

Bank of South Pacific Limited and Subsidiaries

Financial Statements

31 December 2017



Contents of Financial Statements

	Page
Directors' Report	1
Statements of Comprehensive Income	3
Statements of Financial Position	4
Statements of Changes in Shareholders' Equity	5
Statements of Cash Flows	6
Notes to the Financial Statements	7
Note 1 Accounting Policies	7
Note 2 Net Interest Income	20
Note 3 Fee and Commission Income	20
Note 4 Other Income	21
Note 5 Operating Expenses	21
Note 6 Income Tax Expense	21
Note 7 Intangible Assets	23
Note 8 Investment in Subsidiaries	23
Note 9 Investment in Associates and Joint Ventures	24
Note 10 Cash and Balances with Central Bank	25
Note 11 Treasury and Central Bank Bills	25
Note 12 Amounts Due from Other Banks	25
Note 13 Loans, Advances and Other Receivables from Customers	25
Note 14 Property, Plant and Equipment	27
Note 15 Investment Properties	29
Note 16 Other Financial Assets	29
Note 17 Other Assets	29
Note 18 Amounts Due to Other Bank	29
Note 19 Customer Deposits	29
Note 20 Subordinated Debt Securities	30
Note 21 Other Liabilities	30
Note 22 Other Provisions	30
Note 23 Ordinary Shares	30
Note 24 Retained Earnings and Other Reserves	31
Note 25 Contingent Liabilities and Commitments	32
Note 26 Fiduciary Activities	33
Note 27 Directors and Executive Remuneration	33
Note 28 Reconciliation of Operating Cash flow	35
Note 29 Segment Information	36
Note 30 Related Party Transactions	37
Note 31 Bank Operations, Risks and Strategies in Using Financial Instruments	38
Note 32 Capital Adequacy	38
Note 33 Credit Risk and Asset Quality	39
Note 34 Liquidity Risk	41
Note 35 Operational Risk	42
Note 36 Foreign Exchange Risk	43
Note 37 Interest Rate Risk	44
Note 38 Fair Values of Financial Assets and Liabilities	45
Note 39 Insurance	47
Note 40 Events Occurring After Balance Sheet Date	49
Note 41 Remuneration of Auditor	49
Independent Auditor's Report	50

Directors' Report

for the Year Ended 31 December 2017

The Directors take pleasure in presenting the Financial Statements of the Bank of South Pacific Limited and its subsidiaries (Bank and the Group) for the year ended 31 December 2017. In order to comply with the provisions of the Companies Act 1997, the Directors report as follows:

Principal activities

The principal activity of the Bank of South Pacific Limited (BSP) is the provision of commercial banking and finance services. The Group's activities also include stock broking, fund management and life business services throughout Papua New Guinea and the Asia Pacific region. BSP is a company listed on the Port Moresby Stock Exchange (POMSoX), incorporated under the Companies Act of Papua New Guinea, and is an authorised Bank under the Banks and Financial Institutions Act of Papua New Guinea. The Group is also licensed to operate in the Solomon Islands, Fiji Islands, Cook Islands, Samoa, Tonga, Vanuatu and Cambodia. The registered office is at Douglas Street, Port Moresby.

Review of operations

For the year ended 31 December 2017, Group's profit after tax was K757.003 million (2016: K643.451 million). The Bank's profit after tax was K720.953 million (2016: K606.674 million).

The Directors are of the view that there are reasonable grounds to believe that the Bank and the Group will be able to pay their debts as and when they become due and payable; and the attached financial statements and notes thereto are in accordance with the PNG Companies Act 1997, including compliance with accounting standards and give a true and fair view of the financial position and performance of the Bank and the Group.

The results of the Bank and the Group operations during the financial year have, in the opinion of the Directors, not been materially affected by items of an abnormal nature, other than those disclosed in the financial statements.

In the opinion of the Directors, no circumstances have arisen, that make adherence to the existing method of valuation of assets or liabilities of the Bank and the Group misleading or inappropriate.

At the date of this report the Directors are not aware of any circumstances that would render the values attributed to current assets in the financial statements misleading.

No contingent liability other than that disclosed in the notes to the attached financial statements has become enforceable, or is likely to become enforceable, within a period of twelve months from the date of this report, that will materially affect the Bank and the Group in its ability to meet obligations as and when they fall due.

Dividends

Dividend payments totalling K521.858 million were paid in 2017 (2016: K413.973 million). A detailed breakup of this is provided in Note 23.

Directors and officers

The following were directors of the Bank of South Pacific Limited at 31 December 2017:

Sir K Constantinou, OBE	Mr. R Fleming, CSM	Mr. S Davis
Mr. E B Gangloff	Ms. F Talao	Mr. R Bradshaw
Mr. G Robb, OAM	Mr. A Mano	
Mr. A Sam	Dr. F Lua'iufi	

Details of directors' tenure and directors and executives' remuneration during the year are provided in Note 27 of the Notes to the Financial Statements. The CEO Robin Fleming is the only executive director.

The company secretary is Mary Johns.

Independent auditor's report

The financial statements have been audited and should be read in conjunction with the independent auditor's report on page 50. Details of amounts paid to the auditors for audit and other services are shown in Note 41 of the Notes to the Financial Statements.

Directors' Report

for the Year Ended 31 December 2017

Donations and sponsorships

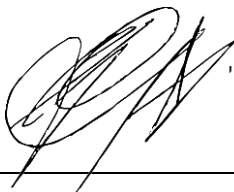
Donations and sponsorship by the Group during the year amounted to K6.457 million (2016: K5.789 million).

Change in accounting policies

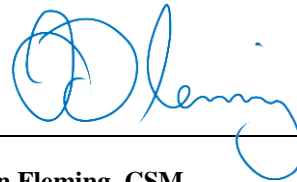
No changes in accounting policies significantly impacted the Group during the year.

For, and on behalf of, the Directors.

Dated and signed in accordance with a resolution of the Directors in Port Moresby this 28th day of February 2018.



Sir Kostas Constantinou, OBE
Chairman



Robin Fleming, CSM
Group Chief Executive Officer/Director

Statements of Comprehensive Income

for the Year Ended 31 December 2017

<i>All amounts are expressed in K'000</i>	Note	Consolidated		Bank	
		2017	2016	2017	2016
Interest income	2	1,432,640	1,267,911	1,349,134	1,214,671
Interest expense	2	(154,964)	(160,225)	(141,106)	(153,783)
Net interest income		1,277,676	1,107,686	1,208,028	1,060,888
Fee and commission income	3	373,673	362,337	345,919	340,764
Other income	4	307,171	298,078	310,059	277,045
Net banking operating income		1,958,520	1,768,101	1,864,006	1,678,697
Net insurance premium income		131,022	118,418	-	-
Investment revenue		137,479	85,616	-	-
Increase in policy liabilities	39(b)	(64,813)	(45,036)	-	-
Policy maintenance and investment expenses		(95,078)	(80,395)	-	-
Claims, surrender and maturities		(90,393)	(71,390)	-	-
Share of profits from associates and jointly controlled entities		21,613	16,743	-	-
Net insurance operating income	39(a)	39,830	23,956	-	-
Net operating income before impairment and operating expenses		1,998,350	1,792,057	1,864,006	1,678,697
Impairment on loans and advances	13	(77,678)	(98,622)	(65,111)	(90,460)
Impairment on subsidiary	8	-	-	(6,749)	-
Operating expenses	5	(852,148)	(769,641)	(777,891)	(709,139)
Profit before income tax		1,068,524	923,794	1,014,255	879,098
Income tax expense	6	(311,521)	(280,343)	(293,302)	(272,424)
Net profit for the year		757,003	643,451	720,953	606,674
Other comprehensive income					
<i>Items that may be subsequently reclassified to profit or loss</i>					
Translation of financial information of foreign operations to presentation currency	24	48,326	42,054	25,589	24,602
<i>Items that will not be reclassified to profit or loss:</i>					
Recognition of deferred tax on asset revaluation reserve	24	(10,165)	11,816	(8,977)	11,816
Net movement in asset revaluation	24	38,064	(1,265)	30,314	(1,832)
Other comprehensive income, net of tax		76,225	52,605	46,926	34,586
Total comprehensive income for the year		833,228	696,056	767,879	641,260
Earnings per share - basic and diluted (toea)	23	162.0	137.7	154.3	129.8

The attached notes form an integral part of these financial statements.

Statements of Financial Position

As at 31 December 2017

<i>All amounts are expressed in K'000</i>	Note	Consolidated		Bank	
		2017	2016	2017	2016
ASSETS					
Cash and balances with Central Bank	10	1,205,196	1,656,260	985,803	1,410,008
Treasury and Central Bank bills	11	3,298,626	2,933,621	3,287,162	2,918,484
Amounts due from other banks	12	949,214	804,233	887,337	691,152
Statutory deposits with Central Banks	25	1,598,378	1,474,656	1,541,096	1,440,530
Other financial assets	16	2,457,327	2,331,472	2,062,341	2,044,905
Loans, advances and other receivables from customers	13	11,209,493	10,102,909	10,094,470	9,255,080
Property, plant and equipment	14	738,670	683,498	574,305	569,168
Assets subject to operating lease	14	70,689	44,668	70,689	44,668
Investment in associates and joint ventures	9	154,135	125,620	19,157	16,513
Investment in subsidiaries	8	-	-	338,400	318,261
Intangible assets	7	107,818	91,626	100,750	84,727
Investment properties	15	134,020	117,590	-	-
Tax receivable	6	-	576	-	3,670
Deferred tax assets	6	181,934	170,089	200,021	182,625
Other assets	17	264,361	294,985	202,142	247,535
Total assets		22,369,861	20,831,803	20,363,673	19,227,326
LIABILITIES					
Amounts due to other banks	18	160,400	47,323	238,272	73,855
Customer deposits	19	17,901,692	16,912,349	16,843,756	16,143,696
Subordinated debt securities	20	75,525	75,525	75,525	75,525
Other liabilities	21	1,382,888	1,312,462	596,633	618,402
Provision for income tax	6	31,708	-	25,231	-
Other provisions	22	189,313	169,807	173,254	156,398
Total liabilities		19,741,526	18,517,466	17,952,671	17,067,876
SHAREHOLDERS' EQUITY					
Ordinary shares	23	373,001	373,101	373,001	373,101
Retained earnings	24	1,904,462	1,670,595	1,777,627	1,576,974
Other reserves	24	346,388	266,090	260,374	209,375
Equity attributable to the members of the company		2,623,851	2,309,786	2,411,002	2,159,450
Minority interests		4,484	4,551	-	-
Total shareholders' equity		2,628,335	2,314,337	2,411,002	2,159,450
Total equity and liabilities		22,369,861	20,831,803	20,363,673	19,227,326

The attached notes form an integral part of these Financial Statements.

Statements of Changes In Shareholders' Equity

for the Year Ended 31 December 2017

<i>All amounts are expressed in K'000</i>	Note	Share capital	Reserves	Retained earnings	Minority Interests	Total
Bank						
Balance as at 1 January 2016		374,621	216,369	1,340,000	-	1,930,990
Net profit		-	-	606,674	-	606,674
Other comprehensive income		-	34,586	-	-	34,586
Total comprehensive income		-	34,586	606,674	-	641,260
2015 final dividend paid	23	-	-	(294,448)	-	(294,448)
2016 interim dividend paid	23	-	-	(116,832)	-	(116,832)
Share buyback	23	(1,520)	-	-	-	(1,520)
Total transactions with owners		(1,520)	-	(411,280)	-	(412,800)
Transfer from Asset Revaluation Reserve	24	-	(42,537)	42,537	-	-
BSP Life policy reserve	24	-	957	(957)	-	-
Balance at 31 December 2016		373,101	209,375	1,576,974	-	2,159,450
Net profit		-	-	720,953	-	720,953
Other comprehensive income		-	46,926	-	-	46,926
Total comprehensive income		-	46,926	720,953	-	767,879
2016 final dividend paid	23	-	-	(369,414)	-	(369,414)
2017 interim dividend paid	23	-	-	(149,541)	-	(149,541)
Share buyback	23	(100)	-	-	-	(100)
Total transactions with owners		(100)	-	(518,955)	-	(519,055)
Recognition of deferred tax		-	-	3,739	-	3,739
Transfer from Asset Revaluation Reserve	24	-	(1,418)	407	-	(1,011)
BSP Life policy reserve	24	-	5,491	(5,491)	-	-
Balance at 31 December 2017		373,001	260,374	1,777,627	-	2,411,002
Group						
Balance as at 1 January 2016		374,621	255,065	1,399,490	-	2,029,176
Net profit		-	-	643,451	-	643,451
Other comprehensive income		-	52,605	-	-	52,605
Total comprehensive income		-	52,605	643,451	-	696,056
2015 final dividend paid	23	-	-	(297,141)	-	(297,141)
2016 interim dividend paid	23	-	-	(116,832)	-	(116,832)
Minority interest capital		-	-	-	4,598	4,598
Share buyback	23	(1,520)	-	-	-	(1,520)
Total transactions with owners		(1,520)	-	(413,973)	4,598	(410,895)
Loss attributable to minority interests		-	-	47	(47)	-
Transfer from Asset Revaluation Reserve	24	-	(42,537)	42,537	-	-
BSP Life policy reserve	24	-	957	(957)	-	-
Balance at 31 December 2016		373,101	266,090	1,670,595	4,551	2,314,337
Net profit		-	-	757,003	-	757,003
Other comprehensive income		-	76,225	-	-	76,225
Total comprehensive income		-	76,225	757,003	-	833,228
2016 final dividend paid	23	-	-	(372,317)	-	(372,317)
2017 interim dividend paid	23	-	-	(149,541)	-	(149,541)
Share buyback	23	(100)	-	-	-	(100)
Loss attributable to minority interests	24	-	-	67	(67)	-
Total transactions with owners		(100)	-	(521,791)	(67)	(521,958)
Recognition of deferred tax		-	-	3,739	-	3,739
Transfer from asset revaluation reserve	24	-	(1,418)	407	-	(1,011)
BSP Life policy reserve	24	-	5,491	(5,491)	-	-
Balance at 31 December 2017		373,001	346,388	1,904,462	4,484	2,628,335

The attached notes form an integral part of these Financial Statements.

Statements of Cash Flows

for the Year Ended 31 December 2017

	Note	Consolidated		Bank	
		2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>					
CASH FLOW FROM OPERATING ACTIVITIES					
Interest received		1,432,265	1,269,316	1,330,842	1,185,621
Fees and other income		700,928	669,187	655,978	581,669
Interest paid		(145,505)	(161,093)	(135,083)	(155,774)
Amounts paid to suppliers and employees		(727,730)	(629,235)	(674,116)	(569,818)
Operating cash flow before changes in operating assets & liabilities	28	1,259,958	1,148,175	1,177,621	1,041,698
Increase in loans, advances and other receivables from customers		(1,164,516)	(1,392,582)	(887,123)	(1,130,592)
Increase in statutory deposits with the Central Banks		(123,723)	(115,050)	(100,566)	(98,880)
(Increase)/decrease in bills receivable and other assets		(4,430)	(78,874)	54,287	(48,610)
Increase in customer deposits		989,343	1,960,281	700,060	1,895,400
Increase in bills payable and other liabilities		120,241	92,305	38,252	20,999
Net cash flow from operations before income tax		1,076,873	1,614,255	982,531	1,680,015
Income taxes paid	6	(293,697)	(338,647)	(282,645)	(330,331)
Net cash flow from operating activities		783,176	1,275,608	699,886	1,349,684
CASH FLOW FROM INVESTING ACTIVITIES					
Increase in government securities		(490,860)	(453,058)	(386,113)	(388,010)
Expenditure on property, plant and equipment		(118,518)	(69,179)	(72,321)	(39,597)
Expenditure on software development costs		(50,096)	(22,580)	(48,109)	(21,871)
Proceeds from disposal of property, plant and equipment		2,182	70,250	2,165	69,982
Purchase of controlled entities, net of cash acquired		-	162,870	-	(38,020)
Additional funding of subsidiaries		-	-	(26,889)	(20,372)
Net cash flow used in investing activities		(657,292)	(311,697)	(531,267)	(437,888)
CASH FLOW FROM FINANCING ACTIVITIES					
Share buyback	23	(100)	(1,520)	(100)	(1,520)
Non-controlling interests shares		-	4,551	-	-
Dividends paid	23	(521,858)	(413,973)	(518,955)	(411,280)
Proceeds from borrowings	21	33,127	253,969	33,127	253,969
Principal and interest repayments of borrowings	21	(101,973)	-	(101,973)	-
Net cash flow used in financing activities		(590,804)	(156,973)	(587,901)	(158,831)
Net (decrease)/increase in cash and cash equivalents		(464,920)	806,938	(419,282)	752,965
Effect of exchange rate movements on cash and cash equivalents		45,760	37,955	26,845	21,085
Cash and cash equivalents at the beginning of the year	28	2,413,170	1,568,277	2,027,305	1,253,255
Cash and Cash Equivalents at the end of the year	28	1,994,010	2,413,170	1,634,868	2,027,305

The attached notes form an integral part of these Financial Statements.

