MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Unless otherwise indicated, the following discussion is based upon the restated financial statements, prepared in accordance with Polish AP, and the notes thereto included in Appendix A attached to this Offering Circular, and should be read in conjunction with such financial statements, and the condensed financial information included in "Summary Restated Financial Statements".

KGHM's core mining and smelting activities are conducted through KGHM Polska Miedź S.A. and in 1996 these activities represented approximately 92 per cent. of the Company's consolidated sales. Prior to 1995, the Company was not required to produce consolidated financial statements under Polish AP. In addition, it has not been required to produce interim financial statements on a consolidated basis under Polish law. Due to the unavailability of 1994 consolidated financial information and consolidated interim information for 1997 and given the dominance of the core operations on KGHM's results, the discussion set forth below is based primarily on the unconsolidated financial statements of the Company as at and for the three years ended 31st December, 1996 and the unaudited unconsolidated financial statements of the Company as at and for the three months ended 31st March, 1997 appearing in Appendix A to this Offering Circular. In addition, following the discussion of the unconsolidated results of operations of the Company, there is a brief discussion of the Company's audited consolidated results of financial statements as at and for the two years ended 31st December, 1996 which also appear in Appendix A to this Offering Circular. The discussion set forth below should be read in conjunction with such unconsolidated and consolidated financial statements.

Introduction

Significant factors influencing the Company's results of operations.

The substantial majority of the Company's unconsolidated sales revenues are generated from the sale of copper products (approximately 82 per cent. of sales in 1996) with a substantial portion of the remainder generated from the sale of silver products (approximately 13 per cent. of sales in 1996). The Company's copper and silver products are generally sold at prices based on market prices for copper and silver on the LME and the LBM, respectively, which are quoted in US dollars. The prices for these commodities are highly volatile and can be affected by numerous factors beyond the Company's control. See "Investment Considerations – Considerations Relating to the Company – Copper Price Volatility" In addition, because the Company's financial statements are denominated in złoty while the vast majority of its sales are denominated in dollars, changes in the U.S. dollar/złoty exchange rate can significantly impact the Company's reported copper and silver revenues. The value of the złoty has declined significantly versus the U.S. dollar in recent years, although the rate of such decline has not been constant between periods. The rate of decline (based on average annual Fixing Rates) was 6.7 per cent. and 11.2 per cent. in 1995 and 1996, respectively. The average Fixing Rate in the first three months of 1997 was 18.4 per cent. higher than the annual average Fixing Rate in 1996. For a more detailed discussion of exchange rates, see "Foreign Exchange Rates" and "Investment Considerations – Considerations Relating to the Company – Effects of Currency Devaluation and Polish Inflation on the Company's Results".

Poland has experienced significant levels of inflation during the years covered by the financial statements included herein, and, consistent with Polish AP, the Company's unconsolidated and consolidated financial statements (and the financial information derived therefrom and included herein) have not been adjusted to reflect the effects of inflation. Trends shown in the Company's unconsolidated and consolidated financial statements would be materially different had such financial statements been adjusted for the effects of inflation. The Polish inflationary environment causes distortions to the Company's historical financial statements, thereby complicating any review of the Company's financial condition or results of operations and rendering meaningful period to period comparisons of financial performance difficult. The average annual rate of consumer price inflation (according to official statistics reported by the Central Statistics Office) in 1995 and 1996 was 27.8 per cent. and 19.9 per cent., respectively, and the average rate of consumer price inflation in the first three months of 1997 was 5.0 per cent. During periods of high inflation, the Minister of Finance of Poland has the authority to require all Polish companies to revalue their fixed assets to reflect current values. The effect of such valuations has generally been to increase fixed asset values and therefore to increase depreciation expenses. The Minister of Finance ordered revaluations of fixed assets at 1st January, 1994 and 1995. No such revaluation was required in 1996. Although inflation has remained at relatively low levels in 1996 and 1997, there can be no assurance that a revaluation will not be required at 1st January, 1998 or thereafter.

The Company's margins can also be affected by differences in any period between the level of domestic inflation in Poland and the level of devaluation of the złoty against the dollar. Generally speaking, in periods where the level of inflation is higher than the level of devaluation of the złoty against the dollar, the Company's margins can be adversely affected as costs increase at a faster rate than revenues. Similarly, in periods where the level of inflation is lower than the level of devaluation of the złoty against the dollar, the Company's margins can improve as revenues increase at a faster rate than expenses. In 1995 the level of Polish inflation was higher than the level of devaluation of the złoty against the dollar. The same was true in 1996, although to a lesser extent.

Format and restatement of financial statements.

Format. Historically, the Company has prepared its financial statements using a "cost by type" reporting format used by many Polish companies. Under this format, all operating expenditures incurred in a period are included under operating expenses irrespective of whether these expenditures are subsequently capitalised. The portion of such expenditure that is capitalised is also treated as a sales equivalent thereby increasing the value of total sales. In addition, in the "cost by type" format, general administration costs and selling expenses are included in operating expenses. In connection with the Polish Public Offering and in compliance with the Polish laws and regulations relating thereto, the Company has changed the presentation of its financial statements to the more traditional "cost by function" format in which capitalised expenditures are excluded from operating costs and general administration costs and selling costs are separately disclosed in the profit and loss account. The Company's unconsolidated and consolidated financial statements set forth in Appendix A to this Offering Circular are presented in the "cost by function" format. Because applicable Polish laws and regulations specify only certain line items for disclosure in the "cost by function" format, no detailed breakdown of costs of sales is available. However, in note 19.2 of Section 5.4 and note 4 to Section 5.5.8.2 of the financial statements set forth in Part I of Appendix A hereto, respectively, (and note 20.2 in "Summary Restated Financial Statements") the Company does provide a breakdown of operating expenses derived from the Company's unconsolidated "cost by type" financial statements. Accordingly, to assist the reader in understanding the trends underlying the Company's costs of sales, the discussions below includes a discussion of these unconsolidated "cost by type" operating expenses. Although such operating expenses include capitalised costs and general administration costs and selling costs, the Company believes that the trends in such operating costs are generally indicative of the trends underlying its cost of sales.

