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Consolidated Financial Statements  
*(Expressed in US dollars)*

# **INTEROIL CORPORATION**

Years ended December 31, 2003 and 2002

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## AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of InterOil Corporation as at December 31, 2003 and 2002 and the consolidated statements of earnings, cash flows and shareholders' equity for the years then ended. 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 audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance 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 statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



KPMG  
Sydney, Australia

March 4, 2004, except as to note 13 which  
is as at March 24, 2004

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# InterOil Corporation

Consolidated Balance Sheets  
December 31, 2003 and 2002

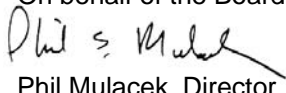
(Expressed in United States dollars)

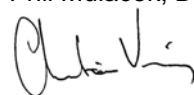
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	2003	2002
	\$	\$
<b>Assets</b>		
Current assets:		
Cash and cash equivalents (note 2)	9,313,682	3,288,539
Temporary investments (note 11)	24,723,572	7,105,701
Other assets	311,093	-
Other receivables	175,491	503,859
Prepaid expenses	488,532	80,359
	<hr/> 35,012,370	<hr/> 10,978,458
Plant and equipment (note 4)	202,309,465	121,217,700
Oil and gas properties (note 10)	23,018,015	2,878,703
	<hr/> <b>260,339,850</b>	<hr/> <b>135,074,861</b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	5,835,583	6,744,515
Due to related parties (note 5)	1,478,751	2,784,560
Current portion of secured loan (note 9)	9,000,000	-
Foreign currency forward contracts	-	678,648
	<hr/> 16,314,334	<hr/> 10,207,723
Secured loan (note 9)	74,000,000	31,000,000
Indirect participation interest (note 10)	16,600,000	-
Non-controlling interest (note 3)	6,467,496	6,490,398
Shareholders' equity:		
Share capital (note 6)	157,449,200	94,120,609
Other paid in capital	540,222	769,964
Accumulated deficit	(11,031,402)	(7,513,833)
	<hr/> 146,958,020	<hr/> 87,376,740
	<hr/> <b>260,339,850</b>	<hr/> <b>135,074,861</b>
Commitments (note 12)		

See accompanying notes to consolidated financial statements.

On behalf of the Board

  
Phil Mulacek, Director

  
Christian Vinson, Director

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# InterOil Corporation

Consolidated Statements of Earnings  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

	2003	2002
	\$	\$
<b>Revenue</b>		
Interest	246,912	373,015
Other	12,368	11,211
	259,280	384,226
<b>Expenses</b>		
Administrative and general	2,337,255	2,241,911
Management fees for prior periods waived (note 5)	(840,000)	-
Exploration costs	164,992	92,673
Legal and professional fees	1,421,390	464,253
Foreign exchange	678,774	(1,094,787)
	3,762,411	1,704,050
(Loss) before income taxes and non-controlling interest	(3,503,131)	(1,319,824)
Income tax (expense) benefit (note 7)	(37,339)	(1,446)
(Loss) before non-controlling interest	(3,540,470)	(1,321,270)
Non-controlling interest	22,901	5,383
<b>Net (loss)</b>	<b>(3,517,569)</b>	<b>(1,315,887)</b>
<b>Basic (loss) per share</b> (note 8)	<b>(0.16)</b>	<b>(0.06)</b>
<b>Diluted (loss) per share</b> (note 8)	<b>(0.16)</b>	<b>(0.06)</b>

*See accompanying notes to consolidated financial statements*

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## InterOil Corporation

Consolidated Statements of Cash Flows  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

	2003 \$	2002 \$
<b>Cash flows from operating activities</b>		
Net (loss)	(3,517,569)	(1,315,887)
Non-controlling interest	(22,901)	(5,383)
Change in non-cash operating working capital	286,540	189,140
	<u>(3,253,930)</u>	<u>(1,132,130)</u>
<b>Cash flows from investing activities</b>		
Expenditure on oil and gas properties	(15,824,292)	(606,886)
Purchase of plant and equipment	(88,005,351)	(38,765,401)
Redemption/(purchase) of temporary investments	(17,617,871)	9,894,299
	<u>(121,447,514)</u>	<u>(29,477,988)</u>
<b>Cash flows from financing activities</b>		
Proceeds from borrowings	52,000,000	30,240,000
Proceeds from indirect participation interest	16,300,000	
Other net (payments)/advances to/from related party (note 5)	(776,902)	2,100,000
Proceeds from issue of securities	63,203,489	891,222
	<u>130,726,587</u>	<u>33,231,222</u>
Increase in cash and cash equivalents	6,025,143	2,621,104
Cash and cash equivalents, beginning of year	3,288,539	667,435
	<u>9,313,682</u>	<u>3,288,539</u>
<b>Cash and cash equivalents, end of year (note 2)</b>		
<b>Supplemental cash flow information</b>		
Interest paid	4,138,290	1,948,043
Interest received	149,631	840,337

