

**Assessment of the standing of KGHM Polska Miedź S.A.  
for financial year 2017,  
including an evaluation of the internal control, risk management  
and compliance systems and the internal audit function**

May, 2018

*Translation from the original Polish version. In the event of differences resulting from the translation,  
reference should be made to the official Polish version.*

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## **1. Introduction**

In accordance with section II.Z.10.1 of the „Best Practice for GPW Listed Companies” the Supervisory Board of KGHM Polska Miedź S.A. hereby presents an „Assessment of the standing of KGHM Polska Miedź S.A. for financial year 2017, including an evaluation of the internal control, risk management and compliance systems and the internal audit function”. This assessment was prepared based on documents submitted by the Management Board, discussions held with the participation of the Management Board and other individuals invited to attend meetings of the Supervisory Board, and also takes into account the financial statements and the reports of the Management Board on the activities of KGHM Polska Miedź S.A. and of the KGHM Polska Miedź S.A. Group, and based on the conclusions from the audit of the Company’s accounts by a Certified Auditor.

## **2. Economic results of KGHM Polska Miedź S.A. in 2017**

### **2.1 Mine and metallurgical production**

In 2017 extraction of ore (dry weight) amounted to 31.2 million tonnes, which was 0.8 million tonnes less than in 2016. The decrease in extraction in 2017 was due to limitation of work on statutorily free days due to the lower-than-planned processing of concentrates at the Głogów I Copper Smelter and Refinery and optimisation of concentrates inventories in the metallurgical plants.

Average copper content in extracted ore amounted to 1.50% and was at a level similar to that of 2016. In the case of silver in ore, content was higher by 3% and amounted to 47.8 g/t.

As a result the amount of copper in extracted ore was lower than in 2016 by 13.2 thousand tonnes of Cu and amounted to 466.8 thousand tonnes. The volume of silver in ore increased by 8 tonnes and amounted to 1 490 tonnes.

In 2017, 31.5 million tonnes of ore (dry weight) were processed (or 246 thousand tonnes less than in 2016). The lower amount of ore extracted by the mines directly affected the amount of copper in concentrate, which amounted to 419.3 thousand tonnes.

The production of concentrate (dry weight) decreased as compared to 2016 by 33 thousand tonnes (a decrease from 1 866 thousand tonnes to 1 833 thousand tonnes). The amount of silver in concentrate was higher than the amount produced in 2016 by 25 tonnes (an increase from 1 265 t to 1 290 t).

The production of electrolytic copper as compared to 2016 decreased by 13.6 thousand tonnes, or by 2.5%. The lower production of electrolytic copper was the result of bringing the Głogów I Copper Smelter and Refinery to full production capacity and to the breakdown in the recovery boiler which occurred on 3 October 2017 (on 30 October 2017 production commenced at the Głogów I Copper Smelter and Refinery). By supplementing own concentrate with purchased metal-bearing materials in the form of scrap, copper blister and imported concentrate, existing technological capacity was effectively used.

The production of other metallurgical products (silver, wire rod, OFE rod and round billets) derives from the level of electrolytic copper production and depends on the type of raw material used, and above all on market demand.

In comparison to 2016, the production of metallic gold increased by 3.5 thousand troy ounces, or 3%, and for the first time in the history of KGHM Polska Miedź S.A. reached the level of 117.3 thousand troy ounces. Metallic silver production was higher by 27 tonnes, closing the year at 1 218 tonnes.

### **2.2 Macroeconomic conditions in 2017**

In 2017 the average annual price of copper was 6 166 USD/t, or an increase compared to the prior year by 27%. The price of silver, which averaged 17.05 USD/ounce, decreased by 1%.

The average annual USD/PLN exchange rate (per the NBP) in 2017 amounted to 3.78 USD/PLN and was lower by 4% than the rate in 2016 (3.94 USD/PLN).

### **2.3 Sales**

In 2017, as compared to 2016, KGHM Polska Miedź S.A. recorded a decrease in the sales volume of copper products by 53.8 thousand tonnes (10%), as a result of lower electrolytic copper production. Sales of cathodes

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were lower by 12.9 thousand tonnes (5%) as well as of copper wire rod and OFE rod by 5.2 thousand tonnes (2%).

