



**Falkland Oil & Gas Limited**  
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**Falkland Oil and Gas Limited**  
**Annual report and financial statements 2010**



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**Directors**

Richard Liddell Chairman  
Tim Bushell Chief Executive Officer  
David Hudd Non-executive Director (Deputy Chairman)  
Timothy Jones Non-executive Director (Finance Director)  
Colin More Exploration Director

**UK Office**

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**Registered Office**

56 John Street, Stanley, Falkland Islands, FIQQ 1ZZ  
Registration 12913

Falkland Oil and Gas Limited is listed on AIM, a market operated by the London Stock Exchange (Symbol FOGL)

**Secretary**

Serina Bierer, 32-34 Wigmore Street, London, W1U 2RR & McGrigors Nominee Company (Falklands) Limited

**Solicitors to the Company as to Falkland Islands Law**

McGrigors LLP, 56 John Street, PO Box 21, Stanley, Falkland Islands

**Solicitors to the Company as to English Law**

McGrigors LLP, Princes Exchange, 1 Earl Grey Street, Edinburgh EH3 9AQ

**Nominated advisor and broker**

Oriel Securities Limited, 125 Wood Street, London EC2V 7AN

**Auditors**

BDO LLP, 55 Baker Street, London W1U 7EU

**Registrars**

Capita Registrars (Jersey) Limited, 12 Castle Street, St Helier, Jersey JE2 3RT

**Depository**

The Registry, 34 Beckenham Road, Beckenham, Kent BR3 4TU

# Contents

# Officers and Advisors

2010 was a landmark year for Falkland Oil and Gas Limited (the Company) in which we drilled our first exploration well, the first well ever drilled on the East Falklands Basin. We were pleased that the well was drilled on budget and without incident.

It was a significant achievement to have progressed the project from concept to drilling in just six years since FOGL was listed and despite the failure of Toroa to find reservoir hydrocarbons, the well has provided encouragement on the presence of good quality reservoirs and source rocks and given us valuable information to plan future wells.

Although Toroa was an attractive target for initial drilling, we believe the potential of our deepwater prospects is greater and we therefore look forward with much anticipation to the commencement of the next drilling campaign. FOGL is at an advanced stage in contract negotiations for a suitable deepwater rig for the Southern Licence Area. BHP Billiton (BHPB), as operator of the Northern Licence Area, is also engaged in related negotiations to secure a rig slot to drill Loligo.

During the year, the terms of the Northern Licence Area were successfully renegotiated with the Falkland Islands Government (FIG). The licences were extended by one year without any additional work commitments or acreage relinquishments being required.


On the Southern Licence Area, having fulfilled the Phase 1 work commitment with the drilling of Toroa, the second phase commenced on 3 December 2010. BHPB elected not to enter the second phase of the licences and has assigned its 51% of the Southern Licence Area and operatorship to FOGL, taking FOGL's interest in these licences back to 100%. The FIG has formally approved this assignment of interest and transfer of operatorship to FOGL.

In order to provide further drilling options across FOGL's acreage, we are currently undertaking a site survey programme. The vessel is performing surveys on a number of separate sites including Vinson, in the Tertiary channel play, and two new prospects (Scotia and Hero), within the mid Cretaceous fan play. Site surveys will also be acquired on Inflexible, a Springhill fault-block and Undine, a prospect in the Tertiary fold-belt play. These latter two prospects are similar to those that Borders and Southern Petroleum plc (B&S) intends to drill and will provide the option for FOGL to drill either of them in the event that B&S has encouraging drilling results. In addition, the company may elect to acquire up to 1,300 km of new 2D seismic data, using the same vessel. This data will assist with prospect definition and aid the selection of drilling locations.

Regaining 100% working interest and operatorship of the Southern Licence Area has not only given us greater control over the pace of future development, but also the option to pursue another farm-out agreement for this asset.

### **Financials**

FOGL started 2010 with US\$93.5 million in cash. During the year we invested US\$21.8 million in the exploration programme, including US\$19.7 million to drill Toroa, and a further US\$2.6 million for administration costs. The Company ended the year with a cash balance of US\$69.8 million and therefore the Company is fully funded for its share of the costs of the Northern Licence Area work commitment. The loss before tax for the 12 month period was \$3.7 million (2009: \$5.3 million). No dividend is proposed.