Notes to the Financial Statements

for the Year Ended 31 December 2017

1. Accounting Policies

The principal accounting policies adopted in the preparation of these Financial Statements are set out below. These policies have been consistently applied to all the periods presented unless otherwise stated. The assets and liabilities are presented in order of liquidity on the Statements of Financial Position.

A. Basis of Presentation and General Accounting Policies

The Financial Statements of the Bank of South Pacific Limited (the Bank) and the Group are prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and interpretations of these standards issued by the International Financial Reporting Interpretations Committee. They are prepared on the basis of the historical cost convention, as modified by the revaluation of certain non-current assets, financial instruments and liabilities.

Estimates and assumptions have been used to achieve conformity with generally accepted accounting principles in the preparation of these financial statements. These assumptions and estimates affect balances of assets and liabilities, contingent liabilities and commitments at the end of the reporting period, and amounts of revenues and expenses during the reporting period. Whilst the estimates are based on management's best knowledge of current events and conditions, actual results may ultimately differ from those estimates.

The financial statements are presented in Papua New Guinea Kina, expressed in thousands of Kina, as permitted by International Financial Reporting Standards.

Standards, amendments and interpretations effective in the year ended 31 December 2017

There are a number of standards, amendments and interpretations that became applicable for the first time during the accounting period beginning 1 January 2017. Listed below is the amendment relevant to the Bank and Group:

- Amendments to IAS 7 'Statement of Cash Flows' on disclosure initiative. These amendments to IAS 7 introduce an additional disclosure that will enable users of financial statements to evaluate changes in liabilities arising from financing activities.

Standards, amendments and interpretations issued but not yet effective for the year ended 31 December 2017 or adopted early

The following standards, amendments and interpretations to existing standards have been published and are mandatory for the entity's accounting periods beginning on or after 1 January 2018 or later periods, but the entity has not early adopted them:

- Amendments to IFRS 2 'Share based payments' on clarifying how to account for certain types of share-based payment transactions (effective 1 January 2018). This amendment clarifies the measurement basis for cash-settled, share-based payments and the accounting for modifications that change an award from cash-settled to equity-settled. It also introduces an exception to the principles in IFRS 2 that will require an award to be treated as if it was wholly equity-settled, where an employer is obliged to withhold an amount for the employee's tax obligation associated with a share-based payment and pay that amount to the tax authority.
- IFRS 9, 'Financial Instruments' (effective 1 January 2018) replaces the guidance in IAS 39 with a standard that is more principles based. The new standard simplifies the model for classifying and recognising financial instruments and aligns hedge accounting more closely with common risk management practices. Changes in own credit risk in respect of liabilities designated at fair value through profit or loss shall now be presented within Other Comprehensive Income; this change can be adopted early without adopting IFRS 9. IFRS 9's new impairment model is a move away from IAS 39's incurred credit loss approach to an expected credit loss model. Earlier recognition of impairment losses is likely to result and for entities with significant lending activities, an overhaul of related systems and processes will be needed.

Governance and project management

The adoption of IFRS 9 is a significant initiative for the Group, involving substantial resources and effort from both the finance and credit teams. The Group's existing credit policies are being refined and revised where required to meet the requirements of IFRS 9. The Group has applied many components of its existing credit risk management framework to ensure that appropriate validations and controls will be in place over new key processes and significant areas of judgment.

Notes to the Financial Statements

for the Year Ended 31 December 2017

Adoption of IFRS 9 in 2018 will result in revisions to accounting policies and procedures, changes and amendments to internal control documents, applicable credit risk manuals, and implementation of new models to create expected loss rates and associated methodologies and new processes within risk management. Progress updates have been provided to executive management and the BSP Board throughout the span of this project and BSP is well positioned to adopt in 2018.

The following is a summary of key items that are important in understanding the impact of IFRS 9:

Classification and measurement

The Standard introduces new requirements to determine the measurement and classification of financial assets on the basis of cash flow characteristics and observable business model within which the financials assets are being managed. Accordingly, the basis of measurement for the Group's financial assets may change. The Standard allows recording of fair value changes through Other Comprehensive Income (OCI) where cash flows from the financial asset is solely payments of principal and interest and the business model is 'hold to collect and sell'.

The Group's insurance business measures its investments in fixed interest securities at 'Fair Value Through Profit and Loss' under IAS 39. However, these securities are held in the business model of hold to collect or sell and they meet the requirements of SPPI. Under IFRS 9, these assets could be classified as Fair Value through Other Comprehensive Income which will reduce volatility in the profit or loss account. Discussions are being held with the actuaries to ascertain the impact this will have, if any, on valuation of policy liabilities before a decision is made. For other financial instruments, the Group does not expect the implementation will result in a significant change in the classification and measurement of the Group's financial assets, between Amortized Cost, Fair Value through OCI and Fair Value through Profit and Loss.

Impairment

The adoption of IFRS 9 will have an impact on the Group's loan impairment methodology. The IFRS 9 expected credit loss (ECL) model is forward looking compared to the current incurred loss approach. Expected credit losses reflect the present value of all cash shortfalls related to default events either (i) over the following twelve months or (ii) over the expected life of a financial instrument depending on credit deterioration from inception. ECL should reflect an unbiased, probability-weighted outcome as opposed to the single best estimate allowed under the current approach. The probability-weighted outcome considers multiple scenarios based on reasonable and supportable forecasts.

IFRS 9 considers the calculation of ECL by multiplying the Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD).

S&P Global Market Intelligence (S&P), given their understanding of the Group's internal rating system and comprehensive data bank accumulated over a significant time period, were engaged to assist with calculating the PD rates that are compliant with IFRS requirements. S&P's default experience is blended with BSP's internal default experience to derive a recalibrated master scale to produce Through the Cycle (TTC) PDs. Macroeconomic forecasts are applied to convert the TTC PDs into Point in Time (PiT) PDs as required by IFRS 9 (refer "Macroeconomic Factors and Forward Looking Information" section below). This methodology of producing blended PDs is grounded in the theoretical principle as elucidated in paragraph 462 of the Revised Basel Accord, whereby attributing external credit assessment institution's observed default rates to internal grades is acceptable as long as the underlying methodology of the internal models mimic the methodology of the external credit assessment institution. Management is still determining the most appropriate LGD and EAD to use in the calculation.

The IFRS 9 Impairment model uses a three stage approach based on the extent of credit deterioration since origination:

Stage 1 – includes financial assets that have not had a significant increase in credit risk since initial recognition. For these assets, 12-month expected credit losses (ECL) are recognized. The ECL will be computed using a 12-month PD that represents the probability of default occurring over the next 12 months.

Notes to the Financial Statements

for the Year Ended 31 December 2017

Stage 2 – includes financial instruments that have had a significant increase in credit risk since initial recognition but that do not have objective evidence of impairment at balance date. This requires the computation of ECL based on lifetime PD that represents the probability of default occurring over the remaining estimated life of the financial asset. Provisions are higher in this stage because of an increase in risk and the impact of a longer time horizon being considered compared to 12 months in Stage 1.

Stage 3 – includes financial assets that have an objective evidence of impairment at reporting date. Similar to Stage 2, the allowance for credit losses will continue to capture the lifetime expected credit losses. Revenue recognition in stage 3 is based on the effective interest rate on the net balances as opposed to gross balances.

Some of the key concepts in IFRS 9 that have the most significant impact and require a high level of judgement are:

Assessment of Significant Increase in Credit Risk (SICR)

The assessment of SICR is done on a relative basis. To assess whether the credit risk on a financial asset has increased significantly since origination, the Group compares the risk of default occurring over the expected life of the financial asset at the reporting date to the corresponding risk of default at origination, using key risk indicators that are used in the Group's existing risk management processes. At each reporting date, the assessment of a change in credit risk will be individually assessed for those considered individually significant and at a portfolio level for retail exposures. This assessment is symmetrical in nature, allowing credit risk of financial assets to move back to Stage 1 if the increase in credit risk since origination has reduced and is no longer deemed to be significant. BSP will consider qualitative, quantitative factors and a backstop of 30 days in determination of SICR.

Macroeconomic Factors and Forward Looking Information

IFRS 9 requires an unbiased and probability-weighted estimate of credit losses by evaluating a range of possible outcomes that incorporates forecasts of future economic conditions. The systemic factors used by S&P include widely accepted economic indicators, market indicators as well as industry indicators. Some forecasts can be national, regional or global, reflecting the specificities of an institution's exposure. The aim of the overlay is to convert PD curves based on long term average default rates (blended TTC PDs as described above) into forward looking PD curves (PiT PD) taking into account current and future economic conditions, as required by IFRS 9. The conversion process looks at the historical relationship between long term PDs for a particular year and the observed default rate for the same year (known as the Z-factor) and a set of systematic factors for the year. This is then compared to the expected systematic factors and long-term PDs for a future year to estimate the PiT PDs for that future year.

Experienced credit judgment

The Group's ECL allowance methodology requires the Group to use its experienced credit judgement to incorporate the estimated impact of factors not captured in the modelled ECL results, in all reporting periods.

Expected Life

When measuring ECL, the Group must consider the maximum contractual period over which the Group is exposed to credit risk. All contractual terms should be considered when determining the expected life, including prepayment options and extension and rollover options. For certain revolving credit facilities that do not have a fixed maturity, the expected life is estimated based on the period over which the Group is exposed to credit risk and where the credit losses would not be mitigated by management actions.

Definition of Default and Write-off

Material exposures classified as stage 3 or approaching stage 3 are monitored on a monthly basis by the Restructure Committee which is governed by its own charter. Exposures are reviewed and decisions made on ongoing strategies to manage such accounts and appropriate provisioning requirements. The policy on the write-off of loans remains unchanged with the introduction of IFRS 9.

Notes to the Financial Statements

for the Year Ended 31 December 2017

Transition impact

Given that the Group's existing provisioning policies have adopted a prudent approach in respect to Stage 1 loans with the application of TTC probability of defaults whilst under IAS 39, it is expected that changes in provisions with the transition to IFRS 9 will not be material. The Group is in the process of assessing the actual impact upon transition. The Group continues to revise, refine and validate the impairment models and related processes leading up to the effective date of the standard of 1st January 2018 and applicable to the first financial reporting period for BSP ending 30th June 2018.

- IFRS 15 'Revenue from contracts with customers' (effective 1 January 2018) is a converged standard from the IASB and FASB on revenue recognition and replaces IAS 11 and IAS 18. The new standard is based on the principle that revenue is recognised when control of a good or service transfers to a customer – so the notion of control replaces the existing notion of risks and rewards.

The entity will have to adopt a new 5-step process for the recognition of revenue:

- identify contracts with customers
- identify the separate performance obligations
- determine the transaction price of the contract
- allocate the transaction price to each of the separate performance obligations, and
- recognise the revenue as each performance obligation is satisfied.

The entity is in the process of determining the impact of IFRS 15 but does not expect the new standard to have a significant impact on current revenue practice.

- IFRS 16, 'Leases' (effective 1 January 2019) replaces the guidance in IAS 17 and will have an impact on accounting by lessees. The previous distinction under IAS 17 between finance leases and operating leases for lessees has been removed. IFRS 16 now requires a lessee to recognise a lease liability representing future lease payments and a 'right-of-use asset' for virtually all lease contracts. There is an optional exemption for certain short-term leases and leases of low-value assets. Under IFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. The entity expects that certain leases of property and equipment that are currently accounted for as operating leases will, from January 2019, be required to be recognised as right-of-use assets and depreciated, with a corresponding lease liability. This will increase reported debt levels in the statement of financial position and will increase the reporting charges for depreciation and interest expense. The timing of expense recognition will also be brought forward although the impact on reported profit is not expected to be significant.
- Amendments to IFRS 4, 'Insurance contracts' (effective 1 January 2018) regarding implementation of IFRS 9. These amendments introduce two approaches: an overlay approach and a deferral approach. The amended standard will:
 - give all companies that issue insurance contracts the option to recognise in OCI, rather than profit or loss, the volatility that could arise when IFRS 9 is applied before the new insurance contracts standard is issued; and
 - give companies whose activities are predominantly connected with insurance an optional temporary exemption from applying IFRS 9 until 2021, in which case they will continue to apply IAS 39.
- Amendments to IAS 40, 'Investment property' (effective 1 January 2018) relating to transfers of investment property. These amendments clarify that to transfer to, or from, investment properties there must be a change in use. To conclude if a property has changed use there should be an assessment of whether the property meets the definition. This change must be supported by evidence.
- IFRIC 22, 'Foreign currency transactions and advance consideration' (effective 1 January 2018) addresses foreign currency transactions or parts of transactions where there is consideration that is denominated or priced in a foreign currency. The interpretation provides guidance for when a single payment/receipt is made as well as for situations where multiple payments/receipts are made.
- IFRS 17 'Insurance contracts' (effective 1 January 2021) replaces IFRS 4. IFRS 17 will fundamentally change the accounting by all entities that issue insurance contracts and investment contracts with discretionary participation features.

Notes to the Financial Statements

for the Year Ended 31 December 2017

- IFRIC 23, 'Uncertainty over income tax treatments' (effective 1 January 2019) clarifies how the recognition and measurement requirements of IAS 12 'Income Taxes' are applied where there is uncertainty over income tax positions. IFRIC 23 explains how to recognise and measure deferred and current income tax assets and liabilities where there is uncertainty over a tax treatment.

- Annual improvements 2015 – 2017 Cycle

Makes amendments to the following standards:

- IFRS 3 and IFRS 11 – The amendments to IFRS 3 clarify that when an entity obtains control of a business that is a joint operation, it remeasures previously held interests in that business. The amendments to IFRS 11 clarify that when an entity obtains joint control of a business that is a joint operation, the entity does not remeasure previously held interests in that business.
- IAS 12 – The amendments clarify that all income tax consequences of dividends (ie distribution of profits) should be recognized in profit or loss, regardless of how the tax arises.
- IAS 23 – The amendments clarify that if any specific borrowings remains outstanding after the related assets is ready for its intended use or sale, that borrowing becomes part of the funds that an entity borrows generally when calculating the capitalisation rate on general borrowings.

B. Consolidation

The Financial Statements incorporate the assets and liabilities of all controlled entities of the Group as at 31 December 2017, and their results for the year then ended.

Controlled entities are those over which the Group has the power to govern financial and operating policies, generally accompanied by a shareholding that commands the majority of voting rights, and are commonly referred to as subsidiaries.

Subsidiaries are accounted for at acquisition under the acquisition cost method of accounting, where:

- acquisition cost is measured at fair value of assets transferred, equity issued, liabilities assumed and any directly attributable costs of the transaction;
- identifiable net assets are recorded initially at acquisition, at their fair values;
- any excess of the acquisition cost over the relevant share of identifiable net assets acquired is treated as goodwill, and any deficiency is recognised directly in the Statement of Comprehensive Income;

All intercompany transactions and balances are eliminated.

C. Investment in Associates and Joint Arrangements

Investments in Associates

Associates are entities over which the Group has significant, but not controlling influence, generally accompanied by a shareholding conferring between 20% - 50% of voting rights.

