

**INDEPENDENT AUDITORS' REPORT
TO THE SHAREHOLDERS OF GULFSANDS PETROLEUM PLC**

We have audited the Group and Company financial statements of Gulfsands Petroleum plc for the year ended 31 December 2005 which comprise the Consolidated Profit and Loss Account, the Consolidated Statement of Total Recognised Gains and Losses, the Consolidated and Company Balance Sheets, the Consolidated Cash Flow Statement, and related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the Company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The Directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' Report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and transactions with the Company is not disclosed.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. This other information comprises the Chief Executive's Report, Review of Operations and Directors' Report. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of opinion

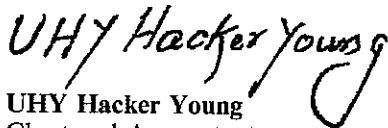
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Group's and the Company's affairs as at 31 December 2005 and of the Group's loss for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985.


UHY Hacker Young
Chartered Accountants
Registered Auditors
9 June 2006

St Alphage House
2 Fore Street
London EC2Y 5DH

**CONSOLIDATED PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31 DECEMBER 2005**

	Notes	2005			2004
		Continuing group share \$'000	Minority share of Northstar Gulfsands (See below) \$'000	Total operations \$'000	\$'000
Turnover	2	24,926	20,086	45,012	33,056
Cost of sales	—	(13,866)	(12,047)	(25,913)	(19,485)
Gross profit		11,060	8,039	19,099	13,571
General and administrative expenses		(4,923)	(1,330)	(6,253)	(4,602)
Amortisation of goodwill		—	—	—	(107)
Accretion of net present value decommissioning provision		(1,370)	(1,234)	(2,604)	(1,352)
		(6,293)	(2,564)	(8,857)	(6,061)
Group operating profit	4	4,767	5,475	10,242	7,510
Exceptional items:					
Loss on disposal of a subsidiary	3	(1,244)	—	(1,244)	—
Goodwill written off on disposal of a subsidiary	3	(1,286)	—	(1,286)	—
Restructuring costs on disposal of a subsidiary	3	(3,550)	—	(3,550)	—
(Loss)/profit on activities before interest		(1,313)	5,475	4,162	7,510
Investment loss		—	—	—	(675)
Interest receivable		1,413	205	1,618	143
Interest payable	5	(2,510)	(1,822)	(4,332)	(3,477)
(Loss)/profit on ordinary activities before taxation ..		(2,410)	3,858	1,448	3,501
Tax on (loss)/profit on ordinary activities	6	(1,551)	—	(1,551)	1,038
(Loss)/profit on ordinary activities after taxation ...		(3,961)	3,858	(103)	4,539
Minority interests	7	13	(3,858)	(3,845)	(2,917)
RETAINED (LOSS)/PROFIT FOR THE PERIOD		(3,948)	—	(3,948)	1,622
Basic (loss)/earnings per share (in \$'s)	8	(0.05)	—	(0.05)	0.02
Diluted (loss)/earnings per share (in \$'s)	8	(0.05)	—	(0.05)	0.02

The profit and loss account “Continuing group share” consists of GP’s 52.6% of Northstar Gulfsands LLC (“NSGS”) and other GP activity, while the “Minority share of NSGS” column is the NSGS 47.4% partner share.

There is no difference between the loss on ordinary activities before taxation and retained loss for the period stated above and their historical cost requirements.

The accompanying notes are an integral part of this consolidated profit and loss account.

**CONSOLIDATED STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
FOR THE YEAR ENDED 31 DECEMBER 2005**

	2005			2004
	Continuing group share	Minority share of Northstar Gulfsands	Total operations	
	\$'000	\$'000	\$'000	\$'000
(Loss)/profit for the period.....	(3,948)	—	(3,948)	1,622
Unrealised gain on investments.....	—	—	—	212
Total Recognised (losses)/gains relating to the period	<u>(3,948)</u>	<u>—</u>	<u>(3,948)</u>	<u>1,834</u>

CONSOLIDATED BALANCE SHEET

AT 31 DECEMBER 2005

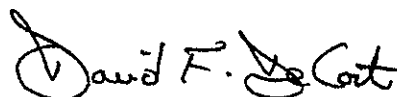
	<u>Notes</u>	<u>2005</u> \$'000	<u>2004</u> \$'000
Fixed assets			
Tangible assets	11	39,236	56,038
Intangible assets	12	<u>35</u>	<u>2,629</u>
		<u>39,271</u>	<u>58,667</u>
Current assets			
Debtors	14	4,983	10,749
Cash at bank and in hand	1.14	<u>36,561</u>	<u>19,579</u>
		41,544	30,328
Creditors: amounts falling due within one year	15	<u>(3,436)</u>	<u>(18,688)</u>
Net current assets		<u>38,108</u>	<u>11,640</u>
Total assets less current liabilities		77,379	70,307
Creditors: amounts falling due after more than one year	15	—	(29,947)
Deferred tax liabilities	16	(173)	—
Provision for liabilities and charges	17	(6,958)	(16,427)
Equity minority interests	7	<u>(260)</u>	<u>(7,873)</u>
NET ASSETS		<u>69,988</u>	<u>16,060</u>
SHARE CAPITAL AND RESERVES			
Share capital	19	9,971	7,306
Share premium account	19	53,651	—
Other reserve	19	11,709	10,149
Profit and loss account	19	<u>(5,343)</u>	<u>(1,395)</u>
SHAREHOLDERS' FUNDS — EQUITY	20	<u>69,988</u>	<u>16,060</u>

The accompanying notes are an integral part of this consolidated balance sheet.

The accounts were approved by the Board of Directors on 9 June 2006 and signed on its behalf by:



John P Dorrier
Chief Executive Officer



David F DeCort
Chief Financial Officer

COMPANY BALANCE SHEET

AT 31 DECEMBER 2005

	<u>Notes</u>	<u>2005</u> <u>\$'000</u>
Fixed assets		
Tangible assets		6
Investments	13	<u>7,306</u>
		7,312
Current assets		
Debtors	14	39,091
Cash at bank and in hand		<u>18,374</u>
		57,465
Creditors: amounts falling due within one year	15	<u>(380)</u>
Net current assets		<u>57,085</u>
Total assets less current liabilities		<u>64,397</u>
		<u>64,397</u>
SHARE CAPITAL AND RESERVES		
Share capital	19	9,971
Share premium account	19	53,651
Profit and loss account	19	<u>775</u>
SHAREHOLDERS' FUNDS — EQUITY		<u>64,397</u>

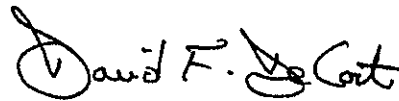
No comparative figures balance sheet is prepared because 31 December 2005 is the Company's first period of account.