Sales of metallic silver in KGHM Polska Miedź S.A. in 2017 amounted to 1 185 tonnes and were similar to the level of sales in 2016 (1 189 t), although in 2016 there additionally occurred a sale of silver in concentrate (91 t). The volume of gold sales in 2017 amounted to 117.1 thousand troy ounces, or an increase by 4% as compared to 2016 (112.5 thousand troy ounces).

Total sales revenue of KGHM Polska Miedź S.A. in 2017 amounted to PLN 16 024 million and were higher by 6% than revenues achieved in 2016 (PLN 15 112 million), mainly due to the increase in copper prices expressed in the Polish zloty.

Revenues from copper sales in 2017 amounted to PLN 12 213 million and were higher than sales in the prior year by 10% (PLN 11 064 million in 2016). Revenues from silver sales in 2017 amounted to PLN 2 447 million and were lower by 6% as compared to the level of sales in 2016. Revenues from gold sales were at the same level as in 2016 (PLN 556 million). The decrease in revenues from silver sales was mainly due to the decrease in the price of this metal expressed in the Polish zloty as compared to 2016.

### **2.4 Cost of sales, selling costs and administrative expenses**

The Company's cost of sales, selling costs and administrative expenses (cost of products, merchandise and materials sold plus selling costs and administrative expenses) in 2017 amounted to PLN 12 889 million and was 3% higher as compared to 2016, mainly due to a higher minerals extraction tax and a higher value of consumed metal-bearing materials purchased.

Total expenses by nature in 2017 were higher by 9% as compared to 2016 and amounted to PLN 13 924 million with a similar structure.

The cost of producing copper in concentrate (C1) was as follows: in 2016: 1.30 USD/lb and in 2017: 1.52 USD/lb. The cost was impacted by a strengthening in the PLN as compared to the USD, a higher minerals extraction tax and lower production of own concentrate.

### **2.5 Financial results**

The Company recorded a profit for 2017 in the amount of PLN 1 323 million, which resulted among others from impairment losses on assets in the amount of PLN 966 million.

The improvement in the result by PLN 5 408 million compared to the result in 2016 (a loss of -PLN 4 085 million) was mainly due to lower impairment losses on assets by PLN 5 290 million, mainly with respect to shares in subsidiaries and the loans granted to them.

Other key factors impacting the change in the result compared to 2016 were:

- the increase in sales revenue by PLN 899 million excluding the impact of hedging transactions, comprised of:
  - an increase in revenues by PLN 2 395 million due to higher copper and gold prices, alongside lower silver prices,
  - a decrease in revenues due to the sale of copper concentrate by PLN 696 million,
  - a decrease in revenues by PLN 565 million from the sale of basic products (Cu, Ag, Au) due to a less favourable average annual USD/PLN exchange rate,
  - a decrease in revenues by PLN 354 million due to lower volumes of copper and silver sales alongside an increase in gold sales,
  - an increase in revenues by PLN 119 million from the sale of merchandise and other goods and services, including the value of third party processing of concentrate into cathodes (+59 million PLN) and higher sales of refined lead (+PLN 43 million),
- an increase in the cost of sales, selling costs and administrative expenses (excluding impairment losses) by PLN 416 million, including a higher minerals extraction tax by PLN 163 million,
- the impact of hedging transactions (-PLN 171 million), adjustments to sales revenue (+PLN 13 million) and the measurement and realisation of derivatives (-PLN 184 million),

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- a decrease in the balance of income and costs due to interest on borrowings, including fees and commissions by PLN 96 million,
- an increase in income tax by PLN 121 million.

## **2.6 Assets, equity and liabilities**

As at 31 December 2017, total assets amounted to PLN 30 947 million, or an increase as compared to the end of 2016 by PLN 847 million, or by 3%, mainly due to:

- a decrease in receivables due to loans granted by PLN 2 349 million, mainly due to:
  - reallocation (described below) of an impairment loss on assets (-PLN 1 368 million),
  - exchange differences (-PLN 1 153 million),
  - recognition of an impairment loss (-PLN 606 million),
  - loans granted (+PLN 499 million),
  - accrued interest (+PLN 298 million),
- an increase in investments in subsidiaries and joint ventures (+PLN 1 011 million), mainly due to reallocation of an impairment loss (+PLN 1 368 million) due to impairment of the value of the investment in KGHM INTERNATIONAL LTD. understood as the total value of shares in the company Future 1 Sp. z o.o. and the value of loans granted to Future 1 Sp. z o.o. and KGHM INTERNATIONAL LTD. Detailed information on the reallocation may be found in note 6.1 of the financial statements for 2017 .
- an increase in inventories (+PLN 1 131 million), mainly half-finished products (primarily own concentrate) and work in progress (+PLN 1 136 million).

