3. Basis of preparation

These consolidated financial statements ("consolidated financial statements", "financial statements") have been prepared in accordance with the International Financial Reporting Standards ("IFRS") endorsed by the European Union and in effect as at December 31st 2018.

These consolidated financial statements have been prepared on the assumption that the Group companies will continue as going concerns in the foreseeable future. As at the date of authorisation of these financial statements for issue, no circumstances were identified which would indicate any threat to the Group companies' continuing as going concerns.

4. New standards and interpretations

The following new standards, amendments to existing standards and interpretations have been endorsed by the European Union (the "EU"):

- Amendments to IFRS 2 *Share-based Payment – Classification and Measurement of Share-Based Payment Transactions* (effective for annual periods beginning on or after January 1st 2018),
- Amendments to IFRS 4 *Insurance Contracts* – Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts* (effective for annual periods beginning on or after January 1st 2018 or from the first-time application of IFRS 9 *Financial Instruments*),
- Amendments to IFRS 15 *Revenue from Contracts with Customers – Clarifications to* IFRS 15 *Revenue from Contracts with Customers* (effective for annual periods beginning on or after January 1st 2018),
- Amendments to IAS 40 *Investment Property – Transfers of Investment Property* (effective for annual periods beginning on or after January 1st 2018),
- Amendments to IFRS 1 and IAS 28 resulting from Annual Improvements to IFRS Standards 2014–2016 Cycle – amendments made as part of the annual IFRS improvements project (IFRS 1, IFRS 12, and IAS 28) primarily to correct conflicts and clarify wording (the amendments to IFRS 1 and IAS 28 are effective for annual periods beginning on or after January 1st 2018),
- IFRIC 22 *Foreign Currency Transactions and Advance Consideration* (effective for annual periods beginning on or after January 1st 2018),
- IFRS 16 *Leases* (effective for annual periods beginning on or after January 1st 2019),
- Amendments to IFRS 9 *Financial Instruments – Prepayment Features with Negative Compensation* (effective for annual periods beginning on or after January 1st 2019),
- IFRIC 23 *Uncertainty over Income Tax Treatments* (effective for annual periods beginning on or after January 1st 2019).

New standards, amendments to existing standards and interpretations which have not been endorsed by the European Union:

- IFRS 14 *Regulatory Deferral Accounts* (effective for annual periods beginning on or after January 1st 2016),
- IFRS 17 *Insurance Contracts* (effective for annual periods beginning on or after January 1st 2021),
- Amendments to IFRS 3 *Business Combinations − Definition of a Business* (effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1st 2020 and to asset acquisitions that occur on or after the beginning of that period),
- Amendments to IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures: Sale or Contribution of Assets between an Investor and its Associate or Joint Venture*, and subsequent amendments (the effective date of the amendments has been postponed until the research project on the equity method has been concluded),
- Amendments to IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors – Definition of Materiality* (effective for annual periods beginning on or after January 1st 2020),
- Amendments to IAS 19 *Employee Benefits – Plan Amendment, Curtailment or Settlement* (effective for annual periods beginning on or after January 1st 2019),
- Amendments to IAS 28 *Investments in Associates and Joint Ventures – Long-term Interests in Associates and Joint Ventures* (effective for annual periods beginning on or after January 1st 2019),
- Amendments to various standards introduced as part of the Annual Improvements to IFRS Standards 2015–2017 Cycle – amendments made to IFRS 3, IFRS 11, IAS 12 and IAS 23 primarily to correct conflicts and clarify wording (effective for annual periods beginning on or after January 1st 2019),
- Amendments to References to the Conceptual Framework in IFRS Standards (effective for annual periods beginning on or after January 1st 2020).

The effective dates are stated in relevant standards issued by the International Accounting Standards Board. The dates of application of standards in the EU may differ from the effective dates stated in those standards and are announced upon their endorsement by the EU.

The Group has not elected to early adopt any of the standards, interpretations, or amendments endorsed by the EU which were not effective as at December 31st 2018.

