of €61 million from the sale of interest rate swaps. The greater part of the miscellaneous non-operating expenses in 2004 consists of a €15 million write-down on a loan.

**[7] Income taxes**
The taxes reflected here are corporate income tax, trade tax and income taxes paid outside Germany.

**[8] Other taxes**
Other taxes are included in the cost of goods sold, selling expenses, research and development expenses or general administration expenses wherever they can be allocated to these categories on the basis of accountability. In other cases they are assigned to other operating expenses. Other taxes for 2004 total €11 million (2003: €80 million).

### [9] Cost of materials

| | 2003 | 2004 |
|---|---:|---:|
| € million | | |
| Expenses for raw materials, supplies and goods purchased for resale | 2,016 | 5 |
| Expenses for purchased services | 124 | 22 |
| | **2,140** | **27** |

### [10] Personnel expenses

| | 2003 | 2004 |
|---|---:|---:|
| € million | | |
| Wages and salaries | 1,013 | 65 |
| Social expenses | 193 | 8 |
| Pension expenses | 96 | 15 |
| | **1,302** | **88** |

The personnel expenses shown here do not contain the interest portion of the allocation to personnel-related provisions, which is included in the non-operating result as other non-operating expense. These personnel-related provisions are mainly for employee pensions.

### [11] Number of employees

The average number of employees at Bayer AG declined from 19,398 to 560, due mainly to the hive-downs effected in 2003. On December 31, 2004 Bayer had 42 fewer employees than at the start of the year. After adjustment for the 40 employees who transferred to LANXESS when it was carved out, the total decline was 2.

| | Average 2003 | Closing date Dec. 31, 2003 | Average 2004 | Closing date Dec. 31, 2004 |
|---|---:|---:|---:|---:|
| Manufacturing | 12,723 | – | – | – |
| Marketing | 1,769 | – | – | – |
| Research and development | 1,107 | – | – | – |
| General administration | 3,799 | 590 | 560 | 548 |
| | **19,398** | **590** | **560** | **548** |

### [12] Valuation write-downs, depreciation for tax purposes

No write-downs were made in 2004. In addition to scheduled amortization and depreciation, write-downs of property, plant and equipment totaling €11 million were made in 2003 to reflect declines in value that went beyond the depletion reflected in depreciation. No depreciation was undertaken specifically for tax purposes in either 2004 or 2003.

### [13] Effects of valuation adjustments made for tax purposes

The net income for 2004 was increased by €32 million (2003: €22 million) as a result of accelerated depreciation for tax purposes and the net effect of allocations to, and partial reversals of, the special item with an equity component in 2004 and prior years. The higher income taxes that will be incurred as a result of these valuation adjustments will be spread over approximately 25 years and therefore will not materially affect net income for the individual years.

## Notes to the Balance Sheets

### [14] Intangible assets

| € million | Acquired concessions, industrial property rights, similar rights and assets, and licenses thereunder | Advance payments | Total |
|---|---|---|---|
| Gross carrying amounts, Dec. 31, 2003 | 3 | – | 3 |
| Capital expenditures | 37 | 1 | 38 |
| Retirements | (2) | – | (2) |
| **Gross carrying amounts, Dec. 31, 2004** | **38** | **1** | **39** |
| Accumulated amortization and write-downs, Dec. 31, 2003 | 3 | – | 3 |
| Amortization and write-downs in 2004 | – | – | – |
| Retirements | (2) | – | (2) |
| **Accumulated amortization and write-downs, Dec. 31, 2004** | **1** | **–** | **1** |
| **Net carrying amounts, Dec. 31, 2004** | **37** | **1** | **38** |
| Net carrying amounts, Dec. 31, 2003 | – | – | – |

### [15] Property, plant and equipment

| € million | Land and buildings | Furniture, fixtures and other equipment | Construction in progress and advance payments to vendors and contractors | Total |
|---|---|---|---|---|
| Gross carrying amounts, Dec. 31, 2003 | 2,457 | 17 | 6 | 2,480 |
| Capital expenditures | 79 | 2 | 3 | 84 |
| Retirements | (10) | (6) | – | (16) |
| Transfers | 5 | – | (5) | – |
| **Gross carrying amounts, Dec. 31, 2004** | **2,531** | **13** | **4** | **2,458** |
| Accumulated depreciation and write-downs, Dec. 31, 2003 | 1,980 | 15 | – | 1,995 |
| Depreciation and write-downs in 2004 | 101 | 1 | – | 102 |
| Retirements | (9) | (6) | – | (15) |
| **Accumulated depreciation and write-downs, Dec. 31, 2004** | **2,072** | **10** | **–** | **2,082** |
| **Net carrying amounts, Dec. 31, 2004** | **459** | **3** | **4** | **466** |
| Net carrying amounts, Dec. 31, 2003 | 477 | 2 | 6 | 485 |