Restatement. Changes in Polish government regulations regarding amortisation of certain assets subject to tax relief resulted in significant changes to the Company's depreciation charges and deferred tax provisions in each of the last three years. In addition, in accordance with best accounting practice in Poland, the Company has elected to establish provisions for certain future costs, principally future mine closure costs, resulting in a disproportionately large charge being recorded in 1996 (representing all provisioning costs that would have been recorded in prior years if similar accounting policies had been applied). The effect of these events was to make year-to-year comparisons of the Company's historical financial statements difficult. As a result, the Company has restated its financial statements to apply a consistent set of accounting principles (including depreciation and provisioning policy) over the period. The Company's financial statements appearing in Appendix A attached to this Offering Circular include both the Company's historical financial statements and its restated financial statements. For a reconciliation of the restated financial statements to the historical financial statements, see the notes to Sections 5.5.8.1, 5.5.8.2 and 5.5.8.3 (relating to the unconsolidated financial statements) and the notes to Sections 9.5.8.1, 9.5.8.2 and 9.5.8.3 (relating to the consolidated financial statements) set forth in Part I of Appendix A hereto. **The discussion set forth below relates only to the restated financial statements.**

Unconsolidated Results of Operations of the Company for the Three Years Ended 31st December, 1996 (Restated) and the Three Months Ended 31st March, 1997.

The following table sets forth selected line items from the Company's unconsolidated profit and loss accounts for the three years ended 31st December, 1996 (restated) and the three months ended 31st March, 1997 expressed as a percentage of total sales.

	Year ended 31st December,			*Three months ended 31st March*
	Restated 1994	*Restated 1995*	*Restated 1996*	*1997*
Sales:				
Sales of finished products	98%	98%	98%	98%
Sales of goods for resale and materials.	2	2	2	2
Total sales	100%	100%	100%	100%
Cost of sales:				
Cost of finished products	60%	63%	75%	64%
Costs of goods for resale and materials . .	2	1	2	2
Total cost of sales	62%	65%	77%	66%
Gross profit	38%	35%	23%	34%
Selling costs	2	1	2	1
General administration costs	10	8	8	6
Other operating expenses, net	1	3	2	1
Operating profit	26%	23%	11%	25%

Sales

Sales of finished products. Sales of finished products increased from approximately PLN 2.6 billion in 1994 to approximately PLN 3.4 billion in 1995, an increase of approximately PLN 800 million or 31 per cent. In 1996, sales of finished products declined by approximately PLN 140 million, or 4 per cent., to approximately PLN 3.3 billion. Sales of finished products during the three months ended 31st March, 1997 were approximately PLN 950 million. During each period sales of finished products represented approximately 98 per cent. of the Company's sales.

The increase in sales of finished products in 1995 resulted primarily from a significant increase of approximately 27 per cent. in average copper prices during the period, with the average copper price on the LME rising from approximately $2,313 per tonne in 1994 to approximately $2,937 per tonne in 1995. For a discussion of copper and silver prices in recent years, see "World Copper and Silver Markets". Another factor benefitting sales of finished products was a 6.7 per cent. fall in the value of złoty versus the U.S. dollar during the period, which had the effect of increasing reported złoty sales (although the level of such devaluation was lower than the rate of inflation in 1995). Copper sale volumes in 1995 were relatively unchanged from 1994 levels. Silver prices (in dollars) and silver volumes each declined during 1995, also partially offsetting the increases generated through higher dollar prices for copper.

The decrease in sales of finished products in 1996 was primarily driven by a 22 per cent. reduction in average copper prices during the period, with the average copper price on the LME falling to approximately $2,290 per tonne in 1996. In addition, silver sales volumes and silver prices (in dollars) were relatively flat during 1996. The decline in copper prices (in dollars) was offset in large part by increased copper sales volumes of approximately 5 per cent. and a 11.2 per cent. fall in the value of the złoty versus the dollar during 1996.

As discussed under "Business – Business Strategy", the Company is implementing a capital expenditure programme to reduce unit production costs. As part of this strategy, the Company intends to increase copper production from current levels of approximately 424,700 tonnes per annum to approximately 470,000 tonnes per annum in 2001. Accordingly, electrolytic copper sales volumes are expected to increase in 1997 and rose to approximately 107,600 tonnes in the first quarter of 1997 as compared to approximately 103,600 tonnes in the corresponding period of 1996. The average copper price on the LME during the first quarter of 1997 was approximately $2,420 per tonne. Refined silver sales volumes declined slightly in the first quarter of 1997, to approximately 208,300 kgs as compared to 211,500 kgs in the corresponding period in 1996. The average silver prices on the LBM during the first quarter of 1997 was $5.01 per troy ounce, a 3.7 per cent. decrease over the average silver price on the LBM during 1996 of $5.20 per troy ounce.

Sales of goods for resale and materials. Sales of goods for resale and materials were approximately PLN 58 million, PLN 57 million and PLN 78 million for the three years ended 31st December, 1996, respectively and approximately PLN 19 million in the first quarter of 1997. In each period, the value of such sales represented approximately 2 per cent. of the Company's sales. Sales of goods for resale and materials result from sales of fuel and certain other materials by the Company to subsidiaries and to external contractors. Changes in sales levels between periods generally reflect changing levels of demand from contractors and changes in fuel and materials purchase costs. The costs of fuel and materials resold by the Company are included under costs of sales, in the Company's profit and loss account.

