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Report of Independent Auditors

To the Board of Directors of
Frontera Resources Corporation:

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of operations, stockholders' equity and cash flows present fairly, in all material respects, the financial position of Frontera Resources Corporation and its subsidiaries (the "Company") at December 31, 2006, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. 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 audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The financial statements of the Company as of December 31, 2005 and for the year then ended were audited by other auditors whose report dated January 28, 2006 expressed an unqualified opinion on those statements.

As discussed in Note 2 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006.

PricewaterhouseCoopers LLP

May 7, 2007

Frontera Resources Corporation and Subsidiaries
Consolidated Balance Sheets
December 31, 2006 and 2005

	2006	2005
Assets		
Current assets		
Cash and cash equivalents	$ 9,927,181	$ 19,586,747
Restricted cash equivalents	-	250,000
Restricted short-term investments	-	2,950,000
Marketable securities	14,823,000	30,600,000
Accounts receivable	139,107	146,300
Inventory	3,124,858	1,970,128
Prepaid expenses and other current assets	267,720	568,804
Total current assets	28,281,866	56,071,979
Property and equipment, net	1,081,213	1,482,221
Oil and gas properties, full cost method		
Properties being depleted	23,750,981	23,750,981
Properties not subject to depletion	27,631,505	5,929,994
	51,382,486	29,680,975
Less: Accumulated depletion	(21,107,707)	(20,685,118)
Net oil and gas properties	30,274,779	8,995,857
Total assets	$ 59,637,858	$ 66,550,057
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 566,396	$ 601,227
Accrued liabilities	502,454	1,758,043
Accrued interest	15,550	114,266
Current maturities of notes payable-vendor	3,450,941	-
Current maturities of notes payable-related party	51,097	403,604
Total current liabilities	4,586,438	2,877,140
Notes payable-vendor	-	3,450,941
Other long-term liabilities	41,669	2,327,366
Total liabilities	4,628,107	8,655,447
Commitments and contingencies		
Stockholders' equity		
Common stock	2,818	2,178
Additional paid-in capital	149,499,177	142,480,721
Common stock warrants	1,266	31,151
Treasury stock, at cost	(567,832)	(567,832)
Accumulated deficit	(94,050,228)	(84,315,968)
Accumulated other comprehensive income	124,550	264,360
Total stockholders' equity	55,009,751	57,894,610
Total liabilities and stockholders' equity	$ 59,637,858	$ 66,550,057

The accompanying notes are an integral part of these consolidated financial statements.

Frontera Resources Corporation and Subsidiaries
Consolidated Statements of Operations
Years Ended December 31, 2006 and 2005

	2006	2005
Revenue - crude oil sales	$ 758,630	$ 1,809,427
Operating expenses		
Field operating and project costs	1,407,321	1,466,364
General and administrative	11,920,999	8,354,984
Depreciation, depletion and amortization	963,678	610,320
Total operating expenses	14,291,998	10,431,668
Loss from operations	(13,533,368)	(8,622,241)
Other income (expense)		
Forgiveness of debt	2,339,098	4,158,861
Interest income	1,698,352	1,445,624
Interest expense	(267,958)	(1,384,583)
Other, net	29,616	(12,594)
Total other income (expense)	3,799,108	4,207,308
Net loss	$ (9,734,260)	$ (4,414,933)
Loss per share		
Basic and diluted	$ (0.15)	$ (0.10)
Number of shares used in calculating loss per share		
Basic and diluted	63,113,205	45,206,970

The accompanying notes are an integral part of these consolidated financial statements.

Frontera Resources Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2006 and 2005

	Convertible Preferred Stock Series E	Common Stock	Additional Paid-in Capital	Common Stock Warrants	Treasury Stock	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balances at 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 and B redeemable preferred stock to common stock	-	172	10,710,880	-	-	-	-	10,711,052
Conversion of Series D and 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 for the year	-	-	-	-	-	-	-	(4,150,573)
Balances at 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	-	619	3,428,262	(29,885)	-	-	-	3,398,996
Exercise of common stock options	-	21	524,979	-	-	-	-	525,000
Compensation expense-common stock options	-	-	3,065,215	-	-	-	-	3,065,215
Unrealized gain on marketable securities	-	-	-	-	-	-	397,993	397,993
Reclassification adjustment for gains on marketable securities included in net income	-	-	-	-	-	-	(537,803)	(537,803)
Net loss	-	-	-	-	-	(9,734,260)	-	(9,734,260)
Total comprehensive loss for the year	-	-	-	-	-	-	-	(9,874,070)
Balances at December 31, 2006	$ -	$ 2,818	$ 149,499,177	$ 1,266	$ (567,832)	$ (94,050,228)	$ 124,550	$ 55,009,751

The accompanying notes are an integral part of these consolidated financial statements.

