Bank of Papua New Guinea

FINANCIAL STATEMENTS 31 DECEMBER 2011

Bank of Papua New Guinea

Report and Financial Statements for the year ending 31 December 2011

For the advantage of the people of Papua New Guinea, the objectives of the Central Bank are:

(a) to formulate and implement monetary policy with a view to achieving and maintaining price stability; and

(b) to formulate financial regulation and prudential standards to ensure stability of the financial system in Papua New Guinea; and

(c) to promote an efficient national and international payments system; and

(d) subject to the above, to promote macro-economic growth in Papua New Guinea.

Central Banking Act, 2000

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GOVERNOR'S FOREWORD

Mr Loi M. Bakani
Governor and Chairman of the Board

World economic recovery was sluggish in 2011, with improved economic activity in some advanced economies, weak growth in others and strong growth in developing and emerging economies – two speed recoveries. The International Monetary Fund (IMF), in its January 2012 World Economic Outlook (WEO) Update, revised downwards its estimate of economic growth for 2011 to 3.8 percent from 4.0 percent it projected in September 2010.

International commodity prices remained relatively high in 2011 in line with the economic recovery. This led to an increase in the export earnings of PNG's primary exports and a consequent improvement in the current account and overall balance of payments position. Increased exports, the continuation of the construction work of the LNG project and the resulting spin-off effect on domestic industries, such as manufacturing and transportation, yielded strong domestic economic growth, giving the PNG economy its ninth consecutive year of growth. The Bank estimated that real Gross Domestic Product (GDP) grew by 9.0 percent in 2011.

A major concern for the Bank over the course of 2011 was the continued increase in the level of liquidity in the banking system, arising from higher foreign exchange inflows and the continued maintenance of funds in Trust accounts at commercial banks. It led to an increase in the costs of conducting monetary policy as the Bank issued more Central Bank Bills to diffuse some of the excess liquidity.

At the end of December 2011 the gross foreign exchange reserves at the Bank were US$4.35 billion (K8.6 billion), up from US$3.1 billion (K8.2 billion) at the end of 2010. Foreign exchange inflows to the Bank totalled US$1.6 billion, compared to outflows of US$0.34 billion over the year.

With the strong foreign exchange inflows the Kina appreciated against the US dollar and Australian dollar and the trade weighted exchange rate index (TWI) over the year. Combined with low imported inflation from the major trading partner economies, this led to a lower headline inflation of 6.9 percent over the year to 31 December 2011, compared to 7.2 percent in 2010. Earlier in the year headline inflation had reached a high of 9.6 percent in the June quarter, attributed to high international fuel and food prices. This prompted the Bank to tighten monetary policy, increasing the policy signalling rate, the Kina Facility Rate (KFR), by 25 basis points each in June, July and August to 7.75 percent. As inflation eased to 8.4 percent in the September quarter and indications pointed to further easing in the December quarter, the Bank maintained the KFR at that rate to the end of the year.

My second year as Governor has been marked by the implementation of a number of strategic initiatives. The Bank's second Strategic Plan for the period 2012 to 2015 was completed, for adoption and implementation starting in 2012. Following the review of the management structure, four Assistant Governor positions were created and subsequent appointments of three Assistant Governors were made in early October 2011. Changes were made to the composition of various internal committees, including the Executive Committee (EXCO), Monetary Policy Committee and Investment Committee, to reflect the new top management structure and evolving roles of various Departments.

A number of key strategic projects continued from 2010 or were introduced during 2011 to enable the Bank to discharge its core functions of conducting monetary policy, promoting and maintaining a sound and stable financial system and ensuring an efficient payment system.

The payments system project advanced further with the awarding of the Automated Transfer System contract and the completion of the draft *National Payments System Act*, following consultations with various stakeholders.

Preparatory work on the Sovereign Wealth Fund legislation continued, with the required constitutional amendment being gazetted in October 2011 and the first reading, debate and vote by Parliament taking place in December.

The Bank is determined to lead work in the area of financial inclusion. The concept of financial inclusion is gaining increasing worldwide recognition as an important catalyst to development. Within PNG, promotion of financial services to the unbanked population is continuing through the spread of micro bank and savings and loan societies. As well, research on financial competency and literacy of the population continued through 2011, in collaboration with both international and domestic institutions, including the World Bank and the Institute of National Affairs. From this research, authorities like the Central Bank can address shortcomings by designing and implementing appropriate policies.

The Bank of Papua New Guinea continued to enjoy cordial working relationships with our international partners throughout 2011. I acknowledge the assistance of the IMF, the World Bank, the Reserve Banks of Australia and New Zealand, the SEACEN Centre, the SEANZA member countries, the Australian Prudential Regulatory Authority (APRA), the Pacific Technical Assistance Centre (PFTAC), the Alliance for Financial Inclusion and the Asian Development Bank.

The Bank's ability to carry out its core objectives and contribute to the financial stability and economic prosperity of Papua New Guinea rests on the capacity and capability of our people to carry out their duties. I would like to thank my fellow Board members for their valuable support and contributions to the Bank in performing its functions.

To the staff of the Bank of Papua New Guinea I offer my sincere thanks for their commitment and dedication in carrying out their duties during 2011.

Loi M. Bakani
Governor and Chairman of the Board

HIGHLIGHTS

Solid investment performance

In spite of the difficult investment climate experienced in 2011 the Bank's external fund managers achieved solid investment returns on the outsourced funds.

New fund manager appointed

The Bank outsourced US$200 million to BlackRock Financial Management Inc in August, bringing the number of external fund managers to five (pages 14 and 26).

Organisation restructure

The Bank's drive to embed a performance-based culture, improve efficiency and reduce day-to-day administration costs led to the establishment of four new Assistant Governor positions and a number of internal management committees to oversee the Bank's core activities.

Strategic Plan launched

The Bank launched its Strategic Plan for the four year period 2012 to 2015.

Effective enforcement action

Following investigation of the SCITB matter, the Bank revoked the licence of National Capital Ltd.

Salaries brought to market level

The Salaries and Conditions Monitoring Committee (SCMC) approved the Bank's recommendations for changes to terms and conditions. With salaries more closely aligned with the general market, the Bank is now more competitive with other employers in attracting quality workers (page 40).

Bank supports expanded banking services

The Bank approved the licence for Kokopo Microfinance Ltd (KML) and is assessing a number of applications from microfinance organisations and companies wanting to provide microfinance business, mobile banking and payment services (pages 16 & 29).

Public awareness raising

The Bank undertook new initiatives on public awareness, focussing on the Bank's Clean Note Policy, money market and Government Securities investments and financial literacy.

Coinciding with the release of the two Monetary Policy Statements, the Governor addressed a number of key industry bodies during the year.

Closure of Currency Distribution Centres (CDCs)

The Bank's three CDCs in Lae, Kokopo and Mt Hagen were closed as from June 2011.

New K100 note

The Bank released a new K100 banknote in 2011 with the signature of the current Governor, Mr Loi M Bakani.

Strong numismatic sales

Sales of commemorative notes and coins in 2011 were almost double the sales in 2010 (page 35).

MISSION

The Bank of Papua New Guinea's MISSION is to serve the people of Papua New Guinea by conducting effective monetary policy and maintaining a sound financial system. We will act at all times to promote macro-economic stability, provide a first class payments system and help foster economic growth of our country.

VISION

A contemporary central bank and regulator excelling in performing our core functions and making a distinct and valuable contribution to the economic well-being of Papua New Guinea.

VALUES

With **INTEGRITY** we build good governance and credibility.

With **EFFICIENCY** we produce quality results, on time and on budget.

With **TRANSPARENCY** our decisions stand scrutiny.

Through **ACCOUNTABILITY** we take responsibility for our decisions and actions.

Through **TEAMWORK** we benefit from sharing skills, knowledge and experience.

Through **PROFESSIONALISM** we strive for best practice.

GOVERNANCE

The Bank's governance practice starts with the Board and its responsibility to ensure the Bank's policies (other than monetary policy and financial system regulation, which are the exclusive responsibility of the Governor) are directed to the greatest advantage of the people of Papua New Guinea.

To this end, the Board's members are drawn from a range of interest groups within the PNG community – civil, church, regulatory, union and industry bodies.

There were a number of changes to the composition of the Board during 2011.

Dr Ken Ngangan was appointed in April 2011 in his capacity as President of CPA (PNG).

In July Ministerial appointees Mr Simon Foo, Sir James Tjoeng and Ms Betty Palaso retired from the Board at the expiry of their terms of office.

Mr Alex Tongayu retired from the Board in November 2011, with the expiry of his term as Chairman of the Securities Commission.

THE BOARD

Governors

Governor and Chairman
Loi M. Bakani

Mr Bakani was appointed Governor of the Bank of Papua New Guinea and Chairman of the Bank Board in December 2009.

He is also a Member of the Board of South East Asian Central Banks (SEACEN), the Alternative Governor for IMF Annual Meetings, Chairman of the PNG-ADB Microfinance and Employment Project, Director of the PNG Institute of Directors (PNGID), Director of the PNG Institute of Banking & Business Management (IBBM) and Member of the Advisory Board of Port Moresby Senior AFL competition.

He holds a Bachelor of Economics from the University of Papua New Guinea and a Masters degree in Commerce, majoring in Economics from the University of Wollongong, Australia.

Deputy Governor
Benny Popoitai MBE

Mr Popoitai was appointed Deputy Governor and Member of the Board in November 2000.

He is also President of the PNG Institute of Directors.

Mr Popoitai holds a Bachelor of Economics with Honours from the University of Papua New Guinea.

Members of the Board

At 31 December 2011

Reverend Sir Samson Lowa KBE

Reverend Sir Samson Lowa, appointed a Member of the Board in 2000, is an ex officio Member in his capacity as Chairman of the PNG Council of Churches.

He is Moderator of the United Church in PNG and a Director of Independence Fellowship Scheme.

He holds Bachelor degrees in Divinity and Education and Diplomas in Theology and Secondary Teaching.

Mr Michael Malabag OBE

Mr Malabag was appointed ex officio to the Board in March 2008, in his capacity as President of the PNG Trade Union Congress.

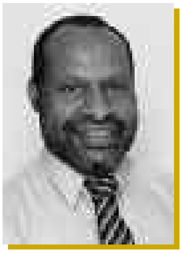
He holds a Higher School Certificate in Public Administration.

Mr John Leahy

Mr Leahy was appointed ex officio to the Board in March 2008, in his capacity as President of the PNG Chamber of Commerce and Industry.

Mr Leahy is also a Director of a number of companies, including Bougainville Copper Ltd, Brands International Ltd, Tasman Constructions Ltd, Price Waterhouse Nominees (PNG) Ltd, Abelia Investments Ltd and Orion Project Services (PNG) Ltd.

He holds a Bachelor of Jurisprudence, majoring in Industrial Relations, from the University of NSW, Australia and a Graduate Certificate in Management from Monash Graduate Business School, Australia.



Dr Ken Ngangan

Dr Ken Ngangan was appointed ex officio to the Board in April 2011, in his capacity as President of CPA PNG.

Dr Ngangan is also Chairman of the Board of National Teachers Insurance Limited (NTIL) and Deputy Chairman of National Development Bank.

He holds a Bachelor of Arts in Commerce with Honours from the University of Papua New Guinea, a Masters degree in Accounting from the University of Glasgow, Scotland, a Doctor of Philosophy in Accounting from the University of Newcastle, Australia and a Post-Doctoral Fellowship from the University of Aberdeen, Scotland.

Board meetings

The Board meets at least once every three months. The March 2011 meeting was held in Wewak, East Sepik Province. Two meetings were held in Port Moresby NCD (June and December) and the September meeting was held in Kimbe, West New Britain Province.

A special Board meeting was held in April in Port Moresby, which was attended by all who were members of the Board at that time.

Board Member	Meetings Eligible to Attend	Meetings Attended
Mr Loi M. Bakani	4	4
Mr Benny Popoitai MBE	4	4
Rev. Sir Samson Lowa KBE	4	4
Ms Betty Palaso OBE	2	1
Mr Michael Malabag OBE	4	3
Mr John Leahy	4	4
Sir James Tjoeng KBE	2	1
Mr Simon Foo CBE	2	2
Mr Alex Tongayu	3	3
Dr Ken Ngangan	3	3

Board Audit Committee

The Board Audit Committee is charged with assisting the Board to ensure the Bank's performance in financial reporting, internal control and governance meets the required standards and expectations.

From January until his retirement from the Board in July Sir James Tjoeng chaired the committee, with members Mr Benny Popoitai and Mr Alex Tongayu. Dr Ken Ngangan was appointed Chairman in July. Mr John Leahy was appointed to the Audit Committee in November, on the replacement of Mr Tongayu as chairman of the Securities Commission.

Transaction transparency and ethical conduct

Internal committees

Several internal committees were convened during the year to establish and review operational frameworks and benchmarks and to oversee, consider and authorise specific aspects of the Bank's activities.

These included the Monetary Policy Committee, the Money Market Operations Committee, the Investment Committee, the Tender Committee and the Budget Committee. Each committee has specific roles and responsibilities designed to ensure the probity of the Bank's various activities.

External checks and balances

In addition to the committee system, the Bank has in place a number of other measures as part of its commitment to good governance. For example, the Bank must meet the statutory obligation of presenting its annual financial statements to the Auditor-General of Papua New Guinea for detailed inspection and audit.

An external agency, the Salaries and Conditions Monitoring Committee, is charged with the responsibility of ratifying changes to staff employment conditions, including pay increases.

Internal audit

Over 2011 the focus of internal audit was on the effectiveness of the Bank's internal controls and operating environment, including foreign exchange reserves and outsourced funds, foreign exchange settlements, domestic money markets and registry operations, procurement and expenditure, currency, banking and financial reporting.

Peer review

The Bank of PNG actively seeks peer review on key decisions from the Reserve Banks of Australia and New Zealand and other regulatory authorities, such as the Australian Prudential Regulatory Authority (APRA).

Co-operation with Government Agencies

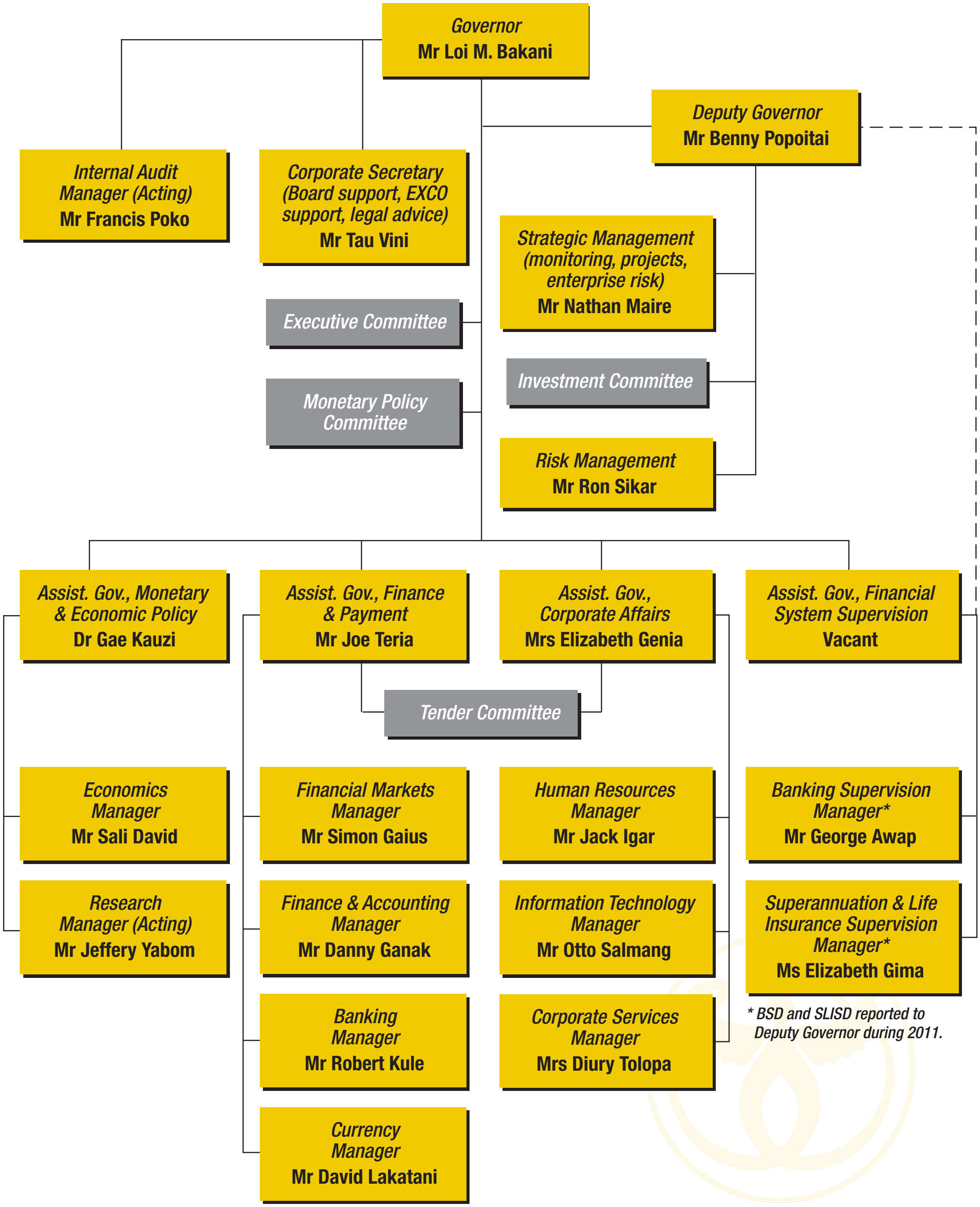
The Bank also works with other Government agencies to mitigate the risk of fraud and other such threats to the PNG financial and payments system.

