

# **JSC KKM Operating Company**

## **Financial Statements**

*Year ended December 31, 2005  
with Independent Auditor's Report*

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**INDEPENDENT AUDITORS' REPORT**

To the Shareholders of JSC KKM Operating Company

We have audited the accompanying financial statements of JSC KKM Operating Company (the "Company"), which comprise the balance sheet as at December 31, 2005 and the statement of income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

***Auditors' Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Opinion***

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental information about oil and gas reserve quantities is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in our audit of the financial statements and, accordingly, we express no opinion on it.



April 25, 2007

**BALANCE SHEET**

As at December 31, 2005

<i>In thousands of tenge</i>	<b>Notes</b>	<b>2005</b>	<b>2004</b>
<b>ASSETS</b>			
<b>Non-current assets</b>			
Intangible assets	4	42,232	31,774
Property, plant and equipment	5	5,114,324	2,655,587
Other non-current assets	6	130,466	414,133
<b>Total non-current assets</b>		<b>5,287,022</b>	<b>3,101,494</b>
<b>Current assets</b>			
Non interest bearing loan to a shareholder	7	420,000	—
Inventories	8	76,923	352,030
Trade receivables	9	500,754	—
Advances paid	10	432,855	1,231,403
Prepaid income tax		171,190	150,018
Other current assets	11	128,347	104,905
Bank deposits	12	21,500	684,897
Available-for-sale securities	13	344,000	—
Cash and cash equivalents	14	54,304	130,998
<b>Total current assets</b>		<b>2,149,873</b>	<b>2,654,251</b>
<b>TOTAL ASSETS</b>		<b>7,436,895</b>	<b>5,755,745</b>
<b>EQUITY AND LIABILITIES</b>			
<b>Equity</b>			
Charter capital	15	1,500,000	1,500,000
Treasury shares	15	(150,000)	—
Treasury shares-additional paid-in capital		30,337	—
Retained earnings		3,290,713	1,926,540
<b>Total equity</b>		<b>4,671,050</b>	<b>3,426,540</b>
<b>Non-current liabilities</b>			
Long-term interest-bearing loans	16	656,426	531,737
Abandonment and site restoration liabilities	17	68,758	69,172
Deferred tax liability	25	178,847	65,234
<b>Total non-current liabilities</b>		<b>904,031</b>	<b>666,143</b>
<b>Current liabilities</b>			
Trade accounts payable	18	317,530	56,844
Due to related parties		21,124	—
Short-term interest-bearing loans	16	1,273,711	1,583,121
Provisions	29	187,462	—
Other current liabilities		61,987	23,097
<b>Total current liabilities</b>		<b>1,861,814</b>	<b>1,663,062</b>
<b>TOTAL EQUITY AND LIABILITIES</b>		<b>7,436,895</b>	<b>5,755,745</b>

*The accounting policies and explanatory notes on pages 5 through 27 form an integral part of these financial statements.*

Signed and authorized for release on behalf of the Board of the Company:

Acting President

Chief Accountant



*D. Smagulov*

*L. Bainiyazova*

**STATEMENT OF INCOME****For the year ended December 31, 2005**

<i>In thousands of tenge</i>	<b>Notes</b>	<b>2005</b>	<b>2004</b>
Revenues		<b>4,611,039</b>	3,573,162
Cost of sales	19	<b>(852,955)</b>	(949,629)
<b>Gross profit</b>		<b>3,758,084</b>	2,623,533
Exploration costs	20	—	(148,147)
Geological and geophysical expenses	21	<b>(63,487)</b>	(49,171)
General and administrative expenses	22	<b>(906,469)</b>	(172,835)
Selling expenses	23	<b>(552,958)</b>	(531,531)
Other operating expenses, net		<b>(19,871)</b>	(6,972)
<b>Operating profit</b>		<b>2,215,299</b>	1,714,877
Interest expense, net	24	<b>(268,614)</b>	(166,839)
Foreign exchange gain, net		<b>(19,783)</b>	76,840
<b>Profit before income tax</b>		<b>1,926,902</b>	1,624,878
Income tax expenses	25	<b>(562,729)</b>	(491,590)
<b>Profit for the year</b>		<b>1,364,173</b>	1,133,288
Basic earnings per share, KZT	26	<b>910</b>	755

*The accounting policies and explanatory notes on pages 5 through 27 form an integral part of these financial statements.*

**STATEMENT OF CASH FLOWS**  
**For the year ended December 31, 2005**

<i>In thousands of tenge</i>	<i>Notes</i>	<b>2005</b>	<b>2004</b>
<b>Cash flows from operating activities:</b>			
Profit before income tax		1,926,902	1,624,878
Adjustments for:			
Depreciation and amortization		393,428	443,250
Provision charge		187,462	
Provision for obsolete inventories		5,295	9,766
Finance costs		268,614	166,839
(Gain) / Loss from disposal of property, plant and equipment		—	8,441
Write-off of property, plant and equipment		—	150,678
Loss from disposal of securities available-for-sale		—	621
Unrealized foreign exchange gain		4,223	(76,840)
<b>Operating profit before working capital changes</b>		<b>2,785,924</b>	<b>2,327,633</b>
(Increase) / decrease in operating assets:			
Inventories		269,812	(236,200)
Trade receivables		(500,754)	30,376
Advances paid and non-interest bearing loan		378,548	(992,933)
Other current assets		(23,442)	9,451
Increase / (decrease) in operating liabilities:			
Due to related parties		21,124	(186,913)
Trade and other payables		260,686	(46,895)
Other current liabilities		38,890	(46,345)
<b>Cash generated from operations</b>		<b>3,230,788</b>	<b>858,174</b>
Interest paid		(274,666)	(74,757)
Income tax paid		(470,288)	(639,485)
<b>Net cash flows provided by operating activities</b>		<b>2,485,834</b>	<b>143,932</b>
<b>Cash flows from investing activities:</b>			
Purchase of property, plant and equipment		(2,900,097)	(1,148,791)
Proceeds from sale of property, plant and equipment		49,584	3,381
Purchase of intangible assets		(12,110)	—
Purchase of investments securities available-for-sale		(344,000)	—
Proceeds from sale of securities available-for-sale		—	98,649
Changes in other non-current assets		(73,273)	—
Advances to vendors for the acquisition of property, plant, and equipment		250,270	(307,103)
Changes in bank deposits		663,397	(684,897)
Interest received		8,141	2,835
<b>Net cash used in investing activities</b>		<b>(2,358,088)</b>	<b>(2,035,926)</b>
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of shares		—	1,186,096
Proceeds from loans received		2,389,571	3,743,564
Repayment of loans		(2,591,846)	(3,015,588)
Usage of the liquidation fund		(2,165)	—
<b>Net cash (used in) provided by financing activities</b>		<b>(204,440)</b>	<b>1,914,072</b>
Net increase in cash and cash equivalents		(76,694)	22,078
Cash and cash equivalents at the beginning of the year	14	130,998	108,920
<b>Cash and cash equivalents at the end of the year</b>	<b>14</b>	<b>54,304</b>	<b>130,998</b>
<b>Supplemental cash flow information:</b>			
Non-cash additions to property, plant and equipment		—	47,227

*The accounting policies and explanatory notes on pages 5 through 27 form an integral part of these financial statements.*

