

**CARNARVON PETROLEUM LIMITED**

ABN 60 002 688 851

**AND ITS CONTROLLED ENTITIES**

**ANNUAL FINANCIAL REPORT**

**30 JUNE 2006**

## **CORPORATE DIRECTORY**

### **Directors**

PJ Leonhardt (Chairman)  
EP Jacobson (Chief Executive Officer)  
NC Fearis (Non-Executive Director)  
KP Judge (Non-Executive Director)

### **Company Secretary**

RA Anderson

### **Auditors**

Grant Thornton Western Australian Partnership

### **Bankers**

Australia and New Zealand Banking Group Limited

### **Registered Office**

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Website: www.carnarvonpetroleum.com

### **Share Registry**

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Investor Enquiries: 1300 557 010 (within Australia)  
Investor Enquiries: +61 3 9415 4000 (outside Australia)  
Facsimile: +61 8 9323 2033

### **Stock Exchange Listing**

Securities of Carnarvon Petroleum Limited are listed on the Australian Stock Exchange.

ASX Code: CVN - ordinary shares

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**CARNARVON PETROLEUM LIMITED**  
**FINANCIAL REPORT 30 JUNE 2006**  
**CHAIRMAN'S STATEMENT**

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Dear Shareholders

This year has seen several significant building blocks put in place for Carnarvon, which the directors believe reflect a new start in the Company's long history.

In December 2005 Ted Jacobson was appointed as a non-executive director, but was soon persuaded to apply his significant technical and commercial experience in the capacity of Chief Executive Officer. Recently retired from Tap Oil Limited, where he was a co-founder and technical director, Ted is a petroleum geophysicist with 37 years experience in petroleum exploration principally in the North Sea, South East Asia, South America and Australia. Within Australia he has been responsible for initiating a number of petroleum discoveries within the Cooper Basin, Barrow Sub Basin, and Timor Sea.

The directors view his appointment as a key step in establishing the Company's technical credentials, and gaining market recognition that Carnarvon has the capability to not only capitalise on the immediate production and exploration opportunities in the Wichian Buri oilfield and surrounding exploration acreage within onshore Thailand, but to also actively pursue other new venture opportunities.

In late 2005 Carnarvon settled litigation with its joint venture partner in Thailand, Tiger Petroleum Inc. This followed the acquisition of Tiger by Pan Orient Energy Corp., a Canadian TSX listed oil and gas company with recognised technical expertise and financial strength. An excellent working relationship has since been established with Pan Orient as the new operator and this is now reflected in the pace of exploration and appraisal activity in the field.

A new 245 square km 3D seismic programme and a 2D reprocessing programme were completed in June. The joint venture is currently in phase one of a two phase drilling programme, comprising up to 27 wells. The results of these wells will allow the Company to update reserves for the Wichian Buri oilfield and will explore the many prospects identified from the new seismic data.

As part of the Company's restructure, the corporate office relocated from Melbourne to Perth in early 2006. Having regard for the move to Perth and the new Board appointments last financial year, Mr Andrew Shelton and Mr David Orth resigned during the year. On behalf of the Board, I wish to thank them for their service to the Company.

The establishment of a new management team with strong technical and commercial experience in oil and gas, together with the revitalisation of the Wichian Buri Joint Venture arrangements, has allowed the Company to successfully access the capital markets. \$4.7 million was raised in the 2006 financial year by way of placements to both new and existing shareholders. In addition, \$3.5 million has been raised subsequent to year end, including \$1 million from an oversubscribed Share Purchase Plan.

I am confident that the progress made over the last twelve months provides the right platform to realise the full potential of the Wichian Buri field and the significant exploration upside that is now emerging as a result of the recent technical work. At the same time an active new ventures programme has been initiated.

We have an excellent small but growing team and I would like to thank them for their outstanding contributions. I look forward to working with them and my fellow directors as we enter an exciting period in the development of our Thai interests.



**Peter Leonhardt**  
Chairman

## **FINANCIAL SUMMARY**

The consolidated entity's loss after income tax for the year ended 30 June 2006 was \$758,150, compared to a \$1,007,325 loss in 2005.

Carnarvon's share of the cash operating profit of the SWIA joint venture of \$343,151 (2005: \$248,666) was augmented by a \$488,182 net profit on the divesture of its interests in PRL's 4 and 5 in Papua New Guinea to its joint venture partners.

Corporate and administration costs for the year were \$1,626,690, compared to \$1,276,735 in the previous corresponding period. This movement primarily reflects an increase in share based payments expense of \$479,083 resulting from options issued during the period, partly offset by a reduction in legal fees of \$156,834 following the settlement of litigation with the SW1A joint venture partner during the first half of the year.

### **SW1A JOINT VENTURE, THAILAND (Carnarvon Petroleum Ltd 40%; Pan Orient Energy Corp. 60%)**

Carnarvon has a 40% interest in the SW1A Joint Venture, which includes the Wichian Buri Oilfield, Si Thep Oilfield and exploration blocks L44/43 and L33/43. During the year, Tiger Petroleum Inc., the 60% joint venture partner and operator of the permits, was acquired by Calgary-based Pan Orient Energy Corp. ("POE"). As a result of the acquisition, POE assumed operatorship of the permits.



During the year Carnarvon, through its renamed subsidiary Carnarvon Thailand Ltd, reached a settlement in the legal proceedings against Tiger Petroleum Inc. for breaches of the joint venture agreements. The settlement terms of the litigation included POE funding US\$350,000 of Carnarvon Thailand Ltd's share of the cost of the first two wells of the Phase I drill programme, a restructure of the joint venture to ensure both parties commercial interests were adequately protected, and confirmation that Carnarvon Thailand Ltd is entitled to a 40% interest in exploration block L33/43.

**CARNARVON PETROLEUM LIMITED**  
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**OPERATING AND FINANCIAL REVIEW (CONTINUED)**

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***Production and financial data***

The consolidated entity's revenue from continuing operations for the year ended 30 June 2006, being its share of the SW1A Joint Venture operations in Thailand, was \$1,090,213 (2005: \$942,840). A fall in the joint venture's oil production to 44,319 bbls (2005: 62,184 bbls) was more than offset by an increase in the achieved oil sale price of US\$47.73 per bbl (2005: US\$30.87) and a small appreciation in the US\$ over the reporting period.

The reduction in production is primarily due to the natural decline in reservoir performance, however it is apparent from an initial analysis that many of the wells are not performing according to normal anticipated production profiles. A programme to re-enter and workover these wells is underway and will continue once the Phase 1 wells are brought onto long term production testing.

The increase in achieved oil price and the largely fixed nature of production costs resulted in a US\$20.36 cash profit per bbl, compared to US\$10.73 in the previous financial year.

***Reserve assessment***

A 31 December 2005 assessment of reserves for the Wichian Buri Oilfield was prepared by Gaffney, Cline and Associates, an independent petroleum consulting company based in Singapore. This reserve report was as follows:

| <b>Proven (mmbo)</b> | <b>Proven + Probable (mmbo)</b> | <b>Proven + Probable + Possible (mmbo)</b> |
|----------------------|---------------------------------|--|
| 0.64                 | 14.2                            | 68.8                                       |

Based on this assessment, Carnarvon's share of proven and probable reserves is estimated at 5.68 mmbbls. This assessment is based on previous seismic and well results in the field. However, since this assessment, the joint venture has reprocessed existing seismic, recorded a new 3D seismic survey, commenced a workover programme on existing producing wells and is currently drilling 5 new development wells in the field. Flow testing of these wells will be conducted beginning early October 2006. Once all this new data is compiled, a new reserve estimate will be made.

***Operations***

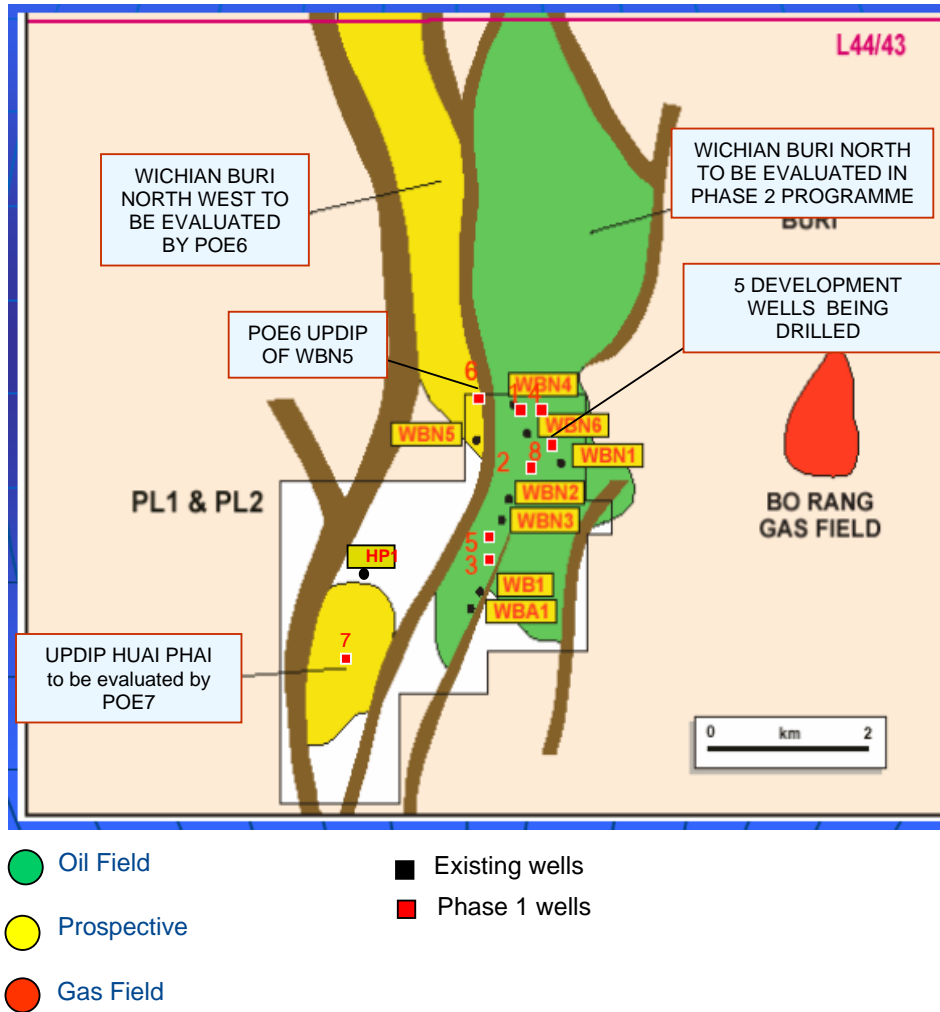
The Wichian Buri Joint Venture set a work programme incorporating an intensive drilling program for the remainder of 2006 through 2007, which will see up to 27 wells drilled in two phases.

***Phase 1 Drilling***

Using the reprocessed and interpreted 3D seismic data over the Wichian Buri Oilfield, the Phase 1 programme comprises 7 wells (including two wells free-carried for Carnarvon up to a total of US\$350,000 on a dry hole basis) to be drilled and completed by the end of October 2006.

The Phase 1 wells comprise 5 appraisal / development wells and 2 exploration wells entirely within the production licence with the aim of improving oil production from the Wichian Buri Oilfield and evaluating a separate fault block to the west of the fault block which contains the Wichian Buri Oilfield. Using the Aztec Rig 7 drilling rig, all wells will be drilled as quickly as possible and cased and suspended ready for production testing. Using a second smaller and cost effective workover rig, each well will be completed for production and flowed for approximately 30 days to enable a good engineering analysis of flow characteristics. It is planned that all 7 wells will be flow tested in this manner between October and December 2006.

At the date of this report, 3 wells in the Phase 1 program have been drilled, logged and cased for production testing, one well requires resumption to remove drill pipe lodged at the base of the hole, and 3 wells are yet to be drilled. The location of Phase 1 wells is shown in Figure 1 below:



**Figure 1**

The Phase 1 drilling programme commenced on 11 July 2006 with the development well POE-2. The order of wells drilled reflects the order in which well sites were prepared, The well numbers, however, are in the sequence approved for drilling.

#### *POE-2 Development Well*

The POE-2 well was positioned 0.24 kilometres to the northeast of the Wichian Buri N-2 production well which has been one of the best producers within the northern part of the field. POE-2 was successfully drilled, logged and cased ready for production testing.

On 31 July the well was drilled to a total depth of 1,119 metres. Logging indicates hydrocarbon pay of 5.8 metres within the "F" sandstone at a depth of 964 metres and 5.6 metres within the G sandstone at a depth of 1,035 metres.

Further analysis of the logging data indicates a zone of possible hydrocarbon pay of approximately 7 metres in the shallower section at a depth of 572 metres. This zone has never been flow tested before and will require such testing to determine the commercial potential.

#### *POE-1 Development Well*

On 21 August the second well in Phase 1, POE-1, was drilled to a total depth of 1,015 metres. The mudlogs and oil shows intersected over the "F" sandstone at a depth of 787 metres are similar to those encountered in POE-2 over the same reservoir level. However, drilling difficulties were encountered while drilling through a fault (geological feature) and the drillstring became lodged in the hole at a location midway between the "F" and deeper "G" sandstone reservoirs, the latter of which was not penetrated. As a consequence logging has not been run at this stage. The well was suspended and the drilling rig mobilized to the next planned well to continue the drill programme.

It is planned that the drilling rig will return to POE-1 to remove the drill pipe in the hole and complete drilling to total depth. Logs will then be run to evaluate potential oil zones within the well at both the "F" and "G" sandstone levels and prepare the well for production testing.

#### *POE-8 Development Well*

On September 1, POE-8 was drilled to a total depth of 1,312 meters, approximately 200 meters below the initially planned total depth of 1,100 meters. The deepening of POE-8 was a decision made on the basis of strong indications of hydrocarbons (oil shows and high mud gas readings) encountered while drilling at and below 1,100 meters.

Logging indicates hydrocarbon pay of approximately 2 meters within the F sand, 3 meters within the G sand and 4 meters in a deeper sand at 1,250 meters. Neither the G nor deeper sand has been flow tested on the concession to date.

Log interpretation also suggests that hydrocarbons may be present in shallower zones at 615 meters, 635 meters, 660 meters and 785 meters and in a deeper hydrocarbon zone within a fractured volcanic sill at 1,155 meters. Flow testing will be required to determine the hydrocarbon potential of these additional zones.

This is an encouraging result with possible hydrocarbon pay interpreted from logs at several levels throughout the well from shallow depths of 615 metres to 1,155 metres. In particular, the log interpreted zone of possible shallow hydrocarbons intersected at 615 metres is consistent with similar log results in POE-2 and other adjacent wells. This interval has previously not been tested and successful flow testing at this level could add significantly to the reserves at the greater Wichian Buri Field.

Drilling of the well has now been successfully completed and the well has been suspended ready for production testing using the smaller workover drilling rig currently working on site.



#### *POE-6 Exploration Well*

The POE-6 well is located 500 metres north and 35 metres structurally up dip from WB-3, a well drilled in the late 1980's that flowed oil to surface from a thin oil column over water.

The POE-6 exploration well has been drilled to a total depth of 1,200 metres and logging has been completed. Current operations are the running of casing in preparation for long term production testing at a later date using a workover rig.

The POE-6 well was primarily targeting the G sand reservoir in a large fault block separate and to the west of the main Wichian Buri field. This separate structure extends approximately 2.5 kilometers north and up dip of the POE-6 location. To date, no oil production has been established in the fault block penetrated by POE-6, and successful flow of oil here could add substantially to the oil reserves in the Wichian Buri area.

Hydrocarbon shows and elevated mud gas readings were encountered over a combined interval of 128 meters while drilling through various targets between 700 to 1,200 meters. After drilling through the G sand target, crude oil approximately ½ centimetre in depth covered the entire reserve mud pit. Preliminary log analysis indicates a total net pay of approximately 22.8 meters in thickness, 10.2 meters in the G sand, 4 meters in the F sand as well as two other zones of 4.9 and 3.7 meters in net thickness.

We expect testing to commence in early October subject to the in-country arrival of perforation charges and transport of these to the concession. A service rig has been contracted and will allow for extended pump testing of the newly drilled wells to establish the potential for commercial production. It will then move to existing producing wells in an attempt to enhance production performance.

The results of logging are encouraging, however until flow testing of the well has been carried out, the commercial significance of the discovery has yet to be determined.

#### *POE-3 Development Well*

The drilling rig is now preparing to drill the fifth well POE-3 located 1.5kms to the north of Wichian Buri-1. This well will evaluate the potential for undrained reserves in the southern part of the Wichian Buri Oilfield.

#### *Further Drilling in Phase 1*

The following wells are planned to be drilled for the remainder of Phase 1 following on from POE-6:

##### a) POE-5 Development Well

Success at POE-3, in addition to the already drilled wells POE-1, 2, 8 and 6, is critical to bringing the Wichian Buri Oilfield back to significant economic production.

##### b) POE-7 Exploration Well

The POE-7 exploration well is designed to evaluate the oil potential updip of the previously drilled Huai Phai-1 well which intersected 2 metres of oil pay on water. POE-7 is located substantially updip and to the south of Huai Phai-1. Bright seismic amplitudes are present on the crest of the structure which have been interpreted as a possible gas cap which in turn would suggest a likely trapping mechanism for hydrocarbons. The success of POE-6, which lies in the same fault block, has upgraded the potential for success at POE-7

#### *Phase 2 Drilling*

An extensive 245 sq km 3D seismic survey was completed in June 2006 to define the complex structural geology of Wichian Buri.

A preliminary version of the new 3D seismic has been received by the joint venture. Based on this, 22 prospects have been identified and submissions have been prepared for government approval for these to be drilled in Phase 2 of the planned up to 20 wells due to commence in December 2006. Preparation of environmental reports and government approvals normally takes 3 months, and to ensure that the programme can commence as planned it was deemed necessary to base these well approval applications on the preliminary seismic processing. Once final processing is received these prospects will be more accurately defined.

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**OPERATING AND FINANCIAL REVIEW (CONTINUED)**

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Also, in order to facilitate the December startup of Phase 2, and to ensure testing of successful wells will not be unduly held up, long lead items including casing and beam pumps are being ordered for 10 of the 20 Phase 2 wells. This is in addition to beam pumps already on order for production testing of the Phase 1 wells.

***Workover programme***

The joint venture has contracted a smaller workover rig which has been mobilized on site. This rig will be used to workover the existing 9 producing wells on the field and complete the current wells ready for production testing. This drilling rig is currently carrying out some minor workovers on existing wells to improve production. Initial work has been successful with increased production rates from the N4 well from 5 to approximately 20 bopd, by replacing the jet pump with a beam pump. Similar improvements are expected from other wells.

***Production Testing***

In October 2006 the workover rig will commence preparation of the Phase 1 wells for production testing. Each well will be flowed for a minimum of 1 month. Although the focus of the testing will be on the "F" and "G" sandstone levels, several other potential hydrocarbon zones identified from well logging will also be prepared for testing.

**CARNARVON BASIN**

**EP 110/EP 424**

**(Carnarvon 35%; Strike Oil 40%; Pancontinental 25%)**

Carnarvon has a 35% interest in the permits EP 110 and EP 424 in the Carnarvon Basin, offshore northwest of Western Australia. Strike Oil is the operator of both permits.

Within EP 424 a new seismic survey of 178 kms has been acquired over the Baniyas prospect, which is a top Barrow Group prospect situated on the downthrown side of the Flinders Fault. Bright seismic amplitudes on the crest of the structure are similar to those observed on other prospects drilled along the Flinders Fault which encountered a gas cap on an oil leg. A large prospect has been identified at Baniyas with the bright seismic amplitudes covering a considerable area.

The new seismic data was acquired to enable detailed mapping of the Baniyas prospect which lies on the western edge of the EP 424 permit and overlaps into the Chevron operated permit TL/4. Costs for the acquisition of the new seismic are being shared between the Chevron operated joint venture and the EP 424 Joint Venture.

The Baniyas Prospect lies 6 kms to the southeast and updip of the Chevron operated Saladin Oil Field and a success at Baniyas could be rapidly tied into the Chevron operated infrastructure.

The year 3 EP 424 exploration program comprises a company commitment of \$152,000. This will be applied to the acquisition, processing and interpretation of the new seismic data.

**PAPUA NEW GUINEA**

**PRL 4 and PRL 5**

During the year Carnarvon sold its interests in PNG petroleum retention licences PRL 4 and 5 for A\$500,000 to its PNG joint venture partners, each of which exercised its pre-emptive rights. Carnarvon received the sale proceeds in the June quarter.

**OTHER EXPLORATION INTERESTS**

Carnarvon is monitoring available opportunities within the region. The corporate objective is for a well balanced spread of assets in terms of the nature of the projects, the number of countries in which they reside, and their upside potential both for the hydrocarbon potential and the access to additional projects.

**CARNARVON PETROLEUM LIMITED**  
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**DIRECTORS' REPORT**

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The directors present their report together with the financial report of Carnarvon Petroleum Limited ("Company") and of the consolidated entity, being the Company and its controlled entities, for the financial year ended 30 June 2006, and the auditor's report thereon.