The largest changes in equity and liabilities mainly comprised:

- an increase in equity by PLN 1 356 million, including with respect to the profit for 2017 in the amount of PLN 1 323 million,
- a decrease in borrowings and cash pool liabilities by PLN 764 million, due to exchange rate differences (-PLN 1 316 million), cash flows (+PLN 352 million) and accrued interest (+PLN 194 million),
- an increase in employee benefits liabilities by PLN 217 million and trade payables by PLN 340 million ,
- alongside a decrease in tax liabilities by PLN 220 million and derivatives by PLN 180 million.

## **3. Key events in 2017**

### **3.1 Review of the Strategy**

At the beginning of 2017, activities continued which were commenced in 2016 related to updating the Strategy of KGHM Polska Miedź S.A., based on a decision of the Company's Management Board that a revision was required. The need to update the Strategy was mainly dictated by changes in the macroeconomic environment at the turn of 2015/2016 which made it impossible to achieve the goals of the Strategy from 2015. As a result of the work of the Team appointed in April 2016 (with a change in its composition in July) to review and develop an update of the Strategy of KGHM Polska Miedź S.A., the document „Strategy of KGHM Polska Miedź S.A. for the years 2017-2021 with an outlook to 2040” was developed, which on 11 May 2017 was adopted by resolution of the Company's Supervisory Board. On the same day the Strategy was made public.

The primary goal of the Strategy adopted in May 2017 is focused on economic criteria – EBITDA at the level of PLN 7 billion in 2021 as well as an EBITDA margin for the Group exceeding 20% on average in the years 2017-2021. Results subsequent to 2017 were better than those originally assumed for this year – EBITDA for the Group was superior to the targeted amount by over 23%, while in turn the EBITDA margin was better by 3.6 percentage points than the target. There was however an unfavourable discrepancy from the plan in the case of production data – the largest shortfall compared to the plan, at the level of 10.5%, was in the case of metallurgical production from own concentrate and was due to the breakdown in the recovery furnace at the Głogów Copper Smelter and Refinery.

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The mission and vision at present are focused on quality-related aspects, and to a large extent are related to achieving the idea of sustainable development. For this reason the year 2017, following adoption of the Strategy, was a year of actions aimed at developing the concept of sustainable development (SD). In August 2017, a Team was appointed to develop a concept and model to manage sustainable development in KGHM Polska Miedź S.A. In November the „Concept and model to manage sustainable development” developed by the Team was accepted by the Company’s Management Board. The senior staff of the Head Office as well as of the Divisions reviewed the principles of the Concept. In addition, training workshops were organised to instruct employees with the assumptions and goals of the SD concept. In 2017, a variety of internal actions were also undertaken to strengthen KGHM as a Company operating in accordance with the principles of sustainable development, among others in December 2017 a Partnership agreement was signed with the Ministry of Development to achieve the goals of sustainable development.

An important change made in the context of managing the Company’s Strategy is to select Strategic Programs from amongst the defined projects and tasks. The selection of these Programs, which are aimed at achieving the key goals of KGHM’s Strategy by assigning to them a strategic character, enables attention to be focused on tasks which create the greatest value for the Company. It also allows for their more effective management and the monitoring of progress. To date, four Strategic Programs have been established: the Program to adapt the technological installations of KGHM to BAT Conclusions for the non-ferrous metals industry together with restricting arsenic emissions (BATAs); the Metallurgy Development Program; the Deposit Access Program; and the KGHM 4.0. Program. In 2018 further programs are expected to be established, comprising projects and tasks defined by the Strategy.

At the end of 2017 key challenges in achieving the Strategy in the coming year are to:

- improve the level of electrolytic copper production from own concentrate in Poland:
  - further improvement in furnace efficiency to achieve target production capacity.
  - start-up of the concentrate roasting installation by year’s end.
  - manage copper concentrate inventories.
- implement the first group of actions aimed at eliminating bottlenecks at the Sierra Gorda mine:
  - increase daily processing of ore to the target level of 130 thousand tonnes in 2019.
- prepare / advance key investments:
  - further expansion and development of mining infrastructure.
  - expansion of the Żelazny Most Tailings Storage Facility.
  - commencement of construction of a revolving-casting-refining (RCR) furnace for processing anode copper at the Legnica Copper Smelter and Refinery.