Cost of Sales

Cost of sales increased from approximately PLN 1.6 billion in 1994 to approximately PLN 2.2 billion in 1995, an increase of approximately PLN 593 million, or 36 per cent. In 1996, cost of sales increased by approximately PLN 355 million, or 16 per cent., to approximately PLN 2.6 billion. Cost of sales during the three months ended 31st March, 1997 were approximately PLN 643 million. The increase in 1995 significantly exceeded inflation and was principally due to substantial increases in materials and energy costs as well as increases in external service costs, real estate taxes and other charges, payroll and payroll related charges and depreciation expense, in each case, in excess of inflation. The increase in 1996 was lower than inflation principally due to increases in materials and energy costs and depreciation expense substantially below inflation. As discussed in "Introduction" above, the Company has not prepared a breakdown of costs of sales in its "cost by function" financial statements included in Appendix A to this Offering Circular, but does provide a breakdown of operating expenses (which include capitalised costs and general administration and selling costs) derived from the company's "cost by type" financial statements in the notes thereto. A breakdown of unconsolidated operating expenses is set forth below and has been extracted from note 4 to Section 5.5.8.2. (relating to the Company's restated unconsolidated financial statements for the three years ended 31st December, 1996) set forth in Part I to Appendix A of this Offering Circular and note 19.2 to Section 1.5 (relating to the Company's unaudited unconsolidated financial statements for the three months ended 31st March, 1997), set forth in Part II of Appendix A to this Offering Circular.

	Years ended 31st December,			*Three months ended 31st March,*
	Restated 1994	*Restated 1995*	*Restated 1996*	*1997*
		(PLN in thousands)		
Operating expenses:				
Materials and energy	763,414	1,151,519	1,226,034	277,593
External services	302,699	406,354	483,705	125,453
Environmental fees, royalties, real estate taxes and other charges	127,617	165,446	207,041	61,312
Payroll	361,431	489,435	562,580	139,511
Payroll related charges	175,753	243,986	278,482	84,670
Depreciation	157,606	268,769	289,629	74,403
Costs of goods for resale	54,678	50,350	69,824	17,793
Other	36,895	31,769	37,464	7,869
Total	1,980,092	2,807,627	3,154,757	788,605

A discussion of the principal operating expenses follows.

Materials and energy expense. Materials and energy expense increased from approximately PLN 763 million in 1994 to approximately PLN 1.2 billion in 1995, an increase of approximately PLN 388 million or 51 per cent. In 1996, materials and energy expense increased by approximately PLN 75 million, or 6.5 per cent., to approximately PLN 1.23 billion. Materials and energy expenses during the three months ended 31st March, 1997 were approximately PLN 278 million.

In 1995, concentrate production at the Rudna mine was reduced below planned levels principally due to a lowering of the average grade of ore mined as a result of a temporary change to the mining plan necessitated by a geologic abnormality encountered during the year. In order to maintain planned production levels at the Company's metallurgical plants, the Company increased its purchases of blister copper and scrap from external sources up to approximately 40,000 tonnes and also purchased concentrate from external sources. In addition, the substantial increase in copper prices in 1995 discussed above resulted in generally increased prices for externally purchased blister copper, scrap and concentrate. These factors were primarily responsible for the significant increase in materials and energy expense in 1995. A secondary factor influencing the increase was general inflationary cost increases of materials. Energy costs, which comprise approximately 19.1 per cent. of total material and energy costs, increased during the period, but at a rate below the level of inflation, principally as a result of a reduction in real energy prices. Energy prices (principally electricity) are regulated in Poland and increased by an average of 20 per cent. in 1995, significantly below the level of domestic inflation in that year.

In 1996, materials and energy costs increased principally due to increased copper production levels and general inflationary cost increases in materials. However, the level of the increase was below inflation as a result of decreased purchases of blister copper, scrap and concentrate in 1996; lower copper prices during the period, which reduced the dollar costs of such materials; and cost reductions associated with the Company's ongoing cost reduction programme. In addition, energy price increases in Poland were below inflation in 1996 (increasing an average of 14 per cent.). External purchases of blister copper, scrap and concentrate declined in 1996 as production of concentrate increased to levels sufficient to supply the needs of the Company's metallurgical plants.

As described under "Business – Business Strategy" the Company intends to increase copper production over the next few years. These production increases will result in real increases in total material and energy costs. However, the Company is implementing a cost reduction strategy which is intended to mitigate the overall level of this increase. As part of this strategy, the Company intends to invest approximately PLN 2.5 billion (approximately $780 million) over the five year period ended 31st December, 2001 to modernise and expand the production processes at its mines and smelters.

External services expense. External service expense increased from approximately PLN 303 million in 1994 to approximately PLN 406 million in 1995, an increase of approximately PLN 104 million or 34 per cent. In 1996 external service expense increased by approximately PLN 77 million, or 19 per cent., to approximately PLN 484 million. External service expense for the three months ended 31st March, 1997 was approximately PLN 125 million. The increase in 1995 included a significant increase in expenses associated with pre-exploitation mine preparation works which is typically performed by external contractors. Generally the Company accelerates its pre-exploitation program in years where copper prices are at relatively high levels and slows the program in years where copper prices are relatively low. Due to the high level of copper prices during 1995, the Company decided to increase the scope of pre-exploitation mine work resulting in increased costs for external contractors who performed the work in that year. The increase in external service expenses in 1996 was generally in line with inflation. As the Company continues implementation of its Restructuring Plan, service areas which were once part of the Company will be spun off into separate subsidiaries. In such circumstances, on an unconsolidated basis, the Company's payroll and payroll related costs and certain material and energy costs will be reduced in real terms while its external service costs will generally increase, reflecting the use of subsidiaries to perform the relevant services.

