FRONTERA RESOURCES CORPORATION

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2005 AND 2004

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Independent Auditors' Report

Board of Directors
Frontera Resources Corporation

We have audited the accompanying consolidated balance sheets of Frontera Resources Corporation and Subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Frontera Resources Corporation and Subsidiaries at December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

UHY Mann Frankfort Stein & Lipp CPAs, LLP

Houston, Texas
January 28, 2006

FRONTERA RESOURCES CORPORATION
CONSOLIDATED BALANCE SHEETS

	December 31, 2005	December 31, 2004
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 19,586,747	$ 1,503,621
Restricted cash equivalent	250,000	-
Restricted short-term investments	2,950,000	-
Marketable securities	30,600,000	-
Trade receivables, net	-	507,868
Accounts receivable - other	146,300	637,816
Inventory	1,970,128	1,700,359
Prepaid expenses and other	568,804	138,057
TOTAL CURRENT ASSETS	56,071,979	4,487,721
PROPERTY AND EQUIPMENT, net	580,419	213,011
OIL AND GAS PROPERTIES, full cost method		
Properties being depleted	24,652,783	24,213,991
Properties not subject to depletion	5,929,994	144,376
	30,582,777	24,358,367
Less: accumulated depletion	(20,685,118)	(20,328,697)
NET OIL AND GAS PROPERTIES	9,897,659	4,029,670
TOTAL ASSETS	$ 66,550,057	$ 8,730,402

	December 31,	
	2005	2004
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
CURRENT LIABILITIES		
Accounts payable	$ 601,227	$ 576,338
Accrued liabilities	1,758,043	2,086,269
Accrued interest	114,266	1,586,530
Line of credit	-	850,670
Current portion of notes payable, related party	403,604	12,784,011
TOTAL CURRENT LIABILITIES OTHER THAN SHARES	2,877,140	17,883,818
REDEEMABLE PREFERRED SHARES		
Series A1, stated at redemption value	-	4,804,856
Series A2, stated at redemption value	-	2,011,959
Series B, stated at redemption value	-	3,805,767
TOTAL REDEEMABLE PREFERRED SHARES	-	10,622,582
TOTAL CURRENT LIABILITIES	2,877,140	28,506,400
NOTES PAYABLE		
Related party, less current portion	-	6,403,604
Vendor	3,450,941	3,450,941
TOTAL NOTES PAYABLE	3,450,941	9,854,545
OTHER LONG-TERM LIABILITIES	2,327,366	2,419,044
TOTAL LIABILITIES	8,655,447	40,779,989
COMMITMENTS AND CONTINGENCIES	-	-
STOCKHOLDERS' EQUITY (DEFICIT)		
Convertible preferred stock - Series E	-	29
Common stock	2,178	242
Additional paid-in capital	142,480,721	48,382,082
Common stock warrants	31,151	36,927
Treasury stock, at cost	(567,832)	(567,832)
Accumulated deficit	(84,315,968)	(79,901,035)
Accumulated other comprehensive income	264,360	-
TOTAL STOCKHOLDERS' EQUITY (DEFICIT)	57,894,610	(32,049,587)
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	$ 66,550,057	$ 8,730,402

See accompanying notes to consolidated financial statements.

FRONTERA RESOURCES CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,	
	2005	2004
REVENUE		
Crude oil sales	$ 1,809,427	$ 1,040,656
TOTAL REVENUE	1,809,427	1,040,656
OPERATING EXPENSES		
Field operating and project costs	1,466,364	189,148
General and administrative	8,354,984	4,035,327
Depreciation, depletion and amortization	610,320	525,902
TOTAL OPERATING EXPENSES	10,431,668	4,750,377
LOSS FROM OPERATIONS	(8,622,241)	(3,709,721)
OTHER INCOME (EXPENSE)		
Forgiveness of debt	4,158,861	114,920
Interest income	1,445,624	-
Interest expense	(1,384,583)	(2,019,378)
Other, net	(12,594)	9,265
TOTAL OTHER INCOME (EXPENSE)	4,207,308	(1,895,193)
NET LOSS	$ (4,414,933)	$ (5,604,914)
Net Loss per common share		
Basic	(0.10)	(0.94)
Diluted	(0.10)	(0.94)
Weighted Average Common Shares Outstanding:		
Basic	45,206,970	5,994,276
Diluted	45,206,970	5,994,276

See accompanying notes to consolidated financial statements.

FRONTERA RESOURCES CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)
YEARS ENDED DECEMBER 31, 2005 AND 2004

	Convertible Preferred Stock Series D	Convertible Preferred Stock Series E	Common Stock	Additional Paid-in Capital	Preferred Stock Warrants	Common Stock Warrants	Treasury Stock	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' (Deficit) Equity
Balance, January 1, 2004	$ -	$ 29	$ 240	$ 43,183,632	$ 5,268,936	$ 36,927	$ (495,366)	$ (74,296,121)	-	$ (26,301,723)
Exercise of common stock warrants	-	-	2	1,198	-	-	-	-	-	1,200
Repurchase of preferred stock Series E warrants	-	-	-	5,189,902	(5,268,936)	-	-	-	-	(79,034)
Issuance of common stock options for services	-	-	-	7,350	-	-	-	-	-	7,350
Purchase of treasury stock	-	-	-	-	-	-	(72,466)	-	-	(72,466)
Net loss	-	-	-	-	-	-	-	(5,604,914)	-	(5,604,914)
Balance, December 31, 2004	-	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)
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

See accompanying notes to consolidated financial statements.

FRONTERA RESOURCES CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,	
	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (4,414,933)	$ (5,604,914)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation, depletion and amortization	610,320	525,902
Interest on redeemable preferred shares	88,470	462,410
Beneficial conversion of bridge loan	625,000	-
Net amortization of debt discounts	-	(74,832)
Common stock options issued for compensation	12,632	7,350
Forgiveness of debt income	(4,158,861)	(114,920)
Changes in operating assets and liabilities:		
Receivables	999,384	(450,211)
Inventory	(269,769)	43,774
Prepaid expenses and other	(430,746)	123,035
Accounts payable	1,320,640	(1,014,335)
Accrued liabilities	(328,226)	(985,600)
Accrued interest	(1,134,754)	1,094,582
NET CASH USED IN OPERATING ACTIVITIES	(7,080,843)	(5,987,759)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in oil and gas properties	(6,224,410)	-
Investment in property and equipment	(621,307)	-
Investment in certificates of deposit	(3,200,000)	-
Investment in marketable securities	(30,335,640)	-
NET CASH USED IN INVESTING ACTIVITIES	(40,381,357)	-
CASH FLOWS FROM FINANCING ACTIVITIES		
(Payment on) proceeds from line of credit	(850,670)	850,670
(Payment on) proceeds from related party notes	(13,758,412)	6,630,711
Payment on long-term liabilities	(91,678)	-
Exercise of common stock warrants	75,906	1,200
Proceeds from issuance of common stock	80,170,180	-
Purchase of treasury stock	-	(151,500)
NET CASH PROVIDED BY FINANCING ACTIVITIES	65,545,326	7,331,081
NET INCREASE IN CASH AND CASH EQUIVALENTS	18,083,126	1,343,322
CASH AND CASH EQUIVALENTS, beginning of year	1,503,621	160,299
CASH AND CASH EQUIVALENTS, end of year	$ 19,586,747	$ 1,503,621
SUPPLEMENTAL CASH FLOW INFORMATION		
Cash paid for interest	$ 1,805,867	$ 555,374