**[16] Investments**

| € million | Investments in subsidiaries | Loans to subsidiaries | Investments in other affiliated companies | Loans to other affiliated companies | Other loans | Total |
|---|---|---|---|---|---|---|
| Gross carrying amounts, Dec. 31, 2003 | 15,115 | 2,100 | 195 | 3 | 96 | 17,509 |
| Additions | 894 | – | – | – | 53 | 947 |
| Retirements | (1,175) | – | (17) | – | (3) | (1,195) |
| **Gross carrying amounts, Dec. 31, 2004** | **14,834** | **2,100** | **178** | **3** | **146** | **17,261** |
| Accumulated write-downs, Dec. 31, 2003 | 4 | – | 163 | 2 | 6 | 175 |
| Write-downs in 2004 | 2 | – | 9 | – | – | 11 |
| Retirements | (1) | – | (16) | – | – | (17) |
| **Accumulated write-downs, Dec. 31, 2004** | **5** | **–** | **156** | **2** | **6** | **169** |
| **Net carrying amounts, Dec. 31, 2004** | **14,829** | **2,100** | **22** | **1** | **140** | **17,092** |
| Net carrying amounts, Dec. 31, 2003 | 15,111 | 2,100 | 32 | 1 | 90 | 17,334 |

To prepare for the spin-off of the LANXESS Group, which has since taken effect, a capital contribution of €450 million in cash was made at LANXESS Deutschland GmbH in June 2004 to enable it to acquire the assets allocable to LANXESS from the local Bayer organizations outside Germany and combine them under LANXESS Deutschland GmbH.

In Germany the respective LANXESS assets and liabilities were transferred from Bayer Chemicals AG and Bayer MaterialScience AG to LANXESS Deutschland GmbH. This impacted both additions to assets and retirements of assets by €289 million.

Effective July 1, 2004, the €739 million carrying amount of the investment in LANXESS Deutschland GmbH resulting from these two transactions was transferred to LANXESS AG. It is reflected in retirements of investments in subsidiaries.

Apart from the capital transactions undertaken in connection with the spin-off of LANXESS, intragroup capital transactions resulted in additions to investments totaling €148 million, including €67 million at Bayer (China) Ltd., €34 million at Erste K-W-A Beteiligungsgesellschaft mbH and €23 million at Bayer Türk Kimya Sanayi Ltd. Sti., Turkey. The acquisition of further shares in P.T. Bayer Indonesia led to an addition of €7 million.

Excluding the transfers to LANXESS Deutschland GmbH and LANXESS AG totaling €1,028 million, retirements of investments in subsidiaries amounted to €147 million. Alongside intragroup divestitures, spin-offs and transfers, they mainly relate to capital repayments of €41 million by Bayer Industry Services GmbH & Co. OHG and €13 million by Bayer (Proprietary) Ltd., South Africa. This item also includes €10 million from the liquidation of Bayer Trading Pte. Ltd., Singapore.

Retirements of investments in other affiliated companies mainly relate to the sale of shares in PPL Therapeutics plc, U.K. Additions to write-downs result from an impairment charge on the interest in Lion Bioscience AG.

Lists of Bayer AG's direct and indirect holdings have been included in the Commercial Register in Cologne.

Additions to other loans include €50 million in profit-participating capital granted to Bayer-Pensionskasse.

**[17] Trade accounts receivable**

| | Dec. 31, 2003 | Dec. 31, 2004 |
|---|---|---|
| € million | | |
| Accounts receivable from subsidiaries | 27 | 27 |
| *of which from companies in the LANXESS Group: €4 million* | | |
| Accounts receivable from other customers | 3 | 1 |
| | **30** | **28** |

**[18] Receivables from subsidiaries**

Receivables from subsidiaries comprise €627 million from companies in the LANXESS Group, including a receivable from a convertible bond in the nominal amount of €200 million issued by LANXESS AG on September 15, 2004. This matures on September 15, 2007. The bond carries a nominal interest rate of 6 percent. It may be converted into LANXESS shares between July 20, 2005 and July 20, 2007. Conversion is mandatory at the end of the term.