Frontera Resources Corporation and Subsidiaries
Consolidated Statements of Cash Flows
Years Ended December 31, 2006 and 2005

	2006	2005
Cash flows from operating activities		
Net loss	$ (9,734,260)	$ (4,414,933)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation, depletion and amortization	963,678	610,320
Gain on sale of asset	(85,000)	-
Interest on redeemable preferred shares	-	88,470
Beneficial conversion of bridge loan	-	625,000
Amortization of warrants	72,504	-
Stock based compensation	3,065,215	12,632
Forgiveness of debt	(2,339,098)	(4,158,861)
Changes in operating assets and liabilities:		
Accounts receivable	7,193	999,384
Inventory	(1,154,730)	(269,769)
Prepaid expenses and other current assets	301,084	(430,746)
Accounts payable	(34,831)	1,320,640
Accrued liabilities	(1,243,857)	(328,226)
Accrued interest	(98,716)	(1,134,754)
Other long-term liabilities	41,669	(91,678)
Net cash used in operating activities	(10,239,149)	(7,172,521)
Cash flows from investing activities		
Investment in oil and gas properties	(21,701,511)	(6,224,410)
Investment in property and equipment	(140,081)	(621,307)
Restricted cash equivalents	250,000	(250,000)
Restricted short-term investments	2,950,000	(2,950,000)
(Investment in) redemption of marketable securities	15,637,190	(30,335,640)
Proceeds from disposal of property, plant and equipment	85,000	-
Net cash used in investing activities	(2,919,402)	(40,381,357)
Cash flows from financing activities		
Repayments of borrowings	(212,878)	(14,533,176)
Exercise of common stock warrants	3,186,863	-
Proceeds from issuance of common stock	-	80,170,180
Exercise of common stock options	525,000	-
Net cash provided by financing activities	3,498,985	65,637,004
Net increase (decrease) in cash and cash equivalents	(9,659,566)	18,083,126
Cash and cash equivalents		
Beginning of year	19,586,747	1,503,621
End of year	$ 9,927,181	$ 19,586,747
Supplemental cash flow information		
Cash paid for interest	$ 121,619	$ 1,805,867
Notes payable used to exercise common stock warrants	212,133	75,906

The accompanying notes are an integral part of these consolidated financial statements.

1. 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.

2. Summary of Significant Accounting Policies

Principles of Consolidation
The consolidated financial statements include the accounts of Frontera Resources Corporation and it's wholly and majority owned subsidiaries. All significant intercompany transactions and accounts have been eliminated in consolidation.

Reclassifications
Certain reclassifications have been made in prior period financials statements to conform with current period presentation. Reclassifications have no impact on the Company's financial position, results of operations, or cash flows.

Use of Estimates
The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management 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.

Estimates of oil and natural gas reserves and their values, future production rates and future costs and expenses are inherently uncertain for numerous reasons, including many factors beyond the Company's control. Reservoir engineering is a subjective process of estimating underground accumulations of oil and natural gas that cannot be measured in an exact manner.

The accuracy of any reserve estimate is a function of the quality of data available and of engineering and geological interpretation and judgment. In addition, estimates of reserves may be revised based on actual production, results of subsequent exploitation and development activities, prevailing commodity prices, operating cost and other factors.

These revisions may be material and could materially affect the Company's future depletion, depreciation and amortization expenses.

The Company's revenue, profitability, and future growth are substantially dependent upon the prevailing and future prices for oil and natural gas, which are dependent upon numerous factors beyond its control such as economic, regulatory developments and competition from other energy sources. The energy markets have historically been volatile and there can be no assurance that oil and natural gas prices will not be subject to wide fluctuations in the future. A substantial or extended decline in oil and natural gas prices could have a material adverse effect on the Company's financial position, results of operations, cash flows and quantities of oil and natural gas reserves that may be economically produced.