See accompanying notes to consolidated financial statements.

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. Prior to 2002, the Company's other significant operating focus was on the exploration and development of an oilfield within the Azerbaijan Republic ("Azerbaijan"), which was sold during 2002 and all operating activities in Azerbaijan ceased at that time.

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 - 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 ("FEGL"), a 50%-owned subsidiary, as control is deemed to reside with the Company. All significant intercompany transactions and accounts have been eliminated in consolidation.

Cash and Cash Equivalents: Cash and cash equivalents include all cash balances, money market accounts and certificates of deposit, all of which have maturities of three months or less.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Restricted Cash Equivalent and Short-Term Investments: At December 31, 2005, the Company has $250,000 and $2,950,000 of restricted cash equivalent and restricted short term investments. The restricted cash equivalent and restricted short-term investments serves as collateral for an irrevocable standby letter of credit that provides financial assurance that the Company will fulfill its obligations with respect to service contracts with certain vendors. The cash is held in custody by the issuing bank, is restricted as to withdrawal or use, and is currently invested in certificates of deposit. Income from these investments is paid to the Company.

Marketable Securities: The Company determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. Debt securities for which the Company does not have the intent or ability to hold to maturity are classified as available-for-sale. Held-to-maturity securities are recorded as either short-term or long-term on the balance sheet based on contractual maturity date and are stated at amortized cost. Marketable securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and are reported at fair value, with unrealized gains and losses recognized in earnings. Debt and marketable equity securities not classified as held-to-maturity or as trading, are classified as available-for-sale, and are carried at fair market value, with the unrealized gains and losses, net of tax, included in the determination of comprehensive income and reported in shareholders' equity.

The fair value of substantially all securities is determined by quoted market prices. The estimated fair value of securities for which there are no quoted market prices is based on similar types of securities that are traded in the market.

At December 31, 2005, available-for-sale securities consist of investments in corporate bonds with an estimated fair value of $30,600,000 and net unrealized holding gains in the amount of $264,360, which have been included in accumulated other comprehensive income.

Inventory: Inventory consists primarily of materials to be used in the Company's foreign oilfield operations and crude oil held in stock tanks. Inventory is valued using the first-in, first-out method and is stated at the lower of cost or market. Inventory consists of the following:

	December 31,	
	2005	2004
Materials and supplies	$ 1,679,538	$ 1,604,488
Crude oil	290,590	95,871
	$ 1,970,128	$ 1,700,359

Property and Equipment: Property and equipment are stated at cost. Expenditures for major renewals and betterments, which extend the original estimated economic useful lives of applicable assets, are capitalized. Expenditures for normal repairs and maintenance are charged to expense as incurred. The costs and related accumulated depreciation of assets sold or retired are removed from the accounts, and any gain or loss thereon is reflected in operations. Depreciation of property and equipment is computed using the straight-line method over the estimated useful lives of the assets, ranging from three to seven years.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

All capitalized costs of oil and gas properties, including the estimated future costs to develop proved reserves, are depleted on the unit-of-production method using estimates of proved reserves. Investments in unproved properties and major development projects are not depleted until proved reserves associated with the projects can be determined or until impairment occurs. In addition, the capitalized costs are subject to a "ceiling test," which limits such costs to the aggregate of the future net revenues from proved reserves, based on current economic and operating conditions, discounted at a 10% interest rate, plus the lower of cost or fair market value of unproved properties. No impairment writedown was necessary for the years ended December 31, 2005 and 2004.

Sales of proved and unproved properties are accounted for as adjustments of capitalized costs with no gain or loss recognized, unless such adjustments would significantly alter the relationship between capitalized costs and proved reserves of oil and gas, in which case the gain or loss is recognized in income. Abandonments of properties are accounted for as adjustments of capitalized costs with no loss recognized.

Income Taxes: The Company follows the provisions of SFAS No. 109, *"Accounting for Income Taxes"*, which requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statements and the tax basis of assets and liabilities using enacted rates in effect for the years in which the differences are expected to reverse. Valuation allowances are established, when appropriate, to reduce deferred tax assets to the amount expected to be realized.

Revenue Recognition: Revenues and their related costs are recognized upon delivery of commercial quantities of crude oil produced from proven reserves, in accordance with the accrual method of accounting.

Foreign Currency Transactions: The financial statements of the foreign subsidiaries are prepared in United States dollars, and the majority of transactions are denominated in United States dollars. Gains and losses on foreign currency transactions are the result of changes in the exchange rate between the time a foreign currency-denominated invoice is recorded and when it is ultimately paid and are included in operations. Foreign currency transaction gains and losses were not material for the years ended December 31, 2005 and 2004.

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 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.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Concentrations of Credit and Other Risks: Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and accounts receivables. The Company maintains its cash in bank deposits with various major financial institutions. These accounts, at times, exceed federally insured limits. Deposits in the United States are guaranteed by the Federal Deposit Insurance Corporation up to $100,000. The Company monitors the financial condition of the financial institutions and has not experienced any losses on such accounts.

Receivables that potentially subject the Company to credit risk consist principally of amounts due from unrelated parties in Georgia. The Company establishes an allowance for doubtful accounts based on factors surrounding the credit risk of the specific debtor, historical trends and other related information. Collateral is generally not required to secure receivables.

