

**FRONTERA RESOURCES CORPORATION**

**CONSOLIDATED FINANCIAL STATEMENTS**

**INTERIM RESULTS FOR THE SIX MONTHS**  
**ENDED JUNE 30, 2006**

FRONTERA RESOURCES CORPORATION  
CONSOLIDATED FINANCIAL STATEMENTS  
SIX MONTHS ENDED JUNE 30, 2006

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FRONTERA RESOURCES CORPORATION  
CONSOLIDATED BALANCE SHEETS

	Unaudited		Audited
	June 30, 2006	June 30, 2005	December 31, 2005
<b>ASSETS</b>			
<b>CURRENT ASSETS</b>			
Cash and cash equivalents	\$ 25,938,108	\$ 60,063,457	\$ 19,586,747
Restricted cash equivalent	4,425,000	-	250,000
Restricted short-term investments	-	-	2,950,000
Marketable securities	8,436,000	-	30,600,000
Accounts receivable - other	194,660	866,075	146,300
Inventory	2,163,740	2,084,346	1,970,128
Prepaid expenses and other	467,310	109,243	568,804
<b>TOTAL CURRENT ASSETS</b>	<b>41,624,818</b>	<b>63,123,121</b>	<b>56,071,979</b>
<b>FIXED ASSETS, net</b>	<b>429,083</b>	<b>319,710</b>	<b>580,419</b>
<b>OIL AND GAS PROPERTIES, full cost method</b>			
Properties being depleted	24,665,368	24,503,780	24,652,783
Properties not subject to depletion	23,898,570	144,376	5,929,994
	48,563,938	24,648,156	30,582,777
Less: accumulated depletion	(20,876,838)	(20,405,102)	(20,685,118)
<b>NET OIL AND GAS PROPERTIES</b>	<b>27,687,100</b>	<b>4,243,054</b>	<b>9,897,659</b>
<b>TOTAL ASSETS</b>	<b>\$ 69,741,001</b>	<b>\$ 67,685,885</b>	<b>\$ 66,550,057</b>

	Unaudited		Audited
	June 30, 2006	June 30, 2005	December 31, 2005
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
<b>CURRENT LIABILITIES</b>			
Accounts payable	\$ 333,731	\$ 176,334	\$ 601,227
Accrued liabilities	5,245,491	1,863,147	1,758,043
Accrued interest	73,429	91,619	114,266
Current portion of notes payable, related party	191,471	-	403,604
<b>TOTAL CURRENT LIABILITIES</b>	<u>5,844,122</u>	<u>2,131,100</u>	<u>2,877,140</u>
<b>NOTES PAYABLE</b>			
Related party, less current portion	-	403,604	-
Vendor	3,450,941	3,450,941	3,450,941
<b>TOTAL NOTES PAYABLE</b>	<u>3,450,941</u>	<u>3,854,545</u>	<u>3,450,941</u>
<b>OTHER LONG-TERM LIABILITIES</b>	<u>2,327,367</u>	<u>2,327,367</u>	<u>2,327,366</u>
<b>TOTAL LIABILITIES</b>	11,622,430	8,313,012	8,655,447
<b>STOCKHOLDERS' EQUITY (DEFICIT)</b>			
Common stock	2,674	2,164	2,178
Additional paid-in capital	147,888,786	142,595,235	142,480,721
Common stock warrants	9,908	31,974	31,151
Treasury stock, at cost	(567,832)	(567,832)	(567,832)
Accumulated deficit	(89,351,835)	(82,688,668)	(84,315,968)
Accumulated other comprehensive income	136,870	-	264,360
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<u>58,118,571</u>	<u>59,372,873</u>	<u>57,894,610</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<u>\$ 69,741,001</u>	<u>\$ 67,685,885</u>	<u>\$ 66,550,057</u>

See accompanying notes to consolidated financial statements.