The accompanying notes are an integral part of this consolidated balance sheet.

The accounts were approved by the Board of Directors on 9 June 2006 and signed on its behalf by:



John P Dorrier
Chief Executive Officer



David F DeCort
Chief Financial Officer

**CONSOLIDATED CASH FLOW STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 2005**

	<u>Notes</u>	<u>2005</u> \$'000	<u>2004</u> \$'000
Net cash inflow from operating activities	21	9,504	14,802
Interest received		1,619	143
Interest paid	5	<u>(3,292)</u>	<u>(2,916)</u>
Net cash outflow from returns on investments and servicing of finance		<u>(1,673)</u>	<u>(2,773)</u>
Capital expenditure			
Payments to acquire tangible fixed assets	11	(16,290)	(22,912)
Payments to acquire intangible fixed assets	12	<u>(35)</u>	<u>(895)</u>
Net cash outflow from capital expenditure		<u>(16,325)</u>	<u>(23,807)</u>
Financing			
Issue of ordinary share capital	19	56,651	1,187
Issue costs	19	(464)	—
Warrants exercised for cash	19	1,689	—
Contributions in a subsidiary undertaking	7	101	160
Receipt of loans less repayments prior to disposal of a subsidiary undertaking ..		2,803	35,236
Repayment of loans		(20,571)	(12,825)
Payment in respect of warrants — restructuring costs	3	(3,550)	—
Minority share — payment as a result of disposal of a subsidiary undertaking ...		<u>(11,183)</u>	<u>—</u>
Net cash inflow from financing		<u>25,476</u>	<u>23,758</u>
Increase in cash in the year		16,982	11,980
Cash at bank and in hand brought forward		<u>19,579</u>	<u>7,599</u>
Cash at bank and in hand carried forward		<u>36,561</u>	<u>19,579</u>
Non-cash investing and financing			
Non-cash capital contributions in subsidiary undertaking		—	2,250
Provision for decommissioning		2,604	1,352
Exceptional items:			
Loss on disposal of a subsidiary undertaking		1,244	—
Write off of goodwill on disposal of a subsidiary undertaking		1,286	—

The accompanying notes are an integral part of this consolidated cash flow statement.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

1. Accounting policies

1.1 Basis of preparation

The consolidated accounts have been prepared in accordance with applicable accounting standards in the United Kingdom and under the historical cost convention. In addition, these accounts have been prepared in accordance with the provisions of the Statement of Recommended Practice (SORP) "Accounting for Oil and Gas Exploration, Development, Production and Decommissioning Activities", issued by the UK Oil Industry Accounting Committee on 7 June 2001.

1.2 Basis of consolidation

Gulfsands Petroleum plc was incorporated on 2 December 2004 for the purpose of achieving admission to trading on Alternative Investment Market ("AIM") of the existing business of Gulfsands Petroleum Ltd. (which was originally established in 1997) and its subsidiaries. During February, March and April 2005, Gulfsands Petroleum plc acquired the entire share capital of Gulfsands Petroleum Ltd. by means of a share for share exchange. The transaction qualified as a group reconstruction within the meaning of Financial Reporting Standard 6 "Acquisition and Mergers", and has been accounted for using the merger accounting method.

These financial statements are the first statutory accounts for Gulfsands Petroleum plc and reflect the results for the year to 31 December 2005. The financial statements consolidate the accounts of Gulfsands Petroleum plc and all its subsidiary undertakings (the "Group"), drawn up to 31 December each year.

In the Group financial statements, merged subsidiary undertakings are treated as if they had always been a member of the Group. The results of such subsidiaries are included for the whole period in the year they join the Group. The corresponding figures for the previous year include their results for that period, the assets and liabilities at the previous balance sheet date and the shares issued by Gulfsands Petroleum plc as consideration as if they had always been in issue. The balance sheet of Gulfsands Petroleum Ltd. and its subsidiaries as at 31 December 2004 is presented as a proforma comparative. Any difference between the nominal value of the shares acquired and those issued by Gulfsands Petroleum plc to acquire them is taken to reserves.

Under the principles of merger accounting, the assets and liabilities of Gulfsands Petroleum Ltd. and its subsidiaries have been brought in at their book values under the accounting policies of Gulfsands Petroleum plc.

The results of subsidiaries acquired or sold are consolidated for the periods from or to the date control passed. Acquisitions are accounted for under the acquisition method, under which purchase consideration is allocated to the assets and liabilities on the basis of fair value at the date of acquisition.

The Company's consolidated statements include the accounts of undertakings when the Company has the power to exercise, or actually exercises, dominant influence or control over the undertaking.

No individual profit and loss account is presented in respect of the Company as permitted by section 230 of the Companies Act 1985. The Company's profit for the year was \$774,263.

A profit and loss account is required by the Companies Act 1985 to cover the first statutory accounting period of Gulfsands Petroleum plc from the date of incorporation on 2 December 2004 to 31 December 2005. The Directors consider that this profit and loss account is not different from the consolidated profit and loss account included in these accounts as there were no significant transactions from 2 December 2004 to 31 December 2004.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

1. Accounting policies (continued)

1.3 Reporting currency

The financial information is presented in U.S. dollars. The Company's operations and the majority of all costs associated with foreign operations are paid in U.S. dollars and not the local currency of the operations. Therefore, the reporting and functional currency is the U.S. dollar. Gains and losses from foreign currency transactions, if any, are recognised in current profit or loss for the period.

1.4 Oil and gas properties

The Group follows the full cost method of accounting for oil and gas properties under which expenditure on pre-license, license acquisition, exploration, appraisal and development activities is capitalised. All capitalised exploration and development expenditures are recorded within an appropriate cost pool within tangible fixed assets, except that certain exploration and appraisal costs may be held outside a cost pool pending determination of commercial reserves, within intangible fixed assets. The Group has two cost pools: USA and Syria.

Pre-license acquisition, exploration and appraisal costs of individual license interests held outside a cost pool remain un-depreciated pending determination but subject to there being no evidence of impairment. When a decision to develop an oil and gas property has been taken, or if there is evidence of impairment in value, the costs are transferred to the appropriate cost pool within tangible fixed assets.

