

# **Evaluation of the situation of PROCHEM S.A. in 2016, including the assessment of the internal control system and the risk management system**

Evaluation of PROCHEM S.A. in 2016 was made in three aspects:

- results of operations,
- the Company's situation,
- functioning of the internal control and risk management system.

## **I. ASSESSMENT OF THE RESULTS OF THE COMPANY FOR 2016**

The Company ended the year 2016 with a net loss of PLN 23,601,000. The Company's revenues amounted to PLN 109,682 thousand. The cash flow statement for the financial year 2016 showed a decrease in cash by PLN 16,524 thousand. The negative financial result was connected mainly with the significant reduction of the margin on the contract implemented in Belarus as a result of incurred not anticipated previously costs for the completion of the contract execution. It should be noted that the contract accounted for in its entirety had a positive margin of 7%. The negative result in last year was the result of the incorrect assessment of the project's result in previous years and the concentration of unforeseen costs in the last year. The company also experienced negative phenomena in the economy: a decrease in investment level and a negative dynamics of construction and assembly production. The Board has negatively evaluated the results achieved by the Company in 2016.

## **II. COMPANY'S POSITION**

According to the Central Statistical Office, GDP in 2016 rose by 2.8%. That is less by 1.1 than a year earlier, when the Polish economy was developing at a rate of 3.9 per cent. The result for last year is the weakest in three years. The decline in growth in the rate of growth compared to the previous year resulted from two factors: a slowdown of investment in infrastructure, which were financed by the European Union and the slowdown in rate of investment of the enterprises, which lowered by 5.5%. This had an impact on the development of the company on the domestic market. Revenues in the country amounted to PLN 94,048 thousand compared to 101,923 thousand in 2015.

According to PKO BP economists, GDP figures for 2016, together with the monthly data concerning economy, indicate, among others to clear reduction of the decline in investment and production in construction at the end of the year and they confirm that the slowdown in GDP growth has passed the bottom, and dynamics of GDP growth will be accelerating. Data on industrial production and construction and assembly production for the first quarter of 2017 confirm these trends. In February for the first time in many months dynamics in the growth of construction and assembly production was positive. GDP growth in the first quarter was 4%. The company should feel this revival in 2017.

The biggest impact on the situation of the company in 2016, has had the implementing of the largest contract - of installations for the production of paraffin, oil and lubricants along with the extension of the complex of energy plant, executed under the agreement with Mineral Wax Factory SA in Swisłocz. Significant costs related to the last phase of implementation of this contract, which were not previously foreseen have led to a deterioration in the Company's current situation, resulting in liquidity problems and resulted in the need for cost restructuring, which was carried out by the Management Board and was monitored on an on-going basis by the Supervisory Board. Banks financing the Company have maintained their engagement. In the second half of the year, the Company's situation stabilized. The improving situation in the investment sector should have a positive impact on the Company's situation in 2017.

Another project having a significant impact on the Company is the developer's project ASTRUM implemented jointly with the financial partner. The size of the project in the first stage is about 22 thousand. M2 - a significant scale of already engaged own funds, being launched credit facilities, but also a competitive situation on the office space market in Warsaw, necessitate careful supervision of the undertaking and ongoing assessments of the risks associated with the implementation, including, above all, those which concern the gaining of reliable tenants. The end of 2016 and beginning of 2017 brought a revival in terms of tenants, who are interested in the project. The company changed its real estate rental agency and signed an agreement with a reputable Cushman and Wakefield agent. The Council monitors continuously the status of the tenancy of the building and interest of potential tenants.

The current situation indicates a revival on the market compared to last year and a good chance of successful commercialization of the building.

### **III. EVALUATION OF THE SYSTEM OF INTERNAL CONTROL AND RISK MANAGEMENT**

The scope of the control covers primarily:

- business activities of the company - basic and auxiliary,
- financial reporting and accounting settlements,
- compliance of the company's activities with the applicable laws and with internal regulations,
- employment and wages.

The specificity of activity of PROCHEM S.A. is related to the realization of the complex investment projects for the customers.

In the company exist and are in use the planning and control systems of the projects. These systems do not operate in real time and the signals flowing from them are analyzed with delay. Unfortunately, in the case of the Belarusian contract the procedure and supervision proved to be insufficient, and cost monitoring did not cover such a large and complex project. This has led to delays in capturing cost divergences and in demonstrating unexpected losses on the above- project, which caused the negative result of the Company. The unsatisfactory result of last year justifies a critical assessment of both the cost control system and the ability to accurately determine the dynamics of the result in complex, large contracts. Both issues, according to the findings of the Supervisory Board, were examined by the Company's Management Board. The Supervisory Board asked the Management Board to take steps aiming to verification of procedures and to seal control procedures. The Management Board has taken corrective action. It was changed instruction "Control the cost of services", and then new head has been appointed of the "Cost control team" responsible for the implementation of modifications and streamlined procedures.

The main task of institutional control is to carry out comprehensive control in the scope of the most important issues for the company and to collect and compile information on the activities of the organizational units of the company, selected

economic issues and other issues that have been recognized by the Company's Management Board in the given period as being the most essential. Apart from the institutional internal control, there is also the so-called functional control in the company, which is exercised by managers at various levels. Managers perform the supervision over the employees, which are subject to Managers, such control consists in the checking of the status of accomplishment of set tasks.

Checks are carried out in all phases of activity as the preliminary control, current and next. The financial and accounting documents are subject to substantive, formal and accounting control. Information on formal and substantive correctness and calculation correctness has a signature in an identifiable manner (full name and surname), or bears the stamp of the authorized person and the date of approval of the document.