In the Financial Statements, these investments are accounted for under the equity method.

Interests In Joint Arrangements

The Group applies IFRS 11 to all joint ventures. Under IFRS 11 investments in joint arrangements are classified as either joint ventures or joint operations depending on the contractual rights and obligations of each investor.

Joint ventures are accounted for using the equity method in the Financial Statements. Under the equity method of accounting, interests in joint ventures are initially recognised at cost and adjusted thereafter to recognise the Group's share of the post-acquisition profits or losses and movements in other comprehensive income. When the Group's share of losses in a joint venture equals or exceeds its interests in the entity (which includes any long-term interests that, in substance, form part of the group's net investment in the joint ventures), the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the joint ventures

Interests in joint ventures classified as held for sale are accounted for under IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

Notes to the Financial Statements

for the Year Ended 31 December 2017

D. Revenue

Interest income and expense

Interest income and expense are recognised in the Statement of Comprehensive Income on an accrual basis using the effective interest method. The income arising from the various forms of instalment credit has been determined using the effective interest method.

Interest income includes coupons earned on inscribed stock, accrued discount and premium on Treasury and Central Bank bills.

Short term insurance contracts

These contracts are the Term Life, Medical and Travel policies sold and underwritten by BSP Health Care (Fiji) Limited.

These contracts protect the Group's customers from the consequences of events such as death, medical emergency or loss on travel. Guaranteed benefits paid on occurrence of the specified insurance event are either fixed or linked to the extent of the economic loss suffered by the policyholder. There are no maturity or surrender benefits.

For all these contracts, premiums are recognised as revenue (earned premiums) proportionally over the period of coverage. The portion of premium received on in-force contracts that relates to unexpired risks at the Statement of Financial Position date is reported as the unearned premium liability. Premiums are shown before deduction of commission.

Claims and loss adjustment expenses are charged to income as incurred based on the estimated liability for compensation owed to contract holders or beneficiaries. They include direct and indirect claims settlement costs and arise from events that have occurred up to the Statement of Financial Position date even if they have not yet been reported to the Group. The Group does not discount its liabilities for unpaid claims. Liabilities for unpaid claims are estimated using the input of assessments for individual cases reported to the Group and statistical analyses for the claims incurred but not reported, and to estimate the expected ultimate cost of more complex claims that may be affected by external factors (such as court decisions).

Foreign exchange income/(losses)

Realised and unrealised gains or losses from foreign currency trading, or from changes in the fair value of the trading assets and liabilities are recognised as income in the Statement of Comprehensive Income in the period in which they arise.

Long term insurance contracts

These contracts insure human life events (for example death, survival, disability or critical illness) over a long duration. Guaranteed benefits paid on occurrence of the specified insurance event are fixed or linked to the level of bonus declared on the policy. Most of the policies have maturity and surrender benefits.

For all these contracts, premiums are recognised as revenue when they become payable by the contract holder. Premiums are shown before deduction of commission.

Approximately 90% of the above contracts in the Group's portfolio contain a Discretionary Participation Feature (DPF). This feature entitles the holder to receive, as a supplement to generated benefits, additional benefits in the form of reversionary bonuses.

The liability for long term insurance contracts (principally Life Insurance) has been determined in accordance with LPS 1.04 Valuation of Policy Liabilities, issued by the Australian Prudential Regulation Authority.

The policy liability is calculated in a way that allows for the systematic release of planned profit margins as services are provided to policy owners and the revenues relating to those services are received (Margin on Services methodology). Services used to determine profit recognition include the cost of expected insurance claims and the allocation of future bonuses. The liability is generally determined as the present value of all future expected payments, expenses, taxes and profit margins reduced by the present value of all future expected premiums and take into consideration projected future bonuses. The liabilities are recalculated at each balance date using best estimate assumptions. These assumptions are revisited regularly and adjusted for actual experiences on claims, expense, mortality and investment returns. The policy liability also includes policy owner retained earnings.

Insurance policy liabilities are further detailed in Note 39.

Notes to the Financial Statements

for the Year Ended 31 December 2017

E. Fee and commission income

Fees and commissions are generally recognised on an accrual basis when the service has been provided. All other risk related fees that constitute cost recovery are taken to income when levied. Loan origination fees are deferred over the expected term of the financial instrument according to the effective interest method. The effective interest method uses the rate that exactly discounts estimated future payments and receipts through the expected life of the instrument or when appropriate, a shorter period to the net carrying amount of the financial asset.

F. Borrowing expenses

Expenses associated with the borrowing of funds are charged to the Statement of Comprehensive Income in the period in which they are incurred.

G. Provision for loan impairment

Loans are originated by providing funds directly to the borrower and are recognised when cash is advanced to borrowers.

All loans, advances and other receivables from customers are subject to continuous management review. A specific provision for loan impairment is established if there is objective evidence that the Group will not be able to collect all amounts due under the terms of loans. The amount of the provision approximates the difference between the carrying amount and the recoverable amount, which is the current best estimate of the present value of expected future cash flows arising from the asset. All bad debts are written off against the specific provision for loan impairment in the period in which they are classified as irrecoverable. Subsequent recoveries are credited to the provision for loan losses in the Statement of Comprehensive Income.

General provisions for impairment are maintained to cover incurred losses unidentified at balance date in the overall portfolio of loans, advances and other receivables from customers. The provisions are determined having regard to the level of risk weighted assets, economic conditions, the general risk profile of the credit portfolio, past loss experience and a range of other criteria. The amount necessary to bring the provisions to their assessed levels, after write-offs, is charged to the Statement of Comprehensive Income.

H. Goodwill

Goodwill represents the excess of the cost of any acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the exchange transaction. Goodwill is reported in the Statement of Financial Position as an intangible asset.

In determining goodwill, management considers various factors including net selling price of the acquired business, existing market share, potential growth opportunities, and other factors inherent in the acquired business. This assessment is reviewed at each balance date, so that any indication of impairment with implications for the recoverability of goodwill can be tested, and adjustments to the carrying value of goodwill made if necessary.

I. Computer systems development costs

Costs incurred to develop and enhance the Group's computer systems are capitalised to the extent that benefits do not relate solely to revenue that has already been brought to account and will contribute to the future earning capacity of the economic entity. These costs are amortised over the estimated economic life of four years using the straight-line method. Costs associated with maintaining computer software programs are recognised as an expense when incurred.

Notes to the Financial Statements

for the Year Ended 31 December 2017

J. Property, plant and equipment

Land and buildings are carried at revalued amounts, being their fair value at the date of revaluation less subsequent accumulated depreciation and impairment losses. Fair value is determined on the basis of regular independent valuations prepared by external valuation experts, based on discounted cash flows or capitalisation of net income (as appropriate). The fair values are recognised in the financial statements and are reviewed at the end of each reporting period to ensure that the carrying value of land and buildings are not materially different from their fair values.

Any revaluation increase arising on the revaluation of land and buildings is credited to the asset revaluation reserve, except to the extent that it reverses a revaluation decrease for the same asset previously recognised as an expense in profit or loss, in which case the increase is credited to the Statement of Comprehensive Income to the extent of the decrease previously charged. A decrease in carrying amount arising on the revaluation of land and buildings is charged as an expense in the Statement of Comprehensive Income to the extent that it exceeds the balance, if any, held in the asset revaluation reserve relating to a previous revaluation of that asset. Buildings under constructions are referred to as work in progress and are accounted for at cost and subsequently reclassified to buildings (premises) upon completion.

Depreciation is provided on property, plant and equipment, including buildings but excluding land. Depreciation is calculated on a straight line basis so as to write off the net cost or other revalued amount of each asset over its expected useful life to its estimated residual value. Leasehold improvements are depreciated over the period of the lease or estimated useful life, whichever is the shorter, using the straight line method. The estimated useful life, residual value and depreciation method is reviewed at the end of each annual reporting period.

The following basis and method of depreciation is used:

Class of asset	Method	Rate
Property (excluding land)	Straight line basis	2 - 3% p.a
Plant and equipment	Straight line basis	10 - 25% pa
Equipment under operating lease	Straight line basis	6- 20% pa

Gains or losses on disposals (being the difference between the carrying value at the time of sale or disposal and the proceeds received) are taken into account in determining operating profit for the year. Where the carrying value of an asset is greater than its estimated recoverable amount, it is written down immediately to its recoverable amount. Repairs and maintenance are taken into account in determining operating profit when the expenditure is incurred.

K. Leases

Bank is lessee

All leases entered into by the Group are operating leases. Total payments made are charged to the Statement of Comprehensive Income using the straight line method.

Bank is lessor

Finance leases are included in Loans, Advances and Other Receivables from Customers and are accounted for under the finance method whereby income is recognised using the effective interest method. Assets subject to operating leases are separately disclosed in the Statements of Financial Position, according to the nature of the asset. These assets are stated at cost or revalued amount less accumulated depreciation. The assets are depreciated on a straight line basis over the life of the operating lease. Lease income is recognised on a straight line basis over the term of the lease.

L. Cash and cash equivalents

For the purpose of the cash flow statement, Cash and cash equivalents comprise notes and coins, and balances due to and from other banks with original maturities of less than three months.

Notes to the Financial Statements

for the Year Ended 31 December 2017

M. Financial assets

The Group classifies its financial assets in the following categories: at fair value through profit or loss, loans and receivables, and available for sale. The classification depends on the purpose for which the financial assets were acquired. Management determines the classification of its financial assets at initial recognition.

a) Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss are financial assets held for trading. A financial asset is classified in this category if acquired principally for the purpose of selling in the short term. Derivatives are also categorised as held for trading unless they are designated as hedges. Assets in this category are classified as current assets if expected to be settled within 12 months, otherwise they are classified as non-current. The Group's financial assets at fair value through profit or loss comprise certain equity securities included under other financial assets in the Statement of Financial Position.

b) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are included in current assets, except for maturities greater than 12 months after the end of the reporting period. These are classified as non-current assets. The Group's loans and receivables comprise 'trade and other receivables' and 'cash and cash equivalents' in the Statement of Financial Position.

c) Held to maturity investments

Held to maturity investments includes non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group has both the intention and ability to hold to maturity. Management determines the classification of investment securities held to maturity at their initial recognition and reassesses the appropriateness of that classification at the end of each reporting period. Investment securities held to maturity are carried at amortised cost. The Group's held to maturity investments comprise securities issued by Governments and Central Banks of respective countries (Treasury and Central Bank Bills) and certain debt securities included under other financial assets in the Statement of Financial Position.

Recognition and measurement

Regular purchases and sales of financial assets are recognised on the trade-date – the date on which the Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss. Financial assets carried at fair value through profit or loss are initially recognised at fair value, and transaction costs are expensed in the Statement of Comprehensive Income. Financial assets are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership. Available-for-sale financial assets and financial assets at fair value through profit or loss are subsequently carried at fair value. Loans and receivables are subsequently carried at amortised cost using the effective interest method.

Gains or losses arising from changes in the fair value of the 'financial assets at fair value through profit or loss' category are presented in the income statement within 'Other banking income' in the period in which they arise. Dividend income from financial assets at fair value through profit or loss is recognised in the income statement as part of other income when the Group's right to receive payments is established.

Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet 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. The legally enforceable right must not be contingent on future events and must be enforceable in the normal course of business and in the event of default, insolvency or bankruptcy of the company or the counterparty.

Notes to the Financial Statements

for the Year Ended 31 December 2017

N. Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that the Group will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at reporting date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows.

When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognised as an asset if it is virtually certain that reimbursement will be received and the amount of the receivable can be measured reliably.

O. Employee benefits

A liability is recognised for benefits accruing to employees in respect of wages and salaries, annual leave, and long service leave when it is probable that settlement will be recognised and they are capable of being measured reliably.

Liabilities recognised in respect of employee benefits expected to be settled within 12 months, are measured at their nominal values using the remuneration rate expected to apply at the time of settlement.

Liabilities recognised in respect of employee benefits which are not expected to be settled within 12 months are measured as the present value of the estimated future cash outflows to be made by the consolidated entity in respect of services provided by employees up to reporting date.

Post-employment benefits - defined contribution plans

A defined contribution plan is a pension plan under which the Group pays fixed contributions into a separate fund, and there is no recourse to the Group for employees if the fund has insufficient assets to pay employee benefits relating to service up to the balance sheet date.

The Group pays contributions to publicly or privately administered superannuation plans on a mandatory, contractual or voluntary basis in respect of services rendered up to balance sheet date by all staff members other than non-citizen contract staff for whom there is no legal obligation to do so. The contributions are at the current rate of employees' gross salary. Once the contributions have been paid, the Group has no further payment obligations for post-employment benefits from the date an employee ceases employment with the Group.

P. Income tax

Current Tax

Current tax is calculated by reference to the amount of income taxes payable or recoverable in respect of the taxable profit or tax loss for the period. It is calculated using tax rates and tax laws that have been enacted or substantively enacted by the reporting date. Current tax for current and prior periods is recognised as a liability (or asset) to the extent that it is unpaid (or refundable).

Deferred tax

Deferred tax is accounted for using the balance sheet liability method. Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the Statement of Financial Position. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

In principle, deferred tax liabilities are recognised for all taxable temporary differences. Deferred tax assets are recognised to the extent that it is probable that sufficient taxable amounts will be available against which deductible temporary differences or unused tax losses and tax offsets can be utilised. However, deferred tax assets and liabilities are not recognised if the temporary differences giving rise to them arise from the initial recognition of assets and liabilities which affects neither taxable income nor accounting profit.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period(s) when the asset and liability giving rise to them are realised or settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the reporting date. The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Group expects, at the reporting date, to recover or settle the carrying amount of its assets and liabilities.

Notes to the Financial Statements

for the Year Ended 31 December 2017

Deferred tax assets and liabilities are offset when they relate to income taxes levied by the same taxation authority and the Group intends to settle its current tax assets and liabilities on a net basis.

Current and deferred tax for the period

Current and deferred tax is recognised as an expense or income in the Statement of Comprehensive Income, except when it relates to items credited or debited directly to equity, in which case the deferred tax is also recognised directly in equity.

Q. Foreign currency

The Financial Statements of the Group are presented in the currency of the primary economic environment in which the entity operates (its functional currency). For the purpose of these Financial Statements, the results and financial position of the Bank are expressed in Papua New Guinea kina, which is the Bank's functional and presentation currency.

In preparing the Financial Statements, transactions in currencies other than the entity's functional currency (foreign currencies) are recorded at the rates of exchange prevailing on the dates of the transactions. At each balance sheet date, monetary items denominated in foreign currencies are retranslated at the rates prevailing at the balance sheet date. Non-monetary items carried at fair value that are denominated in foreign currencies are retranslated at the rates prevailing on the date when the fair value was determined. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Foreign operations

On consolidation, the assets and liabilities of the consolidated entity's overseas operations are translated at exchange rates prevailing at the reporting date. Income and expense items are translated at the average exchange rates for the period unless exchange rates fluctuate significantly. Exchange differences arising, if any, are recognised in the foreign currency translation reserve, and recognised in profit or loss on disposal of the foreign operation.

R. Share capital

Share issue costs

External costs directly attributable to the issue of new shares are deducted from equity net of any related income taxes.

Dividends on ordinary shares

Dividends on ordinary shares are recognised in equity in the period in which they are declared.

Dividends for the year, declared after the balance sheet date, are dealt with in the subsequent events note.

S. Asset impairment

At each reporting date, the Group reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where the asset does not generate cash flows that are independent from other assets, the Group estimates the recoverable amount of the cash-generating unit to which the asset belongs.

Goodwill, intangible assets with indefinite useful lives and intangible assets not yet available for use are tested for impairment annually and whenever there is an indication that the asset may be impaired. An impairment of goodwill is not subsequently reversed.

Recoverable amount is the higher of fair value less cost of disposal and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

Notes to the Financial Statements

for the Year Ended 31 December 2017

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised in profit or loss immediately, unless the relevant asset is carried at fair value, in which case the impairment loss is treated as a revaluation decrease.