Effect of applying new standards

The accounting policies applied in preparing these financial statements are consistent with the policies applied in preparing the Company's financial statements for the year ended December 31st 2017, save for the effect of applying new or amended standards and interpretations effective for annual periods beginning on or after January 1st 2018.

IFRS 9 *Financial Instruments*

The new IFRS 9 removes the categories of financial assets under IAS 39 and introduces classification of instruments as measured at fair value (fair value through profit or loss − FVTPL, or fair value through other comprehensive income − FVTOCI) or at amortised cost. The Group adopted IFRS 9 *Financial Instruments* from its effective date, i.e. January 1st 2018, without restating the comparative data as at December 31st 2017.

Measurement of financial assets and liabilities

Upon initial recognition, the entity measures financial assets at amortised cost, at fair value through other comprehensive income or at fair value through profit or loss. The entity classifies a financial asset based on its business model of financial asset management and the asset's contractual cash flow characteristics ('SPPI'). For a description of the accounting policies for classification and measurement of assets and liabilities, see Note 7.20.

The table below presents the effect of implementation of IFRS 9 on the change in the classification of the Company's financial assets as at January 1st 2018:

Item	Measurement category IAS 39	Measurement category IFRS 9	Carrying amount in accordance with IAS 39 as at December 31st 2017	Carrying amount in accordance with IFRS 9 as at January 1st 2018
Financial assets				
Derivative financial instruments	Financial assets through profit or loss	Measured at fair value through profit or loss	164.5	164.5
Trade receivables	Loans and receivables	Amortised cost	2,677.0	2,677.0
Cash and cash equivalents	Loans and receivables	Amortised cost	1,920.7	1,920.7
Other financial assets	Loans and receivables	Amortised cost	429.9	429.9
Shares*	Financial assets available for sale	Measured at fair value through other comprehensive income	9.8	9.8
Total financial assets			**5,201.9**	**5,201.9**

* Measured at historical cost as at December 31st 2017

The Group did not make any changes to the classification and measurement of its financial liabilities.

Impairment

The application of IFRS 9 substantially changes the approach to impairment of financial assets by replacing the incurred loss model with the concept of expected loss, where all the expected credit losses are recognised *ex-ante*. Upon the application of IFRS 9, the impairment loss as at January 1st 2018 remained largely unchanged, therefore no adjustments were made. For information on the accounting policies for impairment of financial assets, see Note 7.21.

Hedge accounting

The Group has elected the option to continue to apply the existing requirements of IAS 39 as of January 1st 2019 and not to apply the new hedge accounting requirements of IFRS 9.

IFRS 15 *Revenue from Contracts with Customers* and Clarifications to IFRS 15

IFRS 15 *Revenue from Contracts with Customers*, which is to replace IAS 18, IAS 11 and the related interpretations, establishes in a systematic way the principles for recognition of revenue from contracts with customers. The standard introduces, among other things, a single five-step model for revenue recognition, applicable to all contracts with customers and based on the identification of performance obligations under a contract and allocation of transaction revenue to such obligations. IFRS 15 also clarifies how variable consideration should be estimated and how to determine whether a contract includes a financing component, and differentiates between recognition of performance obligations under a contract as satisfied over time or satisfied at a certain point in time.

The Group implemented IFRS 15 using the modified retrospective method, that is with the cumulative effect of the first-time application of the standard recognised at the date of initial application, i.e. as at January 1st 2018.

The Group applied IFRS 15 retrospectively only to contracts that are not completed contracts at the date of initial application.

The Group applied the following practical expedients permitted under IFRS 15:

- with respect to the recognition of the effect of a significant financing component – the Group does not adjust the promised amount of consideration for the effect of a significant financing component if it expects, at contract inception, that the period between when the Group transfers a promised good or service to the customer and when the customer pays for that good or service will be one year or less;
- with respect to additional costs to obtain a contract – the Group recognises additional costs to obtain a contract as an expense when incurred if the amortisation period of the asset that would otherwise be recognised by the Company is one year or less;
- in the case of contracts for continuing services, under which the Group is entitled to receive from a customer a consideration in an amount that corresponds directly to the value of the services which the customer received so far, the Group recognises the revenue in the amount it is entitled to invoice.