Carnarvon Petroleum Limited is a listed public company incorporated and domiciled in Australia.

**Directors**

The names and details of the Company's directors in office at any time during or since the end of the financial year are as follows. Directors were in office for this entire period unless otherwise stated.

*Peter J Leonhardt*  
*Chairman*

FCA, FAICD

Age 59. Appointed as a director on 17 March 2005 and appointed Chairman in April 2005.

Mr Leonhardt is an independent company director and adviser with extensive business, financial and corporate experience. He is a Chartered Accountant and a former Senior Partner with PricewaterhouseCoopers and Managing Partner of Coopers & Lybrand in Western Australia.

During the past three years Mr Leonhardt has served as a director of the following listed companies: Centrepoint Alliance Limited (from May 2002); CTI Logistics Limited (from August 1999); Voyager Energy Limited (from March 2001 to September 2005); Titan Resources Limited (from June 2005 to June 2006). He is also a director of the Western Australian Institute for Medical Research and a member of the Advisory Board of the Perth International Arts Festival.

Mr Leonhardt is Chairman of the Audit Committee.

*Edward (Ted) P Jacobson*  
*Chief Executive Officer*

B.Sc (Hons Geology)

Age 57. Appointed as a director on 5 December 2005.

Mr Jacobson is a petroleum geophysicist with 37 years experience in petroleum exploration principally in the European North Sea, South East Asia, South America and Australia. Within Australia he has been responsible for initiating a number of petroleum discoveries within the Cooper Basin, Barrow Sub Basin and Timor Sea. Prior to joining Carnarvon, Ted was co-founder of Discovery Petroleum and more recently since 1996 co-founder and technical director of Tap Oil Ltd which grew to a market capitalisation of over \$400 million under his technical leadership. Ted is a member of the Australian Institute of Geoscientists.

During the past three years Mr Jacobson has served as director of the following listed companies: Rialto Energy Limited (from July 2006); Tap Oil Ltd (from 1996 to September 2005).

*Neil C Fearis*  
*Non-Executive Director*

LL.B (Hons), MAICD, FINSIA

Age 55. Appointed as a director on 30 November 1999.

Mr Fearis has 29 years' experience as a commercial lawyer in the UK and Australia.

During the past three years Mr Fearis has served as a director of the following listed companies: Kresta Holdings Limited (from 1997); Perseus Mining Limited (from 2004). Mr Fearis is also a member of several professional bodies associated with commerce and law.

Mr Fearis is a member of the Audit Committee.

**Directors (continued)**

*Kenneth P Judge  
Non-Executive Director*

B.Com, LL.B  
Age 51. Appointed as a director on 1 April 2005.

Mr. Judge has extensive legal and business management experience having held a number of public company directorships and has been engaged in the establishment or corporate restructure of technology, mining, and oil and gas companies in Australia, United Kingdom, USA, Brazil, Argentina, Mexico and the Philippines.

Mr. Judge is Chairman of Brazilian Diamonds Limited which is listed on both the Toronto Stock Exchange and the AIM market of the London Stock Exchange Plc., and is also Chairman of Hidefield Gold Plc and a director of Block Shield Corporation, both of which are listed on AIM. Mr Judge is also Chairman of Alto Ventures Ltd, which is listed on the TSX Venture Exchange, and Chairman of Columbus Gold Corporation and Empire Mining Ltd.

*David J Orth  
Executive Director and Chief Operating Officer*

B.Sc; DipGeoSc.  
Age 57. Appointed as a director on 14 December 2000. Appointed Chief Operating Officer in July 2003.

Mr Orth is a geologist with in excess of 25 years' industry experience, having worked for Amoco and BHP Petroleum as well as a number of independent oil companies throughout North America, Europe, Africa, the Middle East and Australasia. He is a member of the Petroleum Exploration Society of Australia.

Mr Orth resigned as a director on 27 April 2006.

*Andrew G Shelton  
Non-Executive Director*

B.A., M.A (Cantab.), FAICD  
Age 59. Appointed as a director and Chairman on 1 April 2002. Remained Chairman until April 2005.

Independent corporate finance adviser specializing in strategic and corporate finance advice, capital raisings, mergers and acquisitions, valuations and financial analysis. Principal and director of Andrew Shelton & Co Pty Ltd and Chairman of Whise Acoustics Limited. Past President and Chief Executive Officer of JP Morgan Canada.

Mr Shelton was Chairman of the Audit Committee until he resigned as a director on 30 November 2005.

**Company secretary**

Mr Robert Anderson was appointed Company Secretary in November 2005. Mr Anderson is a Chartered Accountant who has previously held Company Secretarial positions in both companies listed on ASX and private entities.

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DIRECTORS' REPORT (CONTINUED)**

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**Directors' meetings**

The number of directors' meetings and the number of meetings attended by each of the directors of the Company during the financial year are as follows:

|                 | <b>(a)</b> | <b>(b)</b> |
|-----------------|------------|------------|
| Peter Leonhardt | 9          | 9          |
| Ted Jacobson    | 5          | 5          |
| Neil Fearis     | 9          | 9          |
| Ken Judge       | 9          | 9          |
| David Orth      | 7          | 7          |
| Andrew Shelton  | 4          | 4          |

(a) Number of meetings held during period of office

(b) Number of meetings attended

**Audit Committee**

*Names and qualifications of Audit Committee members*

The Committee is to include at least 2 members. Current members of the committee are Mr Peter Leonhardt and Mr Neil Fearis. The qualifications of Audit Committee members are provided in the Directors section of this directors' report.

*Audit Committee meetings*

The number of Audit Committee meetings and the number attended by each of the members during the reporting period were as follows:

|                 | <b>(a)</b> | <b>(b)</b> |
|-----------------|------------|------------|
| Peter Leonhardt | 1          | 1          |
| Neil Fearis     | 2          | 2          |
| Andrew Shelton  | 1          | 1          |

(a) Number of meetings held during period of office

(b) Number of meetings attended

**Remuneration Committee**

The Board considers that the Company is not currently of a size to justify the existence of a Remuneration Committee and therefore there were no Remuneration Committee meetings during the reporting period.

The Board as a whole is responsible for the remuneration arrangements for directors and executives of the Company. If the Company's activities increase in size, scope and/or nature the formation of a Remuneration Committee will be reviewed by the Board and implemented if appropriate.

The Board considers remuneration packages and policies applicable to the executive directors, senior executives, and non-executive directors. It is also responsible for share option schemes, the Employee Share Plan, incentive performance packages, and retirement and termination entitlements.

**Principal activities**

During the course of the 2006 financial year the consolidated entity's principal activities continued to be directed towards oil and gas exploration, development and production.

## **Remuneration report**

The Board determines remuneration policies and practices, evaluates the performance of senior management, and considers remuneration for those senior managers. The Board assesses the appropriateness of the nature and amount of remuneration on an annual basis by reference to industry and market conditions, and with regard to the Company's financial and operational performance.

Total non-executive directors' fees are approved by shareholders and the Board is responsible for the allocation of those fees amongst the individual members of the Board.

The value of remuneration is determined on the basis of cost to the Company and consolidated entity.

### *Principles of compensation (Audited)*

Remuneration of directors and executives is referred to as compensation, as defined in AASB 124.

Compensation levels for key management personnel of the Company and consolidated entity are competitively set to attract and retain appropriately qualified and experienced directors and senior executives. The directors obtain, when required, independent advice on the appropriateness of remuneration packages, given trends in comparative companies both locally and internationally.

Compensation arrangements include a mix of fixed and performance based compensation. A component of share-based compensation is awarded at the discretion of the Board, subject to shareholder approval when required.

Compensation structures take into account the overall level of compensation for each director and executive, the capability and experience of the directors and senior executives, the executive's ability to control the financial performance of the relative business segment, the consolidated entity's performance (including earnings and the growth in share price), and the amount of any incentives within each executive's remuneration.

In considering the consolidated entity's performance and benefits for shareholder wealth the Board have had regard to the change in executive management mid way through the current reporting period; as a consequence, "profit before tax" for the current and previous 4 years has not been a major consideration for assessing compensation for the current senior management.

The movement in the Company's share price over the last four years is shown below. No dividends have been paid or declared during this period.

|                 | <b>30 June 2002</b> | <b>30 June 2003</b> | <b>30 June 2004</b> | <b>30 June 2005</b> | <b>30 June 2006</b> |
|-----------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| Cents per share | 4.9c                | 2.7c                | 1.5c                | 1.8c                | 5.2c                |

The directors believe the increase in share price since June 2005 reflects a number of corporate changes, including the appointment of an experienced Chief Executive Officer in February 2006, and the Company's progress in developing its oil and gas interests.

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DIRECTORS' REPORT (CONTINUED)**

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**Remuneration report (continued)**

*Fixed compensation (Audited)*

Fixed compensation consists of base compensation as well as employer contributions to superannuation funds. Base compensation may be supplemented by an element of share-based compensation.

On 3 April 2006, following shareholder approval, the Company made the following share-based compensation to directors as part of their overall compensation arrangements:

| <b>Director</b> | <b>Shares</b> | <b>Number</b>  |   |
|-----------------|---------------|--|---|
|                 |               | <b>7 cent options exercisable on or before 31 March 2008</b> | <b>10 cent options exercisable on or before 31 March 2009</b> |
| PJ Leonhardt    | 1,500,000     | 3,000,000  | 3,000,000   |
| EP Jacobson     | 3,000,000     | 4,000,000  | 4,000,000   |
| NC Fearis       | -             | 2,000,000  | 2,000,000   |
| KP Judge        | -             | 2,000,000  | 2,000,000   |

This compensation was not subject to a performance related condition. The shares were issued for nil cash consideration.

Mr Leonhardt's share-based compensation recognised his significant contribution to the Company's activities over and above a normal non-executive role since his appointment as Chairman in April 2005. The issue also reflects his agreement to assume a more active day-to-day role in the management of the Company following the move of the corporate office to Perth and to support Mr Jacobson in his role as Chief Executive Officer.

Mr Jacobson's share-based compensation provided an incentive to him in the role of Chief Executive Officer and recognised that his level of cash remuneration is significantly below market levels for an executive in the oil and gas industry with his standing and experience.

The share-based compensation for Mr Fearis and Mr Judge recognised the considerable workload they have undertaken, over and above a normal non-executive role, in the period leading to the settlement of the Company's litigation with its former joint venture partner and the transfer of the corporate office to Perth. Mr Judge played a major role, including extensive travel in Canada, in negotiating the settlement of the litigation and in establishing a strong commercial relationship with the Company's new joint venture partner. Mr Fearis has provided significant assistance with the litigation process and in facilitating the restructuring of the board and the move of the corporate office from Melbourne to Perth during the reporting period.

A former director, Mr Andrew Shelton, provided financial consulting services to the consolidated entity in relation to various strategic, commercial and corporate finance matters concerning the Company, the SW1A Concession in Thailand, and the Company's joint venture partner, Tiger Petroleum Inc. The unpaid value of these fees at 30 June 2005, being \$100,000, was satisfied by the issue of 5,500,000 ordinary shares to Andrew Shelton & Co Pty Ltd, as agreed between the parties on 2 August 2005. The issue of these shares was approved by shareholders on 30 November 2005.

*Non-executive directors (Audited)*

Total remuneration for all non-executive directors, last voted upon by shareholders at a General Meeting in November 2005, is not to exceed \$200,000 per annum. A non-executive director's base fee is currently \$30,000 per annum. The Chairman receives \$45,000 per annum including superannuation. Non-executive directors do not receive any performance related remuneration. Directors' fees cover all main Board activities and membership of Board committees. The Company does not have any terms or schemes relating to retirement benefits for non-executive directors.

Share-based compensation allocated to non-executive directors is set out in the "Fixed Compensation" section of this report.

**Remuneration report (continued)**

*Employee Share Plan (Audited)*

Shares are issued under an Employee Share Plan ("ESP"), which has been approved by shareholders in Annual General Meeting ("AGM"). The purpose of the ESP is to attract, retain and motivate employees and thereby align their interests with those of other shareholders as a means of encouraging them to ensure that Company performance increases shareholder wealth through long term growth. Shares are issued based upon the assessed performance of each employee against their job specifications and the recommendations of the Chief Executive Officer.

The Company Secretary, Mr RA Anderson, was issued with the following ESP shares as part of his compensation arrangements in the period under review:

|                       | <b>15 February 2006</b> | <b>16 June 2006</b> |
|-----------------------|-------------------------|---------------------|
| Number of shares      | 1,785,000               | 215,000             |
| Issue price per share | \$0.051                 | \$0.051             |

This allocation was not subject to a performance condition. The issue price was calculated based on the 5 day weighted average closing price preceding the issues.

The purchases were funded by an interest-free loan of \$101,242. This loan, which was made with a limited recourse security over the plan shares, is subject to the detailed rules of the ESP. The notional interest that would have been charged during the reporting period on the initial loans to Mr Anderson on an arm's length basis is \$2,557.

*Service contracts (Audited)*

The contract duration, period of notice, and termination conditions for current key management personnel are as follows:

- (i) Mr Ted Jacobson, Chief Executive Officer, is engaged through a Consultancy Agreement expiring 21 February 2007, renewable automatically on a rolling 12 month basis. Termination by the Company is with 12 months notice or payment in lieu thereof. Termination by the consultant is with 3 months' notice.
- (ii) Mr Robert Anderson, Company Secretary and Chief Financial Officer, is engaged through a Consultancy Agreement expiring 30 June 2007. The contract can be terminated with 3 months notice by either party.

*Directors' and executives officers' remuneration, Company and consolidated (Audited)*

Details of the nature and amount of each major element of the remuneration of each director of the Company and each of the named Company executives receiving the highest remuneration are set out on the following page.

The fair value of the options is calculated at the date of grant using the Black-Scholes Option Pricing Model. All options granted vest immediately and have been recognized as an expense in the current period. The following factors and assumptions were used in determining the fair value of options on grant date:

| <b>Grant date</b> | <b>Expiry date</b> | <b>Fair value per option</b> | <b>Exercise price</b> | <b>Price of shares at grant date</b> | <b>Expected Volatility</b> | <b>Risk free interest rate</b> | <b>Dividend yield</b> |
|-------------------|--------------------|------------------------------|-----------------------|--------------------------------------|----------------------------|--------------------------------|-----------------------|
| 3 April 2006      | 31 March 2008      | \$0.018                      | \$0.07                | \$0.063                              | 51.5%                      | 5.5%                           | 0%                    |
| 3 April 2006      | 31 March 2009      | \$0.016                      | \$0.10                | \$0.063                              | 51.5%                      | 5.5%                           | 0%                    |



**CARNARVON PETROLEUM LIMITED  
FINANCIAL REPORT 30 JUNE 2006  
DIRECTORS' REPORT (CONTINUED)**

**Remuneration report (continued)**

| Name  | Short Term           | Post Employment                   | Termination Benefits (\$) | Share-based payments |              | Total (\$)  | Proportion of Remuneration Performance Related (%) | Value of Options as a Proportion of Remuneration (%) |
|---|----------------------|-----------------------------------|---------------------------|----------------------|--------------|-------------|--|--|
|   | Salary and fees (\$) | Superannuation Contributions (\$) |                           | Shares (\$)          | Options (\$) |             |  |  |
| <b>Directors</b>  |                      |                                   |                           |                      |              |             |  |  |
| <i>Non-Executive</i>  |                      |                                   |                           |                      |              |             |  |  |
| Mr PJ Leonhardt (Chairman)  |                      |                                   |                           |                      |              |             |  |  |
| 2006  | \$45,000             | -                                 | -                         | \$94,500             | \$101,522    | \$241,022   | -  | 42.12%   |
| 2005  | \$11,250             | -                                 | -                         | -                    | -            | \$11,250    | -  | -  |
| Mr NC Fearis  |                      |                                   |                           |                      |              |             |  |  |
| 2006  | \$27,750             | \$2,250                           | -                         | -                    | \$67,681     | \$97,681    | -  | 69.29%   |
| 2005  | \$27,000             | \$3,000                           | -                         | -                    | -            | \$30,000    | -  | -  |
| Mr KP Judge   |                      |                                   |                           |                      |              |             |  |  |
| 2006  | \$30,000             | -                                 | -                         | -                    | \$67,681     | \$97,681    | -  | 69.29%   |
| 2005  | \$7,500              | -                                 | -                         | -                    | -            | \$7,500     | -  | -  |
| Mr AG Shelton   |                      |                                   |                           |                      |              |             |  |  |
| 2006 (Resigned 30 November 2005)  | \$31,250             | \$1,250                           | -                         | -                    | -            | \$32,500    | -  | -  |
| 2005  | \$131,901            | \$4,500                           | -                         | \$220,000            | -            | \$356,401   | -  | -  |
| <i>Executive</i>  |                      |                                   |                           |                      |              |             |  |  |
| Mr EP Jacobson (Chief Executive Officer)                                |                      |                                   |                           |                      |              |             |  |  |
| 2006 (Appointed 5 December 2005)  | \$76,620             | -                                 | -                         | \$189,000            | \$135,362    | \$400,982   | -  | 33.76%   |
| 2005  | -                    | -                                 | -                         | -                    | -            | -           | -  | -  |
| Mr DJ Orth (Chief Operating Officer)                                    |                      |                                   |                           |                      |              |             |  |  |
| 2006 (Resigned 27 April 2006)   | \$60,000             | \$24,725                          | -                         | -                    | -            | \$84,725    | -  | -  |
| 2005  | \$95,717             | \$25,000                          | -                         | -                    | -            | \$120,717   | -  | -  |
| <b>Executive Officers</b>   |                      |                                   |                           |                      |              |             |  |  |
| Mr RA Anderson (CFO/Company Secretary)                                  |                      |                                   |                           |                      |              |             |  |  |
| 2006 (Appointed 28 November 2005)                                       | \$71,880             | -                                 | -                         | -                    | \$40,421     | \$112,301   | -  | 35.99%   |
| 2005  | -                    | -                                 | -                         | -                    | -            | -           | -  | -  |
| Mr RA Pullia (CFO/Company Secretary)                                    |                      |                                   |                           |                      |              |             |  |  |
| 2006 (Resigned 18 January 2006)   | \$81,274             | \$6,263                           | \$26,070                  | -                    | -            | \$113,607   | -  | -  |
| 2005  | \$123,750            | \$23,400                          | -                         | -                    | \$7,189      | \$154,339   | -  | 4.66%  |
| Total compensation: key management personnel (Company and Consolidated) |                      |                                   |                           |                      |              |             |  |  |
| 2006  | \$423,774            | \$34,488                          | \$26,070                  | \$283,500            | \$412,667    | \$1,180,499 |  |  |
| 2005  | \$397,118            | \$55,900                          | -                         | \$220,000            | \$7,189      | \$680,207   |  |  |

Mr Peter Leonhardt, the Chairman, is currently acting in a part time executive capacity to support the Chief Executive Officer. Mr Leonhardt's fulfillment of this role going forward will be monitored relative to the Company's stage of development.

Directors fees are paid or payable to the director or a director related entity.

**CARNARVON PETROLEUM LIMITED  
FINANCIAL REPORT 30 JUNE 2006  
DIRECTORS' REPORT (CONTINUED)**

**Remuneration report (continued)**

*Equity instruments (Audited)*

(i) Shares

Shares in the Company that were granted as compensation to each key management person during the reporting period are as follows:

| <b>Director</b> | <b>Number of shares issued</b> | <b>Grant date</b> | <b>Fair value per share at grant date (\$)</b> |
|-----------------|--------------------------------|-------------------|--|
| PJ Leonhardt    | 1,500,000                      | 3 April 2006      | 94,500   |
| EP Jacobson     | 3,000,000                      | 3 April 2006      | 189,000  |
| AG Shelton      | 5,500,000                      | 30 November 2005  | 220,000  |

The allocation to Mr Shelton relates to services provided in prior reporting periods.

(ii) Options

All options refer to options over ordinary shares of Carnarvon Petroleum Limited, which are exercisable on the basis of one share for one option. Options over shares in the Company that were granted as compensation to each key management person during the reporting period and details on options that were vested during the reporting period are as follows:

| <b>Director</b> | <b>Number of options granted</b> | <b>Grant date</b> | <b>Number of options vested</b> | <b>Fair value per option at grant date (\$)</b> | <b>Exercise price per option</b> | <b>Expiry date</b> |
|-----------------|----------------------------------|-------------------|---------------------------------|---|----------------------------------|--------------------|
| PJ Leonhardt    | 3,000,000                        | 3 April 2006      | 3,000,000                       | \$0.018   | \$0.07                           | 31 March 2008      |
| PJ Leonhardt    | 3,000,000                        | 3 April 2006      | 3,000,000                       | \$0.016   | \$0.10                           | 31 March 2009      |
| EP Jacobson     | 4,000,000                        | 3 April 2006      | 4,000,000                       | \$0.018   | \$0.07                           | 31 March 2008      |
| EP Jacobson     | 4,000,000                        | 3 April 2006      | 4,000,000                       | \$0.016   | \$0.10                           | 31 March 2009      |
| NC Fearis       | 2,000,000                        | 3 April 2006      | 2,000,000                       | \$0.018   | \$0.07                           | 31 March 2008      |
| NC Fearis       | 2,000,000                        | 3 April 2006      | 2,000,000                       | \$0.016   | \$0.10                           | 31 March 2009      |
| KP Judge        | 2,000,000                        | 3 April 2006      | 2,000,000                       | \$0.018   | \$0.07                           | 31 March 2008      |
| KP Judge        | 2,000,000                        | 3 April 2006      | 2,000,000                       | \$0.016   | \$0.10                           | 31 March 2009      |

The options were issued for nil cash consideration and vest immediately. No options have been granted since the end of the financial year.