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

Restricted Cash Equivalent and Restricted Short-Term Investments
At December 31, 2005 the Company had $250,000 and $2,950,000 of restricted cash equivalents and restricted short term investments, respectively, serving as collateral for an irrevocable stand-by letters of credit that provided financial assurance that the Company would fulfill its obligations with respect to service contracts with certain vendors. At December 31, 2006, the stand-by letters of credit had expired and accordingly the Company has no cash or short term investments restricted as to use or availability.

Marketable Securities
The Company determines the appropriate classification of its investments in debt and equity securities at the time of purchase and re-evaluates 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 stockholders' 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, 2006, available-for-sale securities consist of investments in corporate bonds with an estimated fair value of $14,823,000 and net unrealized holding gains in the amount of $124,550, 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, 2006	December 31, 2005
Materials and supplies	$ 1,405,610	$ 1,679,538
Crude oil	1,719,248	290,590
	$ 3,124,858	$ 1,970,128

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.

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. A ceiling test calculation is performed at each year-end. No impairment write down was necessary for the years ended December 31, 2006 and 2005.

Sales or other dispositions of oil and gas 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 earnings.

Costs Excluded
Costs associated with unproved properties related to continuing operations of $27.6 million as of December 31, 2006 are excluded from amounts subject to amortization. The majority of the evaluation activities are expected to be completed within a three-year period. In addition, the Company's internal engineers evaluate all properties on an annual basis.

Costs Excluded by Year Incurred

	Year Cost Incurred			Excluded Costs at
	Prior Years	2005	2006	December 31, 2006
Property acquisition	$ -	$ -	$ -	$ -
Exploration	144,376	5,785,618	21,701,511	27,631,505
Development	-	-	-	-
Total costs incurred	$ 144,376	$ 5,785,618	$ 21,701,51	$ 27,631,505

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
Oil and natural gas revenues are recorded when title passes to the customer, net of royalties, discounts and allowances, as applicable. Oil and natural gas sold is not significantly different from the Company's share of production.

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, 2006 and 2005.

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.

Concentrations of Credit Risk
Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and accounts receivable. The Company maintains its cash in bank deposits with various major financial institutions. These accounts, at times, may 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 does not anticipate any losses on such accounts. For the years ended December 31, 2006 and 2005, 100% of the Company's crude oil sales were to one unrelated customer.

Fair Value of Financial Instruments

Frontera's financial instruments consist of cash, accounts receivable, accounts payable, a line of credit and notes payables. 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 line of credit and notes payable was determined based upon discount rates which approximate variable interest rates for borrowings of a similar nature. The fair values of the Debt Instruments at December 31, 2006 and 2005 were approximately $3,500,000 and $2,700,000, respectively.

Earnings (Loss) Per Share

Basic earnings (loss) per share amounts are calculated based on the weighted average number of common shares outstanding during the year. Diluted earnings per share are calculated using the weighted average number of common shares outstanding during the year, including the dilutive effect of stock options, warrants, convertible notes, and convertible Preferred Stock. Basic and diluted loss per share for the years ended December 31, 2006 and 2005 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.

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 employee stock options. Under the modified prospective method, the Company records 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 year based on our historical experience of approximately 3%.

The effect of adoption of the new standard related to stock option plans was an additional expense of $3,065,215 ($0.05 per share, basic and diluted) for the year ended December 31, 2006. At December 31, 2006, there was $1,465,718 of total unrecognized compensation cost related to non-vested stock options. This compensation cost is expected to be recognized over a weighted-average period of approximately 0.5 years.

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 the Company's common stock.

Due to the Company's net operating loss position; there are no anticipated windfall tax benefits upon exercise of options.

Prior to January 1, 2006 the Company accounted for stock based compensation in accordance with Accounting Principles Board Opinion No. 25 ("APB No. 25"), "Accounting for Stock Issued to Employees," and related interpretations. 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. The Company also provided the disclosures required under SFAS No. 123, "Accounting for Stock−Based Compensation," as amended by SFAS No. 148, "Accounting for Stock−Based Compensation – Transition and Disclosures."

As a result, no expense was reflected in the consolidated statement of operations in 2005 for stock options, except for repriced stock options, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the pro forma effect on net loss and loss per share as if the Company were applying the fair value recognition provisions of SFAS No. 123R to its stock-based compensation plans for the year ended December 31, 2005:

Net loss	$(4,414,933)
Add: Total stock-based employee compensation expense included in report net loss, net of related tax effects	7,579
Deduct: Total stock based compensation expense determinted under fair value method for all awards vested during the year, net of any tax effects	(3,133,879)
Pro forma net loss	$(7,541,233)
Basic and diluted loss per share	
As reported	$ (0.10)
Pro forma	$ (0.17)

The estimated fair values for options granted in 2005 was calculated using a Black−Scholes option pricing model, with the following weighted average assumptions for 2005: risk free interest rate of 4.28%; no dividend yield; volatility factor of 100%; and an expected option life of ten years.