Fair Value of Financial Instruments: Frontera's financial instruments consist of cash, accounts receivable, accounts payable, and a variety of debt instruments, including a line of credit, and senior and subordinated notes payables (collectively, the "Debt Instruments"). The fair value of cash, accounts receivable and accounts payable are estimated to approximate the carrying value due to the liquid nature of these instruments. The fair value of the Debt Instruments was determined based upon discount rates which approximate variable interest rates for borrowings of a similar nature. The fair values of the Debt Instruments on December 31, 2005 and 2004 were approximately $2.7 million, and $22.5 million, respectively.

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, 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 antidilutive, and therefore are not included in the calculation of dilutive shares. Basic and diluted loss per share for the years ended December 31, 2005 and 2004 are the same since the effect of all common stock equivalents is antidilutive to the Company's net loss per share under SFAS No. 128.

Major Customers: For the years ended December 31, 2005 and 2004, 100% of the Company's crude oil sales were to one unrelated customer.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 reporting period. Actual results could differ from those estimates.

Stock-Based Compensation: In accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "*Accounting for Stock-Based Compensation*", the Company has elected to follow the Accounting Principles Board's Opinion No. 25, *"Accounting for Stock Issued to Employees"*, ("APB 25") and related interpretations in accounting for its employee stock-based compensation plans. Under APB 25, if the exercise price of the Company's employee stock options equals or exceeds the fair value of the underlying stock on the date of grant, no compensation expense is recognized.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

	Year Ended December 31,	
	2005	2004
Net loss attributable to common stockholders, as reported	$ (4,414,933)	$ (5,604,914)
Deduct: total stock based compensation expense determined under fair value based method for all awards, net of related income tax	(3,133,879)	(5,250)
Net loss attributable to common stockholders, pro forma	$ (7,548,812)	$ (5,610,164)
Basic loss per share:		
As reported	(0.10)	(0.94)
Pro forma	(0.17)	(0.94)
Diluted loss per share:		
As reported	(0.10)	(0.94)
Pro forma	(0.17)	(0.94)

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

	December 31,	
	2005	2004
Risk-free interest rate	4.28%	2.38%
Dividend yield	-	-
Weighted-average expected life of options (years)	10	10
Volatility	100%	100%

Recently Issued Accounting Pronouncements: In December 2004, the FASB issued SFAS No. 123R, SHARE-BASED PAYMENT (SFAS 123R). SFAS 123R revises SFAS No. 123, ACCOUNTING FOR STOCK-BASED COMPENSATION, and focuses on accounting for share-based payments for services by employer to employee. The statement requires companies to expense the fair value of employee stock options and other equity-based compensation at the grant date. The statement does not require a certain type of valuation model and either a binomial lattice or Black-Scholes model may be used. The provisions of SFAS 123R are effective for financial statements for annual periods beginning after June 15, 2005. We are currently evaluating the method of adoption and the impact on our operating results, which we believe will be material. Our future cash flows will not be impacted by the adoption of this standard.

NOTE C - 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 in net proceeds through the sale of 30,685,215 shares at a U.S. dollar equivalent price of $2.89. 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 from the offering was used to retire $17,135,000 of long-term and short-term debt, of which approximately $2,500,000 was forgiven. 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:

	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 Convertible Preferred Stock	23,600	2,240,000
Series E Convertible Preferred Stock (1)	2,889,333	13,406,505
	3,624,333	19,926,364

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.

(1) As of December 31, 2004, out of total Series E convertible preferred stock of 2,889,333 outstanding, the Company had repurchased 1,229,234 as treasury stock.

NOTE D - MANDATORY REDEEMABLE PREFERRED STOCK

Series A1 and Series A2 Redeemable Preferred Stock: In March 2005, all of the Company's redeemable preferred stock was converted to common stock during the Company's initial public offering as discussed in Note C above. As of December 31, 2004, the Company had 322,400 designated, issued and outstanding shares of Series A1 Redeemable Preferred Stock ("Series A1") and 135,000 designated, issued and outstanding shares of Series A2 Redeemable Preferred Stock ("Series A2"), respectively. Series A1 and Series A2 had a par value of $0.00001 per share, had no voting or conversion rights and were not entitled to dividends. The holders of Series A1 and Series A2 were afforded preference in liquidation and in redemption over the Company's common stock, Series B Redeemable Preferred Stock, Series D Convertible Preferred Stock and Series E Convertible Preferred Stock.

During the years ended December 31, 2005 and 2004, the Company accreted dividends of $56,882 and $297,310 respectively, relating to the Series A1 and Series A2 shares.

NOTE D - MANDATORY REDEEMABLE PREFERRED STOCK (Continued)

The Company adopted the provisions of SFAS No. 150, "*Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity"*, effective in 2004. SFAS No. 150 requires that financial instruments that are mandatorily redeemable on a certain date or upon an event certain to occur be classified as liabilities. As Series A1 and Series A2 were redeemable on March 15, 2002, these instruments were classified as current liabilities on the accompanying consolidated balance sheet at December 31, 2004.

Series B Redeemable Preferred Stock: In March 2005, all of the Company's redeemable preferred stock was converted to common stock during the Company's initial public offering as discussed in Note C above. As of December 31, 2004, the Company had 254,000 designated, issued and outstanding shares of Series B Redeemable Preferred Stock ("Series B"). Series B had a par value of $0.00001 per share and were identical to Series A1 and Series A2 except no shares of Series B may be redeemed until all shares of Series A1 and Series A2 have been redeemed and Series B is subordinated in liquidation to Series A1 Redeemable Preferred Stock, Series A2 Redeemable Preferred Stock, Series D Convertible Preferred Stock and Series E Convertible Preferred Stock. In accordance with SFAS No. 150, these shares have been classified as a current liability on the accompanying consolidated balance sheet at December 31, 2004.

During the years ended December 31, 2005 and 2004, the Company accreted dividends of $31,588 and $165,100, respectively, relating to Series B shares.

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.

Series D Convertible Preferred Stock: In March 2005, all of the Company's Series D convertible preferred stock was converted to common stock during the Company's initial public offering as discussed in Note C above. As of December 31, 2004, the Company had 23,600, designated, issued and outstanding shares of Series D Convertible Preferred Stock ("Series D"). Series D had a par value of $0.00001 per share and was a voting convertible equity security that was not redeemable. Each share of Series D Preferred Stock was convertible, at the option of the holder thereof, at any time after the date of issuance of such share into the number of shares of Common Stock at the conversion price then in effect upon the earlier to occur of (i) the closing of an underwritten public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended (the "Securities Act"), covering the offer and sale of Common Stock with an offering price per share of at least two times the conversion price (as adjusted to reflect certain recapitalizations) and with gross offering proceeds (prior to underwriting discounts and commissions and offering expenses) to the Company of at least $25 million, or (ii) the date specified by vote or written consent of the holders of at least a majority of the then outstanding Series D Preferred Stock, voting as a class, for such conversion.