Where an impairment loss subsequently reverses, the carrying amount of the asset (cash-generating unit) is increased to the revised estimate of its recoverable amount, but only to the extent that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset (cash-generating unit) in prior years. A reversal of an impairment loss is recognised in profit or loss immediately, unless the relevant asset is carried at fair value, in which case the reversal of the impairment loss is treated as a revaluation increase.

T. Non-current assets held for sale

Non-current assets (and disposal groups) classified as held for sale are measured, with certain exceptions, at the lower of carrying amount and fair value less costs to sell.

Non-current assets and disposal groups are classified as held for sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use. This condition is regarded as met only when the asset (or disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for such a sale and the sale is highly probable. The sale of the asset (or disposal group) must be expected to be completed within one year from the date of classification, except in the circumstances where sale is delayed by events or circumstances outside the Group's control and the Group remains committed to a sale.

U. Investment Property

Property held for long-term rental yields is classified as investment property. Investment property comprises freehold land and buildings. It is carried at fair value. The fair value have been arrived at on the basis of the valuation carried out by Rolle and Associates and Pacific Valuations Limited, independent valuers not related to the group. The valuers have appropriate qualifications and recent experience in the valuation of properties in Fiji. The valuations were arrived at by reference to current net rental income and capital expenditure and external factors in the Fiji commercial and residential environment such as current supply and demand and expected growth.

Changes in fair values are recorded in profit or loss.

Property located on land that is held under an operating lease is classified as investment property as long as it is held for long-term rental yields and is not occupied by more than 50% by the companies in the Group. The initial cost of the property is the lower of the fair value of the property and the present value of the minimum lease payments. The property is carried at fair value after initial recognition.

V. Derivative financial instruments and acceptances

Forward foreign exchange contracts entered into for trading purposes are initially recognised at fair value and subsequently re-measured at fair value based upon the forward rate. Gains and losses on such contracts are taken to the Statement of Comprehensive Income.

Acceptances comprise undertakings by the Group to pay bills of exchange drawn on customers. The Group expects most acceptances to be settled simultaneously with the reimbursement from the customers. Customer acceptances are accounted for as off-balance sheet transactions and are disclosed as contingent liabilities and commitments.

The Group does not actively enter into or trade in complex forms of derivative financial instruments such as currency and interest rate swaps and options.

Notes to the Financial Statements

for the Year Ended 31 December 2017

W. Segment reporting

Segments are reported in a manner consistent with the internal reporting provided to the Group's chief operating decision maker.

X. Earnings per share

Earnings per share is determined by dividing the profit or loss attributable to owners of the Bank by the weighted average number of participating shares outstanding during the reporting year.

Y. Comparatives

Comparative figures have been adjusted to conform to changes in presentation in the current year.

Z. Critical accounting estimates and judgments

The application of the Group's accounting policies requires the use of estimates and assumptions. If different assumptions or estimates were applied, the resulting values would change, impacting the net assets and income of the Group.

The areas involving significant estimates of judgments are:

- Estimated impairment of financial and non-financial assets – note 1(g) and 1(s)
- Estimated goodwill impairment – note 1(h) and 7(a)
- Estimated insurance liability – note 1(d), note 21 note 39
- Estimation of fair value of financial assets and liabilities – note 1(m) and note 38
- Estimation of fair value of non-financial assets - note 38

Estimates and judgments are continually evaluated. They are based on historical experience and other factors, including expectations of future events that may have a financial impact on the entity and that are believed to be reasonable under the circumstances.

Notes to the Financial Statements

for the Year Ended 31 December 2017

2. Net interest income	Consolidated		Bank	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
Interest income				
Loans, advances and other receivables from customers	1,027,861	922,046	944,201	867,010
Other financial assets - inscribed stock	204,685	191,333	204,378	191,333
Treasury bills	195,093	146,692	194,093	146,684
Cash and balances with Central Bank	2,802	4,498	3,417	5,935
Central Bank bills	83	187	83	187
Other	2,116	3,155	2,962	3,522
	1,432,640	1,267,911	1,349,134	1,214,671
Less:				
Interest expense				
Customer deposits	134,381	140,229	120,177	133,757
Other banks	12,276	11,665	12,622	11,695
Subordinated debt securities	8,307	8,331	8,307	8,331
	154,964	160,225	141,106	153,783
	1,277,676	1,107,686	1,208,028	1,060,888
3. Fee and commission income				
Fee and commission income				
Product related	206,882	205,788	195,720	198,864
Trade and international related	18,542	19,447	17,800	18,867
Electronic banking related	114,181	105,758	106,657	100,219
Other	35,142	32,288	26,771	23,720
	374,747	363,281	346,948	341,670
Less:				
Fee and commission expenses				
Agencies	627	384	582	346
International Finance Corporation fees	447	560	447	560
	1,074	944	1,029	906
	373,673	362,337	345,919	340,764

Notes to the Financial Statements

for the Year Ended 31 December 2017

4. Other income	Consolidated		Bank	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
Foreign exchange related	275,576	253,758	249,538	231,436
Operating lease rentals	9,430	10,104	9,430	10,104
Other	22,165	34,216	51,091	35,505
	307,171	298,078	310,059	277,045

Foreign exchange related income includes gains and losses from spot and forward contracts and translated foreign currency assets.

5. Operating expenses				
Administration	136,209	138,176	121,797	127,119
Computing	121,922	75,205	104,682	63,277
Depreciation	72,331	62,125	61,701	58,299
Amortisation of computer development	27,427	32,508	26,359	30,522
Non-executive Directors costs	2,379	2,390	1,961	1,935
Non-lending losses	20,156	25,661	26,780	24,845
Fixed asset impairment expenses	6,682	12,003	6,682	12,003
Premises and equipment	92,978	84,238	85,089	77,987
	480,084	432,306	435,051	395,987
Staff costs				
Defined contribution plans	13,943	13,229	12,890	12,375
Statutory benefit contributions	9,389	10,318	8,485	9,826
Wages and salaries	288,116	255,902	264,233	236,020
Other staff benefits	60,616	57,886	57,232	54,931
	372,064	337,335	342,840	313,152
	852,148	769,641	777,891	709,139

6. Income tax				
Income tax expense				
Current tax	326,675	290,500	313,512	281,352
Deferred tax	(11,845)	(22,700)	(17,396)	(23,335)
Current year	314,830	267,800	296,116	258,017
Adjustment to prior year estimates	(3,309)	12,543	(2,814)	14,407
	311,521	280,343	293,302	272,424
Tax calculated at 30% of profit before tax (2016:30%)	294,622	263,729	304,277	263,729
Tax calculated at respective subsidiary tax rates	16,770	11,231	-	-
Expenses not deductible for tax	4,069	6,175	1,494	2,563
Tax loss not recognised	4,681	2,668	-	-
Income not recognized for tax purposes	(5,312)	(16,003)	(9,655)	(8,275)
Adjustment to prior year estimates	(3,309)	12,543	(2,814)	14,407
	311,521	280,343	293,302	272,424

Income not recognized for tax purpose for the Bank includes dividends received from Subsidiaries which are eliminated upon consolidation whilst the Group number represents actuarial liabilities deductions allowable for BSP Life Fiji Limited.

Notes to the Financial Statements

for the Year Ended 31 December 2017

6. Income tax expense (continued)

Represented by:	Consolidated		Bank	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
Provision for income tax				
At 1 January	576	(39,005)	3,670	(36,168)
Income tax provision	(326,675)	(290,500)	(313,512)	(281,352)
Adjustment to prior year estimates	694	(8,566)	1,966	(9,141)
Tax payments made	293,697	338,647	282,645	330,331
At 31 December	(31,708)	576	(25,231)	3,670
Deferred taxes				
Specific allowance for losses on loans, advances and other receivables from customers	33,694	34,251	30,109	32,666
General allowance for losses on loans, advances and other receivables from customers	132,752	117,976	131,576	113,807
Employee related provisions	23,390	20,459	22,809	19,213
Prepaid expenses	(1,228)	(1,126)	(1,228)	(1,204)
Other provisions	32,294	16,162	31,604	29,041
Property, plant and equipment	(60,565)	(39,842)	(34,969)	(30,500)
Unrealised foreign exchange gains	(897)	(4,250)	(897)	(4,320)
Accruals	22,494	26,459	21,017	23,922
At 31 December	181,934	170,089	200,021	182,625
Represented by:				
Deferred tax asset	244,625	229,867	237,115	218,649
Deferred tax liability	(62,691)	(59,778)	(37,094)	(36,024)
At 31 December	181,934	170,089	200,021	182,625
Deferred taxes movement:				
At 1 January	170,089	147,389	182,625	159,290
Current year movement	27,798	12,448	32,161	13,083
Revaluation recognised in equity	(10,165)	11,816	(8,977)	11,816
Adjustment to prior year estimates	(5,788)	(1,564)	(5,788)	(1,564)
At 31 December	181,934	170,089	200,021	182,625

Notes to the Financial Statements

for the Year Ended 31 December 2017

7. Intangible assets

7(a) Goodwill

<i>All amounts are expressed in K'000</i>	Consolidated		Bank	
	2017	2016	2017	2016
At 1 January	45,307	42,374	41,051	35,672
Net movement	-	2,933	-	5,379
Gross carrying amount	45,307	45,307	41,051	41,051

Goodwill was tested for impairment as at 31 December 2017 and no impairment has been recognised in the Statement of Comprehensive Income.

7(b) Computer development costs

At 1 January	46,319	67,852	43,676	63,929
Additions	50,096	22,580	48,109	21,871
Disposals	(5,727)	(11,605)	(5,727)	(11,602)
Amortisation expense	(28,177)	(32,508)	(26,359)	(30,522)
At 31 December	62,511	46,319	59,699	43,676
Total intangible assets	107,818	91,626	100,750	84,727

8. Investment in subsidiaries

All amounts are expressed in K'000

Name of Subsidiary	Principal activity	Place of incorporation and operation		Balance of Investment	
		Ownership %		2017	2016
BSP Capital Limited	Share brokerage/Fund Management/Capital Raising	PNG	100%	2,251	5,500
BSP Life Limited	Life Insurance	Fiji	100%	93,599	87,599
BSP Convertible Notes Limited	Capital Raising	Fiji	100%	371	371
BSP Finance Limited	Credit Institution	PNG	100%	61,837	44,449
Bank of South Pacific Tonga Ltd	Bank	Tonga	100%	71,610	71,610
Bank South Pacific (Samoa) Ltd	Bank	Samoa	98.7%	70,712	70,712
Bank South Pacific Vanuatu Ltd	Bank	Vanuatu	100%	38,020	38,020
At 31 December				338,400	318,261

Represented by:

<i>All amounts are expressed in K'000</i>	2017	2016
At 1 January	318,261	259,869
Additional capital	26,888	58,392
Provision for impairment of BSP Capital Limited	(6,749)	-
At 31 December	338,400	318,261

Notes to the Financial Statements

for the Year Ended 31 December 2017

Provision for impairment of the Investment in BSP Capital Limited

During year the directors determined that the investment in BSP Capital Limited had been materially impaired as the carrying amount of the investment was greater than its recoverable value. As of the reporting date, the investment amount is written down to its net book value.

9. Investment in Associates and Joint Ventures

Entity	Joint Venture/ Associate	Principal activity	Place of incorporation and operation	Proportion of ownership and voting power held	
				2017	2016
Suva Central Ltd	Joint Venture	Property rental	Fiji	50%*	50%*
Richmond Ltd	Joint Venture	Hotel operation Freight	Fiji	61.3%** ,50%***	61.3%** ,50%***
Williams and Gosling Ltd	Associate	forwarding	Fiji	0%*	27.7%*
BSP Finance Cambodia Plc	Joint Venture	Finance	Cambodia	50%*	50%*

The investments above are accounted for using the equity method in the Financial Statements.

*Both ownership and voting power held, **ownership, ***voting power held.

Shares held in Williams and Gosling Limited (Associate) was divested in 2017. As at 31 December 2016, the net investment in the Associate was K12.859 million. The total net assets of the business was K36.963 million and the Group's share of profit in the Associate was K3.597 million.

	Consolidated		Bank	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
Joint ventures				
Investment in joint ventures	112,762	93,620	16,513	14,570
Investments during the year	11,370	-	-	-
Translation movement	6,715	4,804	969	752
Share of profit for the year	23,288	14,338	1,675	1,191
Net investment at 31 December	154,135	112,762	19,157	16,513
Summarised financial information of joint ventures:				
Total assets	275,782	180,793	81,740	62,959
Total liabilities	(117,841)	(57,663)	(43,426)	(29,933)
Net assets	157,941	123,130	38,314	33,026
Share of profits	12,470	6,574	1,675	1,191
Group fair value alignment	10,818	7,764	-	-
Share of profit in Group	23,288	14,338	1,675	1,191
Associates and Joint Ventures				
Share of associate's net assets - equity	-	12,859	-	-
Shares held in jointly owned entity - at cost less impairment	154,135	112,761	19,157	16,513
Total investments in associates and joint ventures	154,135	125,620	19,157	16,513

Notes to the Financial Statements

for the Year Ended 31 December 2017

	Consolidated		Bank	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
10. Cash and balances with Central Bank				
Notes, coins and cash at bank	475,020	483,966	461,827	445,503
Balances with Central Bank other than statutory deposit	730,176	1,172,294	523,976	964,505
Total cash and balances with Central Bank	1,205,196	1,656,260	985,803	1,410,008

11. Treasury and Central Bank bills

Treasury and Central Bank bills – face value	3,370,252	3,000,888	3,358,788	2,985,751
Discount for interest receivable	(71,626)	(67,267)	(71,626)	(67,267)
At 31 December	3,298,626	2,933,621	3,287,162	2,918,484

Treasury and Central Bank bills are debt securities issued by Central Banks. These bills are classified as assets held for trading and carried at fair value by the Insurance business and as assets held to maturity and carried at amortised cost by the Banking businesses.

12. Amounts due from other banks

Items in the course of collection	29,156	29,779	29,154	29,779
Placements with other banks	920,058	774,454	858,183	661,373
At 31 December	949,214	804,233	887,337	691,152

The Group undertakes thorough compliance and due diligence reviews before entering into any correspondent banking relationships. There is also a cash and cash equivalent of K26.742 million held with counter-party Banks that are not available for use by the Group.

13. Loans, advances and other receivables from customers

Overdrafts	830,851	731,500	776,190	692,256
Lease financing	172,334	198,457	135,700	175,445
Term loans	8,675,849	7,976,794	8,016,448	7,458,125
Mortgages	2,054,173	1,672,965	1,705,081	1,417,495
Policy loans	53,472	46,854	-	-
Gross loans, advance and other receivables due from customers net of reserved interest	11,786,679	10,626,570	10,633,419	9,743,321
Less allowance for losses on loans, advances and other receivables from customers	(577,186)	(523,661)	(538,949)	(488,241)
At 31 December	11,209,493	10,102,909	10,094,470	9,255,080

The spread of the loans are detailed in the maturity analysis table on Note 34. The loans are well-diversified across various sectors and are further analysed on Note 33.