### **3.2 Capital expenditures**

In 2017, capital expenditures on property, plant and equipment amounted to PLN 2 057 million (including expenditures incurred on uncompleted development work of PLN 4 million and external financing costs of PLN 61 million).

Around 54% of expenditures were incurred to advance projects related to the replacement of equipment maintaining mine production in the core production line, and were aimed at maintaining mine production at the planned level.

The remaining expenditures in 2017 were incurred on development projects affecting the core production line, production volume, the implementation of activities optimising the use of existing infrastructure, maintaining production costs and adaptation of the company’s operations to changes in standards, laws and regulations.

In 2017, the Supervisory Board gave particular attention to overseeing the following development projects:

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The <b>Żelazny Most</b> project ensuring the ability to store flotation tailings after 2016 (in 2017 expenditures)	Advancement of the ŻM project is a priority due to the need to ensure the continuity of the Company’s production assets in Poland by ensuring the ability to store flotation tailings in future.
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incurred amounted to PLN 246 million)	<p>Work continued on developing and securing the southern crown of the existing facility, as well as procedures related to preparing terrain for construction of the Southern Quarter.</p> <p>Work was completed on development of an Executory Project for the Southern Quarter and a base project for the Tailings Segregation and Thickening Installation, enabling the utilisation of mine tailings for development of the Żelazny Most Tailings Storage Facility, was developed.</p> <p>A tender announcement was published and procedures were commenced to select a contractor for the Southern Quarter.</p> <p>Approval was received for the environmental impact statement of the Southern Quarter and an application was submitted for a building permit.</p>
<b>Outfitting of the mines</b> (in 2017 expenditures of PLN 220 million were incurred, including PLN 21 million on the Deposit Access Program)	Investments being carried out in the mines are related to developing the infrastructure of the mining regions, ventilation and air conditioning equipment and investments in conveyor belt and pipe transport.
<b>Replacement of the machinery park in the mines</b> (in 2017 expenditures of PLN 237 million were incurred, including expenditures of PLN 230 million in the replacement category)	With respect to modernisation and replacement of mining machinery, 207 pieces of mining equipment were purchased (in the replacement category).
<b>Deposit Access Program – DAP (previously GGP)</b> (in 2017 total expenditures of PLN 311 million were incurred on the project)	<p>Work under the program includes projects related to the development of mine infrastructure (development and access works and mine work and infrastructure required to outfit these areas).</p> <p>Work continued on the sinking of the <b>GG-1 shaft</b> (material-transport, as well as providing ventilation). The shaft's target depth is 1 350 meters with a diameter of 7.5 meters. The shaft has reached a depth of 1070 meters.</p> <p>Preparatory work continued related to obtaining construction permits for <b>construction of the GG-2 („Odra”) shaft complex</b>.</p> <p>Contracts were signed for construction of the <b>Surface-based Central Air Conditioning System at the GG-1 shaft</b> and the <b>Ice Water Transportation System</b>. Design concepts were developed for the ice water transportation system and for stage 1 of the SAS air conditioning station.</p> <p>In 2017, 12 084 meters of tunneling was built in the Rudna and Polkowice-Sieroszowice mines. Also in 2017, a total of 46.5 km of access and preparatory tunneling were built (total investment and other costs) in the Rudna and Polkowice-Sieroszowice mines, representing nearly 79.45% of total access and preparatory tunneling built in KGHM in the Rudna, Polkowice-Sieroszowice and Lubin mines (a total of 58.5 km).</p> <p>Ore extraction in 2017 from the GGP region (mining in the G-25 section of the Rudna mine and drift work carried out through the GU department) amounted to 1 638 thousand tonnes of copper ore, dry weight.</p> <p>Metal grades in the GGP region in KGHM in total in 2017 averaged as follows: 1.60% of copper and 77.5 g/t of silver.</p>

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**Pyrometallurgy  
Modernisation Program**

In 2017, the final stage of the PMP project was advanced – Guarantee tests were performed and the start-up phase of the Flash Furnace installation was carried out, during which the actions performed included regulating equipment, ensuring the proper functioning of individual installations as well as checking their parameters (including efficiency) and comparing them to the target parameters, and achieving the required efficiency of the entire installation for the appropriate concentrate mix.