Setting the right example

The Bank's Values Statement provides clear guidance to Bank employees that all staff members are required to conduct themselves with the highest standard of behaviour.

THE BANK OF PNG MANAGEMENT STRUCTURE

AT 31 DECEMBER 2011



* BSD and SLISD reported to Deputy Governor during 2011.

ACHIEVING STRATEGIC OBJECTIVES

The Bank of Papua New Guinea operates in a dynamic and evolving environment. With the aim of employing best practice to discharge its core functions and recognising the need to be flexible to accommodate change, the Bank undertook a number of strategic decisions and projects during 2011.

Expansion of Funds Management Outsourcing

In line with the Bank's strategic program of outsourcing funds management, during the year the Bank appointed BlackRock Financial Management, Inc. as the Bank's fifth external funds manager. US$200 million was allocated to BlackRock.

Implementation of Financial Inclusion Activities

The Bank has made a strong strategic commitment to fostering financial inclusion in PNG.

For a number of years micro-finance has been a cornerstone of financial inclusion by providing broad access to banking services. The Bank embarked on Stage 2 of the ADB micro-finance project during the year.

Organisational Restructure

Creation of Assistant Governor positions

In 2011 the Bank reconfigured decision-making at the senior level through the restructure of its management, with the objectives of achieving a performance-based culture, improving efficiency and reducing day-to-day administration costs.

Four new Assistant Governor roles were created.

Assistant Governor, Monetary & Economic Policy oversees the Bank's Economics and Research Departments. Dr Gae Kauzi was appointed to this position.

Mr Joe Teria, appointed to the position of Assistant Governor, Finance & Payments, oversees the Bank's Financial Markets and Payments System as well as financial administration.

Assistant Governor, Corporate Affairs heads up the Bank's Human Resources, Information Technology and Corporate Services Departments. Mrs Elizabeth Genia was appointed to this role.

The position of Assistant Governor, Financial System Supervision, which oversees the Banking and Superannuation and Life Insurance Supervision activities of the Bank, was not filled during 2011.

Department restructures

The Bank reviewed its operational support functions, housed within the Human Resources, Information Technology and Corporate Affairs Departments. During the year these Departments were restructured to provide the corporate services required by the Bank as it meets its core responsibilities in a changing world.

Major projects

Strategic long term systems projects, including Data Warehousing and the Payments System) progressed through the year. The Comprehensive Reserve Management System (CRMS) went 'live' in 2011.

Staff capacity building

The Bank of Papua New Guinea has long held a strong reputation for its focus on and commitment to staff development and capacity building, recognising the strategic importance of having appropriate qualified and trained staff.

During 2011 the Bank sponsored a wide range of formal qualifications for staff members. These included:

- Full time or part time degree and diploma courses at PNG universities
- Associate Diploma programs from PNG IBBM
- Study programs offered by the International Training Institute, the Institute of Business Studies and the PNG Institute of Accountants

The ongoing onsite prudential review program gave Supervision Department staff the opportunity to develop professional skills, achieve international experience and share expertise with central bank staff from other nations. The program is supported by the Pacific Technical Exchange Program, with technical assistance from APRA. During 2011, Bank staff participated in onsite reviews in Fiji, Samoa, Vanuatu and the Federated States of Micronesia.

AusAID and Reserve Bank of Australia (RBA) scholarships provide opportunities for Bank staff to further their formal qualifications at Australian universities. In 2011 former Internal Audit Manager, Mr Alfred Napun, was awarded an RBA scholarship and AusAID offered a scholarship to Senior Research Analyst, Ms Williamina Hubert.

The Bank also sponsored staff attendance at a number of overseas conferences, workshops and meetings.

Financial inclusion

The National Government's Vision 2050 Policy Statement encourages wealth creation, reduction of poverty and promotion of economic growth. A policy of 'financial inclusion' has evolved from this, along with three key challenges:

- How to get the unbanked portion of the population into the financial system;
- How to educate the public about managing their finances; and
- How to improve ways of dealing with the perpetrators of money schemes, financial fraud and theft.

The Bank of PNG has embraced financial inclusion as a key aspect of its core responsibilities.

To ensure financial stability is maintained and members' funds are protected, the Bank has placed significant emphasis on financial institution development, strengthening approaches to supervision and building financial literacy under its Strategic Plan.

During 2011 the Bank and its development partners undertook a number of financial inclusion initiatives, including financial literacy training activities and promoting mobile banking and mobile payment services.

In the context of financial literacy training, the Bank liaised very closely with the Department of Education and Pacific Financial Inclusion Programme (PFIP), working to include financial inclusion in the curriculum for schools.

The Bank welcomes the introduction of mobile banking and payment services as they can assist in reducing the cost of banking and contribute to the expansion of financial services in PNG, in particular in the rural areas with limited access to financial products.

While the Bank's official position is to promote business models where authorised (and therefore Bank-supervised) institutions offer mobile banking, the Bank also recognises the opportunity for expanded financial inclusion through non-banks (MNOs) reaching 'the unbanked' through their network coverage.

The US$24.2 million Microfinance Expansion project, which commenced in 2011, is also clearly focused on building financial inclusion. The project is co-funded by ADB, AusAID, the National Government and a number of financial institutions.

The project aims to:

- Build financial literacy to:
  - encourage the unbanked population to become part of the monetarised sector
  - develop the management and technical capacity of microfinance institutions (MFIs)
- Develop an appropriate regulatory framework for supervision of MFIs
- Increase lending to small and medium enterprises (SMEs) through a risk sharing facility.

Sovereign Wealth Fund

To implement the Sovereign Wealth Fund (SWF) in line with the National Executive Council decision of 2010, the SWF Secretaries Committee formalised a Sovereign Wealth Fund Working Group and its terms of reference in February 2011.

Members of the working group, which includes the Bank of Papua New Guinea, assumed leadership responsibility for various aspects of the SWF development process over the course of the year:

Department of Justice & Attorney General (DJ&AG)
- Legislation

Department of Treasury (DoT)
Department of Public Enterprises (DPE)
- Organisational design & governance

Department of Treasury
- Integration with the budget/fiscal framework
- Public awareness
- Stakeholder engagement

Department of Public Enterprises
- Economic modelling

Bank of Papua New Guinea
- Investment mandate & policy

Donor partners, including the Australian government, World Bank and IMF provided assistance during the year. The World Bank funded a study tour of SWF members to Chile in July 2011 and arranged contact to share experiences with authorities in Mongolia, also involved in establishing a sovereign wealth fund. The Australian government provided technical assistance. The IMF provided economic modelling on the effects of the LNG Project on macroeconomic conditions in PNG.

The structure of the SWF originally proposed included three funds – Futures Fund, Stabilization Fund and Development Fund. The National Government formed in August 2011 decided not to go ahead with the Futures Fund, but to concentrate on the Stabilization and Development funds.

In 2011 Bank of PNG staff co-opted onto the SWF committee attended a number of international conferences and seminars in China, Singapore and the Philippines, to discuss issues associated with developing SWFs and managing resource booms. Bank staff also participated in economic modelling assignments in Australia.

Legislative work during the year resulted in the gazettal notices for the constitutional amendments to accommodate the SWF in October and the *Organic Law on the Sovereign Wealth Fund* in November.

In November and December staff from the SWF Committee conducted a series of awareness presentations in Kokopo, Lae, Mt. Hagen and Alotau. The presentations covered the proposed SWF framework, legislation and administrative set-up.

BUSINESS AND COMMUNITY SUPPORT

As is fitting with its leadership position in the Papua New Guinea business sector and broader community, during 2011 the Bank of PNG and its staff supported a range of business and community development activities.

The Bank is a major supporter of local institutions that help develop professional capacity and foster best practice. During the year the Bank made significant contributions to the National Development Bank Ltd, PNG Law & Justice Sector Secretariat, PNG Institute of Directors, ISACA, the PPFSS CEO Forum, the PNG Human Resources Institute, the PNG Chamber of Commerce & Industry, Transparency International (PNG) Inc, the Ipatas Foundation, the Malaysian Association of PNG and the Gipaheka Women's Group.

Health, medical research and welfare charities and initiatives supported by the Bank included Operation Open Heart, the Sir Buri Kidu Heart Institute, the PNG Medical Society's Annual Medical Symposium, Oil Search Cancer Fund, Kimbe General Hospital and Steamships Red Shield Appeal and the National St John Council of PNG.

The Bank also contributed to Papua New Guinea's Paralympic effort as well as staff participation in corporate sporting challenges.

ECONOMICS DEPARTMENT

Monetary Policy Formulation

Under the terms of the *Central Banking Act 2000*, the Bank is required to release two Monetary Policy Statements (MPS) each year. In 2011 the first MPS was released on 31 March and the second on 30 September.

The Bank's formulation of monetary policy during the year was guided by analysis of the main influences on price stability, with consumer price changes being a major factor. The Bank took into account actual and projected developments in the world economy, domestic economic activity, balance of payments and fiscal operations of the National Government and their potential impact on monetary aggregates, the exchange rate, interest rates and inflation.

The Bank maintained a cautious approach to its stance of monetary policy in the first half of 2011. From July the Bank began to tighten monetary policy following high inflationary pressures and inflation outcomes. As a result, the Kina Facility Rate (KFR) was increased by 75 basis points in total to 7.75 percent by September 2011. The Cash Reserve Requirement was also increased by 200 basis points in aggregate to 6.0 percent by August 2011 to support the tightening stance. In response, the commercial banks made adjustments to their Indicator Lending Rates (ILRs), with the spread increasing from 10-95 – 11.95 percent, where it has been since March 2010, to 11.45 – 12.20 percent as of September 2011.

Expansion of Monetary and Financial Data Coverage

The Bank's aim of expanding the coverage of monetary and financial statistics was furthered during 2011, with the Office of Insurance Commissioner (OIC) agreeing to require general insurance companies and brokers to report their monetary and financial data to the Bank. This represented a significant breakthrough since these institutions do not fall within the Bank's supervision responsibilities.

Balance of Payments System

The Bank compiles data on international transactions between PNG and the rest of the world to produce Balance of Payments (BOP) information. BOP information contributes to the MPS, the monthly KFR determination and the Bank's Quarterly Economic Bulletins (QEB) and IMF publications. BOP developments and projections are also discussed with the Department of Treasury for the National Budget projections.

The commercial banks' international transactions reporting systems continued to be the major source of BOP information throughout 2011.

2011 saw increased BOP reporting activity arising from the LNG project. While LNG companies were granted tax exemptions by the State, including exemptions from the Bank of PNG to open foreign currency accounts (FCAs) abroad, the reporting requirements were not exempted. Accordingly, LNG companies were required to submit details of their offshore FCA transactions.

BOP tables and commentaries are published in the Bank's QEBs and available on the Bank's website www.bankpng.gov.pg

International Transactions Monitoring

Foreign Currency Accounts

Applications received in 2011	7
Applications approved*	5

** Of the other applications received, the Bank advised one applicant that no authorisation was required, under the Exemption Regulation Act 2008. The other applicant was requested to provide additional information.*

The Bank instructed a company to close its foreign currency account, which had been opened without its authority.

Gold Export Licences

While the Bank allows residents and non-residents to buy and sell gold freely within PNG, they must obtain a gold export licence from the Bank to sell gold outside the country. Subject to compliance with its conditions, the licence is renewable on application each year.

Applications received in 2011	13
Applications approved & renewed – Au Pacific Gold Limited – Gold Exports Limited – Golden Valley Enterprises Limited – Italpreziosi South Pacific Limited – Repax (PNG) Limited – Wanaka No. 5 Limited – Wingold Limited	7
Applications requiring more information	6
Licences not renewed – Aurora Gold Merchants Ltd – Longreef Limited	

Domestic Lending in Foreign Currency

Lending by Authorised Dealers in any foreign currency to residents of PNG requires prior approval of the Bank.

Applications approved in 2011	3
Value of transactions	K96.5 million

Contingent Guarantees in Favour of Non-Residents

The Bank's approval is required to issue guarantees or indemnities for the benefit of non-residents.

Applications approved in 2011	8
Value of transactions	K16,334.3 million

PNG LNG Project Exemption

Companies engaged in transactions related to the PNG LNG Project led by ExxonMobil and its partners are exempted from the operation of the *Central Banking (Foreign Exchange and Gold) Regulation* (the Regulation). To be entitled to this exemption, a company must demonstrate that its engagement, or a transaction, is primarily for the PNG LNG Project or Project Operations.

Exemption status reviewed in 2011 – 1 PNG LNG Project company – 23 sub-contractors
Exemption status confirmed – 1 PNG LNG Project company – 14 sub-contractors
Exemption status denied – 4 sub-contractors (Exemption did not apply to the remaining 5 sub-contractors, as they were non-resident.

RESEARCH DEPARTMENT

The Department's primary responsibilities are to carry out research that enhances economic knowledge to aid sound decision making, to provide inputs into and assist in the formulation of monetary policy and to increase public understanding of financial and economic issues.

The Department has two units, the Economic Analysis Unit (EAU) and the Projects Unit.

Economic Analysis Unit

EAU's responsibilities include:

- conduct the Bank's main surveys as part of the research work to gather information about the economy;
- collect data on inflation indicators, such as the Consumer Price Index (CPI), Retail Price Index (RPI) and other domestic prices, and conduct modelling and forecasting for inflation;
- collect data and undertake forecasting for GDP; and
- participate in the production of the Bank's Quarterly Economic Bulletins.

Business Liaison Survey 2011 (BLS)

– 94 large private sector companies
Port Moresby-based companies surveyed quarterly. Companies in other centres surveyed annually.

– 320 medium-size companies
Surveyed annually.

Employment Survey 2011

– 412 companies
Surveyed quarterly.

Inflation

EAU's main tasks include analysis and forecasting inflation in PNG. During 2011 this involved collecting data from selected major supermarkets in Port Moresby and price-controlled items from the ICCC and compiling from them the monthly RPI. The Bank uses the monthly RPI and other economic indicators to set the monthly Kina Facility Rate.

The Bank uses the quarterly CPI information collected and compiled by National Statistics Office (NSO) as the official inflation indicator to forecast inflation and set the KFR. During the quarters when the CPI is not available the Bank uses the RPI to assess inflationary pressures in the economy. EAU also collects other price data on various items such as electricity, telecommunication, transport, water and sewerage and postal charges.

Progress towards deriving a new CPI basket continued in 2011 as Household Income Expenditure Survey (HIES) information compiled by NSO was processed.

Estimation and Projection of Gross Domestic Product (GDP)

Data from BLS, BSS, BOP, Government Budget forecasts and other sources were used to produce GDP estimates and forecasts for the March and September MPS. Over the course of the year EAU continued work on improving the robustness of the GDP model.

Projects Unit

The Unit is responsible for carrying out analytical research on topical issues to aid decision-making.

Research Projects

The Unit's major project during 2011, continuing from 2010, considered the supply response by growers of major export commodities to international price movements. This project produced research papers for each of the four major export commodities – coffee, cocoa, palm oil and copra.

Two additional research papers were completed during 2011:

- Determinants of real exchange rate in Papua New Guinea
- Money demand in Papua New Guinea.

All six research papers will form part of the Bank's working paper series.

FINANCIAL MARKETS DEPARTMENT

The primary responsibilities of the Department are to implement monetary policy, manage foreign exchange reserves and provide settlement banking and payment services, including registry services.

Money Market Operations

High liquidity levels presented the Bank with a significant monetary policy challenge over the course of 2011. As high liquidity levels continued to increase and commercial bank balances in their Exchange Settlement Accounts (ESA) increased significantly, the widening gap between the policy and market rates continued to be a concern.

The Bank used various monetary policy instruments to achieve the core objective of price stability. Monthly KFR announcements signaled the Bank's policy stance. As part of the Bank's liquidity management strategy, the Minimum Liquid Asset Ratio (MLAR) was reduced to zero from 25.0 percent, while the Cash Reserve Ratio (CRR) was increased to 6.0 percent in August 2011, up from 3.0 percent in October 2010.

In the open market operation, Central Bank Bills (CBBs) were used to manage liquidity in the banking system. By the end of 2011, net sterilisation of liquidity had resulted in an increase in the Bank's total outstanding CBB stock.