Lease financing

The Group and the bank provide lease financing to a broad range of clients to support financing needs in acquiring movable assets such as motor vehicles and plant and equipment. Finance lease receivables are included within loans, advances and other receivables from customers and are analysed as follows:

Notes to the Financial Statements

for the Year Ended 31 December 2017

13. Loans, advances and other receivables from customers (continued)

<i>All amounts are expressed in K'000</i>	Consolidated		Bank	
	2017	2016	2017	2016
Gross investment in finance lease receivable				
Not later than 1 year	50,224	38,130	30,372	35,604
Later than 1 year and not later than 5 years	142,734	181,996	118,539	156,783
	192,958	220,126	148,911	192,387
Unearned future finance income				
Not later than 1 year	(6,212)	(1,646)	(2,595)	(1,441)
Later than 1 year and not later than 5 years	(14,412)	(20,023)	(10,616)	(15,501)
	(20,624)	(21,669)	(13,211)	(16,942)
Present value of minimum lease payments receivable	172,334	198,457	135,700	175,445
Present value of minimum lease payments receivable is analysed as follows:				
Not later than 1 year	44,012	36,484	27,777	34,163
Later than 1 year and not later than 5 years	128,322	161,973	107,923	141,282
At 31 December	172,334	198,457	135,700	175,445
Provision for impairment				
Movement in allowance for losses on loans, advances and other receivables from customers:				
Balance at 1 January	523,661	446,872	488,241	428,528
Net new and increased provisioning	63,181	75,406	52,853	70,096
Loans written off against provisions / (Write back of provisions no longer required)	(9,656)	1,383	(2,145)	(10,383)
At 31 December	577,186	523,661	538,949	488,241
Provision for impairment is represented by				
Collective provision	461,389	398,988	438,585	379,355
Individually assessed or specific provision	115,797	124,673	100,364	108,886
At 31 December	577,186	523,661	538,949	488,241
Loan impairment expense				
Net collective provision funding	40,926	60,786	38,386	58,491
Net new and increased individually assessed provisioning	22,255	14,620	14,467	11,605
Total new and increased provisioning	63,181	75,406	52,853	70,096
Recoveries during the year	(64,563)	(49,721)	(63,067)	(49,104)
Net write back/(write off)	79,060	72,937	75,325	69,468
At 31 December	77,678	98,622	65,111	90,460

Notes to the Financial Statements

for the Year Ended 31 December 2017

14. Property, plant and equipment

<i>All amounts are expressed in K'000</i>	Consolidated		Bank	
	2017	2016	2017	2016
Carrying value				
Capital Work in Progress	70,711	157,713	51,065	144,975
Premises	650,409	522,393	532,564	475,696
Accumulated depreciation	(90,390)	(119,927)	(81,283)	(112,856)
	560,019	402,466	451,281	362,840
Equipment	355,667	335,088	265,504	227,004
Accumulated depreciation	(247,727)	(211,769)	(193,545)	(165,651)
	107,940	123,319	71,959	61,353
At 31 December	738,670	683,498	574,305	569,168

Reconciliation is as follows:

Capital Work in Progress

At 1 January	157,713	158,621	144,975	151,589
Additions	85,536	51,932	64,049	45,847
Transfers	(172,538)	(52,840)	(157,959)	(52,461)
At 31 December	70,711	157,713	51,065	144,975

Premises

At 1 January	402,466	469,585	362,840	422,672
Additions	192,702	20,723	139,884	15,800
Disposals	(1,683)	(78,279)	(1,527)	(57,144)
Revaluation gains/(losses)	(5,418)	14,915	(23,338)	4,249
Depreciation expense	(28,048)	(24,478)	(26,578)	(22,737)
At 31 December	560,019	402,466	451,281	362,840

Equipment

At 1 January	123,319	93,254	61,353	58,247
Additions	24,099	66,312	40,401	32,014
Disposals	(1,485)	(1,752)	(962)	(1,535)
Depreciation expense	(37,993)	(34,495)	(28,833)	(27,373)
At 31 December	107,940	123,319	71,959	61,353

Notes to the Financial Statements

for the Year Ended 31 December 2017

14. Property, plant and equipment (continued)

<i>All amounts are expressed in K'000</i>	Consolidated		Bank	
	2017	2016	2017	2016
Assets subject to operating lease				
Carrying value				
Aircraft	74,267	130,122	74,267	130,122
Accumulated depreciation	(3,578)	(85,454)	(3,578)	(85,454)
At 31 December	70,689	44,668	70,689	44,668

Reconciliation of carrying value of aircraft is set out below:

Aircraft

At 1 January	44,668	52,857	44,668	52,857
Depreciation	(6,290)	(8,189)	(6,290)	(8,189)
Revaluation net increase	32,311	-	32,311	-
At 31 December	70,689	44,668	70,689	44,668

Future minimum lease receipts

Not later than 1 year	3,334	5,219	3,334	5,219
Later than 1 year and not later than 5 years	-	-	-	-
At 31 December	3,334	5,219	3,334	5,219

The carrying amount of land and buildings and aircraft had they been recognised under the cost model are as follows:

Land	18,951	18,911	18,363	18,433
Buildings	187,607	122,706	178,447	118,655
Aircraft	14,962	18,070	14,962	18,070
At 31 December	221,520	159,687	211,772	155,158

Land and buildings carried at fair value

Independent valuations of the Bank's land and buildings were performed by The Professional Valuers of PNG Limited to determine the fair value of the land and buildings. The valuations, which conform to International Valuation Standards, were determined by reference to capitalization of the notional income stream approach on the Market Value basis. The recent valuation was dated 30 November 2017.

Assets subject to operating lease – aircraft

An independent valuation of the Bank's aircrafts was performed by Charles Taylor Aviation Asset Management to determine the current realistic fair value for each of the aircraft. The valuation, which conforms to International Valuation Standards, takes into consideration the current global market variations for the specific types of aircrafts. The effective date of the valuation was 31 May 2017.

Notes to the Financial Statements

for the Year Ended 31 December 2017

15. Investment properties

<i>All amounts are expressed in K'000</i>	Consolidated		Bank	
	2017	2016	2017	2016
Opening net book value	117,590	101,019	-	-
Additions	5,006	4,127	-	-
Translation movement	6,652	5,250	-	-
Gain on revaluation	4,772	7,194	-	-
At 31 December	134,020	117,590	-	-

16. Other financial assets

Securities – held to-maturity:

Inscribed stock – issued by Central Bank	2,310,279	2,218,037	2,062,341	2,044,905
--	-----------	-----------	-----------	-----------

Financial assets carried at fair value through profit and loss:

Equity securities	147,048	113,435	-	-
At 31 December	2,457,327	2,331,472	2,062,341	2,044,905

17. Other assets

Funds in transit and other assets	107,399	150,018	97,642	145,353
Accrued interest income	82,784	82,409	75,007	74,093
Intercompany account	-	-	10,665	12,344
Outstanding premiums	39,513	35,902	-	-
Inventory	12,749	7,698	-	-
Prepayments	19,664	16,269	17,851	14,999
Accounts receivable	2,252	2,689	977	746
At 31 December	264,361	294,985	202,142	247,535

18. Amounts due to other banks

Vostro account balances	24,479	24,773	55,811	50,038
Other borrowings	135,921	22,550	182,461	23,817
At 31 December	160,400	47,323	238,272	73,855

19. Customer deposits

On demand and short term deposits	13,438,449	12,832,771	12,800,761	12,272,022
Term deposits	4,463,243	4,079,578	4,042,995	3,871,674
At 31 December	17,901,692	16,912,349	16,843,756	16,143,696

The majority of the amounts are due to be settled within twelve months of the balance sheet date as shown in the maturity analysis table on note 34. The deposits are diversified across industries and region.

Notes to the Financial Statements

for the Year Ended 31 December 2017

20. Subordinated debt securities

At 31 December, there is K75.525 million of debt securities outstanding, expected to be settled more than 12 months after the balance sheet date. The notes were issued during 2009, with a maturity date in 2019, and interest is payable semi-annually at 11% per annum. They are valued at amortised cost. There have been no defaults of interest or other breaches with respect to these debt securities since issue.

21. Other liabilities

<i>All amounts are expressed in K'000</i>	<i>Note</i>	Consolidated		Bank	
		2017	2016	2017	2016
Policy liabilities	39(b)	749,876	640,043	-	-
Items in transit and all other liabilities		259,582	293,870	271,407	281,447
Borrowings		199,294	253,968	199,294	253,968
Creditors and accruals		150,525	104,679	125,932	82,987
Premiums received in advance		6,327	5,295	-	-
Outstanding claims		15,060	13,211	-	-
Claims incurred but not reported (IBNR)		2,224	1,396	-	-
At 31 December		1,382,888	1,312,462	596,633	618,402

Reconciliation of changes in liabilities arising from financing activities

A loan amounting to K253,969 (USD80 million) was obtained in 2016 with principal repayment to commence in 2017. During the year, the Bank paid K90,775 and additional loan of K33,127 was received. Foreign currency loss of K2,974 was recognised arising from translation.

22. Other provisions

Staff related	88,071	76,684	75,233	65,206
Provision for non-lending loss	64,310	52,163	64,260	51,944
Provisions – other	36,932	40,960	33,761	39,248
	189,313	169,807	173,254	156,398
Staff related provisions:				
At 1 January	76,684	62,205	65,206	55,274
Provisions charge	62,476	54,303	58,438	51,157
Payouts	(51,089)	(39,824)	(48,411)	(41,225)
At 31 December	88,071	76,684	75,233	65,206

23. Ordinary shares

<i>Number of shares in '000s, Book value in K'000</i>	Number of shares	Book value
At 31 December 2015/1 January 2016	467,525	374,621
Share buyback	(196)	(1,520)
At 31 December 2016 / 1 January 2017	467,329	373,101
Share buyback	(13)	(100)
At 31 December 2017	467,316	373,001

In May 2014, the Directors agreed to introduce a share-buyback scheme of up to K15 million. The share-buyback commenced in July 2014 and was extended to such time when the allocated K15 million buyback was utilised, or if the Board wishes, anytime before that.

Notes to the Financial Statements

for the Year Ended 31 December 2017

23. Ordinary shares (continued)

<i>All amounts are expressed in K'000</i>	Consolidated		Bank	
	2017	2016	2017	2016
Earnings per ordinary share				
Net profit attributable to shareholders (K'000)	757,003	643,451	720,953	606,674
Weighted average number of ordinary shares in use ('000)	467,323	467,427	467,323	467,427
Basic and diluted earnings per share (expressed in toea)	162.0	137.7	154.3	129.8

Basic earnings per ordinary share is calculated by dividing the net profit attributable to shareholders by the weighted average number of ordinary shares in issue during the year. Bank of South Pacific Limited has no dilutive potential ordinary shares. Consequently, basic earnings per ordinary share equals diluted earnings per share.

Dividends paid on ordinary shares

Interim ordinary dividend (2017:32 toea; 2016:25 toea)	149,541	116,832	149,541	116,832
Final ordinary dividend (2016:79 toea; 2015:63 toea)	372,317	297,141	369,414	294,448
	521,858	413,973	518,955	411,280

24. Retained earnings and other reserves

Retained earnings

At 1 January	1,670,595	1,399,490	1,576,974	1,340,000
Net profit for the year	757,003	643,451	720,953	606,674
Dividends paid	(521,858)	(413,973)	(518,955)	(411,280)
Disposal of assets – Asset revaluation	407	42,537	407	42,537
Recognition of deferred tax	3,739	-	3,739	-
BSP Life policy reserve	(5,491)	(957)	(5,491)	(957)
Loss in minority interest	67	47	-	-
At 31 December	1,904,462	1,670,595	1,777,627	1,576,974

Other reserves comprise

Revaluation reserve	161,373	134,892	150,389	130,470
Capital reserve	635	635	635	635
Equity component of Fiji Class Shares	21,578	21,578	-	-
General reserve	37,496	32,005	37,496	32,005
Exchange reserve	125,306	76,980	71,854	46,265
	346,388	266,090	260,374	209,375

Movement in reserves for the year:

Revaluation reserve

At 1 January	134,892	166,878	130,470	163,023
Asset revaluation increment	38,064	(1,265)	30,314	(1,832)
Transfer assets revaluation reserve to retained earnings	(1,418)	(42,537)	(1,418)	(42,537)
Deferred tax on disposal of properties	426	11,816	426	11,816
Deferred tax on asset revaluation – current year	(10,591)	-	(9,403)	-
At 31 December	161,373	134,892	150,389	130,470

Notes to the Financial Statements

for the Year Ended 31 December 2017

24. Retained earnings and other reserves (continued)

<i>All amounts are expressed in K'000</i>	Consolidated		Bank	
	2017	2016	2017	2016
Capital reserve				
At 1 January	635	635	635	635
At 31 December	635	635	635	635
General reserve				
At 1 January	32,005	31,048	32,005	31,048
BSP Life policy reserve	5,491	957	5,491	957
At 31 December	37,496	32,005	37,496	32,005
Exchange reserve				
At 1 January	76,980	34,926	46,265	21,663
Movement during the year	48,326	42,054	25,589	24,602
At 31 December	125,306	76,980	71,854	46,265

Equity component of convertible notes

On 20 April 2010, the Group issued 3,064,967 Fiji Dollars (FJD) denominated mandatory convertible notes through its wholly owned subsidiary BSP Convertible Notes Limited (BSP CN) at an issue price of FJD5.25 (K7.30) per note.

The notes mandatorily converted to Fiji Class Shares on 20 April 2013 based on a conversion ratio of 1:1. Key rights of Fiji Class Shareholders are as follows:

- (i) The right to receive dividend equal to the amount of dividend to be paid on BSP Ordinary Share.
- (ii) The same voting rights as a BSP Ordinary Share and effected through a special voting share held by the Chairman of BSP.
- (iii) The Fiji Class Share may be exchanged on a one for one basis into BSP Ordinary Shares at a subsequent date and at the option of BSP on the occurrence of certain prescribed events.

25. Contingent liabilities and commitments

Off balance sheet financial instruments	Consolidated		Bank	
	2017	2016	2017	2016
Standby letters of credit	35,637	29,230	35,637	29,230
Guarantees and indemnities issued	367,866	346,729	352,525	334,873
Trade letters of credit	60,505	92,540	58,462	85,897
Commitments to extend credit	1,001,653	1,196,875	966,118	1,163,392
	1,465,661	1,665,374	1,412,742	1,613,392

Legal Proceedings

A number of legal proceedings against the Group were outstanding as at 31 December 2017. Based on information available at 31 December 2017, the Group estimates a contingent liability of K18.6 million (2016: K17.9 million) in respect of these proceedings.

Notes to the Financial Statements

for the Year Ended 31 December 2017

25. Contingent liabilities and commitments (continued)

Statutory deposits with Central Banks	Consolidated		Bank	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
Cash reserve requirement: requisite reserve requirements of respective countries	1,598,378	1,474,656	1,541,096	1,440,530
Commitments for capital expenditure				
Amounts with firm commitments, and not reflected in the accounts	32,714	28,753	26,665	19,899
Operating lease commitments - predominantly premises				
Not later than 1 year	32,434	52,259	29,333	49,776
Later than 1 year and not later than 5 years	70,974	60,287	67,333	56,480
Later than 5 years	20,418	26,082	19,591	25,418
	123,826	138,628	116,257	131,674

26. Fiduciary activities

The Group especially through BSP Capital Limited conducts investment fund management, stock broking and other fiduciary activities as responsible entity, trustee, custodian or manager for investment funds and trusts, including superannuation. These funds are not consolidated as the Group does not have direct or indirect control. Where the funds incur liabilities in respect of these activities, and the primary obligation is incurred in an agency capacity, for the fund or clients rather than its own account, a right of indemnity exists against the assets of the applicable fund or trust. As these assets are sufficient to cover the liabilities and it is therefore not probable that the Group will be required to settle the liabilities, the investments in the assets and liabilities of these activities are not included in the Financial Statements.

27. Directors and executive remuneration

Directors remuneration

Directors of the company received remuneration including benefits during 2017 as detailed below:

Name of Director	Meetings attended / total held	Appointed/ (Resigned)	Total remuneration	
			2017	2016
Sir K. Constantinou, OBE	8/8	-	358,533	347,393
T. E. Fox, OBE, BEc	-	(21/06/16)	-	182,818
Dr. I. Temu, PhD, MEc	2/4	(25/08/17)	102,680	130,511
Sir N. Bogan, KBE, LLB	-	(11/11/16)	-	135,546
R. Fleming, CSM, MBA, MMGT	8/8	-	-	-
G. Aopi, CBE, MBA	5/5	(13/09/17)	110,486	140,434
G. Robb, OAM, BA, MBA	8/8	-	400,366	373,776
F. Talao, LL.M, MPHIL	7/8	-	199,508	190,511
E. B Gangloff, CPA, GAICO	8/8	-	175,366	135,546
A. Mano, BEc, MSc	6/8	-	122,881	117,141
A. Sam	8/8	-	161,488	60,268
Dr. F Lua'iufi	8/8	-	126,387	-
S. Davis	4/4	25/08/17	115,107	-
R. Bradshaw	3/3	13/09/17	36,627	-
			1,909,429	1,813,944

Notes to the Financial Statements

for the Year Ended 31 December 2017

27. Directors and executive remuneration (continued)

Non-executive Board Members of the Board - Constantinou, Fox and Robb received an allowance of K60,000 as Directors of BSP Capital Ltd which forms part of the Group.