During the year there was no exercise of options granted as compensation in prior reporting periods, nor was there any forfeiture or vesting of options granted in previous periods. At the end of the reporting period there were no unvested options on issue. All options expire on the expiry date but do not expire as a result of the termination of the holder's employment with the Company.

The movement during the reporting period, by value, of options over ordinary shares held by each Company director and Company executive and granted as part of remuneration is detailed below:

| <b>Director</b> | <b>Value of Options</b>     |                               |                               |  |
|-----------------|-----------------------------|-------------------------------|-------------------------------|--|
|                 | <b>Granted in year (\$)</b> | <b>Exercised in year (\$)</b> | <b>Forfeited in year (\$)</b> | <b>Total option value in year (\$)</b> |
| PJ Leonhardt    | 101,522                     | -                             | -                             | 101,522                                |
| EP Jacobson     | 135,362                     | -                             | -                             | 135,362                                |
| NC Fearis       | 67,681                      | -                             | -                             | 67,681                                 |
| KP Judge        | 67,681                      | -                             | -                             | 67,681                                 |
|                 | <b>372,246</b>              | <b>-</b>                      | <b>-</b>                      | <b>372,246</b>                         |

**Remuneration report (continued)**

*Equity instruments (Audited) (continued)*

(ii) Options (continued)

The issue of shares under the ESP is treated in principle as an option over the Company's shares. The movement during the reporting period, by value, of this option for each Company director and Company executive and granted as part of remuneration is detailed below:

| <b>Executive</b> | <b>Value of Options</b>     |                               |                               | <b>Total option value in year (\$)</b> |
|------------------|-----------------------------|-------------------------------|-------------------------------|--|
|                  | <b>Granted in year (\$)</b> | <b>Exercised in year (\$)</b> | <b>Forfeited in year (\$)</b> |  |
| RA Anderson      | 40,421                      | -                             | -                             | 40,421                                 |

The fair value of the options is calculated at the date of grant using the Black-Scholes Option Pricing Model. All options granted vest immediately and have been recognized as an expense in the current period.

**Identification of independent directors**

The independent directors are identified in the Corporate Governance Statement section of this Annual Report as set on pages 65 to 68.

**Non-audit services**

Subsequent to the approval of shareholders in November 2005 the Company appointed Grant Thornton Western Australian Partnership as auditors. These auditors have not performed any services over and above their statutory duties during the financial year.

The Company's former auditors performed certain other services during the financial year.

The Board has considered the non-audit services provided during the year by the former auditors and, in accordance with advice provided by the audit committee, is satisfied that the provision of those non-audit services during the year by the former auditors is compatible with, and did not compromise, the auditors independence requirements of the Corporations Act 2001.

A copy of the auditor's independence declaration as required under Section 307C of the Corporations Act is included in the directors' report.

Details of the amounts payable to the auditor of the consolidated entity (and their related practices) for audit and non-audit services provided during the year are set out below:

|   | <b>Consolidated 2006 (\$)</b> |                        |
|---|-------------------------------|------------------------|
|   | <b>Current Auditors</b>       | <b>Former Auditors</b> |
| <i>Statutory audit</i>                      |                               |                        |
| - audit and review of the financial reports | 29,105                        | 2,878                  |
| <i>Services other than statutory audit</i>  |                               |                        |
| - taxation compliance services and advice   | -                             | 36,025                 |

**CARNARVON PETROLEUM LIMITED  
FINANCIAL REPORT 30 JUNE 2006  
DIRECTORS' REPORT (CONTINUED)**

**Operating and financial review**

An operating and financial review of the consolidated entity during the financial year ended 30 June 2006 is set out on pages 4 to 9 and forms part of this report.

**Share options**

*Options granted to directors and officers of the Company*

During or since the end of the financial year, the Company granted options over un-issued ordinary shares in the Company for nil cash consideration to the following directors of the Company as part of their remuneration:

| <b>Director</b> | <b>Number of options granted</b> | <b>Grant date</b> | <b>Exercise price per option</b> | <b>Expiry date</b> |
|-----------------|----------------------------------|-------------------|----------------------------------|--------------------|
| PJ Leonhardt    | 3,000,000                        | 3 April 2006      | \$0.07                           | 31 March 2008      |
| PJ Leonhardt    | 3,000,000                        | 3 April 2006      | \$0.10                           | 31 March 2009      |
| EP Jacobson     | 4,000,000                        | 3 April 2006      | \$0.07                           | 31 March 2008      |
| EP Jacobson     | 4,000,000                        | 3 April 2006      | \$0.10                           | 31 March 2009      |
| NC Fearis       | 2,000,000                        | 3 April 2006      | \$0.07                           | 31 March 2008      |
| NC Fearis       | 2,000,000                        | 3 April 2006      | \$0.10                           | 31 March 2009      |
| KP Judge        | 2,000,000                        | 3 April 2006      | \$0.07                           | 31 March 2008      |
| KP Judge        | 2,000,000                        | 3 April 2006      | \$0.10                           | 31 March 2009      |

All options were granted during the financial year. No options have been granted since the end of the financial year.

*Shares under option*

The following unissued ordinary shares of the Company are under option:

| <b>Expiry Date</b> | <b>Grant Date</b> | <b>Exercise Price \$</b> | <b>1 July 2005</b> | <b>Issued</b>     | <b>Number Exercised</b> | <b>Expired</b>      | <b>30 June 2006</b> |
|--------------------|-------------------|--------------------------|--------------------|-------------------|-------------------------|---------------------|---------------------|
| 31/12/2005         | 22/3/2004         | 0.06                     | 38,492,101         | -                 | (26,288)                | (38,465,813)        | -                   |
| 31/03/2008         | 03/04/2006        | 0.07                     | -                  | 11,000,000        | -                       | -                   | 11,000,000          |
| 31/03/2009         | 03/04/2006        | 0.10                     | -                  | 11,000,000        | -                       | -                   | 11,000,000          |
|                    |                   |                          | <b>38,492,101</b>  | <b>22,000,000</b> | <b>(26,288)</b>         | <b>(38,465,813)</b> | <b>22,000,000</b>   |

All options expire on the expiry date but do not expire as a result of the termination of the holder's employment with the Company. Option holders do not have any right, by virtue of the option, to vote or to participate in any share issue of the Company or any related body corporate.

The 26,288 6 cent options were exercised on 31 December 2005, with the balance of 38,465,813 6 cent options expiring on that date. No options have been exercised since the end of the financial year.

There were no amounts unpaid on shares issued upon the exercise of options.

**Dividends**

No dividends were paid during the year and the directors do not recommend payment of a dividend in respect of the current financial year.

### **Directors' interests**

At the date of this report, the relevant interests of the directors in securities of the Company are as follows:

| <b>Name</b>  | <b>Ordinary Shares</b> | <b>Options over Ordinary Shares</b> |
|--------------|------------------------|-------------------------------------|
| PJ Leonhardt | 7,768,493              | 6,000,000                           |
| EP Jacobson  | 13,426,293             | 8,000,000                           |
| NC Fearis    | 6,008,386              | 4,000,000                           |
| KP Judge     | 14,168,596             | 4,000,000                           |

### **Likely developments**

The likely developments for the 2007 financial year are contained in the Operating and Financial Review as set out on pages 4 to 9.

The directors are of the opinion that further information as to the likely developments in the operations of the consolidated entity would prejudice the interests of the Company and the consolidated entity and it has accordingly not been included.

### **Significant changes in state of affairs**

A number of significant events occurred in the year under review:

- Carnarvon restructured its Board and management with the appointment of Ted Jacobson as Chief Executive Officer and the relocation of its corporate office to Perth in January 2006. Mr Jacobson is a petroleum geophysicist with 35 years' experience in international petroleum exploration. He was a co-founder of Discovery Petroleum NL and more recently Tap Oil Ltd which grew to a market capitalization of over \$400 million under his technical leadership.
- The Company's SW1A Joint Venture partner in Thailand, Tiger Petroleum Inc., was acquired by Calgary-based Pan Orient Energy Corp. ("POE"). In November 2005 settlement was reached on outstanding litigation between Carnarvon's subsidiary Carnarvon Thailand Ltd and Tiger Petroleum Inc.
- The SW1A Joint Venture completed the reprocessing and interpretation of all existing 2D and 3D seismic data within the Wichian Buri production licence and the L33/43 and L44/43 exploration permits. Based on the results of the reprocessing, and a new 245 sq km 3D seismic survey undertaken to define the complex structural geology of Wichian Buri, a 7 well exploration / development programme ("Phase 1") and up to 20 well exploration / development programme ("Phase 2") were approved by the joint venture.
- Carnarvon sold its interests in Petroleum Retention Licences 4 and 5 in Papua New Guinea for \$500,000 to its joint venture partners.
- On 22 July 2005 the Company placed 39.8 million shares at 1.8 cents per share, raising \$716,400, for working capital purposes.
- On 3 April 2006 the Company placed 88.9 million shares at 4.5 cents per share, raising \$4,000,500, to principally fund the Company's share of expenditure on the Wichian Buri Oilfield in Thailand and for working capital purposes.

### **Environmental regulation and performance**

The consolidated entity's oil and gas exploration and development activities are concentrated in Thailand and Western Australia. Environmental obligations are regulated under both State and Federal Law in Western Australia and under the Department of Mineral Fuels regulations in Thailand. No significant environmental breaches have been notified by any government agency during the year ended 30 June 2006.

### **Indemnification and insurance of directors and officers**

During the financial year the Company paid a premium to insure the directors and officers of the Company and its controlled entities. The policy prohibits the disclosure of the nature of the liabilities covered and the amount of the premium paid.

### **Lead auditor's independence declaration**

The Lead auditor's independence declaration under Section 307C of the Corporations Act is set out on page 22 and forms part of the directors' report for the financial year ended 30 June 2006.

### **Events subsequent to reporting date**

On 11 July 2006 development drilling commenced at the first well (POE-2) as part of the Phase 1 drilling programme at Carnarvon's 40% owned Wichian Buri Oilfield in Thailand. At the date of this report 3 wells of the 7 well programme have been drilled, logged, and cased ready for production testing.

On 2 August 2006 the Company placed 50 million shares at 5 cents per share, raising \$2,500,000, in conjunction with an issue under a Share Purchase Plan for 20 million shares at 5 cents per share to raise \$1,000,000. The Share Purchase Plan closed oversubscribed on 30 August 2006. Funds raised from the issues are being applied to accelerate the Phase 1 and Phase 2 drilling programmes, evaluation and assessment of new opportunities, and for working capital purposes.

Other than these, no matter or circumstance has arisen since 30 June 2006 that in the opinion of the directors has significantly affected, or may significantly affect in future financial years:

- (i) the consolidated entity's operations, or
- (ii) the results of those operations, or
- (iii) the consolidated entity's state of affairs

Signed in accordance with a resolution of the directors.



**PJ Leonhardt**  
Director

Perth, 29 September 2006

Grant Thornton Western Australian Partnership  
ABN 21 965 022 882  
Chartered Accountants, Business Advisers and Consultants

## AUDITOR'S INDEPENDENCE DECLARATION

In accordance with the requirements of section 307C of the Corporations Act 2001, as lead auditor for the audit of Carnarvon Petroleum Limited for the year ended 30 June 2006, I declare that, to the best of my knowledge and belief, there have been:

- (a) no contraventions of the auditor independence requirements of the Corporations Act 2001 in relation to the audit; and
- (b) no contraventions of any applicable code of professional conduct in relation to the audit.

GRANT THORNTON WESTERN AUSTRALIAN PARTNERSHIP



GREG LEGUIER  
Partner

Dated 29 September 2006

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**INCOME STATEMENTS**

For the year ended 30 June 2006

|   | Notes | Consolidated |             | Company     |             |
|---|-------|--------------|-------------|-------------|-------------|
|   |       | 2006<br>\$   | 2005<br>\$  | 2006<br>\$  | 2005<br>\$  |
| <b>Revenue from continuing operations</b>                               |       | 1,090,213    | 942,840     | -           | -           |
| Other income  | 3     | 189,582      | 190,030     | 184,277     | 222,414     |
| Cost of sales   | 4     | (799,130)    | (776,338)   | -           | -           |
| Administrative expenses   |       | (521,343)    | (342,388)   | (521,343)   | (342,388)   |
| Directors' emoluments   |       | (235,805)    | (305,868)   | (235,805)   | (305,868)   |
| Employee benefits expense   |       | (74,660)     | (157,860)   | (74,660)    | (157,860)   |
| Legal fees  |       | (36,639)     | (193,473)   | (36,639)    | (193,473)   |
| Unrealised foreign exchange gain / (loss)                               |       | 6,935        | (8,441)     | 166,394     | (486,655)   |
| Other expenses  | 5     | (48,661)     | (42,097)    | (48,661)    | (42,097)    |
| Exploration expenditure written off                                     |       | (107,242)    | (68,454)    | (107,242)   | (68,454)    |
| Share based payments  |       | (706,272)    | (227,189)   | (706,272)   | (227,189)   |
| Finance costs   |       | (3,310)      | (7,860)     | (2,357)     | (1,421)     |
| <b>(Loss) before income tax</b>   |       | (1,246,332)  | (997,098)   | (1,382,308) | (1,602,991) |
| Income tax expense  |       | -            | -           | -           | -           |
| <b>(Loss) from continuing operations</b>                                |       | (1,246,332)  | (997,098)   | (1,382,308) | (1,602,991) |
| <b>Profit / (loss) on sale of discontinued operations</b>               | 7     | 488,182      | (10,227)    | 488,182     | (10,227)    |
| <b>(Loss) attributable to members of the parent entity</b>              |       | (758,150)    | (1,007,325) | (894,126)   | (1,613,218) |
| Basic (loss) per share from continuing operations (cents per share)     | 8     | (0.2)        | (0.4)       |             |             |
| Basic profit per share from discontinued operations (cents per share)   | 8     | 0.1          | -           |             |             |
| Diluted profit per share from discontinued operations (cents per share) | 8     | 0.1          | -           |             |             |

*The income statements should be read in conjunction with the accompanying notes to the financial statements.*



**BALANCE SHEETS**

As at 30 June 2006

|                                      | Notes | Consolidated     |                  | Company          |                  |
|--------------------------------------|-------|------------------|------------------|------------------|------------------|
|                                      |       | 2006<br>\$       | 2005<br>\$       | 2006<br>\$       | 2005<br>\$       |
| <b>Current assets</b>                |       |                  |                  |                  |                  |
| Cash and cash equivalents            | 19(b) | 1,897,846        | 301,454          | 1,558,676        | 134,102          |
| Trade and other receivables          | 10    | 175,482          | 114,297          | 47,118           | 1,398            |
| Available-for-sale financial assets  | 11    | -                | 178,214          | -                | 178,214          |
| Inventories                          | 12    | 235,138          | 75,682           | -                | -                |
| Other assets                         | 13    | 18,153           | 26,496           | 18,153           | 12,759           |
| <b>Total current assets</b>          |       | <b>2,326,619</b> | <b>696,143</b>   | <b>1,623,947</b> | <b>326,473</b>   |
| <b>Non-current assets</b>            |       |                  |                  |                  |                  |
| Trade and other receivables          | 10    | 53,400           | 55,220           | 53,400           | 55,220           |
| Other financial assets               | 14    | -                | -                | 6,832,904        | 4,183,108        |
| Property, plant and equipment        | 15    | 6,996,586        | 4,034,010        | 70,364           | 3,532            |
| <b>Total non-current assets</b>      |       | <b>7,049,986</b> | <b>4,089,230</b> | <b>6,956,668</b> | <b>4,241,860</b> |
| <b>Total assets</b>                  |       | <b>9,376,605</b> | <b>4,785,373</b> | <b>8,580,615</b> | <b>4,568,333</b> |
| <b>Current liabilities</b>           |       |                  |                  |                  |                  |
| Trade and other payables             | 16    | 602,640          | 459,237          | 145,131          | 210,056          |
| Provisions                           | 17    | -                | 11,590           | -                | 11,590           |
| <b>Total current liabilities</b>     |       | <b>602,640</b>   | <b>470,827</b>   | <b>145,131</b>   | <b>221,646</b>   |
| <b>Non-current liabilities</b>       |       |                  |                  |                  |                  |
| Provisions                           | 17    | 67,675           | 77,984           | -                | -                |
| <b>Total non-current liabilities</b> |       | <b>67,675</b>    | <b>77,984</b>    | <b>-</b>         | <b>-</b>         |
| <b>Total liabilities</b>             |       | <b>670,315</b>   | <b>548,811</b>   | <b>145,131</b>   | <b>221,646</b>   |
| <b>Net assets</b>                    |       | <b>8,706,290</b> | <b>4,236,562</b> | <b>8,435,484</b> | <b>4,346,687</b> |
| <b>Equity</b>                        |       |                  |                  |                  |                  |
| Issued capital                       |       | 50,219,815       | 45,438,074       | 50,219,815       | 45,438,074       |
| Reserves                             |       | (1,367,909)      | (1,814,046)      | 278,111          | 76,929           |
| Accumulated losses                   |       | (40,145,616)     | (39,387,466)     | (42,062,442)     | (41,168,316)     |
| <b>Total equity</b>                  |       | <b>8,706,290</b> | <b>4,236,562</b> | <b>8,435,484</b> | <b>4,346,687</b> |

*The balance sheets should be read in conjunction with the accompanying notes to the financial statements.*

**STATEMENTS OF CHANGES IN EQUITY**

**Consolidated Entity**

**For the year ended 30 June 2006**

|   | Issued<br>capital<br>\$ | Accumulated<br>losses<br>\$ | Available-<br>for-sale asset<br>revaluation<br>reserve<br>\$ | Translation<br>reserve<br>\$ | Share<br>based<br>payments<br>reserve<br>\$ | Total<br>\$      |
|---|-------------------------|-----------------------------|--|------------------------------|---|------------------|
| <b>Balance at 1 July 2004</b>                                   | 45,318,074              | (38,380,141)                | -  | (1,245,072)                  | -   | 5,692,861        |
| Shares issued, net of<br>transaction costs                      | 120,000                 | -                           | -  | -                            | -   | 120,000          |
| Exchange differences on<br>translation of foreign<br>operations | -                       | -                           | -  | (645,903)                    | -   | (645,903)        |
| Available-for-sale financial<br>assets                          | -                       | -                           | 86,740   | -                            | -   | 86,740           |
| Share based payments  | -                       | -                           | -  | -                            | (9,811)                                     | (9,811)          |
| Loss attributable to<br>members of parent entity                | -                       | (1,007,325)                 | -  | -                            | -   | (1,007,325)      |
| <b>Balance at 30 June 2005</b>                                  | <b>45,438,074</b>       | <b>(39,387,466)</b>         | <b>86,740</b>  | <b>(1,890,975)</b>           | <b>(9,811)</b>                              | <b>4,236,562</b> |
| Shares issued, net of<br>transaction costs                      | 4,781,741               | -                           | -  | -                            | -   | 4,781,741        |
| Exchange differences on<br>translation of foreign<br>operations | -                       | -                           | -  | 244,955                      | -   | 244,955          |
| Available-for-sale financial<br>assets                          | -                       | -                           | (86,740)   | -                            | -   | (86,740)         |
| Share based payments  | -                       | -                           | -  | -                            | 287,922                                     | 287,922          |
| Loss attributable to<br>members of parent entity                | -                       | (758,150)                   | -  | -                            | -   | (758,150)        |
| <b>Balance at 30 June 2006</b>                                  | <b>50,219,815</b>       | <b>(40,145,616)</b>         | <b>-</b>   | <b>(1,646,020)</b>           | <b>278,111</b>                              | <b>8,706,290</b> |

*The statements of changes in equity should be read in conjunction with the accompanying notes to the financial statements.*