The Bank maintained a good working relationship with the Government in its capacity as the official agent in the securities market. Through the money market operations, the Bank issued Treasury bills and Inscribed stock to meet the financing needs of the Government.

Foreign Reserves Management Operations

Increase in Foreign Exchange Reserves

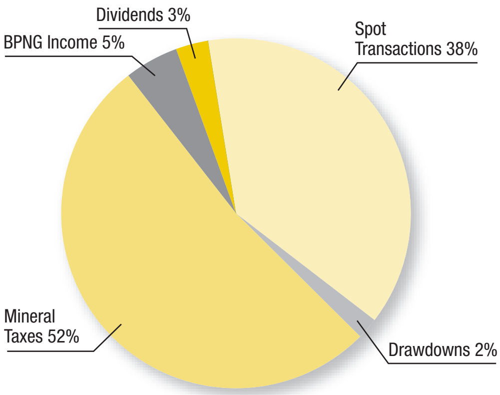
December 2011	US$4.35 billion *(K9.23 billion)*
December 2010	US$3.16 billion *(K8.25 billion)*
Increase	US$1.19 billion
Reason – High commodity export receipts, particularly mineral tax receipts and LNG Project-related capital inflows	

Sources and Uses of Foreign Exchange Reserves

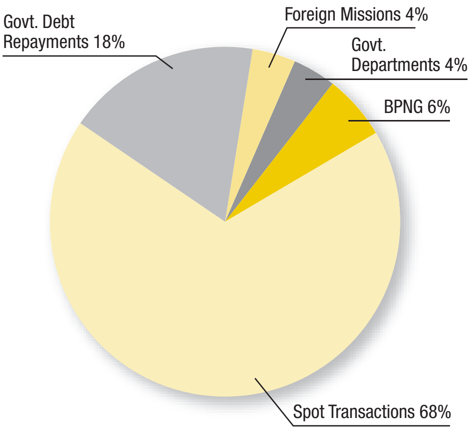
Foreign Exchange Flows in 2011

Inflows	USD (m)	Outflows	USD (m)
Total	**1,585.0**	**Total**	**-343.4**
Major contributors			
Spot Transactions	592.7	Spot Transactions	-230.0
Drawdowns	34.3	Gov't Debt Repayments	-59.7
Mineral Taxes	818.3	Foreign Missions	-14.9
BPNG Income	83.0	Govt Depts	-13.3
Dividends	49.7	BPNG	-19.9

Foreign Exchange Inflows 2011



Foreign Exchange Outflows 2011



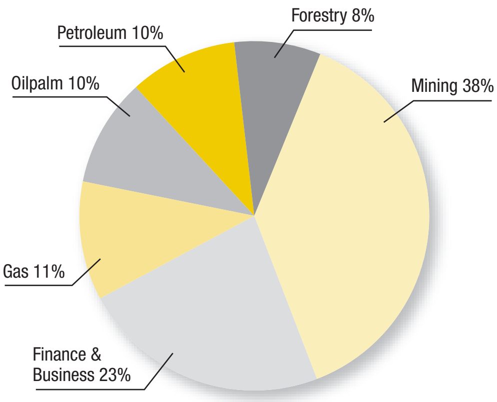
Domestic Foreign Exchange Market

In 2011 the Kina appreciated strongly against most major currencies, appreciating by 23 percent against the US dollar and by 24 percent against the Australian dollar, mainly as a result of large foreign exchange inflows from the mining sector. These inflows more than offset foreign exchange outflows dominated by the retail sector.

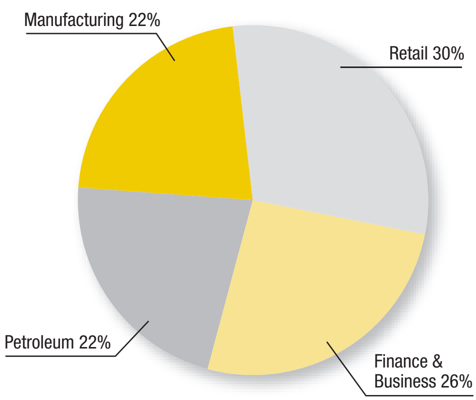
In trade weighted terms, the Kina appreciated by 21 percent against the currencies of its major trading partners.

	January 2011	December 2011	YTD (% Change)
PGK/USD	0.3780	0.4665	23.4
PGK/AUD	0.3704	0.4591	23.9
PGK/EUR	0.2842	0.3605	26.8
PGK/GBP	0.2431	0.3026	24.5
PGK/JPY	30.72	36.17	17.7
PGK TWI	30.86	37.31	20.9

Major Contributions to Fx Inflows – 2011



Major Contributions to Fx Outflows – 2011

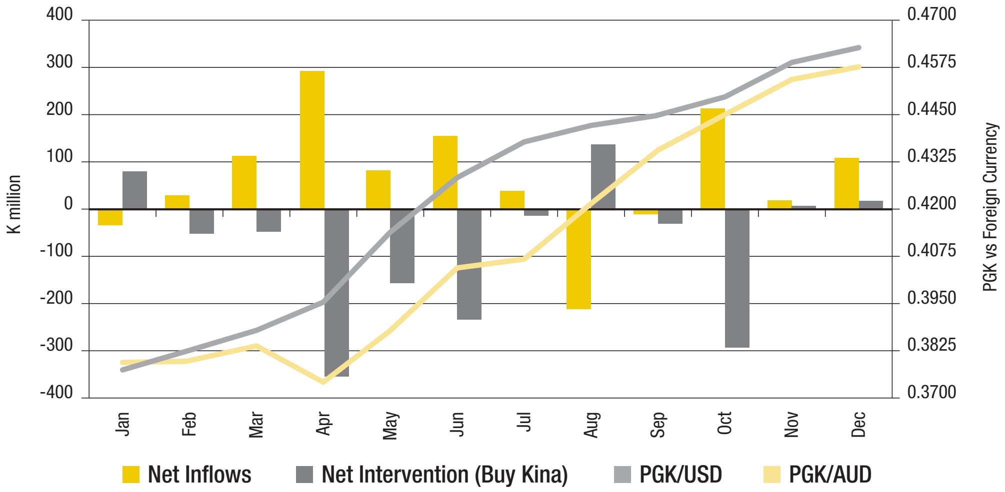


Inflows	USD (m)	Outflows	USD (m)
Total	**15.79**	**Total**	**-14.79**
Major contributors			
Mining sector	4.27% 38 percent of total inflows	Retail sector	-2.85% 30 percent of total outflows

The Bank was a net buyer of US$394 million in the domestic foreign exchange market in 2011. This is equivalent to a net injection of K940 million into the domestic market, compared with a net diffusion of K657 million in 2010. The total turnover in the foreign exchange market in 2011 increased to K36.4 billion, compared to K26.5 billion in 2010.

Summary of the foreign exchange flows, the Bank's intervention and exchange rate movements in 2011 (K million).

Domestic Foreign Exchange Market Overview 2011



Foreign Currency and Interest Rate Risks

A number of macro issues leading to periods of heightened volatility influenced the financial markets in 2011. They included the European sovereign debt crisis, fears of a global economic slowdown, geopolitical events, natural disasters and the downgrade of US Treasuries by credit rating agency Standard & Poors.

Global bond market yields increased during the first quarter of 2011 in line with expectations of improving global economic growth. Following the first quarter, global bond yields declined for the remainder of the year, with both short and long term bond yields falling sharply on the back of investor risk aversion as the European sovereign debt crisis intensified. This led to the appreciation of the US dollar against most major currencies during 2011 as a result of 'safe haven buying'.

During the first quarter of 2011 the Bank took a defensive portfolio duration strategy as global bond yields were expected to increase over the course of the year. The Bank altered this strategy during the second quarter, as fears of a global economic slowdown emerged. The Bank widened its portfolio duration ranges on its investment currencies to accommodate heightened volatility and to take advantage of declining bond yields. In the second half of 2011, the Bank opted to take a neutral to long currency exposure to the US dollar and a neutral to short currency position for the Australian dollar.

Middle Office Operations

The Middle Office unit monitors risks on the Bank's investments, both for the core reserves managed in-house and funds managed externally. These risks include exchange rate risk, interest rate risk and credit risk. The unit also ensures compliance with investment mandates set by the Bank, conducts performance evaluations against benchmarks and maintains a risk register for the Financial Markets Department.

Outsourced Funds – Performance

The Bank continued the funds management outsourcing program during 2011, with the appointment of BlackRock Financial Management, Inc. as the fifth external fund manager and allocation of US$200 million to the company in June.

By the end of 2011 the total value of outsourced funds was US$1,081 million, compared to US$871 million at the end of 2010.

During the year the Bank conducted two reviews of the fund managers, in line with the terms of the Investment Management Agreement (IMA). The reviews focused on performance and compliance with the IMA.

In 2011 all fund managers complied with the IMA. In the light of the difficult global economic environment, some fund managers required the Bank to grant waivers so they could meet the requirements of the IMA.

In this context, the Bank gave a waiver for Sinopia (HSBC Global Asset Management) to hold a Tokyo Electric (Tepco) bond after Standard & Poors downgraded its credit rating to BBB, which falls outside the minimum credit rating specified in the IMA. HSBC holds a EUR 2.1 million bond position which constitutes 1.35% of their overall portfolio.

The Bank also gave a temporary waiver for Deutsche Bank Asset Management International (Deutsche) and BlackRock to hold Eksport Finans debt (Norwegian Debt) after Eksport Finans was downgraded to a credit rating outside the IMA conditions.

In November 2011 Italian Government bonds were downgraded to a level outside the IMA guidelines. This resulted in the granting of a temporary waiver to all external fund managers. Each held positions in Italian Government debt as it comprises around 6 percent of the relevant benchmark (Citibank 1-3 year USD Hedged Bond Index).

Recognising the difficult investment conditions, overall the external fund managers performed relatively well against the benchmark (Citigroup World Government Bond Index 1-3 year hedged to the USD).

External Fund Managers Performance in 2011 vs Benchmark

	Portfolio	Benchmark
Clariden Leu Ltd	1.46%	1.43%
Deutsche Asset Management International	1.43%	1.43%
Schroders Investment Management Ltd	1.53%	1.43%
HSBC Global Asset Management	1.17%	1.43%
BlackRock Financial Management, Inc.*	0.53%	1.43%

** BlackRock performance began in May 2011*

Registry Operations

The Bank of Papua New Guinea acts an agent for the Government in the sale and registration of domestic debt instruments.

As part of its mandate to manage liquidity in the monetary system, the Bank underwrites, issues and acts as a market maker in these instruments. The Bank's services include:

- issuing, transferring and registering securities
- maintaining ownership records
- providing reports to investors and stakeholders on periodical payment of interest and redemption of securities at coupon and maturity date.

Government debt

In 2011 total borrowing by the Government was K5,121 million, comprised of K2,867 million in Inscribed stock and K2,254 million in Treasury bills.

Inscribed stock

Issued in 2011	K780 million
Matured in 2011	K500 million
Net issuance	K280 million

Total holdings Dec 2011	K2,867 million
Total holdings Dec 2010	K2,587 million
Increase in total holdings	K280 million

Bank of PNG portfolio holdings Dec 2011	K417,950 million
Bank of PNG portfolio holdings Dec 2010	K387,290 million
Increase in Bank of PNG portfolio holdings	K30,660 million

Treasury bills

Issued in 2011	K2,920 million
Matured in 2011	K2,224 million
Outstanding at 31 Dec 2011	K2,254 million

The Bank held no Treasury bills in its portfolio in 2011.

Central Bank bills

The Bank uses Central Bank Bills in the conduct of monetary policy.

Issued in 2011	K27,832 million
Matured in 2011	K26,730 million
Outstanding at 31 Dec 2011	K5,715 million

SUPERVISION DEPARTMENTS

Two Departments within the Bank are responsible for the prudential supervision of the nation's financial sector. The Banking Supervision Department (BSD) is responsible for the supervision of deposit taking institutions. The Superannuation & Life Insurance Supervision Department (SLISD) supervises superannuation funds, fund administrators, investment managers, life insurance companies and life insurance brokers.

The Supervision Departments contribute to one of the principal functions of the Bank, conducting prudential supervision as a regulator and promoting stability in the financial system in PNG. This is achieved through:

- setting strict licensing requirements
- promoting proper standards of conduct
- setting prudential guidelines for sound and prudent business practices for authorised institutions and
- ensuring compliance by authorised institutions consistent with the relevant legislation and prudential standards, through effective supervisory activities.

The Financial System

In this context the financial system of Papua New Guinea includes institutions authorised, regulated and supervised by the Bank of Papua New Guinea. It does not include financial institutions that are regulated by other authorities.

By 31 December 2011, the financial system comprised:

Commercial banks	4
Licensed financial institutions, including 3 micro-banks (LFIs)	10
Savings & loan societies (SLSs)	22
Authorised superannuation funds (ASFs)	5
Licensed investment managers (LIMs)	2
Licensed fund administrators (LFAs)	4
Life insurance companies (LICs)	5
Life insurance brokers (LIBs)	4
Authorised money changers	4
Money remitter	1

Total assets	K30.1 billion
Banking industry	78.0 percent
ASFs	20.6 percent
LICs	1.3 percent

Total deposits	K18.1 billion
Commercial banks	93.7 percent
LFIs	4.2 percent
SLSs	2.1 percent

Total loans outstanding	K8.7 billion

Licences and Approvals

In 2011 the Bank considered and made decisions on applications received for new licences, expansion, closure and relocation of operations, changes to controlling interests and name changes.

New Licences Granted

Month	Organisation	Licence granted	Authority
July	Kokopo Microfinance Limited (KML)	LFI	*Banks and Financial Institutions Act 2000*
September	Paivu Tours Limited	Bureau of foreign exchange	*Central Banking Act 2000*
December	PacWealth Capital Limited	LIM	*(General Provisions) Superannuation Act 2000*

New Licence Applications In Progress

Month	Organisation	Licence application
March	Digicel PNG Financial Services Limited	Mobile Banking and Mobile Payment Services
	Papua Finance Limited	LFI
July	Ougarhan Investment Limited	Bureau of Currency Exchange (Money Changer)
August	NDB Microbank Limited	LFI
September	Heduru Moni Limited	Foreign Exchange Dealers Licence

Other Approvals

Month	Organisation	Approval
March	Post PNG Limited	To launch MobileSMK
April	Digicel PNG Financial Services Limited	To launch "Cell Moni"
September	Post PNG Limited	To launch phase 2 mobile banking products (Digicel Direct Top Up and PNG Power Easipay)
October	ANZ Banking Group (PNG) Ltd	'No objection' notice to ANZ's proposed mobile phone banking platform
	Bemobile Limited	To pilot mobile money services in Lae and Port Moresby
	Nationwide Microbank Ltd	To pilot mobile money product 'MiCash' in West New Britain Province
December	Westpac Bank (PNG) Ltd	'No objection' notice to Westpac's proposed mobile phone banking services.

Ongoing Licensing Matters

Organisation	Issue	Status in 2011
Kina Bank Limited (KBL)	Application under *Banks and Financial Institutions Act 2000* to operate as a commercial bank.	Decision pending outcome of further discussions between the Bank and the applicant.
First Commercial Limited	Application under *Banks and Financial Institutions Act 2000* to operate as an LFI.	Assessment in progress.
Teachers Savings & Loan Society	Application under *Banks and Financial Institutions Act 2000* to become an LFI under the name TISA Community Finance Limited.	Review is continuing, pending resolution of issues associated with the dissolution of the savings & loan society.
Resources Investment Finance Limited (RIFL)	Restriction on taking deposits.	On meeting the Bank's requirements, including recapitalising RIFL, the restriction on taking deposits was removed.
Finance Corporation Limited (Fincorp)	To meet certain conditions of the *Banks and Financial Institutions Act 2000*, the Bank granted Fincorp approval to undergo a corporate restructure and surrender its previous banking licence.	Assessment in progress.

Other Regulatory Matters

Organisation	Issue or Application	Decision or Status in 2011
Pasifika Finance Limited (PFL)	Application under *Banks and Financial Institutions Act 2000* to operate as LFI.	Application rejected, as a result of continued failure to submit requested information.
Finance Corporation Limited (Fincorp)	Request to relocate Lae branch.	Approval granted.
PNG Microfinance Limited (PML)	Requests to relocate Alotau and Matirogo branches.	Approvals granted.
ANZ Bank (PNG) Limited	Requests: – open two new branches (Lihir, New Ireland Province and Hides Valley, Southern Highlands Province) – open a new branch at Gusap, Madang Province – close its agency in Bialla – close its Lae Top Town branch	Approvals granted.
Bank South Pacific Limited	Request to open branches at: – Tari, Hela Province – Arawa, Autonomous Region of Bougainville – Motukea in NCD – Komo, Hela Province	Approvals granted.
Credit Corporation Finance Limited	Requests to convert its Solomon Islands, Vanuatu and Fiji subsidiaries into branches.	Approvals granted.
Aon Consulting (PNG) Limited	Application to change name to Aon Hewitt (PNG) Limited.	Approval granted.
Kwila Insurance Corporation Limited	Proposal to restructure its business.	The Bank's decision is pending, subject to assessment of Kwila's final submission to the Bank as required under the *Life Insurance Act*.