1.5 Oil and gas reserves

The Group's definition of commercial reserves is proven and probable reserves. Proven and probable oil and gas reserves are estimated quantities of commercially producible petroleum which the existing geological, geophysical and engineering data show to be recoverable in future years. The proven reserves included herein conform to the definition approved by the Society of Petroleum Engineers ("SPE") and the World Petroleum Congress ("WPC"). The probable reserves included herein conform to definition of probable reserves approved by the SPE/WPC using the deterministic methodology.

1.6 Production assets

Impairment and ceiling test

When events or changes in circumstances indicate that the carrying amount of expenditure within a cost pool may not be recoverable from future net revenues from oil and gas reserves attributable to that pool, a comparison between the net book value of the cost pool and the discounted future cash flows from that cost pool is undertaken. To the extent that the carrying amount exceeds the recoverable amount, the pool is written down to its recoverable amount and charged as additional depreciation.

Depreciation, depletion and amortisation

Costs carried within each pool are depreciated on a unit of production basis using the ratio of oil and gas production in the period to the estimated quantity of commercial reserves at the end of the period plus production in the period. Costs in the unit of production calculation include the net book value of capitalised costs plus estimated future development costs. Changes in estimates of commercial reserves or future development costs are dealt with prospectively.

Decommissioning costs

Where a material liability for the removal of production facilities and site restoration at the end of the production life of a field exists, a provision for decommissioning is recognised. The amount recognised is the present value of estimated future expenditure determined in accordance with local conditions and requirements. Accretion expense is recognised to represent the unwinding of the discount of the present value of the provision for decommissioning. A tangible fixed asset of an amount equivalent to the provision is also created and depreciated on a unit of production basis. Changes in estimates are recognised prospectively, with corresponding adjustments to the provision and the associated fixed asset.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

1. Accounting policies (continued)

1.7 Other tangible fixed assets

Other tangible fixed assets are stated at cost less depreciation and any provision for impairment. Depreciation is provided at rates calculated to write off the cost, less estimated residual value, of assets on a straight-line basis over their estimated useful lives, generally 3 years.

The carrying values of other tangible fixed assets are reviewed for impairment when events or changes in circumstances indicate the carrying values may not be recoverable.

1.8 Debt

Debt is initially stated at the amount of the net proceeds after deduction of issue costs. The carrying amount is increased by the finance cost in respect of the period and reduced by payments made in the period.

Finance costs of debt are recognised in the profit and loss account over the term of the debt instrument at a constant rate on the carrying amount.

1.9 Revenue recognition

Oil sales revenue represents amounts invoiced (exclusive of sales related taxes) for the Group's share of oil and gas sales in the period, in addition to realised gains and losses from hedging activities (see note 27).

1.10 Operating leases

Rentals payable under operating leases are charged in the profit and loss account on a straight line basis over the lease term.

1.11 Taxation

Current tax, including UK corporation tax and overseas tax, is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantially enacted by the balance sheet date.

The liability method is used in accounting for deferred income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The realisability of deferred tax assets are evaluated annually and a valuation allowance is provided if it is more likely than not that the deferred tax asset will not give rise to future benefits in the Company's tax returns.

1.12 Derivative financial instruments

The Company uses forward crude oil and gas sales contracts and swaps to reduce exposure to fluctuations in the price of crude oil and natural gas in order to reduce the volatility of the cash flows of the Company. Contracts are only entered into to hedge physical positions related to the Company's crude oil and natural gas production and are, accordingly, accounted for as hedge transactions. The gain or loss arising on these instruments is deferred and recognised only when the hedged transaction occurs. The Company does not hold or issue derivative financial instruments for speculative purposes.

1.13 Share based compensation

The Company accounts for share based compensation using the intrinsic value method. Under the intrinsic value method the amount recognised is the difference between the fair value of the shares at the date of grant and the amount of consideration to be received for the shares. The amount initially recognised is allocated over the periods to which the employee's performance relates.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

1. Accounting policies (continued)

1.14 Cash at bank and in hand

The Company considers cash in hand and deposits repayable on demand with any qualifying financial institution, less overdrafts from any qualifying financial institution repayable on demand as cash at bank and in hand. Deposits are repayable on demand if they can be withdrawn at any time without notice and without penalty or if a maturity or period of notice of not more than 24 hours or one working day has been agreed. Cash at bank and in hand includes cash in hand and deposits denominated in foreign currencies.

The Company has classified as Cash at bank and in hand certain deposits that are not available for use in its operations. At 31 December 2005, the Company incurred a commitment as part of an escrow agreement to escrow funds for its future decommissioning provision associated with its oil and gas properties at an estimated undiscounted cost of \$17.4 million. At 31 December 2005, the Company had escrowed approximately \$14.6 million of cash for use in the settlement of its decommissioning provision (see note 17).

1.15 Goodwill

Goodwill is the difference between the amount paid on the acquisition of a business and the aggregate fair value of its separable net assets of which oil and gas exploration expenditure is the primary asset.

Goodwill is capitalised as an intangible fixed asset and is amortised and impaired on the same basis as the primary asset. If a subsidiary undertaking is subsequently sold, any goodwill arising on acquisition that has not been amortised through the profit and loss account is taken into account in determining the profit or loss on sale.

1.16 Foreign Currency

Foreign currency transactions of individual companies within the Group are translated in the individual companies' functional currency at the rates ruling when the transactions occurred. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date. All differences are taken to profit and loss account.

On consolidation, assets and liabilities of subsidiary undertakings which are denominated in foreign currencies are translated into US dollars at the rate ruling at the balance sheet date. Income and cash flow statements are translated at average rates of exchange prevailing during the year. Exchange differences resulting from the translation at closing rate of net investments in subsidiary undertakings together with differences between earnings for the year translated at average and closing rates, are dealt with in reserves.

1.17 Investments

Fixed asset investments are included in the balance sheet at cost, less provision for any impairment.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

2. Segmental information

The Group operates a single class of business being oil and gas exploration. All turnover in 2005 relates to income from the Group's oil and gas assets, and arose in USA.