The price at which Common Stock was deliverable upon conversion of the Series D Preferred Stock initially was $237.295 per share of Common Stock, which conversion price was subject to adjustment as provided in the Amended Certificate of Designations.

NOTE E - STOCKHOLDERS' EQUITY (Continued)

Except as otherwise required by law, the holder of each share of Series D Preferred Stock had the right to one vote for each full share of Common Stock into which such Series D Preferred Stock could then be converted. With respect to such vote, such holder had full voting rights and powers equal to the voting rights and powers of the holders of Common Stock and is entitled to vote, together with holders of Common Stock and the holders of any other class or series of stock that also has the right to vote with the holders of the Common Stock, with respect to any question upon which holders of the Common Stock have the right to vote. The holders of Series D also had certain special voting rights that require their consent prior to certain major corporate actions, as defined.

In December 2004, the Company signed an agreement with the Series D holders that, contingent upon the closing of the public offering, all Series D shares would be immediately converted into common shares of the Company at a rate of 94.9153 shares of common stock for each share of Series D Preferred Stock.

Series E Convertible Preferred Stock: In March 2005, all of the Company's Series E convertible preferred stock was converted to common stock during the Company's initial public offering as discussed in Note C above. As of December 31, 2004, the Company had 4,000,000 designated shares and 1,660,099 outstanding shares of Series E Convertible Preferred Stock ("Series E"), respectively. Series E had a par value of $0.00001 per share and was a voting convertible equity security with a preference in liquidation over Series B and common stock but was subordinate in liquidation to Series A1 and Series A2. Each share of Series E Preferred Stock was convertible, at the option of the holder thereof, at any time after the date of issuance of such share into the number of shares of Common Stock equal to $11.60 divided by the conversion price then in effect. Each share of Series E Preferred Stock automatically converted into shares of Common Stock at the conversion price then in effect upon the earlier to occur of (i) the closing of an underwritten public offering pursuant to an effective registration statement under the Securities Act covering the offer and sale of the Company's Common Stock with an offering price per share of at least $18.99 (as adjusted to reflect certain recapitalizations) and with gross offering proceeds (prior to underwriting discounts and commissions and offering expenses) to the Company of at least $25 million, or (ii) the date specified by vote or written consent of the holders of at least a majority of the then outstanding Series E Preferred Stock, voting as a class, for such conversion.

The price at which Common Stock was deliverable upon conversion of the Series E Preferred Stock initially was $8.878214 per share of Common Stock of the Company, which conversion price is subject to adjustment as provided in the Amended Certificate of Designations. As of December 31, 2004, the conversion price for the Series E Preferred Stock was $8.836545.

The holders of the Series E had a right to have the Company redeem their shares of Series E under certain limited circumstances after December 31, 2003, none of which occurred. The redemption price is $11.60 per share, less the per-share amount of any dividends previously declared and paid to holders of Series E Preferred Stock, plus the per-share amount of any declared but unpaid dividends, plus interest on $11.60 per share at a simple rate of 6.5 percent per annum, calculated from the later of the date of issuance or September 30, 1999, to and including the applicable redemption date.

NOTE E - STOCKHOLDERS' EQUITY (Continued)

Other than rights of redemption and the number of shares convertible into the Company's common stock, the conversion, voting, and dividend rights of the Series E were substantially identical to Series D. Similar to Series D, the holders of Series E had certain special voting rights that required their consent prior to certain major corporate actions, as defined.

In December 2004, the Company signed an agreement with the Series E holders that, contingent upon the successful closing of the public offering, all Series E shares would be immediately converted into common shares of the Company at a rate of 4.64 shares of common stock for each share of Series E Preferred Stock.

Preferred Series E Stock Warrant: In 1999, the Company sold a warrant to purchase 96,035 shares of Series E or an equivalent number of common shares as determined by the conversion price at the earliest of the exercise date or the last conversion date of the warrant holder's Series E shares. The Company sold the warrant at a purchase price of $1,017,965. In 2000, the Company sold another warrant to purchase 401,035 shares of Series E of the Company or an equivalent number of common shares for total proceeds of $4,250,971. Both warrants had no expiration date. During 2004, both warrants were repurchased by the Company in a transaction that also included the repurchase of certain Series E shares, for a total purchase price of $150,000. The portion of the purchase price allocated to the warrants was $79,034. The balance of the original proceeds after the $79,034 repurchase was recorded to additional paid-in capital.

As of December 31, 2004, the status of the preferred shares designated and outstanding is summarized as follows:

	Shares Designated	Shares Outstanding
Series A1 Redeemable Preferred Stock	322,400	322,400
Series A2 Redeemable Preferred Stock	135,000	135,000
Series B Redeemable Preferred Stock	254,000	254,000
Series D Redeemable Preferred Stock	23,600	23,600
Series E Redeemable Preferred Stock	4,000,000	1,660,099
	4,735,000	2,395,099
Undesignated	5,265,000	
Total shares authorized	10,000,000	

Common Stock: As of December 31, 2005, the Company is authorized to issue 200,000,000 shares of common stock, par value $.00004 per share. As of December 31, 2005 and 2004, the Company had 54,389,787 and 6,027,872 of common shares outstanding, respectively. At December 31, 2005 and 2004, there are an additional 26.5 million and 25.8 million shares of common stock reserved for the exercise of existing options and warrants, respectively.

NOTE E - STOCKHOLDERS' EQUITY (Continued)

Treasury Stock: The Company has repurchased both common stock and preferred Series E stock as treasury stock. As of December 31, 2005 and 2004, the Company had 5,739,855 and 1,265,433 shares of treasury stock, respectively. Of these amounts, 5,739,855 and 36,209 shares of treasury stock are comprised of common stock in 2005 and 2004, respectively.

1998 Employee Stock Incentive Plan: In 1998, the Company's stockholders approved the 1998 Employee Stock Incentive Plan (the "Plan"), pursuant to which options may be granted to purchase up to 15% of the Company's common shares authorized to be issued by the Company, reduced by the total number of shares of stock subject to stock options and stock awards that have been granted under the Plan and the Frontera Resources Corporation 2000 Nonqualified Stock Option and Stock Award Plan at any given time. The Board of Directors has appointed Frontera's chief executive officer as administer (the "Administrator") of the Plan. In this capacity, the Administrator determines which employees will receive options, the number of shares covered by any option agreement, and the exercise price and other terms of each such option. The Board of Directors is responsible for administering the Plan as it relates to options granted to the chief executive officer.