**STATEMENTS OF CHANGES IN EQUITY**

**Parent Entity**

**For the year ended 30 June 2006**

|  | Issued<br>capital<br>\$ | Accumulated<br>losses<br>\$ | Available-<br>for-sale asset<br>revaluation<br>reserve<br>\$ | Share<br>based<br>payments<br>reserve<br>\$ | Total<br>\$      |
|--|-------------------------|-----------------------------|--|---|------------------|
| <b>Balance at 1 July 2004</b>                    | 45,318,074              | (39,555,098)                | -  | -   | 5,762,976        |
| Shares issued, net of<br>transaction costs       | 120,000                 | -                           | -  | -   | 120,000          |
| Available-for-sale financial<br>assets           | -                       | -                           | 86,740   | -   | 86,740           |
| Share based payments                             | -                       | -                           | -  | (9,811)                                     | (9,811)          |
| Loss attributable to members of<br>parent entity | -                       | (1,613,218)                 | -  | -   | (1,613,218)      |
| <b>Balance at 30 June 2005</b>                   | <b>45,438,074</b>       | <b>(41,168,316)</b>         | <b>86,740</b>  | <b>(9,811)</b>                              | <b>4,346,687</b> |
| Shares issued, net of<br>transaction costs       | 4,781,741               | -                           | -  | -   | 4,781,741        |
| Available-for-sale financial<br>assets           | -                       | -                           | (86,740)   | -   | (86,740)         |
| Share based payments                             | -                       | -                           | -  | 287,922                                     | 287,922          |
| Loss attributable to members of<br>parent entity | -                       | (894,126)                   | -  | -   | (894,126)        |
| <b>Balance at 30 June 2006</b>                   | <b>50,219,815</b>       | <b>(42,062,442)</b>         | <b>-</b>   | <b>278,111</b>                              | <b>8,435,484</b> |

*The statements of changes in equity should be read in conjunction with the accompanying notes to the financial statements.*

**STATEMENTS OF CASH FLOWS**

For the year ended 30 June 2006

|   | Notes | Consolidated       |                  | Company            |                    |
|---|-------|--------------------|------------------|--------------------|--------------------|
|   |       | 2006               | 2005             | 2006               | 2005               |
|   |       | \$                 | \$               | \$                 | \$                 |
| <b>Cash flows from operating activities</b>                       |       |                    |                  |                    |                    |
| Receipts from customers   |       | 1,055,633          | 932,870          | -                  | -                  |
| Payments to suppliers and employees                               |       | (1,619,337)        | (1,567,964)      | (933,105)          | (1,046,696)        |
| Interest received   |       | 45,345             | 9,036            | 45,345             | 9,036              |
| Interest paid   |       | (2,357)            | (1,421)          | (2,357)            | (1,421)            |
| <b>Net cash flows (used in) operating activities</b>              | 19(a) | <u>(520,716)</u>   | <u>(627,479)</u> | <u>(890,117)</u>   | <u>(1,039,081)</u> |
| <b>Cash flows from investing activities</b>                       |       |                    |                  |                    |                    |
| Exploration and development expenditure                           |       | (2,747,147)        | (69,099)         | (159,775)          | (68,454)           |
| Net proceeds / (costs) from discontinued operation                |       | 488,182            | (10,227)         | 488,182            | (10,227)           |
| Proceeds from sale of property, plant and equipment               |       | 100                | 19,814           | 100                | -                  |
| Acquisition of property, plant and equipment                      |       | (120,280)          | (30,586)         | (72,051)           | -                  |
| Proceeds from sale of equity investments                          |       | 90,759             | 395,999          | 90,759             | 395,999            |
| Purchase of equity investments                                    |       | -                  | (2,348)          | -                  | (2,348)            |
| Repayments from joint ventures                                    |       | -                  | 99,778           | -                  | -                  |
| Net (advances to) / repayments from controlled entities           |       | -                  | -                | (2,437,805)        | 353,657            |
| <b>Net cash flows from investing activities</b>                   |       | <u>(2,288,386)</u> | <u>403,331</u>   | <u>(2,090,590)</u> | <u>668,627</u>     |
| <b>Cash flows from financing activities</b>                       |       |                    |                  |                    |                    |
| Proceeds from issue of share capital                              |       | 4,719,077          | -                | 4,719,077          | -                  |
| Payment of share issue costs                                      |       | (320,836)          | -                | (320,836)          | -                  |
| <b>Net cash flows from financing activities</b>                   |       | <u>4,398,241</u>   | <u>-</u>         | <u>4,398,241</u>   | <u>-</u>           |
| <b>Net increase / (decrease) in cash and cash equivalents</b>     |       |                    |                  |                    |                    |
| Cash and cash equivalents at the beginning of the financial year  |       | 1,589,139          | (224,148)        | 1,417,534          | (370,454)          |
| Effect of exchange rate fluctuations on cash and cash equivalents |       | 301,454            | 527,882          | 134,102            | 504,556            |
|   |       | 7,253              | (2,280)          | 7,040              | -                  |
| <b>Cash and cash equivalents at the end of the financial year</b> | 19(b) | <u>1,897,846</u>   | <u>301,454</u>   | <u>1,558,676</u>   | <u>134,102</u>     |

*The statements of cash flows should be read in conjunction with the accompanying notes to the financial statements.*

## **1. Summary of significant accounting policies**

### ***Basis of preparation of the financial report***

The consolidated financial report of the Company for the financial year ended 30 June 2006 comprises the Company and its subsidiaries (the "consolidated entity"). The financial report was authorised for issue by the directors on 29 September 2006. The financial report is presented in Australian dollars.

The financial report is a general purpose financial report prepared in accordance with the requirements of the Corporations Act 2001 and Australian Accounting Standards ("AASBs") adopted by the Australian Accounting Standards Board ("AASB") and Urgent Issues Group Interpretations. International Financial Reporting Standards ("IFRSs") form the basis of AASBs adopted by the AASB, and for the purposes of this report are called Australian equivalents to IFRS ("AIFRS") to distinguish from previous Australian GAAP.

This is the consolidated entity's first full year financial report prepared in accordance with AASBs, being AIFRS, and AASB 1 *First-Time Adoption of Australian Equivalents to International Financial Reporting Standards* has been applied. An explanation of how the transition to AIFRS has affected the reported financial position, financial performance and cash flows of the Company and consolidated entity under previous Australian GAAP is provided in Note 2.

The financial report of Carnarvon Petroleum Limited and its controlled entities and Carnarvon Petroleum Limited, an individual parent entity, complies with AASBs, which include AIFRS. Compliance with AIFRS ensures that the financial report also complies with IFRS.

The financial report is prepared on a historical cost basis, except for available-for-sale financial assets which are measured at fair value.

The accounting policies set out below have been applied consistently to all periods presented in the consolidated financial report and in preparing an opening AIFRS balance sheet at 1 July 2004 for the purposes of transition to AASBs / AIFRS. The accounting policies have been applied consistently by all entities in the consolidated entity.

The AASB has issued a number of AASBs and amendments to AASBs which are applicable for reporting periods commencing on or after 1 January 2006, but which are available for early adoption. The Company and consolidated entity have not early adopted any of these accounting standards or amendments as they are not expected to have a material impact on the financial results of the Company or consolidated entity; they may have an effect on the disclosures of the Company and consolidated entity however a detailed assessment of the potential impact has not been undertaken at the date of this report.

### ***Going concern***

The consolidated financial report has been prepared on a going concern basis, which contemplates continuity of normal business activities and realisation of assets and discharge of liabilities in the ordinary course of business.

The consolidated entity has incurred a loss from continuing operations of \$1,246,332 for the year ended 30 June 2006. The ability of the consolidated entity to continue as a going concern, including the ability of the consolidated entity to pay its debts as and when they fall due, is dependent upon:

- profitability of the SW1A Joint Venture; and/or
- availability of capital and / or
- the sale of its assets and / or the farm-out of its interests

Without the generation of future profits and / or the raising of capital, there is significant uncertainty as to whether the consolidated entity will be able to continue as a going concern and therefore whether it will be able to pay its debts as and when they fall due and realise its assets and extinguish its liabilities in the normal course of business and at the amounts stated in the financial report.

The directors believe that the consolidated entity will generate future profits from derived from the SW1A Joint Venture and / or capital will be available to cover exploration and development commitments, and, accordingly, the report has been prepared on a going concern basis. Consequently, no adjustments have been made relating to the recoverability and classification of recorded asset amounts or to the amounts and classification of liabilities that might be necessary should the consolidated entity not continue as a going concern.

## 1. Summary of significant accounting policies (continued)

### *Accounting Policies*

#### **(a) Principles of Consolidation**

##### *Subsidiaries*

The consolidated financial report comprises the financial statements of the Company and its controlled entities. A controlled entity is any entity controlled by the Company whereby the Company has the power to control the financial and operating policies of an entity so as to obtain benefits from its activities. All inter-company balances and transactions between entities in the economic entity, including any unrealised profits or losses, have been eliminated on consolidation.

Accounting policies of subsidiaries have been changed where necessary to ensure consistency with those applied by the parent entity.

Where controlled entities enter or leave the economic entity during the year, their operating results are included or excluded from the date control was obtained or until the date control ceased.

Investments in subsidiaries are carried at their cost of acquisition in the Company's financial statements.

##### *Joint venture operations and assets*

The economic entity's share of the assets, liabilities, revenue and expenses of joint venture operations are included in the financial statements under the appropriate headings.

#### **(b) Income Tax**

The charge for current income tax expense is based on the result for the year adjusted for any non-assessable or disallowed items. It is calculated using tax rates that have been enacted or are substantively enacted by balance sheet date.

Deferred tax is accounted for using the balance sheet liability method in respect of temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. No deferred income tax will be recognised from the initial recognition of an asset or liability, excluding a business combination, where there is no effect on accounting or taxable profit or loss.

Deferred tax is calculated at the tax rates that are expected to apply to the period when the asset is realised or liability is settled. Deferred tax is recognised in the income statement except where it relates to items recognised directly in equity, in which case it is recognised in equity. Deferred income tax assets are recognised for deductible temporary differences and unused tax losses only if it is probable that future taxable amounts will be available to utilise those temporary differences and tax losses.

The amount of benefits brought to account or which may be realised in the future is based on the assumption that no adverse change will occur in income taxation legislation and the anticipation that the economic entity will derive sufficient future assessable income to enable the benefit to be realised and comply with the conditions of deductibility imposed by the law. The carrying amount of deferred tax assets is reviewed at each balance date and only recognised to the extent that sufficient future assessable income is expected to be obtained.

##### *Tax consolidation*

Carnarvon Petroleum Limited and its wholly-owned Australian resident subsidiaries have formed a tax-consolidated group with effect from 1 July 2003 and are therefore taxed a single entity from that date. Carnarvon Petroleum Limited is the head entity of the tax-consolidated group.

At reporting date the consolidated entity has not recognized any tax assets or tax liabilities in respect of any wholly-owned entity within the consolidated group. In future periods the members of the group will, if required, enter into a tax sharing agreement whereby each company in the group contributes to the income tax payable in proportion to their contribution to the net profit before tax of the tax consolidated group.

**1. Summary of significant accounting policies (continued)**

**(c) Property, Plant and Equipment**

All property, plant and equipment is stated at historical cost less accumulated depreciation and impairment losses. The cost of an item also includes the initial estimate of the costs of dismantling and removing an item and restoring the site on which it is located.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the group and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

Mining property and development assets include costs transferred from exploration and evaluation assets once technical feasibility and commercial viability of an area of interest are demonstrable, together with subsequent costs to develop the asset to the production phase.

*Impairment*

The carrying amount of property, plant and equipment is reviewed at each balance date to determine whether there are any objective indicators of impairment that may indicate the carrying values may not be recoverable in whole or in part. Impairment testing is carried out in accordance with Note 1(f).

Where an asset does not generate cash flows that are largely independent it is assigned to a cash generating unit and the recoverable amount test applied to the cash generating unit as a whole.

If the carrying value of the asset is determined to be in excess of its recoverable amount, the asset or cash generating unit is written down to its recoverable amount.

*Depreciation*

Depreciation on plant and equipment is calculated on a straight line basis over expected useful life to the economic entity commencing from the time the asset is held ready for use. The major depreciation rates used for each class of depreciable assets are:

Plant and equipment:        20% to 33%

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at least annually.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Gains and losses on disposals are determined by comparing proceeds with the carrying amount. These gains and losses are included in the income statement.

Depreciation of mining property and development costs is calculated on a unit of production basis so as to write off the cost of each asset in proportion to the depletion of the estimated recoverable reserves.

**(d) Inventories**

Inventories are stated at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less any estimated selling costs.

Cost includes those costs incurred in bringing each component of inventory to its present location and condition.

**1. Summary of significant accounting policies (continued)**

**(e) Intangible Assets**

*Exploration and evaluation expenditure*

Exploration and evaluation expenditure incurred is accumulated in respect of each identifiable area of interest. These costs are only carried forward to the extent that the consolidated entity's rights of tenure to the area are current and that the costs are expected to be recouped through the successful development of the area, or where activities in the area have not yet reached a stage that permits reasonable assessment of the existence of economically recoverable reserves.

Each area of interest is assessed for impairment to determine the appropriateness of continuing to carry forward costs in relation to that area of interest. Impairment testing is carried out in accordance with Note 1(f).

Accumulated costs in relation to an abandoned area are written off in full against profit in the year in which the decision to abandon the area is made.

Once the technical feasibility and commercial viability of the extraction of mineral resources in an area of interest are demonstrable, exploration and evaluation assets attributable to that area of interest are first tested for impairment and then reclassified from intangible assets to mining property and development assets within property, plant and equipment.

**(f) Recoverable Amount of Assets and Impairment Testing**

Assets that have an indefinite useful life are not subject to depreciation and are tested annually for impairment by estimating their recoverable amount.

Assets that are subject to depreciation are reviewed annually to determine whether there is any indication of impairment. Where such an indicator exists, a formal assessment of recoverable amount is then made. Where this is in excess of carrying amount, the asset is written down to its recoverable amount.

Recoverable amount is the greater of fair value less costs to sell and value in use. Value in use is the present value of the future cash flows expected to be derived from the asset or cash generating unit. In estimating value in use, a pre-tax discount rate is used which reflects the current market assessments of the time value of money and the risks specific to the asset. Any resulting impairment loss is recognised immediately in the income statement.

**(g) Trade Receivables**

Trade receivables are stated at fair value and subsequently measured at amortised cost, less impairment losses. Impairment testing is carried out in accordance with Note 1(f).

**(h) Provisions**

Provisions are recognised when the consolidated entity has a legal or constructive obligation, as a result of past events, for which it is probable that an outflow of economic benefits will result and that outflow can be reliably measured. Provisions are determined by discounting the expected future cash flows at a pre-tax discount rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

*Restoration costs*

The amount of the provision for future restoration and rehabilitation costs is capitalised and depreciated in accordance with the policy set out in Note 1(c). The unwinding of the effect of discounting on the provision is recognised as a finance cost.



**1. Summary of significant accounting policies (continued)**

**(i) Investments and Other Financial Assets**

The consolidated entity determines the classification of its financial instruments at initial recognition and re-evaluates this designation at each reporting date.

Fair value is the measurement basis, with the exception of held-to-maturity investments and loans and receivables which are measured at amortised cost. Fair value is inclusive of transaction costs. Changes in fair value are either taken to the income statement or to an equity reserve (refer below).

Fair value is determined based on current bid prices for all quoted investments. If there is not an active market for a financial asset fair value is measured using established valuation techniques.

The consolidated entity assesses at each balance date whether there is objective evidence that a financial asset or group of financial assets are impaired. In the case of equity securities classified as available-for-sale, a significant or prolonged decline in the fair value of a security below its cost is considered in determining whether the security is impaired. If any such evidence exists the cumulative loss is removed from equity and recognised in the income statement.

*(i) Financial assets at fair value through profit and loss*

A financial asset is classified in this category if acquired principally for the purpose of selling in the short term or if so designated by management. Realised and unrealised gains and losses arising from changes in the fair value of these assets are included in the income statement in the period in which they arise.

*(ii) Loans and receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and are stated at amortised cost using the effective interest rate method.

*(iii) Held-to-maturity investments*

These investments have fixed maturities, and it is the group's intention to hold these investments to maturity. Held-to-maturity investments are stated at amortised cost using the effective interest rate method.

*(iv) Available-for-sale financial assets*

Available for sale financial assets, comprising principally marketable equity securities, are non-derivatives that are either designated in this category or not included in any of the above categories. Available-for-sale financial assets are reflected at fair value. Unrealised gains and losses arising from changes in fair value are taken directly to equity in an available-for-sale investments revaluation reserve. When securities classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains and losses from investment securities.

**(j) Segment Reporting**

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different to those of other business segments.

A geographical segment is engaged in providing products or services within a particular economic environment and is subject to risks and returns that are different from those of segments that are operating in other economic environments.

**1. Summary of significant accounting policies (continued)**

**(k) Foreign Currency**

*Functional and presentation currency*

The functional currency of each of the group's entities is measured using the currency of the primary economic environment in which that entity operates (the "functional" currency). The consolidated financial statements are presented in Australian dollars which is the parent entity's functional and presentation currency.

*Transactions and balances*

Foreign currency transactions are translated into functional currency using the exchange rates prevailing at the date of the transaction. Foreign currency monetary assets and liabilities are translated at the exchange rate at balance sheet date. Non-monetary items measured at historical cost continue to be carried at the exchange rate at the date of the transaction.

Exchange differences arising on the translation of monetary items are recognised in the income statement, except where deferred in equity as a qualifying cash flow or net investment hedge.

Translation differences arising on non-monetary items, such as equities held at fair value through profit and loss, are reported as part of the fair value gain or loss. Translation differences on non-monetary items, such as equities classified as available-for-sale financial assets, are included in the fair value reserve in equity.

*Foreign operations*

The financial performance and position of foreign operations whose functional currency is different from the consolidated entity's presentation currency are translated as follows:

- assets and liabilities are translated at exchange rates prevailing at balance sheet date.
- income and expenses are translated at average exchange rates for the period

Exchange differences arising on translation of foreign operations are transferred directly to the group's foreign currency translation reserve as a separate component of equity. These differences are recognised in the income statement upon disposal of the foreign operation.

**(l) Leases**

Leases are classified at their inception as either operating or finance leases based on the economic substance of the agreement so as to reflect the risks and benefits incidental to ownership.

*Operating leases*

A lease where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments in relation to operating leases are charged to the income statement on a straight-line basis over the period of the lease.

**(m) Share Capital**

Ordinary shares are classified as share capital.

Incremental costs directly attributable an equity transaction are shown as a deduction from equity, net of any recognised income tax benefit.

1. Summary of significant accounting policies (continued)

(n) Employee Benefits

*Wages and salaries, annual leave*

Provision is made for the consolidated entity's liability for employee benefits arising from services rendered by employees to balance date. Employee benefits that are expected to be settled within one year have been measured at the amounts expected to be paid when the liability is settled, plus related on-costs.

*Share based payments – shares and share options*

The fair value of shares and share options granted is recognised as an expense with a corresponding increase in equity. Fair value is measured at grant date and recognised over the period during which the grantees become unconditionally entitled to the shares or share options.

The fair value of share grants at grant date is determined by the share price at that time.

The fair value of share options at grant date is determined using a Black-Scholes option pricing model that takes into account the exercise price, the term of the option, any vesting and performance criteria, the share price at grant date, the expected price volatility of the underlying share, the expected dividend yield and the risk free rate for the term of the option.

*Share based payments – Employee Share Plan*

Share based compensation has been provided to employees via the Carnarvon Employee Share Plan ("ESP"), financed by means of interest free limited recourse loans. Under AASB 2 "*Share-based Payment*", the ESP shares are deemed to be equity settled, share based remuneration and treated as an in-substance grant of options.

*(i) ESP shares allocated prior to 7 November 2002 and / or vested before 1 January 2005*

The consolidated entity has made an election in relation to the transitional exemptions allowed by AASB 1 "*First-time Adoption of Australian Equivalents to International Financial Reporting Standards*" not to apply AASB 2 "*Share-based Payment*" to equity instruments granted after 7 November 2002 that had not vested on or before 1 January 2005. Accordingly, no AIFRS adjustment has been made in respect of these shares.

*(ii) ESP shares vesting subsequent to 1 January 2005*

For new limited recourse loans issued to employees on or after 1 January 2005, the consolidated entity is required to recognise within the income statement a remuneration expense measured at the fair value of the "share option" inherent in the issue to the employees, with a corresponding increase to a share-based payments reserve in equity. The fair value is measured at grant date and recognised when the employees become unconditionally entitled to the shares, effectively on grant. A loan receivable will not be recognised.

The fair value at grant date is determined using a pricing model that factors in the share price at grant date, the expected price volatility of the underlying share, the expected dividend yield, and the risk free rate for the assumed term of the "option".

Upon the exercise of the "option", the balance of the share-based payments reserve relating to the "options" is transferred to share capital.

**1. Summary of significant accounting policies (continued)**

**(o) Earnings Per Share**

Basic earnings per share ("EPS") is calculated by dividing the profit attributable to equity holders of the Company by the weighted number of shares outstanding during the year.

**(p) Cash and Cash Equivalents**

Cash and cash equivalents comprise cash on hand, deposits held at call with banks, and other short-term highly liquid investments.

**(q) Revenue**

Revenue from the sale of goods is recognised when the significant risks and rewards of ownership have been transferred to the buyer. Interest revenue is recognised as it accrues, using the effective interest rate method.

**(r) Goods and Services Tax (GST)**

Revenues, expenses and assets are recognised net of the amount of GST, except where the amount of GST incurred is not recoverable from the Australian Tax Office. In these circumstances the GST is recognised as part of the cost of acquisition of the asset or as part of the expense. Receivables and payables in the balance sheet are shown inclusive of GST.

Cash flows are presented in the cash flow statement on a gross basis, except for the GST component of investing and financing activities, which are disclosed as operating cash flows.