* Managing Director / Chief Executive Officer receives no fees for his services as Director during the year. Other members of BSP executive management who serve as directors of subsidiaries of BSP Group receive no fees for their services as Director.

Executive remuneration

The number of employees or former employees whose income from the Bank was equal to or greater than K100,000 during the year, are classified in income bands of K10,000 as follows:

Remuneration K'000	2017 No.	2016 No.	Remuneration K'000	2017 No.	2016 No.	Remuneration K'000	2017 No.	2016 No.
100 – 110	58	30	440 – 450	-	1	860 – 870	-	1
110 – 120	41	27	460 – 470	5	3	870 – 880	3	-
120 – 130	24	28	470 – 480	4	-	880 – 890	1	1
130 – 140	35	24	480 – 490	-	1	890 – 900	-	1
140 – 150	22	16	490 – 500	-	2	910 – 920	-	1
150 – 160	14	16	500 – 510	-	2	920 – 930	2	-
160 – 170	20	15	510 – 520	2	1	930 – 940	1	-
170 – 180	11	9	520 – 530	2	2	960 – 970	1	-
180 – 190	15	11	530 – 540	-	1	970 – 980	-	2
190 – 200	14	9	540 – 550	1	1	1000 – 1010	1	2
200 – 210	5	7	550 – 560	1	1	1010 – 1020	1	1
210 – 220	9	4	580 – 590	-	1	1040 – 1050	-	1
220 – 230	5	5	590 – 600	-	2	1050 – 1060	1	1
230 – 240	9	2	600 – 610	-	1	1060 – 1070	1	-
240 – 250	3	3	620 – 630	1	-	1100 – 1110	2	-
250 – 260	2	5	640 – 650	-	1	1120 – 1130	1	-
260 – 270	5	1	650 – 660	1	3	1130 – 1140	1	-
270 – 280	-	5	660 – 670	4	2	1180 – 1190	1	1
280 – 290	2	4	670 – 680	2	-	1220 – 1230	-	2
290 – 300	3	3	680 – 690	1	-	1280 – 1290	-	3
300 – 310	9	11	690 – 700	-	3	1290 – 1300	1	-
310 – 320	6	5	700 – 710	1	1	1370 – 1380	-	1
320 – 330	1	2	710 – 720	1	-	1380 – 1390	1	-
330 – 340	3	3	720 – 730	2	2	1400 – 1410	1	-
340 – 350	5	3	730 – 740	-	1	1460 – 1470	1	-
350 – 360	9	3	740 – 750	1	-	1530 – 1540	-	1
360 – 370	4	4	750 – 760	2	1	1680 – 1690	1	-
370 – 380	2	2	760 – 770	2	5	1700 – 1710	-	1
380 – 390	4	5	770 – 780	-	3	1880 – 1890	-	1
390 – 400	5	3	780 – 790	1	1	2050 – 2060	1	-
400 – 410	2	2	790 – 800	1	3	2220 – 2230	1	-
410 – 420	2	4	820 – 830	2	2	4510 – 4520	-	1
420 – 430	3	3	830 – 840	1	1	4670 – 4680	1	-
430 – 440	1	1	850 – 860	2	-			
Total							419	345

Notes to the Financial Statements

for the Year Ended 31 December 2017

27. Directors and executive remuneration (continued)

The specified executives during the year were:

Robin Fleming, CSM	Robert Loggia	Paul Thornton	Hari Rabura
Johnson Kalo (Resigned April 2017)	Peter Beswick	Rohan George	Christophe Michaud
Aho Baliki, OBE	Haroon Ali	Edward Ruha	Richard Borysiewicz

Specified executives' remuneration in aggregate (K'000)

Year	Primary Salary	Primary Bonus	Non-monetary	Super	Post-employment Prescribed benefits	Other	Equity options	Other benefits	Total
2017	14,163	3,802	426	33	1,955	-	-	401	20,780
2016	14,595	3,274	272	249	204	-	960	413	19,967

28 Reconciliation of operating cash flow

	Consolidated		Bank	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
Reconciliation of operating profit after tax to operating cash flow before changes in operating assets				
Operating profit after tax	757,003	643,451	720,953	606,674
Add: Tax Expense	311,521	280,343	293,302	272,424
Operating profit before income tax	1,068,524	923,794	1,014,255	879,098
Major non cash amounts				
Depreciation	72,331	66,401	61,701	58,299
Amortisation of deferred acquisition and computer development costs	27,427	32,508	26,359	30,522
Net profit on sale of fixed assets	-	(15,184)	-	(15,145)
Movement in forex income accrual	(436)	2,385	(436)	2,385
Impairment on loans and advances	53,525	76,789	50,708	59,713
Movement in payroll provisions	11,387	14,479	10,027	9,932
Impairment of subsidiary	-	-	6,749	-
Impairment of fixed assets	6,682	12,003	6,682	12,003
Net effect of other accruals	20,518	35,000	1,576	4,891
Operating cash flow before changes in operating assets & liabilities	1,259,958	1,148,175	1,177,621	1,041,698

Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise the following balances with less than 90 days maturity.

Cash and balances with Central Banks (note 10)	1,205,196	1,656,260	985,803	1,410,008
Amounts due from other banks (note 12)	949,214	804,233	887,337	691,152
Amounts due to other banks (note 18)	(160,400)	(47,323)	(238,272)	(73,855)
	1,994,010	2,413,170	1,634,868	2,027,305

Notes to the Financial Statements

for the Year Ended 31 December 2017

29 Segment information

The Bank and the Group comprise various segments, these being the provision of banking services and products, stock broking and insurance services and asset financing. For management purposes, segment information determination is based on the risks involved with the provision of core banking services and products and the Bank and Group's management reporting system. The main business lines for management purposes are core banking services in PNG, Banking Services in other jurisdictions outside PNG, insurance operations, stock broking, fund management and asset financing activities. The Bank and Group's business segments operate in Papua New Guinea, Fiji, Solomon Islands, Cook Islands, Tonga, Samoa, Vanuatu and Cambodia. Inter segment adjustments reflect elimination entries in respect of inter segment income and expense allocations included funds transfer pricing.

Consolidated

All amounts are expressed in K'000

	PNG Bank	Non PNG Bank	Non Bank Entities	Adjust Inter Segments	Total
Analysis by segments					
Year ended 31 December 2017					
Net interest income	1,053,079	200,692	22,302	1,603	1,277,676
Other income	499,794	204,295	11,391	(34,636)	680,844
Net insurance income	-	-	41,266	(1,436)	39,830
Total operating income	1,552,873	404,987	74,959	(34,469)	1,998,350
Operating expenses	(626,860)	(212,647)	(20,937)	8,296	(852,148)
Impairment expenses	(44,633)	(24,732)	(8,313)	-	(77,678)
Profit before income tax	881,380	167,608	45,709	(26,173)	1,068,524
Income tax	(257,967)	(42,360)	(11,194)	-	(311,521)
Net profit after income tax	623,413	125,248	34,515	(26,173)	757,003
Year ended 31 December 2016					
Net interest income	913,532	179,807	14,347	-	1,107,686
Other income	470,708	185,400	11,753	(7,446)	660,415
Net insurance income	-	-	23,956	-	23,956
Total operating income	1,384,240	365,207	50,056	(7,446)	1,792,057
Operating expenses	(556,709)	(193,365)	(22,757)	3,190	(769,641)
Impairment expenses	(68,947)	(24,642)	(5,033)	-	(98,622)
Profit before income tax	758,584	147,200	22,266	(4,256)	923,794
Income tax	(241,352)	(37,830)	(1,161)	-	(280,343)
Net profit after income tax	517,232	109,370	21,105	(4,256)	643,451

Notes to the Financial Statements

for the Year Ended 31 December 2017

30. Related party transactions

Related parties are considered to be enterprises or individuals with whom the Group is especially related because either they or the Bank are in a position to significantly influence the outcome of transactions entered into with the Group, by virtue of being able to control, dominate or participate in a fiduciary capacity, in decision-making functions or processes. The Group conducted transactions with the following classes of related parties during the year:

- Directors and/or parties in which the director has significant influence
- Key management personnel and other staff and/or parties in which the individual officer has significant influence

A number of banking transactions are entered into with these related parties in the normal course of business, and include loans, deposits, property rentals, share transfers and foreign currency transactions. These transactions are carried out on commercial terms and market rates. For the year ended 31 December 2017, balances and transactions of accounts for Directors, including companies in which directorships were held by BSP directors, were as follows:

	Consolidated	
<i>All amounts are expressed in K'000</i>	2017	2016
Customer Deposits		
Opening balances	65,503	102,940
Net movement	(47,772)	(37,437)
Closing balance	17,731	65,503
Interest paid	18	54
Loans, advances and other receivables from customers		
Opening balances	673,674	618,985
Loans issued	166,939	241,746
Interest	27,901	24,387
Charges	3,752	4,228
Loan repayments	(240,616)	(215,672)
Closing balance	631,650	673,674

Incentive-based transactions are provided for staff. Such transactions include marginal discounts on rates, and specific fee concessions. These incentives are mainly percentage-based on market rates and fees, and as such, staff accounts are always subject to underlying market trends in interest rates and fees. As at 31 December 2017, staff account balances were as follows:

	2017	2016
<i>All amounts are expressed in K'000</i>		
Housing loans	145,551	116,936
Other loans	51,819	42,794
	197,370	159,730
Cheque accounts	6,097	7,997
Savings accounts	15,583	10,082
	21,680	18,079

Notes to the Financial Statements

for the Year Ended 31 December 2017

31. Bank operations, risks and strategies in using financial instruments

All business operations must deal with a variety of operational and financial risks. The business activities of a bank expose it to very critical and specific risks, which are principally related to the Group's primary financial intermediary role in the financial markets, including the use of financial instruments including derivatives. These risks (risk of an advance event in the financial markets that may result in loss of earnings) include liquidity risk, foreign exchange risk, interest rate risk and credit risk.

The Group accepts deposits from customers at both fixed and floating rates and for various periods and seeks to earn above average interest margins by investing these funds in high quality assets. These margins are achieved and increased by consolidating short-term funds and lending for longer periods at higher rates whilst maintaining sufficient liquidity to meet all claims that might fall due.

The Group also seeks to optimise its interest margins by obtaining above average returns, net of provisions, through lending to commercial and retail borrowers with a range of credit standing. In addition to directly advancing funds to borrowers, the Group also enters into guarantees and other commitments such as letters of credit, performance bonds, and other bonds.

The Group also enters into transactions denominated in foreign currencies. This activity generally requires the Group to take foreign currency positions in order to exploit short term movements in the foreign currency market. The Board places limits on the size of these positions. The Group also has a policy of using offsetting commitments for foreign exchange contracts, effectively minimising the risk of loss due to adverse movements in foreign currencies.

Risk in the Group is managed through a system of delegated limits. These limits set the maximum level of risk that can be assumed by each operational unit and the Group as a whole. The limits are delegated from the Board of Directors to executive management and hence to the respective operational managers.

The risk management framework establishes roles, responsibilities and accountabilities of the Asset and Liability Committee, the Credit Committee, the Operational Risk Committee and the Executive Committee, the specific management committees charged with the responsibility for ensuring the Group has appropriate systems, policies and procedures to measure, monitor and report on risk management. The framework also includes policies and procedures which detail formal feedback processes to these management committees, to the Audit, Risk and Compliance Committee of the Board, and ultimately to the Board of Directors.

32. Capital adequacy

The Group is required to comply with various prudential standards issued by the Bank of Papua New Guinea (BPNG), the official authority for the prudential supervision of banks and similar financial institutions in Papua New Guinea. Additionally, subsidiaries and branches in Fiji, Solomon Islands, Cook Islands, Samoa, Tonga, Vanuatu and Cambodia are required to adhere to prudential standards issued by the Reserve Bank of Fiji (RBF), Central Bank of Solomon Islands (CBSI), The Financial Supervisory Commission (FSC), Central Bank of Samoa (CBS), National Reserve Bank of Tonga (NRBT), Reserve Bank of Vanuatu and the National Bank of Cambodia (NBC). One of the most critical prudential standards is the capital adequacy requirement. All banks are required to maintain at least the minimum acceptable measure of capital to risk-weighted assets to absorb potential losses. The BPNG follows the prudential guidelines set by the Bank of International Settlements under the terms of the Basel Accord. The BPNG revised prudential standard 1/2003, Capital Adequacy, prescribes ranges of overall capital ratios to measure whether a bank is under, adequately, or well capitalised, and also applies the leverage capital ratio. The Group complies with the prevailing prudential requirements for total capital and leverage capital. As at 31 December 2017, the Group's total capital adequacy ratio and leverage capital ratio satisfied the capital adequacy criteria for a 'well-capitalised' bank. The minimum capital adequacy requirements set out under the standard are: Tier 1 8%, total risk based capital ratio 12% and the leverage ratio 6%.

The measure of capital used for the purposes of prudential supervision is referred to as base capital. Total base capital varies from the balance of capital shown on the Statement of Financial Position and is made up of tier 1 capital (core) and tier 2 capital (supplementary). Tier 1 capital is obtained by deducting from equity capital and audited retained earnings (or losses), intangible assets including deferred tax assets. Tier 2 capital cannot exceed the amount of tier 1 capital, and can include subordinated loan capital, specified asset revaluation reserves, un-audited profits (or losses) and a small percentage of general loan loss provisions. The leverage capital ratio is calculated as Tier 1 capital divided by total assets on the balance sheet.

Notes to the Financial Statements

for the Year Ended 31 December 2017

32. Capital adequacy (continued)

Risk weighted assets are derived from on-balance sheet and off-balance sheet assets. On balance sheet assets are weighted for credit risk by applying weightings (0, 20, 50 and 100 per cent) according to risk classification criteria set by the BPNG. Off-balance sheet exposures are risk weighted in the same way after converting them to on-balance sheet credit equivalents using BPNG specified credit conversion factors.

The Group's capital adequacy level is as follows:

	Balance sheet / notional amount		Risk-weighted amount	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
Balance sheet assets (net of provisions)				
Currency	2,803,574	3,130,916	-	-
Loans, advances and other receivables from customers	11,209,493	10,102,909	8,333,566	7,851,477
Investments and short term securities	5,755,953	5,265,093	147,048	113,440
All other assets	2,600,841	2,332,885	1,611,670	1,437,945
Off-balance sheet items	1,465,661	1,665,374	303,195	279,385
Total	23,835,522	22,497,177	10,395,479	9,682,247

Capital Ratios	Capital (K'000)		Capital Adequacy Ratio (%)	
	2017	2016	2017	2016
a) Tier 1 capital	2,212,167	1,916,502	21.3%	19.8%
Tier 1 + Tier 2 capital	2,549,443	2,233,493	24.5%	23.1%
b) Leverage Capital Ratio			10.0%	9.3%

33. Credit risk and asset quality

The Bank incurs risk with regard to loans, advances and other receivables due from customers and other monies or investments held with financial institutions. Credit risk is the likelihood of future financial loss resulting from the failure of clients or counter-parties to meet contractual obligations to the Group as they fall due.

Credit risk is managed by analysing the risk spread across various sectors of the economy and by ensuring risk is diversely spread by personal and commercial customer. Individual exposures are measured using repayment performance, reviews and statistical techniques. Comprehensive credit standards and approval limits have been formulated and approved by the Credit Committee. The Credit Committee (which reports to the Board through the Executive and Chief Executive Officer) is responsible for the development and implementation of credit policy and loan portfolio review methodology. The Credit Committee is the final arbiter of risk management and loan risk concentration.

