

CANARGO ENERGY CORP

Form 10-K/A

January 11, 2007

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 10-K/A  
(Amendment No. 1 )**

**ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the Fiscal Year Ended December 31, 2005**

**OR**

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from**

**to**

**Commission File Number 001-32145  
CANARGO ENERGY CORPORATION**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**91-0881481**

*(I.R.S. Employer  
Identification No.)*

**P.O. Box 291, St Peter Port, Guernsey, British Isles GY1 3RR**

*(Address of principal executive offices)*

**Registrant's telephone number, including area code:**

**+(44) 1481 729 980**

**Securities Registered Pursuant to Section 12(b) of the Act:**

**Title of Each Class**

**Name of Each Exchange on Which Registered**

Common Stock, par value \$0.10 per share

American Stock Exchange

**Securities Registered Pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES  NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES  NO

Indicate by check mark whether the registrant: (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (check one)

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

The aggregate market value of the voting and non voting common equity held by non-affiliates was approximately \$248 million as of 10 March 2006, based upon the last reported sales price of such stock on The American Stock Exchange on that date. For this purpose, the Registrant considers Dr. David Robson, Vincent McDonnell, Michael Ayre, Russ Hammond and Nils Trulsvik to be its only affiliates.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: Common Stock, \$0.10 par value, 224,108,606 shares outstanding as of 10 March, 2006.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive Proxy Statement issued in connection with its 2006 Annual Meeting of Shareholders are incorporated by reference in Part III of this Report. Other documents incorporated by reference in this Report are listed in the Exhibit Index.

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**CANARGO ENERGY CORPORATION**  
**FORM 10-K/A**  
**TABLE OF CONTENTS**

|   | <b>Page</b> |
|---|-------------|
| <b>PART II</b>  |             |
| <u>Item 6. Selected Financial Data</u>  | 4           |
| <u>Item 8. Financial Statements and Supplementary Data</u>  | 4           |
| <u>Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u> | 5           |
| <u>Item 9A. Control and Procedures</u>  | 5           |
| <u>Item 9B. Other Information</u>   | 11          |
| <b>PART IV</b>  |             |
| <u>Item 15. Exhibits, Financial Statement Schedules</u>   | 11          |
| <u>Signatures</u>   | 13          |
| <u>Exhibit Index</u>  | 14          |
| <u>Certifications</u>   | 15          |
| <u>EX-23.1: CONSENT OF L J SOLDINGER ASSOCIATES LLC</u>   |             |
| <u>EX-31.1: CERTIFICATION</u>   |             |
| <u>EX-31.2: CERTIFICATION</u>   |             |
| <u>EX-32.1: CERTIFICATION</u>   |             |
| <u>EX-32.2: CERTIFICATION</u>   |             |

**FORWARD-LOOKING STATEMENTS**

*The United States Private Securities Litigation Reform Act of 1995 provides a safe harbor for certain forward-looking statements. Such forward-looking statements are based upon the current expectations of CanArgo and speak only as of the date made. These forward-looking statements involve risks, uncertainties and other factors. The factors discussed elsewhere in this Annual Report on Form 10-K, as amended, are among those factors that in some cases have affected CanArgo's historic results and could cause actual results in the future to differ significantly from the results anticipated in forward-looking statements made in this Annual Report on Form 10-K, as amended, future filings by CanArgo with the Securities and Exchange Commission, in CanArgo's press releases and in oral statements made by authorized officers of CanArgo. When used in this Annual Report on Form 10-K, as amended, the words estimate, project, anticipate, expect, intend, believe, hope, may and similar expressions, as well as other indications of future tense, are intended to identify forward-looking statements. Few of the forward-looking statements in this Report deal with matters that are within our unilateral control. Acquisition, financing and other agreements and arrangements must be negotiated with independent third parties and, in some cases, must be approved by governmental agencies. These third parties generally have interests that do not coincide with ours and may conflict with our interests. Unless the third parties and we are able to compromise their various objectives in a mutually acceptable manner, agreements and arrangements will not be consummated.*

**EXPLANATORY NOTE**

CanArgo Energy Corporation (the Company) is hereby amending this Annual Report on Form 10-K for the fiscal year ended December 31, 2005 (the Report), solely to revise Items 6, 8, 9 and 15 of Part II of the Report as hereinafter set forth. The revisions are intended to respond to the comments of the staff of the Securities and Exchange Commission resulting from their recent review of the Company's Annual Report on Form 10-K. This Amendment No. 1 to the Report continues to speak as of the date of the Report, and we have not updated the disclosures contained in this Amendment No. 1 to the Report to reflect any events that occurred at a date subsequent to the filing of the Report. The filing of this Amendment No. 1 to the Report is not a representation that any statements contained in items of the Report other than that information being amended are true or complete as of any date subsequent to the date of the Report. The revision does not affect the remaining information set forth in the Report, the remaining portions of which have not been amended.



**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA.**

Reference is hereby made to the Section entitled CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS with respect to certain qualifications regarding the following information.

The following data reflect the historical results of operations and selected balance sheet items of CanArgo and should be read in conjunction with Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements included in Item 8. Financial Statements and Supplementary Data herein.

| Reported in \$000 s Except for per Common Share Amounts   | Year Ended December 31, |         |         |         |          |
|---|-------------------------|---------|---------|---------|----------|
|   | 2005                    | 2004    | 2003    | 2002    | 2001     |
| <b>Financial Performance</b>  |                         |         |         |         |          |
| Operating revenues from continuing operations   | 7,582                   | 9,574   | 8,105   | 5,486   | 4,575    |
| Operating loss from continuing operations   | (11,009)                | (2,954) | (159)   | (4,902) | (11,838) |
| Other income (expense) and Minority Interest in income  |                         |         |         |         |          |
| (loss) of consolidated subsidiaries   | (1,327)                 | (2,346) | (597)   | (576)   | 525      |
| Net loss from continuing operations   | (12,335)                | (5,300) | (756)   | (5,478) | (11,313) |
| Net income (loss) from discontinued operations, net of taxes and minority interest(1)   |                         | 542     | (6,608) | 150     | (1,905)  |
| Cumulative effect of change in accounting policy  |                         |         | 41      |         |          |
| Net loss  | (12,335)                | (4,758) | (7,323) | (5,328) | (13,218) |
| Net loss per common share basic and diluted before cumulative effect of change in accounting principle from continuing operations   | (0.06)                  | (0.04)  | (0.01)  | (0.06)  | (0.14)   |
| Net loss per common share basic and diluted before cumulative effect of change in accounting principle from discontinued operations | (0.06)                  | (0.04)  | (0.07)  | (0.00)  | (0.02)   |
| Net loss per common share basic and diluted   | (0.06)                  | (0.04)  | (0.08)  | (0.06)  | (0.16)   |
| Cash generated by (used in) operations  | (4,651)                 | (3,781) | 4,431   | 1,635   | (6,289)  |
| Working capital   | 15,078                  | 23,952  | 3,890   | 10,646  | 14,590   |
| Total assets  | 147,448                 | 105,160 | 73,360  | 70,736  | 70,312   |
| Long term obligations   | 26,524                  | 1,254   |         |         |          |
| Minority shareholder advances   |                         |         |         |         | 450      |
| Options with redemption feature   | 2,120                   |         |         |         |          |
| Stockholders' equity  | 107,849                 | 96,821  | 56,708  | 62,105  | 65,800   |
| Cash dividends per common share   |                         |         |         |         |          |

(1) In September 2002, CanArgo approved a plan to sell CSOP to finance its Georgian and Ukrainian development projects and in October 2002, CanArgo agreed to sell its 50%

holding to Westrade Alliance LLC, an unaffiliated company, for \$4 million in an arms-length transaction, with legal ownership being transferred upon receipt of final payment due in August 2003. The agreed consideration to be exchanged does not result in an impairment of the carrying value of assets held for sale. The assets and liabilities of CSOP have been classified as Assets held for sale and Liabilities for sale for all periods presented. The results of operations of CSOP have been classified as discontinued for all periods presented. The minority interest related to CSOP has not been reclassified for any of the periods presented, however net income from discontinued operations is disclosed net of

taxes and  
minority interest.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.**

The Financial Statements required to be filed in this Report begin at Page F-1 of this Report.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

None.



**Table of Contents**

**ITEM 9A. CONTROLS AND PROCEDURES.**

**Management's Responsibility for Financial Statements**

Our management is responsible for the integrity and objectivity of all information presented in this Annual Report. The consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America and include amounts based on management's best estimates and judgments. Management believes the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements fairly represent the Company's financial position and results of operations. The Audit Committee of the Board of Directors, which is composed solely of independent directors, meets regularly with the independent auditors, L J Soldinger Associates LLC and representatives of management to review accounting, financial reporting, internal control and audit matters, as well as the nature and extent of the audit effort. The Audit Committee is responsible for the engagement of the independent auditors. The independent auditors have free access to the Audit Committee.

***Evaluation of Disclosure Controls and Procedures***

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2005. Based on that evaluation, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are not effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

**Management's Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting, is defined in the rules promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's Board, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting procedures ( GAAP ) and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with US GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and Directors of the Company; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

## **Table of Contents**

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Under the supervision and with the participation of our management, including our principal executive, financial and accounting officers, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2005 based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of our annual or interim financial statements would not be prevented or detected. As of December 31, 2005, we have concluded that our internal control over financial reporting was ineffective as of December 31, 2005 and that we have material weaknesses in each of the following areas:

### ***1. Financial Statement Close Process***

The Company's controls over the financial reporting close process were not consistently applied. As a result, the Company has a material weakness related to its ability to compile and review accurate financial statements.

The financial statement close process relies heavily upon manual rather than automated system process controls and places significant reliance on spreadsheets;

Formal policies and procedures in many functions including maintenance of the Chart of Accounts, financial statement close, purchasing, payroll, and cash management operations do not exist;

Preparation and review of account reconciliations, particularly in Georgia and Kazakhstan, are not performed; and

There is no review, reconciliation or approval of various schedules and reconciliations, including the transfer of amounts from subsidiary trial balances to consolidating spreadsheets prepared to support the financial close and disclosure processes

These material weaknesses related to the financial statement close process affect all of the Company's significant accounts and could result in a material misstatement to the Company's annual or interim consolidated financial statements that would not be prevented or detected.

### ***2. Disclosure Controls***

The Company's disclosure controls and procedures were not effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including chief executive officer and chief financial officer, as appropriate to allow timely decisions. Inadequate controls include the lack of procedures used for identifying, determining, and calculating required disclosures and other supplementary information requirements.

### ***3. Information Technology***

The Company did not adequately implement certain controls over information technology, including certain spreadsheets, used in its core business and financial reporting. These areas included logical access security controls to

financial applications, segregation of

**Table of Contents**

duties and backup and recovery procedures. The Company's controls over the completeness, accuracy, validity, restricted access, and the review of certain spreadsheets used in the period-end financial statement preparation and reporting process was not designed appropriately. This material weakness affects the Company's ability to prevent improper access and changes to its accounting records.

***4. Production***

The Company did not have effective controls and procedures to ensure that revenues and associated costs from the sales of its products based on production and transmission records between the Company and its third party production sharing partner were reconciled or correctly recognized. Controls associated with the product transmission are performed by the third party production sharing partner and there is no evidence that these controls have been reviewed by the Company.

Deficiencies in the Company's internal controls and procedures relating to the recording of production do not allow assurance that revenues and costs are recognized in accordance with generally accepted accounting principles.

***5. Inventory Management***

The Company did not maintain a control environment that fully emphasized the establishment of, adherence to, or adequate communication regarding appropriate internal control for the management of its inventory, including the lack of documented procedures to update and review the material master file and valuation table or compare the cost of inventory to net realizable value.

These weaknesses increased the likelihood of potential material errors in the Company's financial reporting.

***6. Entity Level Controls***

As evidenced by the material weaknesses described above, entity-level controls related to the control environment, risk assessment, monitoring function and dissemination of information and communication activities did not operate effectively. This includes a lack of adequate mechanisms for anticipating and identifying financial reporting risks and for reacting to changes in the operating environment that could have a potential effect on financial reporting. Such entity level controls, and a comprehensive monitoring of internal controls, are part of the framework to ensure that the designed system of internal control is operating effectively to ensure that significant transactions are adequately identified, recorded and disclosed.

As a result, misappropriation of assets and misstatements in the financial statements could occur and not be prevented or detected by the Company's controls in a timely manner. In the light of the review Management, in consultation with the Audit Committee, is reviewing the most cost effective way to address the issues raised. Management considers that remediation measures will include the appointment of a Group Compliance Officer with responsibility for ensuring the preparation, review, testing and updating of the appropriate policies, procedures and standards. Recruitment of a Country Financial Controller in Kazakhstan to strengthen group reporting is underway.

**CEO and CFO Certifications** The Certifications of our CEO and CFO which are attached as Exhibits 31(1) and 31(2) to this Report include information about our disclosure controls and procedures and internal control over financial reporting. These Certifications should be read in conjunction with the information contained in this Item 9A for a more complete understanding of the matters covered by the Certifications.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal control in the fourth quarter.

**Table of Contents**

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and  
Stockholders of CanArgo Energy Corporation

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that CanArgo Energy Corporation did not maintain effective internal control over financial reporting as of 31 December 2005, because of the effect of the Material Weaknesses Identified in Management's Assessment, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). CanArgo Energy Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment.

***Information Technology***

The Company did not adequately implement certain controls over information technology, including certain spreadsheets, used in its core business and financial reporting. These areas included logical access security controls to financial applications, segregation of duties and backup and recovery procedures. The Company's controls over the completeness, accuracy, validity, restricted access, and the review of certain spreadsheets used in the period-end financial statement preparation and reporting process was not designed appropriately. This material weakness affects the Company's ability to prevent improper access and changes to its accounting records.

**Table of Contents**

***Financial Reporting Close Process***

The Company's controls over the financial reporting close process were not consistently applied. As a result, the Company has a material weakness related to its ability to compile and review accurate financial statements.

1. The financial statement close process relies heavily upon manual rather than automated system process controls and places significant reliance on uncontrolled spreadsheets;

2. Formal policies and procedures in many functions including maintenance of the Chart of Accounts, financial statement close, purchasing, payroll, and cash management operations do not exist;

3. Preparation and review of account reconciliations, particularly in Georgia and Kazakhstan, are not performed; and

4. There is no review, reconciliation or approval of various schedules and reconciliations, including the transfer of amounts from subsidiary trial balances to consolidating spreadsheets prepared to support the financial close and disclosure processes

These material weaknesses related to the financial statement close process affect all of the Company's significant accounts and could result in a material misstatement to the Company's annual or interim consolidated financial statements that would not be prevented or detected.

***Disclosure***

The Company's disclosure controls and procedures were not effective in providing reasonable assurance that information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Inadequate controls include the lack of procedures used for identifying, determining and calculating required disclosures and other supplementary information requirements.

***Production***

The Company did not have effective controls and procedures to ensure that revenues and associated costs from the sales of its products based on production and transmission records between the Company and its third party production sharing partner were reconciled or correctly recognized. Controls associated with the product transmission are performed by the third party production sharing partner and there is no evidence that these controls have been reviewed by the Company.

Deficiencies in the Company's internal controls and procedures relating to the recording of production do not allow assurance that revenues and costs are recognized in accordance with generally accepted accounting principles.

***Inventory Management***

The Company did not maintain a control environment that fully emphasized the establishment of, adherence to, or adequate communication regarding appropriate internal control for the management of its inventory, including the lack of documented procedures to update and review the material master file and valuation table or compare the cost of inventory to net realizable value.

These weaknesses increased the likelihood of potential material errors in the Company's financial reporting.

***Entity Level***

As evidenced by the material weaknesses described above, entity-level controls related to the control environment, risk assessment, monitoring function and dissemination of information and communication activities did not operate effectively. This includes a lack of adequate mechanisms for anticipating and identifying financial reporting risks and for reacting to changes in the operating environment that could have a potential effect on financial reporting. Such entity level controls, and a comprehensive monitoring of internal controls, are part of the framework to ensure that the designed system of internal control is operating effectively to ensure that significant transactions are adequately identified, recorded and disclosed.

As a result, misappropriation of assets and misstatements in the financial statements could occur and not be prevented or detected by the Company's controls in a timely manner.

**Table of Contents**

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2005 consolidated financial statements of CanArgo Energy Corporation and our report dated 9 March 2006 expressed an unqualified opinion.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2005 financial statements, and this report does not affect our report dated 9 March 2006 on those financial statements.

In our opinion, management's assessment that CanArgo Energy Corporation did not maintain effective internal control over financial reporting as of 31 December 2005, is fairly stated, in all material respects, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, CanArgo Energy Corporation has not maintained effective internal control over financial reporting as of 31 December 2005, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

L J Solding Associates LLC

Deer Park, Illinois USA

March 9, 2006

**Table of Contents**

**ITEM 9B. OTHER INFORMATION**

On March 14, 2006, we entered into an agreement ( Termination Agreement ) with Europa Oil Services Limited ( Europa ), an unaffiliated company, formally terminating the consultancy agreement between CanArgo and Europa dated January 8, 2004. Under the terms of the consultancy agreement, CanArgo had an outstanding obligation to issue up to 12 million shares of CanArgo common stock to Europa upon certain production targets being met from future developments under the Samgori PSC. With effect from February 16, 2006, we have withdrawn from the Samgori PSC. Pursuant to the terms of the Termination Agreement the parties accordingly agreed that the consultancy agreement had terminated with effect from February 16, 2006. CanArgo has not incurred any material early termination penalties as a result of the termination of the consultancy agreement.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a)(1) *Financial Statements*

The following financial statements and related notes of the Company contained on pages F-1 through F-61 are filed as part of this Report:

Reports of Independent Auditors

Consolidated Statements of Operations Years Ended December 31, 2005, 2004, and 2003.

Consolidated Balance Sheets December 31, 2005 and 2004.

Consolidated Statements of Cash Flows Years Ended December 31, 2005, 2004, and 2003.

Consolidated Statements of Stockholders Equity Years ended December 31, 2005, 2004 and 2003.

Notes to Consolidated Financial Statements

(2) *Financial Statements Schedules*

None

All other schedules are omitted because of the absence of conditions under which they are required or because the required information is included in the consolidated financial statements or notes thereto.

(b) *Exhibits*

Documents filed herewith are identified by a cross ( X ).



**Table of Contents**

23(1) Consent of LJ Soldinger Associates LLC.

31(1) Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer of CanArgo Energy Corporation.

31(2) Rule 13a-14(c)/15d-14(a) Certification of Chief Financial Officer of CanArgo Energy Corporation.

32(1) Section 1350 Certification of Chief Executive Officer.

32(2) Section 1350 Certification of Chief Financial Officer.

11

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**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**CanArgo Energy Corporation**

(Registrant)

By: /s/ Jeffrey Wilkins

Jeffrey Wilkins

Chief Financial Officer (Principal Financial  
and Accounting Officer)

Date: January 10, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: January 10, 2007

By: /s/ David Robson

David Robson, Chairman of the Board,  
Chief Executive Officer and Director  
(Principal Executive Officer)

Date: January 10, 2007

By: /s/ Vincent McDonnell

Vincent McDonnell, President, Executive  
Director, Chief Operating Officer and Chief  
Commercial Officer

Date: January 10, 2007

By: /s/ Michael Ayre

Michael Ayre, Director

Date: January 10, 2007

By: /s/ Russell Hammond

Russell Hammond, Director

Date: January 10, 2007

By: /s/ Nils N. Trulsvik

Nils N. Trulsvik, Director

**Table of Contents**

**EXHIBIT INDEX**

23(1)Consent of L J Solding Associates LLC

31(1)Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer of CanArgo Energy Corporation.

31(2)Rule 13a-14(c)/15d-14(a) Certification of Chief Financial Officer of CanArgo Energy Corporation.

32(1)Section 1350 Certification of Chief Executive Officer.

32(2)Section 1350 Certification of Chief Financial Officer.

13

---

**Table of Contents**

**CANARGO ENERGY CORPORATION  
INDEX TO FINANCIAL STATEMENTS**

|   |     |
|---|-----|
| <u>Report on Management's Responsibilities</u>                      | F-2 |
| <u>Independent Auditors' Report</u>                                 | F-3 |
| <u>Consolidated Balance Sheets</u>                                  | F-4 |
| <u>Consolidated Statements of Operations and Comprehensive Loss</u> | F-5 |
| <u>Consolidated Statements of Cash Flows</u>                        | F-6 |
| <u>Consolidated Statements of Stockholders' Equity</u>              | F-7 |
| <u>Notes to Financial Statements</u>                                | F-9 |

F-1

---

**Table of Contents**

**REPORT ON MANAGEMENT'S RESPONSIBILITIES**

To the Stockholders of CanArgo Energy Corporation:

CanArgo's management is responsible for the integrity and objectivity of the financial information contained in this Annual Report. The financial statements included in this report have been prepared in accordance with accounting principles generally accepted in the United States and, where necessary, reflect the informed judgements and estimates of management.

Management maintains and is responsible for systems of internal accounting control designed to provide reasonable assurance that all transactions are properly recorded in the Company's books and records, that procedures and policies are adhered to, and that assets are safeguarded from unauthorized use.

The financial statements for 2005 and 2004 have been audited by the independent accounting firm of L J Soldinger Associates LLC, as indicated in their report. Management has made available to its outside auditors all the Company's financial records and related data and minutes of directors' and audit committee meetings.

CanArgo's audit committee, consisting solely of directors who are not employees of CanArgo, is responsible for: reviewing the Company's financial reporting; reviewing accounting and internal control practices; recommending to the Board of Directors and shareholders the selection of independent accountants; and monitoring compliance with applicable laws and company policies. The independent accountants have full and free access to the audit committee and meet with it, with and without the presence of management, to discuss all appropriate matters. On the recommendation of the audit committee, the consolidated financial statements have been approved by the Board of Directors.

/s/ Dr. David Robson

/s/ Richard Battey

Dr. David Robson  
Chief Executive Officer

Richard Battey  
Chief Financial Officer

March 16, 2006

F-2

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**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders  
CanArgo Energy Corporation  
St Peter Port, Guernsey, British Isles

We have audited the accompanying consolidated balance sheets of CanArgo Energy Corporation as of December 31, 2005 and 2004, and the related consolidated statements of operations and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of CanArgo Energy Corporation as of December 31, 2005 and 2004, and its consolidated results of operations, changes in stockholders' equity and its cash flows for each of the years in the three-year period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of CanArgo Energy Corporation internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 9, 2005 expressed an unqualified opinion on management's assessment of internal control over financial reporting and an adverse opinion on the effectiveness of internal control over financial reporting.