Under the terms of the Plan, any issued options expire ten years after the date of grant, with the exception of options granted to 10% stockholders which expire five years after the date of grant, or upon earlier termination of employment. Options granted vest over periods ranging from immediate vesting to vesting in equal increments over three years from the date of grant.

2000 Nonqualified Stock Option and Stock Award Plan: In 2000, the Company's Board of Directors approved the 2000 Nonqualified Stock Option and Stock Award Plan (the "Stock Award Plan"), pursuant to which options may be granted to employees, directors, consultants, and advisors of the Company or any of its affiliates, to purchase up to 15% of the Company's common shares authorized to be issued by the Company, reduced by the total number of shares of stock subject to stock options and stock awards that have been granted under the Stock Award Plan and the Frontera Resources Corporation 1998 Employee Stock Incentive Plan. The Board of Directors has appointed Frontera's chief executive officer as administer of the Stock Award Plan. In this capacity, the Administrator determines which employees will receive options, the number of shares covered by any option agreement, and the exercise price and other terms of each such option. The Board of Directors is responsible for administering the Plan as it relates to options granted to the chief executive officer.

Under the terms of the Stock Award Plan, any issued options expire ten years after the date of grant or upon earlier of termination of employment or affiliation relationship between the grantee and the Company. Options granted vest over periods ranging from immediate vesting to vesting in equal increments over three years from the date of grant.

NOTE E - STOCKHOLDERS' EQUITY (Continued)

A summary of the Company's stock option activity and related information follows:

	Options	Weighted-Average Exercise Price
Options outstanding at January 1, 2004	5,997,513	1.28
Granted	60,000	1.00
Exercised	-	-
Surrendered	(62,000)	1.84
Options outstanding at December 31, 2004	5,995,513	1.26
Granted	3,112,500	2.67
Exercised	-	-
Surrendered	(45,000)	1.00
Options outstanding at December 31, 2005	9,063,013	1.74

The following table summarizes information about stock options outstanding at December 31, 2005:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at December 31, 2005	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable at December 31, 2005	Weighted-Average Exercise Price
$0.92 - 1.00	4,993,000	7.24	0.99	4,968,000	0.99
$2.00 - 2.87	3,965,013	8.19	2.57	1,002,513	2.00
$5.28 - 8.85	105,000	2.36	6.30	105,000	6.30
	9,063,013		1.74	6,075,513	1.23

During 2003, the Company repriced 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 December 31, 2005 and 2004, there are 644,084 remaining options subject to variable accounting.

NOTE F - PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	Estimated Useful Lives	December 31, 2005	December 31, 2004
Field equipment	7 years	$ 2,086,084	$ 1,708,557
Automobiles	5 years	302,553	192,701
Telecommunications equipment	7 years	367,337	367,337
Office furniture, fixtures and computer-related equipment	7 years	1,541,810	1,423,224
Leasehold improvements	3 years	29,526	25,196
		4,327,310	3,717,015
Less: accumulated depreciation		3,746,891	3,504,004
		$ 580,419	$ 213,011

NOTE G - GAC ENERGY FARMOUT AGREEMENT

In August 2002, Frontera entered into a Farmout Agreement with GAC Energy ("GAC"), a Houston-based exploration and production company. Under the terms of the Farmout Agreement, Frontera agreed to farmout an interest in the Block 12 PSA to GAC in consideration of a cash payment and work commitments. In 2002, GAC paid Frontera $1,750,000. Although the Company follows the full cost method of accounting for its oil and gas properties, a gain of approximately $786,000 was recognized on this sale because the reduction to the full cost pool for the total proceeds received would have resulted in a significantly altered relationship between capitalized costs and proved reserves.

In August 2003, GAC exercised an option under the Farmout Agreement that created an additional obligation to Frontera that resulted in a gain of approximately $1,458,000, which was deferred because the obligation was entirely financed with an account receivable from GAC. As discussed below, GAC began experiencing financial difficulty and never paid the receivable. Accordingly, the deferred gain was reversed in 2004 and never recorded to the Company's statement of operations.

Shortly after August 2003, GAC began experiencing financial difficulty. As a result, Frontera began making cash calls on behalf of GAC, and recording this as an account receivable from GAC. In February 2004, the Company notified GAC that they were in default of the terms of the Farmout Agreement. At that time, GAC informed the Company that they were putting a financing arrangement in place; however they were unsuccessful in these efforts. As a result, in July 2004, the Company once again notified GAC of the default and set out to remedy GAC's default in accordance with the provisions of the Farmout Agreement. In accordance with prescribed remedies under the Farmout Agreement, GAC's interest in the Block 12 PSA was officially reassigned to Frontera on September 29, 2004. Upon GAC's default, in addition to the interest in the Block 12 PSA, the Company acquired all operating assets, primarily consisting of materials and supplies and also assumed all liabilities, primarily consisting of unpaid operating invoices. Combined with the reassignment of assets and the assumption of liabilities, the Company also applied a receivable from GAC which resulted in a total reassignment cost of approximately $2.4 million.

NOTE H - NOTES PAYABLE AND LINE OF CREDIT

Notes payable and line of credit consist of the following:

		December 31,	
		2005	2004
Line of Credit:			
16% due May 24, 2005	(1)	$ -	$ 850,670
Total Line of Credit		$ -	$ 850,670
Notes Payable - Related Party:			
15% Senior, due April 1, 2005	(2)	$ -	$ 4,000,000
12% Senior, due May 14, 2006	(3)	-	6,000,000
12% Convertible, due March 15, 2005	(4)	-	2,500,000
2001 Stockholders Notes	(5)	-	360,000
2001 Rights Offering	(6)	403,604	403,604
2004 Stockholder Notes	(7)	-	1,358,211
Dynamic Trading, Inc.	(8)	-	250,000
SEM Consulting LLC (#1)	(9)	-	80,800
SEM Consulting LLC (#2)	(10)	-	210,000
CSTN, Ltd.	(11)	-	100,000
Glenmont Enterprises S.A.	(12)	-	100,000
DDJ Assigned Note	(13)	-	3,825,000
Total Notes Payable - Related Party		403,604	19,187,615
Less: Current Portion		403,604	12,784,011
Long-Term Note Payable - Related Party		$ -	$ 6,403,604
Notes Payable - Vendor:			
Saipem S.p.A.	(14)	$ 3,450,941	$ 3,450,941
Total Notes Payable - Vendor		3,450,941	3,450,941
Less: Current Portion		-	-
Long-Term Notes Payable - Vendor		$ 3,450,941	$ 3,450,941

Maturities of notes payable and line of credit as of December 31, 2005 are as follows:

Year Ending December 31,	
2006	$ 403,604
2007	3,450,941
	$ 3,854,545

(1) Line of Credit

In November 2004, the Company raised $850,670 under an unsecured line of credit for up to $1,000,000 from Bank Republic, a financial institution in the Republic of Georgia. The line of credit bore interest at a rate of 16% per annum and was due on May 24, 2005. This note was retired in March 2005 with proceeds from the Company's IPO.