  
**Richard Liddell**  
Chairman  
14 March 2011

  
**Tim Bushell**  
Chief Executive Officer

## **Chairman's and Chief Executive's Statement**

The Company signed a binding Heads of Agreement which facilitated the withdrawal of its joint venture partner, BHPB from the Northern Licence Area once certain conditions had been satisfied, including approval of the FIG to both the assignment of BHPB's 51% interest and transfer of operatorship to FOGL.

In relation to this withdrawal, BHPB will contribute towards the costs of drilling the Loligo well. The funds are to be drawn by FOGL against the costs of drilling the Loligo well. In the event that the Loligo well encounters hydrocarbons, BHPB will have the option to back-into the Loligo development area only, for a maximum of 40% non-operating interest in the discovery, in return for making a cash contribution to FOGL's future exploration and appraisal costs.

The Company conditionally placed 45.7 million new ordinary shares of 0.002 pence in the capital of the Company at a price of 70 pence per share to raise £32 million before expenses. The net proceeds of the placing, together with FOGL's existing cash resources and the proceeds of the settlement with BHPB announced on 31 March 2011, would be used to provide additional drilling options for FOGL's planned 2012 drilling programme, to fund long lead drilling equipment for two exploration wells and to meet the Company's working capital requirements.

FOGL has the financial resources to drill a well on the Loligo complex to penetrate reservoirs containing 46% of the estimated Pmean reserves. The placing will allow the well to target three deeper independent reservoir objectives, which contain the remaining 54% of the Loligo complex's estimated Pmean reserves.

The net proceeds of the Placing, together with FOGL's existing cash resources and the proceeds of the settlement with BHPB, totalling circa US\$160 million will be used to drill the Loligo well and provide additional drilling options for FOGL's planned 2012 drilling programme.

The Company signed a Heads of Agreement with B&S to share a rig to drill in the first half of 2012. This Heads of Agreement outlined the key terms relating to the sharing of a rig to commence drilling the Loligo prospect in the first quarter of 2012. The Company said that it expected the rig to arrive in the Falkland Islands in the fourth quarter of 2011 and that the Company would access the rig for the third well slot in the combined B&S and FOGL programme and would commence drilling in the first quarter of 2012.

The Company reached an agreement with RAB Special Situations (Master Fund) Limited (RAB), who have agreed to amend the RAB Loan Note and exercise its right to exchange the entire principal amount (together with all interest accrued to date and accruing up to 22 December 2011, estimated to amount in total to approximately £10.6 million) for the issue of approximately 15.1 million new ordinary shares at the placing price and an issue of new warrants over 1 million ordinary shares, exercisable at a price equal to a 50% premium to the placing price (or, if lesser, in the event that the Company issues shares, or securities convertible into shares, at a price lower than the placing price, a 30% premium to the price at which those future shares or securities were issued).

Erebus Limited, a wholly owned subsidiary of Falkland Island Holdings Group plc, that holds 12 million ordinary shares, representing 8.2% of FOGL's existing issued share capital, has agreed not to dispose of any of its ordinary shares until the earlier of the announcement of the results of the final well to be drilled on behalf of the Company using the shared B&S rig or 31 May 2012.

FOGL discussed its planned drilling campaign with the FIG and is confident that it will be able to obtain an extension of the Northern Licence Area that is due to expire on 15 December 2011 to cover the planned programme on terms that are acceptable to FOGL.

The Company noted that B&S had signed a substitution agreement with Ocean Rig under which the Eirik Raude has been replaced with the Leiv Eiriksson. FOGL noted that the Heads of Agreement signed with B&S and announced on the 19 April 2011 also applied to the Leiv Eiriksson.

## **Subsequent Events**



### **Toroa Exploration Well**

The Toroa exploration well F61/5-1 was completed in July 2010. The well, which was drilled to a total depth of 2476 metres, did not encounter any reservoir hydrocarbons and was plugged and abandoned.