FRONTERA RESOURCES CORPORATION  
CONSOLIDATED STATEMENTS OF OPERATIONS

	Unaudited		Audited
	Six Months Ended		Year Ended
	June 30, 2006	June 30, 2005	December 31, 2005
REVENUE			
Crude oil sales	\$ 758,630	\$ 351,302	\$ 1,809,427
TOTAL REVENUE	<u>758,630</u>	<u>351,302</u>	<u>1,809,427</u>
OPERATING EXPENSES			
Field operating and project costs	646,918	154,919	1,466,364
General and administrative	5,486,744	4,746,921	8,354,984
Depreciation, depletion and amortization	464,693	298,272	610,320
TOTAL OPERATING EXPENSES	<u>6,598,355</u>	<u>5,200,112</u>	<u>10,431,668</u>
LOSS FROM OPERATIONS	(5,839,725)	(4,848,810)	(8,622,241)
OTHER INCOME (EXPENSE)			
Forgiveness of debt income	11,732	2,863,109	4,158,861
Interest income	926,381	430,819	1,445,624
Interest expense	(144,779)	(1,232,485)	(1,384,583)
Other, net	10,524	(266)	(12,594)
TOTAL OTHER INCOME (EXPENSE)	<u>803,858</u>	<u>2,061,177</u>	<u>4,207,308</u>
NET LOSS	<u>\$ (5,035,867)</u>	<u>\$ (2,787,633)</u>	<u>\$ (4,414,933)</u>
Net Loss Per Common Share:			
Basic and diluted	<u>(0.09)</u>	<u>(0.08)</u>	<u>(0.10)</u>
Weighted Average Common Shares Outstanding:			
Basic and diluted	<u>58,856,834</u>	<u>35,993,168</u>	<u>45,206,970</u>

See accompanying notes to consolidated financial statements.

FRONTERA RESOURCES CORPORATION  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)  
PERIODS ENDED JUNE 30, 2006 AND DECEMBER 31, 2005

	Convertible Preferred Stock Series D	Convertible Preferred Stock Series E	Common Stock	Additional Paid-in Capital	Common Stock Warrants	Treasury Stock	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' (Deficit) Equity
Balance, January 1, 2005	\$ -	\$ 29	\$ 242	\$ 48,382,082	\$ 36,927	\$ (567,832)	\$ (79,901,035)	\$ -	\$ (32,049,587)
Exercise of common stock warrants	-	-	94	81,588	(5,776)	-	-	-	75,906
Issuance of common stock, net of offering costs	-	-	1,229	80,168,951	-	-	-	-	80,170,180
Compensation expense from repricing of stock options	-	-	-	12,632	-	-	-	-	12,632
Conversion of bridge loan to common stock, including beneficial conversion	-	-	43	3,124,957	-	-	-	-	3,125,000
Conversion of Series A1, A2 & B redeemable preferred stock to common stock	-	-	172	10,710,880	-	-	-	-	10,711,052
Conversion of Series D & E preferred stock to common stock	-	(29)	398	(369)	-	-	-	-	-
Unrealized gain on marketable securities	-	-	-	-	-	-	-	264,360	264,360
Net loss	-	-	-	-	-	-	(4,414,933)	-	(4,414,933)
Total comprehensive loss									(4,150,573)
Balance, December 31, 2005	-	-	2,178	142,480,721	31,151	(567,832)	(84,315,968)	264,360	57,894,610
Exercise of common stock warrants	-	-	475	3,304,394	(21,243)	-	-	-	3,283,626
Exercise of common stock options	-	-	21	524,979	-	-	-	-	525,000
Compensation expense from issuance of stock options	-	-	-	1,578,692	-	-	-	-	1,578,692
Unrealized gain on marketable securities	-	-	-	-	-	-	-	(127,490)	(127,490)
Net loss	-	-	-	-	-	-	(5,035,867)	-	(5,035,867)
Total comprehensive loss									(5,163,357)
Balance, June 30, 2006	\$ -	\$ -	\$ 2,674	\$ 147,888,786	\$ 9,908	\$ (567,832)	\$ (89,351,835)	\$ 136,870	\$ 58,118,571

See accompanying notes to consolidated financial statements.