Environmental fees, royalties, real estate taxes and other charges. Environmental fees, royalties, real estate taxes and other charges increased from approximately PLN 128 million in 1994 to approximately PLN 165 million in 1995, an increase of approximately PLN 38 million or 30 per cent. In 1996, this operating expense category increased by approximately PLN 42 million, or 25 per cent., to approximately PLN 207 million. Environmental fees, royalties, real estate taxes and other charges for the three months ended 31st March, 1997 were approximately PLN 61 million. Environmental charges comprised approximately 50 per cent. of the total in each period. Environmental charges are fees paid by the Company for emissions, effluent discharge and waste storage (principally tailings) and water abstraction. The rates used to determine these fees are set by law and are based on the volume of emission, effluent, waste discharged or water abstracted. The rates are adjusted regularly to reflect inflation. Fines or penalties imposed for breach of environmental regulations are accounted for separately under other operating costs. Royalties for minerals excavation are payable by statute at a rate of 3 per cent. of the value of processed minerals produced. However, a discretionary reduction of up to 50 per cent. of the basic rate is permitted to compensate a mining company for difficult mining conditions or for the costs of prevention or remediation work relating to surface subsidence. Each of the Company's mines has obtained reductions from the basic royalty rate, which in 1996 were 35 per cent. for the Lubin and Rudna mines and 35 to

50 per cent. for the Polkowice-Sieroszowice mine (depending on concession area). Although by law, royalties are payable based on the value of the processed minerals produced from the Company mines, the Company calculates royalties payable based on its internal price for copper concentrate. The MEP has permitted this practice historically. However, there can be no assurance that the MEP will not require a different, more costly method in the future See "Business – Polish Regulation and Environmental Matters – Regulation of Mining Activities." The Company's internal price for concentrate is generally based on its production costs for concentrate and therefore does not necessarily reflect market prices for concentrate and does not reflect fluctuations in world copper market prices. Real estate taxes are generally established based on the gross book value of buildings and construction. Accordingly, the level of real estate tax expense is generally affected by changes in gross book value or changes in tax rates.

In 1995, environmental fees, royalties, real estate taxes and other charges increased at a rate above inflation. The principal reason for the increase was an 80 per cent. increase in royalties for minerals excavation which was attributable to an increase in the Company's average internal price for concentrate of approximately 39 per cent. in that year. A slight increase in concentrate production in 1995 also contributed to the increase. These increases were offset by a 7 per cent. decrease in real estate taxes during the period, which principally resulted from a lowering of the gross book value of the Company's buildings and construction to the net book value at 1st January, 1995 (the "1995 Gross Book Value Reduction") in accordance with a directive of the Ministry of Finance. Environmental fees during the period increased by 25 per cent., generally in line with inflation.

In 1996, environmental fees, royalties, real estate taxes and other charges increased at a rate substantially above inflation principally due to a 70 per cent. increase in real estate taxes, a 23 per cent. increase in environmental fees and a 22 per cent. increase in royalties. The large increase in real estate taxes resulted from an 88 per cent. increase in the gross book value of buildings and construction. The increase in gross book value in 1996 resulted from the reversal of the 1995 Gross Book Value Reduction pursuant to a 1996 decision of the Polish constitutional court. With the exception of real estate taxes actually paid, the effect of the 1995 Gross Book Value Reduction and the reversal thereof in 1996 have been eliminated from the Company's restated financial statements as part of the restatement process. Environmental fees increased principally as a result of increased production rates at the Company's mines and metallurgical plants. The increase in royalties resulted from a 10 per cent. increase in concentrate production and an 11 per cent. increase in the Company's average internal concentrate price in 1996.

As the Company continues to increase production in accordance with its strategy, operating costs in this category are expected to increase. The Company is investigating methods of reducing environmental fees by reducing the volume of tailings deposited at Zelazny Most, including disposal of tailings in its mines. See "Business – Polish Regulation and Environmental Matters – Environmental Matters".

Payroll and payroll related charges. Payroll expense increased from approximately PLN 361 million in 1994 to approximately PLN 489 million in 1995, an increase of approximately PLN 128 million or 35 per cent. In 1996 payroll expense increased approximately PLN 73 million, or 15 per cent., to approximately PLN 563 million. Payroll expense for the first three months of 1997 was approximately PLN 140 million. Prior to 1995, employee compensation levels were determined at a national level through negotiations between the mining unions (representing both the coal and copper industries) and representatives of the Government. In 1995, this structure was changed providing the Company with direct access to negotiations and to de-linking negotiations regarding the Company's compensation levels with similar negotiations conducted in the coal mining industry. As consideration for the unions' acceptance of these changes, compensation levels were increased above the level of domestic inflation in 1995. However, the Company's policy thereafter has been to seek to hold compensation increases at or below expected levels of inflation. In addition, pursuant to its Restructuring Plan the Company is reducing the number of its employees (on an unconsolidated basis) in order to focus the Company's business on its core mining and smelting activities. Subsidiaries created in this process may continue to provide services to the Company, which will be accounted for as external services. In 1996, payroll expense increased at a rate below inflation. However the rate of increase was significantly affected by a reduction in average employee numbers (on an unconsolidated basis) of approximately 1,560 persons, or 5 per cent., as a result of the Restructuring Plan and natural attrition. Average monthly compensation levels for employees in the Company rose by approximately 21.6 per cent. in 1996, slightly above inflation. The Company has negotiated a 17 per cent. increase in average compensation levels with its unions for 1997, with the increase to be implemented in stages over the course of the year. This rate is equivalent to the rate suggested to state owned enterprises by a three party commission comprised of representatives of the government of Poland, labour unions and the Polish employers' confederation. After giving effect to the staged implementation schedule, the 1997 increase corresponds roughly to the level of expected Polish inflation in 1997. In addition, during the first quarter of 1997 the Company reduced its employee level by approximately 2,900 persons mainly through transfers to newly formed subsidiaries as part of its Restructuring Plan which resulted in a reduction in payroll and payroll related charges on an unconsolidated basis. See "Management and Employees – Employee Matters".