**STATEMENT OF CHANGES IN EQUITY**

For the year ended December 31, 2005

<i>In thousands of tenge</i>	Charter capital	Treasury shares	Treasury shares- additional paid-in capital	Retained earnings	Total Equity
As at December 31, 2003	313,904	—	—	793,252	1,107,156
Profit for the year	—	—	—	1,133,288	1,133,288
Issue of share capital	1,186,096	—	—	—	1,186,096
As at December 31, 2004	1,500,000	—	—	1,926,540	3,426,540
<b>Purchase of treasury shares</b>	—	<b>(150,000)</b>	<b>30,337</b>	—	<b>(119,663)</b>
Profit for the year	—	—	—	1,364,173	1,364,173
<b>As at December 31, 2005</b>	<b>1,500,000</b>	<b>(150,000)</b>	<b>30,337</b>	<b>3,290,713</b>	<b>4,671,050</b>

*The accounting policies and explanatory notes on pages 5 through 27 form an integral part of these financial statements.*

**NOTES TO THE FINANCIAL STATEMENTS****For the year ended December 31, 2005**

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*In thousands of tenge***1. GENERAL INFORMATION**

JSC KKM Operating Company (the “Company”) was established on April 4, 2004 as a joint stock company by the merging of Kumsai Munay LLP, Mortuk Munay LLP and Kokgide Munay LLP, which were fully owned by JSC KKM Holding at the date of the merger. The Company is engaged in exploration and production of oil from properties within the Republic of Kazakhstan.

The Company signed a subsoil use contract with the Government of Kazakhstan on December 25, 1995 and holds licenses for hydrocarbon exploration and production (the “Licenses”) on Kokgide, Kumsai and Mortuk fields; along with these Licenses the Company concluded agreements with the Government of Kazakhstan on exploration and development of these oil fields (the “Agreements”), which subsequently superseded these Licenses. Further the Agreements were amended in December 2004 and April 2005, and as the result, the rights to explore and produce oil for the Mortuk field were extended till mid 2026, and for Kokgide and Kumsai fields till mid 2027.

The Company’s registered legal address is: 4 A Levitan Street, Aktobe, Republic of Kazakhstan. As at December 31, 2005 and December 31, 2004 the Company employed 281 and 295 employees, respectively.

The financial statements of the Company for the year ended 31 December 2005 were authorized for issue by the Board of Directors of the Company on April 25, 2007.

**Political and economic environment**

The Kazakh economy continues to display certain traits consistent with that of a market economy in transition. These characteristics have in the past included higher than normal historic inflation, lack of liquidity in the capital markets, and the existence of currency controls, which cause the national currency to be illiquid outside of Kazakhstan. The continued success and stability of the Kazakh economy will be significantly impacted by the government’s continued actions with regard to supervisory, legal, and economic reforms.

Meanwhile, the Company’s operations and financial position will continue to be affected by Kazakh political developments including the application of existing and future legislation and tax regulations.

As at December 31, 2005, management of the Company does not believe that any material matters exist relating to the developing markets and evolving fiscal and regulatory environment in Kazakhstan, including current pending or future governmental claims and demands, which would require adjustment to the accompanying financial statements in order for those statements not to be misleading.

**2. BASIS OF PREPARATION**

In accordance with Kazakh legislation, all joint stock companies have to adopt International Financial Reporting Standards (“IFRS”) from January 1, 2005. The Company elected January 1, 2004 to be its date of transition to IFRS and prepared these financial statements for the year ended December 31, 2005, in accordance with IFRS.

Under IFRS 1, “First-time Adoption of International Reporting Standards”, the Company elected to measure its property, plant and equipment at the date of transition to IFRS at its fair value and use that fair value as the deemed cost from that date. These financial statements have been prepared in accordance with IFRS on a going concern basis, which assumes the realization of assets and discharge of liabilities in the normal course of business within the foreseeable future.

The financial statements have been prepared under the historical cost convention.

**Measurement currency**

The Kazakhstan Tenge (“Tenge” or “KZT”) is utilized as the shareholders, the managers and the regulators measure the Company’s performance in KZT. In addition, the KZT, being the national currency of the Republic of Kazakhstan, is the currency that reflects the economic substance of the underlying events and circumstances relevant to the Company. All values are rounded to the nearest thousand except when otherwise indicated.

Transactions in other currencies are treated as transactions in foreign currencies.



**NOTES TO THE FINANCIAL STATEMENTS (continued)**

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*In thousands of tenge*

**2. BASIS OF PREPARATION (continued)****Use of estimates**

The preparation of the financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates relate to the useful lives of property, plant and equipment, allowance for bad and doubtful debts, allowance for obsolete and slow moving inventories and deferred taxation. Actual results could differ from those estimates.

**Foreign currency translation**

Monetary assets and liabilities denominated in foreign currencies are translated at exchange rates prevailing at the balance sheet dates. Transactions denominated in foreign currencies are recorded at the exchange rate prevailing at the date of the transaction. Any exchange gains and losses arising from assets and liabilities denominated in foreign currencies subsequent to the date of the underlying transaction are credited or charged to operations.

Prior to January 1, 2003 daily currency exchange rates established by the National Bank of Kazakhstan were used as the official currency exchange rates in Kazakhstan. Starting from January 1, 2003, the weighted average currency exchange rates established by the Kazakhstan Stock Exchange ("KASE") are used as the official currency exchange rates in Kazakhstan.

Currency exchange rate of KASE as of December 31, 2005 was equivalent to 133.77 Tenge to 1 US dollar and was used to translate monetary assets and liabilities denominated in US dollars as at December 31, 2005 (2004: 130 Tenge to 1 US dollar). The currency exchange rate of KASE as at April 25, 2007 was 121.05 Tenge to 1 US dollar.

**Adoption of new / revised accounting standards**

The accounting policies adopted are consistent with those of the previous financial year except that the Company has adopted those new/revised standards mandatory for financial years beginning on or after 1 January 2005.

- IFRS 2 "Share-Based Payment";
- IFRS 3 "Business Combinations", IAS 36 (revised) "Impairment of Assets" and IAS 38 (revised) "Intangible Assets";
- IFRS 5 "Non-current Assets Held for Sale and Discontinued Operations";
- IAS 1 (revised) "Presentation of Financial Statements";
- IAS 2 (revised) "Inventories";
- IAS 8 (revised) "Accounting Policies, Changes in Accounting Estimates and Errors";
- IAS 10 (revised) "Events after the Balance Sheet Date";
- IAS 16 (revised) "Property, Plant and Equipment";
- IAS 17 (revised) "Leases";
- IAS 24 (revised) "Related Party Disclosures";
- IAS 27 (revised) "Consolidated and Separate Financial Statements";
- IAS 28 (revised) "Investments in Associates";
- IAS 31 (revised) "Interests in Joint Ventures";
- IAS 32 (revised) "Financial Instruments: Presentation and Disclosure";
- IAS 33 (revised) "Earnings per Share";
- IAS 39 (revised) "Financial Instruments: Recognition and Measurement"; and
- IAS 40 (revised) "Investment property".

The adoption of the new / revised accounting standards listed above did not impact on the Company's financial statements.

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

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*In thousands of tenge*

**2. BASIS OF PREPARATION (continued)****Adoption of new / revised accounting standards (continued)**

The Company has not applied the following IFRSs and IFRIC Interpretations that have been issued but are not yet effective:

- IAS 19 (amended 2004) "Employee Benefits";
- IAS 39 (amended 2005) "Financial Instruments: Recognition and Measurement";
- IFRS 6 "Exploration for and Evaluation of Mineral Resources";
- IFRS 7 "Financial Instruments: Disclosures";
- IFRIC 4 "Determining whether an Arrangement contains a Lease";
- IFRIC 5 "Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds".

The Company expects that the adoption of the pronouncements listed above will have no significant impact on the Group's financial statements in the period of initial application.