FRONTERA RESOURCES CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Unaudited		Audited
	Six Months Ended		Year Ended
	June 30, 2006	June 30, 2005	December 31, 2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net loss	\$ (5,035,867)	\$ (2,787,633)	\$ (4,414,933)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation, depletion and amortization	464,693	298,272	610,320
Interest income from unrealized gain	(264,360)	-	-
Interest on redeemable preferred shares	-	88,470	88,470
Beneficial conversion of bridge loan	-	625,000	625,000
Common stock options issued for compensation	1,578,692	138,948	12,632
Forgiveness of debt income	(11,732)	(2,863,109)	(4,158,861)
Changes in operating assets and liabilities:			
Receivables	(48,360)	279,609	999,384
Inventory	(193,612)	(383,987)	(269,769)
Prepaid expenses and other	101,495	28,815	(430,746)
Accounts payable	(580,400)	(400,004)	1,320,640
Accrued liabilities	(1,173,674)	(223,122)	(328,226)
Accrued interest	(40,837)	(1,157,401)	(1,134,754)
<b>NET CASH USED IN OPERATING ACTIVITIES</b>	<b>(5,203,962)</b>	<b>(6,356,142)</b>	<b>(7,080,843)</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Investment in oil and gas properties	(13,006,611)	(618,356)	(6,224,410)
Investment in fixed assets	(110,388)	-	(621,307)
Investment in cash collateral account	(4,425,000)	-	-
Redemption of (investment in) certificates of deposit	3,200,000	-	(3,200,000)
Redemption of (investment in) marketable securities	22,300,870	-	(30,335,640)
<b>NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES</b>	<b>7,958,871</b>	<b>(618,356)</b>	<b>(40,381,357)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Repayment on line of credit	-	(850,670)	(850,670)
Repayment on related party notes	-	(13,693,498)	(13,758,412)
Payment on long-term liabilities	-	(91,678)	(91,678)
Exercise of common stock options	525,000	-	-
Exercise of common stock warrants	3,071,452	-	75,906
Proceeds from issuance of common stock	-	80,170,180	80,170,180
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>3,596,452</b>	<b>65,534,334</b>	<b>65,545,326</b>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>6,351,361</b>	<b>58,559,836</b>	<b>18,083,126</b>
CASH AND CASH EQUIVALENTS, beginning of period	19,586,747	1,503,621	1,503,621
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 25,938,108</u>	<u>\$ 60,063,457</u>	<u>\$ 19,586,747</u>
<b>SUPPLEMENTAL CASH FLOW INFORMATION</b>			
Cash paid for interest	<u>\$ 185,616</u>	<u>\$ 1,805,867</u>	<u>\$ 1,805,867</u>

See accompanying notes to consolidated financial statements.

FRONTERA RESOURCES CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2006

NOTE A - NATURE OF OPERATIONS

Frontera Resources Corporation, a Delaware corporation, and its subsidiaries (collectively "Frontera" or the "Company") are engaged in the development of oil and gas projects in emerging marketplaces. Frontera was founded in 1996 and is headquartered in Houston, Texas. The Company emphasizes development of reserves in known hydrocarbon-bearing basins, and is attracted to exploitation projects that have significant exploration upside. Beginning in 2002, the Company has focused substantially all of its efforts on the exploration and development of oilfields within the Republic of Georgia ("Georgia"), a member of the Former Soviet Union.

In June 1997, the Company entered into a 25 year production sharing agreement with the Ministry of Fuel and Energy of Georgia and State Company Georgian Oil ("Georgian Oil"), which gives the Company the exclusive right to explore, develop and produce crude oil in a 5500 square kilometer area in eastern Georgia known as Block 12, hereafter referred to as the "Block 12 PSA". The Block 12 PSA can be extended if commercial production remains viable upon its expiration in June 2022.

Under the terms of the Block 12 PSA, the Company is entitled to conduct exploration and production activities and is entitled to recover its cumulative costs and expenses from the crude oil produced from Block 12. Following recovery of cumulative costs and expenses from Block 12 production, the remaining crude oil sales, referred to as Profit Oil, are allocated between Georgian Oil and Frontera in the proportion of 51% and 49%, respectively.