The rationale for drilling Toroa was based on the following principles and sound technical considerations:

- The prospect offered a potentially large hydrocarbon resource in the event of success.
- The targeted Springhill reservoir is proven in adjoining basins in Argentina, where large stratigraphic traps, similar to Toroa, are known to contain oil and gas.
- Toroa had encouraging, albeit slightly ambiguous, seismic amplitude and AVO (amplitude versus offset) responses.
- A positive anomaly had also been seen on Controlled Source Electro Magnetic (CSEM) data gathered over the prospect, which again, whilst encouraging, was difficult to fully assess given the un-calibrated nature of the data in an undrilled frontier basin.

The main risk prior to drilling was integrity of the trap. In order for hydrocarbons to be trapped in Toroa an effective side seal was required. Such a seal is created by sands passing laterally into sealing shales and is referred to as a stratigraphic trapping mechanism. There are many giant fields (>500 million barrels) that rely on such stratigraphic seals.

### **Reservoir Potential**

Potential reservoir sands were encountered in the Jurassic to Cretaceous aged Springhill Formation, but these were found to be water bearing. Based on wire-line log interpretation, over 30 metres of net sand were penetrated, with porosities ranging from 18% to 32%. As such, the Springhill play is still viable elsewhere within FOGL's acreage.

A thick sequence of very good quality sands was also encountered in the overlying mid Cretaceous section. This enhances the potential of the deep water mid Cretaceous fan play that FOGL has been actively pursuing across its acreage.

### **Source Rock Potential**

The Toroa well was drilled on the basin margin and as such, is not an ideal location to evaluate potential source rocks. Organic rich shales, that provide the source for hydrocarbons, are more likely to be developed in the deeper parts of the basin. Extensive geochemical analysis has been undertaken on drill cuttings and sidewall core samples collected from the Toroa well. Approximately 120 metres of shales with high Total Organic Carbon (TOC) were identified. TOC content ranged from 12.0% to 18.5%. These shales are considered good quality source rock by generally accepted oil industry standards.

Rock-Eval pyrolysis was undertaken on the shale samples. This is a technique that evaluates the type and the maturity of the organic matter within the shales, as well as determining its petroleum potential. This analysis indicated that these are deltaic shales with a mixture of marine and terrigenous (land derived) organic matter, that were subsequently buried to produce a Type II/III mixed, oil/gas prone source rock, which is almost mature for oil generation at the well location. It is therefore likely that similar shales will have been sufficiently buried in the basinal areas to the east of the Toroa well, to have generated hydrocarbons. The analysis of gasses in the well suggests deep burial of a source, down-dip from the well.

## **Technical Review**

### **Reason for Failure of the Toroa Prospect**

FOGL's post-drilling analysis suggests that Toroa had no lateral seal to trap migrating hydrocarbons. The seismic amplitude and AVO response, which had been interpreted to be hydrocarbon filled sands, were probably the result of a lithological effect (rock type) and in particular due to low density carbonaceous shales and coals that were found overlying the Springhill reservoir. These lithologies may have also contributed to the 'false positive' anomaly seen on the CSEM data.

### **Implications for Future Exploration Elsewhere in the Basin**

FOGL believes that the results of the Toroa well have no negative impact on the plays and prospects in the deep water area of our licences. In particular, they have no bearing on the risk or hydrocarbon potential of Loligo and other prospects within the Tertiary channel play which lie over 250 kilometres away to the north east of Toroa. The seismic amplitude and AVO response at Toroa resulted from the presence of certain rock types that are highly unlikely to be present in the deep water plays within the Company's acreage.