**3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The principal accounting policies, which have been consistently applied in arriving at the financial information set out in these financial statements, are as follows:

**Intangible assets**

Intangible assets include license for subsurface use, computer software reflected at initial cost less accumulated amortization. License is amortized on a unit of production basis. Amortization of other intangible assets is calculated on a straight-line basis over the estimated useful lives of the assets, within a range of 1 to 10 years.

Intangible assets with indefinite useful lives are tested for impairment annually either individually or at the cash-generating unit level. Such intangibles are not amortised. The useful life of an intangible asset with an indefinite life is reviewed annually to determine whether indefinite life assessment continues to be supportable. If not, the change in the useful life assessment from indefinite to finite is made on a prospective basis.

**Property, plant and equipment**

The Company follows the successful efforts method of accounting for its oil exploration, development and production activities.

*Exploration Expenditure*

Exploration expenditure comprises all costs, including premium payments, associated with the acquisition of new license areas, the drilling of exploratory wells and other costs incurred in evaluating the commercial viability of geological entities. Appraisal expenditure comprises costs incurred in the survey, exploration and appraisal of license areas not yet under development or in production.

Exploration and appraisal expenditures are capitalized as an intangible asset within the oil and gas asset account until a decision is reached concerning the commercial viability of the field to which it relates. If the field is not deemed commercially viable, expenditures are then written off to the statement of income. General seismic and other expenditure not connected with a specific exploration license is written off to the statement of income immediately.

*Fields Under Development*

Development expenditure comprises all costs including financing costs, exploration and appraisal expenditure incurred in bringing a field to commercial production and is classified as a tangible asset within the oil and gas asset account. No depreciation is charged in respect of development expenditure, except for crude oil revenues from test production, which are credited against the value of the assets. Once a field achieves commercial production, development expenditure is transferred to production assets.

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Property, plant and equipment (continued)***Fields Under Production*

Expenditure on production assets represents expenditure on the exploration, appraisal and development of oil and gas fields, which are currently in commercial production. The expenditure includes costs of capital assets, financing costs and general technical and supervisory services. Production assets are depreciated by field on a unit of production basis, in the proportion of actual production for the period to the total estimated remaining reserves of the field on an entitlement basis. The remaining reserves figure is that estimated at the end of a period.

*Oil and Gas Reserves*

Proved oil and gas reserves are estimated quantities of commercially viable hydrocarbons which existing geological, geophysical and engineering data show to be recoverable in future years from known reservoirs.

The Company uses the reserve estimates provided by an independent appraisal to assess the oil and gas reserves of its principal operating subdivisions. These reserve quantities used are the basis for calculating the units of production depreciation within the accompanying financial statements.

*Abandonment and Site Restoration (decommissioning)*

Provision for decommissioning is recognized in full, on a discounted basis, at the commencement of oil and natural gas production. The amount recognized is the present value of the estimated future expenditure determined in accordance with local conditions and requirements. A corresponding tangible fixed asset of an amount equivalent to the provision is also created. This asset is subsequently depreciated as part of the capital costs of the production and transportation facilities on a unit-of-production basis.

Changes in the measurement of an existing decommissioning liability that results from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required settling the obligation, or change in the discount rate is reflected as an adjustment to the provision and the fixed asset.

The long-term inflation and discount rates used to determine the balance sheet obligation at December 31, 2005 were 7% and 10% respectively (2004: 7% and 10%). Movements in the provision for asset retirement obligations are disclosed in Note 17.

*Impairment of Oil and Gas Properties*

The Company reviews its oil and gas properties for impairment whenever events and circumstances indicate a decline in the recoverability of their carrying value. The Company compares the expected undiscounted future cash flows from proven reserves to the carrying amount to determine if the carrying amount is recoverable. Impairment adjustment is recorded to write-down the carrying value of oil and gas properties to their recoverable value, when the carrying value of oil and gas properties exceeds undiscounted future net cash flows.

*Other Property, Plant and Equipment*

Property, plant and equipment, other than oil and gas properties, are carried at cost less accumulated depreciation and depreciated on a straight-line basis over the estimated useful lives set out in the following table:

Buildings and constructions	10-50 years
Machinery and equipment	15-30 years
Vehicles	7-11 years
Other	3-10 years

Expenses related to repairs and renewals are charged when incurred and included in general and administrative expenses unless they qualify for capitalization.

All assets under construction are classified as "Capital Work in Progress" and are not depreciated. Once projects are completed and put into use they are transferred to in service assets and become subject for depreciation.

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

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*In thousands of tenge*

**3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Property, plant and equipment (continued)***Impairment of Other Property, Plant and Equipment*

The carrying amounts of property, plant and equipment are reviewed at each balance sheet date to assess whether they are recorded in excess of their recoverable amounts, and where carrying values exceed this estimated recoverable amount, assets are written down to their recoverable amount. The recoverable amount of property, plant and equipment is the greater of net selling price and value in use. In assessing value in use, the Company first decides whether there has been indication of impairment during the year, and if so, the Company will compare the future cash flows with the carrying value of assets to determine whether impairment has occurred. If such impairment has arisen, the estimated future cash flows are then discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For this purpose the whole Company is considered to be a single cash-generating unit.

**Inventories**

Inventories are valued at the lower of cost or net realizable value. Net realizable value is used when the cost could not be recovered due to the following reason: these inventories were damaged, they are considered partially or fully obsolete, or their selling price is decreased.

Inventories cost includes: purchase costs, ordering costs, costs related to their delivery to current location and condition and costs of production or processing. Purchase costs include purchase price, duties, commissions paid for procurement, and other costs directly related to the purchase of inventories. The inventory cost is defined by the weighted average cost method. Reserves on slow-moving and obsolete inventories are charged to expenses in the income statement.

Production processing costs include the cost of natural resources, raw materials, fuel, energy, labor, depreciation of fixed assets used in the production process, as well as other costs directly related to production.

Costs that are not included into production costs are recognized as expenses for the reporting period when they were incurred.

**Investment Securities**

The Company classifies its investment securities as available-for-sale.

Available-for-sale securities are subsequently measured at fair value, which is equal to the market value as at the balance sheet date. When debt securities with fixed maturities are non-marketable or no information is available on market of similar instruments, fair value has been estimated as the discounted future cash flows using current interest rates. When the fair market value of non-marketable securities that do not have fixed maturities can not be reliably measured, they are stated at cost, less allowance for diminution in value unless there are other appropriate and workable methods of reasonably estimating their fair value.

Gains and losses arising from changes in the fair value of available-for-sale investment securities are recognized in shareholders' equity as fair value change of available-for-sale financial assets in the period that the change occurs. When the securities are disposed of or impaired, the related accumulated fair value adjustment is included in the statement of income as gains less losses from available-for-sale securities.

**Cash and cash equivalents**

Cash and cash equivalents are defined as cash on hand, demand deposits and short-term and highly liquid investments with original maturity of not more than three months readily convertible to known amounts of cash, are subject to insignificant risk of change in value and are carried at cost.

**Trade and other receivables**

Trade accounts receivable, which generally have a short-term, are recognized and carried at original invoice amount less an allowance for any uncollectible amounts. An estimate for doubtful debts is made when collection of the full amount is no longer probable. Bad debt is written off when identified.

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

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*In thousands of tenge*

**3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Interest-bearing loans and borrowings**

All loans and borrowings are initially recognized at the fair value of the consideration received less directly attributable transaction costs.

After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortized cost using the effective interest method.

Gains and losses are recognized in net profit or loss when the liabilities are derecognized as well as through the amortization process.