*See accompanying notes to consolidated financial statements*

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## InterOil Corporation

Consolidated Statements of Shareholders' Equity  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

	2003	2002
	\$	\$
<b>Share capital</b>		
At beginning of year	94,120,609	92,808,387
Issue of capital stock	63,328,591	1,312,222
At end of year (note 6)	157,449,200	94,120,609
<b>Additional paid in capital</b>		
At beginning of year	769,964	-
Stock compensation	-	769,964
Options converted to capital stock	(229,742)	-
At end of year	540,222	769,964
<b>Accumulated deficit</b>		
At beginning of year	(7,513,833)	(6,197,946)
Net loss for year	(3,517,569)	(1,315,887)
At end of year	(11,031,402)	(7,513,833)
<b>Shareholders' equity at end of year</b>	<b>146,958,020</b>	<b>87,376,740</b>

*See accompanying notes to consolidated financial statements*

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

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InterOil Corporation's (the "Company" or "InterOil") primary business interest is the development of an oil refinery (the "Project") in Papua New Guinea ("PNG"). The Company is also engaged in oil and gas exploration and development activity in PNG.

## 1. Significant accounting policies

### (a) Basis of presentation

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles on a going concern basis which presumes the realisation of assets and discharge of liabilities in the normal course of business for the foreseeable future.

The consolidated financial statements of the Company include the accounts of SP InterOil, LDC ("SPI") (99.9%), EP InterOil Limited ("EPI") (98.66%), SPI Exploration & Production Corporation (100%), SPI Distribution Limited (100%), InterOil Australia Pty Ltd (100%) and their subsidiaries.

### (b) Cash and cash equivalents

Cash and cash equivalents consist of cash on deposit, bank demand deposits and bank term deposits with an original maturity date of three months or less at the date of acquisition. Cash and cash equivalents are carried at cost. Accrued interest is included in other receivables.

### (c) Plant and equipment

The Company is considered to be in the construction and pre-operating stage of development of the oil refinery in PNG. Project costs, net of any recoveries, incurred during this pre-operating stage are being capitalised as part of plant and equipment. Administrative and general costs are expensed as incurred. Plant and equipment are recorded at cost. Development costs and the costs of acquiring or constructing support facilities and equipment are capitalised. Interest costs relating to the construction and pre-operating stage of the development project prior to commencement of commercial operations are capitalised as part of the cost of such plant and equipment. Plant and equipment will be depreciated over their useful lives, commencing on the date of achieving commercial operations.

### (d) Oil and gas properties

The Company follows the successful efforts method of accounting for oil and gas exploration and development activities. Direct acquisition costs of development properties as well as geological and geophysical costs associated with these properties are capitalised. Costs of development and exploratory wells that result in additions to proven reserves are also capitalised.

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

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Capitalised costs are accumulated and carried forward where they are expected to be recouped through successful development, or by sale, or where exploration and evaluation activities have not yet reached a stage to allow reasonable assessment regarding the existence of economical reserves. Capitalised costs for producing wells will be subject to depletion on the units-of-production method.

(e) Foreign currency

Monetary items denominated in foreign currency are translated to United States dollars at exchange rates in effect at balance sheet date and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Revenue and expense items are translated at rates in effect at the time of the transactions. Foreign exchange gains or losses are included in income.

(f) Derivative financial instruments

During the year, the Company was party to certain derivative financial instruments. Foreign currency forward contracts and put options are used to manage foreign currency exposures on construction contract expenditures. The forward contracts are not recognized in the consolidated financial statements on inception. Gains and losses on foreign currency forward contracts for specific commitments are recognised in the same period as the foreign currency expenditures to which they relate. Gains and losses which relate to forward contracts for general commitments are recognised as they occur.