In the longer term, as the Company's Restructuring Plan is completed, the Company expects that on an unconsolidated basis its payroll costs will be reduced in real terms as the number of employees in the Company is reduced. However, as discussed below, on a consolidated basis any reduction in real payroll costs will be achieved only as the newly formed subsidiaries restructure their compensation arrangements to levels appropriate for their business. See "Business – Restructuring Plan".

Under Polish AP, payroll costs do not include payments made in connection with profit sharing arrangements with employees and certain other employee benefits. Accordingly, the trends discussed above may not correspond to trends in total compensation costs. See "Summary of Significant Differences Between Polish AP, IAS and U.S. GAAP — Profit Sharing Payments".

Payroll related charges primarily consist of social security charges paid by the Company at a rate of 48 per cent. of its payroll expense in each year. Effective 1st July, 1997, employers in Poland are required to pay social security taxes on overtime pay for work by employees on weekends and holidays and on certain employee benefits not previously subject to such taxes.

Depreciation expense. Depreciation expense increased from approximately PLN 158 million in 1994 to approximately PLN 269 million in 1995, an increase of approximately PLN 111 million or 71 per cent. In 1996, depreciation expense increased by approximately PLN 21 million, or 8 per cent., to approximately PLN 290 million. Depreciation expense in the first three months of 1997 was approximately PLN 74 million. As discussed in "Introduction" above, the Company's historical financial statements have been restated to simplify year-to-year comparisons of the Company's financial statements. As part of the restatement, the effects of the 1995 Gross Book Value Reduction and the reversal thereof in 1996 in depreciation expense have been eliminated. The increase in restated depreciation in 1995 principally resulted from the revaluation of fixed assets required by the Minister of Finance as at 1st January, 1995 which significantly increased the Company's gross book value of fixed assets being depreciated. In addition, the Company's ongoing capital expenditure programme also increased, fixed assets thereby increasing total depreciation expense. In 1996, restated depreciation expense increased principally due to increases in the Company's fixed assets resulting from the capital expenditure programme. In the future, the Company expects depreciation expense to increase as its capital expenditure programme continues. However, because depreciation commences only when an asset is placed in production, depreciation expense may not increase on a consistent basis between periods as large projects commenced in one period may not be completed until one or more periods have elapsed. In addition, although Polish inflation has been decreasing in recent years, the Ministry of Finance may elect to require a revaluation of assets in the future, which would result in an increase in gross book values and therefore in depreciation expense. The last revaluation ordered by the Minister of Finance was effective on 1st January, 1995. Finally, as a result of the Restructuring Plan, certain of the Company's fixed assets are being transferred to newly formed subsidiaries. As a result of this process, on an unconsolidated basis, the gross book value of the Company's fixed assets is reduced, thereby reducing depreciation expense. In early 1997, the Company transferred the assets of its Transportation Division into a new subsidiary. This transaction resulted in a reduction of approximately 2.6 per cent. of the Company's unconsolidated gross book value of fixed assets.

Gross profit

Gross profit increased from approximately PLN 1.0 billion in 1994 to approximately PLN 1.2 billion in 1995, an increase of approximately PLN 211 million or 21 per cent. In 1996 gross profit declined by approximately PLN 474 million or 38 per cent. to approximately PLN 758 million. Gross profit for the first three months of 1997 was approximately PLN 328 million. Gross profit margin was approximately 38 per cent., 35 per cent., 23 per cent. and 34 per cent. in the three years ended 31st December, 1996 and the three months ended 31st March, 1997, respectively. Despite the significant increase in sales in 1995 due primarily to rising copper prices, gross profit margin decreased in that year because costs of sales also increased substantially for the reasons discussed above. The significant decline in gross profit margin in 1996 was due primarily to the decrease in copper prices which, after giving effect to increased złoty sales prices resulting from the decline in the value of the złoty versus the US dollar during the period, lead to a 3 per cent. decrease in sales. At the same time, total costs of sales increased by approximately 16 per cent., a rate slightly below inflation. The improved gross profit margin in the first quarter of 1997 as compared to the annual gross profit margin in 1996 reflected the improvement in average copper prices during the period as compared to average copper prices in 1996, the effects of the Company's cost reduction programme and the financial effects (on an unconsolidated basis) of actions taken during the first quarter in connection with the Restructuring Plan. However, as discussed in note 19.2 to Section 1.5 in Part II of Annex A hereto, the financial results for the first quarter of 1997 do not include any accrual for privatisation costs. In addition, because the Company accounts for maintenance costs on a cash rather than an accrual basis, the results for the first quarter may not be indicative of results for the full year.

General administration and sales costs

General administration and sales costs increased from approximately PLN 314 million in 1994 to approximately PLN 323 million in 1995, an increase of approximately PLN 9 million or 3 per cent. In 1996, general administration and sales costs decreased by approximately PLN 4 million, or 1 per cent. to approximately PLN 319 million. General administration and sales costs were PLN 77 million in the first three months of 1997. In each period general administration and sales costs increased at a rate significantly below the level of inflation reflecting cost savings (on an unconsolidated basis) resulting from the transfer of administrative staff to subsidiaries as part of the Restructuring Plan.