**[19] Other receivables and other assets**

| | Dec. 31, 2003 | Dec. 31, 2004 |
|---|---|---|
| € million | | |
| Accounts receivable from other affiliated companies | 11 | 3 |
| Other assets | 593 | 727 |
| | **604** | **730** |

The other assets as of December 31, 2004 include €284 million (2003: €252 million) that represents income earned in the fiscal year but not due to be received until after the closing date. This income consists of accrued interest.

Further items reflected in other assets include claims for tax refunds, payroll receivables, amounts for services rendered but not yet chargeable, and advance payments.

**[20] Receivables and other assets maturing in more than one year**

The total receivables and other assets amounting to €6,625 million (2003: €6,295 million) include €364 million (2003: €78 million) due after 2005. Of this, €355 million (2003: €71 million) comprises receivables from subsidiaries and €9 million (2003: €7 million) comprises other assets.

**[21] Marketable securities**

These are mainly bearer bonds. In 2003 the marketable securities included €100 million invested in units of special investment funds and €4 million in shares of SolarWorld AG, Bonn.

**[22] Deferred charges**

Deferred charges as of December 31, 2004 include a discount of €24 million (2003: €32 million) relating to bonds issued in April 2002. The remaining deferred charges are prepaid premiums for business insurance and prepaid rental and leasing charges.

**[23] Capital stock**
The capital stock changed as follows in 2004:

| € million | Dec. 31, 2003 | Dividend for 2003 | Income after taxes | Spin-off of LANXESS | Dec. 31, 2004 |
|---|---|---|---|---|---|
| Capital stock | 1,870 | | | | 1,870 |
| Capital reserves | 2,942 | | | | 2,942 |
| Other retained earnings | 3,290 | | (128) | (836) | 2,326 |
| Balance sheet profit | 365 | (365) | 402 | | 402 |
| | **8,467** | **(365)** | **274** | **(836)** | **7,540** |

The capital stock of Bayer AG is divided into 730,341,920 no-par bearer shares of a single class.

Authorized capital totaling €250 million was approved by the Annual Stockholders' Meeting on April 26, 2002. It expires on April 26, 2007. The authorized capital can be used to increase the capital stock by issuing new shares against cash contributions. The Board of Management is authorized to exclude subscription rights with respect to €100 million of this authorized capital; however, in this case the issue price of the new shares must not be significantly below the market price. Exclusion of subscription rights for a further €150 million is only possible in specific cases.

Further authorized capital in the amount of €374 million was approved by the Annual Stockholders' Meeting on April 27, 2001. This authorized capital, which expires on April 27, 2006, can be used to increase the capital stock by issuing new shares against non-cash contributions. Subscription rights for existing stockholders are excluded.

Conditional capital of €186.88 million existed on December 31, 2004. This capital may only be utilized to the extent necessary to issue the requisite number of shares as and when conversion or subscription rights are exercised by the holders of convertible bonds or of warrants conferring subscription rights, respectively, that may be issued by Bayer AG or a Group company in which Bayer AG holds a direct or indirect interest of at least 90 percent, through April 29, 2009.

**[24] Special item with an equity component**
The special item with an equity component for 2004 consists of gains from the sale of land and buildings allocated to this item under Article 6b of the Income Tax Act. €1 million (2003: €1 million) was added to this item in 2004.

**[25] Provisions for pensions and other post-employment benefits**
This item includes provisions for current and future pension entitlements.

It also includes commitments to former employees of the business areas and service companies hived down into separate legal entities and former employees who retired before July 1, 2002 or who left the company before this date and have vested pension rights. The respective companies reimburse Bayer AG for these expenses.

This item also includes commitments entered into under early retirement agreements.

### [26] Other provisions

| € million | Dec. 31, 2003 | Dec. 31, 2004 |
|---|---:|---:|
| Provisions for taxes | 186 | 204 |
| Miscellaneous provisions | 386 | 188 |
| | **572** | **392** |

Miscellaneous provisions include amounts for environmental protection measures, vacations, part-time working by older employees, annual bonuses, long-service awards to employees, the costs of preparing and auditing the annual financial statements, and other uncertain liabilities. It also includes anticipated losses, for example on currency and interest rate hedges. The decline in miscellaneous provisions is mainly due to the fact that risks relating to foreign currency valuations and hedging of interest rates are now only recognized if they cannot be offset against the corresponding gains on counter-transactions in closed positions.