3. Initial Public Offering

In March 2005, the Company successfully completed an initial public offering (“IPO”) of common stock. The Company raised approximately $80.2 million in net proceeds through the sale of 30,685,215 shares at a U.S. dollar equivalent price of $2.89 after deducting offering expenses of $8.5 million. 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	2,889,333	13,406,505
	3,624,333	19,926,364

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.

4. Notes Payable

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 line was primarily set up to support letters of credit issued by the Company from time to time in support of it's oil and gas operations. 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 December 31, 2006, the line of credit has not been drawn upon and subsequently, all of the Company's cash and marketable securities were available for use at December 31, 2006.

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 entitled 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. During 2006 the notes became due and were retired in full with the exception of one note holder as the Company was awaiting fund transfer instructions. This note holder was paid in full in early January 2007. Notes payable - related party outstanding as of December 31, 2006 and 2005 was $51,907 and $403,604, respectively.

During 2006 and 2005 warrant holders exercised warrants to purchase 12,468,741 and 2,372,124 common shares, respectively, for approximately $399,000 and $76,000, respectively.

Note Payable - Vendor

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. Notes payable - vendor outstanding as of December 31, 2006 and 2005 was $3,450,941.

During 2006, warrants were exercised to purchase 3,000,000 common shares for $3,000,000 related to a prior senior note.

5. Income Taxes

The Company has incurred losses since inception and, therefore, has not been required to pay federal income taxes. As of December 31, 2006, the Company has generated net operating loss ("NOL") carryforwards of approximately $37.9 million that may be available to reduce future income taxes. These carryforwards begin to expire in 2012 with a limited annual utilization. Several factors may further limit the Company's ability to utilize these carryforwards, including a lack of future taxable income, a change of Company ownership (as defined by federal income tax regulations) or the expiration of the utilization period allowed by federal income tax regulations.

During 2006 and 2005, the valuation allowance increased $3,272,035 and $1,556,945, respectively, primarily due to the Company's losses. The effective tax rate for 2006 and 2005 differs from the statutory tax rate due primarily to the valuation allowance.

The components of the Company's deferred tax liabilities and assets at December 31, 2006 and 2005, are as follows:

	2006	2005
Deferred tax liabilities		
Geological & geophysical	$ (938,023)	$ -
Other	-	-
Deferred tax assets		
Net operating losses - U.S.	12,890,000	9,280,174
Net operating losses - Foreign	16,282,696	15,722,756
Depreciation and amortization	328,891	328,891
Accrued salaries	46,159	-
Other	3,654	9,520
	28,613,377	25,341,341
Valuation allowance	(28,613,377)	(25,341,341)
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.

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.

6. 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:

Years Ending December 31,	
2007	$ 437,627
2008	224,264
2009	228,550
2010	216,110
2011	44,676
	$ 1,151,227

Rental expense for the years ended December 31, 2006 and 2005 was approximately $429,000 and $234,000, respectively.

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 January 2006, Frontera Resources Azerbaijan Corporation was awarded approximately $1.2 million plus interest from 2000 until payment is made in connection with its binding arbitration case with SOCAR. The arbitral panel found that the halting of exports of crude oil from the Kursangi & Karabagli oil fields in the Azerbaijan Republic was in violation of the Agreement on Rehabilitation, Exploration, Development and Production Sharing between SOCAR, Frontera, Delta/Hess and SOCAR Oil Affiliate. The arbitration panel rejected all other claims and counterclaims between the parties. Frontera initiated arbitration against SOCAR in October 2003 related to claims resulting from SOCAR's halting of exports from the onshore Kursangi & Karabagli oilfields in the Azerbaijan Republic during the fourth quarter of 2000. The arbitration was held in Sweden and is binding on the parties under the rules of UNCITRAL, the United Nations Commission on International Trade Law.