**Charter capital**

Charter capital is recognized at fair value of consideration received. Charter capital contributions made in the form of assets other than cash are stated at their fair value at the date of contribution.

External costs directly attributable to the issue of new shares, other than on a business combination, are deducted from equity net of any related income taxes.

Dividends on ordinary shares are recognized as a reduction in equity in the period in which they are declared. Dividends that are declared after the balance sheet date are treated as a subsequent event under IAS 10 "Events After the Balance Sheet Date" and disclosed accordingly.

**Treasury shares**

Own equity instruments which are reacquired (treasury shares) are deducted from equity. No gain or loss is recognized in profit or loss on the purchase, sale, issue or cancellation of the Company's own equity instruments.

**Deferred income tax**

Deferred income tax is provided, using the liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognized for all taxable temporary differences:

- except where the deferred income tax liability arises from goodwill amortization or the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, except where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax assets are recognized for all deductible temporary differences, carry-forward of unused tax assets and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, carry-forward of unused tax assets and unused tax losses can be utilized:

- except where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred tax assets are only recognized to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilized.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantially enacted at the balance sheet date.



**NOTES TO THE FINANCIAL STATEMENTS (continued)**

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*In thousands of tenge*

**3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Other taxes**

Kazakhstan also has various taxes that are assessed on a Company's activities. These taxes are included as a component of cost of sales and general and administrative expenses in the income statement.

**Trade and other payables**

Liabilities for trade and other amounts payable are carried at cost which is the fair value of the consideration to be paid in the future for goods and services received, whether or not billed to the Company.

**Provisions**

Provisions are recognized when the Company has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

**Contingencies**

Contingent liabilities are not recognized in the financial statements unless considered probable. They are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote. A contingent asset is not recognized in the financial statements but disclosed when an inflow of economic benefits is probable.

**Segment reporting**

The Company's operation is highly integrated and principally constitutes a single industry segment, exploration and production of oil, that accounts for a 100% of the Company's business. Accordingly, for the purposes of IAS 14 "Segment reporting", the Company is treated as one business segment. The Company's assets are concentrated in Kazakhstan, and all its revenues and net income is derived from operations in , and connected with, the Republic of Kazakhstan.

**Offsetting**

Financial assets and financial liabilities are only offset and the net amount reported in the balance sheets when there is a legally enforceable right to offset the recognized amounts and the Company intends to either settle on a net basis, or to realize the asset and settle the liability simultaneously.

**Subsequent events**

Post-year-end events that provide additional information about the Company's position at the balance sheet date (adjusting events) are reflected in the financial statements. Post-year-end events that are not adjusting events are disclosed in the notes to the financial statements when material.

**Revenue recognition**

Revenue is recognized when it is probable that the economic benefits associated with the transaction will flow to the Company and the amount of revenue can be reliably measured. Revenue from sale of crude oil is recognized when delivery has taken place and risks and rewards of ownership of the goods have passed to the customer. Crude oil shipped but not yet delivered to the customer is recorded as inventory in the balance sheet.

**Expense recognition**

Expenses are accounted for at the time the actual flow of the related goods or services occur, regardless of when cash or its equivalent is paid, and are reported in the financial statements in the period to which they relate.

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

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*In thousands of tenge*

**3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Related parties**

For the purposes of these financial statements, parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party when making financial or operational decisions. In considering each possible related party relationship, attention is paid to the substance of the relationship, not merely the legal form.

Related parties include Company shareholders, key management personnel, associates and enterprises in which a substantial interest in the voting power is owned, directly or indirectly, by the Company's shareholder or key management personnel.

**Recognition of financial instruments**

The Company recognizes financial assets and liabilities on its balance sheets when, and only when, it becomes a party to the contractual provisions of the instrument. Financial assets and liabilities are recognized using trade date accounting.

Financial assets and liabilities are initially recognized at cost, which is the fair value of consideration given or received, respectively, including or net of any transaction costs incurred, respectively. The accounting policies for subsequent re-measurement of these items are disclosed in the respective notes set out in the accounting policy.

**Derecognition of financial assets and liabilities**

The Company derecognises a financial asset or a portion of a financial asset when, and only when, the Company loses control of the contractual rights that comprise the financial asset (or a portion of the financial asset). The Company loses such control if it utilized the rights to benefits specified in the contract, the rights expire, or the Company surrenders those rights.

The Company derecognizes a financial liability (or a part of a financial liability) from its balance sheets when, and only when, it is extinguished – that is, when the obligation specified in the contract is discharged, cancelled, or expires.

**Significant accounting judgments and estimates**

In the process of applying the Company's accounting policies, management has made the following judgements, apart from those involving estimates, which have the most significant effect on the amounts recognised in the financial statements:

- Excess profit deferred tax;
- Deferred income tax;
- Carrying value of oil and gas properties, which depends on the appraisals of oil and gas reserves;
- Abandonment and site restoration costs.

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***4. INTANGIBLE ASSETS**

As at December 31, 2005 and 2004 intangible assets represent licenses for subsurface use and computer software.

**5. PROPERTY, PLANT AND EQUIPMENT**

The movements on property, plant, and equipment for the years ended December 31, were as follows:

	Oil and gas properties	Buildings and constructions	Machinery and equipment	Vehicles	Other assets	Construction in progress	Total
<b>Cost</b>							
As at December 31, 2004	1,931,916	360,583	115,178	106,101	17,160	564,168	3,095,106
Additions	16,586	130,099	5,287	41,852	32,420	2,673,853	2,900,097
Transfers	704,667	50,000	2,091	—	(1,189)	(755,569)	—
Disposals	(53,418)	—	(1,150)	(2,580)	(914)	(13,503)	(71,565)
<b>As at December 31, 2005</b>	<b>2,599,751</b>	<b>540,682</b>	<b>121,406</b>	<b>145,373</b>	<b>47,477</b>	<b>2,468,949</b>	<b>5,923,638</b>
<b>Accumulated depreciation:</b>							
As at December 31, 2004	(400,780)	(11,570)	(8,266)	(16,668)	(2,235)	—	(439,519)
Charge	(343,277)	(15,228)	(6,913)	(21,036)	(5,322)	—	(391,776)
Transfers	11	9	(20)	—	—	—	—
Disposals	20,125	—	668	805	383	—	21,981
<b>As at December 31, 2005</b>	<b>(723,921)</b>	<b>(26,789)</b>	<b>(14,531)</b>	<b>(36,899)</b>	<b>(7,174)</b>	<b>—</b>	<b>(809,314)</b>
<b>Net book value:</b>							
As at December 31, 2004	1,531,136	349,013	106,912	89,433	14,925	564,168	2,655,587
<b>As at December 31, 2005</b>	<b>1,875,830</b>	<b>513,893</b>	<b>106,875</b>	<b>108,474</b>	<b>40,303</b>	<b>2,468,949</b>	<b>5,114,324</b>

As at December 31, 2005, the Company pledged property, plant and equipment of KZT 999,078 thousand (2004: KZT 1,385,235 thousand) to secure borrowings from Bank TuranAlem (2004: Bank TuranAlem and KazInvestBank) (Note 16).

Construction in progress represents capitalized expenses incurred for an exploration project.

**6. OTHER NON-CURRENT ASSETS**

As at December 31, other non-current assets consisted of the following:

	2005	2004
Technological crude oil	73,273	—
Advances to vendors for property, plant and equipment	37,666	307,103
Production spare parts	19,167	—
Due from KKM Holding JSC	360	107,030
	<b>130,466</b>	<b>414,133</b>

Due from KKM Holding JSC represents an interest free KZT denominated loan and is carried at amortized cost. The part of this loan of KZT 106,670 thousand was settled by the Company's shares with the nominal value of KZT 150,000 thousand in 2005, which were accounted for as treasury shares (Note 15).