There is no separate, organizationally separated risk management structure in PROCHEM S.A. Identification and assessment of risk areas are done by the respective departments of the Company appropriate for relevant risk type. Their responsibilities also include to define the actions needed to reduce the risk.

Supervision, but also key decisions on the scale of risk exposures are taken by the Management Board of the Company. The risk analysis in PROCHEM S.A. has systemic nature included in various types of procedures, pertaining to separate risks. In the opinion of the Supervisory Board, consideration should be given to an appointment (merging) within the organizational structure of the entity responsible for this neuralgic issue in the Company.

In 2016 a negative event of significant scale occurred which could jeopardize the safety of the company's operation - the Company incurred unexpected costs related to the execution of the contract in Belarus amounting to PLN 17.3 million and was exposed to possible penalties related to delay in the execution of the contract, which led to a significant reduction in the financial result and incurring by the Company of a net loss in the whole year. In previous years, the Company showed high margins on the Belarusian contract and did not signal a possible reduction of margin. The functioning risk control procedures did not prevent occurrence of such situation, the Company did not create, for example, reserves to potential costs.

The above event showed that, despite the system of risk control through the procedures, the Company has not anticipated the occurrence of such risk, which means the need to improve these procedures, especially in terms of forecasting and monitoring of the contracts profitability. The Supervisory Board noted the need to seal and improve risk control. In effect was carried out a review and improved of the system of risk management during the implementation of contracts within the process "Integrated Management System" through the sub-process "Risk Management and opportunities." This process is based on the requirements of international standard ISO-31000. The procedure is valid in all organizational units of PROCHEM S.A. involved in preparing the offer and in executing of projects.

In the activity of PROCHEM identified the following risks:

### **1. The risk of economic fluctuations**

The company is highly susceptible to economic fluctuations in the building industry and is strongly depend on the demand for engineering services, this demand is of cyclical character. In order to reduce the impact of that risk on the results and the Company's situation:

- is carried out monitoring of the macroeconomic situation and the situation in selected industries
- the diversification of activities is continued (execution activity, developer's activity and the maintenance activity),
- the geographical diversification is being launched (through development of exports),
- the level of financial reserves is being optimized.

### **2. The risk of loss of key employees**

The Company's activity is based on a well-educated and well-qualified staff, who are also an attractive recruitment target for the competitors.

In order to limit this risk, the Company applies:

- monitoring of the labor market and monitoring of level of payroll,

- maintaining a system of training and raising of qualifications
- incentive programs for the key employees

Active recruitment system through cooperation with universities

### **3. The risk of the occurrence of threats during the execution of contracts**

Types of activities conducted in PROCHEM S.A. - the preparation and management of investment projects for clients - cause that this risk is constantly occurring.

In order to limit this risk, PROCHEM S.A. applies :

- realistic price calculation during the concluding of contracts,
- monitoring of the progress in the implementation of contracts and in the disclosure of threats,
- selection of reliable subcontractors,
- stipulations in contracts, which are limiting the upper level of contractual penalties.

The use of these system's instruments has allowed to avoid the financial consequences during the implementation of the contracts concluded under crisis conditions, including under the conditions of strong price competition. However, the procedures proved to be insufficient in the case of a contract implemented on the Belarusian market. Upon the analysis, instruction of "Control of Services Cost " was modified, and then a new Head of "Team of Cost Control" was appointed.

### **4. The risk of the payment unreliability**

The instruments limiting this constantly occurring type of risk are:

- monitoring of the financial standing of customers before and during the execution of contracts,
- the use of specialized debt collection procedures,
- optimization of payment structures.

## **5. The risk of adverse settlement of litigation with PERN SA**

The current course of judicial proceedings indicates a little risk of becoming such a situation. The Supervisory Board monitors the course of the dispute and held a direct meeting with law office K & L Gates representing the Company in a dispute that did not indicate to occurrence of any new circumstances in the dispute, and has upheld predictions concerning settlement of the dispute, that are positive for the Company.

## **6. Currency risk**

The instruments limiting this constantly occurring type of risk are:

- monitoring and forecasting of exchange rates,
- forward currency transactions,
- purchase of equipment and services in the currency of the contract.

## **7. The risk of dependence on significant buyers of services**

The instruments limiting this constantly occurring type of risk are:

- monitoring of the contracts with major suppliers
- contractual provisions containing the cushioning elements
- maintenance of the partner relations with regular customers

## **RECAPITULATION**

In the Supervisory Board's assessment, the identification of risk factors in 2016, their monitoring and system of the preventive measures did not prevent a major correction of the profitability of the largest contract executed, which led to a net loss in big amount which means that the existing procedures appeared to be insufficient. The Supervisory Board drew the Management Board's attention to the need to take action to increase risk control, especially in the implementation of long-term contracts. In effect, changes have been made to the process of control of the execution of services which result in the new instruction "Service Cost Control". This was modified on the basis of experience from the Belarusian contract. Modification was prepared and now is being implemented by the newly appointed Head of Cost Control Team.

The Supervisory Board is of the opinion that control system and risk management functioning in PROCHEM S.A. in 2016 has not proved to be effective, in effect corrective actions have been implemented, the effects of which will be systematically monitored in 2017. Improving of risk control system in the Company is one of the most important elements of the activity of the Supervisory Board in 2017.

Signatures of the Members of the Supervisory Board:

1. Karol Żbikowski \_\_\_\_\_

2. Andrzej Karczykowski \_\_\_\_\_

3. Krzysztof Obłój \_\_\_\_\_

4. Marcin Pędziński \_\_\_\_\_

5. Michał Suflida \_\_\_\_\_