NOTE H - NOTES PAYABLE AND LINE OF CREDIT (Continued)

(2) 15% Senior Notes Payable - Related Party

During August 2001, the Company raised $400,002, less commitment fees totaling $20,001, from the issuance of three promissory notes to a syndicate made up of three funds managed by DDJ Capital Management, LLC ("DDJ"), a shareholder with a position on the Board of Directors at Frontera. Each promissory note contained the same provisions and terms. Each note was for $133,334, was due in March 2002 and carried an initial interest rate of 15% which increased by 1% per annum at the beginning of each month starting on October 1, 2001. At the same time these three $133,334 notes payable were issued, the Company raised $3,500,000, less commitment fees totaling $113,000, from the issuance of a promissory note to DDJ. This note payable was due in March 2002 and carried an initial interest rate of 15%, which increased by 1% per annum at the beginning of each month starting on October 1, 2001.

On September 1, 2002, the three $133,334 notes payable and the $3,500,000 note payable were renegotiated to increase the aggregate principal amount due to $4,000,000, an increase of $99,998, to remove the upward adjusting interest rate, to amend certain covenants and to issue new promissory notes and warrants to purchase 1,950,000 shares of common stock of the Company at a price of $2.00 per share and expiring on September 1, 2007. Under the terms of the renegotiated note payable agreement, each note holder received a note payable of $1,333,333 bearing interest at 15% per annum, due on September 1, 2004, and 650,000 warrants to purchase shares of common stock. The notes payable agreements were subject to various operational and non-financial covenants, the violation of which results in an event of default. Should there be an event of default, the outstanding note balances are subject to an additional 3% interest per annum and the notes payable can be accelerated to be due immediately. Effective December 31, 2004, the notes payable were amended to waive any and all events of default, including cross-defaults, and the maturity date was extended to April 1, 2005. These notes were retired in March 2005 with proceeds from the Company's IPO.

At the time the $4,000,000 debt was issued, $929,626 in accrued interest was due on the 15% Senior Notes. In accordance with the restructuring agreement, of this amount, $99,998 was converted into debt and applied to the new principal balance, $500,000 was paid to the holders of the 15% Senior Notes, $75,000 was applied to the purchase of the 1,950,000 warrants to purchase shares of common stock and $254,628 was forgiven. The Company accounted for the restructuring of these notes as a troubled debt restructuring in accordance with SFAS No. 15 *"Accounting for Debtors and Creditors for Troubled Debt Restructurings",* and accordingly no gain was recognized on the restructuring. Rather, the face value of $4,000,000 was increased by the amount of accrued interest, offset by the cash paid and warrants transferred, which had a fair value of $1,268 based on the Black-Scholes model.

NOTE H - NOTES PAYABLE AND LINE OF CREDIT (Continued)

(3) 12% Senior Notes Payable - Related Party

In May 2003, the Company entered into a senior note purchase agreement with a syndicate that included two funds managed by DDJ; two directors of the Company; CSTN Ltd., a trust whose primary beneficiary is a director of the Company; Glenmont Enterprises, S.A., an entity controlled by a director of the Company; and Baker Hughes Finance, Incorporated, a shareholder with a position on the Company's board of directors. Under the terms of the agreement, the syndicate committed to loan the Company up to $6,000,000 at a 12% annual interest rate through two different lending tranches. The 12% senior notes are due May 14, 2006. Under the terms of the note payable agreement, the Company pays interest on the unpaid principal amount outstanding in cash quarterly in arrears from their date of issuance until the senior notes are paid in full. The note purchase agreement included warrants to purchase up to 3,000,000 common shares of the Company, at a price of $1.00 per share, allocated among the syndicate members in the same pro rata percentage as their loan commitment. The warrants expire on May 14, 2006. No portion of the proceeds raised through the note payable agreement was allocated to the warrants as the fair value of the warrants on the date of issuance was immaterial.

The note payable agreement is subject to various operational and non-financial covenants, the violation of which results in an event of default. Should there be an event of default, the outstanding note balance is subject to an additional 3% interest per annum and the notes payable can be accelerated to be due immediately. The notes were in default, however effective December 31, 2004, the Company obtained a waiver that cured any and all events of default, including cross-defaults through December 31, 2004. These notes were retired in March 2005 with proceeds from the Company's IPO.

(4) 12% Convertible Note Payable - Related Party

In December 2004, the Company raised $2.5 million through the issuance of four convertible notes payable to a syndicate made up of three funds which are controlled by DDJ and a company controlled by a Frontera director. Each convertible note payable has the same terms and conversion features including an interest rate of 12% per annum and a due date of March 15, 2005. Under the terms of the convertible note payable agreement, the Company pays interest on the unpaid principal amount outstanding monthly from the date of issuance until the note is converted or matures. At any time prior to one business day prior to the maturity date, upon the successful closing of the public offering, the holders of the convertible notes may convert all or a portion of the notes into common shares of the Company at a conversion price which is equal to 80% of the price established by the underwriter in connection with the potential public offering. These notes were converted into 1,081,858 shares in March 2005, and a beneficial conversion feature of $625,000 was recorded as interest expense on that date. This conversion is discussed in further detail in Note C.

(5) 2001 Stockholder Notes

During March 2001, the Company raised $360,000 from the issuance of debt in the form of three notes payable of $120,000 each to certain stockholders at a rate of 6% per annum. Under the original terms, the notes were due on or before April 14, 2001. Effective December 31, 2004, the note was amended to waive any and all events of default, including cross-defaults, and the maturity date was extended to April 15, 2005. The notes were retired in March 2005 from proceeds of the Company's IPO.