The Group profit before interest for the year is analysed by geographical area as follows:

	<u>2005</u>	<u>2004</u>
	\$'000	\$'000
USA	6,274	9,198
Syria	(548)	(234)
Iraq	(1,505)	(651)
Colombia	—	(743)
Common costs	<u>(59)</u>	<u>(60)</u>
Group's profit before interest	4,162	7,510
Net interest	(2,714)	(4,009)
Tax on (loss)/profit on ordinary activities	(1,551)	1,038
Minority interests	<u>(3,845)</u>	<u>(2,917)</u>
(Loss)/profit for the year	<u>(3,948)</u>	<u>1,622</u>

Common costs have not been apportioned to geographical areas.

The net operating assets are analysed by geographical area as follows:

	<u>2005</u>	<u>2004</u>
	\$'000	\$'000
Operating Assets:		
USA	38,792	68,038
Syria	5,440	1,340
Iraq	1	38
Unallocated	<u>21</u>	<u>—</u>
	<u>44,254</u>	<u>69,416</u>
Non-operating assets:		
USA	14,757	18,482
Syria	3,295	7
Iraq	101	—
Colombia	—	6
Unallocated	<u>18,408</u>	<u>1,084</u>
	<u>36,561</u>	<u>19,579</u>

The decrease in operating assets for USA from 2004 to 2005 is due to the disposal of the subsidiary, Northstar Gulfsands LLC as set out in note 3.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

3. Exceptional items

On 9 December 2005, one of the subsidiaries of the Company, Gulfsands Petroleum USA, Inc. ("GP USA") redeemed its membership interest (52.6%) in Northstar Gulfsands LLC (a limited liability company registered in Texas) ("NSGS") in return for the partition of certain assets in NSGS. This was accomplished by a conveyance of a certain undivided interest in its oil and gas properties to GP USA and the retention of the remaining interest therein to NSGS together with certain other assets. As a result of this partition and redemption agreement, NSGS has ceased to be a subsidiary of GP USA. However, the Group will continue to earn its share of turnover from certain oil and gas properties owned and managed by NSGS. Therefore, in accordance with Financial Reporting Standard 3 ("Reporting Financial Performance"), the Directors do not consider this change in arrangement as a discontinued operation as the disposal of NSGS does not have a material effect on the nature and focus of the Group's operations.

As a result of this change in arrangement, the Company recognized a loss on the disposal of \$1,243,583, wrote off the unamortised goodwill of \$1,285,714, and incurred restructuring costs of \$3,550,000. The restructuring cost of \$3,550,000 represents payment made in respect of 52.6% of the outstanding warrants in NSGS as at the time of the partition.

4. Operating profit

This is stated after charging/ (crediting):

	<u>2005</u>	<u>2004</u>
	\$'000	\$'000
Foreign exchange gain	(412)	—
Auditors' remuneration:		
— Audit services	36	87
— Non-audit services	58	31
Depreciation on owned tangible fixed assets	6,157	7,958
Depreciation and impairment on intangible assets	—	1
Amortisation of goodwill	—	107
Operating lease rentals:		
— buildings	245	122
— auto and equipment	35	42

5. Interest payable and similar charges

	<u>2005</u>	<u>2004</u>
	\$'000	\$'000
Debt amortisation	1,040	424
Other loans	3,292	3,053
	<u>4,332</u>	<u>3,477</u>

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

6. Tax on (loss)/profit on ordinary activities

	<u>2005</u>	<u>2004</u>
	\$'000	\$'000
Corporation tax	(340)	—
Deferred tax:		
Net operating loss and capital loss carry forwards	(1,659)	1,707
Basis differences in oil and gas properties and other fixed assets	448	(669)
	<u>(1,551)</u>	<u>1,038</u>

The effective tax rates applicable to continuing operations are as follows:

	<u>2005</u>	<u>2004</u>
Expected tax rate	30%	34%
Expenses not deductible for tax purposes	5%	9%
Net operating loss and capital loss	72%	(53)%
Basis differences in oil and gas properties and property and equipment	—	(7)%
Income not taxable for tax purposes	<u>—</u>	<u>(13)%</u>
	<u>107%</u>	<u>(30)%</u>

7. Minority interests

As a result of the change in arrangement, all minority equity interest resulting from the disposal of NSGS was eliminated (as disclosed in note 3). The minority interest expense in the consolidated profit and loss account mostly represents the minority's 47.4% share of the net income of the former subsidiary — NSGS.

Equity Minority Interests

	\$'000
At 1 January 2005	7,873
Loss on ordinary activities after taxation — Darcy Energy LLC	(13)
Profit on ordinary activities after taxation — Northstar Gulfsands LLC	3,858
Contributions	101
Effect of change in joint arrangement	<u>(11,559)</u>
At 31 December 2005	<u>260</u>

Minority Interest Expense

	\$'000
Minority share — loss on ordinary activities after taxation — Darcy Energy LLC	13
Minority share — profit on ordinary activities after taxation — Northstar Gulfsands LLC ...	<u>(3,858)</u>
	<u>(3,845)</u>

8. (Loss)/earnings per share

The basic loss per ordinary share is based on the loss for the period of \$3,948,000 (2004: profit of \$1,622,000) and weighted average number of shares of 85,442,295 (2004: 68,075,000).

In respect of 2005, the diluted loss per ordinary share is considered to be the same as inclusion of share options would be anti dilutive. The 2004 diluted earnings per share is based on profit for the period of \$1,622,000 and diluted weighted average number of shares of 93,376,637.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

9. Directors' remuneration and share options

The Directors' remuneration in respect of the Company are as follows:

	2005			2004	
	Salaries \$'000	Bonus \$'000	Benefits in kind \$'000	Total \$'000	Total \$'000
Executive					
John Dorrier	263	—	117	380	248
David DeCort	225	—	113	338	204
Mahdi Sajjad	272	—	—	272	220
Non-executive					
Malcolm Butler	21	—	—	21	—
Charles Stonehill	19	—	—	19	—
John Bolsover	40	—	—	40	—
	<u>840</u>	<u>—</u>	<u>230</u>	<u>1,070</u>	<u>672</u>

John Dorrier in his capacity as the Chief Executive is the highest paid director. 2004 figures represent directors' remuneration paid to directors of Gulfsands Petroleum Ltd.