Under the terms of the Block 12 PSA, Frontera is exempt from all taxes imposed by the government of Georgia, and any taxes imposed on the Company shall be paid by Georgian Oil on behalf of the Company from Georgian Oil's 51% share of Profit Oil. Taxes are defined by the Block 12 PSA to mean all levies, duties, payments, fees, taxes or contributions payable to or imposed by any government agency, subdivision, municipal or local authorities within the Government of Georgia.

NOTE B - BASIS OF PRESENTATION

The Frontera Resources Corporation unaudited consolidated financial statements as of, and for the period ended June 30, 2006 should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2005, which was previously filed with the London AIM exchange. The unaudited consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the interim periods. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full year.



FRONTERA RESOURCES CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2006

NOTE C - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation: The consolidated financial statements include the accounts of Frontera Resources Corporation (“FRC”) and its wholly and majority owned subsidiaries. The wholly owned subsidiaries are Frontera International Corporation (“FIC”); Frontera Resources Caucasus Corporation (“FRCC”); Frontera Resources Georgia Corporation (“FRGC”); Frontera Resources Azerbaijan Corporation (“FRAC”); Frontera Resources Overseas Corporation (“FROC”); Frontera Azerbaijan Ventures Corporation (“FAVC”) and Frontera Resources Georgia, Limited (“FRGL”). Also included are the accounts of Frontera Eastern Georgia, Limited (“FEGE”), a 50%-owned subsidiary, as control is deemed to reside with the Company. All significant inter-company transactions and accounts have been eliminated in consolidation.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

Cash and cash equivalents: The Company considers all highly liquid investments with an original maturity of three months or less at the time of purchase to be cash equivalents.

Foreign Operations: Frontera’s future revenues depend on operating results from its operations in the Republic of Georgia. The success of Frontera’s operations is subject to various contingencies beyond management control. These contingencies include general and regional economic conditions, prices for crude oil, competition and changes in regulation. Frontera is subject to various additional political and economic uncertainties in the Republic of Georgia which could include restrictions on transfer of funds, import and export duties, quotas and embargoes, domestic and international customs and tariffs, and changing taxation policies, foreign exchange restrictions, political conditions and regulations.

Oil and Gas Properties: The Company follows the full cost method of accounting for oil and gas properties. Accordingly, all costs associated with acquisition, exploration, and development of oil and gas reserves, including directly related overhead costs, are capitalized. Tarabani and Basin Edge costs are shown as properties not subject to depletion as evaluation of commerciality is ongoing.

Stock-Based Compensation: The Company adopted SFAS No. 123R, *Share-Based Payment*, effective January 1, 2006. This statement requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their grant-date fair values. Compensation costs for awards granted prior to, but not vested, as of January 1, 2006 would be based on the grant date attributes originally used to value those awards for pro forma purposes under SFAS No. 123. The Company adopted SFAS No. 123R using the modified prospective transition method, utilizing the Black-Scholes option pricing model for the calculation of the fair value of our employee stock options. Under the modified prospective method, we record compensation cost related to unvested stock awards as of December 31, 2005 by recognizing the unamortized grant date fair value of these awards over the remaining vesting periods of those awards with no change in historical reported earnings. The Company estimated forfeiture rates for the first six months of 2006 based on our historical experience of approximately 2 percent. The Company recorded \$1,578,692 of stock option expense to general and administrative expense in the first six months of 2006.

The Black-Scholes model incorporates assumptions to value stock-based awards. The risk-free rate of interest is the related U.S. Treasury yield curve for periods within the expected term of the option at the time of grant. The dividend yield on our common stock is assumed to be zero as we have historically not paid dividends and have no current plans to do so in the future. The expected volatility is based on historical volatility of our common stock since it began trading of approximately 40 percent.

FRONTERA RESOURCES CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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NOTE C - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Prior to January 1, 2006, we accounted for our stock-based compensation using Accounting Principles Board Opinion No. 25 ("APB No. 25"). Under APB No. 25, compensation expense is recognized for stock options with an exercise price that is less than the market price on the grant date of the option. For stock options with exercise prices at or above the market value of the stock on the grant date, we adopted the disclosure-only provisions of SFAS No. 123, *Accounting For Stock-Based Compensation*. We also adopted the disclosure-only provisions of SFAS No. 123 for the stock options granted to our employees and directors. Accordingly, no compensation cost was recognized under APB No. 25.