As indicated in Accounting Policy G – Loans and provision for loan impairment, the Group has in place processes that identify, assess and control credit risk in relation to the loan portfolio, to assist in determining the appropriateness of provisions for loan impairment. These processes also enable assessments to be made of other classes of assets that may carry an element of credit risk. The Group assigns quality indicators to its credit exposures to determine the asset quality profile.

Large credit exposures are also monitored as part of credit risk management. These are classified as the largest 25 individual accounts or groups of related counter-parties. As at 31 December 2017, the 25 largest exposures totaled K5.5 billion, accounting for over 51% of the Bank and 47% of the Group's total loan portfolio (2016: K5.4 billion, accounting for over 55% and 51% respectively).

Notes to the Financial Statements

for the Year Ended 31 December 2017

33. Credit risk and asset quality (continued)

The Bank of Papua New Guinea has maintained a revised prudential standard for asset quality since October 2003. The revised standard specifies more detailed criteria for the classification of loans into various grades of default risk and corresponding loss provision levels as a consequence of those gradings.

An analysis by credit quality of loans outstanding at 31 December 2017 is as follows:

Consolidated	Overdrafts	Term loans	Mortgages	Lease financing	Policy loans	Total
<i>Neither past due nor impaired</i>	738,615	7,859,834	1,819,614	151,258	53,472	10,622,793
<i>Past due but not impaired</i>						
- Less than 30 days	80,923	399,877	132,249	14,249	-	627,298
- 30 to 90 days	1,144	283,988	65,245	3,763	-	354,140
- 91 to 360 days	3,384	19,283	6,967	-	-	29,634
- More than 360 days	583	-	-	-	-	583
	86,034	703,148	204,461	18,012	-	1,011,655
<i>Individually impaired loans</i>						
- Less than 30 days	4,076	12,159	3,219	585	-	20,039
- 30 to 90 days	37	4,822	1,886	471	-	7,216
- 91 to 360 days	1,413	36,185	10,668	1,804	-	50,070
- More than 360 days	676	55,701	14,325	204	-	74,906
	6,202	112,867	30,098	3,064	-	152,231
Total gross loans, advances and other receivables from customers	830,851	8,675,849	2,054,173	172,334	53,472	11,786,679
Less impairment provisions	-	-	-	-	-	(577,186)
Net Loans and Advances	830,851	8,675,849	2,054,173	172,334	53,472	11,209,493

Credit related commitments

These instruments are used to ensure that funds are available to a customer as required. The Group deals principally in the credit related commitments set out below.

Guarantees and standby letters of credit, which represent irrevocable assurances that the Group will make payments in the event that a customer cannot meet its obligations to third parties, carry the same risk as loans.

Documentary and trade letters of credit are written undertakings by the Group on behalf of a customer, authorising a third party to draw drafts on the Group for specified amounts under specified terms and conditions. They are collateralised by the underlying shipments of goods to which they relate and therefore carry less risk than a conventional loan.

Commitments to extend credit represent undrawn portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. Whilst the potential exposure to loss equates to the total undrawn commitments, the likely amount of loss is less than the total commitment since the commitments to extend credit are contingent upon customers maintaining specific credit standards. The Group monitors the term to maturity of these commitments because longer term commitments generally carry a greater degree of credit risk than shorter term commitments.

Notes to the Financial Statements

for the Year Ended 31 December 2017

33. Credit risk and asset quality (continued)

Economic sector risk concentrations

Economic sector risk concentrations within the customer loan portfolio are as follows:

All amounts are expressed in K'000

Consolidated				
As at 31 December	2017	%	2016	%
Commerce, finance and other business	5,910,485	53	5,725,076	57
Private households	2,421,546	22	2,001,460	20
Government and public authorities	374,109	3	331,130	3
Agriculture	249,295	2	240,974	2
Transport and communication	1,149,570	10	925,674	9
Manufacturing	226,427	2	202,423	2
Construction	878,061	8	676,172	7
Net loan portfolio balance	11,209,493	100	10,102,909	100

Ownership risk concentrations

Ownership risk concentrations within the customer loan portfolio are as follows:

All amounts are expressed in K'000

Consolidated				
As at 31 December	2017	%	2016	%
Corporate / Commercial	5,885,419	53	5,222,193	52
Government	2,728,957	24	2,665,135	26
Retail	2,595,117	23	2,215,581	22
Net loan portfolio balance	11,209,493	100	10,102,909	100

34. Liquidity risk

Liquidity risk is the risk of being unable to meet financial obligations as they fall due. The Board, through the Asset and Liability Committee, sets liquidity policy to ensure that the Group has sufficient funds available to meet all its known and potential obligations.

The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the management of banking activities. An unmatched position potentially enhances profitability, but can also increase the risk of losses.

Short-term mismatch of asset and liability maturity at 31 December 2017

The maturity profile of material Assets and Liabilities as at 31 December 2017 is shown in the following schedule. The mismatching of maturity of assets and liabilities indicates an apparent negative net "current" asset position. However, as stated in the preceding paragraph, mismatched positions are established and managed to achieve profit opportunities that arise from them, particularly in a normal yield curve environment. Accordingly, this mismatched maturity position is considered manageable by the Group, and does not impair the ability of the Group to meet its financial obligations as they fall due. The Directors are also of the view that the Group is able to meet its financial obligations as they fall due for the following additional reasons:

- The Bank and the Group complies with the Cash Reserve Requirement ("CRR") set by the regulatory authorities of the jurisdictions that the Bank operates in. The CRR specifies that a bank must hold an amount equal to a percentage of its total customer deposits in the form of cash in an account maintained by the respective Central Bank. The Bank complies with this daily requirement on an ongoing basis. The balance of the CRR account is shown in Note 10, Cash and Balances with Central Bank, and Note 28, Cash and Cash Equivalents.

Notes to the Financial Statements

for the Year Ended 31 December 2017

34. Liquidity risk (continued)

Maturity of assets and liabilities

All amounts are expressed in K'000

Consolidated As at 31 December 2017	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
Assets						
Cash and balances with Central Bank	2,803,574	-	-	-	-	2,803,574
Treasury and Central Bank bills	518,700	875,315	1,950,772	35,521	-	3,380,308
Amounts due from other banks	934,197	5,305	9,712	-	-	949,214
Loans, advances and other receivables from customers	1,775,843	489,111	3,010,777	4,530,950	4,307,179	14,113,860
Other financial assets	1,465,879	256,100	654,317	1,767,456	725,339	4,869,091
Total assets	7,498,193	1,625,831	5,625,578	6,333,927	5,032,518	26,116,047
Liabilities						
Amounts due to other banks	82,146	78,254	-	-	-	160,400
Customer Deposits	12,732,092	1,208,856	2,247,610	202,782	1,672,447	18,063,787
Other liabilities	1,183,594	-	-	274,819	-	1,458,413
Other provisions	221,021	-	-	-	-	221,021
Total liabilities	14,218,853	1,287,110	2,247,610	477,601	1,672,447	19,903,621
Net liquidity gap	(6,720,660)	338,721	3,377,968	5,856,326	3,360,071	6,212,426
As at 31 December 2016	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
Total assets	5,654,174	1,685,014	3,922,091	6,411,222	5,406,525	23,079,026
Total liabilities	13,880,976	1,542,508	1,333,995	271,194	1,649,490	18,678,163
Net liquidity gap	(8,226,802)	142,506	2,588,096	6,140,028	3,757,035	4,400,863

35. Operational risk

Operational risk is the potential exposure to unexpected financial or non-financial losses arising from the way in which the Group conducts its business. Examples of operational risks include employee errors, systems failures, fire, floods, or similar losses to physical assets, fraud, or criminal activity. Operational risk is managed through formal policies, documented procedures, business practices and compliance monitoring.

An operational risk management function is responsible for the maintenance of these policies, procedures practices and monitoring the organization's compliance with them. The Operational Risk Committee coordinates the management process across the organization.

An independent internal audit function also conducts regular reviews to monitor compliance with approved BPNG standards and examines the general standard of control.

The Operational Risk Committee and the internal audit function mandatorily report to the Board Risk and Compliance Committee.

Notes to the Financial Statements

for the Year Ended 31 December 2017

36. Foreign exchange risk

Foreign exchange risk is the risk to earnings caused by a change in foreign exchange rates on open currency positions. The objective of foreign exchange risk management within the Group is to minimise the impact on earnings of any such movement.

The Group accepts foreign currency denominated transactions and therefore has exposure to movements in foreign currency. The Group has a policy to offset these transactions to minimise daily exposure. As foreign exchange contracts generally consist of offsetting commitments, they involve only limited foreign exchange risk to the Group and material loss is not envisaged.

Currency concentration of assets, liabilities, and off-balance sheet items

All amounts are expressed in K'000

Consolidated						
As at 31 December 2017	PGK	FJD	SBD	USD	Other	Total
Assets						
Cash and balances with Central Bank	1,632,181	497,338	342,486	2,941	328,628	2,803,574
Treasury and Central Bank bills	3,033,881	5,537	252,175	-	7,033	3,298,626
Amounts due from other banks	89,932	67,902	9,699	170,893	610,788	949,214
Loans, advances and other receivables from customers	6,647,588	2,634,127	440,326	415,889	1,071,563	11,209,493
Other financial assets	2,059,729	360,789	-	-	36,809	2,457,327
Other assets	911,412	578,386	70,533	861	90,435	1,651,627
Total assets	14,374,723	4,144,079	1,115,219	590,584	2,145,256	22,369,861
Liabilities						
Amounts due to other banks	(75,016)	(71,883)	(1,251)	-	(12,250)	(160,400)
Customer Deposits	(11,875,688)	(2,782,064)	(843,836)	(513,112)	(1,886,992)	(17,901,692)
Other liabilities	(480,311)	(906,215)	(41,428)	(201,640)	(49,840)	(1,679,434)
Total liabilities	(12,431,015)	(3,760,162)	(886,515)	(714,752)	(1,949,082)	(19,741,526)
Net on-balance sheet position	1,943,708	383,917	228,704	(124,168)	196,174	2,628,335
Off-balance sheet net notional position	(299)	-	-	(46,380)	30,583	(16,097)
Credit commitments	1,032,450	373,703	9,355	-	52,072	1,467,580
31 December 2016						
Total Assets	13,952,229	3,517,396	1,095,732	681,479	1,584,967	20,831,803
Total Liabilities	(12,254,906)	(3,193,631)	(893,609)	(716,296)	(1,459,024)	(18,517,466)
Net on-balance sheet position	1,697,323	323,765	202,123	(34,817)	125,943	2,314,337
Off-balance sheet net notional position	(18,957)	-	-	(122,730)	127,138	(14,549)
Credit commitments	1,308,204	307,432	6,588	-	41,896	1,664,120

Notes to the Financial Statements

for the Year Ended 31 December 2017

36. Foreign exchange risk (continued)

All amounts are expressed in K'000

The following table presents sensitivities of profit or loss and equity to possible changes in exchange rates applied at the end of the reporting period, relative to the functional currency of the respective Group entities, with all other variables held constant:

	At 31 December 2017		At 31 December 2016	
	Impact on profit or loss	Impact on equity	Impact on profit or loss	Impact on equity
USD strengthening by 1% (2016 – 1%)	1,146	1,146	1,408	1,408
USD dollar weakening by 1% (2016 – 1%)	(1,123)	(1,123)	(1,380)	(1,380)
AUD strengthening by 1% (2016 – 1%)	(39)	(39)	-	-
AUD dollar weakening by 1% (2016 – 1%)	38	38	-	-

37. Interest rate risk

Interest rate risk in the balance sheet arises from the potential for a change in interest rate to have an adverse effect on the revenue earnings in the current reporting period and future years. As interest rates and yield curves change over time the Group may be exposed to a loss in earnings due to the effects of interest rates on the structure of the balance sheet. Sensitivity to interest rates arises from mismatches in the re-pricing dates, cash flows and other characteristics of the assets and their corresponding liability funding. These mismatches are actively managed as part of the overall interest rate risk management process governed by the Assets and Liabilities Committee (ALCO), which meets regularly to review the effects of fluctuations in the prevailing levels of market interest rates on the financial position and cash flows of the Group. The objective of interest rate risk control is to minimise these fluctuations in value and net interest income over time, providing secure and stable sustainable net interest earnings in the long term. The table below illustrates the interest sensitivity of assets and liabilities at the balance date.

Given the profile of assets and liabilities as at 31 December 2017 and prevailing rates of interest, a 1% increase in markets rates will result in a K40.2 million increase in net interest income, whilst a 1% decrease in rates will result in a K49.5 million decrease in net interest income.

Interest sensitivity of assets, liabilities and off balance sheet items – re-pricing analysis

All amounts are expressed in K'000

Consolidated As at 31 December 2017	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Non-interest bearing
Assets						
Cash and Central Bank assets	-	-	-	-	-	1,205,196
Treasury and Central Bank bills	502,496	848,977	1,911,632	35,521	-	-
Amounts due from other banks	483,195	5,305	9,712	-	-	451,002
Statutory deposits - Central Bank	-	-	-	-	-	1,598,378
Loans, advances and other receivables from customers	9,618,884	177,977	783,207	498,884	130,541	-
Other Financial Assets	115,710	163,685	509,298	1,346,239	476,530	-
Other assets	-	-	-	-	-	1,497,492
Total assets	10,720,285	1,195,944	3,213,849	1,880,644	607,071	4,752,068
Liabilities						
Amounts due to other banks	93,829	18,806	-	-	-	47,765
Customer deposits	7,928,614	1,196,875	2,148,215	153,629	65	6,474,294
Other liabilities	-	-	199,294	75,525	-	1,183,594
Other provisions	-	-	-	-	-	221,021
Total liabilities	8,022,443	1,215,681	2,347,509	229,154	65	7,926,674
Interest sensitivity gap	2,697,842	(19,737)	866,340	1,651,490	607,006	(3,174,606)

Notes to the Financial Statements

for the Year Ended 31 December 2017

37. Interest rate risk (continued)

Interest sensitivity of assets, liabilities and off balance sheet items – re-pricing analysis

As at 31 December 2016	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Non-interest bearing
Assets						
Cash and Central Bank assets	-	-	-	-	-	1,656,260
Treasury and Central Bank Bills	267,696	826,806	1,829,719	9,400	-	-
Amounts due from other banks	313,687	1,196	-	9,281	-	480,069
Statutory deposits - Central Bank	-	-	-	-	-	1,474,656
Loans, advances and other receivables from customers	8,775,060	155,994	651,630	385,975	134,250	-
Investments	294,354	291,914	128,461	1,238,363	504,000	-
Other assets	44,545	-	-	-	-	1,358,487
Total assets	9,695,342	1,275,910	2,609,810	1,643,019	638,250	4,969,472
Liabilities						
Amounts due to other banks	-	-	-	-	-	47,323
Customer deposits	7,542,495	1,512,379	1,285,789	194,552	39	6,377,095
Other liabilities	-	-	253,969	75,525	-	1,058,493
Other Provisions	-	-	-	-	-	169,807
Total liabilities	7,542,495	1,512,379	1,539,757	270,077	39	7,652,718
Interest sensitivity gap	2,152,847	(236,469)	1,070,053	1,372,942	638,211	(2,683,246)

38. Fair values of financial assets and liabilities

There is no material difference between the fair values and carrying values of the financial assets and liabilities of the Group.

The table below analyses the Group's financial instruments carried at fair value, by levels in the fair value hierarchy.