As at December 31, 2005 advances to vendors represented advances given for capital construction works.



**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***7. NON-INTEREST BEARING LOAN TO THE SHAREHOLDER**

During 2005 the Company provided a non-interest bearing financial aid to Lancaster Group in the amount of KZT 420,000 thousand with a maturity period in 2006.

**8. INVENTORIES**

As at December 31, inventories comprised:

	2005	2004
Crude oil	30,230	4,940
Spare parts	42,580	320,354
Fuel	2,826	8,872
Construction materials	1,408	1,343
Other materials	14,940	26,287
	91,984	361,796
Less: obsolescence reserve	(15,061)	(9,766)
	76,923	352,030

As at December 31, 2005, the Company pledged 8,900 tons of crude oil (2004: 12,721 tons) against loans from Bank TuranAlem (2004: Bank TuranAlem and KazInvestBank) (Note 16).

**9. TRADE RECEIVABLES**

Trade receivables consisted of receivables from Trade House KazMunaiGaz JSC for the dispatched crude oil.

**10. ADVANCES PAID**

As at December 31, prepayments comprised:

	2005	2004
Advances for raw materials	291,298	694,259
Advances for services	141,557	537,144
	432,855	1,231,403

As at December 31, prepayments by currency comprised the following:

	2005	2004
Kazakhstani Tenge	395,953	647,152
US Dollars	34,057	583,164
Russian Rubles	2,845	3
EURO	—	1,084
	432,855	1,231,403

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***11. OTHER CURRENT ASSETS**

As at December 31, other current assets comprised:

	2005	2004
VAT recoverable	105,782	78,276
Property tax prepaid	2,741	7,481
Receivables for sold inventory and equipment	2,471	10,909
Other	17,353	8,239
	<b>128,347</b>	<b>104,905</b>

As at December 31, 2005, VAT recoverable consists of Tenge-denominated VAT paid on local services provided and goods supplied by Kazakhstani suppliers. The Company plans to recover from the State budget VAT recoverable as at December 31, 2005 in 2006.

**12. BANK DEPOSITS**

As at December 31, 2005 bank deposits represent term deposits with a Kazakhstani bank denominated in Tenge bearing interest at 7.2% per annum which matured in July, 2006.

**13. AVAILABLE FOR SALE SECURITIES**

During 2005 the Company acquired 43,000 shares (22.78%) of JSC IC "Pana Insurance" for KZT 344,000 thousand, the major part of which was subsequently sold in 2006 (Note 30).

**14. CASH AND CASH EQUIVALENTS**

As at December 31, cash and cash equivalents comprised the following:

	2005	2004
KZT bank account	54,218	2,460
Cash on hand	86	523
US Dollar bank account	—	128,015
	<b>54,304</b>	<b>130,998</b>

As at December 31, 2005 and 2004 current accounts with Kazakhstani banks were interest free.

**15. CHARTER CAPITAL**

In April 2004 the subsidiaries of KKM Holding: LLP "Kokgide Munai", LLP "Mortuk Munai", LLP "Kumsai Munai" merged and established a new entity - KKM Operating Company. In addition, the charter capital of the Company was increased up to 1,500,000 shares having KZT 1,000 nominal value each, contributed in cash by the sole shareholder. At December 31, 2005 the Company's authorized, issued and paid-in charter capital comprised 1,350,000 (2004: 1,500,000) common shares.

In January 2005, KKM Holding JSC sold 7,500 common shares of the Company to Oman CPC Company, registered on Cayman Islands. In December 2005 the Company received 150,000 of its own common shares from KKM Holding JSC as the repayment of receivables from it in the amount of KZT 106,670 thousand (Note 6).

	2005		2004	
	Share	Number of Shares	Share	Number of Shares
Lancaster Group Pte. Ltd.	79%	1,186,096	79%	1,186,096
JSC "KKM Holding"	10%	156,404	21%	313,904
Oman CPC Company	1%	7,500	—	—
Treasury shares	10%	150,000	—	—
	<b>100%</b>	<b>1,500,000</b>	<b>100%</b>	<b>1,500,000</b>

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***15. CHARTER CAPITAL (continued)**

Common shares give the holders the right to participate in the management of the Company and shareholders are permitted one vote per share.

As at December 31, 2004 160,091 of the Company's shares were pledged to secure debt with Bank TuranAlem.

The Company did not pay or declare any dividends during the year ended December 31, 2005 and 2004.

**16. INTEREST-BEARING LOANS**

At December 31, interest-bearing loans comprised:

<i>In thousands of tenge</i>	Original Currency	Date of Issue	Maturity Date	Effective interest rate per annum	Frequency of payments	2005	2004
<b>Long-term borrowings:</b>							
Neston production limited Bank TuranAlem	USD	Mar 2001	not established	2.25%	no payment schedule interest - monthly;	114,428	792,995
	KZT	Dec 2004 – Jul 2005	Nov 2006 – Feb 2010	14%-14.5%	principal - at maturity	873,341	531,737
Less current portion of long-term borrowings						(331,343)	(792,995)
						656,426	531,737
<b>Current borrowings:</b>							
Bank TuranAlem					interest - monthly;		
	KZT	May 2005 – Dec 2005	Apr 2006 – Nov 2006	12%-12.5%	principal - at maturity	942,368	624,126
KazInvestBank					interest - monthly;		
	KZT	Aug 2003	Dec 2005	13%	principal - at maturity	–	166,000
Current portion of long- term borrowings						331,343	792,995
						1,273,711	1,583,121

**Bank TuranAlem**

In December 26, 2003 the Company opened a credit line with Bank TuranAlem of KZT 216,000 thousand that was further amended by increasing the amount of credit line to 20,000,000 US Dollars. In 2004, under this credit line Bank TuranAlem provided a number of short-term and long-term loans to the Company to replenish its working capital. The interest on the loans is charged at 12% - 12.5% p.a. for short-term loans and 14% - 14.5% p.a. for long-term loans. In 2005, the Company increased the credit line to 24,000,000 US Dollars. The Company's property, plant and equipment of KZT 999,078 (2004: 1,216,112) thousand, right for oil extraction on Kokgide field, crude oil in the volume of 8,900 (2004: 8,000) tons and zero common shares (2004: 160,091), were pledged as collateral for the credit line as at December 31, 2005.

**KazInvestBank**

In 2004 KazInvestBank provided short-term loans to the Company to replenish working capital. The interest on the loans is charged at 13% per annum. In 2005 the Company repaid all the loans and closed the credit line provided by KazInvestBank.

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***16. INTEREST-BEARING LOANS (continued)****Neston Production Limited**

JSC “KKM Holding”, a shareholder of the Company, is fully owned by Neston Production Limited, a company incorporated under the laws of United Kingdom of Great Britain and Northern Ireland. In March, 2001 the Company concluded a loan agreement with Neston Production Limited for the amount of USD 7,000 thousand repayable by March 2008 with an interest charge of 7.34% per annum. In October 2004 the terms of this contract were amended by decreasing the interest rate from 7.34% to 2.25%. Per terms of contract the Company does not have a specific schedule of principal and interest repayment. The Loan is anticipated to be repaid in 2006 and accordingly has been classified as a short-term loan.

	2005	2004
Short-term loans and current portion of long-term loans	1,273,711	1,583,121
Long-term loans	656,426	531,737
	<b>1,930,137</b>	<b>2,114,858</b>

**17. ABANDONMENT AND SITE RESTORATION LIABILITY**

The abandonment and site restoration liability has been recorded in the financial statements to reflect the cost of restoring well sites to their original condition. The cost has been estimated based on management's best estimates and available historical data.