Work continues on eliminating minor irregularities, optimising the settings of automated devices and security issues.

Assembly of equipment continued which can be carried out in parallel with the functioning of the production line, including completion of construction of the converter furnaces dedusters and handover for start-up of the installation for preparing de-lead slag. Settlement and handover of the investment is underway.

In 2017, the flash furnace installation at the Głogów I Copper Smelter and Refinery achieved an efficiency of 79.5% of target efficiency.

Average accrued efficiency of concentrate processing in the new flash furnace in 2017 was 104.9 t/h and 103.8 t/h (designed capacity of 132 t/h) for the entire period to date from start-up (i.e. since 15 October 2016). Taking into account target efficiency (132 t/h), the figure of 104.9 t/h represents 79.5% of target efficiency. Processing efficiency in the new flash furnace will increase after the start-up and stabilisation of the concentrate roasting installation (third quarter 2018)

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**Metallurgy Development  
Program**

Construction and assembly work continued on technological links under the program's key investment tasks, i.e. construction of a Steam Drier at the Głogów II Copper Smelter and Refinery and a copper concentrate roasting installation, whose planned start-up is in the third quarter of 2018.

Work continues on the realisation, settlement and handover of projects related to adapting technical infrastructure to the change in technology at the Głogów I Copper Smelter and Refinery, based on implementing technical and technological activities with respect to:

- replacement of property, plant and equipment,
- ensuring compliance with EU laws and other legal requirements,
- adapting energy, roadway and other infrastructure at Głogów I, and
- providing power supply, remote control and lighting to existing facilities and equipment at Głogów I.

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**3.3 Pyrometallurgy Modernisation**

In 2017, during operation of the flash furnace at Głogów I, while endeavoring to achieve optimal operating parameters by the installation, events occurred which could not be anticipated while advancing the **Pyrometallurgy Modernisation Program**.

Consequently, the deadlines for handing over some of the key projects under the PMP were altered.

As a result of applying modern technical and technological solutions used in constructing the production line, the concentrate roasting installation was not commissioned, which is the final link in the production line, enabling the achievement of nominal processing efficiency for own concentrate. To bring the copper concentrate roasting installation Cu at the Głogów I Copper Smelter and Refinery on line, it is necessary to modify the installation.

On 3 October 2017 an accident occurred involving the **Recovery Boiler** at the Głogów I Copper Smelter and Refinery, caused by the flaking of sinter from the throat which resulted in a break in the seal, in turn causing a decrease in copper production at the Głogów Copper Smelter and Refinery in 2017. Eliminating the effects of this breakdown and the modernisation work performed aimed at avoiding similar breakdowns in future lasted until 30 October 2017. Since that moment Głogów I has been successively working to attain optimum production capacity.

As at 31 December 2017, production by the flash furnace production line of Głogów I was stabilised. Final settlement and handover of contracts and orders for the Pyrometallurgy Modernisation Program are underway.

Currently in progress are audits and expert reviews of the installation, which are aimed at determining the reasons for the interruptions and developing management action plans. Once the results of these activities have been reviewed, appropriate decisions will be taken which will reduce the risk of such breakdowns occurring in future and will ensure the continuations of the installation's planned efficiencies in 2018.

### **3.4 Situation in the international assets**

#### **Sierra Gorda mine in Chile**

Production of copper in concentrate in 2017 amounted to 97.1 thousand tonnes, while production of molybdenum in concentrate amounted to 35.7 million pounds (on a 100% basis).

In 2017, work was performed to optimise the processing of the sulphide ore. The actions taken were aimed at stabilising the volume and technological parameters of the sulphide ore processing process. The tasks performed focused on stabilising the processing installation and increasing metal recovery.

During 2017 substantial progress was achieved in terms of the efficiency of ore processing. In the fourth quarter of 2017 average monthly molybdenum recovery was 66%.

At present work is aimed at developing the mine by actions aimed at optimising the production line, which should lead to increased production capacity.

In 2017, the nature of the financing changed from project finance to corporate credit, which significantly decreased the limitations and duties of Sierra Gorda S.C.M., and in particular it enhanced the flexibility of the operating and financial activities of Sierra Gorda S.C.M.

Moreover, the documentation related to financing was modified, including guarantees issued by Sumitomo Metal Mining Co., Ltd. and Sumitomo Corporation, and their term of validity was maintained up to the end of the financing period, that is to 15 June 2021, since the Sierra Gorda S.C.M. mine did not achieve on-time part of the parameters specified in the original financing agreement. These changes came into force on 30 June 2017.