(g) Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment. A valuation allowance is provided against any portion of a future tax asset which will more likely not be recovered.

(h) Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the year. Actual results could differ from those estimates.

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

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(i) Earnings per share

Basic earnings per share are computed by dividing net earnings by the weighted average shares outstanding during the reporting period. Diluted earnings per share are computed similar to basic earnings per share except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of stock options, if dilutive. The number of additional shares is calculated by assuming that outstanding stock options were exercised and that the proceeds from such exercises were used to acquire shares of common stock at the average market price during the reporting period.

(j) Stock based compensation

The Company has a stock-based compensation plan, which is described in note 6. The Company accounts for all stock-based payments to non-employees, and employee awards that are direct awards of stock, call for settlement in cash or other assets, or are stock appreciation rights that call for settlement by the issuance of equity instruments, granted on or after January 1, 2002, using the fair value based method. No compensation cost is recorded for all other stock-based employee compensation awards. Consideration paid by employees on the exercise of stock options is recorded as share capital and contributed surplus. The Company discloses the pro forma effect of accounting for these awards under the fair value based method.

Under the fair value based method, stock-based payments to non-employees are measured at the fair value of the consideration received, or the fair value of the equity instruments issued, or liabilities incurred, whichever is more reliably measurable. The fair value of stock-based payments to non-employees is periodically re-measured until counterparty performance is complete, and any change therein is recognised over the period and in the same manner as if the Company had paid cash instead of paying with or using equity instruments. The cost of stock-based payments to non-employees that are fully vested and non-forfeitable at the grant date is measured and recognised at that date.

Under the fair value based method, compensation cost attributable to awards to employees that are direct awards of stock appreciation rights that call for settlement by the issuance of equity instruments is measured at fair value at the grant date and recognised over the vesting period. Compensation cost attributable to awards to employees that call for settlement in cash or other assets is measured at intrinsic value and recognised over the vesting period. Changes in intrinsic value between the grant date and the measurement date result in a change in the measure of compensation cost. For awards that vest at the end of the vesting period, compensation cost is recognised on a straight-line basis; for awards that vest on a graded basis, compensation cost is recognised on a pro rata basis over the vesting period.

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

## (k) Restoration and closure

Estimated costs of future dismantlement, site restoration and abandonment of properties are provided based upon current regulations and economic circumstances at year end. Management estimates there are no legal obligations associated with the retirement of the refinery or with its normal operations relating to future restoration and closure costs. The refinery is being built on land leased from the Independent State of Papua New Guinea. The lease expires on July 26, 2097 and does not outline any terms for restoration or closure costs. As a result, no provision has been raised.

## 2. Cash and cash equivalents

The components of cash and cash equivalents are as follows:

	2003	2002
	\$	\$
Cash on deposit	6,306,202	3,206,084
Bank demand deposits	-	3,131
Bank term deposits	-	79,324
Treasury bills	3,007,480	-
	9,313,682	3,288,539

Included in the 2003 treasury bills are 9,701,548 Kina (2002 – nil), the currency of PNG, representing a US dollar equivalent of \$3,007,480 (2002 – nil).

Included in the 2002 bank term deposits and bank demand deposits are 308,896 Kina representing a US dollar equivalent of \$79,324.

## 3. Non-controlling interest

On September 11, 1998 Enron Papua New Guinea Ltd (“Enron”), SPI’s former joint venture partner, exercised its option (pursuant to a January 1997 joint venture agreement with SPI) to terminate the joint venture agreement. Consequently, SPI purchased Enron’s voting, non-participating shares in EPI for a nominal amount. The capital structure of the joint venture was composed of voting, non-participating shares and non-voting, participating shares. Enron no longer actively participates in the development of the Project but continues to be a non-voting participating shareholder in EPI. SPI now holds all voting non-participating shares issued from EPI and has sole responsibility for managing the Project. Enron does not hold any transfer or conversion rights into shares of InterOil Corporation.

At December 31, 2003 SPI holds 98.66% (2002 – 98.55%) of the non-voting participating shares issued from EPI.