The movements in the abandonment and site restoration liability for the years ended December 31, were as follows:

	2005	2004
Abandonment and site restoration liability as at January 1	69,172	20,314
Unwinding of discount	4,842	1,422
Revision of estimates	(3,091)	35,440
Usage of liquidation fund	(2,165)	—
Provision / (reverse) for the year	—	11,996
Abandonment and site restoration liability as at December 31	<b>68,758</b>	<b>69,172</b>

During 2004 the Company introduced an accelerated program for abandoning wells. This resulted in an increase of KZT 35,440 thousand in the estimate for the cost of abandonment during 2004.

As Kazakh laws and regulations concerning environmental assessments and cleanups evolve, the Company may incur future costs the amount of which is currently indeterminable. Such costs, when known, will be provided for as new information, legislation and estimates evolve.

**18. TRADE ACCOUNTS PAYABLE**

At December 31, 2005 and 2004, the ten largest suppliers accounted for 83% and 81% of the total trade accounts payable, respectively. Trade accounts payable are represented by payables to suppliers and denominated in KZT.

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***19. COST OF SALES**

The composition of cost of sales for the year ended December 31, was as follows:

	2005	2004
Production expenses:		
Depreciation and amortization	375,201	437,610
Salaries and related costs	234,108	148,892
Royalty	142,195	88,749
Fuel	40,336	19,002
Repair and other services	36,673	22,823
Taxes and fees	28,450	21,352
Oil processing	26,738	18,098
Materials	31,347	22,054
Transportation expenses	13,446	39,980
Purchased oil	—	108,705
Other	23,024	7,146
Total production expenses	951,518	934,411
Change in work in progress and finished goods:		
Work in progress and finished goods in progress at 1 January	4,940	20,158
Work in progress and finished goods at 31 December	(103,503)	(4,940)
Net changes in work in progress and finished goods	(98,563)	15,218
	852,955	949,629

**20. EXPLORATION COSTS**

Exploration costs for the year ended December 31, was divided between fields as follows:

	2005	2004
Kokgide field	—	62,051
Mortuk field	—	86,096
	—	148,147

Explorations costs for the years ended December 31, 2004 represent costs related to drilling of exploratory dry wells.

**21. GEOLOGICAL AND GEOPHYSICAL EXPENSES**

Geological and geophysical expenses for the year ended December 31, were divided between fields as follows:

	2005	2004
Kokgide field	52,632	47,854
Mortuk field	6,649	969
Kumsai field	4,206	348
	63,487	49,171

Geological and geophysical expenses for the years ended December 31, 2005 and 2004 represent costs related to seismic works, geophysical research, and exploration of reserves.

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***22. GENERAL AND ADMINISTRATIVE EXPENSES**

The composition of general and administrative expenses for the year ended December 31, was as follows:

	2005	2004
Insurance	399,829	1,734
Provision charge	187,462	—
Salaries and related costs	130,014	70,687
Professional services	63,413	14,259
Operating taxes	15,869	1,179
Bank commissions	14,166	14,839
Training	13,399	3,810
Communication	12,750	9,049
Business trips	11,390	7,594
Depreciation and amortization	11,264	5,640
Rent and office maintenance	7,003	10,702
Charity	5,760	4,661
Provision for inventory obsolescence	5,295	9,766
Fines and penalties	3,501	296
Transportation	110	3,074
Other expenses	25,244	15,545
	<b>906,469</b>	<b>172,835</b>

In 2005 the Company started insuring workers life, employer's liability and property. The insurance cover was obtained from Pana Insurance JSC, a related party.

Rent agreements are subject to renewal on an annual basis.

**23. SELLING EXPENSES**

The composition of selling expenses for the year ended December 31, was as follows:

	2005	2004
Transportation	528,890	496,002
Customs fees	9,556	3,107
Salaries and related costs	8,406	10,080
Oil loading	1,934	20,695
Other expenses	4,172	1,647
	<b>552,958</b>	<b>531,531</b>

Transportation expenses in 2005 and 2004 represent costs related to transportation of oil through the pipeline, which is owned by KazTransOil, subsidiary of national company "KazMunayGaz" that provides oil pipeline transportation services throughout Kazakhstan.

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***24. INTEREST INCOME AND EXPENSE**

The composition of interest income and expense for the year ended December 31, was as follows:

	2005	2004
<b>Interest income</b>		
Interest income- bank deposits	8,141	2,835
	<u>8,141</u>	<u>2,835</u>
<b>Interest expense</b>		
Interest expenses – bank loans	(254,851)	(66,270)
Interest expenses – Neston's loan	(4,080)	(47,070)
(Fair value adjustment ) of receivables from KKM Holding	–	(43,340)
Interest on advance payments from customers.	(12,982)	(11,572)
Liquidation fund	(4,842)	(1,422)
	<u>(276,755)</u>	<u>(169,674)</u>
	<u>(268,614)</u>	<u>(166,839)</u>

In 2005 and 2004 interest on advance payments from customers mostly represents interest charged on the advance from KazMunayGaz Trade House, a subsidiary of national company “KazMunayGaz” and Vitol Central Asia S.A., respectively. The Company sells oil on a prepayment basis to its major customers KazMunayGaz Trade House and Vitol Central Asia S.A. According to the contract the Company is obliged to pay interest for prepayment from the date of payment till the bill of lading date in amount of LIBOR+2.5% and LIBOR +2%, for the years ended December 31, 2005 and 2004 respectively.

**25. INCOME TAXES**

The Company is subject to income tax of 30% on taxable profit as determined under the laws of the Republic of Kazakhstan. Income tax expense consisted of the following for the year ended December 31:

	2005	2004
Current income tax	449,117	616,302
Deferred income tax (benefit)	113,612	(124,712)
	<u>562,729</u>	<u>491,590</u>

A reconciliation of the income tax expense applicable to profit before income tax at the statutory income tax rate against current income tax expense was as follows for the year ended December 31:

	2005	2004
<b>Accounting profit before income tax</b>	<b>1,926,902</b>	<b>1,624,878</b>
Statutory tax rate	30%	30%
<b>Theoretical tax expense at the statutory rate</b>	<b>578,071</b>	<b>487,463</b>
Provision charge	56,239	–
Adjustment to income tax related to prior years	–	(4,542)
Tax effect of expenses that are not deductible for tax purposes	25,226	1,283
Change in deferred tax valuation allowance	(96,807)	7,386
<b>Income tax expense reported in the accompanying financial statements</b>	<b>562,729</b>	<b>491,590</b>

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***25. INCOME TAXES (continued)**

Deferred tax balances calculated by applying the statutory tax rates in effect at the respective balance sheet dates against temporary differences between the tax basis of assets and liabilities and the amounts reported in the financial statements, consisted of the following at December 31:

	2005	2004
<b>Deferred tax assets:</b>		
Property, plant and equipment	38,548	12,860
Account receivables	—	13,003
Accrued expenses	8,368	3,815
Inventory	3,434	2,930
	<u>50,350</u>	<u>32,608</u>
<b>Deferred tax liabilities:</b>		
Sale recognition	(221,493)	—
Intangible assets	(7,704)	(1,035)
	<u>(229,197)</u>	<u>(1,035)</u>
Net deferred tax (liability) assets	(178,847)	31,573
Valuation allowance	—	(96,807)
<b>Net deferred tax position</b>	<u>(178,847)</u>	<u>(65,234)</u>

The Republic of Kazakhstan's tax code covers various taxes such as value added tax, corporate income tax, and payroll taxes, together with others. The tax code has not been in force for significant periods, in contrast to more developed market economies; therefore, implementing regulations are often unclear or non-existent. Accordingly, few precedents with regard to issues have been established. Often, different opinions regarding legal interpretation exist both among and within government ministries and various inspectorates; thus creating uncertainties and areas of conflict. Tax declarations, together with other legal compliance areas (as examples, customs and currency control matters) are subject to review and investigation by a number of authorities that are enabled by law to impose extremely severe fines, penalties and interest charges. These facts create tax risks in Kazakhstan substantially more significant than typically found in countries with more developed tax systems. Generally, tax declarations remain open and subject to inspection for a period of five years. Management believes that it has adequately provided for tax liabilities in the accompanying financial statements; however, the risk remains that relevant authorities could take different positions with regard to interpretative issues and the effect could be significant.