L J SOLDINGER ASSOCIATES LLC  
Deer Park, Illinois, USA  
March 9, 2006

**Table of Contents**

**CANARGO ENERGY CORPORATION**  
**Consolidated Balance Sheets**

|  | December 31,                         |                       |
|--|--------------------------------------|-----------------------|
|  | 2005                                 | 2004                  |
|  | (Expressed in United States dollars) |                       |
| <b>ASSETS</b>  |                                      |                       |
| Cash and cash equivalents  | \$ 18,540,558                        | \$ 24,617,047         |
| Restricted cash  | 3,181,672                            | 1,400,000             |
| Accounts receivable  | 414,597                              | 2,526,442             |
| Crude oil inventory  | 886,250                              | 253,858               |
| Prepayments  | 4,379,553                            | 1,517,836             |
| Assets held for sale   | 600,000                              | 600,000               |
| Other current assets   | 150,712                              | 121,610               |
| <b>Total current assets</b>  | <b>\$ 28,153,342</b>                 | <b>\$ 31,036,793</b>  |
| Capital assets, net (including unevaluated amounts of \$50,644,999 and \$25,102,945, respectively)   | 119,048,049                          | 72,995,666            |
| Prepaid financing fees   | 246,910                              | 648,507               |
| Investments in and advances to oil and gas and other ventures net  |                                      | 478,632               |
| <b>Total Assets</b>  | <b>\$ 147,448,301</b>                | <b>\$ 105,159,598</b> |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                                      |                       |
| Accounts payable trade   | \$ 5,754,882                         | \$ 2,331,945          |
| Loans payable  | 964,142                              | 1,500,000             |
| Deposits   |                                      | 3,080,839             |
| Accrued liabilities  | 6,356,623                            | 172,117               |
| <b>Total current liabilities</b>   | <b>\$ 13,075,647</b>                 | <b>\$ 7,084,901</b>   |
| Long term debt   | 25,000,000                           | 832,165               |
| Other non current liabilities  | 1,001,041                            |                       |
| Provision for future site restoration  | 523,000                              | 422,000               |
| <b>Total Liabilities</b>   | <b>\$ 39,599,688</b>                 | <b>\$ 8,339,066</b>   |
| Commitments and contingencies  |                                      |                       |
| Options with redemption feature  | 2,119,530                            | 723,280               |
| Stockholders equity:   |                                      |                       |
| Common stock, par value \$0.10; authorized 300,000,000 shares; shares issued, issuable and outstanding 222,586,867 at December 31, 2005 and 195,212,089 at December 31, 2004 | 22,258,685                           | 19,521,208            |
| Capital in excess of par value   | 202,892,303                          | 183,418,338           |
| Deferred compensation expense  | (2,220,399)                          | (1,976,102)           |
| Accumulated deficit  | (117,201,506)                        | (104,866,192)         |
| <b>Total stockholders equity</b>   | <b>\$ 105,729,083</b>                | <b>\$ 96,097,252</b>  |

|  |                |                |
|--|----------------|----------------|
| <b>Total Liabilities, Temporary Equity and Stockholders Equity</b> | \$ 147,448,301 | \$ 105,159,598 |
|--|----------------|----------------|

The accompanying notes are an integral part of the consolidated financial statements  
F - 4

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Table of Contents

**CANARGO ENERGY CORPORATION**  
**Consolidated Statements of Operations and Comprehensive Loss**

|   | <b>For Year Ended December 31,</b>          |                    |                    |
|---|---|--------------------|--------------------|
|   | <b>2005</b>                                 | <b>2004</b>        | <b>2003</b>        |
|   | <b>(Expressed in United States dollars)</b> |                    |                    |
| Operating Revenues from Continuing Operations:  |   |                    |                    |
| Oil and gas sales   | \$ 7,582,375                                | \$ 9,574,520       | \$ 7,881,172       |
| Other   |   |                    | 223,608            |
|   | 7,582,375                                   | 9,574,520          | 8,104,780          |
| <br>Operating Expenses:   |   |                    |                    |
| Field operating expenses  | 2,281,434                                   | 2,320,756          | 1,051,905          |
| Direct project costs  | 1,458,315                                   | 1,434,114          | 1,028,682          |
| Selling, general and administrative   | 11,575,826                                  | 7,324,292          | 3,505,489          |
| Depreciation, depletion and amortization  | 3,275,553                                   | 2,881,020          | 3,294,086          |
| Impairment of oil and gas properties, ventures and other assets                           |   | 174,812            |                    |
| Income on dispositions  |   | (1,606,274)        | (616,741)          |
|   | 18,591,128                                  | 12,528,720         | 8,263,421          |
| <br><b>Operating Loss from Continuing Operations</b>                                      | <br>(11,008,753)                            | <br>(2,954,200)    | <br>(158,641)      |
| <br>Other Income (Expense):   |   |                    |                    |
| Interest income   | 829,798                                     | 52,868             |                    |
| Interest and amortization of debt discount and expense                                    | (1,899,522)                                 | (954,998)          | (35,386)           |
| Foreign exchange gains (losses)   | 14,450                                      | (447,455)          | (511,370)          |
| Other   | (116,271)                                   | (790,689)          | (123,541)          |
| Equity Loss from investments  | (155,016)                                   | (205,230)          | 65,544             |
| <br><b>Total Other Expense</b>  | <br>(1,326,561)                             | <br>(2,345,504)    | <br>(604,753)      |
| <br><b>Loss from Continuing Operations Before Taxes</b>                                   | <br>(12,335,314)                            | <br>(5,299,704)    | <br>(763,394)      |
| Income taxes  |   |                    |                    |
| Minority interest in loss of consolidated subsidiaries                                    |   |                    | 7,406              |
| <br><b>Loss from Continuing Operations</b>  | <br>(12,335,314)                            | <br>(5,299,704)    | <br>(755,988)      |
| <b>Net Income (Loss) from Discontinued Operations, net Of taxes and minority interest</b> |   | 542,210            | (6,607,517)        |
| <br><b>Loss Before Cumulative Effect of Change in Accounting Principle</b>                | <br>(12,335,314)                            | <br>(4,757,494)    | <br>(7,363,505)    |
| <b>Cumulative effect of change in accounting principle</b>                                |   |                    | 41,290             |
| <br><b>Net Loss</b>   | <br>\$ (12,335,314)                         | <br>\$ (4,757,494) | <br>\$ (7,322,215) |

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|  |                 |                |                |
|--|-----------------|----------------|----------------|
| Weighted average number of common shares outstanding   |                 |                |                |
| Basic  | 211,586,953     | 134,005,490    | 99,432,000     |
| Diluted  | 211,586,953     | 134,005,490    | 99,432,000     |
| <b>Basic and Diluted Net Loss Per Common Share</b>   |                 |                |                |
| from continuing operations   | \$ (0.06)       | \$ (0.04)      | \$ (0.01)      |
| from discontinued operations   | \$              | \$             | \$ (0.07)      |
| cumulative effect of change in accounting principle, net of<br>Income tax  | \$              | \$             | \$             |
| <b>Basic and Diluted Net Loss Per Common Share After<br/>Cumulative Effect of Change in Accounting Principle</b> | \$ (0.06)       | \$ (0.04)      | \$ (0.08)      |
| <b>Other Comprehensive Income (Loss):</b>  |                 |                |                |
| Foreign currency translation   |                 | 146,463        | (151,131)      |
| <b>Comprehensive Loss</b>  | \$ (12,335,314) | \$ (4,611,031) | \$ (7,473,346) |

The accompanying notes are an integral part of the consolidated financial statements

F - 5

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**Table of Contents**

**CANARGO ENERGY CORPORATION**  
**Consolidated Statements of Cash Flows**

|  | <b>For Year Ended December 31,</b>          |                    |                  |
|--|---|--------------------|------------------|
|  | <b>2005</b>                                 | <b>2004</b>        | <b>2003</b>      |
|  | <b>(Expressed in United States dollars)</b> |                    |                  |
| <b>Operating activities:</b>   |   |                    |                  |
| Net Loss   | (12,335,314)                                | (4,757,494)        | (7,322,215)      |
| Cumulative effect of change in accounting principle  |   |                    | 41,290           |
| Net income (loss) from discontinued operations, net of taxes and minority interest                                 |   | 542,210            | (6,607,517)      |
| Loss from continuing operations  | (12,335,314)                                | (5,299,704)        | (755,988)        |
| Adjustments to reconcile net loss from continuing operations to net cash generated (used) by operating activities: |   |                    |                  |
| Non-cash stock compensation expense  | 2,374,578                                   | 1,395,035          | 276,507          |
| Non-cash interest expense and amortization of debt discount  | 1,277,878                                   | 653,313            | 14,000           |
| Non-cash reduction in selling, general and administrative expenses   |   | (300,000)          |                  |
| Non-cash debt extinguishment expense   |   | 349,923            |                  |
| Common stock issued for services   | 53,600                                      | 118,400            |                  |
| Non-cash miscellaneous expenses  | 193,000                                     |                    |                  |
| Depreciation, depletion and amortization   | 3,275,553                                   | 2,881,020          | 3,294,086        |
| Impairment of oil and gas ventures and other assets  |   | 174,812            |                  |
| Equity loss (income) from investments  | 155,016                                     | 205,230            | (65,544)         |
| Gain on dispositions   |   | (1,606,274)        | (616,741)        |
| Allowance for doubtful accounts  | 145,829                                     | 5,803              | 170,000          |
| Minority interest in loss of consolidated subsidiaries   |   |                    | (7,406)          |
| Changes in assets and liabilities:   |   |                    |                  |
| Restricted cash  | (1,781,672)                                 | (1,400,000)        |                  |
| Accounts receivable  | 2,146,016                                   | (2,370,473)        | (81,169)         |
| Inventory  | (632,392)                                   | 214,935            | (309,897)        |
| Prepayments  | (202,801)                                   | (12,560)           | 54,767           |
| Other current assets   | (29,102)                                    | 84,923             | (30,581)         |
| Accounts payable   | 757,401                                     | 1,848,664          | 78,047           |
| Deferred revenue   | (3,080,839)                                 | (449,255)          | 2,228,899        |
| Income taxes payable   |   | (97,500)           | 36,500           |
| Accrued liabilities  | (585,541)                                   | (177,370)          | 145,442          |
| <b>Net cash generated (used) by operating activities</b>   | <b>(8,268,790)</b>                          | <b>(3,781,078)</b> | <b>4,430,922</b> |
| <b>Investing activities:</b>   |   |                    |                  |
| Capital expenditures   | (33,450,583)                                | (11,190,290)       | (5,283,388)      |
| Proceeds from disposition of investments   |   |                    | 1,000,000        |
| Proceeds from disposition of subsidiary  |   | 2,107,001          |                  |
| Acquisitions, net of cash acquired   | 609,553                                     |                    |                  |
| Investments in oil and gas and other ventures  |   | (383,862)          |                  |
| Repayments from oil and gas and other ventures   |   |                    | 114,428          |
|  |   |                    | 1,443,729        |

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|  |                      |                      |                     |
|--|----------------------|----------------------|---------------------|
| Advance proceeds from the sale of CanArgo Standard Oil Products      |                      |                      | 301,195             |
| Advance proceeds from the sale of CanArgo Petroleum Refining Limited |                      |                      | (804,732)           |
| Change in oil and gas supplier prepayments                           | (855,466)            | (499,933)            |                     |
| <b>Net cash used in investing activities</b>                         | <b>(33,696,496)</b>  | <b>(9,967,084)</b>   | <b>(3,228,768)</b>  |
| Financing activities:  |                      |                      |                     |
| Proceeds from sale of common stock                                   | 4,429,303            | 37,999,516           |                     |
| Share issue costs  | (191,876)            | (4,543,845)          |                     |
| Deferred offering costs  |                      | (309,318)            |                     |
| Advances from joint venture partner                                  |                      | 290,000              | 1,427,612           |
| Payments of joint venture obligations                                |                      | (1,063,146)          | (654,466)           |
| Proceeds from loans  | 39,237,000           | 3,806,000            | 380,000             |
| Repayment of loans   | (7,200,000)          | (1,408,179)          | (277,821)           |
| Deferred loan costs  | (385,630)            |                      |                     |
| <b>Net cash provided by financing activities</b>                     | <b>35,888,797</b>    | <b>34,771,028</b>    | <b>875,325</b>      |
| Discontinued activities:   |                      |                      |                     |
| Net cash generated (used) by operating activities                    |                      |                      | (1,456,303)         |
| Net cash used in investing activities                                |                      | 121,929              | (348,546)           |
| Net cash provided by financing activities                            |                      |                      | 1,614,622           |
| <b>Net cash flows from assets and liabilities held for sale</b>      |                      | <b>121,929</b>       | <b>(190,227)</b>    |
| <b>Net increase (decrease) in cash and cash equivalents</b>          | <b>(6,076,489)</b>   | <b>21,144,795</b>    | <b>1,887,252</b>    |
| <b>Cash and cash equivalents, beginning of period</b>                | <b>24,617,047</b>    | <b>3,472,252</b>     | <b>1,585,000</b>    |
| <b>Cash and cash equivalents, end of period</b>                      | <b>\$ 18,540,558</b> | <b>\$ 24,617,047</b> | <b>\$ 3,472,252</b> |

The accompanying notes are an integral part of the consolidated financial statements

F - 6

Table of Contents

**CANARGO ENERGY CORPORATION**  
**Consolidated Statements of Stockholders Equity**

|   | Common Stock                                  |               |  |                                     |                                    |                        |                                 |
|---|---|---------------|--|-------------------------------------|------------------------------------|------------------------|---------------------------------|
|   | Number of<br>Shares<br>Issued<br>and Issuable | Par Value     | Additional<br>Paid-In<br>Capital<br>(Expressed in United States dollars) | Deferred<br>Compensation<br>Expense | Foreign<br>Currency<br>Translation | Accumulated<br>Deficit | Total<br>Stockholders<br>Equity |
| <b>Balance,<br/>December 31st<br/>2002</b>  | 97,356,206                                    | \$ 9,735,620  | \$ 145,151,475   | \$                                  | \$ 4,668                           | \$ (92,786,483)        | \$ 62,105,280                   |
| Shares issued<br>pursuant to<br>Norio buy-out<br>Sept 2003  | 6,000,000                                     | 600,000       | 540,000  |                                     |                                    |                        | 1,140,000                       |
| Shares issued<br>pursuant to<br>Manavi buy-out<br>Dec 2003  | 2,000,000                                     | 200,000       | 460,000  |                                     |                                    |                        | 660,000                         |
| Shares issued<br>pursuant to<br>Standby Equity<br>Distribution<br>Agreement   | 261,782                                       | 26,178        | (26,178)   |                                     |                                    |                        |                                 |
| Change in<br>accounting<br>policy pursuant<br>to the Company<br>electing to<br>utilize the<br>prospective<br>method of<br>transitioning to<br>fair value<br>method of<br>accounting for<br>stock-based<br>compensation<br>under SFAS<br>No. 148 |   |               | 276,507  |                                     |                                    |                        | 276,507                         |
| Current year<br>adjustment  |   |               |  |                                     | (151,131)                          |                        | (151,131)                       |
| Net loss  |   |               |  |                                     |                                    | (7,322,215)            | (7,322,215)                     |
| <b>Total,<br/>December 31,<br/>2003</b>   | 105,617,988                                   | \$ 10,561,798 | \$ 146,401,804   | \$                                  | \$ (146,463)                       | \$ (100,108,698)       | \$ 56,708,441                   |

|  |           |         |           |             |           |
|--|-----------|---------|-----------|-------------|-----------|
| Current year adjustment  |           |         |           | 146,463     | 146,463   |
| Exercise of stock options and warrants   | 3,815,084 | 381,508 | 118,008   |             | 499,516   |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital)      | 163,218   | 16,322  | 79,446    |             | 95,768    |
| Shares Issued pursuant to Standby Equity Distribution agreement (Newbridge Securities) | 30,799    | 3,080   | 15,091    |             | 18,171    |
| Shares Issued pursuant to consultancy agreement (Europa Oil Services Ltd)              | 4,000,000 | 400,000 | 3,480,000 |             | 3,880,000 |
| Shares Issued pursuant to consultancy agreement (CEOCast)                              | 80,000    | 8,000   | 49,600    |             | 57,600    |
| Issue of Warrants to purchase 1 million shares pursuant to a loan agreement            |           |         | 754,000   |             | 754,000   |
| Issue of Warrants to purchase 300,000 shares pursuant to a Loan agreement              |           |         | 197,040   |             | 197,040   |
| Stock based compensation under SFAS 148  |           |         | 2,647,858 | (1,976,102) | 671,756   |
| Shares Issued pursuant to Standby Equity Distribution                                  | 425,000   | 42,500  | 182,750   |             | 225,250   |

|   |             |               |                |               |                               |
|---|-------------|---------------|----------------|---------------|-------------------------------|
| agreement<br>(Cornell<br>Capital)<br>Issue of<br>Warrants to<br>purchase<br>1 million shares<br>pursuant to a<br>Loan agreement |             |               | 263,786        |               | 263,786                       |
| Shares Issued<br>pursuant to<br>Global public<br>offering   | 75,000,000  | 7,500,000     | 30,000,000     |               | 37,500,000                    |
| Share issue<br>costs  |             |               | (4,543,845)    |               | (4,543,845)                   |
| Shares Issued<br>pursuant to<br>CanArgo Norio<br>Limited<br>Buy-Out   | 6,000,000   | 600,000       | 3,720,000      |               | 4,320,000                     |
| Shares Issueable<br>pursuant to<br>consultancy<br>agreement<br>(CEOCast)  | 80,000      | 8,000         | 52,800         |               | 60,800                        |
| Net Loss  |             |               |                | (4,757,494)   | (4,757,494)                   |
| <b>Total,<br/>December 31,<br/>2004</b>   | 195,212,089 | \$ 19,521,208 | \$ 183,418,338 | \$(1,976,102) | \$(104,866,192) \$ 96,097,252 |

F - 7

**Table of Contents**

|   | <b>Common Stock</b> |                  | <b>Additional</b>                           | <b>Deferred Foreign</b> | <b>Total</b>       |                     |
|---|---------------------|------------------|---|-------------------------|--------------------|---------------------|
|   | <b>Number of</b>    | <b>Par Value</b> | <b>Paid-In</b>                              | <b>Compensation</b>     | <b>Accumulated</b> |                     |
|   | <b>Shares</b>       |                  | <b>Capital</b>                              | <b>Expense</b>          | <b>Deficit</b>     |                     |
|   | <b>and Issuable</b> |                  | <b>(Expressed in United States dollars)</b> |                         |                    | <b>Stockholders</b> |
|   |                     |                  |   | <b>Currency</b>         |                    | <b>Equity</b>       |
|   |                     |                  |   | <b>Translation</b>      |                    |                     |
|   |                     |                  |   | <b>Deficit</b>          |                    |                     |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 380,836             | 38,084           | 469,514                                     |                         |                    | 507,598             |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 335,653             | 33,565           | 458,837                                     |                         |                    | 492,402             |
| Exercise of stock options   | 1,067,833           | 106,783          | 255,850                                     |                         |                    | 362,633             |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 344,758             | 34,476           | 498,072                                     |                         |                    | 532,548             |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 370,599             | 37,060           | 562,940                                     |                         |                    | 600,000             |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 381,170             | 38,117           | 561,883                                     |                         |                    | 600,000             |
| Shares Issued pursuant to Standby Equity Distribution agreement                   | 495,745             | 49,574           | 550,426                                     |                         |                    | 600,000             |



|   |           |         |         |         |
|---|-----------|---------|---------|---------|
| (Cornell Capital) Exercise of stock options                                       | 1,570,000 | 157,000 | 11,000  | 168,000 |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 552,639   | 55,264  | 544,736 | 600,000 |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 473,634   | 47,363  | 552,637 | 600,000 |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 837,054   | 83,705  | 516,295 | 600,000 |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 813,670   | 81,367  | 518,633 | 600,000 |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 872,854   | 87,285  | 512,715 | 600,000 |
| Shares Issueable pursuant to consultancy agreement (CEOCast)                      | 847,458   | 84,746  | 515,254 | 600,000 |
|   | 80,000    | 8,000   | 45,600  | 53,600  |

|   |            |           |           |           |
|---|------------|-----------|-----------|-----------|
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 801,068    | 80,107    | 519,893   | 600,000   |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 812,348    | 81,235    | 518,765   | 600,000   |
| Shares Issued pursuant to Tethys buy-out  | 11,000,000 | 1,100,000 | 7,260,000 | 8,360,000 |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 639,591    | 63,959    | 536,041   | 600,000   |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 596,421    | 59,642    | 540,358   | 600,000   |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 613,246    | 61,325    | 538,675   | 600,000   |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 630,120    | 63,012    | 536,988   | 600,000   |
| Shares Issued pursuant to Standby Equity Distribution agreement (Cornell Capital) | 669,568    | 66,957    | 533,043   | 600,000   |

|   |             |               |                |                |                  |                |
|---|-------------|---------------|----------------|----------------|------------------|----------------|
| Capital)<br>Shares Issued<br>pursuant to<br>Standby Equity<br>Distribution<br>agreement<br>(Cornell<br>Capital) | 761,325     | 76,133        | 523,867        |                |                  | 600,000        |
| Shares Issued<br>pursuant to<br>Standby Equity<br>Distribution<br>agreement<br>(Cornell<br>Capital)             | 783,188     | 78,319        | 521,681        |                |                  | 600,000        |
| Exercise of<br>stock options  | 360,000     | 36,000        | 481,320        |                |                  | 517,320        |
| Exercise of<br>stock options  | 284,000     | 28,400        | 352,950        |                |                  | 381,350        |
| Stock based<br>compensation<br>under SFAS 148   |             |               | 1,222,625      | (244,297)      |                  | 978,328        |
| Share issue<br>costs  |             |               | (1,186,633)    |                |                  | (1,186,633)    |
| Net Loss  |             |               |                |                | (12,335,314)     | (12,335,314)   |
| <b>Total,<br/>December 31,<br/>2005</b>   | 222,586,867 | \$ 22,258,685 | \$ 202,892,303 | \$ (2,220,399) | \$ (117,201,506) | \$ 105,729,083 |

The accompanying notes are an integral part of the consolidated financial statements

F - 8

**Table of Contents**

**CANARGO ENERGY CORPORATION**  
**Notes to Consolidated Financial Statements**

**NOTE 1 NATURE OF OPERATIONS**

CanArgo Energy Corporation, headquartered in Guernsey, British Isles, and its consolidated subsidiaries (collectively CanArgo, we, our, us), is an integrated oil and gas company operating predominately within Georgia and the Republic of Kazakhstan. Our principal activity is the acquisition of interests in and development of crude oil and natural gas fields.

In 2002 and 2003, we approved a plan to sell CanArgo Standard Oil Products Limited (CSOP), Lateral Vector Resources Inc. (LVR), the Georgian American Oil Refinery Limited (GAOR) and a generating power unit. During 2004, CSOP, GAOR and LVR were sold. The results of these operations have been classified as discontinued for all periods presented. Net income (loss) from discontinued operations is disclosed net of taxes and minority interest for all periods presented. The generating power unit has been classified as Assets held for sale for all periods presented.

In the years ended December 31, 2005 and 2004 the Company's revenues from its Georgian operations did not cover the costs of its operations. At December 31, 2005 the Company had unrestricted cash and cash equivalents of approximately \$18,541,000. In 2005 the Company experienced a net cash outflow from operations of approximately \$8,269,000. In addition, the Company has a planned capital expenditure budget in 2006 of approximately \$20,000,000 in Georgia. In the event that the exploration and development wells currently undergoing or waiting to undergo production testing in Georgia fail to produce enough commercially available quantities of oil and or gas, the Company may not have sufficient working capital and may have to delay or suspend its capital expenditure plans and possibly make cutbacks in its operations. There are no assurances the Company could raise additional sources of equity financing and because of the covenants contained in the Senior Secured Convertible Notes (see Note 11) the Company is restricted from incurring additional debt obligations unless it receives consent from at least 51% of the noteholders, which cannot be assured.