The cumulative effect of implementation of IFRS 15 on the items of the statement of financial position as at January 1st 2018 is as follows:

	IAS 18/11 December 31st 2017	Effect of changes in accounting policies	**IFRS 15 January 1st 2018**
ASSETS	**6,236.6**	**(14.8)**	**6,221.8**
Current assets	**6,236.6**	**(14.8)**	**6,221.8**
Inventories	3,559.6	30.8	3,590.4
Trade receivables	2,677.0	(45.6)	2,631.4
EQUITY AND LIABILITIES	**10,843.9**	**(14.8)**	**10,829.1**
Equity			
Retained earnings	8,432.2	(8.7)	8,423.5
Non-current liabilities			
Deferred tax liabilities	210.0	(31.0)	179
Current liabilities			
Trade payables	2,201.7	24.9	2,226.6

The table below presents the amounts which affect the financial statements in the current reporting period following the application of IFRS 15 in comparison with IAS 11, IAS 18 and the related interpretations which were effective prior to the change.

Effect on the statement of comprehensive income for the year ended December 31st 2018:

	Amounts recognised in accordance with IFRS 15	Effect of changes in accounting policies	**Amounts without the effect of applying IFRS 15***
Revenue	30,121.7	(7.4)	30,114.3
Cost of sales	(25,592.7)	(6.3)	25,599.0
Gross profit	**4,529.0**	**(13.7)**	**4,515.3**
Profit before tax	**2,722.6**	**(13.7)**	**2,708.9**
Corporate income tax	(1,135.2)	10.7	(1,124.5)
Net profit	**1,587.4**	**(3.0)**	**1,584.4**

*The column presents the amounts determined in such a manner as if IAS 11, IAS 18 and the related interpretations applied in the current reporting period.

The nature of adjustments as at January 1st 2018 and the reason of key changes affecting the statement of financial position as at December 31st 2018 and the statement of comprehensive income for the year ended December 31st 2018 are presented below:

The Group changed its accounting policy for recognising revenue from sale of hydrocarbons produced from the fields on the Norwegian Continental Shelf in which the Group holds interests. Previously, the Group applied the entitlements (rights) method, according to which revenue is always recognised in the books in proportion to the Group's interest in actual production from the field. Under the newly adopted sales method, revenue is recognised when the product is transferred to the customer and all performance obligations set forth in IFRS 15 are met. The Group believes that the replacement of the previously applied entitlements method with the sales method affects the timing of revenue recognition and ensures compliance of revenue recognition with IFRS 15. The interest in that portion of output which has not been sold and which is allocated to the Group is recognised in accordance with IAS 2 and presented in the consolidated statement of financial position under Inventories.

For logistical reasons, when hydrocarbons are produced from a field by a number of interest holders there are natural differences between the volumes actually produced by the individual interest holders and their respective contractual shares in production. Thus, it is necessary to apply a special mechanism to account for such differences. In accordance with the sales method adopted by the Group, the overlift party, i.e. the interest holder who in a given production cycle produces hydrocarbons in excess of its contractual interest in production from the field, recognises the excess in its financial statements not as revenue, but as a liability to return the produced hydrocarbons. In accordance with contracts, the differences are settled among interest holders in kind (by transferring hydrocarbons). Therefore, the Group measures the liability referred to above based on the average six-month cost to reflect the fair value of expected consideration. Differences on measurement of the liability measured as described above are recognised in the consolidated statement of comprehensive income as Cost of sales.

In accordance with the entitlements method applied by the Group until December 31st 2017, revenue was always recognised in the Group's accounting books in accordance with its entitlement to production from the field. The correct amount of revenue in the financial statements was arrived at in the following manner: the overlift party, i.e. the interest holder which received hydrocarbons in excess of its contractual share of production from a field in a given period, recognised the excess in its accounting books as a liability rather than revenue. Conversely, the underlit party (the party receiving less than its entitlement in a given period) recognised the underlit as a receivable (revenue). In the consolidated statement of financial position, liabilities and receivables under the entitlements method as at December 31st 2017 are presented as: Trade payables and Trade receivables.