Share options

During the year, 2,640,000 share options were issued under the 2005 Stock Option Plan (the "Plan") at an exercise price of £1.30:

- On 31 March 2005, 400,000 share options were issued to two individuals relating to the project in Iraq;
- On 4 April 2005 and on 15 November 2005, 1,850,000 share options were issued to the Directors of the Company;
- On 4 April 2005, 75,000 share options were issued to an employee of one of the subsidiaries of the Company;

The remainder of the share options totaling 315,000 were issued to the employees of the Company during the year. The share options are exercisable immediately unless there is a vesting schedule. The term of each share option was five years from the date of grant. The exercise price of the share options was equal to the market price of the share as at the date of grant. The Board of Directors is responsible for administering the Plan, determining the terms upon which options may be granted, prescribing, amending and rescinding such interpretations and determinations and granting options.

The market price of the shares on 31 December 2005 was £0.92 and the range during the year was £0.88 to £1.30.

Share options issued prior to the share for share exchange were held in Gulfsands Petroleum Ltd. and were initially converted into an equivalent number of share options in the Company at the date of acquisition. The share options and the exercise price were restated on 4 April 2005 following subdivision of the ordinary shares in the Company (see following page).

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

9. Directors' remuneration and share options (continued)

The share options held by Directors (all fully vested) are exercisable from 18 February 2005, at the time of the share for share exchange, and ending at the following dates (excluding item (f)):

(a) 25 November 2008 (b) 2 August 2006 (c) 1 January 2008 (d) 17 October 2008 (e) May 2005
(f) 5 April 2005 and 5 April 2010

	<u>Exercise price</u>	<u>Restated at 4 April 2005</u>	<u>Exercised</u>	<u>Granted during the year</u>	<u>Total</u>
John Dorrier	(a) \$0.11	1,487,500	—	—	1,487,500
	(b) \$0.23	1,487,500	—	—	1,487,500
	(c) \$.043	700,000	—	—	700,000
	(d) \$0.57	1,137,500	—	—	1,137,500
	(f) £1.30	—	—	500,000	500,000
			<u>4,812,500</u>	<u>—</u>	<u>500,000</u>
David DeCort	(a) \$0.11	875,000	—	—	875,000
	(b) \$0.23	875,000	—	—	875,000
	(c) \$.043	568,750	—	—	568,750
	(d) \$0.57	875,000	—	—	875,000
	(f) £1.30	—	—	450,000	450,000
			<u>3,193,750</u>	<u>—</u>	<u>450,000</u>
David Cowan	(b) \$0.23	218,750	—	—	218,750
	(d) \$0.57	175,000	—	—	175,000
	(e) \$0.20	218,750	*(218,750)	—	—
		<u>612,500</u>	<u>(218,750)</u>	<u>—</u>	<u>393,750</u>
Charles Stonehill	(f) £1.30	—	—	125,000	125,000
		—	—	125,000	125,000
Malcolm Butler	(f) £1.30	—	—	125,000	125,000
		—	—	125,000	125,000
John Bolsover	(f) £1.30	—	—	200,000	200,000
		—	—	200,000	200,000
		<u>8,618,750</u>	<u>(218,750)</u>	<u>1,400,000</u>	<u>9,800,000</u>

In addition **Nordman has been granted options as follows:

Nordman Continental S.A.	(b) \$0.23	1,312,500	—	—	1,312,500
	(c) \$.043	568,750	—	—	568,750
	(d) \$0.57	875,000	—	—	875,000
	(e) \$0.20	437,500	(437,500)	—	—
	(f) £1.30	—	—	450,000	450,000
			<u>3,193,750</u>	<u>(437,500)</u>	<u>450,000</u>
		<u>11,812,500</u>	<u>(656,250)</u>	<u>1,850,000</u>	<u>13,006,250</u>

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

9. Directors' remuneration and share options (continued)

* At the date of exercise of these options, the market price of the shares was £0.99 and the exercise price was \$0.20 resulting in a gain of \$331,494.

** Nordman is owned by the IT — 5483 Trust, Grand Cayman, which is a discretionary trust, the trustees of which are Shelter Trust Anstalt Liechtenstein. Mr. Mahdi Sajjad's children are potential beneficiaries under the Trust.

10. Staff costs

The aggregate payroll costs of staff and Directors were as follows:

	<u>Year ended 31 December</u>	
	<u>2005</u>	<u>2004</u>
	<u>\$'000</u>	<u>\$'000</u>
Wages and salaries.....	1,144	494
Social security costs.....	107	23
	<u>1,251</u>	<u>517</u>

The average monthly number of persons employed by the Group, including Directors was as follows:

	<u>Year ended 31 December</u>	
	<u>2005 Number</u>	<u>2004 Number</u>
Finance, technical and administration:	26	10

11. Tangible fixed assets

	<u>Oil and gas properties</u>	<u>Other fixed assets</u>	<u>Total</u>
	<u>\$'000</u>	<u>\$'000</u>	<u>\$'000</u>
At 1 January 2005	64,713	61	64,774
Additions.....	16,167	123	16,290
Transfer from Intangible fixed assets	1,339	—	1,339
Disposal of a subsidiary (note 3)	(35,156)	(116)	(35,272)
Disposals.....	—	(18)	(18)
At 31 December 2005	<u>47,063</u>	<u>50</u>	<u>47,113</u>
<i>Accumulated depreciation:</i>			
At 1 January 2005	(8,702)	(34)	(8,736)
Charge for the period	(6,139)	(18)	(6,157)
Disposal of a subsidiary (note 3)	6,985	13	6,998
Disposals.....	—	18	18
At 31 December 2005	<u>(7,856)</u>	<u>(21)</u>	<u>(7,877)</u>
Net book value at 31 December 2005	<u>39,207</u>	<u>29</u>	<u>39,236</u>
Net book value at 31 December 2004	<u>56,011</u>	<u>27</u>	<u>56,038</u>

The Directors have assessed the carrying value of the oil and gas properties and in their opinion, no impairment provision is considered necessary.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

12. Intangible fixed assets

	Oil and gas properties - unevaluated costs	Goodwill	Computer software	Total
	\$'000	\$'000	\$'000	\$'000
At 1 January 2005	1,339	1,500	10	2,849
Additions	—	—	35	35
Transfer to tangible fixed assets	(1,339)	—	—	(1,339)
Disposals	—	(1,500)	(7)	(1,507)
At 31 December 2005	—	—	38	38
<i>Accumulated depreciation:</i>				
At 1 January 2005	—	(214)	(6)	(220)
Charge for the period	—	—	—	—
Disposals	—	214	3	217
At 31 December 2005	—	—	(3)	(3)
Net book value at 31 December 2005	—	—	35	35
Net book value at 31 December 2004	1,339	1,286	4	2,629

13. Fixed asset investments

<u>Company</u>	<u>Shares in subsidiary undertaking \$'000</u>
Cost:	
Acquisition of Gulfsands Petroleum Ltd. (Note 19)	7,306
At 31 December 2005	7,306

The Company's fixed asset investment represents the Company's acquisition of the entire share capital of Gulfsands Petroleum Ltd. by means of a share for share exchange as explained in note 1.2. The Company issued 7,779,998 ordinary shares at nominal value of 50p each (note 18) in exchange for 7,779,998 ordinary shares at nominal value of \$0.001 in Gulfsands Petroleum Ltd. The investment in Gulfsands Petroleum Ltd. is recorded in the Company's balance sheet at the nominal value of the shares issued.