In March 2006 with the private placement of the \$13,000,000 Senior Subordinated Convertible Guaranteed Notes we have fully funded the currently planned budget for our operating and development expenditure in Kazakhstan for 2006.

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Basis of Presentation***

The consolidated financial statements and notes thereto are prepared in accordance with accounting principles generally accepted in the United States. All amounts are in U.S. dollars. Certain items for prior years in the consolidated financial statements have been reclassified to conform to the current year's presentation. There was no effect on the reported net loss as a result of these reclassifications.

***Consolidation***

The consolidated financial statements include the accounts of CanArgo Energy Corporation and its majority owned subsidiaries. All significant intercompany transactions and accounts have been eliminated. Investments in less than majority owned corporations and corporate like entities in which we exercise significant influence are accounted for using the equity method. Entities in which we do not have significant influence are accounted for using the cost method.

***Equity Method***

Under the guidance of Emerging Issue Task Force D-46, Accounting for Limited Partnership Investments the Company uses the equity method to account for all of its limited partnership interests in oil and gas ventures that exceed 5% and is less than 50%. Under the equity method of accounting, the Company's proportionate share of the investees' net income or loss is included in Equity Income from Investments in the consolidated statements of operations. Any excess of the carrying value of the investment and loan advances over the underlying net equity of the investee is evaluated each reporting period for impairment.

## **Table of Contents**

In accordance with Emerging Issues Task Force ( EITF ) 98-13 Accounting by an Equity Method Investor for Investee Losses When the Investor has Loans to and Investments in Other Securities of the Investee, and 99-10 Percentage Used to Determine the Amount of Equity Method Losses, in the event that minority interest losses exceed stockholders equity for the majority interest, the excess minority interest loss is recorded against loan advances or other forms of equity invested in the subsidiary. In accordance with the requirements of EITF 99-10 the Company has chosen to account for the percentage of losses to be applied to reduce its loan balance based on its ownership percentage and not on its relative percentage of investment in each security class across all investors.

### ***Use of Estimates in the Preparation of Financial Statements***

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates, judgements 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.

Management believes that it is reasonably possible the following material estimates affecting the financial statements could significantly change in the coming year: (1) estimates of proved oil and gas reserves, (2) estimates as to the expected future cash flow from proved oil and gas properties, and (3) estimates of future dismantlement and restoration costs.

### ***Cash and Cash Equivalents***

Cash and cash equivalents, of which include all liquid investments with an original maturity of three months or less are considered to be cash equivalents.

### ***Fair Value of Financial Instruments***

The carrying amounts reflected in the consolidated balance sheets for cash and equivalents, short-term receivables and short-term payables approximate their fair value due to the short maturity of the instruments. The carrying value of the short-term note payable with detachable warrants reflects a discount for the value of warrants and was \$964,142 at December 31, 2005. The face amount of the note payable is \$1,050,000. The carrying value of the short-term debt approximates fair value as the debt bears interest at a market rate. The carrying and face value of \$25,000,000 of the long-term debt approximates fair value as the debt bears interest at a market rate. Please refer to Note 11 Loans Payable and Long Term Debt for a more detailed discussion of the accounting treatment of the long-term debt.

### ***Concentration of Credit Risk***

Although our cash and temporary investments and accounts receivable are exposed to potential credit loss, we do not believe such risk to be significant. Even though a substantial amount of funds were in accounts at financial institutions which were not covered under bank guarantees, management does not believe that maintaining balances in excess of bank guarantees resulted in a significant risk to us.

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

We sold approximately 90%, 82% and 92% of our oil to 2 customers, 4 customers and 3 customers respectively in 2005, 2004 and 2003. Management believes that due to the global nature of the market for oil and gas, that the loss of any customer or group of customers would not have a material effect on its sales.

### ***Reclassification***

Certain items in the consolidated financial statements have been reclassified to conform to the current year presentation. There was no effect on reported net loss as a result of these reclassifications.

**Table of Contents*****Accounts Receivable and Allowance for Doubtful Debts***

Accounts receivable are carried at the amount owed by customers, reduced by an allowance for estimated amounts that may not be collectible in the future. The allowance for doubtful accounts is estimated based upon historical write-off percentages, known problem accounts, and current economic conditions. Accounts are written off against the allowance for doubtful accounts when we determine that amounts are not collectable and recoveries of previously written-off accounts are recorded when collected.

***Inventories***

Inventories of crude oil are valued at the lower of average cost or net realizable value. Inventory costs include expenditures and other charges (including depreciation, depletion and amortization) directly and indirectly incurred in bringing the inventory to its existing condition and location. Selling expenses and general and administrative expenses are reported as period costs and excluded from inventory cost.

***Capital Assets***

Capital assets are recorded at cost less accumulated provisions for depreciation, depletion and amortization unless the carrying amount is viewed as not recoverable in which case the carrying value of the assets is reduced to the estimated recoverable amount. See *Impairment of Long-Lived Assets* below. 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 cost and related accumulated depreciation of assets sold or retired are removed from the accounts and any gain or loss thereon is reflected in operations. Unproved properties are not deemed to be impaired until the right to drill on those properties is lost and planned development has ceased.

*Oil And Gas Properties* CanArgo and the unconsolidated entities (for which it accounts using the equity method) account for oil and gas properties and interests under the full cost method. Under the full cost method, all acquisition, exploration and development costs, including certain directly related employee costs incurred for the purpose of finding oil and gas are capitalized and accumulated in pools on a country by country basis. Capitalized costs include the cost of drilling and equipping productive wells, including the estimated costs of dismantling and abandoning these assets, dry hole costs, lease acquisition costs, seismic and other geological and geophysical costs, delay rentals and costs related to such activities. Employee costs associated with production and other operating activities and general corporate activities are expensed in the period incurred.

Where proved reserves are established, capitalized costs are limited on a country by country basis (the ceiling test). The ceiling test is calculated as the sum of the present value of future net cash flows related to estimated production of proved reserves, using end of the-current-period prices, discounted at 10%, and takes into account expected future costs to develop proved reserves, and operating expenses and income taxes. Under the ceiling test, if the capitalized cost of the full cost pool exceeds the ceiling limitation, the excess is charged as an impairment expense.

Unit-of-production depreciation is applied to capitalized cost of the full cost pool. Unit-of-production rates are based on the amount of proved developed reserves of oil, gas and other minerals that are estimated to be recoverable from existing facilities using current operating methods.

We utilize a single cost center for each country where we have operations for amortization purposes. Any conveyances of properties are treated as adjustments to the cost of oil and gas properties with no gain or loss recognized unless the operations are suspended in the entire cost center or the conveyance is significant in nature.

The costs of investments in unproved properties and portions of costs associated with major development projects are excluded from the depreciation, depletion and amortization ( DD&A ) calculation until the project is evaluated.

Unproved property costs include leasehold costs, seismic costs and other costs incurred during the exploration phase. In areas where proved reserves are established, significant unproved properties are evaluated periodically, but not less than annually, for impairment. If a reduction in value has occurred, these property costs are considered impaired and are transferred to the related full cost pool. Unproved properties whose acquisition costs are not individually significant are aggregated, and the portion of such costs estimated to be ultimately nonproductive, based on experience, is amortized to the full cost pool over an average holding period.

**Table of Contents**

In countries where the existence of proved reserves has not yet been determined, leasehold costs, seismic costs and other costs incurred during the exploration phase remain capitalized in unproved property cost centers until proved reserves have been established or until exploration activities cease or impairment and reduction in value occurs. If exploration activities result in the establishment of a proved reserve base, amounts in the unproved property cost center are reclassified as proved properties and become subject to depreciation, depletion and amortization and the application of the ceiling test. If exploration efforts in a country are unsuccessful in establishing proved reserves, it may be determined that the value of exploratory costs incurred there have been permanently diminished in part or in whole. Therefore, based on the impairment evaluation and future exploration plans, the unproved property cost centers related to the area of interest could be impaired, and accumulated costs charged against earnings.

*Property and Equipment* Depreciation of property and equipment is computed using the straight-line method over the estimated useful lives of the assets ranging from three to five years for office furniture and equipment to three to fifteen years for oil and gas related equipment.

*Property and Equipment (CanArgo Standard Oil Products)* Depreciation of property and equipment at CanArgo Standard Oil Products petrol stations and additions thereto were depreciated over the estimated useful lives of the assets ranging from ten to fifteen years until operations were reclassified as discontinued.

***Revenue Recognition***

*Continuing operations* We recognize revenues when hydrocarbons have been produced and delivered and payment is reasonably assured.

*Discontinued operations* We recognize revenues when goods have been delivered, when services have been performed, or when hydrocarbons have been produced and delivered and payment is reasonably assured.

***Foreign Operations***

Our future operations and earnings will depend upon the results of our operations in the Georgia. There can be no assurance that we will be able to successfully conduct such operations, and a failure to do so would have a material adverse effect on our financial position, results of operations and cash flows. Also, the success of our operations will be subject to numerous contingencies, some of which are beyond management control. These contingencies include general and regional economic conditions, prices for crude oil and natural gas, competition and changes in regulation. Since we are dependent on international operations, specifically those in Georgia, we will be subject to various additional political, economic and other uncertainties. Among other risks, our operations may be subject to the risks and 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.

***Foreign Currency Translation***

The U.S. dollar is the functional currency for our upstream operations and the Lari is the functional currency for marketing operations. All monetary assets and liabilities denominated in foreign currency are translated into U.S. dollars at the rate of exchange in effect at the balance sheet date and the resulting unrealized translation gains or losses are reflected in operations. Non-monetary assets are translated at historical exchange rates. Revenue and expense items (excluding depreciation and amortization which are translated at the same rates as the related assets) are translated at the average rate of exchange for the year.

**Table of Contents****Income Taxes**

We recognize deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax liabilities and assets are determined based on the difference between the financial statement and the tax bases 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.

**Impairment of Long-Lived Assets**

The Company evaluates its long-lived assets for impairment using the guidance of Statement of Financial Accounting Standard ( SFAS ) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 establishes a single accounting model for long-lived assets to be disposed of by sale and requires that those long-lived assets be measured at the lower of carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations.

**Dismantlement, Restoration and Environmental Costs**

We recognize liabilities for asset retirement obligations associated with tangible long-lived assets, such as producing well sites, with a corresponding increase in the related long-lived asset. The asset retirement cost is depreciated along with the property and equipment in the full cost pool. The asset retirement obligation is recorded at fair value and accretion expense, recognized over the life of the property, increases the liability to its expected settlement value. If the fair value of the estimated asset retirement obligation changes, an adjustment is recorded for both the asset retirement obligation and the asset retirement cost. The Company's asset retirement obligations consist of costs related to the plugging of wells, the removal of facilities and equipment, and site restoration on oil and gas properties. Capitalized costs are depleted as a component of the full cost pool using the units of production method.

Upon adoption of this standard in 2003 we recorded the fair value of its existing asset retirement obligations as if the liabilities had been initially accounted for in accordance with SFAS 143 using assumptions present at the date of adoption. The income statement effect of this treatment was recorded as a cumulative effect in accounting principle in the period of adoption. During 2003, we recorded a credit to income for the cumulative effect of change in accounting principle of \$41,290, increased long-term liabilities to recognize our total obligation and increased net capital assets in accordance with the provisions of SFAS No. 143 to the amount of \$82,000. We did not recognize deferred tax expense on the SFAS 143 credit as the group is in a net deferred tax asset position against which full allowance has been made as it is considered more likely than not that the deferred tax asset will not be realized. There was no impact on our cash flows as a result of adopting SFAS No. 143. The asset retirement obligation, which is included on the consolidated balance sheet in provision for future site restoration, was \$523,000 at December 31, 2005, which includes \$58,800 for retirement obligations related to our acquired Tethys operations.

|   | <b>2005</b> | <b>2004</b> |
|---|-------------|-------------|
| Beginning balance, January 1                        | \$ 422,000  | \$ 151,000  |
| Cumulative effect of change in accounting principle |             |             |
| New obligations incurred in 2005                    | 58,800      | 270,000     |
| Liabilities settled in 2005                         |             |             |
| Accretion of expense                                | 42,200      | 14,000      |
| Revision in estimates, including timing             |             | (13,000)    |
| Balance at December 31                              | 523,000     | 422,000     |

**Stock-Based Compensation Plans**

Effective January 1, 2003, we adopted SFAS No. 123 *Accounting For Stock-Based Compensation* ( SFAS 123 ), as amended by SFAS No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123*. We elected to utilize the prospective method of transitioning from the intrinsic value to the fair value method of accounting for stock-based compensation. Stock based awards in existence prior to 2003 will continue to be accounted for under APB Opinion No. 25 *Accounting for Stock Issued to Employees*, unless they are



re-priced or modified.

In accordance with SFAS 123, compensation expense for awards granted on or after January 1, 2003, have been measured by the fair value of the award at the date of grant and recognized over the vesting or requisite service period. The fair value of awards in the form of stock options is estimated using an option-pricing model.

F - 13

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**Table of Contents**

Under Opinion No. 25, stock-based employee compensation cost was not recognized in net income when stock options granted had an exercise price equal, or greater, to the market value of the underlying common stock on the date of grant.

The pro forma information regarding net loss and net loss per share is required by SFAS 123 and has been determined as if we had accounted for our employee stock options under the fair value method of that statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions for 2003; risk free interest rate of 2.91%; dividend yield of 0%; volatility factors of the expected market price of CanArgo common stock of 80.47; and a weighted-average expected life of the options of four years. The following table illustrates the pro forma effect on net loss and net loss per share if the fair value based method had been applied to all outstanding and unvested awards for the year ended December 31, 2003:

|  | <b>For the Year<br/>Ended<br/>December 31, 2003</b> |
|--|---|
| Net Loss as reported   | \$ (7,322,215)                                      |
| Add: Stock-based compensation cost, net of related tax effects, included in the determination of net income As reported  | 276,507   |
| Less: Stock-based compensation cost, net of related Tax effects, that would have been included in the determination of net income reported if the fair value based method had been applied to all awards | 786,783   |
| Pro forma net loss   | (7,832,491)   |
| Loss per share   |   |
| Basic and diluted as reported  | (0.08)  |
| Basic and diluted pro forma  | (0.08)  |

In December 2004, the Financial Accounting Standards Board (FASB) issued a revised Statement of Financial Accounting Standards No. 123 (FAS 123R), *Share-based Payment*, which will become effective for the Company as of January 1, 2006. Adoption of FAS 123R will not materially change the Corporation's existing accounting practices or the amount of share-based compensation recognized in earnings. The Company expects that for options issued in 2005 and 2004 with graded vesting schedules, that each vesting tranche will remain unexercised until the expiration of the option and has thus chosen to amortize compensation costs recorded for those options using the straight line method.

The Company accounts for options issued with redemption features in accordance with Accounting Series Release 268 *Presentation in Financial Statements of Redeemable Preferred Stocks* and EITF D-98: *Classification and Measurement of Redeemable Securities*. Adjustments which are made to the amounts reflected in the temporary equity category for options with redemption features are made against additional paid in capital until such time when the intrinsic value exceeds the fair value originally recorded in which case the excess intrinsic value would be recorded as stock based compensation. In 2005 the temporary equity increased by \$1,396,250 and this amount was less than the fair value originally recorded.

**Recently Issued Pronouncements**

In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, which clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated even though uncertainty exists about the timing and (or) method of settlement. The Company is required to adopt Interpretation No. 47 prior to the end of 2006 and its adoption is not expected to have a significant effect on the Company's results of operations or financial condition.

In November 2004, the FASB issued SFAS No. 151 *Accounting for Inventory Costs* that amends Accounting Research Bulletin (ARB) No. 43, Chapter 4, *Inventory Pricing* to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of *so abnormal* and requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production

facilities. The Company is required to adopt SFAS No. 151 in the beginning of 2006 and its adoption is not expected to have a significant effect on the Company's results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 153 Exchanges of Nonmonetary Assets that amends Accounting Principles

**Table of Contents**

Board (APB) Opinion No. 29, Accounting for Nonmonetary Transactions and Amends FAS 19 Financial Accounting and Reporting by Oil and Gas Producing Companies, paragraphs 44 and 47(e). ARB No. 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged and SFAS 153 amended ABP 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaced it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Company is required to adopt SFAS No. 153 for nonmonetary asset exchanges occurring in the first quarter of 2006 and its adoption is not expected to have a significant effect on the Company's results of operations or financial condition.

In May 2005, the FASB issued SFAS No. 154 Accounting Changes and Error Corrections to replace ABP No. 20 Accounting Changes and SFAS No. 3 Reporting Accounting Changes in Interim Financial Statements. Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, SFAS 154 requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, SFAS 154 requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The implementation of FAS 154 is not expected to have a significant effect on the Company's results of operations or financial condition.

In November 2005, accounting standards were revised to provide guidance for determining and measuring other-than-temporary impairments of debt and equity securities. The new guidance is effective for reporting periods beginning after December 15, 2005. At December 31, 2005, available-for-sale investments in our marketable securities had unrealized losses totaling \$0.9 million which are recorded in Other Accumulated Comprehensive Income. We do not believe that the securities with unrealized losses as of December 31, 2005 currently meet the criteria for recognizing the loss under existing other-than-temporary guidance.

**NOTE 3 BUSINESS COMBINATIONS*****Tethys Petroleum Investments Limited***

On June 7, 2005, CanArgo made an offer to acquire 55% of the ordinary share capital of Tethys Petroleum Investments Limited ( Tethys ) which was held by Provincial Securities Limited ( Provincial ) and Vando International Finance Limited ( Vando ) for consideration of 11,000,000 CanArgo common shares. On June 9, 2005 CanArgo issued 5,500,000 shares to Provincial, of which Russell Hammond (one of our non-executive directors) is Investment Advisor and 5,500,000 shares to Vando in connection with this transaction. At June 7, 2005, the closing price of CanArgo total common stock was \$0.76 giving the common stock consideration a market value of \$8,360,000 for the 11 million shares. On completion of the acquisition, CanArgo held 100% of the ordinary share capital of Tethys through its subsidiary CanArgo Limited and Tethys became a wholly-owned subsidiary of the Company. We have recorded our interest as if the acquisition occurred on June 30, 2005. Tethys primary asset was its 70% interest in BN Munai, a Kazakhstan limited partnership.

The purchase price was allocated to the net assets of Tethys as follows:

|                                       |            |
|---------------------------------------|------------|
| Cash                                  | \$ 609,553 |
| Oil and Gas Properties                | 6,418,115  |
| Other Current Assets                  | 1,688,294  |
| Current Liabilities                   | (297,162)  |
| Provision for future site restoration | (58,800)   |

\$ 8,360,000

The principal reason for the purchase was to secure Tethys' current interests in a proven gas field and significant exploration areas in western Kazakhstan.

The Company has included the results of operations of Tethys in the consolidated financial statements starting July 1, 2005.

F - 15

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**Table of Contents**

The following pro forma presentation assumes the Company's acquisition of Tethys took place on January 1, 2004. The historical column presents the financial information of the Company for the periods indicated.

|  | <b>Pro Forma</b>                             |               |                    |                 |
|--|--|---------------|--------------------|-----------------|
|  | <b>Twelve Months Ended December 31, 2005</b> |               |                    |                 |
|  | <b>Historical</b>                            | <b>Tethys</b> | <b>Adjustments</b> | <b>Combined</b> |
| Revenue  | \$ 7,582,375                                 | \$ 0          | \$                 | \$ 7,582,375    |
| Loss from continuing operations                              | \$(12,335,314)                               | \$(215,649)   | \$ 155,016(1)      | \$(12,395,947)  |
| Net (loss)   | \$(12,335,314)                               | \$(215,649)   | \$ 155,016         | \$(12,395,947)  |
| Basic and diluted loss per Share                             |  |               |                    | \$ (0.06)       |
| Basic and diluted weighted average common shares outstanding |  |               |                    | 211,586,953     |

(1) To add back the equity loss on investment recorded during the first six months of 2005 for the Company's share of losses prior to acquisition of its majority interest.

|  | <b>Pro Forma</b>                             |               |                    |                 |
|--|--|---------------|--------------------|-----------------|
|  | <b>Twelve Months Ended December 31, 2004</b> |               |                    |                 |
|  | <b>Historical</b>                            | <b>Tethys</b> | <b>Adjustments</b> | <b>Combined</b> |
| Revenue  | \$ 9,574,520                                 | \$ 0          | \$                 | \$ 9,574,520    |
| Loss from continuing operations                              | \$(5,299,704)                                | \$ 0          | \$ 0               | \$(5,299,704)   |
| Net (loss)   | \$(4,757,494)                                | \$ 0          | \$ 0               | \$(4,757,494)   |
| Basic and diluted income per share                           |  |               |                    | \$ (0.04)       |
| Basic and diluted weighted average common shares outstanding |  |               |                    | 134,005,390     |

|  | <b>Pro Forma</b>                             |               |                    |                 |
|--|--|---------------|--------------------|-----------------|
|  | <b>Twelve Months Ended December 31, 2003</b> |               |                    |                 |
|  | <b>Historical</b>                            | <b>Tethys</b> | <b>Adjustments</b> | <b>Combined</b> |

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|  |                |      |    |   |                |
|--|----------------|------|----|---|----------------|
| Revenue  | \$ 7,881,172   | \$ 0 | \$ |   | \$ 7,881,172   |
| Loss from continuing operations                              | \$ (755,988)   | \$ 0 | \$ | 0 | \$ (755,988)   |
| Net (loss)   | \$ (7,322,215) | \$ 0 | \$ | 0 | \$ (7,322,215) |
| Basic and diluted income per share                           |                |      |    |   | \$ (0.07)      |
| Basic and diluted weighted average common shares outstanding |                |      |    |   | 99,432,000     |

***Kul Bas LLP***

In November 2005, CanArgo acquired through its subsidiary BN Munai, 100% of the charter capital of Kul-Bas LLP, a company registered in Kazakhstan, for consideration of \$100,000. Kul-Bas LLP owns an Exploration contract, which is for a period of 25 years, with an initial six year exploration period, covering an unexplored area of approximately 2.75 million acres (11,133 km(2)) surrounding the Akkulka area. The purchase price of the company reflected the fair value of the unevaluated property and was allocated to unevaluated oil and gas properties.

**NOTE 4 RESTRICTED CASH**

Restricted cash consisted of the following at December 31:

|                 |                  | <b>2005</b>  | <b>2004</b>  |
|-----------------|------------------|--------------|--------------|
| Restricted Cash | Escrow           | \$           | \$ 1,400,000 |
| Restricted Cash | Secured deposits | 3,181,672    |              |
|                 |                  | \$ 3,181,672 | \$ 1,400,000 |

**Table of Contents**

In the first quarter of 2005 we funded a certificate of deposit in the amount of \$3,900,000 to secure the issuance of a letter of credit as required under the rig rental and drilling contract we entered into with Saipem, S.p.A. Under the terms of the letter of credit \$1,100,000 was released and became unrestricted cash in July 2005. The remaining deposit was due to become unrestricted in January 2006. The letters of credit were extended until June and August 2006 and will become unrestricted then.