Assessment of the effect of implementation of IFRS 16 Leases on the financial statements

IFRS 16 *Leases*	
IFRS 16 is effective for annual periods beginning on or after January 1st 2019 and has been endorsed by the European Union. It replaces IAS 17 as well as IFRIC 4, SIC-15 and SIC-27.	The new standard introduces a single lease accounting model in the lessee's accounting books, which is similar to the recognition of finance leases under IAS 17. Under IFRS 16, a contract is a lease or contains a lease component if it transfers the right to control the use of the identified asset for a given period for consideration. An essential element that differentiates the definitions of lease under IAS 17 and IFRS 16 is the requirement to exercise control over a specific asset used, identified in the contract explicitly or implicitly. The right-of-use is conveyed where the lessee has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use in the period. If the definition of lease is satisfied, the lessee recognises a right-of-use asset and a lease liability, initially measured at the amount of discounted future lease payments to be made over the lease term. Expenditure related to the use of leased assets, previously largely included in cost of services, will now be classified as depreciation and interest expense. Right-of-use assets are depreciated using the straight-line method, while the lease liabilities are settled using the effective interest rate.

Effect of IFRS 16 on the financial statements

The Group carried out an analysis aimed at identifying the agreements under which it uses assets owned by third parties. Each of the agreements so identified was reviewed in terms of satisfying the criteria to be classified as a lease in accordance with IFRS 16. Based on the review, the effect of IFRS 16 on the individual items of the Group's financial statements was calculated.

The Group also made appropriate changes to its accounting policies and operational procedures. It developed and implemented methodologies for correct identification of agreements which are leases as well as for collection of data necessary to correctly account for such transactions. In addition, the Group is in the process of implementing appropriate changes in its IT systems to adapt them to collecting and processing of relevant data.

The Group decided to implement the standard starting from January 1st 2019. In accordance with the transitional provisions of IFRS 16, the new policies were adopted retrospectively: the cumulative impact of applying IFRS 16 was accounted for as an adjustment to equity as at January 1st 2019. Accordingly, the comparative data for the financial year 2018 will not be restated (modified retrospective approach).

IFRS 16 introduces a new definition of lease. However, the Company will use a practical expedient for transition and will not re-assess whether the contracts previously classified include leases. Therefore, the definition of lease compliant with IAS 17 and IFRIC 4 will continue to apply to lease contracts, concluded or amended before January 1st 2019.

Below are presented the individual adjustments made due to the implementation of IFRS 16.

Description of adjustments

Recognition of lease liabilities

Upon adopting IFRS 16, the Group will recognise lease liabilities with respect to agreements which were previously classified as operating leases in compliance with IAS 17. These liabilities have been measured at the present value of lease payments outstanding at the start of application of IFRS 16, discounted using the interest rate implicit in the lease, calculated on the basis of the Group's incremental borrowing rate as at the date of adoption of the standard (January 1st 2019).

Lease payments included in initial measurement of the lease liability comprise the following types of lease payments for the right to use the leased asset over the lease term:

- fixed lease payments net of any lease incentives,
- variable lease payments that depend on market indices,
- amounts expected to be payable by the lessee under residual value guarantees,
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option,
- lease termination penalties if the lessee is entitled to exercise the option to terminate the lease.

To calculate discount rates for the purposes of IFRS 16, the Group assumed that the discount rate should reflect the cost that it would have to pay to borrow the funds necessary to purchase the leased asset. In order to estimate the discount rate, the Group took into account the following parameters of a potential borrowing agreement: agreement type, duration and currency, as well as the margin it would have to pay to the financial institution to obtain the financing.

The Group intends to use the practical expedients available with respect to short-term leases (12 months or less) and leases where the underlying asset has a low value (below PLN 20 thousand) for all asset categories. For those leases, the Group will not recognise the right-of-use assets and associated financial liability.In the case of these leases, the Group will account for lease payments as an expense on a straight-line basis over the lease term. The Group will not separate non-lease and lease components for leases concerning all classes of underlying assets.