### [27] Debentures

| € million | Stated rate % | Effective rate % | Dec. 31, 2003 | Dec. 31, 2004 |
|---|---:|---:|---:|---:|
| Eurobonds 2002/2007 | 5.375 | 5.515 | 3,000 | 3,000 |
| Eurobonds 2002/2012 | 6.000 | 6.108 | 2,000 | 2,000 |
| Bonds 2003/2004: private placement | 3.125 | 3.125 | 25 | – |
| Bonds 2003/2004: private placement | 3.180 | 3.180 | 50 | – |
| Bonds 2003/2005: private placement | 3.500 | 3.500 | 15 | 15 |
| Bonds 2003/2006: private placement | variable | variable | 250 | 250 |
| Bonds 2004/2005: private placement | 2.470 | 2.470 | – | 25 |
| Bonds 2004/2006: private placement | variable | variable | – | 50 |
| Bonds 2004/2008: private placement | 3.490 | 3.502 | – | 20 |
| | | | **5,340** | **5,360** |

On April 10, 2002 Bayer AG launched two Eurobond issues under its €8 billion European Medium Term Notes (EMTN) program. One of these issues, in the nominal volume of €3,000 million, carries a 5 3/8 percent coupon and has a term of 5 years, maturing in 2007. Interest is paid annually for the preceding year. The issue price was 99.402 percent. The other Eurobond issue has a nominal volume of €2,000 million and a term of 10 years, maturing in 2012. The bonds carry a 6 percent coupon. Again, all interest is paid annually for the preceding year. The issue price was 99.45 percent.

Bayer AG also issued bonds totaling €360 million (2003: €340 million) under its EMTN program as private placements. In 2003 these bonds were recognized under miscellaneous liabilities. The prior-year figures have been restated accordingly.

**[28] Trade accounts payable**

| | Dec. 31, 2003 | Dec. 31, 2004 |
|---|---|---|
| € million | | |
| Accounts payable to subsidiaries | 21 | 18 |
| *of which to companies in the LANXESS Group: less than €1 million* | | |
| Accounts payable to other suppliers | 15 | 17 |
| | **36** | **35** |

**[29] Payables to subsidiaries**
The payables to subsidiaries mainly comprise loans and overnight funds invested at Bayer AG by subsidiaries. €48 million of the payables relate to companies in the LANXESS Group.

**[30] Miscellaneous liabilities**
Miscellaneous liabilities are amounts due to third parties and comprise €314 million (2003: €50 million) arising from the utilization of a commercial paper program and €267 million (2003: €251 million) in accrued interest. This item also includes €18 million (2003: €11 million) in short-term capital investments and €12 million (2003: €17 million) in employees' income and church taxes held for paying over to the authorities.

**[31] Further information on other liabilities**
The other liabilities are due as follows:

| | Dec. 31, 2003 | | | Dec. 31, 2004 | | |
|---|---|---|---|---|---|---|
| € million | Maturing in 2004 | Maturing in 2005–2008 | Maturing after 2008 | Maturing in 2005 | Maturing in 2006–2009 | Maturing after 2009 |
| Debentures | 340 | 3,000 | 2,000 | 40 | 3,320 | 2,000 |
| Liabilities to banks | 3 | 13 | 21 | 6 | 25 | 8 |
| Trade accounts payable | 36 | – | – | 35 | – | – |
| Payables to subsidiaries | 8,286 | – | – | 8,951 | – | – |
| Miscellaneous liabilities | 417 | – | – | 643 | – | – |
| | **9,082** | **3,013** | **2,021** | **9,675** | **3,345** | **2,008** |

The total of other liabilities includes €269 million (2003: €253 million) representing amounts – mainly interest and payroll liabilities – attributable to the fiscal year but not due to be paid until after the closing date.

**[32] Contingent liabilities**
Contingent liabilities include sureties of €9 million (2003: €3 million), including €3 million (2003: €3 million) for subsidiaries.

Bayer AG guaranteed the CHF 400 million (€259 million) bond issue launched in April 2000 by its wholly owned subsidiary Bayer Ltd., Japan. The bond, which carries a 3.75 percent coupon, matures in 2005. Similar guarantees have been given to the creditors of USD 70 million (€51 million) in loans granted to Bayer (China) Ltd., and €65 million in loans granted to Bayer Capital Corporation, Netherlands.