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

## 4. Plant and equipment

	2003 \$	2002 \$
Equipment, at cost	48,854,559	48,048,167
Project development costs, at cost	147,601,586	71,349,129
Capitalised borrowing costs, at cost	5,853,320	1,820,404
	202,309,465	121,217,700

Included in equipment above are barges with a carrying amount of \$5,599,467 at December 31, 2003. On December 20, 2001, the Company arranged a US\$3 million loan facility secured by the barges and assets held by Petroleum Independent and Exploration Corporation ("P.I.E."), a company related by virtue of common directorships, and Mr. Phil Mulacek, a director of the Company. At December 31, 2003 the total owing under this facility amounted to \$1,478,750. Interest rates applicable to amounts drawn on this loan facility are 5.75%.

## 5. Related parties

P.I.E. is the general manager of SPI. During 2003, P.I.E. was reimbursed for sponsor's legal, accounting and reporting costs of \$150,000 relating to SPI. P.I.E. also waived \$840,000 of management fees due to it for prior periods and this has been reflected in the Consolidated Statement of Earnings in 2003. Amounts due to related parties of \$1,478,751 (2002 - \$2,784,560) are amounts due to P.I.E. P.I.E. advanced \$2,900,000 to the InterOil Group in 2002 and the Company has repaid \$1,421,249 of this loan as at December 31, 2003. This loan bears interest of 5.75% pa and is due for repayment within the next twelve months. During the year, the Company incurred interest on this loan amounting to \$105,374 (2002 - \$127,639).

Breckland Limited provides technical and advisory services to the Company and/or subsidiaries on normal commercial terms. This party is related by virtue of common directorships. Amounts paid to Breckland Limited during the year totalled \$131,250 (2002 - \$204,522).

Amounts due to Directors at December 31, 2003 totalled \$30,500 (2002 - \$26,000) and are included in accounts payable and accrued liabilities.

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

(Expressed in United States dollars)

## 6. Share capital

The authorised share capital of the Company consists of an unlimited number of common shares with no par value.

	Number of shares	\$
Balance, January 1, 2002	20,186,870	92,808,387
Shares issued for cash	399,073	1,312,222
Balance, December 31, 2002	20,585,943	94,120,609
Shares issued for cash	3,817,500	61,060,640
Shares issued for debt	31,240	316,359
Shares issued on exercise of options	381,278	1,951,592
Balance, December 31, 2003	24,815,961	157,449,200

## Stock options

Options are exercisable on a 1:1 basis. Options are issued at no less than market price to directors, staff and contractors. Options vest at various dates in accordance with the applicable option agreement, have an exercise period of three to five years assuming continuous employment by the InterOil Group and may be exercised at any time after vesting within the exercise period. Upon resignation or retirement, vested options must be exercised within 30 days for employees and 90 days for directors.

The following summarises the stock options outstanding:

	2003		2002	
	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
Outstanding at beginning of year	1,510,085	5.48	1,165,600	4.00
Granted	257,802	14.09	762,585	6.53
Exercised	(381,278)	4.62	(393,000)	3.26
Expired	(23,344)	5.75	(25,100)	5.68
Outstanding at end of year	1,363,265	7.55	1,510,085	5.48

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

(Expressed in United States dollars)

2003	Options issued and outstanding			Options exercisable (vesting)	
	Range of exercise prices \$	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
	\$2.75 to \$5.00	537,463	4.36	528,463	4.36
	\$5.01 to \$8.00	450,000	5.88	365,000	5.59
	\$8.01 to \$12.00	279,700	11.24	107,000	11.65
	\$12.01 to \$23.50	96,102	22.49	25,000	21.82
	\$2.75 to \$23.50	1,363,265	7.55	1,025,463	5.98

The fair value of the 257,802 (2002 - 762,585) options granted subsequent to January 1, 2003 has been estimated at the date of grant in the amount of \$1,087,131 (2002 - \$976,900) using a Black-Scholes option pricing model with the following assumptions: risk-free interest rate of 3.2%; dividend yield of nil; volatility factor of the expected market price of the Company's common stock of 45%; and a weighted average expected life of the options of three years. An amount of \$530,794 (2002 - \$206,936) has been recognized as a proforma compensation expense which includes a fair value of \$13,583 for options granted in 2002 which have vested in 2003. For purposes of pro forma disclosure, the estimated fair value of the options is expensed over the options' vesting period, which is identified in the individual's option agreement.