**(s) Trade and Other Payables**

Trade and other payables are stated at amortised cost. The amounts are unsecured and usually paid within 60 days of recognition.

**(t) Comparative Figures**

When required by Accounting Standards, comparative figures have been adjusted to conform to changes in presentation for the current financial year.

**(u) Accounting Estimates and Judgements**

The directors evaluate estimates and judgements incorporated into the financial report based on historical knowledge and best available current information. Estimates assume a reasonable expectation of future events.

*Key estimate – impairment*

The consolidated entity assesses impairment at each reporting date by evaluating conditions specific to the group that may lead to the impairment of assets. Where an impairment trigger exists, the recoverable amount of the asset is determined. Value-in-use calculations performed in assessing recoverable amounts incorporate a number of key estimates. There was not considered to be any impairment trigger over the carrying value of the consolidated entity's interest in the SW1A Joint Venture at the date of this report.

The presentation of the financial report on a going concern basis is explained on page 28 of this report.

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**2. First-time adoption of Australian equivalents to international financial reporting standards**

**Consolidated Entity**

**Reconciliation of Equity at 1 July 2004**

|                                      | Notes | 1 July 2004<br>Previous<br>AGAAP<br>\$ | Adjustments<br>on introduction<br>of Australian<br>equivalents to<br>IFRS<br>\$ | Australian<br>equivalents to<br>IFRS at<br>1 July 2004<br>\$ |
|--------------------------------------|-------|--|---|--|
| <b>Current assets</b>                |       |  |   |  |
| Cash and cash equivalents            |       | 527,882                                | -   | 527,882  |
| Trade and other receivables          |       | 246,191                                | -   | 246,191  |
| Available-for-sale financial assets  |       | 282,876                                | -   | 282,876  |
| Inventories                          | 2(b)  | 104,841                                | (25,150)  | 79,691   |
| Other assets                         |       | 76,225                                 | -   | 76,225   |
| <b>Total current assets</b>          |       | <b>1,238,015</b>                       | <b>(25,150)</b>   | <b>1,212,865</b>   |
| <b>Non-current assets</b>            |       |  |   |  |
| Trade and other receivables          |       | 61,265                                 | -   | 61,265   |
| Property, plant and equipment        | 2(d)  | 5,912,466                              | (1,161,988)   | 4,750,478  |
| <b>Total non-current assets</b>      |       | <b>5,973,731</b>                       | <b>(1,161,988)</b>  | <b>4,811,743</b>   |
| <b>Total assets</b>                  |       | <b>7,211,746</b>                       | <b>(1,187,138)</b>  | <b>6,024,608</b>   |
| <b>Current liabilities</b>           |       |  |   |  |
| Trade and other payables             |       | 259,322                                | -   | 259,322  |
| Provisions                           |       | 880                                    | -   | 880  |
| <b>Total current liabilities</b>     |       | <b>260,202</b>                         | <b>-</b>  | <b>260,202</b>   |
| <b>Non-current liabilities</b>       |       |  |   |  |
| Provisions                           | 2(g)  | -                                      | 71,545  | 71,545   |
| <b>Total non-current liabilities</b> |       | <b>-</b>                               | <b>71,545</b>   | <b>71,545</b>  |
| <b>Total liabilities</b>             |       | <b>260,202</b>                         | <b>71,545</b>   | <b>331,747</b>   |
| <b>Net assets</b>                    |       | <b>6,951,544</b>                       | <b>(1,258,683)</b>  | <b>5,692,861</b>   |
| <b>Equity</b>                        |       |  |   |  |
| Issued capital                       |       | 45,318,074                             | -   | 45,318,074   |
| Reserves                             | 2(e)  | -                                      | (1,245,072)   | (1,245,072)  |
| Accumulated losses                   | 2(f)  | (38,366,530)                           | (13,611)  | (38,380,141)   |
| <b>Total equity</b>                  |       | <b>6,951,544</b>                       | <b>(1,258,683)</b>  | <b>5,692,861</b>   |

**CARNARVON PETROLEUM LTD**  
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**NOTES TO THE FINANCIAL STATEMENTS**

**2. First-time adoption of Australian equivalents to international financial reporting standards (continued)**

**Consolidated Entity**

**Reconciliation of Equity at 30 June 2005**

|                                      | Notes | 30 June 2005<br>Previous<br>AGAAP<br>\$ | Adjustments<br>on introduction<br>of Australian<br>equivalents to<br>IFRS<br>\$ | Australian<br>equivalents to<br>IFRS at<br>30 June 2005<br>\$ |
|--------------------------------------|-------|---|---|---|
| <b>Current assets</b>                |       |   |   |   |
| Cash and cash equivalents            |       | 301,454                                 | -   | 301,454   |
| Trade and other receivables          |       | 114,297                                 | -   | 114,297   |
| Available-for-sale financial assets  | 2(a)  | 91,474                                  | 86,740  | 178,214   |
| Inventories                          | 2(b)  | 108,576                                 | (32,894)  | 75,682  |
| Other assets                         |       | 26,496                                  | -   | 26,496  |
| <b>Total current assets</b>          |       | <b>642,297</b>                          | <b>53,846</b>   | <b>696,143</b>  |
| <b>Non-current assets</b>            |       |   |   |   |
| Trade and other receivables          | 2(c)  | 72,220                                  | (17,000)  | 55,220  |
| Property, plant and equipment        | 2(d)  | 5,762,755                               | (1,728,745)   | 4,034,010   |
| <b>Total non-current assets</b>      |       | <b>5,834,975</b>                        | <b>(1,745,745)</b>  | <b>4,089,230</b>  |
| <b>Total assets</b>                  |       | <b>6,477,272</b>                        | <b>(1,691,899)</b>  | <b>4,785,373</b>  |
| <b>Current liabilities</b>           |       |   |   |   |
| Trade and other payables             |       | 459,237                                 | -   | 459,237   |
| Provisions                           |       | 11,590                                  | -   | 11,590  |
| <b>Total current liabilities</b>     |       | <b>470,827</b>                          | <b>-</b>  | <b>470,827</b>  |
| <b>Non-current liabilities</b>       |       |   |   |   |
| Provisions                           | 2(g)  | -                                       | 77,984  | 77,984  |
| <b>Total non-current liabilities</b> |       | <b>-</b>                                | <b>77,984</b>   | <b>77,984</b>   |
| <b>Total liabilities</b>             |       | <b>470,827</b>                          | <b>77,984</b>   | <b>548,811</b>  |
| <b>Net assets</b>                    |       | <b>6,006,445</b>                        | <b>(1,769,883)</b>  | <b>4,236,562</b>  |
| <b>Equity</b>                        |       |   |   |   |
| Issued capital                       | 2(h)  | 45,318,074                              | 120,000   | 45,438,074  |
| Reserves                             | 2(e)  | -                                       | (1,814,046)   | (1,814,046)   |
| Accumulated losses                   | 2(f)  | (39,311,629)                            | (75,837)  | (39,387,466)  |
| <b>Total equity</b>                  |       | <b>6,006,445</b>                        | <b>(1,769,883)</b>  | <b>4,236,562</b>  |

**CARNARVON PETROLEUM LTD**  
**FINANCIAL REPORT 30 JUNE 2006**  
**NOTES TO THE FINANCIAL STATEMENTS**

**2. First-time adoption of Australian equivalents to international financial reporting standards (continued)**

**Parent Entity**

**Reconciliation of Equity at 1 July 2004**

|                                     | <b>Notes</b> | <b>1 July 2004<br/>Previous<br/>AGAAP<br/>\$</b> | <b>Adjustments<br/>on introduction<br/>of Australian<br/>equivalents to<br/>IFRS<br/>\$</b> | <b>Australian<br/>equivalents to<br/>IFRS at<br/>1 July 2004<br/>\$</b> |
|-------------------------------------|--------------|--|---|---|
| <b>Current assets</b>               |              |  |   |   |
| Cash and cash equivalents           |              | 504,556  | -   | 504,556   |
| Trade and other receivables         |              | 44,771   | -   | 44,771  |
| Available-for-sale financial assets |              | 282,876  | -   | 282,876   |
| Other current assets                |              | 6,200  | -   | 6,200   |
| <b>Total current assets</b>         |              | <b>838,403</b>                                   | <b>-</b>  | <b>838,403</b>  |
| <b>Non-current assets</b>           |              |  |   |   |
| Receivables                         | 2(c)         | 3,593,282  | (3,532,017)   | 61,265  |
| Other financial assets              | 2(j)         | 1,482,962  | 3,532,017   | 5,014,979   |
| Property, plant and equipment       |              | 6,089  | -   | 6,089   |
| <b>Total non-current assets</b>     |              | <b>5,082,333</b>                                 | <b>-</b>  | <b>5,082,333</b>  |
| <b>Total assets</b>                 |              | <b>5,920,736</b>                                 | <b>-</b>  | <b>5,920,736</b>  |
| <b>Current liabilities</b>          |              |  |   |   |
| Trade and other payables            |              | 156,880  | -   | 156,880   |
| Provisions                          |              | 880  | -   | 880   |
| <b>Total current liabilities</b>    |              | <b>157,760</b>                                   | <b>-</b>  | <b>157,760</b>  |
| <b>Total liabilities</b>            |              | <b>157,760</b>                                   | <b>-</b>  | <b>157,760</b>  |
| <b>Net assets</b>                   |              | <b>5,762,976</b>                                 | <b>-</b>  | <b>5,762,976</b>  |
| <b>Equity</b>                       |              |  |   |   |
| Issued capital                      |              | 45,318,074                                       | -   | 45,318,074  |
| Accumulated losses                  |              | (39,555,098)                                     | -   | (39,555,098)  |
| <b>Total equity</b>                 |              | <b>5,762,976</b>                                 | <b>-</b>  | <b>5,762,976</b>  |

**CARNARVON PETROLEUM LTD**  
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**NOTES TO THE FINANCIAL STATEMENTS**

**2. First-time adoption of Australian equivalents to international financial reporting standards (continued)**

**Parent Entity**

**Reconciliation of Equity at 30 June 2005**

|                                     | Notes | 1 July 2005<br>Previous<br>AGAAP<br>\$ | Adjustments<br>on introduction<br>of Australian<br>equivalents to<br>IFRS<br>\$ | Australian<br>equivalents to<br>IFRS at<br>1 July 2005<br>\$ |
|-------------------------------------|-------|--|---|--|
| <b>Current assets</b>               |       |  |   |  |
| Cash and cash equivalents           |       | 134,102                                | -   | 134,102  |
| Trade and other receivables         |       | 1,398                                  | -   | 1,398  |
| Available-for-sale financial assets | 2(a)  | 91,474                                 | 86,740  | 178,214  |
| Other current assets                |       | 12,759                                 | -   | 12,759   |
| <b>Total current assets</b>         |       | <b>239,733</b>                         | <b>86,740</b>   | <b>326,473</b>   |
| <b>Non-current assets</b>           |       |  |   |  |
| Receivables                         | 2(c)  | 2,772,366                              | (2,717,146)   | 55,220   |
| Other financial assets              | 2(j)  | 1,482,962                              | 2,700,146   | 4,183,108  |
| Property, plant and equipment       |       | 3,532                                  | -   | 3,532  |
| <b>Total non-current assets</b>     |       | <b>4,258,860</b>                       | <b>(17,000)</b>   | <b>4,241,860</b>   |
| <b>Total assets</b>                 |       | <b>4,498,593</b>                       | <b>69,740</b>   | <b>4,568,333</b>   |
| <b>Current liabilities</b>          |       |  |   |  |
| Trade and other payables            |       | 210,056                                | -   | 210,056  |
| Provisions                          |       | 11,590                                 | -   | 11,590   |
| <b>Total current liabilities</b>    |       | <b>221,646</b>                         | <b>-</b>  | <b>221,646</b>   |
| <b>Total liabilities</b>            |       | <b>221,646</b>                         | <b>-</b>  | <b>221,646</b>   |
| <b>Net assets</b>                   |       | <b>4,276,947</b>                       | <b>69,740</b>   | <b>4,346,687</b>   |
| <b>Equity</b>                       |       |  |   |  |
| Issued capital                      | 2(h)  | 45,318,074                             | 120,000   | 45,438,074   |
| Reserves                            | 2(e)  | -                                      | 76,929  | 76,929   |
| Accumulated losses                  | 2(f)  | (41,041,127)                           | (127,189)   | (41,168,316)   |
| <b>Total equity</b>                 |       | <b>4,276,947</b>                       | <b>69,740</b>   | <b>4,346,687</b>   |



**CARNARVON PETROLEUM LTD**  
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**2. First-time adoption of Australian equivalents to international financial reporting standards (continued)**

**Consolidated Entity**

**Reconciliation of Loss for the full year to 30 June 2005**

|  | Notes | Previous<br>AGAAP<br>\$ | Effect of<br>transition to<br>Australian<br>equivalents to<br>IFRS<br>\$ | Australian<br>equivalents to<br>IFRS<br>\$ |
|--|-------|-------------------------|--|--|
| <b>Revenue from continuing operations</b>                  | 2(i)  | 1,368,976               | (426,136)  | 942,840                                    |
| Other income   | 2(i)  | -                       | 190,030  | 190,030                                    |
| Cost of sales  | 2(f)  | (818,763)               | 42,425   | (776,338)                                  |
| Administrative expenses                                    |       | (342,388)               | -  | (342,388)                                  |
| Directors' emoluments                                      |       | (216,134)               | -  | (216,134)                                  |
| Employee benefits expense                                  |       | (157,860)               | -  | (157,860)                                  |
| Consulting fees (directors)                                | 2(f)  | (189,734)               | 100,000  | (89,734)                                   |
| Legal fees   |       | (193,473)               | -  | (193,473)                                  |
| Unrealised foreign exchange losses                         | 2(f)  | (37,418)                | 28,977   | (8,441)                                    |
| Other expenses   | 2(i)  | (278,203)               | 236,106  | (42,097)                                   |
| Exploration expenditure written off                        | 2(i)  | (78,681)                | 10,227   | (68,454)                                   |
| Share based payments                                       | 2(f)  | -                       | (227,189)  | (227,189)                                  |
| Finance costs  | 2(f)  | (1,421)                 | (6,439)  | (7,860)                                    |
| <b>(Loss) before income tax</b>                            |       | (945,099)               | (51,999)   | (997,098)                                  |
| Income tax expense   |       | -                       | -  | -  |
| <b>(Loss) from continuing operations</b>                   |       | (945,099)               | (51,999)   | (997,098)                                  |
| <b>(Loss) on sale of discontinued operations</b>           |       | -                       | (10,227)   | (10,227)                                   |
| <b>(Loss) attributable to members of the parent entity</b> |       | (945,099)               | (62,226)   | (1,007,325)                                |

2. First-time adoption of Australian equivalents to international financial reporting standards (continued)

Parent Entity

Reconciliation of Loss for the full year to 30 June 2005

|  | Notes | Previous<br>AGAAP<br>\$ | Effect of<br>transition to<br>Australian<br>equivalents to<br>IFRS<br>\$ | Australian<br>equivalents to<br>IFRS<br>\$ |
|--|-------|-------------------------|--|--|
| <b>Revenue from continuing operations</b>                  | 2(i)  | 405,209                 | (405,209)  | -  |
| Other income   | 2(i)  | -                       | 222,414  | 222,414                                    |
| Cost of sales  |       | -                       | -  | -  |
| Administrative expenses                                    |       | (342,388)               | -  | (342,388)                                  |
| Directors' emoluments                                      |       | (216,134)               | -  | (216,134)                                  |
| Employee benefits expense                                  |       | (157,860)               | -  | (157,860)                                  |
| Consulting fees (directors)                                | 2(f)  | (189,734)               | 100,000  | (89,734)                                   |
| Legal fees   |       | (193,473)               | -  | (193,473)                                  |
| Unrealised foreign exchange losses                         |       | (486,655)               | -  | (486,655)                                  |
| Other expenses   | 2(i)  | (224,892)               | 182,795  | (42,097)                                   |
| Exploration expenditure written off                        | 2(i)  | (78,681)                | 10,227   | (68,454)                                   |
| Share based payments                                       | 2(f)  | -                       | (227,189)  | (227,189)                                  |
| Finance costs  |       | (1,421)                 | -  | (1,421)                                    |
| <b>(Loss) before income tax</b>                            |       | (1,486,029)             | (116,962)  | (1,602,991)                                |
| Income tax expense   |       | -                       | -  | -  |
| <b>(Loss) from continuing operations</b>                   |       | (1,486,029)             | (116,962)  | (1,602,991)                                |
| <b>(Loss) on sale of discontinued operations</b>           |       | -                       | (10,227)   | (10,227)                                   |
| <b>(Loss) attributable to members of the parent entity</b> |       | (1,486,029)             | (127,189)  | (1,613,218)                                |

**CARNARVON PETROLEUM LTD**  
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**NOTES TO THE FINANCIAL STATEMENTS**

**2. First-time adoption of Australian equivalents to international financial reporting standards (continued)**

**Notes to the reconciliations of equity and profit and loss at 1 July 2004 and 30 June 2005.**

|            |   | <b>30 June 2005</b>         | <b>1 July 2004</b>        |
|------------|---|-----------------------------|---------------------------|
|            |   | <b>\$</b>                   | <b>\$</b>                 |
| <b>(a)</b> | <i>Available-for-sale financial assets</i><br><br><i>Company and consolidated</i><br><br>Under AASB 139 the consolidated entity has categorised certain financial instruments as available-for-sale financial assets fair valued through equity. Under previous AGAAP these were recognised at cost.  | 86,740                      | -                         |
| <b>(b)</b> | <i>Inventories</i><br><br><i>Consolidated</i><br><br>Under AASB 121, assets and liabilities of foreign operations are translated from the entity's functional currency to the consolidated entity's presentation currency of Australian dollars at foreign exchange rates ruling at reporting date. The revenues and expenses of foreign operations are translated to Australian dollars at the exchange rates approximating the exchange rates ruling at the date of the transactions. Foreign exchange differences arising on translation are recognised directly in a separate component of equity.  | (32,894)                    | (25,150)                  |
| <b>(c)</b> | <i>Receivables</i><br><br><i>Company only</i><br><br>Under AASB 121, a loan to a controlled entity has been reclassified as a net investment in a foreign subsidiary.<br><br><i>Company and consolidated</i><br><br>Under AASB 2 " <i>Share-based Payments</i> ", the Employee Share Plan is deemed to be equity settled, share based remuneration and treated as an in-substance grant of options.   | (2,700,146)<br><br>(17,000) | (3,532,017)<br><br>-      |
| <b>(d)</b> | <i>Property, plant and equipment</i><br><br><i>Consolidated</i><br><br>Under AASB 121, assets and liabilities of foreign operations are translated from the foreign entity's functional currency to the consolidated entity's presentation currency of Australian dollars at foreign exchange rates ruling at reporting date. The revenues and expenses of foreign operations are translated to Australian dollars at the exchange rates approximating the exchange rates ruling at the date of the transactions. Foreign exchange differences arising on translation are recognised directly in a separate component of equity.<br><br>AASB 137 requires restoration and other clean up obligations are to be recognised when the liability arises; under AGAAP such provisions could be accrued over the life of the asset. | (1,780,198)<br><br>51,453   | (1,214,325)<br><br>52,337 |

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**NOTES TO THE FINANCIAL STATEMENTS**

**2. First-time adoption of Australian equivalents to international financial reporting standards (continued)**

**Notes to the reconciliations of equity and profit and loss at 1 July 2004 and 30 June 2005.**

|            |   | <b>30 June 2005</b> | <b>1 July 2004</b> |
|------------|---|---------------------|--------------------|
|            |   | <b>\$</b>           | <b>\$</b>          |
| <b>(e)</b> | <i>Reserves</i>   |                     |                    |
|            | <i>Company and consolidated</i>   |                     |                    |
|            | Under AASB 139 the consolidated entity has categorised certain financial instruments as available-for-sale financial assets fair valued through equity.   | 86,740              | -                  |
|            | Under AASB 2 “ <i>Share-based Payments</i> ”, the consolidated entity’s Employee Share Plan are deemed to be equity settled, share based remuneration and treated as an in-substance grant of options.  | 7,189               | -                  |
|            | Under AASB 2 “ <i>Share-based Payments</i> ”, the consolidated entity’s Employee Share Plan are deemed to be equity settled, share based remuneration and treated as an in-substance grant of options.  | (17,000)            | -                  |
|            | <i>Consolidated</i>   |                     |                    |
|            | Under AASB 121, assets and liabilities of foreign operations are translated from the entity’s functional currency to the consolidated entity’s presentation currency of Australian dollars at foreign exchange rates ruling at reporting date. The revenues and expenses of foreign operations are translated to Australian dollars at the exchange rates approximating the exchange rates ruling at the date of the transactions. Foreign exchange differences arising on translation are recognised directly in a separate component of equity. | (1,890,975)         | (1,245,072)        |
| <b>(f)</b> | <i>Accumulated losses</i>   |                     |                    |
|            | <i>Company and consolidated</i>   |                     |                    |
|            | Under AASB 2 “ <i>Share-based Payments</i> ”, the consolidated entity’s Employee Share Plan are deemed to be equity settled, share based remuneration and treated as an in-substance grant of options.  | (7,189)             | -                  |
|            | Under AASB 2 “ <i>Share-based Payments</i> ”, the consolidated entity is required to reflect the cost of equity settled share based transactions with employees that are subject to an approval process at a fair value at the time that approval was obtained. The adjustment includes the reversal of \$100,000 consulting fees and their re-designation as share based payments.   | (120,000)           | -                  |