SOCAR has refused to pay the award and instead filed litigation in Svea Court of Appeals, in Stockholm, Sweden, seeking an order annulling the award. The Company has moved to dismiss SOCAR's Swedish lawsuit on procedural grounds, and the parties are awaiting the court's ruling. As a result of SOCAR's refusal to pay the award, the Company commenced an action in the United States District Court for the Southern District of New York in February 2006, seeking to confirm the award and convert it to a judgment in accordance with applicable law. SOCAR has opposed this proceeding. In March 2007, the New York Court granted SOCAR's Motion to Dismiss, and the Company is considering whether to appeal that decision.

Vendor Invoices

In August 2003 and July 2004, the Company settled vendor invoices of approximately $2.3 million. The terms of these 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 consider it probable that any additional amounts under the settlement agreements will be paid. Accordingly, the remaining liabilities of approximately $2.3 million were written-off for the year ended December 31, 2006.

7. Stockholders' Equity

Preferred Stock

The Company has the authority to issue up to 10,000,000 shares, par value $.00001, of serial preferred stock. No preferred stock is outstanding at December 31, 2006 and 2005. 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.

Common Stock

As of December 31, 2006 the Company is authorized to issue 200,000,000 shares of common stock, par value $.00004 per share. As of December 31, 2006 and 2005, the Company had 70,383,528 and 54,389,787 of common shares issued and outstanding, respectively. At December 31, 2006 and 2005, there are an additional 11,310,000 and 26,500,000 shares, respectively, of common stock reserved for the exercise of existing options and warrants.

Treasury Stock
As of December 31, 2006 and 2005, the Company had 5,739,855 shares of treasury stock, all held as common shares.

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 administrator (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 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 administrator 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 Stock Award 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.

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

	Options	Weighted-Average Exercise Price
Options outstanding at December 31, 2005	9,063,013	$ 1.74
Granted	1,117,500	2.67
Exercised	(525,000)	1.00
Surrendered	(295,500)	2.65
Options outstanding at December 31, 2006	9,360,013	1.87
Options exercisable at December 31, 2006	6,700,684	$ 1.53

At December 31, 2006, the total intrinsic value and weighted average life for stock options outstanding was $0 and 6.85 years, respectively. At December 31, 2006, the total intrinsic value and weighted average life for stock options exercisable was $0 and 6.12 years, respectively.

The following table summarizes information about stock options outstanding at December 31, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Number Outstanding at December 31, 2006**	**Weighted-Average Remaining Contractual Life (Years)**	**Weighted-Average Exercise Price**	**Number Exercisable at December 31, 2006**	**Weighted-Average Exercise Price**
$0.92-1.00	4,443,000	6.20	$ 0.99	4,443,000	$ 1.00
2.00-2.87	4,812,013	7.56	2.58	2,152,684	2.39
5.28-8.85	105,000	1.36	6.30	105,000	6.30
	9,360,013	6.85	$ 1.87	6,700,684	$ 1.53

Stock option information related to the nonvested options for the year ended December 31, 2006, was as follows:

	Number of Shares Underlying Options	Weighted-Average Grant Date Fair Value
Nonvested options outstanding at December 31, 2005	2,988,500	$ 2.30
Granted	1,117,500	0.96
Vested	(1,255,005)	2.08
Canceled	(191,666)	2.05
Nonvested options outstanding at December 31, 2006	2,659,329	$ 1.86

During 2003, the Company repriced certain outstanding options downward to be more in line with the value of the Company. 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. 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 the re-priced options as of January 1, 2006.

The Company granted 1,117,500 options to employees during 2006 with exercise prices ranging between $2.08 and $2.87 which was at or above the market value of the Company's common stock at the time of grant. The weighted average fair value of the options granted in 2006 was $0.96. The fair value of the option grants were calculated using a Black-Scholes option pricing model, with the following weighted average assumptions: risk free interest rate of 4.64%; no dividend yield; volatility factor of 66%; and an expected option life of 8.3 years.

8. Subsequent Event

On May 8, 2007, Frontera raised $47.0 million through a private placement of convertible unsecured notes due May 2012. The notes were issued at par and will bear interest at 10%, payable quarterly in arrears in cash or in kind at the company's discretion. The notes are convertible into common shares at a conversion price of $1.67 per share. The conversion price will be reset to $1.30 per share if the stock price is at or below $1.30 per share for 10 out of any 20 consecutive trading days at any time in the 12 months following the closing date. The notes will be automatically converted into common shares at the conversion price if the stock price exceeds two times the conversion price for at least 20 consecutive trading days.