The Company has investments in the following subsidiary undertakings which principally affected the results or net assets of the Group. All investments are in ordinary shares and are indirectly owned by the Company unless otherwise stated:

<u>Name of Company</u>	<u>Proportion of voting shares at 31 December 2005</u>	<u>Nature of business</u>	<u>Country of incorporation</u>
<i>Directly held by the Company:</i>			
Gulfsands Petroleum Ltd.	100.00%	Holding company	Cayman Islands
<i>Indirectly held by the Company:</i>			
Gulfsands Petroleum Holdings Ltd. ...	100.00%	Holding company	Cayman Islands
Gulfsands Petroleum Colombia Ltd. ..	100.00%	Oil & gas exploration	Cayman Islands
Gulfsands Petroleum Syria Ltd.	100.00%	Oil & gas exploration	Cayman Islands
Gulfsands Petroleum Iraq Ltd.	100.00%	Oil & gas exploration	Cayman Islands
Gulfsands Petroleum USA, Inc.	100.00%	Oil & gas exploration	US
Darcy Energy LLC	83.07%	Oil & gas exploration	US

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

14. Debtors

	<u>Group 2005</u>	<u>2004</u>	<u>Company 2005</u>
	\$'000	\$'000	\$'000
Trade debtors	3,549	6,918	—
Other debtors	182	85	—
Underlift	919	1,748	—
Prepayments and accrued income	333	960	15
Amounts due from subsidiary undertakings	—	—	39,076
Deferred tax asset	—	1,038	—
	<u>4,983</u>	<u>10,749</u>	<u>39,091</u>

Underlift at 31 December 2005 represents underlift acquired as a result of the acquisition of oil and gas properties in May 2004. In accordance with FRS 5, underlift represents a right to future economic benefit (through entitlement to receive equivalent future production), which constitutes an asset. This amount is due after more than one year.

15. Creditors

<u>Amounts falling due within one year</u>	<u>Group 2005</u>	<u>2004</u>	<u>Company 2005</u>
	\$'000	\$'000	\$'000
Trade creditors	236	6,180	40
Other loans	—	5,619	—
Other creditors — decommissioning (see note 17)	2,860	4,814	—
UK Corporation tax payable	340	2,075	340
	<u>3,436</u>	<u>18,688</u>	<u>380</u>
<u>Amounts falling due after more than one year</u>	<u>Group 2005</u>	<u>2004</u>	<u>Company 2005</u>
	\$'000	\$'000	\$'000
Other loans	—	29,947	—
	<u>—</u>	<u>29,947</u>	<u>—</u>

The loans were repaid as a result of disposal of a subsidiary undertaking.

16. Deferred tax liabilities

	<u>2005</u>
	\$'000
Deferred tax liability — accelerated oil and gas tax depreciation allowances	221
Deferred tax asset — net operating losses	(48)
At 31 December 2005	<u>173</u>

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

17. Provision for liabilities and charges

The provision for decommissioning relates to the expected discounted future costs of plugging and abandoning the oil and gas properties held by Gulfsands Petroleum USA, Inc and Darcy Energy LLC. The provision for decommissioning is estimated after taking account of inflation, years to abandonment, and borrowing rates. At 31 December 2005 the oil and gas properties have estimated plugging and abandonment dates between 2006 and 2017. The portion of the provision for decommissioning expected to be settled in 2006 totaling approximately \$2.86 million is included in creditors: amounts falling due within one year (see note 15) and the remainder totaling approximately \$6.96 million is included in provision for liabilities and charges in the consolidated balance sheet at 31 December 2005.

The provision for decommissioning is as follows:

	\$'000
At 1 January 2005 (including \$4,814,000 shown in current liabilities)	21,241
Liabilities settled during the period	(5,206)
Additions	13
Current year accretion of net present value of decommissioning provision	2,604
Reduction due to change in joint arrangement (Note 3)	<u>(8,834)</u>
At 31 December 2005	9,818
Less: current portion (classified within creditors: amounts falling due within one year) ..	<u>(2,860)</u>
	<u>6,958</u>

18. Share capital

Gulfsands Petroleum Plc was incorporated on 2 December 2004 with an authorised share capital of £10,000,000 divided into 17,840,000 ordinary shares and 2,160,000 convertible redeemable shares of 50p each. On 4 April 2005, the authorised share capital was subdivided into 8.75 ordinary shares resulting in 175,000,000 ordinary shares.

On 4 January 2005, the Company redesignated 2,160,000 ordinary shares of 50p as 2,160,000 convertible redeemable shares, having the rights set out in the new articles of association of the Company as described in paragraph 3 of Part 5 of the AIM admission document.

On 18 February 2005, the Company issued 5,349,998 ordinary shares of 50p each and 2,160,000 convertible redeemable shares as consideration for the acquisition of the entire share capital of Gulfsands Petroleum Ltd. Subsequently on 1 April 2005 the company issued 270,000 ordinary shares of 50p each as consideration for the acquisition of 270,000 shares in Gulfsands Petroleum Ltd. following the exercise of warrants in that company. By a resolution of the members passed 4 April 2005, each of the ordinary shares of 50p each was subdivided into 8.75 ordinary shares. Following this subdivision, the conversion rate of the convertible redeemable shares was adjusted such that each convertible redeemable share was convertible into 8.75 ordinary shares.

On 8 April 2005, 24,300,000 new shares were issued for cash — placement at £1.30 each raising \$57 million. The share premium resulting from the placement amounted to \$54 million.

During the year, 656,250 share options were exercised for cash, as disclosed in note 9 of the accounts.

NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005

18. Share capital (continued)

The movements in the share capital and options are summarised below:

	<u>2005 Number</u>	<u>2004 Number</u>	
<i>Authorised:</i>			
Ordinary Shares (par value 5.714p per share)	175,000,000	175,000,000	
	<u>175,000,000</u>	<u>175,000,000</u>	
Allotted, called up and fully paid 93,031,250 ordinary shares of 5.714p each			
	<u>Number of ordinary shares</u>		<u>Number of convertible redeemable shares number</u>
	<u>Number</u>	<u>Number</u>	
Issued on subscription	—	2	—
<i>Share for share exchange — Gulfsands Petroleum Ltd.</i>			
Ordinary share capital issued on 18 February 2005	5,349,998	—	2,160,000
Additional shares issued following exercise of warrants in Gulfsands Petroleum Ltd. on 1 April 2005	<u>270,000</u>	—	—
	5,619,998	2	2,160,000
Conversion of convertible redeemable shares to ordinary shares issued on 18 February 2005 ..	<u>2,160,000</u>	—	<u>(2,160,000)</u>
Total number of shares issued — share for share exchange	—	<u>7,779,998</u>	—
	—	7,780,000	—
Sub-division of shares 8.75	—	68,075,000	—
Shares issued on placement (note 19)	—	24,300,000	—
Share options exercised for cash (note 9)	—	<u>656,250</u>	—
At 31 December 2005	—	<u>93,031,250</u>	—

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

19. Reserves

Group

	<u>Share capital</u> \$'000	<u>Share premium account</u> \$'000	<u>Other reserve</u> \$'000	<u>Profit and loss account</u> \$'000	<u>Total</u> \$'000
At 1 January 2005	7,306	—	10,149	(1,395)	16,060
Share premium arising on exercise of warrants in Gulfsands Petroleum Ltd.	—	—	1,560	—	1,560
Share options exercised	71	58	—	—	129
Shares issued on placement	2,594	54,057	—	—	56,651
Issue costs of shares	—	(464)	—	—	(464)
Retained loss for the year	—	—	—	(3,948)	(3,948)
At 31 December 2005	<u>9,971</u>	<u>53,651</u>	<u>11,709</u>	<u>(5,343)</u>	<u>69,988</u>

The Group's share capital as at 1 January 2005 was restated to take account of share for share exchange as a result of the merger as disclosed in note 1.2. The Company issued 7,779,998 ordinary shares at nominal value of 50p each in exchange for 7,779,998 ordinary shares at nominal value of \$0.001 in Gulfsands Petroleum Ltd. The ordinary shares in the Company were subdivided by 8.75 on 4 April 2005. The nominal value of the ordinary shares issued by the Company amounted to \$7,306,976 whereas the nominal value of the ordinary shares in Gulfsands Petroleum Ltd. as at the date of merger amounted to \$7,000. The difference of \$7,299,000 is taken to other reserve.

Other reserve of \$10,149,000 as at 1 January 2005 represent share premium of Gulfsands Petroleum Ltd. of \$17,448,000 less the merger reserve of \$7,299,000. The share premium of \$1,560,000 arising on exercise of warrants in Gulfsands Petroleum Ltd., subsequent to 1 January 2005, has also been taken to other reserve as it relates to the acquisition of Gulfsands Petroleum Ltd. in a share for share exchange as referred to above.

<u>Company</u>	<u>Share capital</u> \$'000	<u>Share premium account</u> \$'000	<u>Other reserve</u> \$'000	<u>Profit and loss account</u> \$'000	<u>Total</u> \$'000
At 1 January 2005	—	—	—	—	—
Share for share exchange	7,306	—	—	—	7,306
Share options exercised	71	58	—	—	129
Shares issued on placement	2,594	54,057	—	—	56,651
Issue costs of shares	—	(464)	—	—	(464)
Retained profit for the year	—	—	—	775	775
At 31 December 2005	<u>9,971</u>	<u>53,651</u>	<u>—</u>	<u>775</u>	<u>64,397</u>

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

20. Reconciliation of movements in shareholders' funds

	<u>2005</u>	<u>2004</u>
	\$'000	\$'000
(Loss)/profit for the year	(3,948)	1,622
Share options and warrants exercised	1,689	—
Revaluation reserve	—	212
Shares issued on placement	56,651	—
Issue costs of shares	<u>(464)</u>	<u>—</u>
Net additions to shareholders' funds	53,928	1,834
Opening shareholders' funds	<u>16,060</u>	<u>14,226</u>
Closing shareholders' funds	<u>69,988</u>	<u>16,060</u>

21. Reconciliation of operating profit to net cash inflow from operating activities

	<u>2005</u>	<u>2004</u>
	\$'000	\$'000
Operating profit	10,242	7,510
Depreciation	6,157	7,959
Accretion of net present value decommissioning provision	2,604	1,352
Goodwill amortised	—	107
Increase/(decrease) in debtors excluding deferred tax assets	4,726	(7,828)
(Decrease)/increase in creditors, excluding provision for liabilities and charges	<u>(14,225)</u>	<u>5,702</u>
Net cash inflow from operating activities	<u>9,504</u>	<u>14,802</u>

22. Analysis of change in net (debt)/funds

	At 1 January 2005	Net cash flows	Non-cash movements	Minority share	At 31 December 2005
	\$'000	\$'000	\$'000	\$'000	\$'000
Cash at bank and in hand	<u>19,579</u>	<u>28,165</u>	—	<u>(11,183)</u>	<u>36,561</u>
Net cash	19,579	28,165	—	(11,183)	36,561
Debt due after one year	(29,947)	12,519	(1,109)	18,537	—
Debt due within one year	<u>(5,250)</u>	<u>5,250</u>	—	—	—
Net (debt)/funds	<u>(15,618)</u>	<u>45,934</u>	<u>(1,109)</u>	<u>7,354</u>	<u>36,561</u>

23. Reconciliation of net cash flow to movements in net funds/(debt)

	<u>2005</u>	<u>2004</u>
	\$'000	\$'000
Increase in cash in the period	16,982	11,980
Cash inflow/(outflow) from increase in debt	<u>17,769</u>	<u>(22,412)</u>
Change in net debt resulting from cash flows	34,751	(10,432)
Amortisation expense	(1,109)	(192)
Minority share	<u>18,537</u>	<u>—</u>
Movement in net funds/(debt)	52,179	(10,624)
Opening net debt	<u>(15,618)</u>	<u>(4,994)</u>
Closing net funds/(debt)	<u>36,561</u>	<u>(15,618)</u>

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

24. Commitments

Operating leases

Annual commitments under operating leases are as follows:

	2005		2004	
	Land & buildings \$'000	Other \$'000	Land & buildings \$'000	Other \$'000
Leases Expiring within one year	185	—	—	—
Leases Expiring within two years	71	58	139	—
Leases Expiring three years and beyond	<u>577</u>	<u>9</u>	<u>—</u>	<u>116</u>
	<u>833</u>	<u>67</u>	<u>139</u>	<u>116</u>

25. Capital commitments

There are no obligations or contracts outstanding in relation to ongoing projects not provided for in the financial statements at 31 December 2005.