Bayer AG has also guaranteed the following capital market instruments issued by Bayer Corporation, U.S.A.: USD 350 million (€257 million ) of 6.65 % Notes due in 2028; USD 200 million (€147 million) of 7.125 % Notes due in 2015; USD 250 million (€184 million) of Puttable Reset Securities (PURS[SM]) due in 2028 at the latest; and €460 million EMTN Notes with a coupon of 3.75 % due in 2009. Utilization of the Global Commercial Paper Program of Bayer Corporation, which is guaranteed by Bayer AG, amounted to USD 744 million (€546 million) at December 31, 2004. In addition, a USD 414 million (€304 million) guarantee exists with respect to a lease agreement concluded by Bayer Corporation.

Further guarantees totaling €248 million (2003: €90 million) were given to the creditors of other Group companies. Bayer AG's contingent liabilities from debt guarantees thus total €2,521 million (2003: €2,323 million).

In addition to the commitments outlined above, Bayer AG bears joint and several liability under Article 133 of the Companies' Reorganization Act for the liabilities of the business and service areas transferred to legally separate entities where such liabilities relate to the period prior to the transfers. The same applies to the liabilities of LANXESS AG, which was spun off effective July 1, 2004. Liability continues for five years from the effective dates of the respective transfers. The Spin-Off and Acquisition Agreement specifies that Bayer AG and LANXESS AG shall release the other party from those liabilities each has assumed as principal debtor under that Agreement. Bayer AG and LANXESS AG also signed a master agreement covering the apportionment of general liability and of specific liability for environmental contamination, antitrust violations and product liability.

**[33] Other financial commitments**
In addition to provisions, other liabilities and contingent liabilities, there are also other financial commitments.

Minimum non-discounted future payments relating to operating leases total €334 million (2003: €247 million), of which €243 million (2003: €130 million) relates to lease and rental agreements with subsidiaries. The entire latter amount pertains to the two real-estate companies KG III Augusta and Gigas, through which the Agricultural Center in Monheim is financed, and to Bayer Industry Services GmbH & Co. OHG. The commitments under lease and rental agreements mature as follows:

| Maturing in | |
|---|---|
| | € million |
| 2005 | 28 |
| 2006 | 26 |
| 2007 | 26 |
| 2008 | 25 |
| 2009 | 24 |
| After 2009 | 205 |
| | **334** |

Bayer AG has given an undertaking that it will provide Bayer-Pensionskasse with profit-participating capital totaling €150 million which can be utilized by December 31, 2010 at the latest. Of this amount, €100 million was drawn by 2004, so the potential future obligation is €50 million.

In the years 2000 to 2004, all employees were offered opportunities to participate in stock compensation programs, with different programs for different employee groups. All participants have the opportunity to receive free Bayer AG shares or equivalent cash payments over a ten-year period depending on their initial personal investments in the stock, which must be retained for a certain time. The allocation of these benefits to senior executives also depends on internal and external performance criteria which, if achieved, would trigger the corresponding financial commitments.

**[34] Derivative financial instruments**
Bayer AG uses derivative financial instruments principally to hedge foreign exchange and interest rate risks. It generally uses over-the-counter (OTC) instruments, particularly forward rate contracts, currency options, interest rate swaps, and interest and principal currency swaps. All transactions are executed with banks of high credit standing. The instruments are employed according to uniform guidelines and are subject to strict internal controls. Their use is generally confined to the hedging of the operating business and of the related investments and financing transactions. Derivative transactions are also carried out on the commodities markets. In these transactions, Bayer AG acts as the counterparty to hedge raw material and energy prices on behalf of Group companies. The main objective in using derivative financial instruments is to reduce fluctuations in cash flows and earnings associated with changes in interest rates, foreign exchange rates and market prices.