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**NOTES TO THE FINANCIAL STATEMENTS**

**2. First-time adoption of Australian equivalents to international financial reporting standards (continued)**

**Notes to the reconciliations of equity and profit and loss at 1 July 2004 and 30 June 2005.**

|            |   | <b>30 June 2005</b> | <b>1 July 2004</b> |
|------------|---|---------------------|--------------------|
|            |   | <b>\$</b>           | <b>\$</b>          |
| <b>(f)</b> | <i>Accumulated losses (continued)</i>   |                     |                    |
|            | <i>Consolidated</i>   |                     |                    |
|            | Under AASB 121, assets and liabilities of foreign operations are translated from the entity's functional currency to the consolidated entity's presentation currency of Australian dollars at foreign exchange rates ruling at reporting date. The revenues and expenses of foreign operations are translated to Australian dollars at the exchange rates approximating the exchange rates ruling at the date of the transactions. Foreign exchange differences arising on translation are recognised directly in a separate component of equity. | 77,883              | 5,597              |
|            | In accordance with AASB 137, restoration and other clean up obligations are to be recognised when the liability arises; under AGAAP such provisions could be accrued over the life of the asset.  | (26,531)            | (19,208)           |
| <b>(g)</b> | <i>Provisions</i>   |                     |                    |
|            | <i>Consolidated</i>   |                     |                    |
|            | In accordance with AASB 137, restoration and other clean up obligations are to be recognised when the liability arises; under AGAAP such provisions could be accrued over the life of the asset.  | 77,984              | 71,545             |
| <b>(h)</b> | <i>Equity</i>   |                     |                    |
|            | <i>Company and consolidated</i>   |                     |                    |
|            | Under AASB 2 "Share-based payments", the consolidated entity is required to reflect the cost of equity settled share based transactions with employees that are subject to an approval process at a fair value at the time that approval was obtained.  | 120,000             | -                  |

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**2. First-time adoption of Australian equivalents to international financial reporting standards (continued)**

**Notes to the reconciliations of equity and profit and loss at 1 July 2004 and 30 June 2005.**

|            |   | 30 June 2005 | 1 July 2004 |
|------------|---|--------------|-------------|
|            |   | \$           | \$          |
| <b>(i)</b> | <i>Profit and loss reclassifications</i>  |              |             |
|            | <i>Company and consolidated</i>   |              |             |
|            | Under previous AGAAP the proceeds from the sale of non-current assets were included in other revenue and the net gain on disposal was treated as profit. Under AIFRS, the net gain on disposal is included in other income.                               |              |             |
|            | Revenue   | (395,999)    | -           |
|            | Other income  | 202,249      | -           |
|            | Other expenses from ordinary activities   | 193,750      | -           |
|            | Other reclassifications to conform with presentation in 2006:   |              |             |
|            | Revenue   | (9,210)      | -           |
|            | Other income  | 20,165       | -           |
|            | Other expenses  | (10,955)     | -           |
|            | Exploration expenditure   | 10,227       | -           |
|            | Loss from discontinued operation  | (10,227)     | -           |
|            | <i>Consolidated</i>   |              |             |
|            | Under previous AGAAP the proceeds from the sale of non-current assets were included in other revenue and the net gain on disposal was treated as profit. Under AIFRS, the net gain on disposal is included in other income.                               |              |             |
|            | Revenue   | (19,814)     | -           |
|            | Other income  | (33,497)     | -           |
|            | Other expenses from ordinary activities   | 53,311       | -           |
|            | Reclassify interest and other income  |              |             |
|            | Revenue   | (1,113)      | -           |
|            | Other income  | 1,113        | -           |
| <b>(j)</b> | <i>Other financial assets</i>   |              |             |
|            | <i>Company only</i>   |              |             |
|            | Under AASB 121 a loan to a controlled entity which has no fixed date of repayment and is non-interest bearing has been reclassified as a net investment in a foreign operation. Under previous AGAAP this loan was treated as an intercompany receivable. |              |             |
|            |   | 2,700,146    | 3,532,017   |

The adoption of AIFRS has not resulted in any material adjustments to the preparation of the statements of cash flow.

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|   | Notes | Consolidated     |                  | Company         |                 |
|---|-------|------------------|------------------|-----------------|-----------------|
|   |       | 2006             | 2005             | 2006            | 2005            |
|   |       | \$               | \$               | \$              | \$              |
| <b>3. Other income</b>  |       |                  |                  |                 |                 |
| Net gain / (loss) on disposal of property, plant and equipment      |       | 100              | (33,497)         | 100             | -               |
| Net (loss) / gain from sale of equity investments                   |       | (715)            | 202,249          | (715)           | 202,249         |
| Reversal of provision for non-recovery of Employee Share Plan loans |       | 134,520          | 10,955           | 134,520         | 10,955          |
| Finance income  |       | 50,258           | 9,036            | 50,258          | 9,036           |
| Other   |       | 5,419            | 1,287            | 114             | 174             |
|   |       | <u>189,582</u>   | <u>190,030</u>   | <u>184,277</u>  | <u>222,414</u>  |
| <b>4. Cost of sales</b>   |       |                  |                  |                 |                 |
| Production  |       | (251,208)        | (283,529)        | -               | -               |
| Royalty and excise  |       | (173,593)        | (158,124)        | -               | -               |
| Transportation  |       | (47,491)         | (49,149)         | -               | -               |
| Depreciation of production assets and development costs             |       | (46,763)         | (81,964)         | -               | -               |
| Selling, general and administration                                 |       | (280,075)        | (203,572)        | -               | -               |
|   |       | <u>(799,130)</u> | <u>(776,338)</u> | <u>-</u>        | <u>-</u>        |
| <b>5. Other expenses</b>  |       |                  |                  |                 |                 |
| Depreciation – plant & equipment                                    |       | (5,219)          | (2,557)          | (5,219)         | (2,557)         |
| Rental premises – operating lease                                   |       | (43,442)         | (39,540)         | (43,442)        | (39,540)        |
|   |       | <u>(48,661)</u>  | <u>(42,097)</u>  | <u>(48,661)</u> | <u>(42,097)</u> |
| <b>6. Auditors' remuneration</b>                                    |       |                  |                  |                 |                 |
| <i>Audit services:</i>  |       |                  |                  |                 |                 |
| Auditors of the Company   |       | 31,983           | 69,175           | 31,983          | 69,175          |
| Overseas office of auditors of the Company                          |       | -                | 20,875           | -               | -               |
| <i>Other services:</i>  |       |                  |                  |                 |                 |
| Auditors of the Company:  |       |                  |                  |                 |                 |
| Taxation services   |       | 36,025           | 27,282           | 36,025          | 27,282          |
|   |       | <u>68,008</u>    | <u>117,332</u>   | <u>68,008</u>   | <u>96,457</u>   |

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**7. Discontinued operation**

On 28 October 2005 the Company announced that it had accepted a \$500,000 unconditional offer from a third party to acquire the Company's interest in Petroleum Retention Licences ("PRLs") 4 and 5 in Papua New Guinea. Other joint ventures partners subsequently exercised their pre-emptive rights in respect of the sale.

The Company and consolidated entity's financial performance and cash flow information for these licences is as follows:

|   | <b>2006</b>    | <b>2005</b>     |
|---|----------------|-----------------|
|   | <b>\$</b>      | <b>\$</b>       |
| Revenue   | -              | -               |
| Expenses  | (11,818)       | (10,227)        |
| (Loss) before tax   | (11,818)       | (10,227)        |
| Income tax expense  | -              | -               |
| (Loss) after tax, but before gain on sale of discontinued operation | (11,818)       | (10,227)        |
| Gain on sale of discontinued operation, net of tax expense          | 500,000        | -               |
| Profit / (loss) for the period                                      | <u>488,182</u> | <u>(10,227)</u> |
| Net cash flows from / (used) in investing activities                | <u>488,182</u> | <u>(10,227)</u> |
| Net increase / (decrease) in cash from the discontinued operation   | <u>488,182</u> | <u>(10,227)</u> |

The carrying amount of the net assets sold at 30 June 2005 and 28 October 2005 was nil.

**8. Consolidated earnings per share**

|   | <b>2006</b>   | <b>2005</b> |
|---|---------------|-------------|
| <i>Basic (loss)/ profit per share (cents per share)</i>   |               |             |
| From continuing operations  | (0.2)         | (0.4)       |
| From discontinued operations  | 0.1           | -           |
| <i>Diluted earnings / (loss) per share (cents per share)</i>  |               |             |
| From discontinued operations  | <u>0.1</u>    | <u>-</u>    |
| Weighted average number of ordinary shares  | 339,955,762   | 272,312,513 |
| Weighted average number of ordinary shares (diluted)  | 345,139,324   | 272,312,513 |
| Loss used in calculating basic loss per share from continuing operations  | (\$1,246,332) | (\$997,098) |
| Profit / (loss) used in the calculation of basic and diluted earnings / (loss) per share from discontinued operations | \$488,182     | (\$10,227)  |

All potential ordinary shares, being options to acquire ordinary shares, are not considered dilutive in the calculation of basic earnings per share from continuing operations as the exercise of the options would not decrease the earnings per share or increase the loss per share.



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| Notes  | Consolidated |           | Company   |           |
|--|--------------|-----------|-----------|-----------|
|  | 2006         | 2005      | 2006      | 2005      |
|  | \$           | \$        | \$        | \$        |
| <b>9. Income tax expense</b>   |              |           |           |           |
| <i>Numerical reconciliation between pre-tax loss and income tax expense:</i> |              |           |           |           |
| Prima facie income tax benefit on pre-tax loss                               | 227,445      | 302,198   | 268,238   | 483,965   |
| Tax effect of:   |              |           |           |           |
| Foreign sourced income   | 88,631       | 38,304    | -         | -         |
| Foreign sourced exploration project costs                                    | -            | (9,208)   | -         | (9,208)   |
| Exempt gain on sale of discontinued foreign operation                        | 146,455      | -         | 146,455   | -         |
| Unrealized foreign exchange gains / (losses)                                 | 2,081        | (2,532)   | 49,919    | (145,996) |
| Non-assessable income  | 40,356       | 60,675    | 40,356    | 60,675    |
| Non-deductible expenditure   | (235,793)    | (120,175) | (235,793) | (120,175) |
| Current year tax benefit not brought to account                              | (269,175)    | (269,262) | (269,175) | (269,261) |
| Income tax benefit on pre-tax loss   | -            | -         | -         | -         |

*Unrecognised net deferred tax assets*

Deferred tax assets have not been recognised in respect of the following items (refer Note 1(b)):

|                                  |         |           |         |           |
|----------------------------------|---------|-----------|---------|-----------|
| Deductible temporary differences | 16,200  | 29,157    | 16,200  | 29,157    |
| Tax losses                       | 824,212 | 2,067,507 | 824,212 | 2,238,232 |
|                                  | 840,412 | 2,096,664 | 840,412 | 2,267,389 |

*Tax Consolidation*

Effective 1 July 2003, for the purposes of Australian income taxation, Carnarvon Petroleum Ltd ("Carnarvon") and its 100% owned subsidiaries formed a tax consolidated group. The head entity of the tax consolidated group is Carnarvon.

The impact of consolidating for tax purposes is that Carnarvon's Australian subsidiaries are treated as divisions of Carnarvon rather than as separate entities for tax purposes. The members of the group will, if required, enter into a tax sharing arrangement in order to allocate group tax related liabilities to contributing members on a reasonable basis. The agreement will provide for the allocation of income tax liabilities between entities should the head entity default on its tax payment obligations.

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|  | Notes | Consolidated |           | Company |           |
|--|-------|--------------|-----------|---------|-----------|
|  |       | 2006         | 2005      | 2006    | 2005      |
|  |       | \$           | \$        | \$      | \$        |
| <b>10. Trade and other receivables</b>         |       |              |           |         |           |
| <i>Current</i>                                 |       |              |           |         |           |
| Trade and other receivables                    |       | 175,482      | 114,297   | 47,118  | 1,398     |
| <i>Non-Current</i>                             |       |              |           |         |           |
| Employee Share Plan loans                      |       | 60,000       | 194,850   | 60,000  | 194,850   |
| Provision for non-recovery                     |       | (6,600)      | (141,120) | (6,600) | (141,120) |
|  |       | 53,400       | 53,730    | 53,400  | 53,730    |
| Other debtors                                  |       | -            | 1,490     | -       | 1,490     |
|  |       | 53,400       | 55,220    | 53,400  | 55,220    |
| <b>11. Available-for-sale financial assets</b> |       |              |           |         |           |
| <i>Current</i>                                 |       |              |           |         |           |
| Listed equity securities available-for-sale    |       | -            | 178,214   | -       | 178,214   |
| <b>12. Inventories</b>                         |       |              |           |         |           |
| <i>Current</i>                                 |       |              |           |         |           |
| Raw materials                                  |       | 235,138      | 75,682    | -       | -         |
|  |       | 235,138      | 75,682    | -       | -         |
| <b>13. Other assets</b>                        |       |              |           |         |           |
| <i>Current</i>                                 |       |              |           |         |           |
| Deposits and prepayments                       |       | 18,153       | 26,496    | 18,153  | 12,759    |

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|  | <b>Consolidated</b> |             | <b>Company</b> |             |
|--|---------------------|-------------|----------------|-------------|
|  | <b>2006</b>         | <b>2005</b> | <b>2006</b>    | <b>2005</b> |
|  | <b>\$</b>           | <b>\$</b>   | <b>\$</b>      | <b>\$</b>   |
| <b>14. Other financial assets</b>            |                     |             |                |             |
| <i>Non-current</i>                           |                     |             |                |             |
| Investments in controlled entities – at cost | -                   | -           | 6,832,904      | 4,183,108   |

The consolidated entity has the following interests in joint venture operations:

| <b>Joint venture</b>                                  | <b>Principal activities</b>                                     | <b>Ownership interest</b> |
|---|---|---------------------------|
|   |   | <b>%</b>                  |
| <i>Thailand</i>                                       |   |                           |
| SW1A Concession, Exploration Blocks L44/43 and L33/43 | Exploration, development, production and marketing of crude oil | 40%                       |
| <i>Western Australia</i>                              |   |                           |
| EP 110 & 424 (Carnarvon Basin)                        | Exploration for hydrocarbons                                    | 35%                       |

Included in the assets and liabilities of the consolidated entity's interest are the following assets and liabilities employed by the SW1A joint venture:

|                                      | <b>Consolidated</b> |                  |
|--------------------------------------|---------------------|------------------|
|                                      | <b>2006</b>         | <b>2005</b>      |
|                                      | <b>\$</b>           | <b>\$</b>        |
| <b>Current assets</b>                |                     |                  |
| Cash and cash equivalents            | 339,170             | 167,352          |
| Trade and other receivables          | 128,364             | 112,899          |
| Inventories                          | 235,138             | 75,682           |
| Other assets                         | -                   | 13,737           |
| <b>Total current assets</b>          | <u>702,672</u>      | <u>369,670</u>   |
| <b>Non-current assets</b>            |                     |                  |
| Property, plant and equipment        | 6,926,222           | 4,030,478        |
| <b>Total non-current assets</b>      | <u>6,926,222</u>    | <u>4,030,478</u> |
| <b>Total assets</b>                  | <u>7,628,894</u>    | <u>4,400,148</u> |
| <b>Current liabilities</b>           |                     |                  |
| Payables                             | 14,657              | 99,862           |
| <b>Total current liabilities</b>     | <u>14,657</u>       | <u>99,862</u>    |
| <b>Non-current liabilities</b>       |                     |                  |
| Provisions                           | 67,675              | 77,984           |
| <b>Total non-current liabilities</b> | <u>67,675</u>       | <u>77,984</u>    |
| <b>Total liabilities</b>             | <u>82,332</u>       | <u>177,846</u>   |
| <b>Net assets</b>                    | <u>7,546,562</u>    | <u>4,222,302</u> |

The SW1A concession joint venture's contribution to the operating profit of the consolidated entity was \$295,435 (2005: \$156,656).

Expenditure on the EP 110 and EP 424 joint ventures is expensed as incurred. Expenditure in respect of the current reporting period was \$107,242 (2005: \$47,987).

During the reporting period the Company disposed of its interest in PRLs 4 and 5 in Papua New Guinea (see Note 7).

Capital expenditure commitments and contingent liabilities in respect of the joint ventures are disclosed in Notes 20 and 21 respectively.

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| Notes                                    | Consolidated     |                  | Company       |               |
|--|------------------|------------------|---------------|---------------|
|  | 2006             | 2005             | 2006          | 2005          |
|  | \$               | \$               | \$            | \$            |
| <b>15. Property, plant and equipment</b> |                  |                  |               |               |
| <i>Plant and Equipment</i>               |                  |                  |               |               |
| Cost:                                    |                  |                  |               |               |
| Balance at beginning of financial year   | 203,658          | 173,827          | 11,316        | 11,316        |
| Acquisitions                             | 120,280          | 32,866           | 72,051        | -             |
| Disposals                                | (2,726)          | (53,311)         | (2,726)       | -             |
| Effects of movements in foreign exchange | 6,067            | 50,276           | -             | -             |
| Balance at end of financial year         | <u>327,279</u>   | <u>203,658</u>   | <u>80,641</u> | <u>11,316</u> |
| Depreciation and impairment losses:      |                  |                  |               |               |
| Balance at beginning of financial year   | 120,114          | 88,673           | 7,784         | 5,227         |
| Disposals                                | (2,726)          | -                | (2,726)       | -             |
| Depreciation charge for year             | 30,545           | 31,441           | 5,219         | 2,557         |
| Balance at end of financial year         | <u>147,933</u>   | <u>120,114</u>   | <u>10,277</u> | <u>7,784</u>  |
| Carrying amount                          | <u>179,346</u>   | <u>83,544</u>    | <u>70,364</u> | <u>3,532</u>  |
| <i>Mining property and development</i>   |                  |                  |               |               |
| Cost:                                    |                  |                  |               |               |
| Balance at beginning of financial year   | 4,279,320        | 4,941,098        | -             | -             |
| Acquisitions                             | 2,639,906        | -                | -             | -             |
| Disposals                                | -                | (2,320)          | -             | -             |
| Effects of movements in foreign exchange | 248,305          | (659,458)        | -             | -             |
| Balance at end of financial year         | <u>7,167,531</u> | <u>4,279,320</u> | <u>-</u>      | <u>-</u>      |
| Depreciation and impairment losses:      |                  |                  |               |               |
| Balance at beginning of financial year   | 328,854          | 275,774          | -             | -             |
| Depreciation charge for year             | 21,437           | 53,080           | -             | -             |
| Balance at end of financial year         | <u>350,291</u>   | <u>328,854</u>   | <u>-</u>      | <u>-</u>      |
| Carrying amount                          | <u>6,817,240</u> | <u>3,950,466</u> | <u>-</u>      | <u>-</u>      |
| Total carrying amount                    | <u>6,996,586</u> | <u>4,034,010</u> | <u>70,364</u> | <u>3,532</u>  |

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|   | Notes | Consolidated   |                | Company        |                |
|---|-------|----------------|----------------|----------------|----------------|
|   |       | 2006           | 2005           | 2006           | 2005           |
|   |       | \$             | \$             | \$             | \$             |
| <b>16. Trade and other payables</b>     |       |                |                |                |                |
| <i>Current</i>                          |       |                |                |                |                |
| Trade payables                          |       | 43,962         | 54,040         | 29,305         | -              |
| Non-trade payables and accrued expenses |       | 107,907        | 190,710        | 94,206         | 110,056        |
| Owing to SWIA joint venture partner     |       | 429,151        | 114,487        | -              | -              |
| Owing to related parties                |       | 21,620         | 100,000        | 21,620         | 100,000        |
|   |       | <u>602,640</u> | <u>459,237</u> | <u>145,131</u> | <u>210,056</u> |

**17. Provisions**

|  |  |               |               |          |          |
|--|--|---------------|---------------|----------|----------|
| <i>Current</i>                               |  |               |               |          |          |
| Employee leave entitlements                  |  | -             | 11,590        | -        | 11,590   |
| <i>Non-current</i>                           |  |               |               |          |          |
| Site restoration:                            |  |               |               |          |          |
| Balance at beginning on financial year       |  | 77,984        | 71,545        | -        | -        |
| Provisions (reversed) / made during the year |  | (10,309)      | 6,439         | -        | -        |
| Balance at end of financial year             |  | <u>67,675</u> | <u>77,984</u> | <u>-</u> | <u>-</u> |

**18. Issued capital**

|  | Company and consolidated |                    |
|--|--------------------------|--------------------|
|  | 2006                     | 2005               |
|  | Number of Shares         |                    |
| <i>Issued capital</i>                  |                          |                    |
| Balance at beginning on financial year | 272,312,513              | 272,312,513        |
| Share placements issued for cash       | 128,733,333              | -                  |
| Equity settled compensation            | 10,000,000               | -                  |
| Employee Share Plan issue              | 715,000                  | -                  |
| Exercise of options                    | 26,288                   | -                  |
| Balance at end of financial year       | <u>411,787,134</u>       | <u>272,312,513</u> |

Ordinary shares have the right to one vote per share at meetings of the Company, to receive dividends as declared and, in the event of a winding-up of the Company, to participate in the proceeds from the sale of all surplus assets in proportion to the number of, and amounts paid up on, shares held.