A summary of our stock option activity and related information as of June 30, 2006 is as follows:

	Shares Under Options	Weighted- Average Exercise Price
Balance at January 1, 2006	9,063,013	\$ 1.74
Granted	487,500	2.50
Surrendered	(216,666)	2.87
Exercised	(525,000)	1.00
Outstanding at June 30, 2006	<u>8,808,847</u>	1.81
Exercisable at June 30, 2006	<u>6,505,519</u>	

If the Company applied the fair value provisions of SFAS No. 123, net loss would have been as follows:

	Six Months Ended June 30, 2005	Year Ended December 31, 2005
Net loss attributable to common stockholders, as reported	\$ (2,787,633)	\$ (4,414,933)
Deduct: total stock-based compensation expense determined under fair value based method for all amounts, net of related income tax	<u>(989,653)</u>	<u>(3,133,879)</u>
Net loss attributable to common stockholders, pro forma	<u>\$ (3,777,286)</u>	<u>\$ (7,548,812)</u>
Basic and diluted loss per share:		
As reported	\$ (0.08)	\$ (0.10)
Pro forma	(0.10)	(0.17)

FRONTERA RESOURCES CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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NOTE C - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The fair value for these options was estimated at the date of grant using a Black Scholes pricing model with the following weighted-average assumptions:

	Six Months Ended June 30, 2005	Year Ended December 31, 2005
Risk-free interest rate	4.22%	4.28%
Dividend yield	-	-
Weighted-average expected life of options (years)	10	10
Volatility	100%	100%

Earnings Per Share: Basic earnings per share amounts are calculated based on the weighted average number of shares of Common Stock outstanding during each period. Diluted earnings per share is based on the weighted average number of shares of Common Stock outstanding for the periods, including the dilutive effect of stock options, warrants granted, convertible notes, and convertible Preferred Stock. Dilutive options and warrants that are issued during a period or that expire or are canceled during a period are reflected in the computations for the time they were outstanding during the periods being reported. Options and warrants where the exercise price exceeds the average stock price for the period are considered anti-dilutive, and therefore are not included in the calculation of dilutive shares. As the Company was in a net loss position for all periods presented, no convertible instruments have been considered in the diluted earnings per share calculation as the effect would be anti-dilutive.

Recently Issued Accounting Pronouncements: In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes". FIN 48 is an interpretation of FASB Statement No. 109 "Accounting for Income Taxes" and must be adopted by the Company no later than January 1, 2007. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting, and disclosing in the financial statements uncertain tax positions that the company has taken or expects to take in its tax returns. The Company is evaluating the impact of adopting FIN 48.

NOTE D - INITIAL PUBLIC OFFERING

In March 2005 the Company successfully completed its initial public offering (IPO) of common stock. The Company raised approximately \$80,000,000 through the sale of 30,685,215 shares at a U.S. dollar equivalent price of \$2.89 per share. In conjunction with the IPO the Company was admitted for trading on the AIM market of the London Stock Exchange. A portion of the proceeds of the offering were used to retire \$17,135,000 of long and short term debt. Also, immediately prior to the IPO all of the Company's Series A1, A2, B, D and E preferred shares were converted to common stock as follows:

FRONTERA RESOURCES CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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NOTE D - INITIAL PUBLIC OFFERING (Continued)

	Number of Preferred Shares Prior to IPO	Number of Common Shares Upon Conversion
Series A1 Redeemable Preferred Stock	322,400	1,935,913
Series A2 Redeemable Preferred Stock	135,000	810,633
Series B Redeemable Preferred Stock	254,000	1,533,313
Series D Redeemable Preferred Stock	23,600	2,240,000
Series E Redeemable Preferred Stock	<u>2,889,333</u>	<u>13,406,505</u>
	<u>3,624,333</u>	<u>19,926,364</u>

Also in March 2005, the Company converted \$2,500,000 of related party debt into common stock at a pre-agreed discount to the IPO price. The Company issued 1,081,858 shares of common stock and recorded a beneficial conversion feature to interest expense and additional paid in capital in the amount of \$625,000 in connection with the conversion.