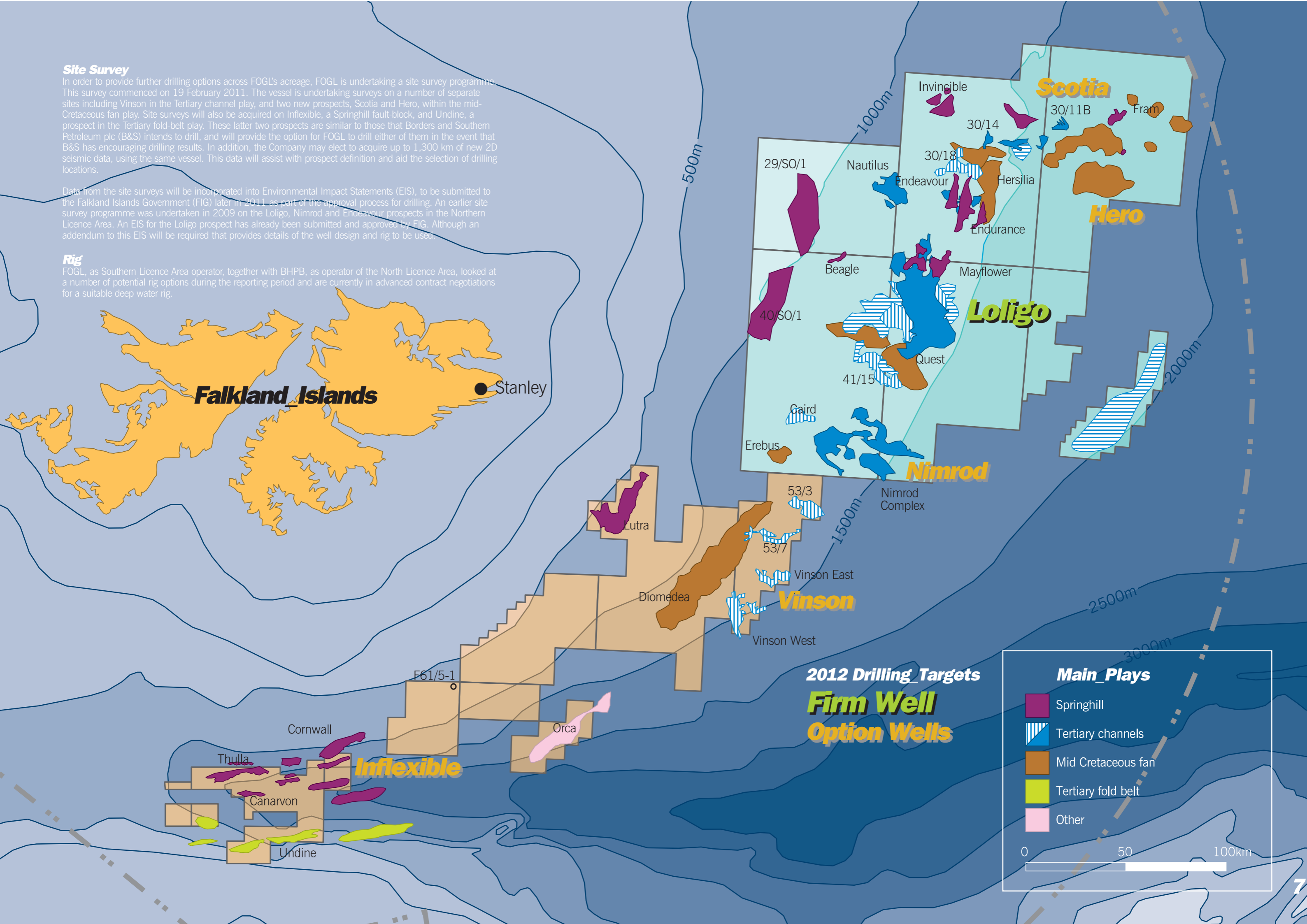
**Site Survey**

In order to provide further drilling options across FOGL's acreage, FOGL is undertaking a site survey programme. This survey commenced on 19 February 2011. The vessel is undertaking surveys on a number of separate sites including Vinson in the Tertiary channel play, and two new prospects, Scotia and Hero, within the mid-Cretaceous fan play. Site surveys will also be acquired on Inflexible, a Springhill fault-block, and Undine, a prospect in the Tertiary fold-belt play. These latter two prospects are similar to those that Borders and Southern Petroleum plc (B&S) intends to drill, and will provide the option for FOGL to drill either of them in the event that B&S has encouraging drilling results. In addition, the Company may elect to acquire up to 1,300 km of new 2D seismic data, using the same vessel. This data will assist with prospect definition and aid the selection of drilling locations.