Prudential Standards

Single Borrower and Large Exposure Limits

In January 2011 this prudential standard was released to the industry for implementation.

Mobile Banking

A prudential standard on Mobile Banking and Mobile Payment Services was drafted, circulated to industry and other stakeholders for comments and finalised pending approval and release.

The Bank also produced a submission on the Regulation of Mobile Banking and Mobile Payment Services for the Minister of Finance and Treasury and ratification by the National Executive Council.

Legislative Developments

Savings & Loan Societies

Consultations associated with the review of the draft *Savings & Loans Societies (Amended) Act 1995* continued through 2011.

Superannuation

Parliament did not pass the Bill proposing amendments to the *Superannuation (General Provisions) Act 2000*, in spite of support for the Bill by the National Executive Council.

Review of the Life Policy Definition

The review of the life policy definition issue continued in 2011. With the Office of Insurance Commissioner maintaining its stand against the Bank's revised life policy definition, the Bank continued to explore different strategies to resolve this issue.

Supervisory Enforcement Actions

Reviews

As part of the Bank's supervisory role in strengthening the risk management systems and compliance capacities of the authorised institutions and licensed entities, 13 on-site prudential reviews or examinations were conducted in 2011. These included eight full scope reviews and two reviews specifically targeting credit risks.

Reviews were conducted on 3 banks, 2 LFIs (pre-licence visits), 5 SLSs, 2 ASFs and 1 LIM.

The Bank further conducted prudential consultations with 2 LFIs, 2 SLSs and 2 ASFs, 1 of which was visited twice.

Statutory Administration, Revocation, Management and Liquidation Activities

AGC (Pacific) Limited

The Bank formally revoked AGC's licence under Section 14 of the BFIA, effective 1 February 2011.

Pacific Capital Limited

The Bank revoked PCL's licence in April 2011 for various prolonged non-compliance issues.

Sios Workers Ritaia Fund Trustee Services Limited (SWRFTSL)

The Bank considered that SWRFTSL was unable to meet its obligations as a licensed trustee due to continuous breaches or non-compliance with regulatory requirements. As a result the company was placed under statutory management for a period of 6 months, effective November 2011.

The immediate tasks of the Statutory Manager were to secure the assets of the fund and ensure that it is managed as a going concern and to obtain the records of the fund for timely audit action. The Bank will determine the future of the fund in consultation with the Statutory Manager.

PEA Superannuation Fund (PEASF)

Having appointed Nambawan Super Limited (NSL) as the new trustee of PEASF with full responsibility for the Fund's management and administration in 2010, NSL's first priorities were to get the accounts in order and wind down the Fund's operations. During 2011 the PEASF accounts were audited and preparations for crediting the members' accounts were made.

Workers Mutual Insurance (PNG) Limited (WMI)

The liquidation process continued during 2011. The liquidator, Guinn PKF, advised via public notice that the liquidation would be completed by the end of 2012.

National Capital Limited (NCL)

In August 2011 the Bank issued a final notice to NCL to revoke its licence as a licensed investment manager. The revocation decision was based on a review of NCL and its recommendation to National Superannuation Fund (Nasfund) to invest in the Sovereign Community Infrastructure Treasury Bill (SCITB). NCL filed an application with the National Court to review the Bank's decision, which was dismissed by the National Court in November 2011. NCL appealed the decision and the matter is with the Bank's lawyers.

Investigation of Non-complying Employers

The Bank investigates employers with more than 15 employees who fail to contribute to an Authorised Superannuation Fund as required by the *Superannuation Act*. These investigations continued through 2011.

Microfinance Expansion Project

Phase two of the ADB microfinance project in PNG is well underway. A number of milestones were reached in 2011:

- Appointment of Project Manager and project consultants
- Establishment of the Microfinance Project Steering Committee, comprising representatives from all relevant stakeholders and Government Departments
- Opening of the trust account
- Recruitment of a curriculum and training development specialist
- Identification of appropriate office space to house the National Financial Inclusion Centre and
- Completion of the inception report in November 2011.

Other External Developments

Sovereign Community Infrastructure Treasury Bill (SCITB)

The Bank conducted a review on the SCITB investment during 2011, the recommendations from which resulted in the Bank revoking National Capital Limited's licence in August.

In December the Bank issued a final notice to Nasfund to declare that the Joint CEO involved in the investment deal did not meet the ‘fit and proper’ requirements and accordingly his employment should be terminated. The Bank imposed other conditions on Nasfund, including review and improvement of corporate governance practices and internal structures.

Public Awareness

During the year the Bank continued its press campaign to raise public awareness of how to differentiate between authorised financial institutions and illegal money schemes and scams.

BANKING DEPARTMENT

The Bank of Papua New Guinea provides banking services to the National Government and other statutory authorities. The financial transactions of the National Government are carried out by the Department of Finance through the Waigani Public Account, from which transfers of funds are initiated and executed to various Government department drawing and trust accounts, provincial government accounts and statutory authority accounts.

Cheque Security

No major incidents of fraud in Government drawing accounts were reported in 2011. This positive result is attributed to the effectiveness of the Cheque Matching Process and improvements made to the Bank’s overall system for cheque processing.

Temporary Advance Facility

The Bank of PNG operates a Temporary Advance Facility (TAF) to meet the National Government’s short-term funding requirements arising from cash flow mismatches during the year.

The Government sought temporary financing under the facility once during 2011, which was approved by the Bank on 9 March. K6.5 million was drawn down under the TAF on 24 March.

For the rest of 2011 the Government’s cash position was in net credit.

Trust Accounts

The National Government maintained a total of 71 trust accounts at the Bank of PNG in 2011, of which 46 were opened during the year. Sixteen accounts were closed towards the end of 2011, with a total of K229 million transferred back to Waigani Public Account.

The total closing balance in the trust accounts was K732.5 million at year end, after peaking at K806 million in December 2011.

Given the high level of liquidity in the banking system, the Bank sought the Government’s assistance to transfer all deposits in trust accounts held with the commercial banks to the Bank of PNG. The Minister directed the Department of Finance to close all trust accounts held at the commercial banks and transfer the balances to the main accounts held at the Bank of PNG. In spite of the directive, the Department of Finance continued to transfer large sums from the main trust accounts to subsidiary accounts held at the commercial banks during 2011.

Numismatic Issues

The Department sells special commemorative notes and coins from its stock of previous and new issues under the Bank's Numismatic Currency Program. In 2011 sales generated net proceeds of K307,846.28, a significant increase over the K154,366.91 achieved in 2010.

The 1991 South Pacific Games uncut commemorative notes of K2 and K5 generated the most interest with buyers, achieving sales of K137,948. The uncut K2 Bank of PNG 25th Anniversary notes recorded the next highest sales level of K57,760.

The special albums in Deluxe and Premium categories generated sales proceeds of K16,610 and numismatic coins generated K40,116.42 in 2011.

Telling Service

The Bank is required to provide telling services to Government Departments and Bank staff, and limited service to the public and commercial banks through its Customer Services Unit.

Cash handled by Bank of PNG tellers

2011	2010
Inward receipts K99,398,730	Inward receipts K74,545,826
Outward payments K98,175,120	Outward payments K74,000,486

Cheque Clearance

Cheques & vouchers processed

2011	2010
380,900	382,125
– Government Drawing accounts (247,403) – Commercial bank cheques (95,314) – Staff accounts (31,350) – BPNG cheques (6,833)	

The cheques were presented for payment through the tellers at the commercial banks and at different times of the day cleared through the inter-bank clearing exchanges conducted by the Bank of Papua New Guinea and all commercial banks.

Payments Systems Development

During the year the draft *National Payments System Act* was finalised with all stakeholders, ready for the legislative process.

CURRENCY DEPARTMENT

The Department is responsible for issuing currency banknotes and coins and ensuring adequate supplies of quality banknotes and coins in circulation at all times. It is also responsible for withdrawing and destroying soiled and mutilated banknotes that are not fit for circulation.

Clean Banknote Policy Awareness Program

The Bank continued to conduct awareness sessions about the Clean Banknote Policy. Staff members visited the commercial banks in Port Moresby and Alotau and super-markets and schools in Port Moresby, Goroka and Lae. They informed the public about proper ways of handling banknotes, different security features on the banknotes, the characteristics of unfit banknotes and how to identify genuine banknotes from counterfeit notes. The Bank also used the opportunity during provincial cultural shows to speak to the public on the Clean Banknote Policy. The team participated during Goroka Show, Divine Word University Cultural Show, Morobe Show and Alotau Canoe and Kundu Festival.

Soiled and damaged banknotes continue to remain in circulation, especially for the lower denominations such as K2 and K5 notes in the rural areas. Maintaining quality notes continues to be a challenge. With most rural areas being without access to the formal banking system it is difficult to withdraw and replace substandard notes.

New Banknote Orders

The Bank placed an order in June 2011 with Note Printing Australia Limited for the print and supply of the following banknotes.

Denomination	Quantity (million)	Value (K'm)
K2	27	54
K10	12	120
K20	13	260
K50	18	900
K100	12	1,200
Total	**82**	**2,534**

Cash Distribution

Currency is distributed around the country from the regional Cash Distribution Centres (CDCs). There are four distribution centres in the four regions – Port Moresby for the Southern region, Lae for the Momase region, Mount Hagen for the Highlands region and Kokopo for the Islands region. The Bank operates the CDCs from head office in Port Moresby.

Since 1975 the Bank has had an agency agreement with Bank of South Pacific (BSP) to provide the cash distribution services in Mt Hagen, Lae and Kokopo. However, in June 2011 BSP closed these centres due to concerns about undue operational risks.

From June 2011, each commercial bank collects their cash at their own risk from the Bank of PNG for distribution to their branches and sub-branches outside Port Moresby.

Release of New K100 Banknotes

In December 2011 the Bank issued a reprint of new K100 banknotes for circulation. The new notes retain the original design elements and security features of the existing K100 banknotes but show the signature of Mr Loi M. Bakani as the Governor of Bank of Papua New Guinea.

Numismatic Coins

In January 2011 the Bank signed a Memorandum of Understanding with the World Coin Association to produce and sell numismatic gold and silver coins in overseas markets at no cost to the Bank. Part of the proceeds from the sale of these coins will be paid to the Bank. These numismatic coins depict flora and fauna of Papua New Guinea and special events such as the Olympic Games. 10,000 pieces of each of the following numismatic coins in 2011 were produced in 2011.

Coin	Depiction
K5 Coin (Silver)	Olympic Games 2012 Swimming
K5 Coin (Gold)	Bird of Paradise
K5 Coin (Silver)	Diamond Jubilee HM Queen Elizabeth II
K5 Coin (Silver)	Olympic Games 2016 Female Weight Lifting
K1 Coin (Gold)	Birdwing Butterfly

Currency in Circulation

Notes and Coins in Circulation as at 31 December 2011

Notes Denomination	Value (K'm) 2011	Value (K'm) 2010
K2	46.2	38.6
K5	44.4	36.5
K10	77.8	70.3
K20	213.9	154.2
K50	452.2	363.9
K100	635.4	475.1
Sub Total	**1,469.9**	**1,138.6**
Coins Denomination		
K2	0.3	0.3
K1	16.5	12.8
50 Toea	6.5	5.9
20 Toea	16.8	15.1
10 Toea	16.5	14.8
05 Toea	5.6	5.1
Sub Total	**62.2**	**54.0**
Total	**1,532.1**	**1,192.6**

New Notes and Coins issued in 2011

New notes and coins issued in 2011 totalled K693.7 million, compared to K738.3 million in 2010. The decline of K44.0 million was attributed to the closure of the CDCs in Mt Hagen, Lae and Kokopo.

Notes Denomination	Value (K'm) 2011	Value (K'm) 2010
K2	22.2	20.7
K5	21.8	22.2
K10	33.9	41.5
K20	118.8	139.9
K50	199.0	200.8
K100	291.0	306.1
Sub Total	**686.7**	**731.2**
Coins Denomination		
K2	0.00	.00
K1	3.20	.50
50 Toea	0.36	.04
20 Toea	1.57	.08
10 Toea	1.51	1.10
05 Toea	0.33	0.38
Sub Total	**6.97**	**7.10**
Total	**693.67**	**38.30**

Security of the Note Issue

Since the introduction of polymer notes in 1991, no counterfeit of any polymer note has been detected. The security of the Papua New Guinea currency note issue remains very high.

Destruction of Soiled Notes

Note Denomination	Soiled Notes Destroyed in 2011 (K'm)	Soiled Notes Destroyed in 20010 (K'm)
K2	13.2	21.5
K5	16.4	13.3
K10	26.8	30.7
K20	62.2	118.0
K50	109.1	115.3
K100	136.3	160.0
Total	**364.0**	**458.8**

The bulk of the culled notes were K50 and K100 commemorative notes of paper substrate, which were destroyed under strict environmental standards.

CORPORATE SERVICES DEPARTMENT

From the beginning of 2011 until October the Department's key responsibilities included:

- involvement in the Executive Committee (ExCo)
- risk management advisory services
- coordination of the strategic planning process
- coordination and release of the Bank's public announcements
- management of the Bank's website content
- management of the Bank's properties and fixed assets register
- management of the Bank's vehicle fleet
- management of the staff cafeteria and
- management of the staff housing scheme.

As part of the Bank's organisational restructure, the Department was renamed Corporate Services in October 2011. From that date the Deputy Governor assumed responsibility for the functions of risk management advisory services, strategic planning and Projects office, previously handled within Corporate Affairs.

During the year the Department continued its focus on reducing non-core activities and management costs. However, in 2011 costs associated with the Bank's real estate portfolio and property management rose. The cost increase was a result of implementing the Board decision to obtain residential properties for the Statutory Appointees (Governor and Deputy Governor) and purchasing land in Lae to build a cash dispensing centre, in the wake of BSP ending its CDC arrangements with the Bank.

Other activities

The Department also concentrated on asset management. For example, the Bank's main premises, To Robert Haus in Port Moresby's CBD, underwent facility upgrades.

Review of the Bank's security arrangements remained a priority. During 2011 the Bank confirmed the engagement of an external security specialist to commence in 2012.

The Staff Housing Scheme was reviewed and revised. The Board approved the revised scheme, which was then implemented during the year.

Risk Management

While the Bank's Risk Management Advisory function, previously operating within Corporate Affairs, was removed with the restructure to Corporate Services, the Department retained responsibility for a number of activities focused on managing operational risk, as contrasted with reputation, strategy or policy risks.

These include ensuring the effectiveness of the Bank's operations, processes, procedures and systems, mitigating operational disruptions.

INFORMATION TECHNOLOGY DEPARTMENT

The Department's strategic role is to ensure the Bank's information systems and communications technology support the core functions of the Bank.

In 2011 the Department was restructured into two functional units with the aim of providing a more effective and efficient IT service. The Corporate Systems unit is responsible for applications used by the Bank for daily business operations and Operations unit is responsible for IT infrastructure.

The restructure also provided the opportunity to ensure the Department is staffed with well-qualified and highly skilled IT professionals. Most of the positions within the Department were advertised publicly, to attract external candidates as well as applications from existing staff. By the end of 2011, ninety percent of the advertised positions had been successfully filled.

IT projects and system enhancements

During 2011 the Department implemented a number of upgrades and systems enhancements, including:

- upgrade of the management information system for Savings & Loans Societies in association with the Federation of Savings & Loans Societies (Fesalos). By the end of 2011 eight Societies had successfully launched the upgraded system.
- upgrade of the SWIFT system

Other system improvements approved during 2011 for implementation in the first quarter of 2012 included:

- acquisition of a new enterprise-wide backup and restoration system
- upgrade of the Bank's Local Area Network (LAN)

HUMAN RESOURCES DEPARTMENT

The Department's role is to manage and build the capacity of the Bank's human resources. Human Resources Department (HRD) plays a key role in developing the appropriate organisational structure for the Bank and ensuring appropriate staffing.

During 2011 HRD facilitated the creation of the four Assistant Governor positions and the restructure of the Information Technology Department. HRD also developed plans for the complete restructure of Corporate Services and Human Resources Department for approval.

HRD worked closely with the Department of Personnel Management's Salaries and Conditions Monitoring Committee and an external consultancy to review the employment terms and conditions of Bank staff. The revised terms and conditions were approved and implemented in December 2011.

As mentioned previously in this Report, the Bank is committed to maintaining a culture of continuous learning. HRD supported this commitment with the facilitation of numerous training and skills development opportunities for Bank staff.