The condition precedent to the issuance of the aforementioned guarantees was the granting of a re-guarantee of repayment of a specified part of payment by KGHM towards Sumitomo Metal Mining Co., Ltd. and Sumitomo Corporation. On 30 June 2017, the Management Board of KGHM granted permission to issue a re-guarantee of repayment of a specified part of payment, if it is made by Sumitomo Metal Mining Co., Ltd. and Sumitomo Corporation towards the financing banks, in the amount equal to the pro rata share of KGHM, but no more than the amount of USD 180 million. As at 31 December 2017, the value of the financing from the loan agreement amounts to around USD 710 million.

#### **Operating assets of KGHM International**

In 2017, the production assets of KGHM International (excluding Sierra Gorda) produced in total 81 thousand tonnes copper, 1.1 thousand tonnes of nickel, 1.6 tonnes of silver and 74 thousand ounces of gold, palladium and platinum.

With respect to actions undertaken to date aimed at further development of the production assets of KGHM International, the basic technical and economic assumptions of the production assets were updated. In the Robinson mine, in 2017 a variety of technical work was performed which enabled prolongation of the mine's life by 2 years through the planned mining of the area Ruth West 5.

### **3.5 Occupational health and safety in KGHM Polska Miedź S.A. in 2017**

In 2017, the Company recorded a decrease in the total number of workplace accidents (as defined by the Act dated 30 October 2002 on social insurance due to workplace accidents and occupational illnesses), with a year-on-year decrease from 370 to 300 injured (-70). In particular, there was a significant drop in the number of accidents in the Company's mining divisions. The number of workplace accidents in the mines of KGHM Polska Miedź S.A. in 2017 amounted to 235 injured, as compared to 318 events in 2016 (-83). Most of the accidents (approx. 98%) involved light injuries, mainly caused by loss of balance by employees, contact (striking) by or through moveable/immovable objects, falling rocks, and injuries caused by the use of workplace tools.

In 2017, there was a decided drop in the number of accidents related to major threats from the rockmass, which are associated with the underground mining of copper ore deposits in the mines of KGHM Polska Miedź S.A. As compared to 2016, the number of those injured in this regard was lower by 60.4 %. The ratio LTIFR<sub>KGHM</sub> (Lost Time Injury Frequency Rate KGHM), or the total number of workplace accidents (as defined by the Act on social insurance due to workplace accidents and occupational illnesses) being the number of accidents per million hours worked for the entire core business of KGHM Polska Miedź S.A., decreased substantially in 2017 and amounted to 10.40 (2016 = 12.7).

In 2017, the Company continued work involving implementation of the multi-year Program to Improve Occupational Health and Safety in KGHM Polska Miedź S.A., adding new initiatives. The program is an element of the updated strategy of KGHM Polska Miedź S.A. for the years 2017 – 2021 with an outlook to 2040. The Company intends to continue its efforts to achieve the long-term vision of „Zero accidents due to personal and technical reasons, zero occupational illnesses among our employees and contractors”.

It should also be pointed out that, over the long term, i.e. since 2010, the number of workplace injuries in KGHM Polska Miedź S.A. decreased from 556 to 300 (a drop of 46%), while the ratio LTIRF<sub>KGHM</sub> decreased by around 44%, from 18.6 to 10.4).

## **4. 4. Assessment of the risk management system in the Company in 2017**

The KGHM Polska Miedź S.A. Group defines risk as uncertainty, being an integral part of the activities conducted and having the potential to result in both opportunities and threats to achievement of the business goals. The current, future, actual and potential impact of risk on the KGHM Polska Miedź S.A. Group's activities is assessed. Based on this assessment, management practices are reviewed and adjusted in terms of responses to individual risk factors.

Under the Corporate Risk Management Policy and Procedure updated in 2017 and the Rules of the Corporate Risk and Compliance Committee, the process of corporate risk management in the Group is consistently performed. In 2017, the companies of the Group updated rules and procedures regulating the management of corporate risk which are consistent with those of the Parent Entity. KGHM Polska Miedź S.A. oversees the process of managing corporate risk in the Group. Each year, the process of managing corporate risk is subjected to an efficiency audit (compliant with the guidelines of Best Practice for WSE Listed Companies 2016).