Use of practical expedients

When first applying IFRS 16, the Group will opt for the following practical expedients available under the standard:

- it will apply a single discount rate to a portfolio of leases with reasonably similar characteristics,
- operating leases whose remaining term as at January 1st 2019 is less than 12 months will be treated as short-term leases,
- it will exclude the initial direct costs from the measurement of the right-of-use asset at the date of initial application, and
- it will use hindsight in determining the lease term if the contract contains options to extend or terminate the lease.

Effect on the statement of financial position

Estimated effect of implementation of IFRS 16 on the recognition of additional financial liabilities and related right-of-use assets:

	January 1st 2019
Right-of-use assets	
Land	626.5
Buildings and structures	9.9
Service stations	141.0
Vehicles	314.2
Total right-of-use assets	**1,091.6**
Lease liabilities	
Non-current liabilities	885.6
Current liabilities	206.0
Total lease liabilities	**1,091.6**

Effect on equity

The implementation of IFRS 16 will have no effect on retained earnings or equity as at January 1st 2019 due to the fact that the right-of-use assets and lease liabilities will be recognised in the same amount.

Effect on financial ratios

Given the fact that practically all lease contracts will be recognised in the consolidated statement of financial position, the implementation of IFRS 16 by the Group will affect its balance sheet ratios, including the debt to equity ratio. In addition, the implementation of IFRS 16 will result in changes to the profits metrics (e.g. operating profit, EBITDA) and to cash flows from operating activities. The Group has analysed the implications of these changes for the fulfilment of covenants contained in its credit facility agreements. No risk of default has been identified.

5. Use of accounting assumptions, estimates and judgements

The preparation of financial statements in accordance with the International Financial Reporting Standards requires a number of assumptions, judgements and estimates which affect the value of items disclosed in these financial statements.

Although the assumptions and estimates are based on the management's best knowledge of the current and future events and developments, the actual results might differ from the estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Any change in an accounting estimate is recognised in the period in which it was made if it refers exclusively to that period, or in the current period and future periods if it refers to both the current period and future periods. Material assumptions used in making the estimates are described in the relevant notes to these financial statements.

While making assumptions, estimates and judgements, the Company's Management Board (Management Board) relies on its experience and knowledge and may take into consideration opinions, analyses and recommendations issued by independent experts.

Critical assumptions and estimates

Employee benefit obligations

Employee benefit obligations are estimated using actuarial methods. For information on the actuarial assumptions and valuation of employee benefit obligations, see Note 24.3.

Depreciation and amortisation

Depreciation and amortisation of the assets of onshore and offshore oil and gas extraction facilities is calculated (using the units-of-production method) based on 2P hydrocarbon reserve estimates (proved and probable reserves), evaluated, revised and updated by the Group, as well as forecast production volumes from the individual oil and gas fields based on geological data, test production, subsequent production data and the schedule of work adopted in the long-term strategy.

Depreciation and amortisation charges on refining and other non-current assets are determined based on the expected useful lives of property, plant and equipment and intangible assets. The Group reviews the useful lives of its assets annually, based on current estimates. The relevant estimate update which had an effect on the Group's financial statements for 2018 applied in the first place to the Parent, which recorded a PLN 0.6m decrease in depreciation or amortisation of these assets.

Fair value of financial instruments

The fair value of financial instruments for which no active market exists is determined by means of appropriate valuation methods. In selecting the methods and assumptions appropriate for these objectives, the Group relies on professional judgement.
For more information on the assumptions adopted for the measurement of fair value of financial instruments, see Note 7.20.

Deferred tax assets

The Group recognises deferred tax assets if it is assumed that taxable income will be generated in the future against which the assets can be utilised. If taxable profit deteriorates in the future, this assumption may prove invalid. The Parent's Management Board reviews its estimates regarding the likelihood of recovering deferred tax assets taking into account changes in the factors on which such estimates were based, new information and past experience.

For information on deferred tax assets, see Note 10.3.