The notional amount of financial derivative contracts concluded with external counterparties was €10.9 billion on December 31, 2004 (2003: €8.9 billion). Back-to-back derivatives contracts in a notional amount of €4.0 billion (2003: €2.4 billion) were concluded with Group companies. The notional amounts of derivative financial derivatives totaled €14.9 billion (2003: €11.3 billion) on the closing date and were comprised as follows:

| € million | Notional amount | | Fair value | | Carrying amount | |
|---|---|---|---|---|---|---|
| | Dec. 31, 2003 | Dec. 31, 2004 | Dec. 31, 2003 | Dec. 31, 2004 | Dec. 31, 2003 | Dec. 31, 2004 |
| Forward rate contracts | | | | | | |
| Positive fair values | 2,327 | 2,937 | 154 | 105 | | |
| Negative fair values | 2,214 | 3,509 | (70) | (93) | | |
| | 4,541 | 6,446 | 84 | 12 | (59) | (60) |
| Currency options | | | | | | |
| Positive fair values | 130 | 115 | 11 | 10 | | |
| Negative fair values | 86 | 113 | (6) | (10) | | |
| | 216 | 228 | 5 | 0 | 0 | 0 |
| Interest/principal swaps | | | | | | |
| Positive fair values | 891 | 753 | 222 | 259 | | |
| Negative fair values | 872 | 734 | (265) | (302) | | |
| | 1,763 | 1,487 | (43) | (43) | (265) | (47) |
| Interest swaps | | | | | | |
| Positive fair values | 3,814 | 4,801 | 118 | 199 | | |
| Negative fair values | 924 | 447 | (7) | (20) | | |
| | 4,738 | 5,248 | 111 | 179 | (7) | (20) |
| Commodity futures | | | | | | |
| Positive fair values | – | 758 | – | 4 | | |
| Negative fair values | – | 758 | – | (4) | | |
| | – | 1,516 | – | 0 | – | 0 |
| | **11,258** | **14,925** | **157** | **148** | **(331)** | **(127)** |

To hedge currency risks Bayer AG mainly uses forward rate agreements, currency options and interest and principal swaps. Hedging is focused on operating business. To hedge the currency risk arising from receivables and liabilities at Group companies, futures contracts in a notional amount of €2.0 billion were concluded with external counterparties. Back-to-back transactions with Group companies total €1.2 billion. The net market value of these transactions is €27 million.

External forward rate agreements and currency options in a notional amount of €0.7 billion exist mainly to hedge planned sales. Back-to-back agreements in a notional amount of €0.6 billion are concluded with Group companies. These contracts have a negative net fair value of €3 million.

Currency risks relating to intragroup loans between Bayer AG and other Group companies are hedged through forward rate agreements and interest and principal swaps with a notional volume of €1.3 billion and a net market value on the closing date of €4 million. Further, the company has contracts in a notional amount of €2.6 billion with a total negative fair value of €59 million.

Interest rate swaps are mainly used to hedge the interest risk relating to bonds issued by Bayer AG. These comprise a notional amount of €4.0 billion and have a positive fair value of €167 million. Further interest swaps in a notional amount of €1.2 billion have a positive fair value of €12 million.

The external commodity futures contracts concluded for the first time in 2004 were passed on to Group companies on reflecting terms, so no income was derived.

The fair value of derivative financial instruments is derived from the price at which they are quoted or traded. If no market price is available, the value is determined using capital market pricing models. Wherever possible, derivative financial instruments are valued in closed positions with the corresponding underlyings, so no unrealized gains or losses had to be recognized. The positive fair value of €275 million (2003: €488 million) relating to the remaining derivatives was not recognized. Negative fair values totaling €127 million (2003: €331 million) are recognized in miscellaneous provisions.

## Total remuneration of the Board of Management and the Supervisory Board, advances and loans

The remuneration of the Board of Management comprises an annual base salary, a fixed supplement, and a variable bonus that is oriented to the achievement of defined gross cash flow targets for the Bayer Group. In addition, members of the Board of Management may participate in a cash-settlement-based stock option program provided that they place shares of their own in a special deposit account. The stock option program constitutes a further performance-related component of their compensation.

The total remuneration of members of the Board of Management in 2004 amounted to €6,518,626 (2003: €4,431,023), comprising €1,940,016 (2003: €1,945,293) in base salaries, €810,573 (2003: €303,383) in fixed supplements and €3,665,880 (2003: €2,081,169) in variable bonuses. Also included in the total is an aggregate €102,157 (2003: €101,178) of remuneration in kind, consisting mainly of amounts such as the value assigned for taxation purposes to the use of a company car. In the previous year, further remuneration of €159,623 was paid to members of the Board of Management who have since ceased to be members.