Staff Numbers	31 Dec 2011
Governors	2
Assistant Governors	3
Secretariat	14
Audit	10
Economics	42
Research	10
Financial Markets	25
Banking Supervision	28
Superannuation & Life Insurance Supervision	17
Banking	28
Currency	23
Corporate Services	49
Information Technology	17
Human Resources	11
Finance & Accounting	39
TOTAL	**318**
Males	167
Females	151
Nationals	316
Non-nationals	2

Senior Officers

Governor	**Loi M. Bakani**
Deputy Governor	Benny Popoitai, MBE
Assistant Governor, Corporate Affairs	Elizabeth Genia
Assistant Governor, Finance & Payments	Joe Teria
Assistant Governor, Monetary & Economic Policy	Gae Kauzi
Assistant Governor, Financial System Supervision	Vacant
Audit (Internal)	
Acting Department Manager	Francis Poko
Economics	
Department Manager	Sali David
Manager, Monetary Policy and Analysis Unit	Wilson Jonathan
Manager, Balance of Payments Unit	Gaona Gwaibo
Manager, Public Information Unit	Maryanne Kani
Manager, Int'l Transactions Monitoring Unit	Elim Kiang
Research	
Department Manager (Acting)	Jeffrey Yabom
Manager, Economic Analysis Unit	Vacant
Manager, Projects Unit	Boniface Aipi
Financial Markets	
Department Manager	Simon Gaius
Manager, Foreign Reserves	Vacant
Manager, Money Markets	Bui Minig
Manager, Registry	Timothy Nawa
Banking Supervision	
Department Manager	George Awap
Manager, Banks & Finance Companies Unit	Boas Irima
Manager, Savings & Loans Development Unit	William Saigir
Manager, Licensing & Policy Unit	Sabina Deklin
Manager, Micro-Finance Unit	Nickson Kunjil
Superannuation & Life Insurance Supervision	
Department Manager	Elizabeth Gima
Manager, Superannuation Unit	Tom Milamala
Manager, Policy and Licensing Unit	John Topal
Manager, Life Insurance	Benek Beriso
Banking	
Department Manager	Robert Kule
Manager, Customer Services	Kila Bagere
Manager, Clearing Accounts	Aiva Aku
Manager, Government Accounts	Jason Tirime

Senior Officers continued	
Financing & Accounting	
Department Manager	Danny Ganak
Manager, Management Reporting	Noine Noine
Acting Manager, Accounting & Payments	Oliver Kludapalo
Manager, Settlements	Soms Yankey
Currency	
Department Manager	David Lakatani
Manager, Control Unit	John Yenas
Manager, Processing Unit	Edward Kisakau
Corporate Services	
Department Manager	Diury Tolopa
Manager, Building	Emmanuel Fabila
Manager, General Services	Bridgit Kubak
Manager, Security	Charles Karemo
Manager, Cafeteria	Tovoga Wong
Information Technology	
Department Manager	Otto Salmang
Manager, Corporate Systems	Naime Kilamanu
Manager, Operations	Aileen Watangia
Human Resources	
Department Manager	Jack Igar

FINANCIAL PERFORMANCE

Under the terms of the *Central Banking Act 2000*, the Bank of Papua New Guinea distributes its operating profit to the Government. Non-operating profit, comprised of net gains or losses from revaluation of foreign currency assets and liabilities, is not available for distribution to the Government.

Operating Income

Total operating income for the year ended 31 December 2011 was K273 million. The income was derived mainly from interest on overseas investments, fees and commissions on foreign exchange trading and domestic government securities.

Operating Expenditure

Total operating expenditure, comprising interest expense and general administration costs, was K280 million, an increase of K35 million from 2010. The increase in expenditure was largely due to higher interest expenses associated with an increase in the issuance of Central Bank Bills (CBB) for monetary policy operations.

Net Operating Loss

The Bank recorded a net operating loss of K7.6 million for the 2011 year, compared to an operating profit of K21.9 million in 2010.

Unrealised Gain/(Loss)

The Bank recorded a net foreign and domestic financial assets revaluation loss of K1.7 billion for the year ended 31 December 2011, which was transferred to the Unrealised Profits/(Loss) Reserve. This was a direct result of the sharp appreciation of the Kina against all major currencies during the financial year.

Gold valuation loss of K15.2 million was transferred to the Gold Reserve.

Appropriation

The provisions of the CBA give the Bank of PNG's Board responsibility to determine the Bank's net profit. These provisions require the Board to consult with the Minister on the amount to be placed to the credit of the Reserve Funds, with the balance of the net profits to be paid into Consolidated Revenue Fund.

However no amount is to be paid into Consolidated Revenue where, in the opinion of the Central Bank, the assets of the Bank are (or after payment would be) less than the sum of its liabilities and paid up capital. Further, under the terms of Section 50(1), net profits arising from revaluations of the Bank's assets and liabilities and/or from foreign exchange movements, shall not be available as a dividend to the Government or paid into Consolidated Revenue.

The realised loss of K7.6 million for the year ended 31 December 2011 was transferred to the Retained Profits/(Loss) Reserve.

Net Profit Available for Appropriation

(K million)	2009	2010	2011
Total comprehensive income/(loss)	196.2	195.1	(1,737.1)
Unrealised profit/(loss)	(148.6)	(173.2)	(1,729.5)
DISTRIBUTABLE PROFIT/(LOSS)	**47.6**	**21.9**	**(7.6)**
Transferred to:			
Currency Movement Reserve	47.6	-	-
Unrealised Profits Reserve	-	-	(1,714.3)
Gold Reserve		31.8	(15.2)
Retained Profit/(Loss)	-	-	(7.6)
Capital Reserve	-	-	-
Consolidated Revenue (Govt)	-	21.9	-

2012 Budget Forecast

	Budget 2012 (K million)	Actual 2011 (K million)
Operating Income		
Interest received (overseas)	228.6	227.4
Interest received (domestic)	47.8	40.4
International trading/forex fees	3.2	0.4
Other income	3.4	4.7
TOTAL INCOME	**283.0**	**272.9**
Operating Payments		
Interest expenses	181.1	186.2
Currency	11.0	21.7
Financial Markets	1.4	1.4
Outsourced investments fees & charges	5.0	3.8
Audit fees	1.3	1.3
Board fees & meeting expenses	0.5	0.7
Legal & consultancy fees	3.7	3.0
Depreciation & amortisation	4.0	3.7
Property, plant & equipment	9.0	7.5
Staff employment	36.0	35.0
Staff training & development	3.9	2.1
Staff Housing Scheme	2.9	2.7
Travel	4.6	3.6
Insurance	0.9	0.5
Security	2.0	2.0
Cafeteria operations	0.3	0.3
Special projects	2.5	0.5
Other expenses	6.6	4.5
TOTAL PAYMENTS	**276.7**	**280.5**
NET OPERATING PROFIT/(LOSS)	**6.3**	**(7.6)**

Bank of Papua New Guinea

Financial Statements
for the year ending 31 December 2011

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STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER 2011

	Note	2011 K'000	2010 K'000
Income from foreign currency investments			
Interest income	2	212,882	222,815
Realised gain/(loss) on financial assets		14,521	1,670
Foreign exchange commissions		447	3,006
Total income from foreign currency operations		**227,850**	**227,491**
Expenses on foreign currency investments			
Interest expense on liabilities with IMF		(1,913)	(1,544)
Custodian and investment management fees		(3,752)	(4,494)
Total expenses from foreign currency operations		**(5,665)**	**(6,038)**
Net Foreign Currency Income		**222,185**	**221,453**
Income from domestic operations			
Interest income	3	40,480	35,929
Other income	4	4,650	3,646
Total income from domestic operations		**45,130**	**39,575**
Expense on domestic investments			
Interest expense	5	(184,384)	(164,710)
Total expenses on domestic operations		**(184,384)**	**(164,710)**
Net Domestic Income/(Expense)		**(139,254)**	**(125,135)**
TOTAL NET OPERATIONS INCOME		**82,931**	**96,318**
Less: Operating Expenses			
General and administration expenses	6	(90,506)	(74,420)
Operating (Loss) / profit for the year		**(7,575)**	**21,898**
Other unrealised income and (expense)			
Fair value and foreign exchange revaluation (loss)/gain on foreign currency investments		(1,702,814)	9,860
Fair value revaluation (loss)/gain on domestic investments		(11,511)	72,807
(LOSS)/PROFIT FOR THE YEAR		**(1,721,900)**	**104,565**
Other comprehensive income			
Gain on property revaluation		-	58,747
(Loss)/gain on gold asset revaluation		(15,197)	31,817
Other comprehensive (loss)/income for the year		**(15,197)**	**90,564**
TOTAL COMPREHENSIVE (LOSS)/INCOME FOR THE YEAR		**(1,737,097)**	**195,129**

The accounting policies and notes to the financial statements form an integral part of these financial statements.

STATEMENT OF FINANCIAL POSITION

AT 31 DECEMBER 2011

	Note	2011 K'000	2010 K'000
Assets			
Foreign Currency Financial Assets			
Gold		142,049	157,288
Cash and cash equivalents	8	1,251,573	2,045,663
Financial assets at fair value	9	7,786,246	5,834,933
Assets held with IMF	7	34,200	43,639
Other assets	12	52,541	50,421
Total Foreign Currency Financial Assets		**9,266,609**	**8,131,944**
Local Currency Financial Assets			
Government of Papua New Guinea securities	10	437,165	409,470
Loans and advances	11	9,717	11,299
Total Local Currency Financial Assets		**446,882**	**420,769**
Total Financial Assets		**9,713,491**	**8,552,713**
Other Assets			
Property, plant & equipment	13	124,264	124,278
Capitalised currency production cost		39,550	56,012
Other assets	12	11,106	10,805
Total Other Assets		**174,920**	**191,095**
TOTAL ASSETS		**9,888,411**	**8,743,808**
Liabilities and Equity			
Foreign Currency Financial Liabilities			
Liabilities with IMF	7	412,950	511,992
Financial liabilities	17	5,232	30,655
Total Foreign Liabilities		**418,182**	**542,647**
Local Currency Financial Liabilities			
Deposits from banks & third parties	14	1,733,287	817,701
Deposits from Government and Government entities		1,718,749	1,035,128
Debt securities issued	15	5,654,380	4,576,182
Currency in circulation	16	1,532,447	1,192,711
Other liabilities	17	72,111	61,087
Total Local Currency Financial Liabilities		**10,710,974**	**7,682,809**
TOTAL LIABILITIES		**11,129,156**	**8,225,456**

AT 31 DECEMBER 2011

	Note	2011 K'000	2010 K'000
Equity			
Capital	**18**	145,540	145,540
Gold reserve		122,314	137,511
Property revaluation reserve		83,074	83,074
Unrealised profit/(loss) reserve		(1,650,776)	63,549
BPNG reserve fund		-	-
Distributable profit reserve		-	-
Retained profit/(loss)		59,103	88,678
Total Equity/(Deficiency)		**(1,240,745)**	**518,352**
TOTAL LIABILITIES AND EQUITY		**9,888,411**	**8,743,808**

The accounting policies and notes to the financial statements form an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 2011

In Kina (K'000)	Capital	Gold Reserve	Property Revaluation Reserve	Currency Movement Reserve	Unrealised Profit/(Loss) Reserve	Bank of PNG Reserve Fund	Distributable Profit Reserve	Retained Profit/ (Loss)	Total
Balance at 1 Jan. 2010	**145,540**	**105,694**	**24,327**	**47,662**	**-**	**-**	**-**	**-**	**323,223**
Profit for the year	-	-	-	-	-	-	-	21,899	21,899
Other Comprehensive Income for the year	-	31,817	58,747	-	82,666	-	-	-	173,230
Reclassification of reserves (Note 1 (n) (d).	-	-	-	(47,662)	(19,117)	-	-	66,779	-
Balance at 31 Dec. 2010	**145,540**	**137,511**	**83,074**	**-**	**63,549**	**-**	**-**	**88,678**	**518,352**
Loss for the year	-	-	-	-	-	-	-	(7,575)	(7,575)
Other comprehensive Income/(Loss) for the year	-	(15,197)	-	-	(1,714,325)	-	-	-	(1,729,522)
Dividend paid	-	-	-	-	-	-	-	(22,000)	(22,000)
Balance at 31 Dec. 2011	**145,540**	**122,314**	**83,074**	**-**	**(1,650,776)**	**-**	**-**	**59,103**	**(1,240,745)**

STATEMENT OF DISTRIBUTION

FOR THE YEAR ENDED 31 DECEMBER 2011

	2011 K'000	2010 K'000
Total Comprehensive Income/(loss) for the year:	**(1,737,097)**	**195,129**
Unrealised (profit)/loss	1,729,522	(173,230)
Realised loss	7,575	-
Distributable profit	**-**	**21,899**

The accounting policies and notes to the financial statements form an integral part of these financial statements.

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 2011

	Note	2011 K'000	2010 K'000
Cash flows from operating activities			
Interest received – foreign currency		210,762	222,308
Interest received – local currency		40,968	35,213
Fees, commissions and other income received		5,099	2,158
Interest paid – foreign currency		(1,914)	(1,544)
Interest paid – local currency		(170,529)	(154,643)
Payments to employees		(37,247)	(27,214)
Payments to suppliers		(36,491)	(44,722)
Fees and commissions paid		(3,752)	(4,015)
Net proceeds from/(payments for) foreign investments		(3,665,029)	188,715
Net Cash Flow from Operating Activities	**19**	**(3,658,133)**	**216,256**
Cash Flows from Investing Activities			
Net increase/(decrease) in foreign deposits including IMF		(99,042)	(18,544)
Net increase/(decrease) in deposits from Banks		915,585	1,642
Net deposit from/(payment to) Government		663,028	442,253
Net increase/(decrease) in assets held with IMF		9,439	446,630
Net payment for/(proceeds from) investment in Government Securities		(39,206)	(33,255)
Purchase of property, plant and equipment		(3,705)	(9,566)
Proceeds from sale of institutional housing/motor vehicle		79	3,489
Net increase/(decrease) in other assets & liabilities		21,932	4,279
Net Cash Flow from Investing Activities		**1,468,110**	**836,928**
Cash Flows from Financing Activities			
Net issue of currency in circulation		339,735	195,618
Net increase/(decrease) in debt securities issued		1,078,198	467,071
Dividend paid to the Government		(22,000)	-
Net Cash Flow from Financing Activities		**1,395,933**	**662,689**
Net Increase/(Decrease) in Cash and Cash Equivalents		**(794,090)**	**1,715,873**
Cash and cash equivalent at 1 January		2,045,663	329,790
Cash and Cash Equivalent at 31 December	**8**	**1,251,573**	**2,045,663**

The accounting policies and notes to the financial statements form an integral part of these financial statements.

Note 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

(a) Basis of preparation

The accompanying financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), and in accordance with the *Central Banking Act (CBA) 2000* (the "Act"). In the event of any conflict between the requirements of the Act and the Accounting Standards, the Bank (BPNG) is required to comply with the Act.

All amounts are expressed in Kina rounded to the nearest thousand unless another currency is indicated. Current market values are used for all BPNG major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for premises. In all other cases, a historical cost basis of accounting is used. Revenues and expenses are brought to account on an accrual basis. All revenues, expenses and profits are from the ordinary activities of BPNG.

Going concern

The Bank is exposed to significant valuation losses in its foreign currency reserves as a result of the appreciation of the PNG Kina against other major currencies. The Bank recorded a total comprehensive loss of K1,737.1 million (2010: profit of K195.1 million) and experienced negative operating cash flows of K3,658.1 million (2010: positive cash flow of K216.3 million) for the year. In addition, total liabilities of the Bank exceeded its total assets by K1,240.7 million (2010 – net assets of K518.4 million). The Bank envisages this net deficiency position to continue as a result of ongoing appreciation of the PNG Kina over the foreseeable future and the combined high cost of monetary policy management stemming from high domestic liquidity. This condition results in material uncertainty that may cast significant doubt on the Bank's ability to continue as a going concern and therefore it may not be able to realise its assets and discharge its liabilities in the normal course of business.

Section 50(2) of the *Central Banking Act 2000 (CBA Act 2000)* provides that where the Bank incurs a loss due to a change in the value of assets or liabilities, the Minister shall cause to be paid to the Bank such amount out of the Consolidated Revenue Fund as is necessary to avoid the loss.

Subsection 50(4) of that Act further provides that the Minister may create and issue to the Central Bank non-interest bearing non-negotiable notes for an amount not exceeding any payment made by the Minister to the Central Bank out of the Consolidated Revenue Fund in accordance with Subsections (1) and (2) of the Act.

The above provisions of the Act effectively require the Government to provide financial support to the Bank. On this basis, the Governor, Deputy Governor and the Board of Directors of the Bank believe that the preparation of the financial statements of the Bank on a going concern basis is appropriate.

The Bank has brought this matter to the attention of the Minister and has submitted a letter dated 9 May 2012 to the Minister requesting a promissory note for K1.74 billion. However this promissory note has not been provided to the Bank at the current time.

(b) Revised standard, amendments to existing standards and interpretations adopted by the Bank

The following revised standards, amendments to existing standards and interpretations are mandatory for annual periods beginning 1 January 2011:

IAS 24 (Revised), Related Party Disclosures (effective 1 January 2011). The revised standard clarifies and simplifies the definition of a related party and removes the requirement for government-related entities to disclose details of all transactions with the government and other government-related entities. The Bank applied the revised standard from 1 January 2011.