Other operating revenue and expense

Other operating expense (net of other operating income) was approximately PLN 27 million, PLN 111 million and PLN 65 million for the three years ended 31st December, 1996 and approximately PLN 11 million for the three months ended 31st March, 1997. Other operating income in each period related principally to revenues from sales of fixed assets by the Company. Other operating expenses principally related to the value of fixed assets sold and the value of assets (including cash) donated for charitable purposes in each period. The significant increase in other operating expense in 1995 principally related to a high level of donations by the Company in that year. The majority of such donations related to the transfer as part of the Restructuring Plan of certain unproductive assets such as housing, sports facilities and other social buildings to local governments.

Financial revenue and expense

Financial revenue is principally derived from income and capital gains realised on short term debt securities and bank accounts held by the Company. Due to the cost by type format utilized in preparing the Company's financial statements, sales of debt securities prior to maturity or receipt of payment at maturity on debt securities is accounted for as other financial revenue, while the costs of acquiring such securities are accounted for as other financial expense. However, the effect of the increases in other financial revenue and other financial expense is a net gain which represents capital gains recognised on the securities over the period. Net financial income (financial revenues less financial expenses) was approximately PLN 10 million, PLN 103 million and PLN 73 million for the three years ended 31st December, 1996 and approximately PLN 2 million for the three months ended 31st March, 1997. The increase is net financial income in 1995 resulted from the investment of the significant cash flow the Company received in that year (due principally to the high level of copper prices) in one year treasury bills and three year treasury bonds issued by the Polish Government. These funds were saved for use in connection with the Company's capital expenditure programme which at that time was in the planning stage. See "Business – Business Strategy". As a result of the investments in treasury bills and treasury bonds in 1995, net financial income (principally interest and capital gains recognised), increased substantially in 1995. The decrease in net financial income in 1996 and the relatively low level of net financial income in the first quarter of 1997 reflected lower interest rates during the relevant periods and a reduction in the level of funds invested as the Company continued its capital expenditure program.

Extraordinary items

Extraordinary losses during each period reflected the write-off of debt in circumstances where an outstanding debt was settled at less than full value. The extraordinary loss in 1996 of approximately PLN 8.4 million related principally to the settlement of a large outstanding debt which had been in dispute for several years. As a result of the settlement the Company recovered approximately PLN 8.6 million but was required to write-off the remaining PLN 5.2 million of the debt. In addition, in 1996 the Company settled another large outstanding receivable which resulted in a write-off of approximately PLN 2.4 million.

Taxation

Corporate income taxes increased from approximately PLN 287 million in 1994 to approximately PLN 387 million in 1995 but fell to approximately PLN 195 million in 1996. For the three months ended 31st March, 1997, corporate income taxes were approximately PLN 106 million. As a percentage of profit before tax, corporate income taxes were approximately 42 per cent., 43 per cent. and 45 per cent. and 44 per cent. in the three years ended 31st December, 1996 and the three months ended 31st March, 1997, respectively. The statutory rate of corporate income taxation was 40 per cent. in each of 1994, 1995 and 1996. In 1997, the basic corporate tax rate was reduced from 40 per cent. to 38 per cent. and, under current law, will continue to fall at a rate of 2 per cent. per year with the basic rate reaching 32 per cent. by 2000. Differences between the statutory rate and the Company's effective tax rates set forth above principally relate to certain costs which are not deductible for tax calculation purposes.

Net profit

Net profit increased from approximately PLN 373 million in 1994 to approximately PLN 496 million in 1995, an increase of approximately PLN 123 million or 33 per cent. In 1996, net profit decreased by approximately PLN 291 million, or 59 per cent., to approximately PLN 206 million. For the three months ended 31st March, 1997, net profit was approximately PLN 116 million. The trends in net profit in 1995 and 1996 principally reflect the trends in gross profit described above. In addition, in 1995 net profit was also improved as compared to 1994 by a large increase in financial revenues (net of financial expenses) which resulted from the investment of excess cash flows generated in that year due to the high level of copper prices. The level of net profit for the first quarter of 1997 reflects the improved gross profit margin described above.

Profit sharing payments

In each of 1994, 1995 and 1996 profit sharing payments were made to employees based on the Company's net profit totalling PLN 67.1 million, PLN 90.5 million and PLN 70.7 million, respectively. These payments represented approximately 18 per cent., 18 per cent. and 34 per cent. of net profit in 1994, 1995 and 1996, respectively. Consistent with Polish AP, these payments were approved by the Company's shareholder. Any decisions in the future on profit sharing payments will be taken at the ordinary meeting of shareholders of the Company.

Consolidated Results of Operations of the Company for the Two Years Ended 31st December, 1996 (Restated)