From the 2004 tranche of the stock option program, the members of the Board of Management received a total of 32,025 (2003: 30,300) stock options by virtue of their own investments. These options are blocked for the first three years. During the two-year exercise period thereafter, the holders will receive a cash payment not exceeding ten times their own investment, provided demanding performance criteria are met. The stock options from the 2004 tranche had a fair value of €31.53 each at December 31, 2004. Those from the 2003 tranche had a fair value of €36.08 each at December 31, 2003.

Emoluments to retired members of the Board of Management and their surviving dependents amounted to €9,917,575 (2003: €10,184,254).

Pension provisions for these individuals, amounting to €91,330,601 (2003: €93,375,261) are reflected in the balance sheet of Bayer AG.

The remuneration of the Supervisory Board amounted to €1,173,000 (2004: €752,250). Of this, variable components accounted for €153,000 (2003: €624,750).

There were no loans to members of the Board of Management or the Supervisory Board outstanding as of December 31, 2004, nor any repayments of such loans during the year.

## Proposal for Distribution of the Profit

The financial statements of Bayer AG show a balance sheet profit of €402 million. We propose that this amount be used to pay a dividend of €0.55 per no-par share on the capital stock of €1,870 million entitled to the dividend for 2004.

Leverkusen, March 1, 2005

Bayer Aktiengesellschaft
The Board of Management

# Supervisory Board and Board of Management

## Supervisory Board

**Hermann Josef Strenger**
Honorary Chairman, Leverkusen

Members of the Supervisory Board of Bayer AG hold or held offices as members of the supervisory board or a comparable supervising body of the corporations listed (as at December 31, 2004 or the date on which they ceased to be members of the Supervisory Board of Bayer AG):

**Dr. Manfred Schneider**
Chairman of the Supervisory Board, Leverkusen
* Dec. 21, 1938
Allianz AG
DaimlerChrysler AG
Linde AG (Chairman)
Metro AG
RWE AG
TUI AG

**Erhard Gipperich**
Vice Chairman of the Supervisory Board; Chairman of the Group and Central Works Councils of Bayer AG, Leverkusen
* April 30, 1942
Baywoge GmbH

**Dr. Paul Achleitner**
Member of the Board of Management of Allianz AG, Munich
* Sept. 28, 1956
Allianz Global Investors AG
Allianz Immobilien GmbH (Chairman)
MAN AG
RWE AG
ÖIAG *(until June 18, 2004)*

**Dr. Josef Ackermann**
Spokesman of the Board of Managing Directors and Chairman of the Group Executive Committee of Deutsche Bank AG, Frankfurt am Main
* Feb. 7, 1948
Deutsche Lufthansa AG
Linde AG
Siemens AG

**Karl-Josef Ellrich**
Chairman of the Works Council, Dormagen site
* Oct. 5, 1949
Bayer CropScience AG

**Thomas Hellmuth**
Agricultural Engineer, Langenfeld
* May 29, 1956

**Prof. Dr. Ing. e.h. Hans-Olaf Henkel**
President of the Leibniz Association, Berlin
* March 14, 1940
Continental AG
Deutsche Industriebank AG (IKB) *(until May 10, 2004)*
DaimlerChrysler Aerospace AG
SMS GmbH
Orange SA
Ringier AG

**Dr. h.c. Martin Kohlhaussen**
Chairman of the Supervisory Board of Commerzbank AG, Frankfurt am Main
* Nov. 6, 1935
Heraeus Holding GmbH
Hochtief AG (Chairman)
Infineon Technologies AG
Intermediate Capital Group
National Pensions Reserve Fund
Schering AG
ThyssenKrupp AG
Verlagsgruppe
Georg von Holtzbrinck GmbH

**John Christian Kornblum**
Chairman of Lazard & Co. GmbH, Berlin
* Feb. 6, 1943
ThyssenKrupp Technologies AG
Motorola Inc.