NOTE E - STOCKHOLDERS' EQUITY

The Company has the authority to issue up to 10,000,000 shares, par value \$.00001, of serial preferred stock. The Board of Directors may designate and authorize the issuance of such shares with such voting power and in such classes and series, and with such designation, preferences and relative participation, optional, or other special rights, qualifications, limitations, or restrictions as deemed appropriate by the Company's Board of Directors.

All previously issued and outstanding preferred shares were converted into common shares in conjunction with the Company's March 2005 IPO on the London AIM. See note D for conversion details. In conjunction with the IPO the Company authorized 10,000,000 preferred shares with a par value of \$.00001 each, of which zero were outstanding at June 30, 2006, December 31, 2005, and June 30, 2005.

Common Stock: As of June 30, 2006, the Company is authorized to issue 200,000,000 shares of common stock, par value \$.00004 per share. As of June 30, 2006, December 31, 2005, and June 30, 2005, the Company had 66,778,066, 54,389,787 and 54,046,299 common shares outstanding, respectively.

Treasury Stock: The Company has repurchased both common stock and preferred Series E stock as treasury stock. As of June 30, 2006, December 31, 2005, and June 30, 2005, the Company had 5,739,855 shares of treasury stock. Of these amounts, all 5,739,855 shares of treasury stock are comprised of common stock as all series E preferred stock, including series E held in treasury, was converted to common stock during the Company's IPO.

FRONTERA RESOURCES CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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NOTE E - STOCKHOLDERS' EQUITY (Continued)

Stock Options: During 2003, the Company re-priced certain outstanding options downward to be more in line with the value of the Company. According to FIN 44, *Accounting for Certain Transactions Involving Stock Compensation - An Interpretation of APB Opinion No. 25*, if a fixed stock option or award is canceled or modified such that a new measurement of compensation cost or variable accounting is required, compensation cost shall be adjusted for increases or decreases in the intrinsic value of the modified award in subsequent periods until that award is exercised, is forfeited, or expires unexercised. However, compensation cost shall not be adjusted below the intrinsic value (if any) of the modified stock option or award at the original measurement date unless the award is forfeited because the employee fails to fulfill an obligation. As of June 30, 2005, there were 631,584 remaining options subject to variable accounting. During the six months ended June 30, 2005, the Company recorded compensation expense of \$138,948 related to the re-priced options. Effective January 1, 2006, the Company adopted SFAS 123(R), which does not allow this treatment for re-priced stock options. Accordingly, the Company ceased expensing these options beginning as of January 1, 2006.

NOTE F - COMMITMENTS AND CONTINGENCIES

BJ Services Company Middle East Limited Litigation: In September 2004, BJ Services Company Middle East Limited ("BJ Services") filed a claim in Tbilisi District Court in Tbilisi, Georgia against FEGL due to non-payment for services rendered. BJ Services performed certain oil field services for FEGL between May and June 2003; however, the Company has argued that the services were defective and that certain other charges were not properly levied. The BJ Services claim with interest and penalties is \$299,375, net of a \$160,000 prepayment made by the Company in advance of the services being undertaken. This matter was settled in May 2005 by payment of \$61,146 plus court fees of approximately \$1,400.

SOCAR Arbitration: In June 1998 Frontera Resources Azerbaijan Corporation ("FRAC"), an indirect wholly owned subsidiary of the Company, entered into a production sharing agreement with SOCAR, the State Oil Company of Azerbaijan Republic, hereafter referred to as the "Azerbaijan PSA".

In October 2003, FRAC initiated arbitration proceedings against SOCAR to recoup funds resulting from SOCAR's halting of exports from the onshore Kursangi & Karabagli oilfields in the Azerbaijan Republic during the fourth quarter of 2000.

In January 2006, the arbitral panel found that the halting of exports of crude oil from the Kursangi & Karabagli oil fields was in violation of the Azerbaijan PSA, and FRAC was awarded approximately \$1,250,000 plus interest at a rate equal to LIBOR plus 4% from January 1, 2001 until full payment is made. The award also included a requirement for the Company to pay for certain costs of arbitration of approximately \$254,000 and to pay SOCAR approximately \$290,000 for part of SOCAR's costs of arbitration. The arbitration panel rejected all other claims and counterclaims between the parties and the arbitration therefore resolves all claims between Frontera and SOCAR with respect to the Azerbaijan PSA.