The Company first prepared consolidated financial statements for the year ended 31st December, 1995. Accordingly, the following discussion is limited to the consolidated results of operations of the Company for 1995 and 1996. With respect to any company in which the Company holds a 50 per cent. or greater voting interest (a "subsidiary"), the Company fully consolidates the subsidiary's financial statements into the Company's consolidated financial statements and reflects the portion, if any, of equity not held by the Company as a minority interest. With respect to any company in which the Company holds a voting interest of more than 20 per cent. but less than 50 per cent. voting interest (an "associated company"), the Company accounts for its interest in such company using the equity method (i.e., recognising its percentage share of income or loss of the relevant company). The Company accounts for companies in which it holds less than a 20 per cent. voting interest as investments (i.e., it recognises income to the extent dividends are received from the relevant company and income or losses on any sale of its interest in the relevant company). Prior to its transformation into a joint stock company in 1991, the Company had no subsidiaries, associated companies or investments. As discussed under "Business – Restructuring Plan", the Company is currently separating non-core businesses from its core mining and smelting businesses by moving non-core operations into separate subsidiaries. The Company has formed two subsidiary holding companies, KGHM Metale and DSI, to hold and manage these newly created subsidiaries. This two step process (creation of the subsidiary and transferring the subsidiary to one of the subsidiary holding companies) has been ongoing for several years and will continue in the future. In addition, in connection with the settlement of certain unpaid receivables in recent years, the Company obtained minority interests in several Polish businesses, including interests in several copper wire cable producers. Finally, the Company has acquired or developed interests in several Polish businesses which it considers to be strategic, the most notable of which is its 19.25 per cent. interest in Polkomtel S.A. As a result of the foregoing, the Company currently holds interests, indirectly or directly, in a significant number of relatively small businesses. However, the Company continues to dominate KGHM's consolidated results of operations, with products of the core mining, smelting and refining operations contributing approximately 92 per cent. of consolidated sales in 1996. Consequently, trends in the Company's restated consolidated financial statements generally reflect the trends in the Company's restated unconsolidated financial statements discussed above. Accordingly, the discussion of the restated consolidated financial statements below discusses generally only those trends which were affected by consolidation.

Because implementation of the Restructuring Plan continued throughout 1995 and 1996 and because certain small businesses were acquired or sold in each of these years, the effect of consolidation is not directly comparable between periods. In general terms, there were three principal effects of consolidation in 1995 and 1996. First, the consolidation of the Company's subsidiaries impacted gross profit and operating profit differently in 1995 and 1996. Gross profit in 1995 improved from approximately PLN 1.23 billion on unconsolidated basis to approximately PLN 1.36 billion on a consolidated basis, an increase of 11 per cent. In 1996, gross profit improved from approximately PLN 758 million on an unconsolidated basis to approximately PLN 866 million on a consolidated basis, an increase of 14 per cent. These effects illustrate the positive contribution of the subsidiaries to the Company's consolidated results. Operating profit improved in 1995 from approximately PLN 797 million on an unconsolidated basis to approximately PLN 862 million on a consolidated basis, an increase of 8 per cent. However, in 1996 consolidation resulted in a decrease in operating profit from approximately PLN 374 million on an unconsolidated basis to approximately PLN 370 million on a consolidated basis, a decrease of 1 per cent. The principal explanation for these effects on operating profit lies in the nature of the Company's subsidiaries, the vast majority of the Company's subsidiaries in 1995 and 1996 were new subsidiaries created as part of the Restructuring Plan. In general, the Company is the principal (and often sole) customer of these subsidiaries and, as a result, the profitability of the subsidiaries is highly dependent on the Company's demand for their products and services. However, the Company's demand tends to vary depending on the profitability of the Company's core operations. As a result, in 1995, with copper prices at relatively high levels, the profitability of the Company's core mining and smelting operations created a relatively high level of demand for products and services supplied by the subsidiaries, resulting in an aggregate contribution by the subsidiaries to consolidated operating profit. However, as copper prices fell in 1996, demand from the Company declined significantly. At this early stage in their development many subsidiaries have high general administrative costs. Because of these high costs, the decline in demand in 1996 resulted in operating losses at two of the subsidiaries which had the effect, in aggregate, of reducing consolidated operating profit in 1996. As discussed under "Business – Restructuring Plan", the Company has established DSI and KGHM Metale as subsidiary holding companies to hold and manage the subsidiaries created as part of the Restructuring Plan with the intention of improving the operations and profitability of those subsidiaries which have the potential to be profitable or selling or otherwise disposing of unprofitable subsidiaries. Accordingly, in the longer term, as the Company's Employment Guarantee System expires and as DSI and KGHM Metale have sufficient time to improve the subsidiaries' operations (including lowering general administration costs and lessening their dependence on the Company), the Company expects that its subsidiaries will generally contribute to its consolidated operating profit.

The second principal effect of consolidation was to increase financial revenues and financial expenses in each of 1995 and 1996 on a consolidated basis. In 1995, financial revenue (net of financial expense) decreased from approximately PLN 103 million on an unconsolidated basis to approximately PLN 73 million on a consolidated basis. However, in 1996 financial revenue (net of financial expense) increased from approximately PLN 73 million on an unconsolidated basis to approximately PLN 78 million on a consolidated basis. The principal explanation for these effects relates to the level of Company loans to subsidiaries in each period. The existence of such loans creates interest income on an unconsolidated basis which is eliminated upon consolidation. In 1995, the Company provided loans to several subsidiaries resulting in net financial revenues on an unconsolidated basis in excess of net financial revenues on a consolidated basis. In 1996 all loans to subsidiaries were repaid thereby eliminating the negative consolidation effect. The resulting increase in net financial revenue on a consolidated basis in 1996 is attributable to the net financial revenue (principally income on investments) recognised by the Company's subsidiaries in that year.

The final effect of consolidation is the contribution to net profit included in each of 1995 and 1996 from the associated companies. Associated companies are accounted for using the equity method and, accordingly, a proportionate share (representing the Company's ownership interest) of the associated company's net profit is included in the Company's consolidated net profit. The aggregate contribution of associated companies to the Company's consolidated net profit was approximately PLN 10 million and PLN 11 million in 1995 and 1996, respectively. With few exceptions, the Company's associated companies were profitable in each year.