In the third quarter of 2005, we deposited approximately \$300,000 to secure the issuance of a letter of credit as required under the drilling contract we entered into with Baker Hughes International.

Restricted cash of \$1,400,000 at December 31, 2004 related to money placed in a third party escrow account in October 2004, to fund part of the horizontal development program, of which WEUS Holding Inc., a subsidiary of Weatherford International Limited ( Weatherford ) was the primary contractor, at the Ninotsminda and Samgori Fields in Georgia. These funds were disbursed to the contractor in July 2005 in satisfaction of liabilities for drilling services provided to the Company in 2005 in accordance with the terms of the escrow agreement.

**NOTE 5 ACCOUNTS RECEIVABLE**

Accounts receivable consisted of the following at December 31:

|   | <b>2005</b>       | <b>2004</b>         |
|---|-------------------|---------------------|
| Trade receivables before allowance for doubtful debts | \$ 1,021,868      | \$ 1,081,055        |
| Allowance for doubtful debts                          | (1,012,068)       | (866,239)           |
| Due from Samgori PSC partner                          |                   | 1,057,534           |
| Insurance receivable                                  | 31,755            | 1,047,359           |
| Fees due from underwriters                            | 180,000           |                     |
| Other receivables                                     | 193,042           | 206,733             |
|   | <b>\$ 414,597</b> | <b>\$ 2,526,442</b> |

Bad debt expense for 2005, 2004 and 2003 was \$145,829, \$5,803 and \$170,000 respectively, and is reflected under other income in the statement of operations.

In September 2004, a blow-out occurred at the N100 well on the Ninotsminda Field. Our insurers will cover 80% of the costs associated with the blow out up to a maximum cover of \$2,500,000. We received \$800,000 from our insurers in the second quarter of 2005 in respect of costs incurred to date. As of December 31, 2005 and 2004, \$31,755 and \$1,047,359 was recorded as a receivable, respectively.

Included in receivables as of December 31, 2004 was \$1,057,534 due from Georgian Oil Samgori Limited ( GOSL ) for its share of capital expenditure, on the planned horizontal well drilling program on the Samgori Field. We funded 100% of the costs which were mainly related to mobilizing Weatherford to Georgia for the commencement of the horizontal well drilling program. Following the failure of Weatherford to successfully complete any horizontal sidetrack development wells on the Ninotsminda Field using Under-Balanced Coiled Tubing Drilling technology, Weatherford demobilised its equipment and left Georgia in July 2005. These costs have now been transferred to oil and gas properties.

**NOTE 6 INVENTORY**

Inventory of crude oil consisted of the following at December 31:

|           | <b>2005</b>       | <b>2004</b>       |
|-----------|-------------------|-------------------|
| Crude oil | \$ 886,250        | \$ 253,858        |
|           | <b>\$ 886,250</b> | <b>\$ 253,858</b> |



**Table of Contents****NOTE 7 PREPAYMENTS**

Prepayments consisted of the following at December 31:

|                      | <b>2005</b>         | <b>2004</b>         |
|----------------------|---------------------|---------------------|
| Drilling Contractors | \$ 4,053,471        | \$ 1,324,147        |
| Financing Fees       | 115,158             |                     |
| Other                | 210,924             | 193,689             |
|                      | <b>\$ 4,379,553</b> | <b>\$ 1,517,836</b> |

**NOTE 8 CAPITAL ASSETS**

Capital assets, net of accumulated depletion, depreciation and amortization ( DD&A ) and impairment, include the following at December 31, 2005:

|  | <b>Cost</b>           | <b>Accumulated<br/>DD&amp;A and<br/>Impairment</b> | <b>Net Capital<br/>Assets</b> |
|--|-----------------------|--|-------------------------------|
| Oil and Gas Properties                             |                       |  |                               |
| Proved properties                                  | \$ 83,451,848         | \$ (26,033,501)                                    | \$ 57,418,347                 |
| Unproved properties                                | 50,644,999            |  | 50,644,999                    |
|  | 134,096,847           | (26,033,501)                                       | 108,063,346                   |
| Property and Equipment                             |                       |  |                               |
| Oil and gas related equipment                      | 15,453,405            | (5,146,040)  | 10,307,365                    |
| Office furniture, fixtures and equipment and other | 1,135,601             | (458,263)  | 677,338                       |
|  | 16,589,006            | (5,604,303)  | 10,984,703                    |
|  | <b>\$ 150,685,853</b> | <b>\$ (31,637,804)</b>                             | <b>\$ 119,048,049</b>         |

Capital assets, net of accumulated depletion, depreciation and amortization and impairment ( DD&A ), include the following at December 31, 2004:

|  | <b>Cost</b>   | <b>Accumulated<br/>DD&amp;A and<br/>Impairment</b> | <b>Net Capital<br/>Assets</b> |
|--|---------------|--|-------------------------------|
| Oil and Gas Properties                             |               |  |                               |
| Proved properties                                  | \$ 61,458,503 | \$ (23,382,448)                                    | \$ 38,076,055                 |
| Unproved properties                                | 25,102,945    |  | 25,102,945                    |
|  | 86,561,448    | (23,382,448)                                       | 63,179,000                    |
| Property and Equipment                             |               |  |                               |
| Oil and gas related equipment                      | 14,119,443    | (4,693,368)  | 9,426,075                     |
| Office furniture, fixtures and equipment and other | 689,439       | (298,848)  | 390,591                       |
|  | 14,808,882    | (4,992,216)  | 9,816,666                     |

\$ 101,370,330      \$ (28,374,664)      \$ 72,995,666

We expensed \$3,275,553, \$2,881,020 and \$3,294,086 in respect of depletion, depreciation and amortization for the years ended December 31, 2005, 2004 and 2003, respectively.

Depletion (and Depletion per Barrel of Oil Equivalent on a Units of Production basis) was \$2,651,053 (\$18.67), \$2,298,218 (\$8.45) and \$2,634,459 (\$6.17) for the years ended December 31, 2005, 2004 and 2003, respectively. All production in the periods presented related to Georgia. Production from our Samgori Field attracted depletion from the date of acquisition in April 2004 to December 31, 2005. Production from our Ninotsminda Field attracted depletion for all years presented.

F - 18

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**Table of Contents*****Oil and Gas Properties***

Ultimate realization of the carrying value of our oil and gas properties will require production of oil and gas in sufficient quantities and marketing such oil and gas at sufficient prices to provide positive cash flow to CanArgo, which is dependent upon, among other factors, achieving significant production at costs that provide acceptable margins, reasonable levels of taxation from local authorities, and the ability to market the oil and gas produced at or near world prices. In addition, we must mobilize drilling equipment and personnel to initiate drilling, completion and production activities. If one or more of the above factors, or other factors, are different than anticipated, we may not recover our carrying value.

In 2005, 2004 and 2003, CanArgo did not need to write-down oil and gas properties due to the ceiling test.

We generally have the principal responsibility for arranging financing for the oil and gas properties and ventures in which we have an interest. There can be no assurance, however, that we or the entities that are developing the oil and gas properties and ventures will be able to arrange the financing necessary to develop the projects being undertaken or to support our corporate and other activities or that such financing as is available will be on terms that are attractive or acceptable to or are deemed to be in the best interests of the Company, such entities or their respective stockholders or participants.

The consolidated financial statements of CanArgo do not give effect to any additional impairment in the value of our investment in oil and gas properties and ventures or other adjustments that would be necessary if financing cannot be arranged for the development of such properties and ventures or if they are unable to achieve profitable operations. Failure to arrange such financing on reasonable terms or failure of such properties and ventures to achieve profitability would have a material adverse effect on our financial position, including realization of assets, results of operations, cash flows and prospects.

Unproved property additions relate to our exploration activity in the period.

We plan to test a substantial portion of our unproved properties for oil and gas in 2006. In the event that we do not find oil and gas, we could incur substantial impairments were the amounts to exceed our ceiling test.

***Costs Not Being Amortised***

Oil and gas property costs not being amortized at December 31, 2005, for both Georgia and Kazakhstan by year that the costs were incurred are as follows:

|       | <b>Year Ended December 31:</b> | <b>Exploration</b> | <b>Acquisition</b> | <b>Total<br/>Capital</b> |
|-------|--------------------------------|--------------------|--------------------|--------------------------|
| 2005  |                                | \$ 16,133,409      | \$ 9,408,644       | \$ 25,542,054            |
| 2004  |                                | 5,282,204          |                    | 5,282,204                |
| 2003  |                                | 1,286,388          |                    | 1,286,388                |
| Prior |                                | 13,816,708         | 4,717,646          | 18,534,353               |
|       |                                | \$ 36,518,709      | \$ 14,126,290      | \$ 50,644,999            |

Unevaluated costs include \$23,703,850 for the Ninotsminda Field. \$2,000,000 was allocated to the Cretaceous on acquisition prior to 2003. The structure named Manavi was proved to contain oil and gas by an original exploration well in 2003. This well was sidetracked in 2005 and now awaits testing. Another appraisal well is drilling ahead and is expected to be completed within approximately five months.

Unevaluated costs include \$16,304,554 for the Norio Field. An exploration well was completed at the end of 2005 and is currently being prepared for testing. The results of this test will determine whether further appraisal or development drilling is required.

Unevaluated costs include \$3,802,151 for the Nazvrevi Field. \$2,695,145 was allocated to the Field on acquisition prior to 2003. It also includes the significant Kumisi Cretaceous gas prospect for which we recently signed a Memorandum of Understanding ( MOU ) which includes the terms of a take-or-pay natural gas supply contract with the Ministry of Energy of Georgia. This MOU provides the commercial basis for CNL to move forward with the appraisal of Kumisi and, based on this and subject to regulatory approval, CNL plans to spud a well on Kumisi between May

and December of this year.

**Table of Contents**

Unevaluated costs include \$9,529,588 for Tethys. \$9,408,644 was allocated to unevaluated areas on acquisition in 2005. In Kazakhstan, we are in the process of completing a five well exploration program. A number of new gas discoveries have already been made & current plans are to undertake further exploration drilling in 2006.

**Property and Equipment**

Property and Equipment, Oil and gas related equipment includes related equipment currently in use by us in the development of the Ninotsminda Field.

**NOTE 9 PREPAID FINANCING FEES**

Prepaid financing fees at December 31:

|                                  | <b>2005</b> | <b>2004</b> |
|----------------------------------|-------------|-------------|
| Commission and Professional fees | \$ 246,910  | \$ 648,507  |
|                                  | \$ 246,910  | \$ 648,507  |

Prepaid financing fees as at December 31, 2005 are corporate finance fees incurred in respect of the private placement of a \$25,000,000 issue of Senior Convertible Secured Loan Notes due July 25, 2009 ( Senior Secured Notes ) with a group of investors, discussed in Note 12. The Company is amortizing the professional fees incurred in relation to the Senior Secured Notes over the term of the Senior Secured Notes. Professional fees of \$42,312 were amortized on a straight-line basis in 2005 in connection with the Senior Secured Notes.

As at December 31, 2004, commissions and professional fees related to the additional Ozturk Long Term Loan with Detachable Warrants and the Standby Equity Distribution Agreement ( SEDA ) dated February 11, 2004 between CanArgo and Cornell Capital Partners LP ( Cornell Capital ) were included in Prepaid financing fees.

Fees of \$25,000 and \$6,250 were amortized on a straight-line basis in 2005 and 2004 respectively in connection with the Ozturk Long Term Loan with Detachable Warrants.

Commissions and professional fees of \$604,757 at December 31, 2004 relating to the SEDA dated (See note 17) February 11, 2004 between CanArgo and Cornell Capital were offset against equity in March 2005 after sufficient draw downs under the SEDA.

**NOTE 10 INVESTMENT IN AND ADVANCES TO OIL AND GAS AND OTHER VENTURES**

As discussed in Note 3, on June 9, 2005 we acquired 100% ownership of Tethys Petroleum Investments Limited and this entity is now consolidated in our financial statements. A summary of our net investment in and advances to oil and gas and other ventures consisted of the following at December 31, 2005 and December 31, 2004:

|   | <b>2005</b> | <b>2004</b>  |
|---|-------------|--------------|
| Kazakhstan Through 45% ownership of Tethys Petroleum Investments Limited                | \$          | \$ 683,862   |
| Total Investments in and Advances to Oil and Gas and Other Ventures                     | \$          | \$ 683,862   |
| Equity in Profit (Loss) of Oil and Gas and Other Ventures Kazakhstan                    | \$          | \$ (205,230) |
| Cumulative Equity in Profit (Loss) of Oil and Gas and other ventures                    |             | (205,230)    |
| Total Investments in and Advances to Oil and Gas and Other Ventures, Net of Equity Loss | \$          | \$ 478,632   |

In September 2003, together with Atlantic Caspian Resources plc ( ACR ), we formed a limited partnership, Tethys Petroleum Investments Limited ( TPI ) and its wholly owned subsidiary Tethys Kazakhstan Ltd ( TKI ). As part of this investment, ACR contributed its 70% ownership interest in Too BN Munai LLP ( BNM ) into TKI in exchange for 10% ownership of TPI and we committed to funding the day to day operations and provide management services until third party financing could be arranged in exchange for 90% ownership of TPI. BNM's interest centers on the Akkulka

exploration area and the Kyzylai Gas Field, located in western Kazakhstan, just to the west of the Aral Sea. In the four years prior to our ownership interest, ACR drilled two deep

F - 20

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**Table of Contents**

exploration wells in the Akkulka area, which they plugged and abandoned after demonstrating the presence of hydrocarbons, due to funding limitations on their part. On the same day that we consummated the transaction to create TPI, we entered into an agreement to sell half of our ownership interest in TPI to Provincial Securities Limited, an investment company to which Mr. Russell Hammond, one of our non-executive directors, is an Investment Advisor, in consideration for future services of providing advice to us concerning funding the development of TPI as we intend to fund the majority of the development of the Kyzylloi Gas Field through third party financing.

The following day we entered into a Technical Services Agreement and a Loan Agreement with TPI in which we agreed to provide our managerial expertise and to provide cash advances to fund and manage the day to day operations of TPI and to provide funding to secure additional site licenses within the vicinity of the Kyzylloi Gas Field. The advances under the agreement, both cash and the value of services we perform on behalf of TPI, bear interest at the rate of 10% per annum and are repayable immediately upon the receipt by TPI of third party financing.

On June 9, 2005 we acquired the remaining 55% ownership of Tethys Petroleum Investments Limited, by issuing 11,000,000 shares of our common stock, valued at \$8,360,000, and this entity is now consolidated in our financial statements. Prior to this, we chose to use our equity ownership percentage as the basis for recording our portion of our investees loss and therefore first reduced our investment of \$17,366 to zero and then applied the remaining equity losses of \$187,864 to reduce the carrying value of our advances to \$478,632.

In 2005 our total investment and advances amounted to \$2,900,886 which consisted of cash investment and advances of \$2,750,886 and \$150,000 in non-cash management fees. In addition, we accrued an additional \$128,293 in interest on our advances and fees to TPI during 2005.

In 2004 our total investment and advances amounted to \$683,862 which consisted of cash investment and advances of \$383,862 and \$300,000 in non-cash management fees. In addition, we accrued an additional \$30,215 in interest on our advances and fees to TPI during 2004.

At December 31, 2004 the carrying value of our investment and advances exceeded the underlying equity in the net assets of the investee by \$190,312.

**NOTE 11 LOANS PAYABLE AND LONG TERM DEBT**

Loans payable at December 31 consisted of the following:

|   | <b>2005</b>   | <b>2004</b>  |
|---|---------------|--------------|
| Short term loans payable Promissory Notes | \$            | \$ 1,500,000 |
| Loan with detachable warrants             | \$ 1,050,000  | \$           |
| Unamortized debt discount                 | (85,858)      |              |
| Loans payable                             | \$ 964,142    | \$ 1,500,000 |
| Long term debt                            |               |              |
| Senior Convertible Secured Loan Notes     | \$ 25,000,000 | \$           |
| Long term loans with detachable warrants  | \$            | \$ 1,050,000 |
| Unamortized debt discount                 | \$            | \$ (217,835) |
| Long term debt                            | \$ 25,000,000 | \$ 832,165   |

On April 26, 2004, we entered into two loan and warrant agreements, one with Salahi Ozturk in which Mr. Ozturk advanced us \$1,000,000 in exchange for which we issued to Mr. Ozturk a promissory note in the amount of \$1,000,000 ( Original Loan ) and the other for \$306,000 with CA Fiduciary Services, Ltd Trustee for the SP525A Settlement ( CA ), for which we issued to CA a promissory note in the amount of \$306,000. The notes to Mr. Ozturk and to CA attracted interest at the rate of 7.5% per annum and had a term of six months. In addition to the promissory notes, we issued Mr. Ozturk a warrant to subscribe up to 1,000,000 shares of our common stock, with an exercise price of \$1.00 per share and a term of five years from the date of grant and we issued to CA a warrant to subscribe up to 300,000 shares of our common stock, with an exercise price of \$1.05 per share and a term of five years from the

date of grant. In the event that the Company were to raise gross proceeds of at least \$10 million in any future equity offering, these notes would become due and payable within seven days from the closing of the future equity offering. We granted Mr. Ozturk a lien covering 50% of the revenues of Ninotsminda Oil Company Limited, our 100% owned subsidiary company, (or its interest in the oil sales contract) as security for repayment of the note.

F - 21

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**Table of Contents**

Under Accounting Principles Board (APB) 14: Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants we allocated the proceeds from the issuances of the promissory note and warrants based on a fair value basis of each item. The fair value of the warrants was determined to be \$754,000 for the 1,000,000 warrants issued to Mr. Ozturk and \$197,040 for the 300,000 warrants issued to CA and was recorded as a discount to the value of the promissory note.

We used the following assumptions to determine the fair value of the debt and warrants:

|                                 | <b>Ozturk<br/>Loan</b> | <b>CA Loan</b> |
|---------------------------------|------------------------|----------------|
| Stock price on date of grant    | \$ 0.87                | \$0.78         |
| Risk free rate of interest      | 1.19%                  | 1.15%          |
| Expected life of warrant months | 60                     | 60             |
| Dividend rate                   |                        |                |
| Historical volatility           | 138%                   | 132%           |

The discounts were amortized to interest expense over the life of the promissory note using the effective interest method.

On August 27, 2004, we entered into an amended and restated loan and warrant agreement ( Amended Agreement ) with Mr. Ozturk, amending the loan and warrant agreement between the parties dated April 26, 2004. Under the terms of the amended loan and warrant agreement, Mr. Ozturk agreed to cancel the original warrant agreement and to advance the Company an additional \$1,050,000 ( Additional Loan ) and extend the maturity date of the original loan to one year from six months. The Additional Loan is repayable two years and one day from the date of the Amended Agreement unless it has previously been converted. Corporate finance fees of \$50,000 were paid in respect of the Additional Loan. Interest is payable on the Additional Loan at a rate of 7.5% per annum. The first interest payment date was December 31, 2004 and included rolled up interest for the period from April 26, 2004 until December 31, 2004. The Additional Loan was convertible into shares of CanArgo Common Stock ( Conversion Stock ) at 15% above a market price of \$0.60 in effect when the agreement was reached, subject to customary anti-dilution adjustments. We had the option to force conversion of the Additional Loan if our share price exceeded 160% of \$0.60 (or \$0.96 per share) for a period of 20 consecutive trading days. No conversion is possible for a period of one year from the date of the Amended Agreement.

In consideration for advancing funds under the Amended Agreement and the Additional Loan, we issued to Mr. Ozturk a warrant to subscribe for 2,000,000 shares of our common stock at an exercise price 5% above the market price of our common stock on the date of grant, subject to customary anti-dilution adjustments. The new warrant was issued on August 27, 2004 and is exercisable for a period of four years commencing one year from the date of the Amended Agreement. The warrants are transferable to non-US persons and may only be exercised outside the US. The Company agreed to register the shares underlying the convertible note and warrants on a best efforts basis and that there were no penalties included in the agreement for failure to register or to keep registered.

Under the provisions of Emerging Issues Task Force ( EITF ) 96-19 Debtor s Accounting for a Modification or Exchange of Debt Instruments , the Company has treated the Amended Agreement as extinguishment of the Original Loan due to its determination that the provisions of the Amended Agreement represented a substantial modification of terms as defined in the EITF. The result of the extinguishment was for the Company to record a loss on extinguishment in the amount of \$349,923, which represented the unamortized portion of the discount of the original loan on the date of the Amended Agreement.

The Company s stock price at the time of the Amended Agreement was \$0.51; consequently, pursuant to EITF 98-5 Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios and EITF 00-27 Application of Issue No. 98-5 to Certain Convertible Instruments , the issuance of the Additional Loan and detachable warrants resulted in a discount being recorded in the amount of \$263,786, which resulted from the relative fair value of the warrants, as determined using the black-scholes model, and will be amortized over the term of the Notes using the effective interest method.

We used the following assumptions to determine the fair value of the debt and warrants:

|                                    | <b>Additional<br/>Loan</b> |
|------------------------------------|----------------------------|
| Stock price on date of grant       | \$ 0.51                    |
| Risk free rate of interest         | 2.51%                      |
| Expected life of warrant    months | 48                         |
| Dividend rate                      |                            |
| Historical volatility              | 108%                       |

F - 22

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**Table of Contents**

The discounts are being amortized to expense interest over the life of the loan using the effective interest method. The effective interest rate was 18.9%. As of December 31, 2005 and December 31, 2004 we had amortized \$177,928 and \$45,951 respectively, of the debt discount as interest expense.

As a result of our completing an equity offering on September 22, 2004, we repaid both the Original Loan to Mr. Ozturk and the CA loan on September 30, 2004. The payoff of the CA loan resulted in our expensing the remaining unamortized debt discount for that loan. On payment of the Original Loan to Mr. Ozturk, the lien covering 50% of the revenues of Ninotsminda Oil Company Limited was terminated.

On May 19, 2004, we signed a promissory note with Cornell Capital Partners, L.P. ( Cornell Capital ) whereby Cornell Capital agreed to advance us the sum of \$1,500,000. This amount would be payable on the earlier of 180 days from the date of the promissory note or within 60 days from the date that the Registration Statement on Form S-3 filed with the SEC on May 6, 2004 (Reg. No. 333-115261) would be declared effective. If the promissory note was not repaid in full when due, interest would accrue on the outstanding principal owing at the rate of 12% per annum. We paid to Cornell Capital a commitment fee of 5% of the principal amount of the promissory note which would be set-off against the first \$75,000 of fees payable by us to Cornell Capital under the Standby Equity Distribution Agreement dated February 11, 2004. The promissory note would become immediately due and payable upon the occurrence of any of the following: (i) failure to pay the amount of any principal or interest when due under the promissory note; (ii) any proceedings under any bankruptcy laws of the United States of America or under any insolvency, reorganization, receivership, readjustment of debt, dissolution, liquidation or any similar law or statute of any jurisdiction filed by or against us for all or any part of our property. The Registration Statement was declared effective on February 3, 2005; we have repaid the promissory note by making a series of takedowns in February and March 2005 under the Standby Equity Distribution Agreement.