2010 Improvements to IFRS (effective for annual periods on or after January 1, 2011)

Several amendments were introduced during the year which are part of the International Accounting Standards Board (IASB)'s annual improvements project published in August 2009. These also include amendments that are terminology or editorial changes only which have either minimal or no effect on accounting. These improvements did not have a significant impact on the Bank's financial statements.

New standards, amendments and interpretations to existing standards that are not yet effective and not early adopted by the Bank unless otherwise stated

The IASB has issued new accounting standards, amendments and interpretations that are applicable for accounting periods beginning after 1 January 2011 and which the Bank has not adopted early. This includes IFRS 9 which was issued in November 2009 and replaces those parts of IAS 39 relating to the classification and measurement of financial assets. Key features of this standard are as follows:

- Financial assets are required to be classified into two measurement categories: those to be measured subsequently at fair value, and those to be measured subsequently at amortised cost. The decision is to be made at initial recognition. The classification depends on the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instrument.
- An instrument is subsequently measured at amortised cost only if it is a debt instrument and both the objective of the entity's business model is to hold the asset to collect the contractual cash flows, and the asset's contractual cash flows represent only payments of principal and interest (that is, it has only 'basic loan features'). All other debt instruments are to be measured at fair value through profit or loss.

- All equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other equity investments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses through other comprehensive income rather than profit or loss. There is to be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.
- While adoption of IFRS 9 is mandatory from 1 January 2015, earlier adoption is permitted.

The Bank is considering the implications of IFRS 9, the impact on the Bank and timing of its adoption.

IFRS 13, fair value measurement, was released in September 2011. It explains how to measure fair value and aims to enhance fair value disclosures. The Bank has yet to determine which, if any, of its current measurement techniques will have to change as a result of the new guidance. It is therefore not possible to state the impact, if any, of the new rules on any of the amounts recognised in the financial statements. However, application of the new standard will impact the type of information disclosed in the notes to the financial statements. The Bank does not intend to adopt the new standard before its operative date, which means that it would be first applied in the annual reporting period ending 31 December 2013.

The Bank does not consider that there are any measurement or recognition issues arising from the release of other new pronouncements during the year that will have a significant impact on the reported financial position or financial performance of the Bank.

(c) Foreign currency

Transactions in foreign currency are translated to Kina at the foreign exchange rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated to Kina at the foreign exchange rate prevailing at reporting date. Foreign exchange differences arising on translation are recognised in the statement of comprehensive income.

Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated to Kina at foreign exchange rates prevailing at the dates the values were determined.

(d) Financial assets and liabilities

Definition of financial instruments

A financial instrument is defined as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. The Bank's financial instruments are its domestic government securities, foreign government securities, gold holdings, Central Bank Bills issued, bank deposits, cash and cash equivalents, deposit liabilities and currency in circulation.

The Bank accounts for its financial instruments in accordance with IAS 39 – Financial Instruments: Recognition and Measurement and reports these instruments under IFRS 7 – Financial Instruments: Disclosures.

(i) Domestic Government securities

The Bank holds inscribed stocks with fixed coupon rates issued by the Government. They are accounted for on a fair value basis with reference to prices determined using valuation models, with valuations occurring on a monthly basis with all changes in fair value taken to the statement of comprehensive income in accordance with IAS 39. Interest earned on the securities is accrued over the term of the security and included as revenue in the statement of comprehensive income. Interest is received biannually at the coupon rate and the principal is received at maturity.

(ii) Foreign exchange holdings

Foreign exchange holdings are invested mainly in securities (issued by the Governments of Australia, the United Kingdom, United States of America, Germany, France and Japan) and bank deposits (with highly-rated international banks, Central banks and international agencies). These instruments are classified as ‘financial assets held for trading” in accordance with IAS 39. Accordingly, these assets are measured at their fair value. External fund managers engaged by the Bank also enter into forward exchange contracts to hedge the returns of portfolios under their management to the US Dollar. No PNG Kina forward contracts are entered into.

Assets and liabilities denominated in foreign currency are converted to Kina equivalents at the prevailing exchange rate on balance date in accordance with IAS 21 – The Effects of Changes in Foreign Exchange Rates. Realised and unrealised gains or losses on foreign currency are taken to profit or loss, but only realised gains are available for distribution.

(iii) Foreign government securities

Foreign government securities comprise coupon and discount securities and securities held under repurchase agreements. Coupon securities have biannual or annual interest payments depending on the currency and type of security; the principal of these securities is received at maturity. Interest earned on discount securities is the difference between the actual purchase cost and the face value of the security; this is amortised over the term of the securities. The face value is received at maturity. Foreign securities, except those contracted for sale under repurchase agreements, are classified under IAS 39 as ‘at fair value through statement of comprehensive income’, as they are held for trading. In accordance with this standard, the securities are valued at market bid prices on balance date; realised and unrealised gains or losses are taken to profit. Only realised gains are available for distribution. Interest earned on securities is accrued over the term of the security as revenue in the statement of comprehensive income.

(iv) Foreign bank deposits

The Bank invests part of its foreign currency reserves in deposits with highly-rated international banks; it also maintains working accounts in foreign currencies. Deposits are classified as ‘loans and receivables’ under IAS 39 and recorded at their face value, which is equivalent to their amortised cost using the effective interest method. Interest is accrued over the term of deposits and is received periodically or at maturity. Interest accrued but not received is included in interest receivable in the statement of financial position.

Foreign exchange holdings, foreign governments and private securities and foreign bank deposits are included in foreign investments in note 9 to the financial statements.

(v) Foreign currency forward contracts

External fund managers engaged to manage part of the Bank’s investment portfolio enter into forward foreign exchange contracts to hedge the return of portfolios under their management to the US Dollar. Gains/(losses) on this portfolio are treated as unrealised by the Bank as they remain as part of the overall portfolio under the management of external fund managers. These forward contracts are accounted for on a fair value basis, with all changes in fair value being reflected in the statement of comprehensive income in accordance with IAS 39. The fair values are determined with reference to prevailing exchange rates at balance date.

(vi) Repurchase agreements

(a) Buy repurchase agreements

In the course of its financial market operations, the BPNG engages in repurchase agreements involving foreign and domestic marketable securities. Securities purchased and contracted for sale under buy repurchase agreements are classified under IAS39 as ‘loans and receivables’ and valued at amortised cost. The difference between the purchase and sale price is accrued over the term of the agreement and recognised as interest revenue.

(b) Sell repurchase agreements

Securities sold and contracted for purchase under sell repurchase agreements are classified under IAS 39 as ‘at fair value through profit and loss’, as they are held for trading, and reported on the Balance Sheet within the relevant investment portfolio. The counterpart obligation to repurchase the securities is reported in Other Liabilities at amortised cost; the difference between the sale and purchase price is accrued over the term of the agreement and recognised as interest expense.

(vii) Deposit liabilities

Deposits include deposits at call and term deposits. Deposits are classified as financial liabilities under IAS 39. Deposit balances are shown at their amortised cost, which is equivalent to their face value.

(viii) Central Bank Bills on issue

Since 2006, the Bank has issued Central Bank Bills as part of its money market operations. These are classified as financial liabilities. The Bills issued have maturities ranging from 28 days to 181 days and are recorded at their amortised cost using the effective interest method. Interest is paid at maturity.

(ix) Gold

Gold holdings which are on loan to other institutions are valued at the Kina equivalent of the prevailing exchange rate at balance date. Unrealised gains and losses on gold are recognised in the gold revaluation reserve until such time as they are realised whereby they are recognised in profit and loss from ordinary activities. The Bank lends gold to financial institutions participating in the gold market. Gold holdings are a financial instrument and the Bank accounts for these in accordance with IAS 39 and reports these loans under IFRS 7.

(x) Loans and Advances

Loans and advances are non-derivative financial assets with fixed or determinable repayment terms that are not quoted in an active market. Loans are receivables and initially recognised at fair value which is the cash consideration to originate or purchase the loan including any transaction costs and measured subsequently at amortised cost using the effective interest rate method.

(xi) Assets and Liabilities with the International Monetary Fund (IMF)

As Papua New Guinea is an IMF member nation, special drawing rights (SDR) are periodically allocated. The Bank recognises the allocation as an asset. The IMF assets and liabilities are denominated in SDR, which are based on the weighted average of four main trading currencies. These are translated to PGK using the SDR market rate at balance date. These assets and liabilities are accounted for on a fair value basis, with changes to the fair value being taken to the statement of comprehensive income in accordance with IAS39.

(e) Determination of fair value

For financial instruments trading in active markets, the determination of fair values of financial assets and financial liabilities is based on quoted market prices or dealer price quotations. This includes quoted debt instruments on major trading exchanges and broker quotes from Bloomberg and Reuters.

A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from the exchange, dealer, broker, pricing service or regulatory agencies, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

For all other financial instruments, fair value is determined using valuation techniques. In these techniques, fair values are estimated from observable data in respect of similar financial instruments, using models to estimate the present value of expected future cash flows or other valuation techniques, using inputs (for example, foreign exchange rates, volatilities and counterparty spreads) existing at the dates of the statement of financial position.

The Bank uses widely recognised valuation models for determining fair values of non-standardised financial instruments of lower complexity.

For more complex instruments, the Bank uses internally developed models, which are usually based on valuation methods and techniques generally recognised as standard within the industry. Valuation models are used primarily to value unlisted debt securities and other debt instruments for which markets were or have become illiquid. Some of the inputs to these models may not be market observable and are therefore estimated based on assumptions.

(f) Property and equipment

Formal valuations of all the Bank's properties are conducted on a triennial basis. The properties are valued by local independent valuers. The most recent independent valuation of the properties was at 31 December 2010. In accordance with IAS 16 – Property, Plant and Equipment, properties are valued at market value, which reflects observable prices and are based on the assumption that assets would be exchanged between knowledgeable, willing parties at arm's length. Valuation gains and losses are transferred to the Property Revaluation Reserve. Annual depreciation is based on fair values and assessments of the useful remaining life of the relevant asset. Management has assessed the fair value of all property and equipment as at year end and consider them to be appropriate.

The range of useful lives used for each class of assets is:

	Years
Residential properties	20 & 30
Office buildings	50
Computer equipment	5
Vehicles	4
Equipment	5
Computer Software	13

(g) De-recognition

A financial asset is de-recognised when the Bank loses control over the contractual rights that comprise the asset. This will occur when the rights are realised, expired or surrendered. A financial liability shall be de-recognised when it is extinguished.

(h) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously.

(i) Currency production cost

From 1 January 2010 the cost of the printing of notes and minting of coins are initially capitalised until such time as they are issued into circulation, at which point the related cost is expensed. All other expenditures of a non capital nature are expensed when incurred.

(j) Cash and cash equivalents

Cash and cash equivalents comprise balances with a maturity of less than three months from the date of acquisition, including cash on hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less.

(k) Other receivables

Other receivables are stated at amortised cost.

(l) Employee benefits

(i) Pension Fund

The Governor and Deputy Governor contribute to the Bank's defined benefit pension fund and all other employees contribute to an approved external superannuation fund. Interest is paid on the Bank's pension fund balance half yearly based on the average interest rate of Nasfund and Nambawan Superannuation Fund.

Contributions to the Bank's pension fund and external superannuation fund are recognised as an expense in the Bank's statement of comprehensive income. The value of the Bank's pension fund defined benefit obligations and the fair value of the Bank's pension fund assets are determined with sufficient regularity to ensure that the amounts recognised in the Bank's financial statements do not differ materially from the amounts that would be determined at the balance date.

(ii) Provision For Leave Entitlement

The Bank maintains provisions for accrued annual leave in accordance with IAS 19-Employees Benefits, calculated on salaries expected to prevail when leave is anticipated to be taken. The Bank also maintains provisions for long service leave. The provision of employee benefits for long service leave represent the present value of the estimated future cash outflows to be made resulting from employees' service provided to balance date. The provision is calculated using expected future increases in wages and salary rates including related on-costs and expected settlement dates based on staff turnover history and is discounted using the rates attaching to PNG Government bonds at balance date which most closely match the terms of maturity of the related liabilities.

(m) Other payables

Other payables are initially recognised at their fair value and subsequently recognised at amortised cost.

(n) Reserves

The Bank shall maintain the following reserves. Their purpose and method of operation is to be as follows:

(i) Bank of Papua New Guinea Reserve Fund

The Bank of Papua New Guinea Reserve Fund was created under the *Central Banking Act 2000* Section 42, and represents reserves set aside as determined are required to meet contingencies which arise in the course of the Central Bank's operations in carrying out its functions.

(ii) Asset Revaluation Reserve

The asset revaluation reserve reflects the impact of changes in the market value of property.

(iii) Unrealised Profits Reserve

Unrealised gains and losses on foreign exchange balances and securities are recognised in the unrealised profits reserve until such gains and losses are realised whereby they are recognised in profit and loss from ordinary activities.

(iv) Currency Movement Reserve

Realised gains and losses are recognised in profit and loss from ordinary activities and are transferred to the Currency Movement Reserve at the discretion of the Bank.

(v) Distributable Profit Reserve

The distributable profit reserve reflects closing distributable profit which may be distributed to the Government of Papua New Guinea after ensuring that the current financial position of the Bank meets the requirements under the *Central Banking Act 2000* Section 49(3).

(vi) Gold Revaluation Reserve

Gold is valued at current quoted market prices. Unrealised gains and losses arising from revaluation are recognised in the Gold Revaluation Reserve at end of the accounting period. Realised gains and losses are recognised in profit and loss from ordinary activities.

(o) Determination of distributable profit

Profits of the Bank are determined and dealt with in accordance with Sections 49 and 50 of the *Central Banking Act 2000* as follows:

(a) Section 50 (1) states that net profit arising from revaluation and foreign currency movements shall not be available to be distributed to the Government or paid into the Consolidated Revenue Fund. Accordingly such unrealised profits are transferred to the Unrealised Profits Reserve.

(b) The Board of the Bank is required to determine the net profit of the Bank and then consult with the Minister to determine the amount of profit that is to be placed to the credit of the Bank's reserves.

(c) The balance of net profit after any transfer in (a) and (b) in accordance with Sections 49(2)(a) and 50(1) of the Act is paid to the Consolidated Revenue Fund.

(d) The unrealised profit reserve of the Bank represents gains or loss arising from the revaluation of gold, properties and other financial assets of the Bank. These gains and losses are separately classified under the respective reserves in the statement of changes in equity.

(p) Critical accounting estimates

Fair value of financial instruments that are not traded in an active market (for example over the counter derivatives or PNG Government inscribed stock) is determined using valuation techniques. The Bank uses its judgement to select a variety of methods and make assumptions that are mainly based on market conditions existing at the end of each reporting period. Derivative transactions are entered into on behalf of the Bank by the external fund managers and similar valuation techniques are used in valuing these derivatives.

These financial statements are not considered to contain any significant accounting estimates, as the most significant balance sheet items can be valued with reference to market rates, and revenue and expense recognition criteria are clearly defined.

(q) Tax Exemption

Bank of Papua New Guinea is exempt from income tax under section 87 of the *Central Banking Act 2000*.

(r) Comparatives

Comparative financial information have been restated to conform to current year presentation where necessary.

(s) Rounding

Financial information has been rounded to the nearest thousand Kina.

	2011 K'000	2010 K'000
Note 2: INTEREST INCOME – FOREIGN CURRENCY OPERATIONS		
Foreign securities and bank deposits	212,781	222,059
Assets with the IMF	101	756
	212,882	**222,815**

Interest income on foreign securities and bank deposits includes income of K56.9 million (2010: K63.7 million) in relation to investments managed by external fund managers.

	2011 K'000	2010 K'000
Note 3: INTEREST INCOME – DOMESTIC OPERATIONS		
Inscribed stock	40,309	35,873
Other interest income	171	56
	40,480	**35,929**

	2011 K'000	2010 K'000

Note 4: OTHER INCOME – DOMESTIC OPERATIONS

Licensing fees	2,578	2,104
Numismatic currency	308	154
Property rents	1,185	1,197
Other	579	191
	4,650	**3,646**

Note 5: INTEREST EXPENSE – DOMESTIC OPERATIONS

Central Bank bills issued	183,616	163,886
Other	768	824
	184,384	**164,710**

Note 6: GENERAL AND ADMINISTRATION EXPENSES

Staff costs	34,535	24,270
Staff training and development	2,107	1,892
Premises and equipment	13,467	12,119
Depreciation of property, plant and equipment	3,708	3,016
Amortisation of coins production expenses	6,622	531
Amortisation of notes production expenses	10,216	8,841
Currency distribution expenses	4,042	8,131
Audit fee	1,275	1,275
Travel	3,631	2,740
Legal & consultancy fees	3,032	2,230
Board & meeting expenses	677	522
Other expenses	7,194	8,853
	90,506	**74,420**

Note 7: IMF RELATED ASSETS & LIABILITIES

Assets		
SDR holding	34,200	43,639
Liabilities		
IMF number 1 and 2 loan accounts	1,557	1,557
SDR allocation	411,393	510,435
	412,950	**511,992**

Papua New Guinea has been a member of the IMF since 1975. The Bank of Papua New Guinea acts as the fiscal agent for the IMF on behalf of the Government. As fiscal agent, the Bank of Papua New Guinea is authorised to carry out all operations and transactions with the Fund.