Risk factors in various areas of the Group's operations are continuously identified, assessed and analysed in terms of their possible limitation. Key risk factors in the Group undergo in-depth analysis in order to develop a Risk Response Plan and Corrective Actions. Other risk factors undergo constant monitoring by the Department of Corporate Risk Management, Compliance and Continuity of Operations, and in terms of financial risk by the division of the Executive Director for Finance and Risk Management.

This comprehensive approach to analysing risk factors also comprises the identification of risk factors related to achieving the strategic goals. In 2017, risks were reviewed related to achievement of the strategic goals contained in the Main Strategy and in the Executory and Support Strategies.

Presented below is the organisational structure of risk management in the Parent Entity. The breakdown of rights and responsibilities applies best practice principles for Corporate Governance and the generally recognised model of three lines of defense.

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**Schemat 1. Organisational structure of risk management in KGHM Polska Miedź S.A.**

<b>Supervisory Board (Audit Committee)</b>				
Performs annual assessment of the effectiveness of the risk management process and monitors the level of key risk factors and ways to address them.				
<b>Management Board</b>				
Has ultimate responsibility for the risk management system and supervision of its individual elements.				
<b>1st line of defense</b>	<b>2nd line of defense</b>			<b>3rd line of defense</b>
<b>Management</b>	<b>Risk Committees</b>			<b>Audit</b>
<p>Managers are responsible for identifying, assessing and analysing risk factors and for the implementation, within their daily duties, of responses to risk. The task of the management staff is ongoing supervision of the application of appropriate responses to risk within the tasks realised, to ensure the expected level of risk is not exceeded.</p>	Support effective risk management and ongoing supervision of key risk factors.			
	<b>Corporate Risk and Compliance Committee</b>	<b>Market Risk Committee</b>	<b>Credit Risk Committee</b>	<b>Financial Liquidity Committee</b>
	Manages corporate risk and continuously monitors key risk factors	Manages risk of changes in metals prices (e.g.: copper and silver) as well as exchange and interest rates	Manages risk of failure of debtors to meet their obligations	Manages risk of loss of liquidity, understood as the ability to pay financial liabilities on time and to obtain financing for operations
	<i>Corporate Risk Management Policy</i>	<i>Market Risk Management Policy</i>	<i>Credit Risk Management Policy</i>	<i>Liquidity Management Policy</i>
	Department of Corporate Risk Management, Compliance and Continuity of Operations	Executive Director, Finance and Risk Management		
	<i>Reports to the President of the Management Board</i>	<i>Reports to the Vice President of the Management Board (Finance)</i>		
				The Internal Audit Plan is based on assessing risk and subordinated business goals, assessed is the current level of individual risk factors and the degree of efficiency with which they are managed.
				<i>Internal Audit Rules</i>
				Internal Audit Department
				<i>Reports to the President of the Management Board</i>

**Market, credit and liquidity risk**

The management of individual market, credit and liquidity risks is regulated by individual, detailed regulations in KGHM Polska Miedź S.A. as set forth in the following documents:

- Market Risk Management Policy and the Rules of the Market Risk Committee,
- Credit Risk Management Policy and the Rules of the Credit Risk Committee, and
- Financial Liquidity Management Policy and the Rules of the Financial Liquidity Committee.

Based on the Market Risk Management Policy, Financial Liquidity Management Policy and Credit Risk Management Policy adopted by the Company, the Company's Management Board manages the identification of various types of financial risk to the Company in a conscientious and responsible manner. Understanding the threats arising from the Company's exposure to risk and maintaining an appropriate organisational structure and procedures enable an effective achievement of tasks. The Company identifies and measures financial risk on an ongoing basis, and also takes actions aimed at minimising their impact on the financial position.

The process of financial risk management in the Company is supported by the work of the Market Risk Committee, the Financial Liquidity Committee and the Credit Risk Committee.

## *Assessment of the standing of KGHM Polska Miedź S.A. for financial year 2017, including an evaluation of the internal control, risk management and compliance systems and the internal audit function*

The goal of market, credit and liquidity risk management in KGHM Polska Miedź S.A. is to restrict the undesired impact of financial factors on cash flow and financial results in the short and medium terms and to enhance the Group's value over the long term. The Management Board is responsible for the management of the types of risk described in the Company and for complying with the individual policies adopted in this regard. The Management Board is supported in the execution of risk management policy by the Market Risk Committee and the Credit Risk Committee, entities which have functioned in the Company for many years, as well as by the Financial Liquidity Committee created in 2015. The management of these risk factors includes both the processes of risk identification and measurement as well as its restriction to acceptable levels. The process of risk management is supported by an appropriate policy, organisational structure and procedures applied in the Company.