On April 26, 2005 we signed a promissory note with Cornell Capital whereby Cornell Capital agreed to advance us the sum of \$15 million ( Promissory Note ) under the following terms:

This \$15 million and interest at a rate of 7.5% per annum was payable either in cash or using the net proceeds of drawdowns under the SEDA, within 270 calendar days from the date of the Promissory Note. Pursuant to the terms of the Promissory Note, we escrowed 25 requests for advances under the SEDA each in an amount not less than \$600,000 and one advance of \$289,726.03 (representing estimated interest) together with 16,273,592 shares of CanArgo common stock, as at the agreement date, 664,966 shares were already in escrow. The escrow agent released requests every 7 calendar days from May 2, 2005 provided we had not previously made a payment to Cornell Capital in cash. We had the ability at our sole discretion upon 24 hours prior written notice to Cornell Capital to repay all and any amounts due under the Promissory Note in immediately available funds and withdraw any advance notices yet to be effected.

The Promissory Note was repaid in full in cash on August 1, 2005, all escrowed advances cancelled and 7,260,647 shares of CanArgo common stock were returned from escrow and duly cancelled on October 5, 2005. On July 25, 2005 notice was given to Cornell Capital to terminate the SEDA with effect as of August 24, 2005.

In order to ensure timely procurement of long lead items for our drilling program in Georgia and for working capital purposes during 2004, we entered into a number of loan agreements of which those outstanding during 2005 are described below.

*Senior Secured Convertible Notes:* On July 25, 2005, CanArgo completed a private placement of \$25,000,000 in aggregate principal amount of our Senior Secured Convertible Notes due July 25, 2009 (the Senior Secured Notes ) with a group of private investors arranged through Ingalls & Snyder LLC of New York City, as Placement Agent, pursuant to a Note Purchase Agreement of even date (the Note Purchase Agreement ).

The Company paid approximately \$100,000 of legal fees for the Purchasers and a \$250,000 arrangement fee to Orion Securities in connection with the Senior Secured Notes.

The unpaid principal balance under the Senior Secured Notes bears interest (computed on the basis of a 360-day year of twelve 30-day months) (a) at increasing rates ranging from 3% from the date of issuance to December 31, 2005; 10% from January 1, 2006 until December 31, 2006; and 15% from January 1, 2007 until final payment, payable semi-annually, on June 30 & December 30, commencing December 30, 2005, until the principal shall have become due and payable, and (b) at 3% above the applicable rate on any overdue payments of principal and

interest,

F - 23

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**Table of Contents**

Pursuant to the provisions of Emerging Issue Task Force 86-15: Increasing-Rate Debt ), the Company recognizes interest expense using the effective interest rate method, which results in the use of a constant interest rate for the life of the Senior Secured Notes. The effective interest rate is approximately 12.3% per annum. The difference between the interest computed using the actual interest rate in effect in 2005 (3% per annum) and the effective interest rate (12.3% per annum) of \$1,001,041 as of December 31, 2005 has been accrued as a non-current liability.

The Senior Secured Notes are convertible any time, in whole or in part, at the option of the Note holder, into shares of CanArgo common stock ( the Conversion Stock ) at a conversion price per share of \$0.90 (the Conversion Price ), which is subject to customary anti-dilution adjustments.

We may, at our option, upon at least not less than 90 days and not more than 120 days prior written notice, prepay at any time and from time to time after July 31, 2006, all or any part of the Senior Secured Notes, in a principal amount of not less than \$100,000 at the following Redemption Prices (expressed as percentages of the principal amount so prepaid): 105% after July 31, 2006; 104% after January 1, 2007; 103% after July 1, 2007; 102% after January 1, 2008; 101% after July 1, 2008, and 100% after January 1, 2009, together with all accrued and unpaid interest.

The Senior Secured Notes are subject to mandatory prepayment due to a change in control of the Company, as defined by the Note Purchase Agreement.

In connection with the execution and delivery of the Note Purchase Agreement, CanArgo entered into a Registration Rights Agreement with the Purchasers pursuant to which it agreed to register the Conversion Stock for resale under the Securities Act and indemnify the purchasers in connection with the registration.

The Company agreed to register the shares underlying the convertible note and warrants on a best efforts basis and that there were no penalties included in the agreement for failure to register or to keep registered.

The Senior Secured Notes are secured by substantially all of the assets of the Company and its subsidiaries and contain certain negative and affirmative covenants and also restricts the ability of the Company to pay dividends to its common stockholders until the loan and all accrued interest have been paid or the noteholders elect to convert their loans to common stock. All of the outstanding shares of Ninotsminda Oil Company Limited have been put into escrow and pledged. The Company cannot enter into any new borrowing arrangements without the Consent of the noteholders. Any new subsidiary created by the Company must also become party to the guarantee agreement that all material subsidiaries of CanArgo have agreed to. (See page 30 Liquidity and Capital Resources section of Item 2 below for a more detailed discussion of covenants).

**NOTE 12 OTHER LIABILITIES**

Other liabilities consisted of the following at December 31:

|   | <b>2005</b> | <b>2004</b>  |
|---|-------------|--------------|
| Prepaid sales and oil sales security deposit    | \$          | \$ 2,699,644 |
| Prepaid license fees                            |             | 80,000       |
| Advanced proceeds from the sale of other assets |             | 301,195      |
|   | \$          | \$ 3,080,839 |

As of December 31, 2004 prepaid sales and oil sales security deposit included \$2,300,000 arising from security deposit payments under an oil sales agreement with Primrose Financial Group ( Primrose ) dated May 5, 2004. In February 2005, we cancelled the May 2004 oil sales agreement with Primrose, repaid the security deposit in full and concluded a new oil sales agreement with Primrose. (See Note 16)

As of December 31, 2004 advanced proceeds from the sale of other assets referred to the sale of a generator for which the proposed buyer had paid a non-refundable deposit of \$301,195. The proposed buyer failed to meet the sale contract terms resulting in the loss of its deposit in the third quarter, 2005. The \$301,195 has been credited to Other Income. (See Note 20)

**Table of Contents****NOTE 13 ACCRUED LIABILITIES**

Accrued liabilities consisted of the following at December 31:

|                      | <b>2005</b>         | <b>2004</b>       |
|----------------------|---------------------|-------------------|
| Drilling contractors | \$ 4,984,261        | \$                |
| Professional fees    | 1,005,000           | 93,001            |
| Other                | 367,362             | 79,116            |
|                      | <b>\$ 6,356,623</b> | <b>\$ 172,117</b> |

Included in the amounts due to drilling contractors at December 31, 2005 are amounts invoiced by Weatherford of \$4,931,332. We have formally notified Weatherford that we dispute the validity of these billings to the Company for work Weatherford performed in the first and second quarter of 2005. We have recorded all amounts billed by Weatherford as of December 31, 2005 pending the outcome of the dispute resolution which may require referral to the London Court of International Arbitration for resolution in accordance with the provisions of the contract.

**NOTE 14 MINORITY INTEREST*****Tethys Petroleum Investments Limited***

In September 2003, together with Atlantic Caspian Resources plc ( ACR ), we formed a limited partnership, Tethys Petroleum Investments Limited ( TPI ) and its wholly owned subsidiary Tethys Kazakhstan Ltd ( TKI ). As part of this investment, ACR contributed its 70% ownership interest in BN Munai LLP ( BN Munai ) into TKI in exchange for 10% ownership of TPI and we committed to funding the day to day operations and provide management services until third party financing could be arranged in exchange for 90% ownership of TPI. BN Munai's interest centers on the Akkulka exploration area and the Kyzylloi Gas Field, located in western Kazakhstan, just to the west of the Aral Sea. In the four years prior to our ownership interest, ACR drilled two deep exploration wells in the Akkulka area, which they plugged and abandoned after demonstrating the presence of hydrocarbons, due to funding limitations on their part. On the same day that we consummated the transaction to create TPI, we entered into an agreement to sell half of our ownership interest in TPI to Provincial Securities Limited, an investment company to which Mr. Russell Hammond, one of our non-executive directors, is an Investment Advisor, in consideration for future services of providing advice to us concerning funding the development of TPI as we intended to fund the majority of the development of the Kyzylloi Gas Field through third party financing.

The following day we entered into a Technical Services Agreement and a Loan Agreement with TPI in which we agreed to provide our managerial expertise and to provide cash advances to fund and manage the day to day operations of TPI and to provide funding to secure additional site licenses within the vicinity of the Kyzylloi Gas Field. The advances under the agreement, both cash and the value of services we perform on behalf of TPI, bear interest at the rate of 10% per annum and are repayable immediately upon the receipt by TPI of third party financing.

On June 9, 2005, through our acquisition of the remaining 55% of Tethys Petroleum Investments Limited (See Note 3) we acquired a 70% ownership interest in BN Munai ( BN Munai ). BN Munai has only suffered losses from inception and currently the Company is the only partner funding the current operating losses, therefore, no minority interest is recorded at December 31, 2005 for the 30% ownership not under our control. The Company does not expect the minority partners in BN Munai to contribute funds to the partnership.

Under a loan agreement with BN Munai, TKL will take 100% of the net cash flow of the Kyzylloi development until the loan is repaid. The principal loan value of \$9,389,162 plus interest of \$805,451 was accrued as of the loan agreement date and was originally assigned to TKL from ACR as part of its exchange of its 70% ownership interest in BN Munai for 10% ownership of TPI. As at December 31, 2005 the principal amount of the loan outstanding was \$15,518,240 plus accrued interest of \$1,287,095. Interest is recorded in line with the loan agreement using a 3 month LIBOR rate as at the first business day of each quarter.

The Company has recorded 100% of its losses in BN Munai for 2005 as it is the only funding partner.

**Table of Contents*****CanArgo Norio Limited***

In September 2003, CanArgo Norio Limited ( CNL ) signed a Farm-In agreement (the Agreement ) relating to the Norio PSA with a wholly owned subsidiary of Georgian Oil, the Georgian State Oil Company ( Georgian Oil ). Georgian Oil is already a party to the Norio PSA as the commercial representative of the State. The Agreement obligates Georgian Oil to pay up to \$2,000,000 to complete the MK-72 well on the Norio prospect in return for a 15% interest in the contractor share of the Norio PSA. Georgian Oil would also have an option (the Option ) exercisable for a limited period after completion of the well, to increase its interest to 50% of the contractor share of the Norio PSA on payment to CNL of \$6,500,000.

Coincident with the Georgian Oil farm-in, we concluded a transaction to purchase some of the minority interests in CNL by a share swap for shares in CanArgo. Through this exchange we acquired an additional 10.8% interest in CNL increasing our interest to 75%. This maintains our effective interest in the Norio PSA after Georgian Oil has completed the first stage of the farm-in at approximately 63.7%. The purchase was achieved by issuing 6,000,000 restricted CanArgo shares to the minority interest holders in CNL. Of the interests in CNL, 4% were owned by Provincial Securities Limited, a company to which Mr. Russell Hammond, a non-executive director of CanArgo, is a financial advisor. Provincial Securities Limited received 2,273,523 shares of common stock in return for their interest. In the event that Georgian Oil exercises the Option and pays the required \$6,500,000 to CNL we would be obligated to issue a further 3,000,000 restricted shares to the minority interest holders.

On September 30, 2004 we announced that we had increased our interest in CNL, by buying out the remaining minority shareholder in that company, NPET Oil Limited. CNL will now become a wholly owned subsidiary of CanArgo. Following completion of the Georgian Oil farm-in to the Norio PSA, CNL will hold an 85% interest in the Norio PSA. CNL also holds 100% of the contractor's interest in the Block XI(G) and XI(H) Production Sharing Contract ( Tbilisi PSC ). This transaction has therefore increased our interest in the Norio PSA by 21.25%, and by 25% in the Tbilisi PSC. We have issued 6,000,000 restricted shares of our common stock valued at \$4,320,000 to NPET Oil Limited in connection with this transaction. Upon recording this transaction, minority interest of \$1,351,022 was reduced to \$0 and oil and gas properties increased by \$2,968,978. At the same time, our commitment under the Norio PSA and the original shareholders' agreement for a bonus payment of \$800,000 to be paid by us to the other shareholders should commercial production be obtained from the Middle Eocene or older strata and a second bonus payment of \$800,000 should production exceed 250 tonnes (approximately 1,900 barrels) of oil per day over any 90 day period has terminated.

***CanArgo Standard Oil Products Limited***

In September 2002, we approved a plan to sell our interest in CanArgo Standard Oil Products Limited ( CSOP ), a petroleum product retail business in Georgia, to finance our Georgian and Ukrainian development projects. In October 2002, we reached agreement with Westrade Alliance LLC, an unaffiliated company, to sell our wholly owned subsidiary, CanArgo Petroleum Products Limited ( CPPL ), which held our 50% interest in CSOP for \$4,000,000 in an arms-length transaction, with legal ownership being transferred upon receipt of final payment due originally in August 2003 and subsequently extended. The final payment of the consideration was received by us in December 2004 at which time we transferred our ownership in CPPL to Westrade Alliance LLC. The results of CSOP's operations have been presented for financial statement purposes as discontinued operations (See Note 20 Discontinued Operations).

***Georgian American Oil Refinery***

In November 2000, we completed the acquisition of a 51% interest in the Georgian American Oil Refinery ( GAOR ), a company which owns a small refinery located at Sartichala, Georgia. From that date, GAOR became a subsidiary of CanArgo and its results have been included in our consolidated financial statements. However, due to operational difficulties and changes to the fiscal system in Georgia, GAOR ceased to operate during 2001.

As a result of the uncertainty as to the ultimate recoverability of the carrying value of the refinery, we recorded in 2001 a write-down of the refinery's property, plant and equipment of approximately \$3,500,000. During 2003, a debit balance of \$1,274,895 in minority interest was written-off due to a change in the intentions of our minority interest owner and a plan to dispose of the asset. In 2004, we came to an agreement to sell our interest in the refinery. Our interest in the refinery was sold in February 2004.





**Table of Contents****NOTE 15 COMMITMENTS AND CONTINGENCIES**

We have contingent obligations and may incur additional obligations, absolute and contingent, with respect to the acquisition and development of oil and gas properties and ventures in which we have interests that require or may require us to expend funds and to issue shares of our Common Stock.

At December 31, 2005, we had the contingent obligation to issue an aggregate of 187,500 shares of our Common Stock to Fielden Management Services PTY, Ltd (a third party management services company), subject to the satisfaction of conditions related to the achievement of specified performance standards by the Stynawske Field project, an oil field in Ukraine in which we had a previous interest. As far as management is aware, the project is not progressing at the desired pace of development and consequently, in management's opinion the chance of having to issue these shares is remote.

Under the Production Sharing Contract for Blocks XI(G) and XI(H) (the Tbilisi PSC) in Georgia our subsidiary CanArgo Norio Limited will acquire additional seismic data within three years of the effective date of the contract which is September 29, 2003. The total commitment over the next ten months is \$350,000. In the event that no commercial producing wells are developed, our interest in the PSC terminates 10 years from commencement in March 2011.

In 2002, the Participation Agreement for the three well exploration program on the Ninotsminda/Manavi area with AES Gardabani (a subsidiary of AES Corporation) (AES) was terminated without AES earning any rights to any of the Ninotsminda/Manavi area reservoirs. We therefore have no present obligations in respect of AES. However, under a separate Letter of Agreement, if gas from the Sub Middle Eocene is discovered and produced from the exploration area covered by the Participation Agreement, AES will be entitled to recover at the rate of 15% of future gas sales from the Sub Middle Eocene, net of operating costs, approximately \$7,500,000, representing their prior funding under the Participation Agreement. AES have now withdrawn from Georgia, but hydrocarbons have been discovered in the Manavi area reservoir and in the event of a successful gas development from the Sub Middle Eocene, it is reasonably possible that AES may exercise their rights under the Letter of Agreement.

In April 2004, we acquired a 50% interest in the Samgori (Block XI(B)) Production Sharing Contract (Samgori PSC) in Georgia. This interest was acquired from Georgian Oil Samgori Limited (GOSL), a company wholly owned by Georgian Oil, by one of our subsidiaries, CanArgo Samgori Limited (CSL). Under the terms of the agreement dated January 8, 2004, up to 10 horizontal wells will be drilled on the Samgori Field. Completion of well S302, which was funded 100% by us, satisfied our commitment to GOSL under the acquisition agreement. It was planned that the remainder of the drilling program will be funded jointly by CSL and GOSL, the Contractor parties, pro rata to their interest in the Samgori PSC. The total cost to us of participating in the whole program, which was due to be completed by June 2008, was anticipated to be up to \$13,500,000.

Furthermore, under the assignment agreement NPL had agreed outstanding costs and expenses of \$37,528,964 in relation to the Samgori PSC which were recoverable by NPL receiving 30% of annual net profit from the Field until such costs had been fully repaid. After NPL's costs are repaid from either Field production or other production in the PSC (in the event that new fields are developed in areas identified using seismic surveys originally performed by NPL), NPL would continue to receive 5% of annual net profit.

Under the Samgori PSC, up to 50% of petroleum produced under the contract is allocated to the Contractor parties for the recovery of the cumulative allowable capital, operating and other project costs associated with the Samgori Field and exploration in Block XI(B) (Cost Recovery Oil). The cost recovery pool includes the \$37,528,964 costs previously incurred by NPL. The balance of production (Profit Oil) is allocated on a 50/50 basis between the State and the Contractor parties respectively until capital costs are recovered after which they would receive 30% of Profit Oil. Under the Samgori PSC, Georgian Oil as the State representative in the contract is entitled to receive up to 250,000 tons (approximately 1.6 million barrels) of oil (Base Level Oil) from a maximum of 50% per calendar quarter of production when the value of the cumulative Cost Recovery Petroleum, cumulative Profit Oil and cumulative Profit Natural Gas delivered to the Contractor parties exceeds the cumulative allowable capital, operating and other project costs including finance costs associated with the Samgori Field and exploration in Block XI(B) and the NPL costs. While Base Level Oil is being delivered to Georgian Oil, the Contractor parties will continue to be entitled to a maximum of 50% of the remaining Profit Oil. The Base Level Oil is an estimate of the amount of oil that Georgian

Oil would have expected to produce from the contract area had the State not come to a contractual arrangement with the previous Contractor party in 1996.

Upon completion of the acquisition of an interest in the Samgori PSC we had a contractual obligation to issue 4,000,000 shares of CanArgo Common Stock to Europa Oil Services Limited ( Europa ), an unaffiliated company in connection with a consultancy agreement with Europa in relation to this acquisition. On April 16, 2004 Europa was issued with 4,000,000 restricted shares of CanArgo Common Stock in an arms length transaction. A further 12,000,000 shares of CanArgo Common Stock are issuable upon

F - 27

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**Table of Contents**

certain production targets being met from future developments under the Samgori PSC. On March 14, 2006, we signed an agreement with Europa formally terminating the consultancy agreement.

On February 17, 2006 we issued a press release announcing that our subsidiary, CSL, was not proceeding with further investment in the Samgori PSC and associated farm-in, and accordingly we terminated our interest in the Samgori PSC with effect from February 16, 2006. On termination, we have now been released of all commitments and contingencies that the Company had as at December 31, 2005 in respect of the Samgori PSC.

In May 2004, NOC entered into a crude oil sales agreement with Primrose Financial Group ( PFG ) to sell its monthly share of oil produced under the Ninotsminda production sharing contract with a total contractual commitment of 84,000 metric tonnes (636,720 bbls) ( Sales Agreement ). As security for payment and having the right to lift up to 8,400 metric tonnes (approximately 64,000 bbls) of oil per month, the buyer caused to be paid to NOC \$2,300,000 ( Security Deposit ) to be repaid at the end of the contract period either in money or through the delivery of additional crude oil equal to the value of the security. The Security Deposit replaces the previous security payments totalling \$2,300,000 which had been originally made available under previous oil sales agreements.

On February 4, 2005, NOC and PFG agreed to terminate the Sales Agreement and enter into a new agreement ( New Agreement ) whereby PFG would receive an immediate repayment of its Security Deposit and obtain an extended term over which it can purchase crude oil produced from the Ninotsminda Field while NOC receives better commercial terms for the sale of its production. The New Agreement has a minimum term of 45 months and contains the following principal terms:

(i) NOC will make available to PFG NOC's entire share of production from the Ninotsminda Field including a minimum total amount of 68,555 metric tonnes (the Minimum Contract Quantity ). In the event NOC fails to produce the Minimum Contract Quantity it will have no liability to PFG;

(ii) The deliver point shall be at Georgian Oil's storage reservoirs at Samgori (adjacent to the Ninotsminda Field);

(iii) The price for the oil will be in US Dollars per net US Barrel equal to the average of the mean of three quotations in *Platts Crude Oil Marketwire(C) for Brent Dated Quotations minus a discount: ranging for sales (a) up to the Minimum Contract Quantity from \$6.00 to \$7.50 based on Brent prices per barrel ranging from less than \$15.00 to greater than \$25.01, respectively; and (b) for sales of oil in excess of the Minimum Contract Quantity at the commercial discount in Georgia for oil of similar quality less \$0.10 per barrel with the maximum discount being \$6.00 per barrel for export sales and \$5.50 per barrel for local sales; and*

(iv) PFG will pay NOC for the monthly quantity of oil in advance of delivery.

NOC's obligations are subject to customary Force Majeure provisions, title and risk of loss pass to buyer at the delivery point, NOC agrees to assist the buyer to sell the oil locally or export oil in accordance with applicable law and the Agreement is governed by English law.

In September 2004, a blow-out occurred at the N100 well on the Ninotsminda Field. The Company currently estimates that the total costs attributable to the blow-out, including compensation and cleaning of the environment will be \$2,000,000. The Company's insurance policies cover 80% of these costs up to a maximum of \$2,500,000 and the remaining 20% insurance retention being payable by the Company. On June 3, 2005 we received \$800,000, as a first instalment, from our insurance company and the chance of receiving the remaining amount of up to 80% of our total costs is deemed probable.

On July 27, 2005, GBOC Ninotsminda, an indirect subsidiary of the Company, received a claim raised by certain of the Ninotsminda villagers (listed on pages 1 to 76 of the claim) in the Tbilisi Regional Court in respect of damage caused by the blowout of the N100 well on the Ninotsminda Field in Georgia on September 11, 2004. An additional claim was received in December 2005 thus bringing the relief sought pursuant to both claim to the sum of 32.4 million GEL (approximately \$19.0 million at the exchange rate of GEL to US dollars in effect on December 31, 2005). We believe that we have meritorious defenses to this claim and intend to defend it vigorously and as a result of discussions with our legal advisors in Georgia, we would consider the chances of the claim being successful to be remote.