**26. EARNINGS PER SHARE**

Earnings per share is calculated by dividing the net income attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the period, excluding the average number of ordinary shares purchased by the Company and held as treasury shares (Note 15).

The following reflects the income and share data used in the basic earnings per share computation:

	2005	2004
Weighted average number of ordinary shares outstanding	1,500,000	1,500,000
Profit for the year attributable to equity holders	1,364,173	1,133,288
Basic earnings per share, KZT	910	755



**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***27. RELATED PARTY TRANSACTIONS**

Related parties may enter into transactions which unrelated parties might not, and transactions between related parties may not be effected on the same terms, conditions and amounts as transactions between unrelated parties.

The nature of the related party relationships for those related parties with whom the Company entered into significant transactions for the year ended December 31, 2005 and 2004 or had significant balances outstanding at December 31, 2005 and 2004 are detailed below. Transactions were entered into with related parties in accordance with terms of contracts.

Balances and transactions with related parties of the Company as at and for the year ended December 31, 2005 and 2004 consisted of the following:

**Revenues**

	Nature of Transactions	2005	2004
ERC Holding	Interest expenses	361	–
Pana Insurance	Insurance services	7	–
KazInvestBank	Interest expenses	1,376	–
		<u>1,744</u>	<u>–</u>

**Expenses**

	Nature of Transactions	2005	2004
Neston Production Ltd.	Interest expenses	4,080	47,070
Oman CPC Company	Oil transportation	36,314	–
Lancaster Group	Services	21,841	–
Pana Insurance	Insurance services	396,021	–
	Fair value adjustment of		
KKM Holding JSC	financial support	–	43,340
KazInvestBank	Interest expenses	10,169	21,416
Other		–	834
		<u>468,425</u>	<u>112,660</u>

**Account Receivables**

	Nature of Transactions	2005	2004
Lancaster Group	Financial support	420,000	–
Syrymbet LLP	Financial support	527	176,299
KBK Corporation LLP	Financial support	–	121,198
ERC Holding	Leasing fee	415	–
KIB	Interest receivable	372	–
KKM Holding JSC	Financial support	361	107,030
SPC Munai Invest LLP	Financial support	–	11,691
		<u>421,675</u>	<u>416,218</u>

**Advances paid**

	Nature of Transactions	2005	2004
Pana Insurance	Insurance fee	40,020	–
		<u>40,020</u>	<u>–</u>

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***27. RELATED PARTY TRANSACTIONS (continued)****Available-for-sale investment securities**

	Nature of Transactions	2005	2004
Pana Insurance	Investment	344,000	—
		<u>344,000</u>	<u>—</u>

**Accounts payable**

	Nature of Transactions	2005	2004
Oman CPC Company	Oil transportation	18,153	—
Lancaster Group	Consulting services	2,971	—
		<u>21,124</u>	<u>—</u>

**Interest-Bearing Loans**

	Nature of Transactions	2005	2004
Neston Production Ltd.	Interest bearing loan	114,428	792,995
KazInvestBank	Interest bearing loan	—	166,000
		<u>114,428</u>	<u>958,995</u>

**Compensation to key management personnel**

Key management personnel totaled 6 and 7 persons as at December 31, 2005 and 2004 respectively. Total compensation to key management personnel included in personnel costs in the accompanying statement of income amounted to KZT 80,578 thousand and KZT 40,034 thousand for the years ended December 31, 2005 and December 31, 2004, respectively. Compensation to key management personnel consists of contractual salary.

**28. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES**

The Company, in connection with its activities, is exposed to various financial risks associated with its financial instruments. Financial instruments are comprised primarily of cash and cash equivalents, trade receivables, other receivables, accounts payable and loans.

**Interest rate risk**

The Company's only interest rate risk relates to interest payable associated with its loans. The Company does not enter into any hedging instruments to mitigate any potential risk, as management does not believe the interest rate risk associated with the loan obligation is significant.

**Liquidity risks**

Liquidity risk arises from the possibility that customers may not be able to settle obligations to the Company within the normal terms of trade. To manage this risk the Company enters into prepayment contracts with the majority of its customers.

Cash flow requirements are monitored on a regular basis and management ensures that sufficient funds are available to meet any commitments as they arise. The management of the Company believes that any possible fluctuations of future cash flows associated with a monetary financial instrument will not have a material impact on the Company's operations.

**Commodity price risk**

The Company is exposed to commodity price risk, since oil prices are determined by world market. The Company does not hedge this risk.

**NOTES TO THE FINANCIAL STATEMENTS (continued)***In thousands of tenge***28. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)****Credit risks**

Credit risks or the risk of counterparties defaulting, is controlled by the application of credit approvals, limits and monitoring procedures. The extent of the Company's credit exposure is represented by the balance of accounts receivable. While the Company may be subject to losses up to the contract value of the instruments in the event of non-performance by its counterparts, it does not expect such losses to occur.

**Currency risk**

Currency risk is the risk that the value of financial instruments will fluctuate due to changes in foreign exchange rates. The Company's operations are carried out in the Republic of Kazakhstan and, as such, a significant portion of the Company's business is transacted in Kazakh Tenge. Company's management believes that any possible fluctuations of foreign exchange rates will not have a material impact on the financial position of the Company and the results of its operations.

**Fair value of financial instruments**

Set out below is a comparison by category of carrying amounts and fair values of all of the Company's financial instruments that are carried in the balance sheet:

	<b>Carrying amount</b>		<b>Fair value</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Financial assets:</b>				
Available-for-sale securities	344,000	–	344,000	–
Bank deposits	21,500	684,897	21,500	684,897
Trade and other receivables	1,481,956	1,336,308	1,481,956	1,336,308
Cash and cash equivalents	54,304	130,998	54,304	130,998
<b>Financial liabilities:</b>				
Borrowings	1,930,137	2,114,858	1,930,137	2,114,858
Trade and other payables	400,641	79,941	400,641	79,941

The fair value of borrowings is based on cash flows discounted using the market interest rates. Fair values of available-for-sale investments, bank deposits, trade and other receivables, cash and cash equivalents and trade and other payables approximate their carrying amounts due to their short maturity.

**29. COMMITMENTS AND CONTINGENCIES****Commitment**

As at December 31, 2004, the Company had commitments for rent of drill bits in the amount of KZT 39,000 thousand and commitment to incur additional minimal exploration expenses of KZT 850,330 thousand and KZT 207,870 thousand in 2005 and 2006 respectively.

As at December 31, 2005, the Company had commitments for a reserve letter of credit opened in favour of ABN AMRO Trustees on payments for transportation expenses through the CPC pipeline totalling KZT 35,182 thousand and commitments for a minimal work program in amount of KZT 213,898 thousand.