Data from the site surveys will be incorporated into Environmental Impact Statements (EIS), to be submitted to the Falkland Islands Government (FIG) later in 2011 as part of the approval process for drilling. An earlier site survey programme was undertaken in 2009 on the Loligo, Nimrod and Endeavour prospects in the Northern Licence Area. An EIS for the Loligo prospect has already been submitted and approved by FIG. Although an addendum to this EIS will be required that provides details of the well design and rig to be used.

**Rig**

FOGL, as Southern Licence Area operator, together with BHPB, as operator of the North Licence Area, looked at a number of potential rig options during the reporting period and are currently in advanced contract negotiations for a suitable deep water rig.



**Falkland Islands**

● Stanley

**Main Plays**

- Springhill
- Tertiary channels
- Mid Cretaceous fan
- Tertiary fold belt
- Other



**2012 Drilling Targets**

**Firm Well**  
**Option Wells**

The Company is committed to social, environmental and ethical stewardship when considering business practices. This statement provides an outline of the key areas of Social Responsibility which the Company is committed to when dealing with social, environmental and ethical matters in the workplace.

Directors, company employees and contractors are responsible for ensuring compliance with the following statements. These entities are required to:

- Respect the rights of employees, treating them fairly and without discrimination
- Maintain high ethical standards in carrying out business activities when dealing with: gifts, hospitality, corruption, fraud and the use of inside information and whistle blowing
- Commit to provide opportunities for staff development
- Provide equal employment opportunities
- Commit to being honest and fair in all dealings with partners, contractors and suppliers
- Commit to a proactive quality assurance programme ensuring stakeholders are satisfied with the Company results, the way the business operates and how it promotes continuous improvement in the overall operations of the Company
- Maintain and regularly review the Health and Safety and Environmental (HSE) policies
- Ensure that the HSE Management System is appropriate for the Company's activities

FOGL is committed to continual improvement in all the Company's standards and practices.



**Tim Bushell**  
Chief Executive Officer  
14 March 2011

**Richard Liddell**  
Chairman

Richard Liddell was Operations Director of Premier Oil from 1999 before joining the Board in March 2005. He has many years' experience in the oil and gas industry and prior to Premier Oil, he spent two years as Director of Development at BG Exploration and Production. He previously held a number of senior international positions during an eighteen-year career at Philips Petroleum Company.

**Tim Bushell**  
Chief Executive Officer

Tim Bushell joined FOGL in January and the Board in February 2006 from Paladin Resources plc where he was Managing Director, Norway, from 2001. Tim joined Paladin Resources from Lasmo where he worked for 10 years, including spells as Manager of Lasmo's North Sea assets and General Manager of its South Atlantic business unit, which included the drilling campaign in the North Falklands Basin in 1998. Prior to joining Lasmo, Tim spent time at Ultramar, British Gas and Schlumberger. A qualified geologist, he has a total of 28 years' experience in the oil and gas industry.

**David Hudd FCA**

**Non-executive Director (Deputy Chairman)**

David Hudd, was a partner in PriceWaterhouse until 1982. Since then he has been Chairman or Chief Executive of a number of listed companies. He is currently Executive Chairman of Falkland Islands Holdings plc which he joined in March 2002 and is a major shareholder in the Company. Mr Hudd was a founder Director of the Company in 2004.

**Timothy Jones FCA**

**Non-executive Director (Finance Director)**

Timothy Jones qualified as a Chartered Accountant with PriceWaterhouse in 1974 where his clients included a major UK offshore oil and gas operator. In 1983, he left PriceWaterhouse to join a client as Financial Director before founding his own accountancy and consultancy practice in 1990. He now has clients in a range of business sectors and sits on the boards of a number of companies. Mr Jones joined the Board in September 2004.

**Colin More**

**Exploration Director**

Colin More joined FOGL in April 2006 and has 28 years' experience in the oil and gas industry. Mr More joined FOGL from Paladin Resources plc where he was the Exploration Manager in the UK. Prior to Paladin, he was the Exploration Manager at Cairn Energy, initially responsible for China, before moving on to India. Mr More has previously worked in technical positions at Conoco and Scott Pickford. Mr More joined the Board of FOGL in March 2009.