On September 12, 2005, WEUS Holding Inc ( WEUS ) a subsidiary of Weatherford International Ltd lodged a formal Request for Arbitration with the London Court of International Arbitration against CanArgo Energy Corporation in respect of unpaid invoices for work performed under the Master Service Contract dated June 1, 2004

between the Company and WEUS for the supply of under-balanced coil tubing drilling equipment and services during the first and second quarter of 2005. Pursuant to the Request for  
F - 28

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**Table of Contents**

Arbitration, WEUS demand for relief is \$4,931,332.55. Although the Company has recorded all amounts billed by Weatherford as of December 31, 2005 (see Note 13) the Company is contesting the claim and intends to file a counterclaim. We believe that we have meritorious defenses to this claim and intend to defend it vigorously. At this point in the proceedings it is not possible to predict the outcome of the arbitration. However, in the event that Weatherford is successful, the extent of the loss to the Company would be limited to payment of Weatherford's professional fees in regards to this matter.

The Company has been named in with a group of defendants by former interest holders of the Lelyakov oil field in the Ukraine. The plaintiffs are seeking damages of approx 600,000 CDN (approx \$514,000 at December 31, 2005 exchange rates) The former owners of UK-Ran Oil Company disposed of their investment in the field prior to selling the Company to CanArgo. CanArgo believes the claim against it to be meritless. The Company is unable at this time to determine a potential outcome but in general would consider the chances of the claim being successful to be remote.

Under the Ninotsminda PSC, Ninotsminda Oil Company Ltd is required to relinquish at least half of the area then covered by the production sharing contract, but not in portions being actively developed, at five year intervals commencing December 1999. In 1998, these terms were amended with the initial relinquishment being due in 2006 and a reduction in the area to be relinquished at each interval from 50% to 25% whereby the Contractor selects the relinquishment portions.

CanArgo Norio Limited currently owns a 100% interest in the Norio (Block XI(C)) and North Kumisi Production Sharing Agreement ( Norio PSA ), although this interest has a 25 year term it may be reduced to 85% should the state oil company, Georgian Oil, exercise an option available to it under the PSA for a limited period following the submission of a field development plan. Although we are not able to speak for Georgian Oil, in management's opinion it is likely that Georgian Oil would exercise the option available to it in the event of a commercial oil or gas discovery. As a contractor party, Georgian Oil would be liable for all costs and expenses in relation to any interest it may acquire in the PSA. This PSA covers an area of approximately 381,034 acres (1,542 km (2)), however, it is subject to a 25% relinquishment every 5 years, commencing in March 2006 whereby the Contractor selects the relinquishment portions.

Our 2004 Long-Term Stock Incentive Plan ( 2004 Plan ) allows for up to 7,500,000 shares of the Company's common stock to be issued to officers, directors, employees, consultants and advisors pursuant to the grant of stock based awards, including qualified and non-qualified stock, options, restricted stock, stock appreciation rights and other stock based performance awards. Stock options may be exercised, in whole or in part, by giving written notice of exercise to the Corporation specifying the number of shares to be purchased. However, in the event of a Change of Control (as defined in the 2004 Plan) an optionee (other than an optionee who initiated a Change of Control in a capacity other than as an officer or director of the Corporation) may elect to surrender all or part of the stock option to the Corporation and to receive in cash an amount equal to the amount by which the fair market value per share of the Stock on the date of exercise shall exceed the purchase price per share under the stock option multiplied by the number of shares of the Stock granted under the stock option as to which the right granted by this proviso shall have been exercised. In management's opinion, a Change of Control event (as defined in the 2004 Plan) at this moment in time, is deemed to be remote,. As of December 31, 2005, options to acquire an aggregate of 1,454,000 shares of common stock had been granted under this Plan and were outstanding, 1,214,000 of which are currently vested.

*Lease Commitments* We lease office space under non-cancelable operating lease agreements. Rental expense for the years ended December 31, 2005, 2004 and 2003 was \$456,908, \$379,102, and \$395,355 respectively. Future minimum rental payments over the next five years for our lease obligations as of December 31, 2005, are as follows:

|            |            |
|------------|------------|
| 2006       | \$ 426,604 |
| 2007       | 449,947    |
| 2008       | 355,867    |
| 2009       | 355,867    |
| 2010       | 204,225    |
| Thereafter | 197,183*   |

\$ 1,989,693

\* This represents  
payments for  
3 years and  
9 months after  
2010.

No parent company guarantees have been provided by CanArgo with respect to our contingent obligations and commitments.

F - 29

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**Table of Contents****NOTE 16 OPTIONS WITH REDEMPTION FEATURES**

Our 2004 Plan allows for up to 7,500,000 shares of the Company's common stock to be issued to officers, directors, employees, consultants and advisors pursuant to the grant of stock based awards, including qualified and non-qualified stock, options, restricted stock, stock appreciation rights and other stock based performance awards. Stock options may be exercised, in whole or in part, by giving written notice of exercise to the Corporation specifying the number of shares to be purchased. However, in the event of Change of Control (as defined in the 2004 Plan) an optionee (other than an optionee who initiated a Change of Control in a capacity other than as an officer or director of the Corporation) may elect to surrender all or part of the stock option to the Corporation and to receive in cash an amount equal to the amount by which the fair market value per share of the Stock on the date of exercise shall exceed the purchase price per share under the stock option multiplied by the number of shares of the Stock granted under the stock option as to which the right granted by this proviso shall have been exercised.

Under SEC Accounting Series Release 268 Presentation in Financial Statements of Redeemable Preferred Stocks, the Company has calculated and classified the intrinsic value of \$2,119,530 as at December 31, 2005 and \$723,280 as at December 31, 2004 to options with redemption features, the vested portion of issued share options from our 1995 Long-Term Incentive Plan in accordance with the related guidance.

**NOTE 17 STOCKHOLDERS EQUITY**

On July 8, 1998, at a Special Meeting of Stockholders, the stockholders of CanArgo approved the acquisition of all of the common stock of CanArgo Oil and Gas ( CAOG ) for Common Stock of the Company pursuant to the terms of an Amended and Restated Combination Agreement between those two companies (the Combination Agreement ). Upon completion of the acquisition on July 15, 1998, CAOG became a subsidiary of CanArgo, and each previously outstanding share of CAOG common stock was converted into the right to receive 0.8 shares (the Exchangeable Shares ) of CAOG which are exchangeable generally at the option of the holders for shares of CanArgo's Common Stock on a share-for-share basis.

On January 24, 2002 we announced that we had established May 24, 2002 as the redemption date for all of the Exchangeable Shares of CAOG since the number of outstanding Exchangeable Shares had fallen below the minimum 853,071 share threshold. Each Exchangeable Share was purchased by CanArgo for shares of CanArgo Common Stock on a share-for-share basis resulting in the issuance of an aggregate of 148,826 shares of Common Stock. No cash consideration was issued by CanArgo and the purchase did not increase the total number of shares of Common Stock of CanArgo deemed issued and issuable.

In February 2004, we announced that we had signed a Standby Equity Distribution Agreement that allowed us, at our option, to issue shares to US-based investment fund Cornell Capital Partners LP up to a maximum value of \$20,000,000 over a period of up to two years from the date on which the Registration Statement on Form S-3 registering for resale the shares under the Securities Act of 1933, as amended ( Securities Act ) is declared effective. The Registration Statement was declared effective by the SEC on February 3, 2005

The total number of shares of common stock authorized was 300,000,000 as of December 31, 2005 and 2004 and 150,000,000 for 2003.

As of December 31, 2005 and 2004, we had 5,000,000 shares of \$0.10 par value preferred stock authorized, of which none were outstanding. The Board of Directors may at any time issue additional shares of preferred stock and may designate the rights and privileges of a series of preferred stock without any prior approval by the stockholders.

During the years ended December 31, 2005, 2004 and 2003, the following transactions regarding CanArgo's Common Stock were consummated pursuant to authorization by CanArgo's Board of Directors or duly constituted committees thereof.

**Table of Contents**

***Year Ended December 31, 2005***

We issued to Cornell Capital Partners, L.P. pursuant to the Standby Equity Distribution Agreement, the following shares at the dates and prices indicated:

In February 2005, 380,836 shares of our common stock were issued at \$1.31 per share.

In February 2005, 335,653 shares of our common stock were issued at \$1.47 per share.

In March 2005, 344,758 shares of our common stock were issued at \$1.54 per share.

In March 2005, 370,599 shares of our common stock were issued at \$1.62 per share.

In March 2005, 381,170 shares of our common stock were issued at \$1.57 per share.

In March 2005, 495,745 shares of our common stock were issued at \$1.21 per share.

In April 2005, 552,639 shares of our common stock were issued at \$1.09 per share.

In April 2005, 473,634 shares of our common stock were issued at \$1.27 per share.

In May 2005, 837,054 shares of our common stock were issued at \$0.72 per share.

In May 2005, 813,670 shares of our common stock were issued at \$0.74 per share.

In May 2005, 872,854 shares of our common stock were issued at \$0.69 per share.

In May 2005, 847,458 shares of our common stock were issued at \$0.71 per share.

In June 2005, 801,068 shares of our common stock were issued at \$0.75 per share.

In June 2005, 812,348 shares of our common stock were issued at \$0.74 per share.

In June 2005, 639,591 shares of our common stock were issued at \$0.94 per share.

In June 2005, 596,421 shares of our common stock were issued at \$1.00 per share.

In July 2005, 613,246 shares of our common stock were issued at \$0.98 per share.

In July 2005, 630,120 shares of our common stock were issued at \$0.95 per share.

In July 2005, 669,568 shares of our common stock were issued at \$0.90 per share.

In July 2005, 761,325 shares of our common stock were issued at \$0.79 per share.

In August 2005, 783,188 shares of our common stock were issued at \$0.77 per share.



**Table of Contents**

Other stock issuances were as follows:

In March 2005, 1,067,833 shares of our common stock were issued at an average of \$0.34 per share as a result of employees exercising stock options.

In March 2005, 1,570,000 shares of our common stock were issued at an average of \$0.11 per share as a result of employees exercising stock options.

In May 2005, 80,000 shares of CanArgo common stock were issuable to CEOcast Inc. in relation to a consultancy agreement between CanArgo and CEOcast.

In June 2005, 5,500,000 shares of our common stock were issued at \$0.76 per share to Provincial, of which Russell Hammond (one of our non-executive directors) is Investment Advisor and 5,500,000 shares of our common stock were issued at \$0.76 per share to Vando, in connection with the Tethys acquisition.

In August 2005, 360,000 shares of our common stock were issued at an average of \$1.44 per share as a result of stock options being exercised.

In September 2005, 284,000 shares of our common stock were issued at an average of \$1.34 per share as a result of stock options being exercised.

***Year Ended December 31, 2004***

In February 2004, 163,218 shares of our common stock were issued at \$0.56 per share to Cornell Capital Partners, L.P. as part payment of the commitment fee payable pursuant to the Standby Equity Distribution Agreement between Cornell and the Company ( Equity Line of Credit ).

In February 2004, 30,799 shares of our common stock were issued at \$0.33 per share to Newbridge Securities Corporation pursuant to the Placement Agent Agreement among CanArgo Energy Corporation, Newbridge Securities Corporation and Cornell Capital Partners in terms of which Newbridge advised the Company and acted as our exclusive placement agent in respect of the Equity Line of Credit.

In March 2004, 3,815,084 shares of CanArgo common stock were issued at an average of \$0.13 per share as a result of employees exercising stock options.

In April, 2004 we issued 4,000,000 shares of CanArgo common stock at \$0.94 per share to Europa Oil Services Limited pursuant to a consultancy agreement to acquire an interest in the Samgori PSC.

In July, 2004 we issued 80,000 shares of CanArgo common stock at 0.70 per share to CEOcast Inc in relation to a consultancy agreement between CanArgo and CEOcast Inc dated May 17, 2004.

In July 2004, we issued 425,000 shares of our common stock at \$0.50 per share to Cornell Capital Partners, L.P. as part payment of the commitment fee payable pursuant to the Standby Equity Distribution Agreement between Cornell and the Company ( Equity Line of Credit ).

In September 2004, we completed a global public offering ( Global Offering ) of 75 million shares of our common stock at an offering price of \$0.50 per share. We raised gross proceeds of \$37,500,000 and paid total commissions and expenses related to the Global Offering of \$4,543,845 which resulted in net proceeds to the Company of \$32,956,155.

In September, 2004 we issued 6,000,000 restricted shares of our common stock at \$0.60 per share to NPET Oil Limited to increase our interest in CanArgo Norio Limited, by buying out the remaining minority shareholder in that company, NPET Oil Limited.

In November 2004, 80,000 shares of CanArgo common stock were issueable to CEOcast Inc in relation to a consultancy agreement between CanArgo and CEOcast.

F - 32

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**Table of Contents****Year Ended December 31, 2003**

In September 2003, CanArgo issued 6,000,000 shares at \$0.19 per share for purchase some of an additional 10.8% interest in CanArgo Norio.

In December 2003, CanArgo issued 2,000,000 shares at \$0.33 per share upon completion of the purchase of the interest of the farm-in partner in the Manavi well.

In December 2003, CanArgo issued 261,782 shares at \$0.33 per share upon completion of a Standby Equity Distribution Agreement that allowed CanArgo, at its option, to issue shares to US-based investment fund Cornell Capital Partners LP up to a maximum value of \$6 million. This facility was terminated on February 11, 2004 when the Company entered into a further standby equity distribution agreement.

**NOTE 18 NET LOSS PER COMMON SHARE**

Earnings (loss) per share is calculated in accordance with SFAS No. 128, Earnings Per Share. Basic and diluted earnings per share are provided for continuing operations, discontinued operations, cumulative effect of change of accounting principle and net income (loss). Basic earnings (loss) per share is computed based upon the weighted average number of shares of common stock outstanding for the period and excludes any potential dilution. Diluted earnings per share reflects potential dilution from the exercise of securities (warrants, options and convertible debt) into common stock. Outstanding options and warrants to purchase common stock are not included in the computation of diluted loss per share because the effect of these instruments would be anti-dilutive for the loss periods presented.

Basic and diluted net loss per common share for the years ended December 31, 2005, 2004 and 2003 were based on the weighted average number of common shares outstanding during those periods. Options and warrants to purchase CanArgo's Common Stock were outstanding during the years ended December 31, 2005, 2004 and 2003 but were not included in the computation of diluted net loss per common share because the effect of such inclusion would have been anti-dilutive. The total number of such shares excluded from diluted net loss per common share were 41,644,516, 14,834,080 and 7,986,167 for each of the years ended December 31, 2005, 2004 and 2003 respectively (See Notes 14 and 24).

**NOTE 19 INCOME TAXES**

CanArgo and its U.S. domestic subsidiaries file a U.S. consolidated income tax return. No benefit for U.S. income taxes has been recorded in these consolidated financial statements because of CanArgo's inability to recognize deferred tax assets under provisions of SFAS 109. Due to the implementation of the quasi-reorganization as of October 31, 1988, future reductions of the valuation allowance relating to those deferred tax assets existing at the date of the quasi-reorganization, if any, will be allocated to capital in excess of par value.

A reconciliation of the differences between income taxes computed at the U.S. federal statutory rate of 34% and CanArgo's reported provision for income taxes is as follows:

|                                      | <b>Year Ended December 31,</b> |                |                |
|--------------------------------------|--------------------------------|----------------|----------------|
|                                      | <b>2005</b>                    | <b>2004</b>    | <b>2003</b>    |
| Income tax benefit at statutory rate | \$ (4,194,007)                 | \$ (1,617,548) | \$ (2,386,000) |
| Benefit of losses not recognized     | 4,194,007                      | 1,617,548      | 2,386,000      |
| Provision for income taxes           | \$                             | \$             | \$             |
| Effective tax rate                   | 0%                             | 0%             | 0%             |

The components of deferred tax assets consisted of the following as of December 31:

|  | <b>2005</b>  | <b>2004</b>   |
|--|--------------|---------------|
| Net operating loss carryforwards   | \$ 7,775,000 | \$ 10,957,000 |
| Foreign net operating loss carryforwards                                 | 2,961,000    | 3,573,000     |
| Net timing differences on impairments and accelerated capital allowances | 9,383,000    | 9,383,000     |

|  |                            |                            |
|--|----------------------------|----------------------------|
| Valuation allowance                                | 20,119,000<br>(20,119,000) | 23,913,000<br>(23,913,000) |
| Net deferred tax asset recognized in balance sheet | \$                         | \$                         |

F - 33

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**Table of Contents**

On August 1, 1991, August 17, 1994, July 15, 1998 and June 28, 2000, CanArgo experienced changes in ownership as defined in Section 382 of the Internal Revenue Code ( IRC ). The effect of these changes in ownership is to limit the utilization of certain existing net operating loss carryforwards for income tax purposes to approximately \$2,920,000 per year on a cumulative basis. As of December 31, 2005, total unexpired U.S. net operating loss carryforwards were approximately \$38,242,378. Of that amount, approximately \$15,375,000 was incurred prior to the ownership change in 2000 and is subject to the IRC Section 382 limitation (See Note 2).

The U.S. net operating loss carryforwards expire from 2006 to 2025. CanArgo also has approximately \$8,709,000 of foreign net operating loss carryforwards. A significant portion of the foreign net operating loss carryforwards may be subject to limitations similar to IRC Section 382.

CanArgo's available net operating loss carryforwards may be used to offset future taxable income, if any, prior to their expiration. CanArgo may experience further limitations on the utilization of net operating loss carryforwards and other tax benefits as a result of additional changes in ownership.

**NOTE 20 DISCONTINUED OPERATIONS*****CanArgo Standard Oil Products***

In September 2002, we approved a plan to sell our interest in CanArgo Standard Oil Products Limited ( CSOP ), a petroleum product retail business in Georgia, to finance our Georgian and Ukrainian development projects. In October 2002, we reached agreement with Westrade Alliance LLC, an unaffiliated company, to sell our wholly owned subsidiary, CanArgo Petroleum Products Limited ( CPPL ), which held our 50% interest in CSOP for \$4,000,000 in an arms-length transaction, with legal ownership being transferred upon receipt of final payment due originally in August 2003 and subsequently extended. The total payment received in 2004 was \$1,857,000 with the final payment of the consideration received by us in December 2004 at which time we transferred our ownership in CPPL to Westrade Alliance LLC. The gain recorded on disposition of subsidiary was \$1,275,351.

The results of discontinued operations in respect of CSOP consisted of the following for the years ending December 31:

|  | <b>2005</b> | <b>2004</b> | <b>2003</b>  |
|--|-------------|-------------|--------------|
| Operating Revenues                               | \$          | \$          | \$ 9,837,445 |
| Income Before Income Taxes and Minority Interest |             | 18,242      | 392,411      |
| Income Taxes                                     |             |             | (25,297)     |
| Minority Interest in Income                      |             |             | (183,557)    |
| Net Income from Discontinued Operation           | \$          | \$ 18,242   | \$ 183,557   |

***Lateral Vector Resources Inc***

Lateral Vector Resources Inc. ( LVR ), a wholly-owned subsidiary of CanArgo acquired by us in July 2001, negotiated and concluded with Ukrnafta, the Ukrainian State Oil Company, a Joint Investment Production Activity ( JIPA ) agreement in 1998 to develop the Bugruvativske Field located in Eastern Ukraine.

In 2003, due to the lack of progress with the implementation of the JIPA, and failure to reach a negotiated agreement with Ukrnafta, management reached the decision to dispose of its interest in the Bugruvativske project and withdraw from Ukraine. In negotiations with possible buyers in 2003 the Company believed the realizable value to be approximately \$250,000. Consequently, we recorded in 2003 a write-down in respect to the LVR deal and the acquisition of the Bugruvativske Field of approximately \$4,790,727, which reduced the carrying value of LVR to \$250,000 as of December 31, 2003. No gain or loss was recorded in 2004 upon the sale of LVR.

On May 28, 2004, we announced that pursuant to a signed agreement between CanArgo Acquisition Corporation, our wholly owned subsidiary, and Stanhope Solutions Ltd., we had completed a transaction to sell our interest in the Bugruvativske Field through the disposal of LVR for \$2,000,000. We received \$250,000 as an initial payment and will receive the remaining \$1,750,000 based upon certain production targets being achieved on the project. As of March 14, 2005, we had not received any further payments nor does management expect to receive any further

payment.

F - 34

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**Table of Contents**

The results of operations of LVR have been classified as discontinued for the year ended December 31, 2003.

The results of discontinued operations in respect of LVR consisted of the following for the years ending December 31:

|   | <b>2005</b> | <b>2004</b> | <b>2003</b>    |
|---|-------------|-------------|----------------|
| Income (Loss) Before Income Taxes and Minority Interest |             |             | (4,849,036)    |
| Net Income (Loss) from Discontinued Operation           | \$          | \$          | \$ (4,849,036) |

***Georgian American Oil Refinery***

In 2003, we approved a plan to dispose of our interest in the Georgian American Oil Refinery Limited ( GAOR ) as the refinery had remained closed since 2001 and neither we nor our partners could find a commercially viable option to putting the refinery back into operation. In February 2004, we reached an agreement with a local Georgian company to sell our 51% interest in GAOR for a nominal price of one US dollar and the buyers assumption of all the obligations and debts of GAOR to the State of Georgia including deferred tax liabilities of approximately \$380,000. The gain recorded on disposition of GAOR was \$330,923. In 2003, we announced publicly that we were re-evaluating our treatment in our 2001 and 2002 financial statements of our minority interest in GAOR. After reviewing the basis for our accounting for our interest in GAOR and after discussions with our former auditors we have concluded that our interest was properly accounted for in those statements.

The results of operations of GAOR have been classified as discontinued for all periods presented. The minority interest related to GAOR has not been reclassified for any of the periods presented, however net income from discontinued operations is disclosed net of taxes and minority interest. During 2003, a debit balance of \$1,274,895 in minority interest was written-off due to a change in the intentions of our minority interest owner and a plan to dispose of the asset. The plan to dispose of the asset also led to the write-off of an inter-company payable relating to oil sales purchased from Ninotsminda Oil Company Limited. These items have been respectively recorded in impairment of other assets and other income (expense) components of continuing operations.

The results of discontinued operations in respect of GAOR consisted of the following for the years ending December 31:

|   | <b>2005</b> | <b>2004</b>  | <b>2003</b>    |
|---|-------------|--------------|----------------|
| Operating Revenues                                      | \$          | \$           | \$             |
| Income (Loss) Before Income Taxes and Minority Interest |             |              | (1,485,705)    |
| Minority Interest in Loss                               |             | (523,968)    | (492,592)      |
| Net Income (Loss) from Discontinued Operation           | \$          | \$ (523,968) | \$ (1,978,297) |

***3-megawatt duel fuel power generator***

In 2003, we signed a sales agreement disposing of a 3-megawatt duel fuel power generator for \$600,000 and have received a non-refundable deposit of approximately \$300,000. The unit was shipped to the United States where it underwent tests in late 2004. On completion of these tests to the satisfaction of the buyer, we were to transfer title for this equipment and receive the final payment of \$300,000. Although the unit was successfully tested, the buyer failed to meet the sale contract terms resulting in the loss of its deposit in the third quarter, 2005. We are currently remarketing the generator.