NOTE H - NOTES PAYABLE AND LINE OF CREDIT (Continued)

(6) 2001 Stockholder Rights Offering and Notes Payable - Related Party

Effective December 31, 2001, the Company raised $500,394 through the issuance of a Rights Offering consisting of 6% notes payable plus warrants which entitle the holders to purchase an aggregate of 15,637,329 shares of common stock of the Company at an exercise price of $0.032 per share. The notes are due on December 31, 2006, and the warrants expire on December 31, 2006. Holders of common stock are entitled to purchase one Right for every 20.8333 shares of common stock held on December 19, 2001. Holders of Series D preferred shares and Series E preferred shares were entitled to purchase one Right for every 20.8333 shares of common stock that their preferred shares could be converted into on December 19, 2001. Each Right entitled the holder to purchase for $1 subscription price $1 in principal amount of Notes and Warrants to purchase 31.25 shares of common stock. In accordance with APB No. 14 *"Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants"*, the Company allocated the proceeds to the notes and the warrants based on relative fair values. Accordingly, $338,347 was allocated to the notes, $37,478 was allocated to the warrants, and the remaining proceeds of $124,566 was recorded to paid-in capital.

During 2003, a warrant holder exercised warrants to purchase 758,946 common shares for $24,286, resulting in a $24,286 decrease in notes payable and a corresponding aggregate increase in common stock and additional paid in capital. During 2004, a warrant holder exercised warrants to purchase 37,500 common shares for $1,200, resulting in a $1,200 decrease in notes payable and a corresponding aggregate increase in common stock and additional paid-in capital. During 2005 warrant holders exercised warrants to purchase 2,372,124 common shares for $75,906 in cash.

(7) 2004 Stockholder Notes - Related Party

During the year ended December 31, 2004, the Company raised an aggregate amount of $1,358,211 from directors, officers and stockholders of the Company in amounts ranging from $10,000 up to $600,003 through the issuance of negotiable promissory notes. The terms and conditions of the notes payable were identical, each issued at a rate of 1% per month due on various dates throughout 2004. Effective December 31, 2004 the notes were amended to waive any and all events of default, including cross-defaults, and the maturity date was extended to April 15, 2005. These notes were retired in March and May 2005 from proceeds of the Company's IPO.

(8) Negotiable Promissory Note Payable to Dynamic Trading, Inc. - Related Party

During March 2001, the Company raised $250,000 from the issuance of debt in the form of a negotiable promissory note payable to Dynamic Trading, Inc. ("Dynamic Trading"), a company controlled by a director of Frontera, at a rate of 6% per annum. At the time it was issued, the note was due on April 27, 2001. Effective December 31, 2004, the note was amended to waive any and all events of default, including cross-defaults, and the maturity date was extended to April 15, 2005. This note was retired in March 2005 from the proceeds of the Company's IPO.

NOTE H - NOTES PAYABLE AND LINE OF CREDIT (Continued)

(9) Negotiable Promissory Note Payable to SEM Consulting, LLC #1 - Related Party

During April 2001, in exchange for consulting services provided, the Company issued to SEM Consulting, LLC ("SEM"), a company controlled by a director of Frontera, a $175,000 negotiable promissory note payable at a rate of 6% per annum. During 2002, the Company made a payment to SEM of $108,200, of which $94,200 was applied to outstanding debt and $14,000 was applied to accrued interest. Effective December 31, 2004, the note was amended to waive any and all events of default, including cross-defaults, and the maturity date was extended to April 15, 2005. This note was retired in March 2005 with proceeds from the Company's IPO.

(10) Negotiable Promissory Note Payable to SEM Consulting, LLC #2 - Related Party

During December 2002, in exchange for consulting services provided, the Company issued SEM a $210,000 negotiable promissory note payable at a rate of 6% per annum. At the time it was issued, the note was due on December 31, 2003. Effective December 31, 2004, the note was amended to waive any events of default, including counter-defaults, and the due date was changed to April 15, 2005. This note was retired in March 2005 with proceeds from the Company's IPO.

(11) Negotiable Promissory Note Payable to CSTN, Ltd. - Related Party

During August 2001, the Company raised $100,000, less a $5,000 commitment fee, from the issuance of a $100,000 negotiable promissory note payable to CSTN, Ltd. ("CSTN") at a rate of 15% per annum. At the time it was issued, the note was due on March 8, 2002. Effective December 31, 2004, the note was amended to waive any and all events of default, including cross-defaults, and the maturity date was extended to April 15, 2005. This note was retired in March 2005 with proceeds from the Company's IPO.

(12) Negotiable Promissory Note Payable to Glenmont Enterprises S.A. - Related Party

During August 2001, the Company raised $100,000, less a $5,000 commitment fee, from the issuance of a $100,000 negotiable promissory note payable to Glenmont Enterprises S.A. at a rate of 15% per annum. At the time it was issued, the note was due on March 8, 2002. Effective December 31, 2004, the note was amended to waive any and all events of default, including cross-defaults, and the maturity date was extended to April 15, 2005. This note was retired in March 2005 with proceeds from the Company's IPO.

(13) DDJ Assigned Note Payable - Related Party

In August 2002, the Company settled a disputed account payable which was incurred in 2001 to Schlumberger Overseas S.A. ("Schlumberger") by issuing a note payable for $4,000,000. Under the terms of the Schlumberger note payable and settlement agreement, the Company agreed to pay Schlumberger $175,000 at the time of the settlement and the remaining $3,825,000 on or before August 22, 2005. The note bears interest at 5% per annum.

NOTE H - NOTES PAYABLE AND LINE OF CREDIT (Continued)

The Schlumberger note was purchased by two funds controlled by DDJ (collectively, the "Assignees") on October 29, 2003. The Assignees assumed all legal rights to the note as to which Schlumberger was entitled. On December 31, 2004, the Assignees and the Company agreed to an option whereby the Company would be allowed to purchase the Schlumberger note payable from the Assignees for $1.3 million, plus interest accrued at a rate of 12% per annum beginning on December 31, 2004. Further, the Company agreed to a mandatory repurchase of the Schlumberger note payable within ten business days of a successful public stock offering. During March 2005 the Company exercised it's option to repurchase the note using proceeds from the Company's IPO and the difference was recorded as forgiveness of debt income.

(14) Saipem S.p.A. Note Payable

Effective October 1, 2004, the Company converted a $3,450,941 account payable to Saipem S.p.A. ("Saipem") into a note payable for the same amount. Under the terms of the Saipem note payable agreement, the Company agreed to pay Saipem quarterly interest-only payments until September 30, 2007, the maturity date, at which date the note is due in full. The note bears interest at 5% per annum.