# Social Responsibility Statement

# Board of Directors

The Directors present their report and the audited financial statements of the Group for the year ended 31 December 2010.

**Principal activity and review of the business**

The principal activity of the Company is that of oil and gas exploration.

**Results and dividends**

The results for the year are set out on page 18.

The Directors do not recommend payment of a dividend.

**Review of business and future developments**

A review of the business and likely future developments of the Group are contained in the Chairman's and Chief Executive's Statement on page 2.

**Directors and Directors' interests**

The Directors of the Company during the year are noted on page 9.

Details of Directors' interests in share options are disclosed in note 19.

**Political and charitable contributions**

During the year a total of \$3,805 was contributed in support of 'The Chile Earthquake Appeal' (2009:\$816 was contributed in support of "The Blackfriars settlement").

**Policy and practice on payment of creditors**

It is Group policy to settle all debts on a timely basis, taking account of the credit period given by each supplier. Trade creditors at 31 December 2010 were equivalent to 14 days of purchases (2009 - 14 days) based on the average daily amount invoiced by suppliers during the year.

**Financial instruments**

Details of the use of financial instruments by the Group are contained in note 18 to the financial statements.

**Principal risks and uncertainties**

There are risks associated with the oil exploration industry. The Board regularly reviews the risks to which the Group is exposed and endeavours to minimise these risks as far as possible. The following summary, which is not exhaustive, outlines some of the risks and uncertainties facing the Group at its present stage of development:

- The exploration for and development of oil reservoirs involves technical risks, which even a combination of careful evaluation and knowledge may not eliminate;
- There can be no assurance that the Group's projects will be fully developed in accordance with the current plans. Future development work and financial returns arising may be adversely affected by factors outside the control of the Group;

**Events after the reporting date**

There have been no events after the reporting date that require disclosure or materially impact on the amounts contained in these financial statements.

**Related party contract of significance**

RAB Special Situations (Master) Fund Limited (RAB) have subscribed for a total of £8 million of convertible loan notes (Notes). The terms of the Notes are set out in note 16 to the financial statements. No further notes were issued during the year (2009 £nil).

**Auditors**

All of the current Directors have taken all the steps that they ought to have taken to make themselves aware of any information needed by the Company's Auditors for the purposes of their audit and to establish that the Auditors are aware of that information. The Directors are not aware of any relevant audit information of which the Auditors are unaware.

BDO LLP have expressed their willingness to continue in office and a resolution to re-appoint them will be proposed at the annual general meeting.

By order the Board



**Timothy Jones**  
Director  
14 March 2011

**Report of the Directors for the year  
ended 31 December 2010**

### **The Combined Code**

Falkland Oil and Gas Limited's shares are traded on AIM and as such, FOGL is not subject to the requirements of the Combined Code on capital Corporate Governance, nor is it required to disclose its specific policies in relation to capital Corporate Governance. The Directors, however, support high standards of Corporate Governance and will progressively adopt best practices in line with the Combined Code on Corporate Governance, so far as is practicable.

The Board of Directors operates within the framework described below.

### **The workings of the Board and its Committees**

#### **The Board of Directors**

The Board meets frequently to consider all aspects of the Company's activities. A formal schedule of matters reserved for the Board has been issued and approved and includes overall strategy and approval of major capital expenditure.

The Board consists of the Chairman, Deputy Chairman, Chief Executive Officer, Finance Director and Exploration Director. All Directors have access to the advice and services of the Company Secretary and the Company's professional advisers.

	Remuneration	Audit	Nomination	Board
<b>No. of meetings</b>	<b>5</b>	<b>1</b>	<b>-</b>	<b>8</b>
<b>Attendance</b>				
Richard Liddell (non executive)	5	1	-	8
Tim Bushell	-	-	-	8
David Hudd (non executive)	5	1	-	8
Timothy Jones	4	1*	-	8
Colin More	-	-	-	8

\*By invitation

#### **Remuneration Committee**

The Remuneration Committee comprises Richard Liddell, Timothy Jones and David Hudd and is chaired by Richard Liddell. Its terms of reference are discussed in the remuneration report.