The different levels have been defined as follows:

- Level 1 - quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 - inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Consolidated

All amounts are expressed in K'000

2017	Level 1	Level 2	Level 3	Total
Financials assets				
Equity securities	-	144,911	2,137	147,048
Non-financial assets				
Land & buildings	-	560,019	-	560,019
Assets subject to operating lease	-	-	70,689	70,689
Total	-	704,930	72,826	777,756
Financials liabilities				
Policy liabilities	-	-	749,876	749,876

Notes to the Financial Statements

for the Year Ended 31 December 2017

38. Fair values of financial assets and liabilities (continued)

2016	Level 1	Level 2	Level 3	Total
<i>Financials assets</i>				
Equity securities	-	111,612	1,823	113,435
<i>Non-financial assets</i>				
Land & buildings	-	402,466		402,466
Assets subject to operating lease	-	-	44,668	44,668
Total	-	514,078	46,491	560,569
<i>Financial liabilities</i>				
Policy liabilities	-	-	640,043	640,043
Total liabilities	-	-	640,043	640,043

	Consolidated	
Financial asset at fair value through profit & loss	2017	2016
Opening balance	46,491	54,392
Total gains and losses recognized in:		
- Profit & loss	(5,977)	(7,901)
- Other comprehensive income	32,311	-
Closing balance	72,825	46,491

There were no changes in valuation technique for Level 3 recurring fair value measurements during the year ended 31 December 2017. Property, plant and equipment represents commercial land and buildings owned by the Group based on valuations provided by independent valuers. The valuation is based on the capitalisation method with an assessment of the property based on its potential earning capacity. Disposal cost for properties classified as held for sale is not expected to be material.

In the normal course of trading, the Group enters into forward exchange contracts. The Group does not actively enter into or trade in, complex forms of derivative financial instruments such as currency and interest rate swaps and options.

Exposures in foreign currencies arise where the Group transacts in foreign currencies. This price risk is minimised by entering into counterbalancing positions for material exposures as they arise. Forward and spot foreign exchange contracts are used.

Notes to the Financial Statements

for the Year Ended 31 December 2017

38. Fair values of financial assets and liabilities (continued)

Forward exchange contracts outstanding at 31 December 2017 stated at the face value of the respective contracts are:

All amounts are expressed in respective FCY'000 and K'000

As at 31 December 2017		USD	AUD	EURO	GBP	JPY	Other	Total
Selling	FCY	(21,155)	(572)	-	(270)	(540,715)	(3,319)	-
	Kina	(10,189)	-	-	-	-	-	(10,189)
Buying	FCY	6,801	9,850	-	-	56,000	10,207	-
	Kina	9,890	-	-	-	-	-	9,890
As at 31 December 2016		USD	AUD	EURO	GBP	JPY	Other	Total
Selling	FCY	(55,034)	(1,410)	-	(1,700)	(360,607)	(1,094)	-
	Kina	(38,981)	-	-	(4,796)	-	-	(43,777)
Buying	FCY	16,374	60,315	-	1,197	37,100	1,914	-
	Kina	16,420	-	-	-	8,400	-	24,820

39 Insurance

(a) Net insurance operating income

	Consolidation		Bank	
	2017	2016	2017	2016
<i>All amounts are expressed in K'000</i>				
Net insurance income	39,830	23,956	-	-

Presentation of insurance business results in the Statement of Comprehensive Income has been regrouped to more accurately reflect the insurance business contribution to shareholder profits. Comparative figures have been adjusted to conform to changes in presentation in the current year.

(b) Policy liabilities

Key assumptions used in determining this liability are as follows:

Discount rates

For contracts in Statutory Fund 1 which have a Discretionary Participating Feature (DPF), the discount rate used is linked to the assets which back those contracts. For 31st December 2017 this was 5.916% per annum (31st December 2016: 6.24% per annum), based on current 10 year government bond yields and expected earnings from the investment portfolio. For contracts without DPF and Accident Business, a rate of 4.8% per annum was used at 31st December 2017 (31st December 2016: 5.16% per annum). These rates were based on the 10 year government bond rate as published by the Reserve Bank of Fiji.

Notes to the Financial Statements

for the Year Ended 31 December 2017

39 Insurance (continued)

Investment and maintenance expenses

Future maintenance and investment expenses are based on the budgeted expenses. Future inflation in Fiji has been assumed to be 3.5% per annum (31st December 2016: 3.5% per annum) for determining future expenses.

Taxation

The rates of taxation in Fiji enacted or substantially enacted at the date of the valuation (20%) are assumed to continue into the future.

Mortality and morbidity

Projected future rates of mortality for insured lives are based on the Fiji Mortality Statistics table FJ90-94 Male. These are then adjusted for the Group's own experience. The mortality rate used was 70% of the FJ90-94 Male table for participating business in Statutory Fund 1.

Rates of discontinuance

Best estimate assumptions for the incidence of withdrawal and discontinuance vary by product and duration and are based on the Group's experience which is reviewed regularly. Rates used were adjusted for recent experience at certain durations. Rate used for the long term insurance contracts are as follows:

	2017	2016
Whole of Life and Endowment Insurance	14%	15%
Term Insurance	16%	18%
Accident Insurance	17%	14%

Basis of calculation of surrender values

Surrender values are based on the provisions specified in the policy contracts. There have been no changes to surrender bases during the period (or the prior periods) which have materially affected the valuation result.

Discretionary Participating Business

For most participating business, bonus rates are set such that, over long periods, the returns to contract holders are commensurate with the investment returns achieved on the pool of assets which provide security for the contract, together with other sources of profit arising from this business. Profits from these policies are split between contract holders and shareholders in accordance with the policy conditions which allow for shareholders to share in allocations at a maximum rate of 20%. For business written between 1995 and 1998 the shareholder receives 11% of profits.

In applying the contract holders' share of profits to provide bonuses, consideration is given to equity between generations of policyholders and equity between the various classes and sizes of contracts in force. Assumed future bonus rates included in the liability for the long term insurance contracts were set such that the present value of the liabilities equates to the present value of assets supporting the business together with assumed future investment returns, allowing for the shareholder's right to participate in distributions.

Reinsurance

Contracts entered into by the Group with Reinsurers under which the Group is compensated for losses on one or more contracts issued by the Group, are classified as reinsurance contracts.

As the reinsurance agreements provide for indemnification by the Reinsurers against loss or liability, reinsurance income and expenses are recognised separately in profit or loss when they become due and payable in accordance with the reinsurance agreements.

Reinsurance recoveries are recognised as claim recoveries under profit or loss. This is netted off against the claim expenses. Reinsurance premiums are recognised as Reinsurance Expenses.

Notes to the Financial Statements

for the Year Ended 31 December 2017

39 Insurance (continued)

All amounts are expressed in K'000

	2017	2016
<u>Policy Liabilities</u>		
Opening balance	640,043	563,441
Translation movement	38,525	24,541
Increase in policy liabilities	64,813	45,036
Increase in policy liabilities on revaluation of land	6,495	7,025
Total policy liabilities	<u>749,876</u>	<u>640,043</u>

40. Events occurring after balance sheet date

The Bank of Papua New Guinea (BPNG) granted BSP a licence to operate a life insurance company in PNG on 25 January 2018. The life insurance business will be conducted by BSP Life PNG Limited, a fully owned subsidiary of BSP. The business will be launching a variety of life insurance products during the course of 2018.

41. Remuneration of auditor

All amounts are expressed in K'000	Consolidated		Bank	
	2017	2016	2017	2016
Financial statement audits	2,871	2,762	2,137	2,081
Other services	1,350	999	1,130	947
	<u>4,221</u>	<u>3,761</u>	<u>3,267</u>	<u>3,028</u>

The external auditor PricewaterhouseCoopers is also engaged in providing other services to the Bank and Group as required and as permitted by prudential standards. The provision of other services included taxation and general training.



Independent auditor's report

To the shareholders of Bank of South Pacific Limited

Report on the audit of the financial statements of the Bank and the Group

Our opinion

We have audited the financial statements of Bank of South Pacific Limited (the Bank), which comprise the statements of financial position as at 31 December 2017, and the statements of comprehensive income, statements of changes in shareholders' equity and statements of cash flows for the year then ended, and the notes to the financial statements that include a summary of significant accounting policies and other explanatory information for both the Bank and the Group. The Group comprises the Bank and the entities it controlled at 31 December 2017 or from time to time during the financial year.

In our opinion the accompanying financial statements:

- comply with International Financial Reporting Standards and other generally accepted accounting practice in Papua New Guinea; and
- give a true and fair view of the financial position of the Bank and the Group as at 31 December 2017, and their financial performance and cash flows for the year then ended.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the financial statements* section of our report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We are independent of the Bank and Group in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants (IESBA Code)*, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Our firm carries out services for the Group in the areas of audit-related, non-audit related and tax advice services. The provision of these other services has not impaired our independence as auditor of the Bank and the Group.

Our audit approach

An audit is designed to provide reasonable assurance about whether the financial statements are free from material misstatement. Misstatements may arise due to fraud or error. They are considered material if individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the management structure of the Bank and the Group, their accounting processes and controls and the industries in which they operate.

PricewaterhouseCoopers

*PwC Haus, Level 6, Harbour City, Konedobu. PO Box 484, PORT MORESBY, PAPUA NEW GUINEA
T: (675) 321 1500 / (675) 305 3100, F: (675) 321 1428, www.pwc.com.pg*



<i>Materiality</i>	<i>Audit scope</i>	<i>Key audit matters</i>
<ul style="list-style-type: none"> • For the purpose of our audit of the Group we used overall group materiality of K52.3 million which represents approximately 5% of the Group's profit before taxes. • We applied this threshold, together with qualitative considerations, to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements on the financial statements as a whole. • We chose Group profit before taxes as, in our view, it is the metric against which the performance of the Group is most commonly measured and is a generally accepted benchmark. • We selected 5% based on our professional judgement noting that it is also within the range of commonly acceptable related thresholds. 	<ul style="list-style-type: none"> • We (PwC Papua New Guinea) conducted the audit over all of the Group's operations in Papua New Guinea (PNG), which are the most significant to the Group, and directed the scope of the audit of other subsidiaries included in the Group financial statements sufficient to express an opinion on the financial statements as a whole. • For the Group's activities in Fiji, Samoa, Tonga, Solomon Islands, Cook Islands, and Vanuatu the audit work was performed by other PwC network firms or other firms operating under our instructions. In addition we visit significant overseas operations and this year we met with management and the local audit team in Fiji, Samoa and Solomon Islands. • Our audit focused on where the directors made subjective judgements; for example, significant accounting estimates involving assumptions and inherently uncertain future events. 	<ul style="list-style-type: none"> • Amongst other relevant topics, we communicated the following key audit matters to the Board Audit Committee: <ul style="list-style-type: none"> • Loan loss provisioning • IT systems and controls • These matters are further described in the <i>Key audit matters</i> section of our report.



Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements for the current period. The key audit matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. We have determined the matters described below to be key matters to be communicated in our report. Further, commentary on the outcomes of the particular audit procedures is made in that context.

Key audit matter	How our audit addressed the key matter
<p>Loan loss provisioning amounting to K577.186m - Refer to Note 13</p> <p>Our audit focused on this area, owing to the significance of loans and advances to the financial statements, the prevailing economic environments in the markets in which the group operates, particularly PNG, and the subjectivity and management judgements involved in determining whether loans within the portfolio are impaired, and the amount of impairment loss that should be recognised in the current period.</p> <p>In making an assessment of loans that are impaired and determining the impairment provision required, the Group generally takes a portfolio approach, except in the case where a specific provision is required based on an assessment of individual exposures. In either case, the application of the Group's policy is inherently judgmental.</p> <p>For the individual assessment or specific provision, loans (excluding retail personal loans) are reviewed for impairment indicators, using various event thresholds, such as repayment performance. Where an impairment indicator exists, the amount of the expected future cash flows related to the loan is estimated, together with the expected realisable value of collateral held.</p> <p>All other loans are collectively assessed on a portfolio basis. For this assessment impairment models are used which aim to build in the impact of credit conditions and default risk for determining the provision. The inputs to these models also include judgmental overlays which aim to take into account emerging trends or particular situations which are not captured by the models, such as sectoral weaknesses in particular markets. This assessment involves various judgements, for example how loans are categorised for credit risk purposes and the probability of default associated with each risk grade.</p>	<p>The procedures we performed to support our audit conclusions, included:</p> <ul style="list-style-type: none"> Assessing the design and testing the operating effectiveness of the controls over loan impairment provisioning processes. The key controls over this process include the role of the Credit Committee in ensuring governance and monitoring of the credit function, appropriate identification of emerging credit risks, including stress testing, and its impact on key inputs to the loan provisioning process, identification and management of material exposures and the establishment of impairment models to capture losses. For individually assessed provisions, applying sampling procedures for testing the operating effectiveness of controls over the Credit Inspection Unit's customer loan file reviews, testing the completeness of the credit watch list and delinquencies, assessing the Group's estimates of specific provisions, and re-performing the calculations for accuracy. For collectively assessed provisions, critically examining the model methodology for consistency and appropriateness, evaluating the probability of default factors used for appropriateness, testing the accuracy of data, such as risk grades used in the models and re-performance of model calculations. For judgmental overlays to model calculations, we considered the potential for impairment to be affected by events not captured in the models. This included making our own independent assessment of the credit environment and evaluating the impact of the Group's stress testing of loans on the credit watch list.



Key audit matter	How our audit addressed the key matter
<p><i>IT systems and controls</i></p> <p>We focused on this area because the Group is heavily dependent on complex IT systems for the processing of significant volumes of transactions and for financial accounting and reporting purposes. For example, these systems are also critical to capturing various data that are used to produce reports which management use to make decisions, monitor and control the business and for financial reporting purposes.</p> <p>Our audit approach relies on reports that are generated from these critical IT systems, and therefore the operating effectiveness of automated controls as well as IT dependent manual controls is important to enable that reliance.</p> <p>In particular, our audit focused on access rights, because they aim to ensure that changes to applications are authorised and made appropriately. Ensuring staff have appropriate access to IT systems, and that access is monitored, are key controls in mitigating the potential for fraud and error as a result of a change to an application or underlying data.</p>	<p>The procedures we performed to support our audit conclusions, included:</p> <ul style="list-style-type: none"> • We assessed and tested the design and operating effectiveness of the controls over the continued integrity of the IT systems that are relevant to financial reporting and upon which we relied for the purpose of our audit. • We examined the framework of governance over the Group’s IT organisation, the controls over program changes and development, access to programs and data and IT operations, including compensating controls where required. We also carried out procedures over certain aspects of security of the Group’s IT systems including access management and segregation of duties. <p>The combination of the tests of controls and substantive audit procedures we performed gave us sufficient evidence to enable us to rely on the continued and proper operation of the Group’s IT systems for the purposes of our audit.</p>

Information other than the financial statements and auditor’s report

The directors are responsible for the other information. The other information comprises the Directors’ Report (but does not include the financial statements and the auditors’ report thereon), which we obtained prior to the date of this auditor’s report, and the annual report, which is expected to be made available after that date. Our opinion on the financial statements does not cover the other information and we do not, and will not, express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If, based on the work we have performed on the other information that we obtained prior to the date of this auditor’s report, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

When we read the annual report, if we conclude that there is a material misstatement therein, we are required to communicate the matter to those charged with governance.

Responsibilities of the directors for the financial statements

The directors are responsible, on behalf of the Bank for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards and other generally accepted accounting practice in Papua New Guinea and the Companies Act 1997 and for such internal control as the directors determine is necessary to enable the preparation of financial statements are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Bank or any of its subsidiaries, or to cease operations, or have no realistic alternative but to do so.



Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements, as a whole, are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements of the Group. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements for the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulations preclude public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.



Report on other legal and regulatory requirements

The Companies Act 1997 requires that in carrying out our audit we consider and report on the following matters. We confirm in relation to our audit of the financial statements for the year ended 31 December 2017:

- We have obtained all the information and explanations that we have required;
- In our opinion, proper accounting records have been kept by the Bank as far as appears from an examination of those records.

Who we report to

This report is made solely to the Bank's shareholders, as a body, in accordance with the Companies Act 1997. Our audit work has been undertaken so that we might state to the Bank's shareholders those matters which we are required to state to them in an auditor's report and for no other purpose. We do not accept or assume responsibility to anyone other than the Bank and the Bank's shareholders, as a body, for our audit work, for this report or for the opinions we have formed.

PricewaterhouseCoopers

PricewaterhouseCoopers

A handwritten signature in blue ink, appearing to read 'Jonathan Seeto', written over the printed name.

Jonathan Seeto
Partner

Registered under the Accountants Act 1996

Port Moresby
1 March 2018