Since 2014, the Company has centralised the process of market risk management in selected mining companies of the Group (KGHM Polska Miedź S.A., KGHM INTERNATIONAL LTD., FNX Mining Company inc., Robinson Nevada Mining Company, KGHM Ajax Mining Inc. and Sociedad Contractual Minera Franke). The goals of market risk management at the Group level are achieved by their realisation in individual Group companies, with coordination of these activities by the Parent Entity, i.e. KGHM Polska Miedź S.A. Key tasks were centralised in the Company related to the process of market risk management in the Group (such as coordination of the identification of sources of exposure to market risk, the proposal of hedging strategies, contacts with financial institutions aimed at concluding, confirming and settling derivatives transactions and calculating estimates of fair value).

### **5. Evaluation of the compliance system in the Company in 2017**

KGHM Polska Miedź S.A. defines compliance as adherence to laws generally in force and to voluntarily adopted legal regulations (e.g. ISO standards). The Company recognises that compliance is an important element in its effective functioning, which requires that decisive actions to be taken to ensure that this goal is achieved.

For this reason as well, despite the functioning of certain elements of the compliance management system (such as access by employees to a legal acts data base, formal internal procedures for requesting interpretations of laws, and processes to identify legal requirements and to assess their compliance with the ISO standards in force in the Company), in 2013 a Corporate Risk Management and Compliance Department (currently the Department of Corporate Risk Management, Compliance and Continuity of Operations) was created, whose task is to coordinate the process of management compliance in the Company in all of its business operations which include elements of the compliance system.

In 2017, a broad range of work was carried out in the Company in cooperation with its business functions which was aimed at adapting the organisation to regulatory changes, as well as to implementation of the ISO 50001 standard (an energy management system).

The process of management compliance satisfies the individual principles described in the updated collection of principles - Best Practice for GPW Listed Companies 2016, adopted by the Supervisory Board of the Warsaw Stock Exchange, as confirmed during an audit za rok 2017 conducted by the Internal Audit Department of KGHM. In subsequent years this process will be reviewed annually in terms of its effectiveness by the internal audit function – in accordance with the requirements of Best Practice for GPW Listed Companies 2016.

### **6. Evaluation of the internal audit and internal control systems**

The internal audit function is performed by a separate organisational unit in the structure of – the Internal Audit Department.

The Internal Audit Department systematically evaluates and monitors the control mechanisms and identifies potential risks in individual processes occurring in the Company and in the entire Group, as well as uncovers irregularities and violations of existing procedures.

Auditing activities focus on assessing risk and evaluating and monitoring the functioning of the internal control systems in individual processes occurring in the Company and Group.

The work of internal auditing in KGHM Polska Miedź S.A. is based on the principle of independence, and may encompass virtually all areas of the Company's and Group's operations. In cases where the employees of the

*Assessment of the standing of KGHM Polska Miedź S.A. for financial year 2017, including an evaluation of the internal control, risk management and compliance systems and the internal audit function*

Internal Audit Department do not possess sufficient competence in an area which is to be assessed, the Department makes use of independent internal or external experts.

In 2017, the Department performed assessments in 43 various subject areas. Most of these assessments in specific areas were performed in several, or a dozen or so, Group subsidiaries simultaneously. These tasks were performed both in the divisions as well as in companies of the KGHM Polska Miedź Group, including those outside Poland.

As a result of audits performed in 2017, recommendations were formulated for implementation which eliminated ineffective controls mechanisms and minimised potential risks in analysed processes. The observations, results and recommendations from the comprehensive work were described in the Report on the implementation of the audit and internal control Plan of the KGHM Polska Miedź S.A. Group for 2017.

The projects carried out uncovered irregularities and violations most often of a procedural nature (improper execution of internal regulations), improper operation of equipment, violation of employee obligations, and also ineffective management of resources and irregularities in the execution of services by contractors in various units of the KGHM Group. The recommendations made in respect of the controlled units were aimed at eliminating the identified irregularities and implementing mitigative procedures.

The implementation of recommendations is continuously monitored by the Internal Audit Department.