Special Drawing Rights (SDR) are allocated by the IMF to members on the basis of members' quota at the time of the SDR allocation. The Bank of Papua New Guinea pays interest on its SDR allocations and earns interest on its holdings of SDR.

	2011 K'000	2010 K'000

Note 8: CASH & CASH EQUIVALENTS

	2011 K'000	2010 K'000
Foreign currency holdings – Nostro accounts	1,251,573	2,045,663
	1,251,573	**2,045,663**

The foreign currency holdings represent the Bank's foreign Nostro holding with corresponding foreign banks.

Note 9: FINANCIAL ASSETS AT FAIR VALUE

	2011 K'000	2010 K'000
Foreign investments	7,765,983	5,833,872
Derivative assets	20,263	1,061
	7,786,246	**5,834,933**

Foreign investments include K2.28 billion (2010: K2.27 billion) of investments managed by the external fund managers. The remainder is managed directly by the Bank.

Note 10: GOVERNMENT OF PAPUA NEW GUINEA SECURITIES

	2011 K'000	2010 K'000
Inscribed stock	437,165	409,470
	437,165	**409,470**

Note 11: LOANS AND ADVANCES

	2011 K'000	2010 K'000
Loan & advances to Government	-	1,238
Agricultural export commodity support loans	1,386	1,386
Loans and advances to staff (including housing loans)	8,331	8,675
	9,717	**11,299**

Note 12: OTHER ASSETS

(a) Foreign Currency Other Assets

	2011 K'000	2010 K'000
Interest receivable	52,541	50,421
Prepayment	-	-
	52,541	**50,421**

(b) Domestic Other Assets – receivables

	2011 K'000	2010 K'000
Interest receivable	7,517	7,821
Other receivables	3,589	2,984
	11,106	**10,805**

	Land and Buildings K'000	Equipment K'000	Motor Vehicles K'000	Computer Equipment K'000	Computer Software K'000	Total K'000

Note 13: PROPERTY PLANT & EQUIPMENT

	Land and Buildings K'000	Equipment K'000	Motor Vehicles K'000	Computer Equipment K'000	Computer Software K'000	Total K'000
At 31 December 2010						
Cost	110,417	4,908	1,806	4,172	9,707	131,010
Accumulated depreciation	-	(1,861)	(1,200)	(3,173)	(498)	(6,732)
Net Book Amount	**110,417**	**3,047**	**606**	**999**	**9,209**	**124,278**
Year end December 2011						
Opening net book amount	110,417	3,047	606	999	9,209	124,278
Additions	473	1,329	867	882	154	3,705
Disposals	-	-	(501)	-	-	(501)
Transfers	-	(3,143)	-	-	3,143	-
Write-back accumulated depreciation on disposal	-	-	490	-	-	490
Depreciation charges	(1,603)	(484)	(374)	(384)	(863)	(3,708)
Closing Book Amount	**109,287**	**749**	**1,088**	**1,497**	**11,643**	**124,264**
At 31 December 2011						
Cost	110,890	3,094	2,172	5,054	13,004	134,214
Accumulated Depreciation	(1,603)	(2,345)	(1,084)	(3,557)	(1,361)	(9,950)
Net Book Amount	**109,287**	**749**	**1,088**	**1,497**	**11,643**	**124,264**

The Bank's properties were externally re-valued in December 2010. These revaluations are performed every 3 years. The next revaluation will be performed in 2013.

The deferred cost of computer software is the net cost of the Opics system since going live upon completion in May 2010, plus accumulated cost of work-in-progress for payment and data warehouse systems. These costs will be amortised over a period of 13 years, which is in line with the life of the licence.

Note 14: DEPOSITS FROM BANKS & THIRD PARTIES

	2011 K'000	2010 K'000
Banks		
Exchange settlement accounts	778,682	280,153
Cash reserve requirement	944,874	530,073
Other Deposits	9,731	7,475
	1,733,287	**817,701**

	2011 K'000	2010 K'000

Note 15: SECURITIES ISSUED

Central Bank bills issued	**5,654,380**	**4,576,182**

Securities issued are debt securities issued by the Bank of Papua New Guinea for terms of twenty-eight days, three or six months. These bills are used to manage liquidity in the money market open market operations in the domestic financial markets.

Interest on securities issued varied between 2.4% and 4.8% during the year (2010: 2.3%, 5.3%). Accrued interest is included in other liabilities in Note 17(b).

Note 16: CURRENCY IN CIRCULATION – DOMESTIC LIABILITY

Currency in circulation	**1,532,447**	**1,192,711**

Currency in circulation represents currency issued having a claim on the Bank of Papua New Guinea. The liability for currency in circulation is recorded at its fair value in the statement of financial position.

Note 17: FINANCIAL LIABILITIES

(a) Foreign Currency Liabilities

Derivative liabilities	644	26,748
Foreign currency deposits	4,588	3,907
	5,232	**30,655**

(b) Domestic Other Liabilities

Provisions for employee entitlements	11,082	8,055
Accrued interest on deposits and securities issued	32,206	18,351
Accrued currency warehouse &production costs	-	4,832
Expense creditors	16,335	22,934
Other liabilities	12,488	6,915
	72,111	**61,087**

Outstanding warrants include cheques or warrant issued by the Bank but not yet presented for clearance and subsequent encashment by government departments, investors and suppliers.

Note 18: SHARE CAPITAL

At 31 December 2011 the authorised and subscribed capital of the Bank was K145.54 million (2010: K145.54 million). The capital is fully subscribed by the Government of Papua New Guinea.

At the beginning of the year	145,540	145,540
At the end of the year	**145,540**	**145,540**

	2011 K'000	2010 K'000

Note 19: RECONCILIATION OF NET PROFIT TO OPERATING CASH FLOW

	2011 K'000	2010 K'000
Total comprehensive (loss)/profit	(1,737,097)	195,129
Add/(Subtract) Non-Cash Items		
Depreciation	3,708	3,016
Provisions for staff entitlements	3,243	1,688
Net unrealised gold (gain)/loss	15,197	(31,898)
Net unrealised (gain)/loss on property valuation	-	(58,747)
Net unrealised market value changes	11,511	(72,807)
Add/(Subtract) Movements in Other Financial Assets		
(Increase)/decrease in interest receivable	(1,632)	(1,142)
Increase/(decrease) in interest payable	13,855	10,067
(Increase)/decrease in foreign investment including derivatives	(1,976,735)	161,250
(Increase)/decrease in other receivable	15,675	13,371
Increase/(decrease) in other payables	(5,858)	(3,671)
	-	-
Net Cash Flow from Operating Activities	**(3,658,133)**	**216,256**

Note 20: SEGMENT REPORTING

The Bank's primary function as a Central Bank is the implementation of monetary policy in one geographical area – Papua New Guinea.

Note 21: RISK MANAGEMENT

Note 21(i): Financial Risk Management

International Financial Reporting Standard (IFRS) 7 (Financial Instruments: Disclosures) requires disclosure of information relating to financial instruments, their significance, performance, accounting policy, terms and conditions, fair values and the Bank's policies for controlling risks and exposures relating to the financial instruments.

A financial Instrument is defined as any contract that gives rise to both a financial asset of one enterprise and financial liability or equity instrument of another entity. The identifiable financial instruments for BPNG are its domestic government securities, its foreign government securities, loans and advances, bank deposits, central bank bills, currency in circulation and deposit liabilities.

Fair value is the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction. BPNG 's recognised instruments are carried at amortised cost or current market value.

The Bank is involved in policy-oriented activities. Therefore, the Bank's risk management framework differs from the risk management framework for most other financial institutions. The main financial risks to which the Bank is exposed include commodity price risk, credit risk, foreign exchange risk and interest rate risk. In the management of foreign reserves, minimising liquidity risk is the prime consideration in order to ensure the availability of currency as required. Like most central banks, the nature of the Bank's operations creates exposure to a range of operational and reputational risks.

Bank management seeks to ensure that strong and effective risk management and control systems are in place for assessing, monitoring and managing risk exposure. Experienced staff conduct the Bank's local currency, foreign currency reserves management and foreign exchange dealing operations in accordance with a clearly defined risk management framework, including delegated authority limits set by the Governor.

The Bank is subject to an annual audit by an external auditor. Auditing arrangements are overseen by an Audit Committee of the Board to monitor the financial reporting and audit functions within the Bank. The Committee also reviews the internal audit functions. The Committee reports to the Board of Directors on its activities.

The overall risk management framework is designed to strongly encourage the sound and prudent management of the Bank's risk. The Bank seeks to ensure the risk management framework is consistent with financial market best practice. The risks tables in this note are based on the Bank's portfolio as reported in its statement of financial position.

Note 21(ii): Credit Risk

Credit risk is the risk of loss arising from a counterparty to a financial contract failing to discharge its obligations.

(a) Credit Risk Management

The Bank manages credit risk by employing the following strategies;

Selection of a counterparty is made based on their respective credit rating. Investment decisions are based on the credit rating of the particular issuer, the issue size, country limits and counterparty limits in place to control exposures.

Foreign currency placements are made in approved currencies with Government, Government guaranteed or other approved counterparties. Geographical exposures are controlled by country limits. Limits are updated periodically where necessary based on the latest market information. Credit risk in the Bank's portfolio is monitored, reviewed and analysed regularly.

(b) Concentration of Credit Exposure

The Bank's significant end-of-year concentrations of credit exposure by industry type were as follows:

	2011 K'000	2010 K'000
Papua New Guinea Government	437,165	409,470
Other Government Institutions	1,386	2,624
Foreign Governments, Banks and Financial Institutions	9,266,608	8,131,944
Other	8,331	8,675
Total Financial Assets	**9,713,490**	**8,552,713**

The Bank's maximum exposure to credit risk is limited to the amount of financial assets carried in the statement of financial position.

Credit exposures arising from securities under agreements to re-sell (reverse repurchase agreements) are classified according to the issuer of the credit exposure of the security for credit exposure concentration purposes.

95% of the total exposure is derived from loans and advances to banks and other financial institutions, of which 46% of the total assets have a credit rating of AA or above.

(c) Credit Exposure by Credit Rating

The following table represents the Bank's financial assets based on Standard and Poor's and Moody's credit ratings of the issuer. Under Standard and Poor's ratings, AAA is the highest quality rating possible and indicated the entity has an extremely strong capacity to pay interest and principal. AA is a high grade rating, indicating a very strong capacity. A is an upper medium grade, indicating a strong capacity. BBB is the lowest investment grade rating, indicating a medium capacity to pay interest and principal.

	2011 K'000	% 2011 Financial Assets	2010 K'000	% 2010 Financial Assets
Investment in Financial Assets				
AAA	2,106,666	27.2	2,931,524	50.0
AA+	441,172	6.0	-	-
AA	674,233	9.0	611,869	10.0
AA-	327,736	4.0	-	-
A+	33,600	0.4	-	-
A	166,074	2.0	498,231	9.0
A-	120,979	1.0	-	-
A 1	3,865,478	49.9	1,792,248	31.0
BBB	28,707	0.3	-	-
BB+	21,600	0.2	-	-
Total Financial Assets	**7,786,245**	**100**	**5,833,872**	**100**

Note 21(iii): Market Risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risks arise from open positions in interest rate and currency products, all of which are exposed to general and specific market movements and changes in the level of volatility of market rates or prices, such as interest rates, credit spreads and foreign exchange rates. The Bank separates exposures to market risk into either in-house or outsourced investment portfolios.

Market risks arising from the outsourced investment portfolio are managed by external fund managers through the use of forward exchange derivative contracts.

(a) Foreign Exchange Risk

Currency risk (foreign exchange rate risk) is a form of risk that arises from the change in price of one currency against another, which directly affects the value of foreign exchange reserves as well as investments. Foreign exchange reserve management and investment functions within BPNG are guided by an Investment Committee. The decisions of the Investment Committee and dealing practices approved by the Investment Committee serve as operational guidelines for the Bank's reserve management and investments. The guidelines are directed towards managing different types of risks, while earning a reasonable return. There is an approved benchmark for investment in terms of currency composition, portfolio duration and proportion of different assets within the Bank. Dealers/portfolio managers endeavour to comply with this benchmark through rebalancing the investment portfolio following daily or weekly benchmarking as approved by the Investment Committee.

As at 31 December 2011 the Bank's net exposure to major currencies was as follows:

	CURRENCY DENOMINATION								
	US Dollar K'000	Gold K'000	Euro K'000	AUD K'000	GBP K'000	JPY K'000	SDR K'000	Other K'000	Total K'000
At 31 December 2011									
Foreign Currency Financial Assets									
Foreign currency	498,268	-	394,144	235,973	64,169	58,016	-	1,003	1,251,573
Investments	3,996,232	-	957,753	2,073,922	383,236	388,951	-	-	7,800,094
Assets held with IMF	-	-	-	-	-	34,200	-	34,200	
Derivative assets	20,263	-	-	-	-	-	-	-	20,263
Other assets	-	142,049	-	-	-	-	-	18,430	160,479
	4,514,763	**142,049**	**1,351,897**	**2,309,895**	**447,405**	**446,967**	**34,200**	**19,433**	**9,266,609**
Foreign Currency Financial Liabilities									
Liabilities with IMF	-	-	-	-	-	-	412,950	-	412,950
Foreign currency liabilities	5,225	-	-	7	-	-	-	-	5,232
	5,225	**-**	**-**	**7**	**-**	**-**	**412,950**	**-**	**418,182**
Net Foreign Currency Exposure	**4,509,538**	**142,049**	**1,351,897**	**2,309,888**	**447,405**	**446,967**	**(378,750)**	**19,433**	**8,848,427**

	CURRENCY DENOMINATION								
	US Dollar K'000	Gold K'000	Euro K'000	AUD K'000	GBP K'000	JPY K'000	SDR K'000	Other K'000	Total K'000
At 31 December 2010									
Foreign Currency Financial Assets									
Foreign currency	864,460	-	236,580	588,274	148,048	206,391	-	1,910	2,045,663
Investments	3,133,386	-	865,767	1,432,340	230,496	197,905	-	-	5,859,894
Assets held with IMF	-	-	-	-	-	-	43,639	-	43,639
Derivative assets	1,061	-	-	-	-	-	-	-	1,061
Other assets	-	157,288	-	-	-	-	-	24,399	181,687
	3,998,907	**157,288**	**1,102,347**	**2,020,614**	**378,544**	**404,296**	**43,639**	**26,309**	**8,131,944**
Foreign Currency Financial Liabilities									
Liabilities with IMF	-	-	-	-	-	-	511,992	-	511,992
Foreign currency liabilities	30,649	-	-	6	-	-	-	-	30,655
	30,649	**-**	**-**	**6**	**-**	**-**	**511,992**	**-**	**542,647**
Net Foreign Currency Exposure	**3,968,258**	**157,288**	**1,102,347**	**2,020,608**	**378,544**	**404,296**	**(468,353)**	**26,309**	**7,589,297**

The functional currency of all operations is PNG Kina.

(b) Interest Rate Risk

Interest rate risk is the risk that the fair value or cash flows of financial instruments will fluctuate because of movements in market interest rates. The Bank is exposed to considerable interest rate risk because most of its assets are financial assets, such as domestic and foreign securities, which have a fixed income stream. The price of such securities increases when market interest rates decline, while the price of a security due to the associated income stream is fixed for a longer period.

The Bank manages interest rate risk by investing in securities with different maturity dates to mitigate against any adverse fluctuation in interest rates.

(c) Liquidity Risk

Liquidity risk is the risk that the Bank will encounter difficulty in meeting obligations associated with its financial liabilities in its operations. The ultimate source of liquidity is Kina and the Bank has the authority to create liquidity by issuing unlimited amounts of Kina.

Liquidity risk is also associated with financial assets to the extent that the Bank may have to sell a financial asset at less than its fair value. The Bank manages this risk by holding a diversified portfolio of highly liquid domestic and foreign assets. The Bank's assets held for managing liquidity risk comprise cash and bank balances with other Central Banks and Government bonds and other securities that are readily acceptable in repurchase agreements with other Central Banks.

The table below summarises the maturity profile of the Bank's financial liabilities based on the contractual repayment date. This is determined on the basis of the remaining period at the balance sheet date to the contractual maturity date.