The Company does not have authorised capital or par value in respect of its issued shares.

*Translation reserve*

Movements in the translation reserve are set out in the Statement in Changes in Equity on page 25.

The translation reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations where their functional currency is different to the presentation currency of the reporting entity.

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**18. Issued capital and reserves (continued)**

*Available-for-sale asset revaluation reserve*

Movements in the available-for-sale asset revaluation reserve are set out in the Statement in Changes in Equity on page 25 and 26.

This reserve includes the cumulative net change in the fair value of available-for-sale investments until the investment is derecognised.

*Share based payments reserve*

Movements in the share based payments reserve are set out in the Statement in Changes in Equity on pages 25 and 26.

This reserve represents the fair value at grant of share options issued, including the value of shares issued under the Company's ESP. This reserve will be reversed against share capital when shares are issued on exercise of the options, or, in the case of the shares issued under the ESP, the loan is repaid.

**19. Reconciliation of cash flows from operating activities**

|  | Notes | Consolidated     |                  | Company          |                    |
|--|-------|------------------|------------------|------------------|--------------------|
|  |       | 2006             | 2005             | 2006             | 2005               |
|  |       | \$               | \$               | \$               | \$                 |
| <b>(a) Cash flows from operating activities</b>  |       |                  |                  |                  |                    |
| Loss for the period  |       | (758,150)        | (1,007,325)      | (894,126)        | (1,613,218)        |
| <i>Adjustments for:</i>  |       |                  |                  |                  |                    |
| Equity settled share based payment expense   |       | 706,272          | 127,189          | 706,272          | 127,189            |
| Reversal of provision for impairment losses  |       | (134,520)        | (10,955)         | (134,520)        | (10,955)           |
| Depreciation   |       | 51,982           | 84,521           | 5,219            | 2,557              |
| (Gain) / loss on disposal of property plant & equipment                                      |       | (100)            | 33,497           | (100)            | -                  |
| Exploration and development costs written off  |       | 107,242          | 71,419           | 107,242          | 68,454             |
| Foreign exchange (gains) / losses  |       | (6,935)          | 8,441            | (166,394)        | 486,655            |
| Loss / (gain) on disposal of available-for-sale financial assets                             |       | 715              | (202,249)        | 715              | (202,249)          |
| <b>Operating loss before changes in working capital and provisions:</b>                      |       | <b>(33,494)</b>  | <b>(895,462)</b> | <b>(375,692)</b> | <b>(1,141,567)</b> |
| <b>Changes in assets and liabilities:</b>  |       |                  |                  |                  |                    |
| (Increase) / decrease in trade and other receivables   |       | (54,802)         | 32,116           | (44,230)         | 43,373             |
| (Increase) / decrease in inventories   |       | (156,176)        | (3,735)          | -                | -                  |
| Decrease / (increase) in other assets  |       | 8,938            | 49,729           | (5,394)          | (6,559)            |
| Increase / (decrease) in trade and other payables  |       | 224,899          | 162,497          | 34,971           | 44,735             |
| (Decrease) / increase in provisions and employee benefits                                    |       | (21,899)         | 17,149           | (11,590)         | 10,710             |
| <b>Cash flows from operating activities after changes in working capital and provisions:</b> |       | <b>(32,534)</b>  | <b>(637,706)</b> | <b>(401,935)</b> | <b>(1,049,308)</b> |
| (Gain) / loss on sale of discontinued operations net of income tax                           | 7     | (488,182)        | 10,227           | (488,182)        | 10,227             |
| <b>Net cash flows (used in) operating activities</b>   |       | <b>(520,716)</b> | <b>(627,479)</b> | <b>(890,117)</b> | <b>(1,039,081)</b> |
| <b>(b) Reconciliation of cash and cash equivalents</b>                                       |       |                  |                  |                  |                    |
| Cash at bank and at call   |       | 1,897,846        | 301,454          | 1,558,676        | 134,102            |

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**20. Capital and other commitments**

|   | <b>Consolidated</b> |             | <b>Company</b> |             |
|---|---------------------|-------------|----------------|-------------|
|   | <b>2006</b>         | <b>2005</b> | <b>2006</b>    | <b>2005</b> |
|   | <b>\$</b>           | <b>\$</b>   | <b>\$</b>      | <b>\$</b>   |
| <hr/>   |                     |             |                |             |
| <i>(a) Joint venture commitments</i>                          |                     |             |                |             |
| <hr/>   |                     |             |                |             |
| Share of capital commitments of the joint venture operations: |                     |             |                |             |
| Within one year   | 1,389,531           | -           | -              | -           |
|   | <hr/>               |             |                |             |

*(b) Exploration expenditure commitments*

Due to the nature of the consolidated entity's operations in exploring and evaluating areas of interest, it is difficult to accurately forecast the nature or amount of future expenditure, although it will be necessary to incur expenditure in order to retain the entity's present permit interests. Expenditure commitments on exploration permits can be reduced by selective relinquishment of exploration tenure, by the renegotiation of expenditure commitments, or by farming out portions of the entity's equity.

Exploration expenditure commitments forecast but not provided for in the financial statements are as follows:

|                 | <b>Consolidated</b> |             | <b>Company</b> |             |
|-----------------|---------------------|-------------|----------------|-------------|
|                 | <b>2006</b>         | <b>2005</b> | <b>2006</b>    | <b>2005</b> |
|                 | <b>\$</b>           | <b>\$</b>   | <b>\$</b>      | <b>\$</b>   |
| Within one year | 427,006             | 180,000     | 152,985        | -           |
|                 | <hr/>               |             |                |             |

**21. Contingencies**

*Contingent liabilities considered remote*

- (a) In accordance with normal petroleum industry practice, the consolidated entity has entered into joint ventures and farmin agreements with other parties for the purpose of exploring and developing its petroleum permit interests. If a party to a joint venture defaults and does not contribute its share of joint venture obligations, then the other joint venturers are liable to meet those obligations. In this event, the interest in the permit held by the defaulting party may be redistributed to the remaining joint venturers.
- (b) During the year the Company sold its interests in Production Retention Licences 4 and 5 in Papua New Guinea for \$500,000. Under the terms of the sale, if approval and registration of the Deeds and Transfer Instruments is not obtained within 12 months of the date the documents are lodged for approval and registration, the sale proceeds shall be refunded to the purchasers.
- (c) The SW1A Joint Venture operation, in which the consolidated entity has a 40% interest, has issued a bank guarantee for an amount of 20 million Thai Baht (A\$685,000) as security for a Customs Bond. It is anticipated that this guarantee will be returned within one year.

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**22. Employee benefits**

Directors and employees are considered to be mutually exclusive for the purposes of this disclosure. Details of shares and options issued to directors are set out in Note 26, and in the Remuneration Report as set out on pages 13 to 18.

*(a) Share based payments*

*Employee Share Plan*

Under the terms of the Carnarvon Employee Share Plan ("ESP"), as approved by shareholders, the Company may, in its absolute discretion, make an offer of ordinary fully paid shares in Carnarvon petroleum Limited to any eligible employee to be funded by a limited recourse loan granted by the Company.

The issue price is determined by the directors and is not to be less than the weighted average market price of the Company's shares on the five trading days prior to the date of offer. Eligible employees receive an interest free advance to acquire the shares. The Company is empowered to sell, as agent, any shares held under the ESP by an eligible employee upon the cessation of employment, and to apply the net sale proceeds in discharging the employee's loan from the Company.

The movements in the ESP during the financial year were as follows:

|                                    | <b>1 July 2005</b> | <b>Issued</b> | <b>Reverted to<br/>the Company</b> | <b>Re-allocated</b> | <b>30 June 2006</b> |
|------------------------------------|--------------------|---------------|------------------------------------|---------------------|---------------------|
| Number of shares                   | 3,985,000          | 715,000       | (1,785,000)                        | 1,785,000           | 4,700,000           |
| Loan (\$)                          | 211,850            | 36,465        | (134,850)                          | 90,277              | 203,742             |
| Average issue price per share (\$) | \$0.053            | \$0.051       | \$0.076                            | \$0.051             | \$0.043             |

The ESP shares on issue at 1 July 2005 and 30 June 2006 include 200,000 shares for the benefit of Mr Neil Fearis, a director, and 1,000,000 shares for the benefit of Mr David Orth, a former director. These shares were all issued prior to 1 July 2004.

In accordance with AASB 2 the issue of shares under the ESP is accounted for as an in principle option. The fair value of services received in return for these options for both the Company and consolidated entity is measured by reference to the fair value of share options granted using the Black-Scholes model, as set out below.

| <b>Fair value of share options and<br/>related assumptions</b> | <b>Key<br/>management<br/>personnel<br/>2006</b> | <b>Key<br/>management<br/>personnel<br/>2005</b> | <b>Other<br/>employees<br/>2006</b> | <b>Other<br/>employees<br/>2005</b> |
|--|--|--|-------------------------------------|-------------------------------------|
| Fair value at measurement date                                 | \$0.020  | \$0.007  | \$0.020                             | -                                   |
| Share price at date of issue                                   | \$0.051  | \$0.017  | \$0.051                             | -                                   |
| Exercise price   | \$0.051  | \$0.017  | \$0.051                             | -                                   |
| Expected volatility  | 51.5%  | 50%  | 51.5%                               | -                                   |
| Assumed option life  | 3 years  | 3 years  | 3 years                             | -                                   |
| Expected dividends   | Nil  | Nil  | Nil                                 | -                                   |
| Risk-free interest rate  | 5.5%   | 5.5%   | 5.5%                                | -                                   |
| Share based expense recognised                                 | \$40,421   | \$7,189  | \$10,105                            | -                                   |

Current year volatility is based on the historic volatility over a 3 month period to reporting date, reflecting the impact on the share price of the new Chief Executive Officer's appointment. The volatility in the prior reporting period was based on an assumed rate of 50%.



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**23. Related party disclosures**

*Ultimate parent*

Carnarvon Petroleum Limited is the ultimate parent company.

*Wholly owned group transactions*

During the reporting period there have been transactions between the Company and its controlled entities. The Company provided accounting and administrative services to its controlled entities for which it did not charge a management fee.

Loans are made by the Company to one of its controlled entities to fund the expenditure program of its joint venture. During the financial year ended 30 June 2006 such loans to controlled entities totalled \$2,437,805 (2005: net repayment from controlled entities of \$353,657)

The carrying value of loans made by Carnarvon Petroleum Limited to its controlled entities at 30 June 2006 was \$6,043,322 (2005: \$3,393,495), of which \$693,349 (2005: \$693,349) has been provided for. These loans are unsecured, non-interest bearing, and have no fixed terms of repayment. The net carrying value of the loans has been classified as part of the net investment in a foreign subsidiary.

*Other related party balances*

At 30 June 2006 an amount of \$7,500 is included in trade and other payables for outstanding director fees.

**24. Operating leases**

*Leases as lessee*

Non-cancellable operating lease rentals are payable as follows:

|                            | Consolidated   |              | Company        |              |
|----------------------------|----------------|--------------|----------------|--------------|
|                            | 2006           | 2005         | 2006           | 2005         |
|                            | \$             | \$           | \$             | \$           |
| Less than one year         | 86,962         | 3,150        | 86,962         | 3,150        |
| Between one and five years | 77,022         | -            | 77,022         | -            |
| More than five years       | 44,013         | -            | 44,013         | -            |
|                            | <u>207,997</u> | <u>3,150</u> | <u>207,997</u> | <u>3,150</u> |

During the reporting period \$18,022 was recognised as an expense in the consolidated income statement in respect of operating leases (2005:\$Nil).

**25. Segment information**

Segment information is presented in respect of the consolidated entity's business and geographical segments. The primary format, geographical segments, is based on the consolidated entity's management and internal reporting structure. Segment results, assets and liabilities include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. In presenting information on the basis of geographical segments, segment revenue is based on the geographical location of customers, and segment assets are based on the geographical location of the assets.

The consolidated entity operated predominantly in oil and gas exploration and development in Australia, Thailand and Papua New Guinea during the reporting period.

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**25. Segment information (continued)**

| <i>Geographical Segments</i>                 | <b>Australia</b>   |                  | <b>Thailand</b>    |                  | <b>Papua New Guinea<br/>(discontinued)</b> |                  | <b>Consolidated</b> |                  |
|--|--------------------|------------------|--------------------|------------------|--|------------------|---------------------|------------------|
|  | <b>2006 (\$)</b>   | <b>2005 (\$)</b> | <b>2006 (\$)</b>   | <b>2005 (\$)</b> | <b>2006 (\$)</b>                           | <b>2005 (\$)</b> | <b>2006 (\$)</b>    | <b>2005 (\$)</b> |
| Revenue                                      |                    |                  |                    |                  |  |                  |                     |                  |
| Sales  | -                  | -                | 1,090,213          | 942,840          | -  | -                | 1,090,213           | 942,840          |
| Other  | 184,277            | 222,414          | 5,305              | (32,384)         | -  | -                | 189,582             | 190,030          |
| Total revenue                                | 184,277            | 222,414          | 1,095,518          | 910,456          | -  | -                | 1,279,795           | 1,132,870        |
| Segment result                               |                    |                  |                    |                  |  |                  |                     |                  |
| Result from continuing operations            | (1,541,767)        | (1,153,754)      | 295,435            | 156,656          | -  | -                | (1,246,332)         | (997,098)        |
| Discontinued operations                      | -                  | -                | -                  | -                | 488,182                                    | (10,227)         | 488,182             | (10,227)         |
| Total segment result                         | (1,541,767)        | (1,153,754)      | 295,435            | 156,656          | 488,182                                    | (10,227)         | (758,150)           | (1,007,325)      |
| Assets                                       |                    |                  |                    |                  |  |                  |                     |                  |
| Property, plant and equipment                | 70,364             | 3,532            | 6,926,222          | 4,030,478        | -  | -                | 6,996,586           | 4,034,010        |
| Other  | 1,675,857          | 380,203          | 702,672            | 369,670          | 1,490                                      | 1,490            | 2,380,019           | 751,363          |
| Total segment assets                         | 1,746,221          | 383,735          | 7,628,894          | 4,400,148        | 1,490                                      | 1,490            | 9,376,605           | 4,785,373        |
| Liabilities                                  |                    |                  |                    |                  |  |                  |                     |                  |
| Total segment liabilities                    | 145,131            | 221,646          | 525,184            | 327,165          | -  | -                | 670,315             | 548,811          |
| Other segment information:                   |                    |                  |                    |                  |  |                  |                     |                  |
| Acquisition of property, plant and equipment | 72,051             | -                | 2,688,135          | 32,866           | -  | -                | 2,760,186           | 32,866           |
| Depreciation                                 | 5,219              | 2,557            | 46,763             | 81,964           | -  | -                | 51,982              | 84,521           |
| <i>Business Segments</i>                     |                    |                  |                    |                  |  |                  |                     |                  |
|  | <b>Oil and gas</b> |                  | <b>Unallocated</b> |                  | <b>Consolidated</b>                        |                  |                     |                  |
|  | <b>2006 (\$)</b>   | <b>2005 (\$)</b> | <b>2006 (\$)</b>   | <b>2005 (\$)</b> | <b>2006 (\$)</b>                           | <b>2005 (\$)</b> |                     |                  |
| Revenue from external customers              | 1,090,213          | 942,840          | 189,582            | 190,030          |  |                  | 1,279,795           | 1,132,870        |
| Segment assets                               | 7,628,894          | 4,400,148        | 1,746,221          | 385,225          |  |                  | 9,376,605           | 4,785,373        |
| Acquisition of non-current assets            | 2,688,135          | 32,866           | -                  | -                |  |                  | 2,688,135           | 32,866           |

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**26. Key management personnel disclosures**

*(a) Key management personnel*

The following were key management personnel of the consolidated entity at any time during the reporting period and, unless otherwise indicated, were key management personnel for the entire period.

*Non-executive directors*

PJ Leonhardt (Chairman)  
 NC Fearis  
 KP Judge  
 AG Shelton (resigned 30 November 2005)

Mr Leonhardt is currently acting in a part time executive capacity to support the Chief Executive Officer. Mr Leonhardt's fulfillment of this role going forward will be monitored relative to the Company's stage of development.

*Executive directors*

EP Jacobson – Chief Executive Officer (appointed a director on 5 December 2005 and executive director on 22 February 2006)  
 D J Orth – Chief Operating Officer (resigned 27 April 2006)

*Executives*

RA Anderson - Chief Financial Officer and Company Secretary (appointed 28 November 2005)  
 RA Pullia - Chief Financial Officer and Company Secretary (resigned 18 January 2006)

*(b) Key management personnel compensation*

Key management personnel compensation included in employee benefits expense, directors emoluments, share based payments and administration expenses are as follows:

|                              | <b>Consolidated</b> |                 | <b>Company</b>   |                 |
|------------------------------|---------------------|-----------------|------------------|-----------------|
|                              | <b>2006(\$)</b>     | <b>2005(\$)</b> | <b>2006(\$)</b>  | <b>2005(\$)</b> |
| Short term employee benefits | 423,774             | 397,118         | 423,774          | 397,118         |
| Post-employment benefits     | 34,488              | 55,900          | 34,488           | 55,900          |
| Termination benefits         | 26,070              | -               | 26,070           | -               |
| Equity compensation benefits | 696,167             | 227,189         | 696,167          | 227,189         |
|                              | <u>1,180,499</u>    | <u>680,207</u>  | <u>1,180,499</u> | <u>680,207</u>  |

Information regarding Individual directors and executives compensation is provided in the Remuneration Report section of the directors' report as set out on pages 13 to 18.

Apart from the details disclosed in this note, no director has entered into a material contract with the Company or the consolidated entity since the end of the previous financial year and there were no material contracts involving directors' interests existing at year end.

*(c) Other key management personnel transactions with the Company or its controlled entities*

Amounts payable to key management personnel at reporting date in respect of outstanding fees and expenses are as follows:

|                          | <b>Consolidated</b> |                 | <b>Company</b>  |                 |
|--------------------------|---------------------|-----------------|-----------------|-----------------|
|                          | <b>2006(\$)</b>     | <b>2005(\$)</b> | <b>2006(\$)</b> | <b>2005(\$)</b> |
| <i>Current</i>           |                     |                 |                 |                 |
| Trade and other payables | 21,620              | 100,000         | 21,620          | 100,000         |

An amount of \$2,748 was paid or payable during the year to an entity associated with Mr Fearis in respect of office accommodation and outgoings. These charges were calculated on an arms length basis.

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**26. Key management personnel disclosures (continued)**

*(d) Movements in shares*

The movement during the reporting period in the number of ordinary shares in Carnarvon Petroleum Limited held, directly, indirectly or beneficially, by each key management person, including their related parties, is as follows:

|                  | <b>Held at<br/>1 July 2005<br/>(or when appointed)</b> | <b>Net<br/>acquired/<br/>(sold)</b> | <b>Granted as<br/>compensation</b> | <b>Employee<br/>Share Plan</b> | <b>Held at<br/>30 June 2006<br/>(or on retirement)</b> |
|------------------|--|-------------------------------------|------------------------------------|--------------------------------|--|
| <b>Directors</b> |  |                                     |                                    |                                |  |
| PJ Leonhardt     | 2,010,504  | 4,000,000                           | 1,500,000                          | -                              | 7,510,504  |
| EP Jacobson      | 4,166,555  | 6,022,752                           | 3,000,000                          | -                              | 13,189,307   |
| NC Fearis        | 4,871,400  | 1,000,000                           | -                                  | -                              | 5,871,400  |
| KP Judge         | 11,168,596   | 3,000,000                           | -                                  | -                              | 14,168,596   |
| AG Shelton       | 9,208,906  | -                                   | 5,500,000                          | -                              | 14,708,906   |
| DJ Orth          | 1,569,127  | -                                   | -                                  | -                              | 1,569,127  |
| <b>Executive</b> |  |                                     |                                    |                                |  |
| RA Anderson      | -  | 1,464,998                           | -                                  | 2,000,000                      | 3,464,998  |

Shares granted as part of compensation were issued for nil cash consideration. Mr Leonhardt, Mr Jacobson and Mr Fearis all participated in a share placement, as approved by shareholders on 3 April 2006. Their participation was on the same terms as other placees, at an issue price of 4.5 cents per share.