The generator has been classified as Assets held for sale for all periods presented. The generator was impaired in 2003 by \$80,000 to reflect its fair value less cost to sell. The Company believes that the fair value established in 2003 is still valid. The Company's marketing efforts include a sales price less expected costs of any future sale to be in line with the fair value established in 2003. The results for the generator are the following for the years ending December 31:

|   | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|---|-------------|-------------|-------------|
| Income (Loss) Before Income Taxes and Minority Interest |             |             | (80,000)    |
| Net Income (Loss) from Discontinued Operation           | \$          | \$          | \$ (80,000) |

Gross consolidated assets in respect of the generator included in assets held for sale consisted of the following at December 31:

|                       | <b>2005</b> | <b>2004</b> |
|-----------------------|-------------|-------------|
| Assets held for sale: |             |             |
| Capital assets, net   | 600,000     | 600,000     |
|                       | \$ 600,000  | \$ 600,000  |



**Table of Contents****NOTE 21 SEGMENT AND GEOGRAPHICAL DATA**

During the year ended December 31, 2004 CanArgo disposed of its downstream activities in Georgia and all operations outside of Georgia.

As of December 31, 2004 Georgia represented the only geographical segment.

During the year ended December 31, 2005 CanArgo's continuing operations operated through one business segment, oil and gas exploration.

Operating revenues from continuing operations for the year ended December 31, 2005 by geographical area were as follows:

|   | <b>2005</b>  |
|---|--------------|
| Oil and Gas Exploration, Development And Production |              |
| Georgia   | \$ 7,582,375 |
| Republic of Kazakhstan                              |              |
| Total   | \$ 7,582,375 |

Operating (loss) income from continuing operations for the year ended December 31, 2005 by geographical area was as follows:

|   | <b>2005</b>     |
|---|-----------------|
| Oil and Gas Exploration, Development And Production |                 |
| Georgia   | \$ 1,168,653    |
| Republic of Kazakhstan                              | (729,179)       |
| Corporate and Other Expenses                        | (11,448,227)    |
| Total Operating Loss                                | \$ (11,008,753) |

Net (loss) income before minority interest from continuing operations for the year ended December 31, 2005 by geographical area was as follows:

|   | <b>2005</b>     |
|---|-----------------|
| Oil and Gas Exploration, Development And Production |                 |
| Georgia   | \$ 1,168,653    |
| Republic of Kazakhstan                              | (729,179)       |
| Corporate and Other Expenses                        | (12,774,788)    |
| Net (Loss) Income Before Minority Interest          | \$ (12,335,314) |

The segment and geographical data below is presented as of December 31, 2005.

Identifiable assets of continuing and discontinued operations as of December 31, 2005 by business segment and geographical area were as follows:

|                                   | <b>2005</b> |
|-----------------------------------|-------------|
| Corporate                         |             |
| Georgia                           | \$ 785,607  |
| Republic of Kazakhstan            |             |
| Western Europe (principally cash) | 27,730,478  |
| Total Corporate                   | 28,516,085  |

|   |                |
|---|----------------|
| Oil and Gas Exploration, Development and Production |                |
| Georgia   | 106,905,403    |
| Republic of Kazakhstan                              | 11,426,813     |
| Assets Held for Sale                                |                |
| Western Europe                                      | 600,000        |
| Total Identifiable Assets                           | \$ 147,448,301 |

F - 36

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**Table of Contents****NOTE 22 SUPPLEMENTAL CASH FLOW INFORMATION**

|   | <b>2005</b>  | <b>2004</b>  | <b>2003</b> |
|---|--------------|--------------|-------------|
| Non-cash transactions:  |              |              |             |
| Stock compensation expense  | \$ 2,374,578 | \$ 1,395,035 | \$ 276,507  |
| Interest expense and amortization of debt discount and loan fees  | 1,277,878    | 653,313      |             |
| Debt Extinguishment expense   |              | 118,400      |             |
| Non cash miscellaneous expense Financing fees   | 193,000      |              |             |
| Issuance of common stock for services   | 53,600       | 56,000       |             |
| Issuance of common stock for purchase of farm-in partner of Manavi well                                     |              |              | 6,600,000   |
| Issuance of common stock to buy out minority shareholders in CanArgo Norio                                  |              | 4,320,000    | 1,140,000   |
| Issuance of common stock pursuant to SEDA(1)  | 10,327,305   | 331,182      | 86,388      |
| Issuance of common stock for Consultancy agreement (Europa Oil Services Ltd) to acquire interest in Samgori |              | 3,880,000    |             |
| Issuance of common stock to acquire 55% remaining interest in Tethys Petroleum Investments, Ltd.            | 8,360,000    |              |             |

(1) The amount recorded in 2005 included the following

|  | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|--|-------------|-------------|-------------|
| Repayment of principal of \$1.5 million Cornell advance from 2004        | 1,500,000   |             |             |
| Repayment of principal of \$15 million Cornell promissory note from 2005 | 7,800,000   |             |             |
| Payment of offering costs with proceeds from SEDA                        | 994,757     |             |             |
| Payment of interest on the \$1.5 million Cornell advance from 2004       | 32,548      |             |             |
|  | 10,327,305  |             |             |

There was no cash paid for income taxes for the years ended December 31, 2005, 2004 and 2003.

|                                   |           |         |        |
|-----------------------------------|-----------|---------|--------|
| Reclassification temporary equity | 1,396,250 | 723,200 |        |
| Cash paid for interest expense    | 621,644   | 11,559  | 35,387 |

**NOTE 23 STOCK-BASED COMPENSATION PLANS**

At December 31, 2005, stock options and warrants had been issued from the following stock based compensation plans:

*1995 Long-Term Incentive Plan ( 1995 Plan )*. The 1995 Plan was approved by our stockholders at the annual meeting of stockholders held on February 6, 1996. This Plan allows for up to 7,500,000 shares of the Company's common stock to be issued to officers, directors, employees, consultants and advisors pursuant to the grant of stock based awards, including qualified and non-qualified stock, options, restricted stock, stock appreciation rights and other stock based performance awards. As of December 31, 2005, options to acquire an aggregate of 1,454,000 shares of common stock had been granted under this Plan and were outstanding, 1,214,000 of which are currently vested. The Plan expired on November 13, 2005. The awards have a term of

5 years from date of issue and vest immediately.

F - 37

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**Table of Contents**

*The Amended and Restated CanArgo Energy Inc. Plan (the CEI Plan ).* The CEI Plan (also known as the CAOG Plan) was adopted by the Company's Board of Directors on September 29, 1998. All Options outstanding under the Plan as of July 15, 1998 were assumed by the Company pursuant to the terms of an Amended and Restated Combination Agreement between the Company and CanArgo Energy Inc. dated February 2, 1998 which was approved by the Company's stockholders on July 8, 1998. This Plan allowed for up to 1,250,000 shares (of which only 988,000 shares were registered) of the Company's common stock to be issued to any director or full-time employee of the Company or a subsidiary of the Company. As of December 31, 2005, five year options to acquire an aggregate of 220,000 shares of common stock had been granted under this Plan and were outstanding, 145,000 of which are currently 100% vested. The awards have a term of 5 years from date of issue, each award having a special vesting provision defined in the award.

*Special Stock Options and Warrants.* This plan was created to allow the Company to retain and provide incentives to existing executive officers and directors and to allow retirement of new officers and directors following the Company's decision to relocate finance and administration functions from Calgary, Canada to London, England. As of December 31, 2005, special stock options and warrants issued under this plan exercisable for an aggregate of 535,000 shares were outstanding, subject to customary anti-dilution adjustments. The awards have term of 5 years from date of issue, each award having a vesting provision defined in the award.

*2004 Long Term Stock Incentive Plan ( 2004 Plan ).* The 2004 Plan was approved by our stockholders at the annual meeting of stockholders held on May 18, 2004. This Plan allows for up to 10,000,000 shares of the Company's common stock to be issued to officers, directors, employees, consultants and advisors pursuant to the grant of stock based awards, including qualified and non-qualified stock options, restricted stock, stock appreciation rights and other stock based performance awards. As of December 31, 2005, seven year options to acquire an aggregate of 7,836,000 shares of common stock had been granted under this Plan and were outstanding, 4,044,000 of which vested at that date. The 2004 Plan will expire on May 17, 2014, although the Board of Directors may terminate the 2004 Plan at any time prior to that date. The awards have a term of 7 years from date of issue and vest 1/3 for each year over 3 years beginning immediately.

The purpose of the Company's stock option plans is to further the interest of the Company by enabling officers, directors, employees, consultants and advisors of the Company to acquire an interest in the Company by ownership of its stock through the exercise of stock options and stock appreciation rights granted under its various stock option plans.

**Table of Contents**

A summary of the status of stock options granted under the 1995 Plan, CAOG Plan and special stock options and warrants is as follows:

|  | <b>Shares Issuable<br/>Under<br/>Outstanding<br/>Options</b> | <b>Weighted<br/>Average<br/>Exercise Price</b> |
|--|--|--|
| <b>Balance, January 1, 2003</b>        | 6,734,501  | 0.93   |
| Options (1995 Plan):                   |  |  |
| Increase in shares available for issue |  |  |
| Granted at market                      | 1,291,833  | 0.10   |
| Exercised                              |  |  |
| Expired                                | (132,500)  | 1.35   |
| CAOG Plan                              |  |  |
| Authorization:                         |  |  |
| Granted at market                      | 297,333  | 0.10   |
| Exercised                              |  |  |
| Expired                                | (205,000)  | 1.19   |
| <b>Balance, December 31, 2003</b>      | 7,986,167  | 0.26   |
| Options (1995 Plan):                   |  |  |
| Granted at market                      | 1,005,000  | 0.73   |
| Exercised                              | (3,120,667)  | 0.14   |
| Expired                                |  |  |
| CAOG Plan                              |  |  |
| Authorization:                         |  |  |
| Granted at market                      | 205,000  | 0.60   |
| Exercised                              | (399,000)  | 0.10   |
| Expired                                |  |  |
| Special Stock options and warrants:    |  |  |
| Increase in shares available for issue |  |  |
| Granted at market                      |  |  |
| Exercised                              | (291,667)  | 0.10   |
| Expired                                |  |  |
| Options (2004 Plan):                   |  |  |
| Increase in shares available for issue |  |  |
| Granted at market                      | 5,088,000  | 0.65   |
| Exercised                              |  |  |
| Expired                                |  |  |
| <b>Balance, December 31, 2004</b>      | 10,472,833   | 0.56   |
| Options (1995 Plan):                   |  |  |
| Granted at market                      |  |  |
| Exercised                              | (1,477,500)  | 0.13   |
| Expired                                |  |  |
| CAOG Plan                              |  |  |
| Authorization:                         |  |  |

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|  |                   |             |
|--|-------------------|-------------|
| Granted at market                      |                   |             |
| Exercised                              | (305,000)         | 0.22        |
| Expired                                |                   |             |
| Special Stock options and warrants:    |                   |             |
| Increase in shares available for issue |                   |             |
| Granted at market                      |                   |             |
| Exercised                              | (1,118,333)       | 0.83        |
| Expired                                | (275,000)         | 1.44        |
| Options (2004 Plan):                   |                   |             |
| Increase in shares available for issue |                   |             |
| Granted at market                      | 3,129,000         | 1.03        |
| Exercised                              | (381,000)         | 0.65        |
| Expired                                |                   |             |
| <b>Balance, December 31, 2005</b>      | <b>10,045,000</b> | <b>0.72</b> |

F - 39

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**Table of Contents**

Shares issuable upon exercise of vested options and the corresponding weighted average exercise price are as follows:

|                   | <b>Shares Issuable<br/>Under<br/>Exercisable<br/>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> |
|-------------------|--|--|
| December 31, 2003 | 7,337,167  | \$ 0.23  |
| December 31, 2004 | 6,480,833  | \$ 0.49  |
| December 31, 2005 | 5,938,000  | \$ 0.63  |

The weighted average fair value of options granted during the year was \$0.83, \$0.53 and \$0.10 for the years ended December 31, 2005, 2004 and 2003 respectively.

We used the Black-Scholes option pricing model using the following assumptions to determine the fair value of the options issued under our plans during the following years:

|                                 | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|---------------------------------|-------------|-------------|-------------|
| Stock price on date of grant    | \$ 0.97     | \$ 0.63     | \$ 0.10     |
| Risk free rate of interest      | 4.16%       | 3.65%       | 2.91%       |
| Expected life of warrant months | 84          | 82          | 48          |
| Dividend rate                   | 0%          | 0%          | 0%          |
| Historical volatility           | 109.49%     | 104.94%     | 80.47%      |

The numbers above reflect the weighted average for the options issued during the year.

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

|                                 | <b>Options Outstanding</b>   |  |  | <b>Options Exercisable</b>   |  |
|---------------------------------|--|--|--|--|--|
|                                 | <b>Number of<br/>Shares<br/>Outstanding at<br/>December 31,<br/>2005</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Term</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Number of<br/>Shares<br/>Exercisable at<br/>December 31,<br/>2005</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> |
| <b>Range of Exercise Prices</b> |  |  |  |  |  |
| \$0.10 to \$0.14                | 1,120,000  | 2.20   | 0.10   | 1,110,000  | 0.10   |
| \$0.15 to \$0.69                | 5,486,000  | 5.70   | 0.65   | 3,495,000  | 0.65   |
| \$0.70 to \$1.47                | 3,439,000  | 6.37   | 1.03   | 1,333,000  | 1.02   |
| \$0.10 to \$1.47                | 10,045,000   | 5.54   | 0.72   | 5,938,000  | 0.63   |

**NOTE 24 RELATED PARTY TRANSACTIONS**

A company owned by significant employees of Georgian British Oil Company Ninotsminda until February 2005 and the same employees of CanArgo Georgia Limited from February 1, 2005 provided certain equipment, office and storage space to Georgian British Oil Company Ninotsminda until February 2005 and to CanArgo Georgia Limited from February 1, 2005. Total rental payments for this equipment, office and storage space in 2005 were \$281,024 (\$107,946 in 2004). In 2004, the same company provided additional services to Georgian British Oil Company Ninotsminda in accordance with a farm-in agreement in respect of the Manavi well for the value of \$450,000. No additional services were provided in 2005.

Of the 50% of CanArgo Standard Oil Products Limited not held by CanArgo prior to its disposal in December, 2004, 41.65% was held by Standard Oil Products, an unrelated third party entity, and 8.35% held by an individual, Mr Levan Pkhakadze, who is one of the founders of Standard Oil Products and is an officer and director of CanArgo Standard Oil Products. The majority of refined product purchased by CanArgo Standard Oil Products for resale at its



petrol stations is purchased from a company controlled by Standard Oil Products who together with and an individual shareholder, own the 50% interest in CanArgo Standard Oil Products not held by CanArgo.

Dr. David Robson, Chief Executive Officer, provides all of his services to CanArgo through Vazon Energy Limited of which he is the sole owner and Managing Director. In addition management services agreements exists between CanArgo and Vazon Energy whereby the services of Dr. Robson, Mrs. Landles (Corporate Secretary & Executive Vice President) and Mr. Battey (Chief Financial Officer), amongst others, are provided to CanArgo. Approximately \$930,000 was paid to Vazon in respect of these services.

F - 40

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**Table of Contents**

On June 7, 2005, CanArgo made an offer to acquire 55% of the ordinary share capital of Tethys which was held by Provincial and Vando for consideration of 11,000,000 CanArgo common shares. On June 9, 2005 CanArgo issued 5,500,000 shares to Provincial, of which Russell Hammond (one of our non-executive directors) is Investment Advisor in connection with this transaction.

Mr. Russell Hammond, a non-executive director of CanArgo, is also an Investment Advisor to Provincial Securities Limited who became a minority shareholder in the Norio and North Kumisi Production Sharing Agreement through a farm-in agreement to the Norio MK72 well. On September 4, 2003 we concluded a deal to purchase Provincial Securities Limited's minority interest in CanArgo Norio Limited by a share swap for shares in CanArgo. Provincial Securities Limited received 2,234,719 shares of CanArgo common stock in relation to the transaction (see Note 14). Provincial Securities Limited also had an interest in Tethys Petroleum Investments Limited which was sold in June 2005 to us by a share exchange for shares in CanArgo. Provincial Securities Limited received 5,500,000 shares of CanArgo common stock in relation to the transaction, Transactions with affiliates or other related parties including management of affiliates are to be undertaken on the same basis as third party arms-length transactions.

Transactions with affiliates are reviewed and voted on solely by non-interested members of the board of directors.

**NOTE 25 SUBSEQUENT EVENTS*****Loan with Detachable Warrants***

On February 14, 2006 we exercised the option forcing conversion of the loan from Salahi Ozturk advanced pursuant to the amended and restated loan and warrant agreement dated August 27, 2004 ( Amended Agreement ) into 1,521,739 shares of our common stock.

***Samgori PSC***

On February 17, 2006 we issued a press release announcing that our subsidiary, CanArgo Samgori Limited ( CSL ), was not proceeding with further investment in the Samgori PSC and associated farm-in, and accordingly we terminated our interest in the Samgori PSC with effect from February 16, 2006. The decision by CSL not to proceed with further investment under the current farm-in arrangements was due to the inability of CSL's partner in the project, Georgian Oil Samgori Ltd, to provide its share of funding to further the development of the Field. We consider that there would have been insufficient time to meet the commitments under the Agreement with NPL and we were not prepared to fund the project, which is not without risk, on a 100% basis without different commercial terms and an extension to the commitment period. It was not possible to negotiate a satisfactory position on either matter. CSL has been informed that, given this, NPL have indicated that they now intend to exercise their right to take back 100% of the Contractor Share in the Samgori PSC from GOSL and, accordingly, effective February 16, 2006 we have withdrawn from the Samgori PSC. CSL had been sharing in both costs and revenues from ongoing production since April 2004, and had approximately broken-even on a cash basis on the project. In 2005 the Samgori PSC added approximately \$0.8 million in net revenues to CanArgo. Since 2004, we have capitalized costs of approximately \$1.25 million in relation to the Samgori PSC which are part of our cost pool which will be amortized and depleted in accordance with CanArgo's usual accounting policies for oil and gas properties.

***Financing***

On March 3, 2006, we announced that we had entered into a \$13,000,000 private placement with a small group of accredited investors ( Note holders ) of senior subordinated convertible guaranteed notes (the Subordinated Notes ) and two year warrants to purchase an aggregate of 13,000,000 shares of common stock ( Warrants ).

The Subordinated Notes are convertible in whole or in part into CanArgo common stock at a price of \$1.37 per share, subject to certain anti-dilution adjustments, and will mature on September 1, 2009. Subject to the consent of the Senior Secured Note holders, CanArgo may call the Subordinated Notes from March 1, 2007 at an initial price of 105% of par, declining 1% every six months. Interest will be payable in cash at 3% per annum until December 31, 2006, 10% per annum thereafter. The Subordinated Notes will be subordinated to CanArgo's existing issue of Senior Secured Notes and guaranteed on a subordinated basis by CanArgo's material subsidiaries.

The Subordinated Note holders will have the right (as an alternative) until March 3, 2007 (or until 30 days after receipt of the consent of the Senior Secured Note holders is obtained if such conversion is prevented under the terms of the Senior Secured Notes) to convert their notes into shares of common stock of TPI, with a nominal value of £0.10 per share at a conversion price per share based on a formula determined by dividing the sum of \$52 million plus the

amount of any unreimbursed amounts advanced by the Company

F - 41

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**Table of Contents**

to TPI by 100,000 in the Subordinated Note holders Relevant Percentages (as defined in the Note Purchase Agreement). At the time of any TPI conversion any further advances (in excess of the \$13 million) from CanArgo to TPI may be, at CanArgo's discretion, either repaid, or converted into TPI equity based on a valuation of \$52 million [plus the amount of any unreimbursed amounts advanced by the Company to TPI], with the Subordinated Note holders having the ability to maintain their equity position by providing further funding on a pro-rata basis.

The Warrants will be exercisable in whole or in part for CanArgo common stock at an exercise price of \$1.37 per share, subject to adjustment. The expiration date of the Warrants may be accelerated at CanArgo's option in the event that the Manavi M12 appraisal well in the Georgia (which is currently being drilled) indicates, by way of an independent engineering report, sustainable production potential, if developed, in excess of 7,500 barrels of oil per day.

The proceeds are required by the agreement to be used to fund the development of the Kyzylloi Gas Field in the Kazakhstan and on the commitment exploration programs in Kazakhstan through TPI, which holds CanArgo's Kazakhstan assets and therefore these funds will not be available for the Company for general working capital.

In connection with the offering the Company entered into a registration rights agreement with the note holders and agreed to register the shares of common stock underlying the warrants and the convertible note (in the event that they are converted into shares of the Company's common stock). The registration rights agreement gives the note holders the right to piggy back or demand registration rights and the Company must use its best efforts to have the registration declared effective within 120 days of any demand by the note holders. In addition, the agreement requires the Company have a registration agreement covering the shares underlying the note and the warrants declared effective no later than December 31, 2006 if not demanded earlier by the note holders. The Company is required under the registration rights agreement to maintain the effectiveness of the registration for a period of the earlier of two years or when the securities are no longer restricted securities. The registration rights agreement does not contain penalty provisions in the event the Company fails to register or maintain an effective registration statement covering the resale of the underlying common stock. The Company is only required to register for resale shares of its common stock, and does not have to register shares of its wholly owned subsidiary, TPI, in the event that the note holders elect to convert into shares of TPI as defined in the agreement.

On March 14, 2006, we entered into an agreement ( Termination Agreement ) with Europa Oil Services Limited ( Europa ), an unaffiliated company, formally terminating the consultancy agreement between CanArgo and Europa dated January 8, 2004. Under the terms of the consultancy agreement, CanArgo had an outstanding obligation to issue up to 12 million shares of CanArgo common stock to Europa upon certain production targets being met from future developments under the Samgori PSC. With effect from February 16, 2006, we have withdrawn from the Samgori PSC. Pursuant to the terms of the Termination Agreement the parties accordingly agreed that the consultancy agreement had terminated with effect from February 16, 2006. CanArgo has not incurred any material early termination penalties as a result of the termination of the consultancy agreement.