		MATURITY PERIOD				
	Balance Total K'000	0 to 3 months	3 to 12 months	1 to 5 years	Over 5 Years	No specific maturity
At 31 December 2011						
Liabilities in 2011						
Foreign Currency Financial Liabilities						
Liabilities with IMF	412,950	-	-	-	-	412,950
Foreign currency liabilities	5,232	5,232	-	-	-	-
	418,182	**5,232**	**-**	**-**	**-**	**412,950**
Local Currency Financial Liabilities						
Deposits from banks and third parties	1,733,287	1,733,287	-	-	-	-
Deposits from Government	1,718,749	1,718,749	-	-	-	-
Securities issued	5,715,100	3,959,700	1,755,400	-	-	-
Currency in circulation	1,532,447	-	-	-	-	1,532,447
	10,699,583	**7,411,736**	**1,755,400**	**-**	**-**	**1,532,447**
Other Liabilities						
Other liabilities	72,111	72,111	-	-	-	-
	72,111	72,111	-	-	-	-
Total Liabilities	**11,189,876**	**7,489,079**	**1,755,400**	**-**	**-**	**1,945,937**
At 31 December 2010						
Liabilities in 2010						
Foreign Currency Financial Liabilities						
Liabilities with IMF	511,992	-	-	-	-	511,992
Foreign currency liabilities	30,864	30,864	-	-	-	-
	542,856	**30,864**	**-**	**-**	**-**	**511,992**
Local Currency Financial Liabilities						
Deposits from banks and third parties	817,701	817,701	-	-	-	-
Deposits from Government	1,035,128	1,035,128	-	-	-	-
Securities issued	4,613,100	3,981,100	632,000	-	-	-
Currency in circulation	1,192,711	-	-	-	-	1,192,711
	7,658,640	**5,833,929**	**632,000**	**-**	**-**	**1,192,711**
Other Liabilities						
Other liabilities	61,087	61,087	-	-	-	-
	61,087	**61,087**	**-**	**-**	**-**	**-**
Total Liabilities	**8,262,583**	**5,925,880**	**632,000**	**-**	**-**	**1,704,703**

Note 21(iv): Sensitivity Analysis

At 31 December 2011, if interest rates had been 100 basis points lower with all other variables constant, loss for the year would have been K8.1 million higher and the net assets at year end would have been K8.1 million lower (2010: K13.9 million), arising mainly as a result of lower interest income on financial assets. Conversely if interest rates had been 100 basis points higher with all other variables held constant the loss for the year would have been K8.1 million lower and the net assets at year end would have been K8.1 million higher (2010: K13.9 million) arising mainly as a result of higher interest income on financial assets.

At 31 December 2011, if the Kina had weakened 10 per cent against the principal currencies in its foreign reserves portfolio with all other variables held constant, loss for the year would have been K884.8 million lower, (2010: K758.9 million). Conversely if the Kina had strengthened 10 percent against the same currencies with all other variables held constant, the Bank would have experienced an increase in the loss for the year of K884.8 million (2010: K758.9 million).

Note 21(v): Fair Value

Fair value represents the amount at which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction. Fair value has been based on management assumptions according to the portfolio of the asset and liability base. IFRS requires that the fair value of the financial assets and liabilities be disclosed according to their classification under IAS 39. The following table summarises the financial assets and liabilities in accordance with IAS 39 classifications.

	2011 K'000	2010 K'000
Financial Assets		
At fair value through profit/(loss)	8,399,660	6,445,330
Loans and receivables	1,313,831	2,107,383
	9,713,491	**8,552,713**
Financial Liabilities		
At fair value through profit/(loss)	418,182	542,647
At amortised cost	10,710,974	7,683,809
	11,129,156	**8,225,456**

Fair values of the above financial instruments are estimated to be the same as their carrying values in the statement of financial position.

Fair Value Hierarchy

IFRS 7 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources. Unobservable inputs reflect the Bank's market assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities. This level includes listed equity securities and debt instruments on exchanges.
- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). This level includes over the counter derivative contracts. The sources of input parameters are Bloomberg or Reuters.
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs). This level includes equity investments and debt instruments with significant unobservable components.

This hierarchy requires the use of observable market data when available. The Bank considers relevant and observable market prices in its valuations where possible. The table below shows the Bank's assets and liabilities in their applicable fair value level.

31 December 2011	Level 1 K'000	Level 2 K'000	Level 3 K'000	Total K'000
Financial assets held at fair value through profit and loss				
– Domestic Government securities (Inscribed Stock)	-	437,165	-	437,165
– Foreign Government and semi-Government bonds	2,354,796	-	-	2,354,796
– Money market instruments	-	3,153,020	-	3,153,020
– Derivatives managed by external fund managers	-	20,263	-	20,263
– Investments in bonds and other instruments managed by external fund managers	2,258,167	-	-	2,258,167
– Gold	142,049	-	-	142,049
– Assets held with IMF	34,200	-	-	34,200
Total assets	**4,789,212**	**3,610,448**	**-**	**8,399,660**
Financial liabilities held at fair value through profit and loss				
– Derivatives	-	644	-	644
– Liabilities with IMF	412,950	-	-	412,950
Total liabilities	**412,950**	**644**	**-**	**413,594**

Investments managed by external fund managers include foreign Government bonds and other debt instruments for which quoted prices are available, as well as derivatives which are valued with reference to observable market data. Accordingly, these are classified under level 1 and 2 respectively.

31 December 2010	Level 1 K'000	Level 2 K'000	Level 3 K'000	Total K'000
Financial assets held at fair value through profit and loss				
Financial assets held for trading				
– Domestic Government securities (Inscribed Stock)	-	409,470	-	409,470
– Foreign Government and semi-Government bonds	2,205,818	-	-	2,205,818
– Money market instruments	288,507	1,069,932	-	1,358,439
– Derivatives managed by external fund managers	-	1,061	-	1,061
– Investments in bonds and other instruments managed by external fund managers	2,269,615	-	-	2,269,615
– Gold	157,288	-	-	157,288
– Assets held with IMF	43,639	-	-	43,639
Total assets	**4,964,867**	**1,480,463**	**-**	**6,445,330**
Financial liabilities held at fair value through profit and loss				
– Derivatives	-	26,748	-	26,748
– Liabilities with IMF	511,992	-	-	511,992
Total liabilities	**511,992**	**26,748**	**-**	**538,740**

Note 22: EVENTS AFTER THE BALANCE DATE

Subsequent to the balance date, no events have occurred which require adjustments to/or disclosures in the financial statements.

Note 23: CONTINGENT LIABILITIES

The Bank had no material contingent liabilities at 31 December 2011 (2010 Nil) and there are no transactions or events that will have material impact on the financial report during the preparation of this report.

Note 24: CAPITAL COMMITMENTS

The Bank has no material capital commitments.

Note 25: REMUNERATION OF MEMBERS OF THE BOARD AND KEY MANAGEMENT PERSONNEL

IAS 24 – Related Party Disclosures requires disclosure of information relating to aggregate compensation of key management personnel. The key management personnel of the Bank are members of the Board and senior staff who have responsibility for planning, directing and controlling the activities of the Bank. This group comprises 25 in total (2010: 26), including the Governor, Deputy Governor, 3 Assistant Governors, 8 non-executive Board members and 12 senior staff. The Salaries and Remuneration Committee (SRC) and Salaries, Conditions & Monitoring Committee (SCMC) determine the terms and conditions on which the Governor and Deputy Governor hold office in accordance with the *Central Banking Act 2000*. The Governor, in consultation with the Salaries, Conditions & Monitoring Committee (SCMC), determines the remuneration of other key executives.

Key Management Personnel Remuneration

	2011 K'000	2010 K'000
Short term benefits	5,201	2,884
Post employment benefits	492	444
Other long term benefits	2,133	1,493
	7,826	**4,820**

Short term benefits include cash salary and in the case of staff, annual leave and motor vehicle and housing benefits. Post employment benefits include superannuation benefit payments. Other long term benefits include long service leave. The components of benefits are reported on an accruals basis.

As at 31 December 2011 the loans owed by the key management personnel to the Bank stood at K1,948,730 (2010: K1,433,671).

Note 26: AUDITOR'S REMUNERATION

The total audit fee for the year was K1,275,313 (2010: K1,275,313). This represents the total statutory audit fee paid to the Auditor General's Office.

Note 27: TRANSACTIONS WITH GOVERNMENT AND GOVERNMENT CONTROLLED ENTERPRISES

The Bank of Papua New Guinea acts as the banker to the Government and its various government departments and controlled enterprises. The Government of Papua New Guinea is restricted under the *Central Banking Act 2000* from actively participating in Bank's decision and policy formulations. All related party transactions are carried out with reference to market rates. Transactions entered into include:

(a) Acting as the fiscal agent, banker and financial advisor to the Government. The Bank is the depository of the Government and or its agents or institutions providing banking services to Government and Government departments and corporations.

(b) Acting as the agent of the Government or its agencies and institutions, providing guarantees, participating in loans to Government departments and corporations.

(c) As the agent of the Government managing public debt and foreign reserves.

DECLARATION BY MANAGEMENT

In our opinion the foregoing Statement of Financial Performance and Statement of Financial Position, including the Notes to and forming part thereof, have been drawn up so as to give a true and fair view of the matters to which they relate for the year ended 31 December 2011.

Going concern

The Bank recorded a total comprehensive loss of K1,737.1 million (2010: profit of K195.1 million) and experienced negative operating cash flows of K3,658.1 million (2010: positive cash flow of K216.3 million) for the year. In addition, total liabilities of the Bank exceeds its total assets by K1,240.7 million (2010 – net assets of K518.4 million). The Bank envisages this net deficiency position to continue as a result of ongoing appreciation of the PNG Kina over the foreseeable future and the combined high cost of monetary policy management stemming from high domestic liquidity.

Safeguard available to the Bank

Section 50(2) of the *Central Banking Act 2000* (CBA Act 2000) provides that where the Bank incurs a loss due to a change in the value of assets or liabilities, the Minister shall cause to be paid to the Bank such amount out of the Consolidated Revenue Fund as is necessary to avoid the loss. This is a statutory obligation imposed on the Minister to ensure the viability of the Central Bank.

Subsection 50(4) of that Act further provides that the Minister may create and issue to the Central Bank non-interest bearing non-negotiable notes for an amount not exceeding any payment made by the Minister to the Central Bank out of the Consolidated Revenue Fund in accordance with Subsections (1) and (2).

The above provisions effectively require the Government to provide financial support to the Bank to the extent determined by the Bank's Board. Such financial assistance need not involve any cash flow.

Steps taken by the Bank and other mitigating factors

Building Capital and Reserves

In 1996, the Board of the Bank had approved the retention of part of the operating profits to build up capital and reserves for the Bank and continues to build its capital and reserves.

The Bank reported a distributable profit of K22 million for the year 2010. The Board recommended retaining that profit as part of the Bank's Capital and Reserves. Subsequent to the Board's endorsement, the Bank corresponded the same with the then Minister for Treasury, citing as well that the Government's 2011 budget had required no dividends from the Bank. However, the Bank was subsequently directed by a National Executive Council (NEC) Decision in September 2011 to pay the K22 million as dividends.

Promissory Note

In the June 2011 meeting the Board of the Central Bank had determined that Section 50(2) of the *Central Banking Act 2000* (CBA) be invoked. There has since been continuous dialogue between the Bank, the Secretary for Treasury and the Minister requesting payment from Consolidated Revenue combined with the issue of a Promissory Note to the Bank.

The Bank has submitted a letter dated 9 May 2012 to the Minister requesting a promissory note for K1.74 billion which is reflective of the forecasted net deficiency position of the Bank as at 31 December 2012.

Operation of TAP facility on behalf of the Government

In 2011 the Bank also initiated dialogue with the Treasury Department on the option of operating a TAP facility on behalf of the Government. This option was put forward as a means of reducing the Bank's major domestic liability of Central Bank Bills, by shifting some liquidity management burden to the Government, thereby easing pressure on the Bank's liquidity management operation, hence a more healthier net position.

Movement of Trust Accounts from Commercial Banks

Externally held trust funds continue to have an adverse impact on the liquidity management operations of the Bank. The Bank has approached the Government to consider moving all trust accounts in commercial banks back to Bank of PNG. The Government conceded and about K200 million was transferred from various commercial bank trust accounts to the Bank during the year.

Resources Sector gains to be held as Reserves by the Bank

Discussions have been underway between the Bank and the Government on the possibility of the Government placing excess funds from the LNG operations and other mining and petroleum operations in the custody of the Bank to manage offshore in addition to the Bank's current in-house managed and externally managed foreign reserves. An outcome of this dialogue is still pending.

The Bank will continue the dialogue with the appropriate Government authorities to ensure the Bank's net deficiency position and ensuing implications on going concern as well as stakeholder confidence are fully appreciated and addressed in a timely manner. On this basis, we believe that the preparation of the financial statements of the Bank on a going concern basis is appropriate.

For and on behalf of the Bank of Papua New Guinea,

Loi M Bakani
Governor

Benny Popoitai MBE
Deputy Governor
Regulation

31 May 2012

AUDITOR-GENERAL'S OFFICE
PAPUA NEW GUINEA

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The Honourable Don Polye, MP
Minister for Finance and Treasury
Office of the Minister
Vulupindi Haus - 4th Floor
PO Box 710
WAIGANI, NCD

Reference: 30-13-4

INDEPENDENT AUDITOR'S REPORT ON THE
BANK OF PAPUA NEW GUINEA
FOR THE YEAR ENDED 31 DECEMBER 2011

I have audited the accompanying financial statements of the **Bank of Papua New Guinea** for the year ended 31 **December, 2011**as set out on pages 2 to **24** which comprise the statement of financial position as at 31 December, 2011, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

The Bank Board's Responsibility for the Financial Statements

The Bank's Board is responsible for the preparation and fair presentation of these financial statements in accordance with *International Financial Reporting Standards*, other generally accepted accounting practice in Papua New Guinea and other statutory requirements including the *Papua New Guinea Central Banking Act*, 2000. This responsibility includes designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error.

Responsibility of the Auditor-General

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with the *Audit Act* and *International Standards on Auditing*. These standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

AUDIT OPINION

In my opinion:

(a) the financial statements are based on proper accounts and records;

(b) the financial statements are in agreement with those accounts and records and show fairly the state of affairs of the Bank as at 31 December, 2011 and the results of financial operations, changes in equity and its cash flows for the year then ended; and

(c) I have obtained all the information and explanation that were required.

PNauga

PHILIP NAUGA
Auditor-General

12 June, 2012

AUDITOR-GENERAL'S OFFICE
PAPUA NEW GUINEA

PAPUA NEW GUINEA

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The Honourable Don Polye, MP
Minister for Finance and Treasury
Office of the Minister
P.O Box 710
WAIGANI, NCD

Reference: 30-13-4

BANK OF PAPUA NEW GUINEA

In accordance with the provisions of Section 8(2) of the *Audit Act*, 1989 *(as amended)*, I have inspected and audited the accounts and records of the financial transactions and records relating to the assets and liabilities and assets in the custody of the **Bank of Papua New Guinea** for the year ended **31 December, 2011**.

My report on the financial statements of the Bank together with a copy of the financial statements was forwarded to you on 12 June, 2012. The report did not contain any qualifications.

OTHER MATTERS

I wish to bring to your attention the following matters which, in my opinion, are important.

1. Net Asset Deficiency – Going Concern

The Bank recorded a total comprehensive loss of K1,737 million (2010: Profit of K195 million) and experienced negative operating cashflows of K3,858 million (2010: positive cashflow of K215 million) for the year. The Bank's financial statement showed that the Bank is in a negative net asset position of K1,241 million as at 31 December, 2011. This is a direct result of significant loss incurred through revaluation of foreign currency asset as a result of substantial appreciation of kina against all major currencies.

The Bank also continued to incur losses after year end due to the effect of continuing appreciation of the kina against other foreign currencies denominated mostly in US Dollar, Euro and Australian Dollar. Appreciation of PNG Kina against these currencies has resulted in significant unrealized losses in relation to these investments.

Given the positive future outlook of the PNG economy there is reasonable expectation that kina may remain strong. Therefore the condition of the loss and deficiency in net assets may continue. This situation may have some impact on the financial independent and the ability of the Bank to maintain price stability.

The *Central Banking Act, 2000, Section 50 (2)*, states that;

"*where anytime the Central Bank incurs a loss due to value of any asset or liability held by the Central Bank, that in the opinion of the Board may lead to a significant reduction in the reserve funds of the Central Bank, the Minister shall cause to be paid to the Central Bank out of the Consolidated Revenue Fund such amount as the Board reasonably considers necessary to avoid such a reduction.*"

Relying on the above provision of the Act, an unmodified audit opinion was issued.

2. Contravention of the Central Bank Act, 2000

The Bank distributed K22 million in dividends to the State based on the National Executive Council's decision in September 2011. However, the Board of Directors of the Bank had passed a resolution in June 2011 not to make any distribution relating to 2011 and recommended to transfer the operating profit to Capital Reserves.

Section 49 (3) of the *Central Banking Act, 2000* specifies that no distribution will be made where the distribution will result in a deficiency in net assets. This distribution was made in contravention to the *Central Banking Act, 2000*.

PHILIP NAUGA
Auditor-General

12th June, 2012

NOTES

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