#### **Audit Committee**

The Audit Committee comprises David Hudd and Richard Liddell, and is chaired by David Hudd. It is responsible for ensuring that the financial performance of the Company is properly reported on and monitored, and for reviewing the auditors' reports relating to accounts and internal control systems.

#### **Nomination Committee**

The Nomination Committee comprises Richard Liddell and David Hudd and is chaired by Richard Liddell. It is responsible for the selection and appointment of Board Members.

#### **Relations with shareholders**

Communications with shareholders are given a high priority by the Board of Directors who take responsibility for ensuring that a satisfactory dialogue takes place. Directors plan to meet with the Company's institutional shareholders following the announcement of interim and final results and at other appropriate times. The Directors are also in regular contact with stockbrokers' analysts. The Company has developed a website containing investor information to improve communications with individual investors and other interested parties.

#### **Internal control**

The Directors acknowledge their responsibility for the Company's system of internal control and for reviewing its effectiveness. The system of internal control is designed to manage the risk of failure to achieve the Company's strategic objectives. It cannot totally eliminate the risk of failure but will provide reasonable, although not absolute, assurance against material misstatement or loss.

#### **Going concern**

The Directors consider that the Company has adequate financial resources to enable it to continue in operation for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the Financial Statements.

The Directors are responsible for preparing the Directors' Report and the financial statements for the Group and Parent Company accounts in accordance with applicable Falkland Islands law and regulations.

Falkland Islands legislation requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Group and Parent Company and of the profit or loss of the Group for that year. The Directors are required to use the International Financial Reporting Standards "IFRS" as adopted by the European Union (IFRS) in preparing the Group's financial statements. The Directors have chosen to prepare financial statements for the Company in accordance with IFRS.

International Accounting Standard 1 requires that the financial statements present fairly for each financial period the Group and Parent Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's "Framework for the preparation and presentation of financial statements". In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRS. A fair presentation also requires the Directors to:

- consistently select and apply appropriate accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; and
- provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the financial statements comply with the Companies Act 1948 and as amended by the Companies (Amendment) Ordinance 2006 (Falkland Islands Companies Act) as it applies in the Falkland Islands. They are also responsible for safeguarding the assets of the Group and the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Financial information is published on the Company's website. The maintenance and integrity of this website is the responsibility of the Directors; the work carried out by the Auditors does not involve consideration of these matters and, accordingly, the Auditors accept no responsibility for any changes that may occur to the financial statements after they are initially presented on the website.

Legislation in the Falkland Islands governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

**Corporate governance statement  
for the year ended 31 December 2010**

**Statement of Directors' responsibilities  
for the year ended 31 December 2010**

## Report of the Board on Remuneration

During the year under review, the members of the Remuneration Committee (the Committee) were Richard Liddell (Chairman), David Hudd and Tim Jones. The Committee met formally five times during the year.

### Remuneration Policy

The Committee, in forming its policy on remuneration, has given due consideration to the needs of the Company, the shareholders and the provisions of the Combined Code. The ongoing policy of the Committee is to provide competitive remuneration packages to enable it to retain and motivate its key executives and to cost effectively incentivise them to deliver long-term shareholder value.

The Committee keeps itself informed of relevant developments and best practice in the field of remuneration and seeks advice where appropriate from external advisors. During the year the Committee engaged the services of Towers Watson to benchmark the executive incentive scheme and to advise the Committee on improvements to the remuneration programme to bring it into line with industry best practice. The Committee therefore made its recommendations for changes to the design of the incentive scheme based upon independent specialist advice, the objectives of which are to provide better alignment between the incentivisation of the Executive Directors and the interests of shareholders.

Towers Watson provided no other services to the Company during the year.

The remuneration policy for the Chairman and the Non-executive Directors, is determined by the Board, taking into account the limit set in the Articles of Association.

### Explanation of the implementation of the Remuneration Policy

It is the aim of the Committee to reward key executives on a basis, which is focussed on delivering value for the enterprise and therefore shareholders. Whilst all share incentives are connected to the share price, a significant amendment during 2010 has been to adopt market value share options, which require an increase in share price for any value to be delivered to the executives. In addition, the performance conditions attached to these share options requires a continuous level of out performance against the benchmark to be achieved throughout the whole of the performance period for full vesting of the share options. This is achieved by linking the incentives to strategic milestone deliverables (restricted shares) and absolute value for shareholders (share options). Also the remuneration is subject to the broader principle that their remuneration should be competitive with that enjoyed by directors of comparable companies.