**Table of Contents****NOTE 25 QUARTERLY FINANCIAL DATA (Unaudited)**

|  | <b>2005<br/>First<br/>Quarter</b> | <b>2005<br/>Second<br/>Quarter</b> | <b>2005<br/>Third<br/>Quarter</b> | <b>2005<br/>Fourth<br/>Quarter</b> |
|--|-----------------------------------|------------------------------------|-----------------------------------|------------------------------------|
| Operating revenue from continuing operations                                       | \$ 1,333,467                      | \$ 1,232,532                       | \$ 2,580,847                      | \$ 2,435,419                       |
| Operating income (Loss) from continuing operations                                 | (2,206,718)                       | (2,209,444)                        | (2,591,715)                       | (4,000,876)                        |
| Net income (loss) from continuing operations                                       | (2,473,476)                       | (2,256,483)                        | (2,941,930)                       | (4,663,425)                        |
| Net income (loss) from discontinued operations, net of taxes and minority Interest |                                   |                                    |                                   |                                    |
| Cumulative effect of change in Accounting policy                                   |                                   |                                    |                                   |                                    |
| Net income (loss)  | (2,473,476)                       | (2,256,483)                        | (2,941,930)                       | (4,663,425)                        |
| Comprehensive income (loss)  | (2,473,476)                       | (2,256,483)                        | (2,941,930)                       | (4,663,425)                        |
| Net income (loss) per common share basic and diluted from continuing operations    | (0.01)                            | (0.01)                             | (0.01)                            | (0.02)                             |
| Net income (loss) per common share basic and diluted from discontinued operations  |                                   |                                    |                                   |                                    |
| Net income (loss) per common share basic and diluted                               | (0.01)                            | (0.01)                             | (0.01)                            | (0.02)                             |
|  | <b>2004<br/>First<br/>Quarter</b> | <b>2004<br/>Second<br/>Quarter</b> | <b>2004<br/>Third<br/>Quarter</b> | <b>2004<br/>Fourth<br/>Quarter</b> |
| Operating revenue from continuing operations                                       | \$3,360,471                       | \$ 2,078,553                       | \$ 2,007,838                      | \$ 2,127,658                       |
| Operating income (Loss) from continuing operations                                 | 974,195                           | (992,604)                          | (1,401,093)                       | (1,534,698)                        |
| Net income (loss) from continuing operations                                       | 1,032,016                         | (1,405,230)                        | (2,644,174)                       | (1,834,860)                        |
| Net income (loss) from discontinued operations, net of taxes and minority Interest | 490,364                           | (43,539)                           | 95,384                            |                                    |
| Cumulative effect of change in Accounting policy                                   |                                   |                                    |                                   |                                    |
| Net income (loss)  | 1,522,380                         | (1,448,769)                        | (2,548,790)                       | (1,834,860)                        |
| Comprehensive income (loss)  | 1,984,516                         | (1,691,382)                        | (2,458,082)                       | (1,998,628)                        |
| Net income (loss) per common share basic and diluted from Continuing operations    | 0.01                              | (0.01)                             | (0.02)                            | (0.01)                             |
| Net income (loss) per common share basic and diluted from discontinued operations  |                                   |                                    |                                   |                                    |

|   |      |        |        |        |
|---|------|--------|--------|--------|
| Net income (loss) per common share<br>basic and diluted | 0.01 | (0.01) | (0.02) | (0.01) |
|---|------|--------|--------|--------|

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F - 43

**Table of Contents****NOTE 26 SUPPLEMENTAL OIL AND GAS DISCLOSURE (Unaudited)  
ESTIMATED NET QUANTITIES OF OIL AND GAS RESERVES**

Users of this information should be aware that the process of estimating quantities of proved and proved developed natural gas and crude oil reserves is very complex, requiring significant subjective decisions in the evaluation of all available geological, engineering and economic data for each reservoir. The data for a given reservoir may also change substantially over time as a result of numerous factors including, but not limited to, additional development activity, evolving production history and continual reassessment of the viability of production under varying economic conditions. Consequently, material revisions to existing reserve estimates occur from time to time. Although every reasonable effort is made to ensure that reserve estimates reported represent the most accurate assessments possible, the significance of the subjective decisions required and variances in available data for various reservoirs make these estimates generally less precise than other estimates presented in connection with financial statement disclosures.

Proved reserves are estimated quantities of natural gas, crude oil and condensate that geological and engineering data demonstrate, with reasonable certainty, to be recoverable in future years from known reservoirs with existing equipment under existing economic and operating conditions.

Proved developed reserves are proved reserves that can be expected to be recovered through existing wells with existing equipment and under existing economic and operating conditions.

No major discovery or other favorable or adverse event subsequent to December 31, 2004 is believed to have caused a material change in the estimates of proved or proved developed reserves as of that date.

***Oil and gas reserves***

The following tables set forth our net proved oil and gas reserves, including the changes therein, and net proved developed reserves at December 31, 2005, as estimated by the independent petroleum engineering firm, Oilfield Production Consultants Limited for Georgia:

## Net Proved Developed and Undeveloped Reserves Oil (In Thousands of Barrels):

|   | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|---|-------------|-------------|-------------|
| January 1   | 4,076       | 4,395       | 2,901       |
| Purchase of properties                              |             |             |             |
| Revisions of previous estimates                     | (410)       | (76)        | 1,951       |
| Extension, discoveries, other additions             |             |             |             |
| Production  | (152)       | (243)       | (457)       |
| Disposition of properties                           |             |             |             |
| December 31   | 3,514       | 4,076       | 4,395       |
| Net Proved Developed Oil Reserves December 31, 2005 | 2,013       |             |             |

## Net Proved Developed and Undeveloped Reserves Gas (In Million Cubic Feet) Georgia

|   | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|---|-------------|-------------|-------------|
| January 1   | 1,703       | 1,941       | 2,414       |
| Purchase of properties                              |             |             |             |
| Revisions of previous estimates                     |             | (66)        | (197)       |
| Extension, discoveries, other additions             |             |             |             |
| Production  | (104)       | (172)       | (276)       |
| Disposition of properties                           |             |             |             |
| December 31   | 1,599       | 1,703       | 1,941       |
| Net Proved Developed Oil Reserves December 31, 2005 | 858         |             |             |





**Table of Contents**

Net proved oil reserves in Georgia consisted of the following at December 31:

|                            | 2005                               |  | 2004                               |  |
|----------------------------|------------------------------------|--|------------------------------------|--|
|                            | Oil<br>Reserves<br>Gross<br>(MSTB) | PSC<br>Entitlement<br>Volumes<br>(MSTB)(1) | Oil<br>Reserves<br>Gross<br>(MSTB) | PSC<br>Entitlement<br>Volumes<br>(MSTB)(1) |
| Proved Developed Producing | 3,151                              | 2,013                                      | 3,264                              | 2,122                                      |
| Proved Undeveloped         | 2,348                              | 1,501                                      | 3,007                              | 1,954                                      |
| Total Proven               | 5,499                              | 3,514                                      | 6,271                              | 4,076                                      |

Net proved gas reserves in Georgia consisted of the following at December 31:

|                            | 2005                               |  | 2004                               |  |
|----------------------------|------------------------------------|--|------------------------------------|--|
|                            | Gas<br>Reserves<br>Gross<br>(MMCF) | PSC<br>Entitlement<br>Volumes<br>(MMCF)(1) | Gas<br>Reserves<br>Gross<br>(MMCF) | PSC<br>Entitlement<br>Volumes<br>(MMCF)(1) |
| Proved Developed Producing | 1,343                              | 858  | 1,462                              | 950  |
| Proved Undeveloped         | 1,159                              | 741  | 1,158                              | 753  |
| Total Proven               | 2,502                              | 1,599                                      | 2,620                              | 1,703                                      |

(1) PSC Entitlement Volumes attributed to CanArgo are calculated using the economic interest method applied to the terms of the production sharing contract. PSC Entitlement Volumes are those produced volumes which, through the production sharing contract, accrue to the benefit of Ninotsminda Oil Company after

deduction of Georgian Oil shares which includes all Georgian taxes, levies and duties. As a result of CanArgo's interest in Ninotsminda Oil Company, these volumes accrue to the benefit of CanArgo for the recovery of capital, repayment of operating costs and share of profit.

The following tables set forth our net proved oil and gas reserves, including the changes therein, and net proved developed reserves at December 31, 2005, as estimated by the independent petroleum engineering firm, Oilfield Production Consultants Limited for Kazakhstan:

***Republic of Kazakhstan***

| Net Proved Developed and Undeveloped Reserves | Gas (In Million Cubic Feet) | Kazakhstan  |             |
|---|-----------------------------|-------------|-------------|
|   | <b>2005(1)</b>              | <b>2004</b> | <b>2003</b> |
| January 1                                     |                             |             |             |
| Purchase of properties                        | 29,699                      |             |             |
| Revisions of previous estimates               |                             |             |             |
| Extension, discoveries, other additions       | 2,995                       |             |             |
| Production                                    |                             |             |             |
| Disposition of properties                     |                             |             |             |
| December 31                                   | 32,694                      |             |             |
| Net Proved Developed Oil Reserves             |                             |             |             |
| December 31, 2005                             |                             |             |             |

**Table of Contents**

Net proved gas reserves in the Kazakhstan consisted of the following at December 31:

|                            | 2005(1)                   |                                   | 2004                      |                                |
|----------------------------|---------------------------|-----------------------------------|---------------------------|--------------------------------|
|                            | Gas Reserves Gross (MMCF) | PSC Entitlement Volumes (MMCF)(2) | Gas Reserves Gross (MMCF) | PSC Entitlement Volumes (MMCF) |
| Proved Developed Producing |                           |                                   |                           |                                |
| Proved Undeveloped         | 32,694                    | 32,694                            |                           |                                |
| Total Proven               | 32,694                    | 32,694                            |                           |                                |

(1) On June 9, 2005 we acquired 100% ownership of Tethys Petroleum Investments Limited (TPI) and as at 31 December 2005, this entity is now consolidated in our financial statements. TPI through its 100% owned Kazakhstan subsidiary TKL (Tethys Kazakhstan Limited), holds 70% ownership rights in BN Munai LLP, a Kazakh registered company that has the 100% rights to the Kyzylloi field. Prior to the Company's 100% ownership, we chose to use our equity ownership

percentage as the basis for recording our portion of our investees' loss. No reserves were assessed before we owned 100% of TPI.

- (2) TPI through its 100% owned Kazakhstan subsidiary TKL, holds 70% ownership rights in BN Munai LLP, a Kazakh registered company that has the 100% rights to the Kyzylloi field. Under a loan agreement with BN Munai LLP, TKL will take 100% of the net cash flow of the Kyzylloi development until its loan is repaid. This loan is currently in excess of net cash flows generated from the production of gross proven reserves.

***Results of operations for oil and gas producing activities***

Results of operations for oil and gas producing activities, all in Georgia, for 2005, 2004 and 2003 are as follows:

| <b>Year Ended December 31, 2005</b>      | <b>Eastern Europe</b> |
|--|-----------------------|
| Revenues                                 | \$ 7,582,375          |
| Operating expenses                       | 2,281,434             |
| Depreciation, depletion and amortization | 3,275,553             |
| Operating Income (Loss)                  | 2,025,388             |
| Income tax provision                     |                       |

|   |              |
|---|--------------|
| Results of Operations for Oil and Gas<br>Producing Activities | \$ 2,025,388 |
|---|--------------|

|  |                       |
|--|-----------------------|
| <b>Year Ended December 31, 2004</b>      | <b>Eastern Europe</b> |
| Revenues                                 | \$ 9,574,520          |
| Operating expenses                       | 2,320,756             |
| Depreciation, depletion and amortization | 2,298,218             |
| Operating Income (Loss)                  | 4,955,546             |
| Income tax provision                     |                       |

|   |              |
|---|--------------|
| Results of Operations for Oil and Gas<br>Producing Activities | \$ 4,955,546 |
|---|--------------|

|  |                       |
|--|-----------------------|
| <b>Year Ended December 31, 2003</b>      | <b>Eastern Europe</b> |
| Revenues                                 | \$ 7,882,870          |
| Operating expenses                       | 1,051,905             |
| Depreciation, depletion and amortization | 2,634,459             |
| Operating Income (Loss)                  | 4,196,506             |
| Income tax provision                     |                       |

|   |              |
|---|--------------|
| Results of Operations for Oil and Gas<br>Producing Activities | \$ 4,196,506 |
|---|--------------|

Georgia was the only country where we had oil and gas producing activities for 2005, 2004 and 2003. Although we have Proved Undeveloped reserves in Kazakhstan as at December 31, 2005, we have not yet completed the infrastructure to produce these reserves.

**Table of Contents*****Costs incurred for oil and gas property acquisition, exploration and development activities***

Costs incurred for oil and gas property acquisition, exploration and development activities for 2005, 2004 and 2003 are as follows:

| <b>Year Ended December 31, 2005</b> | <b>Eastern Europe(1)</b> |
|-------------------------------------|--------------------------|
| Property Acquisition                |                          |
| Unproved(2)                         | \$ 9,408,644             |
| Proved                              | 1,034,294                |
| Exploration                         | 16,133,410               |
| Development                         | 20,959,051               |
| Total costs incurred                | \$ 47,535,399            |

| <b>Year Ended December 31, 2004</b> | <b>Eastern Europe</b> |
|-------------------------------------|-----------------------|
| Property Acquisition                |                       |
| Unproved(2)                         | \$ 3,416,900          |
| Proved                              | 3,880,000             |
| Exploration                         | 1,757,010             |
| Development                         | 6,588,137             |
| Total costs incurred                | \$ 15,642,047         |

| <b>Year Ended December 31, 2003</b> | <b>Eastern Europe</b> |
|-------------------------------------|-----------------------|
| Property Acquisition                |                       |
| Unproved(2)                         | \$                    |
| Proved                              |                       |
| Exploration                         | (329,998)             |
| Development                         | 5,200,614             |
| Total costs incurred                | \$ 4,870,616          |

(1) On June 9, 2005 we acquired 100% ownership of Tethys Petroleum Investments Limited (TPI) and this entity as at 31 December 2005, is now consolidated in our financial statements. TPI through its 100%

owned  
Kazakhstan  
subsidiary TKL  
(Tethys  
Kazakhstan  
Limited), holds  
70% ownership  
rights in BN  
Munai LLP, a  
Kazakh  
registered  
company that  
has the 100%  
rights to the  
Kyzylloi field.  
Prior to 100%  
ownership, we  
chose to use our  
equity ownership  
percentage as the  
basis for  
recording our  
portion of our  
investees' loss.

- (2) These amounts represent costs incurred by CanArgo and excluded from the amortization base until proved reserves are established or impairment is determined.

***Aggregate Capitalized Costs***

Capitalized costs relating to Oil and Gas Activities is as follows:

|  | <b>December 31, 2005</b> | <b>Georgia</b>        | <b>Republic of<br/>Kazakhstan</b> |
|--|--------------------------|-----------------------|-----------------------------------|
|  |                          | <b>(In thousands)</b> |                                   |
| Proved   |                          | \$ 81,555             | \$ 1,897                          |
| Unproved   |                          | 41,115                | 9,530                             |
| Total capitalized Costs                              |                          | 122,670               | 11,427                            |
| Accumulated depreciation, depletion and amortization |                          | (28,213)              |                                   |
| Net capitalized costs                                |                          | \$ 94,457             | 11,427                            |

| <b>December 31, 2004</b>                             | <b>Georgia</b>        | <b>Republic<br/>of<br/>Kazakhstan</b> |
|--|-----------------------|---------------------------------------|
|  | <b>(In thousands)</b> |                                       |
| Proved   | \$ 61,458             | \$                                    |
| Unproved   | 25,103                |                                       |
| Total capitalized Costs                              | 86,561                |                                       |
| Accumulated depreciation, depletion and amortization | (23,382)              |                                       |
| Net capitalized costs                                | \$ 63,179             |                                       |

F - 47

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**Table of Contents**

(1) On June 9, 2005 we acquired 100% ownership of Tethys Petroleum Investments Limited (TPI) and as at December 31, 2005 this entity is now consolidated in our financial statements. TPI through its 100% owned Kazakhstan subsidiary TKL (Tethys Kazakhstan Limited), holds 70% ownership rights in BN Munai LLP, a Kazakh registered company that has the 100% rights to the Kyzylloi field. Prior to 100% ownership, we chose to use our equity ownership percentage as the basis for recording our portion of our investees' loss.

***STANDARDIZED MEASURE OF DISCOUNTED FUTURE NET CASH FLOWS RELATING TO PROVED OIL AND GAS RESERVES***

The following information has been developed utilizing procedures prescribed by SFAS No. 69 *Disclosure about Oil and Gas Producing Activities* ( SFAS 69 ) and based on crude oil reserve and production volumes estimated by the Company's engineering staff. It may be useful for certain comparative purposes, but should not be solely relied upon in evaluating the Company or its performance. Further, information contained in the following table should not be considered as representative of realistic assessments of future cash flows, nor should the Standardized Measure of

Discounted Future Net Cash Flows be viewed as representative of the current value of the Company.

CanArgo believes that the following factors should be taken into account in reviewing the following information: (1) future costs and selling prices will probably differ from those required to be used in these calculations; (2) actual rates of production achieved in future years may vary significantly from the rate of production assumed in the calculations; (3) selection of a 10% discount rate is arbitrary and may not be reasonable as a measure of the relative risk inherent in realizing future net oil and gas revenues; and (4) future net revenues may be subject to different rates of income taxation.

Under the Standardized Measure, future cash inflows were estimated by applying period-end oil prices adjusted for fixed and determinable escalations to the estimated future production of period-end proven reserves. Future cash inflows were reduced by estimated future development, abandonment and production costs based on period-end costs in order to arrive at net cash flow before tax. Future income tax expenses has been computed by applying period-end statutory tax rates to aggregate future pre-tax net cash flows, reduced by the tax basis of the properties involved and tax carryforwards. Use of a 10% discount rate is required by SFAS No. 69.

Management does not rely solely upon the following information in making investment and operating decisions. Such decisions are based upon a wide range of factors, including estimates of probable as well as proven reserves and varying price and cost assumptions considered more representative of a range of possible economic conditions that may be anticipated.

***Standardized measure of discounted future net cash flows relating to proved oil and gas reserves***

The standardized measure of discounted future net cash flows relating to proved oil and gas reserves is as follows:

| <b>December 31, 2005</b>                                 | <b>Georgia</b>        | <b>Republic of<br/>Kazakhstan(2)</b> |
|--|-----------------------|--------------------------------------|
|  | <b>(In thousands)</b> |                                      |
| Future cash inflows                                      | \$ 179,340            | \$ 27,180                            |
| Less related future:                                     |                       |                                      |
| Production costs   | 26,406                | 3,060                                |
| Development and abandonment costs                        | 18,808                | 11,000                               |
| Future net cash flows before income taxes                | 134,126               | 13,120                               |
| Future income taxes                                      | (6,567)               | (7,220)                              |
| Future net cash flows(1)                                 | 127,559               | 5,900                                |
| 10% annual discount for estimating timing of cash flows  | 51,056                | 2,733                                |
| Standardized measure of discounted future net cash flows | \$ 76,503             | \$ 3,167                             |

**Table of Contents**

| <b>December 31, 2004</b>                                 | <b>Georgia</b>        | <b>Republic<br/>of<br/>Kazakhstan</b> |
|--|-----------------------|---------------------------------------|
|  | <b>(In thousands)</b> |                                       |
| Future cash inflows                                      | \$ 112,894            | \$                                    |
| Less related future:                                     |                       |                                       |
| Production costs   | 27,643                |                                       |
| Development and abandonment costs                        | 10,200                |                                       |
| Future net cash flows before income taxes                | 75,051                |                                       |
| Future income taxes                                      | (38)                  |                                       |
| Future net cash flows(1)                                 | 75,013                |                                       |
| 10% annual discount for estimating timing of cash flows  | 28,602                |                                       |
| Standardized measure of discounted future net cash flows | \$ 46,411             | \$                                    |

(1) In Georgia, future cash flows are based on PSC Entitlement Volumes attributed to CanArgo using the economic interest method applied to the terms of the production sharing contract. PSC Entitlement Volumes are those produced volumes which, through the production sharing contract, accrue to the benefit of Ninotsminda Oil Company Limited after deduction of Georgian Oil's share which includes all

Georgian taxes, levies and duties. As a result of our interest in Ninotsminda Oil Company Limited, these volumes accrue to the benefit of CanArgo for the recovery of capital, repayment of operating costs and share of profit. In Kazakhstan, Tethys Petroleum Investment Limited (TPI) through its 100% owned Kazakhstan subsidiary TKL (Tethys Kazakhstan Limited), holds 70% ownership rights in BN Munai LLP, a Kazakh registered company that has the 100% rights to the Kyzylloi field. Under a loan agreement with BN Munai LLP, TKL will take 100% of the net cash flow of the Kyzylloi development until its loan is repaid. This loan is currently in excess of net cash flows

generated from the production of gross proven reserves.

- (2) On June 9, 2005 we acquired 100% ownership of Tethys Petroleum Investments Limited (TPI) and as at December 31, 2005 this entity is now consolidated in our financial statements. TPI through its 100% owned Kazakhstan subsidiary TKL (Tethys Kazakhstan Limited), holds 70% ownership rights in BN Munai LLP, a Kazakh registered company that has the 100% rights to the Kyzylloi field. Prior to 100% ownership, we chose to use our equity ownership percentage as the basis for recording our portion of our investees loss.

A summary of the changes in the standardized measure of discounted future net cash flows applicable to proved oil and gas reserves for Georgia is as follows:

|             | <b>December 31</b> |             |
|-------------|--------------------|-------------|
| <b>2005</b> | <b>2004</b>        | <b>2003</b> |

|   |           | <b>In thousands</b> |           |
|---|-----------|---------------------|-----------|
| Beginning of year   | \$ 46,411 | \$ 37,530           | \$ 14,107 |
| Purchase (sale) of reserves in place  |           |                     |           |
| Revisions of previous estimates   | (13,209)  | (4,251)             | 24,576    |
| Development costs incurred during the period  | 27,437    | 6,588               | 324       |
| Additions to proved reserves resulting from Extensions, discoveries and improved Recovery |           |                     |           |
| Accretion of discount   | 4,641     | 1                   |           |
| Sales of oil and gas, net of production costs   | (3,495)   | (6,004)             | (6,829)   |
| Net change in sales prices, net of Production costs                                       | 56,113    | 18,057              | 8,317     |
| Changes in production rates (timing) and other(1)   | (41,396)  | (5,510)             | (2,965)   |
| Net increase (decrease)   | 30,091    | 8,881               | 23,423    |
| End of year   | \$ 76,502 | \$ 46,411           | \$ 37,530 |

(1) Other changes include a reduction in our cash flows resulting from a change in our oil entitlement as governed by the Ninotsminda PSC primarily due to increased oil prices used in the standardized measure of discounted future net cash flow for 2005.

**Table of Contents**

|   | <b>December 31</b>  |             |             |
|---|---------------------|-------------|-------------|
|   | <b>2005(1)</b>      | <b>2004</b> | <b>2003</b> |
|   | <b>In thousands</b> |             |             |
| Beginning of year   | \$                  | \$          | \$          |
| Purchase (sale) of reserves in place  | 2,644               |             |             |
| Revisions of previous estimates   | 523                 |             |             |
| Development costs incurred during the period  |                     |             |             |
| Additions to proved reserves resulting from Extensions, discoveries and improved Recovery |                     |             |             |
| Accretion of discount   |                     |             |             |
| Sales of oil and gas, net of production costs   |                     |             |             |
| Net change in sales prices, net of Production costs                                       |                     |             |             |
| Changes in production rates (timing) and other  |                     |             |             |
| Net increase (decrease)   | 3,167               |             |             |
| End of year   | \$ 3,167            | \$          | \$          |

(1) On June 9, 2005 we acquired 100% ownership of Tethys Petroleum Investments Limited (TPI) and as at 31 December 2005, this entity is now consolidated in our financial statements. TPI through its 100% owned Kazakhstan subsidiary TKL (Tethys Kazakhstan Limited), holds 70% ownership rights in BN Munai LLP, a Kazakh registered company that has the 100% rights to the

Kyzyloi field.  
Prior to 100%  
ownership, we  
chose to use our  
equity ownership  
percentage as the  
basis for  
recording our  
portion of our  
investees' loss.  
No reserves were  
assessed before  
we owned 100%  
of TPI.

F - 50