26. Contingent liabilities

Due to the nature of the Group's business, some contamination of the real estate property owned or leased by the Group is possible. Environmental site assessments of the property would be necessary to adequately determine remediation costs, if any. Management of the Group does not consider the amounts that would result from any environmental site assessments to be significant to the financial position or results of operations of the Group. Accordingly, except for the provision made against decommissioning costs (note 17), no further provision for potential remediation costs is reflected in the accompanying financial statements.

27. Financial instruments and derivatives

Risk assessment

The Group's oil and gas activities are subject to a range of financial and operational risk, as described below which can significantly impact its performance.

Liquidity rate risk

The overriding financial risk to the Group during 2005 was not that of liquidity. The Group started the year with considerable funds to progress its expanding exploration portfolio and those cash resources were enhanced during the year by the admission to trading on the AIM Market. At the end of the year the Group had cash in hand of \$36 million.

Cash forecasts identifying the liquidity requirements of the Group are produced frequently. These are reviewed regularly by management and the board to ensure that sufficient financial headroom exists for at least a 12 month period. With the Group's Syria drilling programme scheduled and the Gulf of Mexico activities, the Board is also keen to ensure that there also exists a sufficient reserve for expansion.

With surplus funds and all debt repaid during 2005, the Group ended the year in a strong cash position. The current strategy of no debt will continually be reviewed in the light of developments with existing projects and new project opportunities as they arise.

Currency risk

The Group has minimal currency exposure arising from transactions, as most of its transactions were in its functional currency.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

27. Financial instruments and derivatives (continued)

Operational risk

Operational risks include equipment failure, well blowouts, pollution, fire and the consequences of bad weather. Where the Group is a project operator of either a producing field or an exploration drilling programme, it takes increased responsibility for ensuring that all relevant legislation is met, and that all partners have appropriate insurance cover in place. The Group's insurance policies contain overall limits and deductibles, which are reviewed each year prior to policy renewal.

Financial assets

The Group's financial assets consist of cash at bank and debtors. The interest rate profile at 31 December for these assets was as follows:

	Financial assets on which floating rate interest is earned	Financial assets on which no interest is earned	Total
	<u>\$'000</u>	<u>\$'000</u>	<u>\$'000</u>
2005			
US Dollar	31,926	8,592	40,518
UK Sterling	934	82	1,016
Syrian Pound	<u>—</u>	<u>10</u>	<u>10</u>
	<u>32,860</u>	<u>8,684</u>	<u>41,544</u>
2004			
US Dollar	16,873	13,455	30,328
UK Sterling	<u>—</u>	<u>—</u>	<u>—</u>
Syrian Pound	<u>—</u>	<u>—</u>	<u>—</u>
	<u>16,873</u>	<u>13,455</u>	<u>30,328</u>

The UK sterling assets are comprised of cash on call accounts. The US dollar assets represent cash on call accounts, money market accounts, and short term debtors. The Group earned interest on its interest bearing financial assets at rates between 1.3% and 3.88%. All financial assets on which no interest is earned are considered immediately available to turn into cash on demand.

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

27. Financial instruments and derivatives (continued)

Financial liabilities

The Group's financial liabilities consist of short term creditors and decommissioning liabilities. The interest rate profile at 31 December of these liabilities is shown below:

	<u>Financial liabilities on which no interest paid</u> \$'000
2005	
US Dollar	(10,014)
UK Sterling	<u>(380)</u>
	<u>(10,394)</u>
2004	
US Dollar	(35,115)
UK Sterling	<u>—</u>
	<u>(35,115)</u>

The Group's short term creditors are considered payable on demand. The Group's decommissioning liabilities that are due within one year amounted to \$2.86 million and the balance of \$6.96 million is due after more than one year. Further details of the decommissioning liabilities are set out in notes 15 and 17.

In respect of the year ended 31 December 2004, the financial liabilities are made up of accrued interest and related loan decommissioning liabilities and short term creditors.

Derivatives

The Group has exposure to changes in oil and gas prices. The Group utilises derivative financial instruments to reduce exposure to market risks resulting from fluctuations in oil and gas prices in order to reduce the volatility of the cash flows of the Group.

The Group has entered into forward swap contracts as of 31 December 2005 and 2004. The counter-parties to the contracts are non-related third parties. The contracts settle monthly and are scheduled to coincide with either oil production equivalent to barrels ("bbi") per month or gas production equivalent to volumes in millions of British thermal units ("MMbtu") per month. The contracts represent agreements between the Group and the counter-parties to exchange cash based on a designated price. Prices are referenced to oil or natural gas futures contracts traded on either the Houston Ship Channel/Beaumont, Texas index or on the New York Mercantile Exchange ("NYMEX") index. Cash settlement occurs monthly based on the floating price. The Group accounts for any realised gains and losses from the contracts as adjustments to turnover in the period of the settlement.

	\$'000
Unrecognised losses at 1 January 2004	1,317
Gains and losses arising in previous years that were recognised in the period	(1,317)
Gains and losses arising in the period that were not recognised in the period	<u>2,719</u>
Unrecognised losses at 31 December 2004	<u>2,719</u>
Unrecognised losses at 1 January 2005	2,719
Gains and losses arising in previous years that were recognised in the period	(2,719)
Gains and losses arising in the period that were not recognised in the period	<u>5,676</u>
Unrecognised losses at 31 December 2005	<u>5,676</u>

**NOTES TO THE CONSOLIDATED ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 2005**

27. Financial instruments and derivatives (continued)

Fair values

At 31 December 2005 and 2004, the fair value and book value of the Group's financial assets and liabilities were materially the same.

28. Related party transactions

There were no related party transactions during the year ended 31 December 2005.

29. Ultimate controlling party

Ultimate control is exercised by the shareholders of Gulfsands Petroleum plc.