(15) M-I Drilling Fluids Co. Note Payable

During April 2001, the Company converted a $691,623 account payable to M-I Drilling Fluids Co. ("M-I") into a note payable for the same amount. Under the terms of the M-I note payable agreement, the Company agreed to pay M-I $691,623 on or before April 1, 2002. The note bore interest at 9% per annum, payable monthly beginning on May 1, 2001. Due to the financial condition of the Company during that period, the Company was unable to make all required principal and interest payments, and the note was renegotiated in August 2003. At that time, the Company agreed to pay M-I $175,000 to settle the outstanding note payable and accrued interest. This settlement resulted in forgiveness of $516,623 in debt and $124,492 in accrued interest. In exchange for agreeing to settle the note payable, the Company agreed to pay M-I up to 20% of its share of Profit Oil, as defined in the Production Sharing Contract and Refinery Study between the Company and the State Company Georgian Oil, in excess of operating costs through the earlier of August 2007 or until M-I has recovered $641,115 from the Company in additional cash payments. Because Profit Oil is determined based on cumulative operating expenses, the Company does not expect to pay M-I any additional amounts under this settlement; however, the $641,115 will continue to be accrued in other long-term liabilities until August 2007 when the contingent aspect of the settlement expires.

NOTE I - INCOME TAXES

The Company files a consolidated U.S. federal income tax return. No benefit for U.S. income taxes has been recorded in these consolidated financial statements because of Frontera's inability to recognize deferred tax assets under provisions of SFAS 109. A reconciliation of the differences between income taxes computed at the U.S. federal statutory rate of 34% and Frontera's reported provision for income taxes is as follows:

	Year ended December 31,	
	2005	2004
Income tax benefit (expense) at statutory rate	$ 1,621,029	$ 1,886,619
Utilization (benefit) of losses not recognized	(1,621,029)	(1,886,619)
Income tax expense (benefit) at effective tax rate	$ -	$ -

At December 31, 2005, the Company has a net operating loss carryforward of approximately $72.5 million for tax purposes that will expire at various dates through 2025.

Significant components of the Company's deferred tax liabilities and assets as of December 31, 2005 and 2004 are as follows:

	Year Ended December 31,	
	2005	2004
Deferred tax liabilities:		
Depreciation and amortization	$ 328,891	$ -
Accrued salaries	-	-
Other	-	-
Deferred tax assets:		
Net operating losses - U.S.	9,280,174	7,941,210
Net operating losses - Foreign	15,722,756	15,772,756
Depreciation and amortization	-	61,335
Other	9,520	9,095
	25,341,341	23,784,396
Valuation allowance	(25,341,341)	(23,784,396)
Net deferred tax assets	$ -	$ -

The valuation allowance is primarily attributed to U.S. federal deferred tax assets. Management believes enough uncertainty exists regarding the realization of these items and has recorded a full valuation allowance.

NOTE I - INCOME TAXES (Continued)

Profits derived from oil and gas operating activities are subject to a profits tax on taxable income as defined by Georgian law. However, under the terms of the Block 12 PSA, Georgian Oil is responsible for paying the Company's profit tax liabilities with respect to income derived from these activities. Although the Company has incurred operating losses in Georgia, no adjustment with respect to deferred tax assets or a potentially related valuation allowance has been made, as any future benefit related to these operating losses would serve to reduce Georgian Oil's liability.

NOTE J - DEFINED CONTRIBUTION SAVINGS PLAN

The Company sponsors a defined contribution 401(k) savings plan which covers all eligible employees. Company matching contributions to the defined contribution plan are discretionary. During the years ended December 31, 2005 and 2004, the Company made contributions of $3,561 and $3,313 to the defined contribution plan, respectively.

NOTE K - COMMITMENTS AND CONTINGENCIES

Operating Leases: The Company has non-cancelable operating leases for office facilities and lodging. Approximate future minimum annual rental commitments under these operating leases are as follows:

Year Ending December 31,	
2006	$ 403,287
2007	215,811
2008	218,989
2009	223,274
2010	256,830
	$ 1,318,191

Rental expense for the years ended December 31, 2005 and 2004 was approximately $234,000 and $161,000, respectively.

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.

NOTE K - COMMITMENTS AND CONTINGENCIES (Continued)

SOCAR Arbitration: In June 1998 Frontera Resources Azerbaijan Corporation, 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". The Azerbaijan PSA covered onshore oilfields in an area of Azerbaijan known as the K&K Block. The Company and an operating partner undertook an exploration and development program on the K&K Block. The Company's relationship with SOCAR deteriorated as a result of several disputes under the Azerbaijan PSA and the Company was unsuccessful at reaching a settlement with SOCAR.

In October 2003, FRAC initiated arbitration proceedings against SOCAR to recoup funds for oil deliveries made between 1999 and 2002. The Azerbaijan PSA provided that arbitration shall be governed by the United National Commission on International Trade Law rules on arbitration and a hearing has been scheduled for March 2005 in Stockholm, Sweden.

In January 2006, 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 in connection with its binding arbitration case with SOCAR. 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, SOCAR filed a challenge to the arbitral award in the Svea Court of appeal in Sweden. As part of its challenge, SOCAR requests that the Company be required to pay all costs of the arbitrators and SOCAR's full costs for the arbitration. The Company intends to vigorously defend the challenge by SOCAR. No gain or loss from this ruling has been recorded in the Company's consolidated financial statements pending ultimate resolution on this matter.

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 L - NON-CASH INVESTING AND FINANCING ACTIVITIES

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

During 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.

During 2005 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.

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

During 2005, Related Party Notes Payable of $75,906 were utilized by note holders to fund the exercise of common stock warrants with a total exercise price of $75,906.

During 2005, an entity of the Georgian government acknowledged responsibility of previously accrued social taxes, resulting in forgiveness of debt income of $1,131,134.

During 2005, a number of old payables were deemed to be forgiven, resulting in forgiveness of debt income of $164,606.

The following non-cash transactions took place during the year ended December 31, 2004:

The Company converted a vendor account payable of $3,450,941 into a note payable which matures in 2007.

During 2004, the Company transferred a vendor account payable of $1,607,214 to long-term liabilities upon the negotiation of a settlement agreement which will not be recognized as income from forgiveness of debt until 2008.

During 2004, the Company reacquired oil & gas properties of $2,532,598 by agreeing to forgive a $1,962,268 payable with the operator and by assuming the payables and accrued liabilities of the operator. Included in this transaction was the assumption of $3,802,712 in current liabilities and the acquisition of current assets of $1,270,114. At the time this transaction closed, the Company reversed the existing $1,458,168 deferred gain associated with the 2003 sale of an interest in the property which was never recognized.