**Legal actions and claims**

The Company is subject to various legal proceedings related to business operations, such as property damage claims. The Company does not believe that pending or threatened claims of these types, individually or in aggregate, are likely to have any material adverse effect on the Company's financial position or results of operations.

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

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*In thousands of tenge*

**29. COMMITMENTS AND CONTINGENCIES (continued)****Legal actions and claims (continued)**

The Company assesses the likelihood of material liabilities arising from individual circumstances and makes provision in its financial statements only where it is probable that events giving rise to the liability will occur and the amount of the liability can be reasonably estimated. No provision has been made in these financial statements for any of the contingent liabilities mentioned above.

**Tax contingencies**

Various types of legislation and regulations are not always clearly written and their interpretation is subject to the opinions of the local tax inspectors and the Ministry of Finance of the Republic of Kazakhstan. Instances of inconsistent opinions between local, regional and national tax authorities are not unusual. The current regime of penalties and interest related to reported and discovered violations of Kazakhstan laws, decrees and related regulations is severe. Penalties include confiscation of the amounts at issue (for currency law violations), as well as fines of generally 50% of the taxes unpaid. Interest is assessed at 18.75% per annum. As a result, penalties and interest can result in amounts that are multiples of any unreported taxes.

The Company believes that it has paid or accrued all taxes that are applicable. Where practice concerning the provision of taxes is unclear, the Company has accrued tax liabilities based on management's best estimate. The Company's policy is to recognize provisions in the accounting period in which a loss is deemed probable and the amount is reasonably determinable.

Because of the uncertainties associated with the Kazakhstan tax system, the ultimate amount of taxes, penalties and interest, if any, may be in excess of the amount expensed to date and accrued at December 31, 2005. Although such amounts are possible and may be material, it is the opinion of the Company's management that these amounts are either not probable, not reasonably determinable, or both.

The Company's operations and financial position may be affected by Kazakh political developments, including the application of existing and future legislation and tax regulations. The Company does not believe that these contingencies, as related to its operations, are any more significant than those of similar enterprises in Kazakhstan.

Other provisions are recorded where the Company has a legal or constructive obligation and a future outflow of resources is considered probable. As of December 31, 2005, other provisions of KZT 187,462 include provisions for liabilities concerning income taxes and the related fines and penalties.

The Company also recognises that additional excess profit tax liabilities of KZT 855,772 thousand could arise. The Company recognises the likelihood of these liabilities being accrued as possible as the tax authorities need to prove the absence of a tax stability clause with respect to excess profits tax in order to accrue any additional liabilities. At the same time the Company considers that the excess profits tax regime is stable.

**Retirement and pension obligations**

The Company does not have any substantial pension arrangements separate from the State pension scheme of the Republic of Kazakhstan, which requires current contributions by the employer and calculated as a percentage of current gross salary payments. Such contributions are expensed as they arise.

**Financial contingency**

As of December 31, 2005 the Company does not have in storage, the required volume of extracted crude oil as stated in the pledge agreements (Note 16). The Company does not believe that there is a risk that the Banks would demand repayment of loans immediately, as the Company has sufficient volume of proved developed reserves that upon request could be extracted. No provision has been made in these financial statements for the contingent liability mentioned above.

**NOTES TO THE FINANCIAL STATEMENTS (continued)**

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*In thousands of tenge*

**29. COMMITMENTS AND CONTINGENCIES (continued)****Environmental matters**

The Company may also be subject to loss contingencies relating to regional environmental claims that may arise from the past operations of the related fields in which it operates. As Kazakhstani laws and regulations evolve concerning environmental assessments and site restoration, the Company may incur future costs, the amount of which is currently indeterminable due to such factors as, the ultimate determination of responsible parties associated with these costs and the Government's assessment of respective parties' ability to pay for the costs related to environmental reclamation. The calculation of abandonment and site restoration is considered in Note 17. It is the opinion of management that such costs will not have a material effect on the financial condition of the Company and accordingly no provisions for future environmental claims or penalties are included in the accompanying financial statements.

However, depending on any unfavorable claims or penalties assessed by the Kazakhstani regulatory agencies, it is possible that the Company's future results of operations or cash flow could be materially affected in a particular period.

**Insurance matters**

The Company has obligatory insurance coverage for its vehicles and employer civil and legal liability insurance. Furthermore, the Company insured its civil and legal liability for harm to the environment (ecological risks) and for harm caused to third parties (liability of the owners of hazardous objects). Until the Company obtains adequate insurance coverage, there is a risk that the loss or destruction of certain assets could have a material adverse effect on the Company's operations and financial position.

The Company is creating insurance regulations assessing the real risks associated with its production activities and their possible influence on the Company's financial situation. At the same time the Company is taking into consideration the requirements of laws of the Republic of Kazakhstan and subsurface use contracts concluded.

**30. SUBSEQUENT EVENTS****Subsoil agreement**

At the end of 2005 the Company won the rights for the oilfield North Karpovsky, which is situated in the Western Kazakhstan region. During 2006 the Company started the process of negotiations with the Government of Kazakhstan regarding the terms of the subsoil agreement. The subscription bonus for the North Karpovsky area comprises KZT 3,344 million, that is payable in 2007.

**Loans**

In January 2006 the Company fully repaid the debt to Neston Production Ltd. In July 2006 the Company paid off the debt and closed the credit line provided by Bank TuranAlem and opened a new credit line in amount of 80,000,000 US Dollars in KazkommertsBank at 10.73% per annum and maturity in 2009.

**Investments**

In July 2006 the Company sold 28,000 (KZT 1,000 par value) common shares of JSC IC "Pana Insurance" for KZT 224,000 thousand and decreased its holding from 22.78% to 7.5%.

## SUPPLEMENTAL INFORMATION – DISCLOSURES ABOUT OIL AND GAS RESERVE QUANTITIES - UNAUDITED

*In thousands of tenge*

### PROVED OIL AND GAS RESERVE QUANTITIES (UNAUDITED)

As at years ended December 31, 2005 and 2004 Kokgide and Kumsai field received an independent appraisal of their proved reserves.

As determined by independent reservoir engineers, McDaniels that performed the appraisal of oil reserves as at December 31, 2005 and Halliburton International Inc. that performed the appraisal of oil reserves as at December 31, 2004 the following information presents the balances of proved oil and gas reserve quantities as at December 31, 2005 and 2004.

The McDaniels follows the SPE/WPC (Society of Petroleum Engineers/World Petroleum Congress) definition of recoverable hydrocarbon reserves and follows SPE reserves Estimation.

In determining proved reserve quantities, proved reserves are the estimated quantities of oil and gas which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic conditions. In some cases, substantial new investment in additional wells and related support facilities and equipment will be required to recover such proved reserves. Due to inherent uncertainties and the limited nature of reservoir data, estimates of underground reserves are subject to change over time as additional information becomes available.

Proved developed reserves are those reserves, which are expected to be recovered through existing wells with existing equipment and operating methods. Proved undeveloped reserves are those reserves, which are expected to be recovered as a result of future investments to drill new wells, to recomplete existing wells and/or install facilities to collect and deliver the production from existing and future wells.

<i>In thousands of tonnes</i>	2005 (unaudited)	2004 (unaudited)
Proved developed reserves as at January 1,	430,000	572,427
Revision of previous estimates	207,850	(26,306)
Production for the year	(103,300)	(116,121)
<b>Proved developed reserves as at December 31,</b>	<b>534,550</b>	<b>430,000</b>
<b>Total proved (developed and undeveloped) reserves as at December 31,</b>	<b>1,001,800</b>	<b>1,206,000</b>