Liquidity and Capital Resources

On a consolidated basis, the Company's cash flows from operating activities totalled approximately PLN 628 million in 1995 and PLN 369 million in 1996. The significant level of cash flow from operating activities in 1995 was generated principally because of the high copper price levels during this period. The greater part of 1995 cash flow from operating activities was used to fund KGHM's working capital needs and its capital expenditure programme in 1995. The remainder of these cash flows were invested in treasury bills and treasury bonds issued by the Polish government. These funds were invested for use as a source of future funding for the Company's capital investment programme. Cash flows from operations decreased in 1996, principally reflecting reduced copper price levels during the period, while the Company's capital expenditure increased significantly during 1996. As a result, KGHM's working capital needs and capital expenditures exceeded cash flows from operating activities in 1996 by approximately PLN 134 million and the shortfall was funded through a reduction in short term investments and through an increase in short term bank borrowings.

As at 16th May, 1997, the Company and its majority owned subsidiaries had the following outstanding borrowings, indebtedness in the nature of borrowings, contingent liabilities and guarantees.

	(PLN millions)
Loans maturing in less than one year	
secured bank loans	118.8
unsecured bank loans	108.5
other loans	4.5
Loans maturing in more than one year	
secured bank loans	0.9
unsecured bank loans	3.2
other loans	12.4
Contingent liabilities and guarantees	136.2

As at 16th May, 1997 the Company and its majority owned subsidiaries had open futures positions on the LME and the LBM which oblige the Company or a majority owned subsidiary to purchase or sell specified volumes of copper or silver at a specified price on a future date. Based on closing futures prices on 16th May, 1997, if the Company had closed these positions, it would have recognised a net profit of approximately PLN 10 million.

Except for the above, as at 16th May, 1997, the Company and its majority owned subsidiaries had outstanding no outstanding borrowings, indebtedness in the nature of borrowings, contingent liabilities or guarantees.

As discussed under "Business Strategy", the Company is continuing to implement a capital investment programme intended to increase production and decrease costs with an objective of reducing its unit production costs (in real terms). During the next five year period ended 31st December, 2001, the Company intends to invest approximately PLN 2.5 billion (approximately $780 million) in connection with this programme. The Company expects that the bulk of these capital expenditures will be financed by cash generated from operating activities (after payment of dividends to shareholders, see "Dividends – Dividend Policy"), and from the use of existing cash and cash equivalents. The Company expects to finance the remainder of its capital expenditures through bank borrowings or debt offerings. Given its low debt levels at present, the Company does not expect any material difficulty in finding appropriate sources for such debt financing.

The Management Board is satisfied that, taking into account availability of existing bank facilities, KGHM has sufficient working capital for its present requirements. The Company has recently agreed terms for a working capital facility for up to $200 million with a group of international banks.

Recent Developments

Pursuant to an ordinance of the President of the Securities Commission in Poland (the "Polish Securities Commission"), following the listing of the Shares on the Warsaw Stock Exchange the Company will be required to publish monthly and year to date unaudited unconsolidated financial information (the "Monthly Unconsolidated Financial Information") no later than 18 days after the end of each calendar month. In addition, as a condition to approval of the application to admit the Shares to public trading in Poland, the Polish Securities Commission required the Company to publish Monthly Unconsolidated Financial Information for April and May 1997. This unaudited information, which was published in Poland on 28th June, 1997, is set forth in the table below:

	One month ended 30th April, 1997	*Four months ended 30th April, 1997*	*One month ended 31st May, 1997*	*Five months ended 31st May, 1997*
	(PLN thousands)			
Sales	366,684	1,337,668	364,299	1,701,966
Operating profit	75,432	315,289	107,454	422,744
Profit before tax	73,030	315,044	106,185	421,229
Profit after tax	24,638	140,318	51,532	191,849

The Monthly Unconsolidated Financial Information is unaudited and is prepared on the basis of data produced from the Company's management reporting systems. Accordingly, the Monthly Unconsolidated Financial Information does not reflect certain accounting adjustments which would be made in connection with the preparation of the Company's annual financial statements. In particular, for monthly reporting purposes, the Company values its stock (i.e. work in progress and finished goods) at internal prices based on planned average yearly cost. Internal prices are based on a formula including, among other things, an internal reference price denominated in U.S. dollars. In złoty terms these internal prices may not reflect the actual złoty costs of production during the relevant month. During April and May 1997 in accordance with adopted policies by the Company, the Company's internal price was not adjusted despite higher than planned devaluation of the złoty versus the U.S. dollar and actual złoty production cost reductions. If such a disparity were to exist at year end and was not otherwise offset by other factors, the Company would expect to provide for the difference in cost which would reduce reported net income for the year. Had the Company adjusted the stock value at 31st May, 1997 to reflect actual production costs, net income for the five months ended 31st May, 1997 would have been reduced. The correction of the overvaluation of stock in respect of the period from 1st January, 1997 to 31st May, 1997 would lead to an estimated reduction of net income for the five months ended 31st May, 1997 of not more than approximately 4.5 per cent.

The Monthly Unconsolidated Financial Information for April and May 1997 reflected production at planned levels in both periods combined with average copper prices of US$2,391 and US$2,517 per tonne in April and May 1997, respectively. The Company's cost cutting program and Restructuring Plan continued during the period and also contributed to operating results. In the Monthly Unconsolidated Financial Information for April 1997 the Company began to account for privatisation costs and maintenance costs and other items on an accrual basis and included in such information accruals of such items not only for April but also for the first three months of 1997, which had a disproportionate effect on operating profit in April. In addition, because privatisation costs are not deductible for Polish tax purposes and maintenance costs are not deductible for tax purposes until actually paid, taxes in each of April and May remained at relatively constant levels as the bulk of the accruals for such items were not deductible in either period.

Following a competitive tender, on 5th June 1997, the Company's Supervisory Board appointed Deloitte & Touche Audit Services Sp. z o.o. as auditors of the Company.