The following is the Company's pro forma earnings with the fair value method applied to all options issued during the year and options vested in current year that were issued in the prior year:

	2003	
	Loss \$	Loss per share \$
Loss for the year	3,517,569	(0.16)
Pro forma compensation expense related to fair value of stock options issued	530,794	(0.02)
Pro forma loss for the year	4,048,363	(0.18)

The loss per share disclosed above would not change had the shares under option been exercised.

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

(Expressed in United States dollars)

## 7. Income taxes

Income tax expense differs from the amount that would be computed by applying the Federal and provincial statutory income tax rates of 35.12% (2002 – 38.62%) to income before income taxes and non-controlling interest. The reasons for the differences are as follows:

	2003	2002
	\$	\$
Computed tax (benefit)	(1,230,300)	(509,716)
Increase (decrease) resulting from:		
Tax rate differential on foreign subsidiaries	143,502	188,788
Non-taxable items	2,744,745	(183,802)
Future income tax benefit not brought to account for:		
Tax losses	836,142	346,526
Temporary differences	(2,498,773)	158,204
Over provision for tax in prior years	-	(332)
Other taxes	42,023	1,778
	37,339	1,446

Non taxable items represents income/(loss) in foreign jurisdictions with a zero tax rate.

The tax effects of temporary differences that give rise to significant portions of the future tax assets and future tax liabilities at December 31, 2003 and 2002 are presented below:

	2003	2002
	\$	\$
Future tax assets:		
Carried forward tax losses	2,558,406	1,366,190
Temporary differences	(1,194,314)	671,323
	1,364,092	2,037,513
Less valuation allowance	(1,364,092)	(2,037,513)
Net future tax asset (liability)	-	-

No tax benefits have been recorded in respect of losses and temporary differences incurred by the Company and its subsidiaries since such are in foreign jurisdictions that do not provide tax relief.

Carried forward tax losses in PNG expire within seven years.  
During the year the Company paid withholding taxes in PNG of \$11,034 (35,593 Kina) and income taxes in Australia of \$53,857 (A\$71,907).

# InterOil Corporation

Notes to Consolidated Financial Statements  
Years ended December 31, 2003 and 2002

*(Expressed in United States dollars)*

## 8. Loss per share

Loss per share is computed on the weighted average number of shares on issue during the year of 22,649,924 (2002 – 20,462,167). Had the shares under option, referred to in note 6, been exercised in 2003 and 2002, the loss per share would not have changed.

## 9. Secured loan:

On June 12, 2001, EPI entered into a loan agreement with the Overseas Private Investment Corporation (“OPIC”) to secure an \$85 million project financing facility. As of December 31, 2003 disbursements totalling \$83 million has been received, and the remaining balance of \$2 million remains available. EPI has committed to pay OPIC an annual commitment fee of 0.5% of the undrawn amount, and a one time facility fee in the amount of 1.0% of the total project financing facility.

The loan expires June 30, 2013 and half yearly repayments of \$4.5 million commence on June 30, 2004. The agreement contains certain financial covenants including the maintenance of minimum levels of tangible net worth and limitations on the incurrence of additional indebtedness. The interest rate is equal to the treasury cost applicable to each promissory note outstanding plus the OPIC spread. The OPIC spread is 3.0% per annum prior to project completion and 3.5% per annum on and after project completion. The weighted average interest rate for the year ended December 31, 2003 was 6.70%.

## 10. Oil and gas properties

	2003	2002
	\$	\$
PPL 238, at cost	21,192,055	1,193,910
Other exploration properties, at cost	1,825,960	1,684,793
	23,018,015	2,878,703

The above Petroleum Prospecting Licenses (“PPLs”) are in Papua New Guinea. The Company is undertaking phase one of an exploration program in these PPLs, evaluation with a drilling program underway on PPL 238. The recoupment of expenditure carried forward in respect of these PPLs depends on successful development and commercial exploitation or sale of mineral resources which may be discovered in those properties.

During the year, the Company provided an indirect interest in the Company’s phase one exploration program within the area governed by Petroleum Prospecting License PPL 238 to PNG Energy Investors LLC, for \$7,650,000. This interest is subject to the terms of the agreement dated April 3, 2003 between the Company and PNG Energy Investors LLC, under which all or part of \$5,400,000 may be converted to common shares in the Company at a price of C\$15 per share, and an agreement dated April 16, 2003 between the same parties under which all or part of \$2,250,000 may be converted to common shares of the Company at a price of C\$17 per share. Alternatively, all or part of the indirect participation interest may be converted to debt due in December 2006. Should neither of these conversion rights be exercised, the indirect participation interest in the

# InterOil Corporation

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*(Expressed in United States dollars)*

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drilling program will be maintained and distributions will be paid in accordance with the agreements.