In February 2006, FRAC filed an action in the United States District Court, Southern District of New York, seeking to enforce the tribunal's award in the United States of America. Contemporaneously, SOCAR filed a challenge to the award with the Swedish Court of Appeals. FRAC intends to vigorously defend the challenge by SOCAR. No gain or loss from the arbitration ruling has been recorded in the Company's consolidated financial statements pending ultimate resolution of the appeal.

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NOTE F - COMMITMENTS AND CONTINGENCIES

Vendor Invoices: In August 2003 and July 2004, the Company settled vendor invoices of \$79,036 and \$1,607,214, respectively. The terms of both settlement agreements provided that Frontera would not be responsible to repay the liability unless the Company generated Profit Oil revenues, as defined in the Block 12 PSA by August 2007 and July 2008, respectively. Because Profit Oil is determined based on the recovery of cumulative costs incurred for the development of Block 12, the Company does not expect to pay these vendors any additional amounts under the settlements; however, the costs will continue to be accrued until the Profit Oil contingency expires.

NOTE G - NON-CASH INVESTING AND FINANCING ACTIVITIES

The following non-cash transactions took place during the six months ended June 30, 2006:

- The Company adopted the provisions of SFAS 123R and recorded compensation expense related to the issuance of common stock options in the amount of \$1,578,692.
- The Company recorded interest income of \$264,360 related to an amount previously treated as an unrealized gain.
- Related Party Notes Payable of \$212,174 were utilized by note holders to fund the exercise of common stock warrants.
- The Company recorded forgiveness of debt income of \$11,732 related to an old payable deemed to be forgiven.
- The Company had accounts payable and accrued liabilities of \$4,985,761 which related to investments in oil and gas properties.

The following non-cash transactions took place during the year ended December 31, 2005:

- A 12% Convertible \$2,500,000 Note Payable to a related party was converted to common stock at a 20% discount. In conjunction with this transaction the Company recorded a beneficial conversion feature to interest expense and additional paid in capital of \$625,000 and the related note payable was retired. This transaction is discussed in further detail in Note C.
- A Note Payable to a related party for \$3,825,000 and related accrued interest of \$370,164 was settled for \$1,332,055 resulting in forgiveness of debt income of \$2,863,109.
- Related Party Notes Payable of \$75,906 were utilized by note holders to fund the exercise of common stock warrants.
- An entity of the Georgian government acknowledged responsibility of previously accrued social taxes, resulting in forgiveness of debt income of \$1,131,134.
- A number of old payables were deemed to be forgiven, resulting in forgiveness of debt income of \$164,606.

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NOTE G - NON-CASH INVESTING AND FINANCING ACTIVITIES (Continued)

The following non-cash transactions took place during the period ended June 30, 2005:

- A 12% Convertible \$2,500,000 Note Payable to a related party was converted to common stock at a 20% discount. In conjunction with this transaction the Company recorded a beneficial conversion feature to interest expense and additional paid in capital of \$625,000 and the related note payable was retired. This transaction is discussed in further detail in Note D.
- A Note Payable to a related party for \$3,825,000 and related accrued interest of \$370,164 was settled for \$1,332,055 resulting in forgiveness of debt income of \$2,863,109.
- Related Party Notes Payable of \$64,915 were utilized by note holders to fund the exercise of common stock warrants.

NOTE H - LINE OF CREDIT

During 2006 the Company established a \$10,000,000 line of credit with a commercial bank by agreeing to collateralize \$15,000,000 of cash and marketable securities. The cash and marketable securities can be accessed at any time to the extent that the line of credit has not been drawn upon. As of June 30, 2006 \$2,950,000 of the line of credit is not available as it was used to support two letters of credit for vendors utilized in the Company's drilling program in Georgia. Accordingly, approximately \$4,425,000 of the Company's cash is being used as collateral and is shown as restricted cash equivalents in the Company's consolidated balance sheet.