*(e) Options and rights over equity instruments granted as compensation*

The movement during the reporting period in the number of options over ordinary shares in Carnarvon Petroleum Limited held, directly, indirectly or beneficially, by each key management person, including their related parties, is as follows:

|                  | <b>Held at<br/>1 July 2005<br/>(or when appointed)</b> | <b>Granted as<br/>compensation</b> | <b>Acquired/<br/>(sold)</b> | <b>Expired</b> | <b>Held at<br/>30 June 2006<br/>(or on retirement)</b> |
|------------------|--|------------------------------------|-----------------------------|----------------|--|
| <b>Directors</b> |  |                                    |                             |                |  |
| PJ Leonhardt     | 589,128  | 6,000,000                          | -                           | (589,128)      | 6,000,000  |
| EP Jacobson      | -  | 8,000,000                          | -                           | -              | 8,000,000  |
| NC Fearis        | 3,693,700  | 4,000,000                          | (3,693,700)                 | -              | 4,000,000  |
| KP Judge         | -  | 4,000,000                          | -                           | -              | 4,000,000  |
| AG Shelton       | 1,600,703  | -                                  | -                           | (1,600,703)    | -  |

Options granted as compensation vest immediately. During the financial year there was no forfeiture or vesting of options granted in previous periods. There were no options on issue that were still to vest at the end of the reporting period.

The fair value of the options is calculated at the date of grant using the Black-Scholes Option Pricing Model. All options granted vest immediately and have been recognized as an expense in the current period. The following factors and assumptions were used in determining the fair value of options on grant date:

| <b>Grant date</b> | <b>Expiry date</b> | <b>Fair value<br/>per option</b> | <b>Exercise<br/>price</b> | <b>Price of<br/>shares at<br/>grant date</b> | <b>Expected<br/>Volatility</b> | <b>Risk free<br/>interest<br/>rate</b> | <b>Dividend<br/>yield</b> |
|-------------------|--------------------|----------------------------------|---------------------------|--|--------------------------------|--|---------------------------|
| 3 April 2006      | 31 March 2008      | \$0.018                          | \$0.07                    | \$0.063                                      | 51.5%                          | 5.5%                                   | 0%                        |
| 3 April 2006      | 31 March 2009      | \$0.016                          | \$0.10                    | \$0.063                                      | 51.5%                          | 5.5%                                   | 0%                        |

Volatility is based on the historic volatility over a 3 month period to reporting date, reflecting the impact on the share price of the appointment of a new Chief Executive Officer in February 2006.

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**27. Non-key management personnel disclosures**

*Identity of related parties*

The consolidated entity has a related party relationship with its subsidiaries (see note 28), joint venture operations (see note 14) and with its key management personnel (see note 26).

**28. Consolidated entities**

| <b>Name</b>             | <b>Country of Incorporation</b> | <b>Ownership interest</b> |             |
|-------------------------|---------------------------------|---------------------------|-------------|
|                         |                                 | <b>2006</b>               | <b>2005</b> |
| <i>Parent entity</i>    |                                 |                           |             |
| Carnarvon Petroleum Ltd |                                 |                           |             |
| <i>Subsidiaries</i>     |                                 |                           |             |
| Carnarvon Thailand Ltd  | British Virgin Islands          | 100%                      | 100%        |
| Lassoc Pty Ltd          | Australia                       | 100%                      | 100%        |
| SRL Exploration Pty Ltd | Australia                       | 100%                      | 100%        |

Strategic Exploration (Asia) Ltd changed its name to Carnarvon (Thailand) Limited during the reporting period.

**29. Subsequent events**

On 11 July 2006 development drilling commenced at the first well (POE-2) as part of the Phase 1 drilling programme at Carnarvon's 40% owned Wichian Buri Oilfield in Thailand. At the date of this report 3 wells of the 7 well programme have been drilled, logged, and cased ready for production testing.

On 2 August 2006 the Company placed 50 million shares at 5 cents per share, raising \$2,500,000, in conjunction with an issue under a Share Purchase Plan for 20 million shares at 5 cents per share to raise \$1,000,000. The Share Purchase Plan closed oversubscribed on 30 August 2006. Funds raised from the issues are being applied to accelerate the Phase 1 and Phase 2 drilling programmes, evaluation and assessment of new opportunities, and for working capital purposes.

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**30. Financial instruments**

(a) *Interest rate risk*

The consolidated entity's exposure to interest rate risk is considered minimal. The effective interest rates of income-earning financial assets at the reporting date are as follows. There were no interest-bearing financial liabilities.

|                           | <b>Floating<br/>interest<br/>rate, at call<br/><br/>2006 (\$)</b> | <b>Weighted<br/>average<br/>effective<br/>interest rate<br/><br/>2006</b> | <b>Floating<br/>interest rate, at<br/>call<br/><br/>2005 (\$)</b> | <b>Weighted<br/>average<br/>effective<br/>interest rate<br/><br/>2005</b> |
|---------------------------|---|---|---|---|
| <i>Financial assets</i>   |   |   |   |   |
| Cash and cash equivalents | 1,897,846   | 4.47%   | 301,454   | 2.6%  |

(b) *Foreign currency risk*

The consolidated entity is exposed to foreign currency risk on sales and purchases that are denominated in a currency other than the A\$. The currency primarily giving rise to this risk is the US\$. The consolidated entity considers that US\$ sales and purchases provide a natural hedge and that the net exposure is kept to an acceptable level.

(c) *Credit risk*

Exposure to credit risk is considered minimal but is monitored on an ongoing basis. At balance date there were no significant concentrations of credit risk. The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the balance sheet.

(d) *Fair values*

All financial assets and financial liabilities have been recognised in the statement of financial position at balance date at their fair values

|                                      | <b>Carrying<br/>amount<br/>2006 (\$)</b> | <b>Consolidated<br/>Fair<br/>Value<br/>2006 (\$)</b> | <b>Carrying<br/>amount<br/>2005 (\$)</b> | <b>Fair<br/>Value<br/>2005 (\$)</b> |
|--------------------------------------|--|--|--|-------------------------------------|
| Equity securities available for sale | -  | -  | 178,214                                  | 178,214                             |
| Trade and other receivables          | 228,882                                  | 228,882  | 169,517                                  | 169,517                             |
| Cash and cash equivalents            | 1,897,846                                | 1,897,846  | 301,454                                  | 301,454                             |
| Trade and other payables             | (602,640)                                | (602,640)  | (459,237)                                | (459,237)                           |
|                                      | <u>1,524,088</u>                         | <u>1,524,088</u>                                     | <u>189,948</u>                           | <u>189,948</u>                      |

The fair value of securities is based on quoted market prices at the balance sheet date without any deduction for transactions costs. All trade and other receivables / payables have a life of less than one year, and therefore their notional amount is deemed to reflect their fair value.

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DIRECTORS' DECLARATION**

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- (1) In the opinion of the directors of Carnarvon Petroleum Limited:
- (a) the financial statements and notes of the company and of the consolidated entity (including the audited remuneration disclosures contained in the Remuneration Report contained in the Directors' Report) set out on pages 23 to 61 are in accordance with the Corporations Act 2001, including:
    - (i) giving a true and fair view of the company's and consolidated entity's financial position as at 30 June 2006 and of their performance, as represented by the results of their operations and their cash flows, for the financial year ended on that date; and
    - (ii) complying with Australian Accounting Standards and the Corporations Regulations 2001; and
  - (b) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable.
- (2) This declaration has been made after receiving the declarations required to be made to the directors in accordance with section 295A of the Corporations Act 2001 for the financial period ending 30 June 2006.

Signed in accordance with a resolution of the directors.



**PJ Leonhardt**  
Director

Perth,  
29 September 2006

## INDEPENDENT AUDIT REPORT TO MEMBERS OF CARNARVON PETROLEUM LIMITED

### Scope

#### The Financial Report and Directors' Responsibility

The financial report comprises the balance sheet, income statement, statement of changes in equity, statement of cash flows, accompanying notes to the financial statements, and the directors' declaration for both the Company and the consolidated entity, for the year ended 30 June 2006. The consolidated entity comprises both the company and the entities it controlled during that year.

The Company has disclosed information about the remuneration of key management personnel (remuneration disclosures) as required by AASB 124, under the heading "remuneration report" on pages 13 to 18 of the directors' report, as permitted by the Corporations Act 2001.

The directors of the company are responsible for the preparation and true and fair presentation of the financial report in accordance with the Corporations Act 2001. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report. The directors are also responsible for the remuneration disclosures contained in the directors' report.

### Audit approach

We conducted an independent audit in order to express an opinion to the members of the company. Our audit was conducted in accordance with Australian Auditing Standards, in order to provide reasonable assurance as to whether the financial report is free of material misstatement. The nature of an audit is influenced by factors such as the use of professional judgment, selective testing, the inherent limitations of internal control, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

We performed procedures to assess whether in all material respects the financial report presents fairly, in accordance with the Corporations Act 2001, including compliance with Accounting Standards and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the company's and the consolidated entity's financial position, and of their performance as represented by the results of their operations and cash flows. We also performed procedures to assess whether the remuneration disclosures comply with AASB 124 and the Corporations Regulations 2001.

We formed our audit opinion on the basis of these procedures, which included:

- examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial report; and
- assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the directors.



## INDEPENDENT AUDIT REPORT TO MEMBERS OF CARNARVON PETROLEUM LIMITED (cont)

While we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our audit was not designed to provide assurance on internal controls.

Our audit did not involve an analysis of the prudence of business decisions made by the directors or management.

We have read the other information in the annual report to determine whether it contained any material inconsistencies with the financial report.

### Independence

In conducting our audit, we followed the applicable independence requirements of Australian professional and ethical pronouncements and the Corporations Act 2001.

In accordance with ASIC Class Order 05/83, we declare to the best of our knowledge and belief that the auditor's independence declaration has not changed as at the date of providing our audit opinion.

### Audit opinion

In our opinion

1. the financial report of Carnarvon Petroleum Limited is in accordance with:
  - a) the Corporations Act 2001, including:
    - i. giving a true and fair view of the company's and consolidated entity's financial position as at 30 June 2006 and of their performance for the year ended on that date; and
    - ii. complying with Accounting Standards in Australia and the Corporations Regulations 2001; and
  - b) other mandatory financial reporting requirements in Australia.
2. the audited remuneration disclosures that are contained on pages 13 to 18 of the directors' report comply with Accounting Standard AASB 124 and the Corporations Regulations 2001.

### Inherent Uncertainty regarding continuation as going concern

Without qualification to the audit opinion expressed above, attention is drawn to the following matter. As a result of the matter described at Note 1 to the financial statements, there is significant uncertainty whether the consolidated entity will be able to continue as a going concern and therefore whether it will be able to realise its assets and extinguish its liabilities in the normal course of business and at the amounts stated in the financial report.

GRANT THORNTON WESTERN AUSTRALIAN PARTNERSHIP



GREG LEGUIER  
Partner  
Perth, WA.

Dated this 29<sup>th</sup> day of September 2006

## **Introduction**

Carnarvon Petroleum Limited ("Carnarvon") is a small company with an uncomplicated corporate structure and relatively simple financial and management control requirements. It adheres to the ten Essential Corporate Governance Principles as published by the ASX Corporate Governance Council and has adopted those of the Best Practice Recommendations which the Board considers to be relevant and essential for the efficient management of the Company and its business whilst safeguarding shareholder assets.

The following additional information about the Company's corporate governance practices is set out on the Company's website at [www.carnarvonpetroleum.com](http://www.carnarvonpetroleum.com):

- Corporate governance disclosures and explanations;
- Statement of Board and management functions;
- Composition of the Board and new appointments;
- Committees of the Board;
- Summary of code of conduct for directors;
- Summary of policy on securities trading;
- Audit Committee Charter;
- Summary of policy and procedure for compliance with ASX Listing Rule disclosure requirements;
- Summary of arrangements regarding communication with and participation of shareholders;
- Summary of Company's risk management policy and internal compliance and control system; and
- Corporate code of conduct.

## **Skills, experience, expertise and term of office of each director**

A profile of each director containing the applicable information is set out in the directors' report.

## **Statement concerning availability of independent professional advice**

If a director considers it necessary to obtain independent professional advice to properly discharge the responsibility of his/her office as a director then, provided the director first obtains approval for incurring such expense from the chairman, the Company will pay the reasonable expenses associated with obtaining such advice.

## **Number of audit committee meetings and names of attendees**

The number of Audit Committee meetings and names of attendees is set out in the directors' report.

## **Names and qualifications of audit committee members**

The names and qualifications of Audit Committee members are set out in the directors' report.

**Explanations for departures from best practice recommendations**

From 1 July 2005 to 30 June 2006 (the "Reporting Period") the Company complied with each of the Ten Essential Corporate Governance Principle (Note 1 below) and the corresponding Best Practice Recommendations (Note 2 below) as published by the ASX Corporate Governance Council ("ASX Principles and Recommendations"), other than in relation to the matters specified below:

| <b>Principle Reference</b> | <b>Recommendation Reference</b> | <b>Notification of Departure</b>   | <b>Explanation for Departure</b>   |
|----------------------------|---------------------------------|--|--|
| 2                          | 2.1                             | The Board did not comprise a majority of independent directors. The Board currently consists of two independent and two non-independent directors. | Mr Peter Leonhardt, the Chairman, is currently acting in a part time executive capacity as a non-independent director to support the Chief Executive Officer. Mr Leonhardt's fulfilment of this role going forward will be monitored relative to the Company's stage of development.   |
| 2                          | 2.2                             | The Chairman is not an independent director.   | Mr Peter Leonhardt, the Chairman, is currently acting in a part time executive capacity as a non-independent director to support the Chief Executive Officer. Mr Leonhardt's fulfilment of this role going forward will be monitored relative to the Company's stage of development.   |
| 2                          | 2.4                             | A separate Nomination Committee has not been formed.   | The Board considers that the Company is not currently of a size to justify the formation of a Nomination Committee. The Board as a whole undertakes the process of reviewing the skills base and experience of existing directors to enable identification or attributes required in new directors. Where appropriate independent consultants are engaged to identify possible new candidates for the Board. |

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Notes

- (1) A copy of the Ten Essential Corporate Governance Principles are set out on the Company's website under the section entitled "Corporate Governance".
- (2) A copy of the Best Practice Recommendations are set out on the Company's website under the section entitled "Corporate Governance".

**CARNARVON PETROLEUM LIMITED**  
**FINANCIAL REPORT 30 JUNE 2006**  
**CORPORATE GOVERNANCE STATEMENT (CONTINUED)**

**Explanations for departures from best practice recommendations (continued)**

| <b>Principle Reference</b> | <b>Recommendation Reference</b> | <b>Notification of Departure</b>   | <b>Explanation for Departure</b>   |
|----------------------------|---------------------------------|--|--|
| 4                          | 4.3                             | Since February 2006 the Audit Committee has comprised two directors, one of whom is non-independent and is the Chairman of the Board. This does not meet the criteria set out in Best Practice Recommendation 4.3. | In accordance with Listing Rule 12.7, the Company is not required to comply with Recommendation 4.3.   |
| 8                          | 8.1                             | A formal performance evaluation of the Board was not carried out during the Reporting Period   | A review of the functioning of the Board in general did occur by way of an informal review by the Chairman during the regular Board meetings.  |
| 9                          | 9.2                             | A separate Remuneration Committee has not been formed.   | The Board considers that the Company is not currently of a size to justify the formation of a Remuneration Committee. The Board as a whole is responsible for the remuneration arrangements for directors and executives of the Company. If the Company's activities increase in size, scope and/or nature the appointment of a Remuneration Committee will be reviewed by the Board and implemented if appropriate. |
| 9                          | 9.3                             | Non-executive directors were allocated options, as approved by shareholders, in April 2006.  | The option issue to the non-executive directors recognised the considerable workload they had undertaken, over and above a normal non-executive role, during the Reporting Period. In addition, the satisfaction of non-executive remuneration in part by options results in lower cash compensation and helps maintain the entity's cash reserves.  |

Recommendations 1 to 10 state that the Company should make publicly available a number of its corporate governance documents and procedures, ideally by posting it to the Company's website in a clearly marked corporate governance section. This did not occur during the Reporting Period, but was in place prior to the signing of this financial report.

**Existence and terms of any schemes for retirement benefits for non-executive directors**

The Company does not have any terms or schemes relating to retirement benefits for non-executive directors.

**Company's remuneration policies**

The Company's remuneration policies are set out in the Remuneration Report on pages 13 to 18.

The Company has separate remuneration policies for executive and non-executive directors. Non-executive directors receive a fixed fee and, when appropriate, share options. Executive directors receive a salary or fee and, when appropriate, shares and share options.

**Identification of independent directors**

The Company's two independent directors are considered to be Mr Neil Fearis and Mr Ken Judge.

Neither of these directors was considered to have a material relationship with the Company or another group member during the Reporting Period as professional advisor, consultant, supplier, customer, or through any other contractual relationship, nor did they have any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the Company. The Board considers "material" in this context to be where any director related business relationship represents the lesser of at least 5% of the Company's or the director-related business's revenue.

**CARNARVON PETROLEUM LIMITED**  
**FINANCIAL REPORT 30 JUNE 2006**  
**ADDITIONAL SHAREHOLDER INFORMATION**

Additional information required by the Australian Stock Exchange ("ASX") Limited Listing Rules and not disclosed elsewhere in this report is set out below.

**a) Shareholdings as at 25 September 2006**

*Substantial shareholders*

There are no substantial shareholder notices lodged with the Company.

*Voting Rights*

The voting rights attaching to Ordinary Shares are governed by the Constitution. On a show of hands every person present who is a member or representative of a member shall have one vote and on a poll, every member present in person or by proxy or by attorney or duly authorised representative shall have one vote for each share held. No options have any voting rights.

*Twenty Largest Shareholders*

| Name of Shareholder                                     | Number of Shares | % held       |
|---|------------------|--------------|
| ANZ Nominees Limited (Cash Income A/C)                  | 28,826,046       | 5.98         |
| Hamilton Capital Partners Ltd                           | 11,168,596       | 2.32         |
| Arne Investments Pty Ltd                                | 8,916,906        | 1.85         |
| HSBC Custody Nominees (Australia) Limited               | 8,830,000        | 1.83         |
| Mr Edward Patrick Jacobson                              | 8,000,000        | 1.66         |
| Mr Peter James Leonhardt                                | 7,768,493        | 1.61         |
| Petroleum Ventures Pty Ltd                              | 7,715,978        | 1.60         |
| Arne Investments Pty Ltd                                | 6,710,493        | 1.39         |
| Mr Lawrence Addision Brown and Mrs Jill Brown           | 5,754,407        | 1.19         |
| Mr William Douglas Goodfellow                           | 5,740,173        | 1.19         |
| Pendomer Investments Pty Ltd (Law Settlements Fund A/C) | 5,668,493        | 1.18         |
| Citicorp Nominees Pty Limited                           | 5,350,305        | 1.11         |
| Dalkeith Resources Pty Ltd                              | 4,873,173        | 1.01         |
| Invesco Nominee Pty Ltd                                 | 4,819,718        | 1.00         |
| Toltec Holdings Pty Ltd                                 | 4,757,381        | 0.99         |
| National Nominees Limited                               | 4,672,927        | 0.97         |
| Wickham Holdings SA                                     | 4,333,333        | 0.90         |
| Mr Gregory John Munyard (the GJ Munyard Family A/C)     | 4,272,694        | 0.89         |
| Mr John Thomas Roy                                      | 3,987,728        | 0.83         |
| Mr Edward Patrick Jacobson                              | 3,817,903        | 0.79         |
|   |                  | <b>30.29</b> |

*Distribution of equity security holders*

| Size of Holding   | Number of shareholders | Number of fully paid shares |
|-------------------|------------------------|-----------------------------|
| 1 to 1,000        | 86                     | 38,611                      |
| 1,001 to 5,000    | 116                    | 339,736                     |
| 5,001 to 10,000   | 223                    | 2,066,315                   |
| 10,001 to 100,000 | 1,421                  | 67,988,362                  |
| 100,001 and over  | 630                    | 411,354,110                 |
|                   | <b>2,476</b>           | <b>481,787,134</b>          |

The number of shareholders holding less than a marketable parcel of ordinary shares is 250.

**CARNARVON PETROLEUM LIMITED**  
**FINANCIAL REPORT 30 JUNE 2006**  
**ADDITIONAL SHAREHOLDER INFORMATION (CONTINUED)**

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**b) Unlisted option holdings as at 25 September 2006**

|   | <b>Unlisted 7 cent<br/>Options expiring 31<br/>March 2008</b> | <b>Unlisted 10 cent<br/>Options expiring<br/>31 March 2009</b> |
|---|---|--|
| Number on issue                           | 11,000,000  | 11,000,000   |
| Number of holders                         | 4   | 4  |
|   | <b>Number held</b>  | <b>Number held</b>   |
| Those holding more than 20% of the class: |   |  |
| EP Jacobson                               | 4,000,000   | 4,000,000  |
| PJ Leonhardt                              | 3,000,000   | 3,000,000  |

**c) On-market buyback**

There is no current on-market buyback.

**d) Schedule of permits**

| <u>Location</u>                    | <u>Permit</u> | <u>Equity</u> |
|------------------------------------|---------------|---------------|
| Thailand                           | L 44/43       | 40%           |
| Thailand                           | L 33/43       | 40%           |
| Carnarvon Basin, Western Australia | EP 110        | 35%           |
| Carnarvon Basin, Western Australia | EP 424        | 35%           |