The Company provided an indirect interest in the Company's phase one exploration program within the area governed by Petroleum Prospecting Licences 236, 237 and 238 to PNG Drilling Ventures Limited for \$12,185,000. The amount paid by this interest at December 31, 2003 is \$8,950,000 and the remaining \$3,235,000 was received on March 22, 2004. This interest is subject to the terms of the agreement dated July 21, 2003 between the Corporation and PNG Drilling Ventures Limited, under which all or part of \$11,620,000 may be converted to common shares in the Company at a price no less than C\$20.85. Alternatively, all or part of \$1,969,000 of the indirect participation interest may be converted to debt due in December 2005 and December 2006. Should neither of these conversion rights be exercised, the indirect participation interest in the drilling program will be maintained and distributions will be paid in accordance with the agreements.

## 11. Financial instruments

With the exception of cash and cash equivalents and short term investments, all financial assets are non interest bearing. Cash and cash equivalents earned average interest rates of 1.5% (2002 – 3.5%). Temporary investments of \$24,626,154 (2002 – nil) in a Managed Trust investment and \$97,417 (2002 – nil) in rolling term deposits earn an average rate of interest of 1.5%. A \$97,417 held in term deposits is restricted and unavailable to the Company while Petroleum Prospecting Licences 236 and 237 are being utilised by the Company. At December 31, 2003, the temporary investments had a fair market value of \$24,739,069.

Credit risk is minimised as all cash amounts and certificates of deposit are held with large banks which have acceptable credit ratings determined by a recognised rating agency.

The Company had no outstanding foreign currency forward contracts at December 31, 2003. At December 31, 2002, the Company had contracts valued at \$62,000,000 to acquire Australian dollars to hedge Australian dollar amounts payable pursuant to the refinery construction. These hedging contracts have all matured during 2003. At December 31, 2003, the Company has no unrealised gain or loss resulting from hedge contracts (December 31, 2002 – unrealised loss \$4,001,462). An unrealised exchange loss of \$678,648 was recognised on the balance sheet for contracts in excess of specific commitments at December 31, 2002.

As a requirement of the hedging contracts a collateral arrangement was entered into whereby as at December 31, 2003 an amount of US\$38,040 (2002 - \$7,105,701) was held on deposit and had been pledged in favour of the provider of the hedge and recorded as a temporary investment. Funds required to be held on deposit as collateral have reduced over time as project expenditure is undertaken and the foreign currency forward contracts are closed out. These amounts had reduced to nil as at January 31, 2004.

To define a maximum potential amount payable on the outstanding hedge contracts, the Company acquired Australia dollar put options for total premiums of \$218,530 (year ended December 2002 - \$85,000). The maturity dates and nominal amounts of the put

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options coincided with the exercise dates and nominal amounts of the outstanding hedge contracts. There were no outstanding put options at December 31, 2003

The carrying values of cash and cash equivalents, other receivables, accounts payable and accrued liabilities and amounts due to related parties approximate fair values due to the short term maturities of these instruments. It is not possible to determine the fair value of amounts due to related parties. The carrying amount of the secured loan approximates its fair value.

## **12. Commitments**

InterOil has Petroleum Prospecting and Retention Licence expenditure commitments of \$2,838,000 (2002 - \$4,100,000) which relate to various holdings in PNG for the next year.

Clough Niugini Limited has been contracted to build the oil refinery in Napa Napa under a US\$91,000,000 (A\$171 million) fixed price construction contract. The company has commitments remaining under this contract of approximately \$1,900,000 as at December 31, 2003 (2002 - \$71,000,000).

## **13. Subsequent event**

InterOil announced in March 2004 that it had entered into a share sale agreement with BP plc to acquire BP's PNG subsidiary, BP Papua New Guinea Limited, including all its petroleum distribution assets and operations in Papua New Guinea. This transaction is valued at US\$11.3 million for assets and inventory. The effective date of this transaction is March 1, 2004 (subject to receiving the necessary regulatory approvals).

InterOil received the outstanding balance of \$3,235,000 from PNG Drilling Ventures Limited on March 22, 2004.