**Petra Kronen**
Chairman of the Works Council, Uerdingen site
* Aug. 22, 1964
Bayer MaterialScience AG
*(effective July 16, 2004)*

**Dr. Heinrich von Pierer**
Chairman of the Supervisory Board of Siemens AG, Munich
* Jan. 26, 1941
Hochtief AG
Münchener Rückversicherungs-Gesellschaft AG
Volkswagen AG

**Wolfgang Schenk**
Graduate Engineer, Leverkusen
* Sept. 24, 1953
Bayer CropScience AG

| Committees of the Supervisory Board of Bayer AG | |
|---|---|
| **Presidial Committee/Mediation Committee** | Schneider (Chairman), Gipperich, von Pierer, Schmoldt |
| **Audit Committee** | Kohlhaussen (Chairman), Henkel, Schenk, Schneider, Wendlandt, de Win |
| **Human Resources Committee** | Schneider (Chairman), Ellrich, Kohlhaussen, Kronen |

**Hubertus Schmoldt**
Chairman of the German Mine, Chemical and Power Workers' Union, Hannover
* Jan. 14, 1945
BHW AG
Deutsche BP AG
DOW Olefinverbund GmbH
E.ON AG
RAG AG *(effective May 28, 2004)*

**Dieter Schulte**
Former Chairman of the German Unions Federation, Duisburg
* Jan. 13, 1940
ThyssenKrupp AG
*(until January 23, 2004)*

**Dipl.-Ing. Dr.-Ing. e.h. Jürgen Weber**
Chairman of the Supervisory Board of Deutsche Lufthansa AG, Frankfurt am Main
* Oct. 17, 1941
Allianz Lebensversicherungs-AG
Deutsche Bank AG
Deutsche Post AG
Thomas Cook AG (Chairman)
Voith AG
Loyalty Partner GmbH (Chairman)
Tetra Laval Group

**Siegfried Wendlandt**
North Rhine District Secretary of the German Mine, Chemical and Power Workers' Union, Düsseldorf
* July 27, 1947
Baywoge GmbH
HT Troplast AG
Rütgers AG

**Reinhard Wendt**
Chairman of the Works Council of Wolff Walsrode AG, Walsrode
* March 6, 1945
Wolff Walsrode AG

**Thomas de Win**
Commercial Clerk, Cologne
* Nov. 21, 1958

**Prof. Dr. Dr. h.c. Ernst-Ludwig Winnacker**
President of the German Research Association (DFG), Bonn
* July 26, 1941
MEDIGENE AG
KWS Saat AG

**Dr. Hermann Wunderlich**
Former Vice Chairman of the Company's Board of Management, Odenthal
* April 29, 1932
Freudenberg & Co.
*(until June 26, 2004)*

## Board of Management

Members of the Board of Management hold or held offices as members of the supervisory board or a comparable supervising body of the corporations listed (as at December 31, 2004).

**Werner Wenning**
Chairman of the Board of Management
* Oct. 21, 1946
Gerling-Konzern Versicherungs-Beteiligungs-AG
Henkel KGaA

**Klaus Kühn**
* Feb. 11, 1952
Bayer CropScience AG (Chairman)
Bayer Business Services GmbH (Chairman) *(effective June 2004)*

**Dr. Udo Oels**
* Jan. 2, 1944
Bayer Chemicals AG (Chairman)
Bayer Industry Services Geschäftsführungs-GmbH (Chairman) *(effective May 2004)*
Bayer Technology Services GmbH (Chairman) *(effective June 2004)*
ThyssenKrupp Services AG

**Dr. Richard Pott**
* May 11, 1953
Bayer HealthCare AG (Chairman)
Bayer MaterialScience AG (Chairman) *(effective July 2004)*

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**Forward-Looking Statements**
These financial statements contain forward-looking statements. These statements use words like "believes", "assumes", "expects" or similar formulations. Various known and unknown risks, uncertainties and other factors could lead to material differences between the actual future results, financial situation, development or performance of our company and those either expressed or implied by these statements. These factors include, among other things:

- downturns in the business cycle of the industries in which we compete;
- new regulations, or changes to existing regulations, that increase our operating costs or otherwise reduce our profitability;
- increases in the price of our raw materials, especially if we are unable to pass these costs along to customers;
- loss or reduction of patent protection for our products;
- liabilities, especially those incurred as a result of environmental laws or product liability litigation;
- fluctuation in international currency exchange rates as well as changes in the general economic climate; and
- other factors identified in these financial statements.

These factors include those discussed in our public reports filed with the Frankfurt Stock Exchange and with the U.S. Securities and Exchange Commission (including our Form 20-F). In view of these uncertainties, we caution readers not to place undue reliance on these forward-looking statements. We assume no liability whatsoever to update these forward-looking statements or to conform them to future events or developments.

The financial statements and management report of Bayer AG for 2004 are published in the Bundesanzeiger and have been included in the Commercial Register in Cologne.