### Base salary

The policy is to pay a fair and reasonable base salary, taking into account comparative salaries for similar roles in similar companies. The base salary is reviewed annually by the Committee having regard to the performance of the Company and economic conditions.

### Benefits

The Executive Directors receive a car allowance and payments are made to defined contribution pension schemes for the Executive Directors.

### Remuneration

	Salary/ Fees £*	Pension £*	Taxable benefits £*	2010 Total £*	2010 Total \$	2009 Total £*	2009 Total \$
<b>Non-executive Directors</b>							
David Hudd	50,000	-	-	50,000	77,235	50,000	78,195
Richard Liddell	85,000	-	-	85,000	131,299	85,000	132,931
Timothy Jones	47,640	-	-	47,640	78,321	35,414	55,773
<b>Subtotal</b>	<b>182,640</b>	<b>-</b>	<b>-</b>	<b>182,640</b>	<b>286,855</b>	<b>170,414</b>	<b>266,899</b>
<b>Executive Directors</b>							
Tim Bushell	290,020	36,000	7,417	333,437	515,377	527,314	650,956
Colin More	214,000	17,490	-	231,490	357,572	273,555	325,549
<b>Subtotal</b>	<b>504,020</b>	<b>53,490</b>	<b>7,417</b>	<b>564,927</b>	<b>872,949</b>	<b>800,869</b>	<b>976,505</b>
<b>Total</b>	<b>686,660</b>	<b>53,490</b>	<b>7,417</b>	<b>747,567</b>	<b>1,159,804</b>	<b>971,283</b>	<b>1,243,404</b>

\*These figures are shown in Sterling for information purposes only. Sterling is the currency in which remuneration payments are made to the Directors.

The total share based payment charge during the year in respect of Directors was £157,089 (2009: £174,289).

### Directors interests in Shares

The Directors who held office at the end of the year had the following interests in the issued share capital of the Company.

	31 December 2010	31 December 2009
Richard Liddell	85,000	85,000
Tim Bushell	85,000	85,000
Timothy Jones	180,185	213,031
David Hudd	160,000	160,000
Colin More	25,000	25,000
<b>Total</b>	<b>535,185</b>	<b>568,031</b>

### Short-term incentive plan

The Executive Directors participate in annual performance related bonus arrangements. The Chief Executive had the potential during 2010 of earning a bonus of up to 100% of his salary. 50% of the bonus is attributed to the achievement of specified personal and corporate objectives, and up to 50% is payable subject to the achievement of specified increases in the share price over the year. The Chief Executive was paid a bonus of 19.2% of salary. The Exploration Director had the potential during 2010 to earn a bonus of up to 50% of his basic salary, based upon the achievement of personal and corporate objectives. The Exploration Director was paid a bonus of 16% salary. Bonus payments are not pensionable.

### Long-term incentive schemes

There are two equity-based incentive schemes under which options to acquire shares in the Company, have been granted to the Executive Directors and employees. These schemes provide incentives, which are a mix of FOGI Share Option Scheme options with a market value exercise price, and annual FOGI Long Term Incentive Plan awards with performance conditions, but a 'par value' exercise price (restricted shares).

During 2010 the schemes were re-designed and going forward, long term incentive awards will be granted as a mix of restricted shares and market value options.

### 2010 Share Price Performance



## Remuneration report for the year ended 31 December 2010

### The Falkland Oil & Gas Share Option Scheme

Under the pre-existing scheme options were granted in three tranches, which require the achievement of share price targets over 3 year performance periods in order to vest. Each tranche of options requires a minimum compound annual growth rate (CAGR) in the Company's share price of not less than 10% per annum for any to vest, and a CAGR of not less than 25% for all to vest. The first tranche lapsed on 31 December 2010. This tranche has been replaced with a new one-off option grant so that the total market value (taken at the relevant dates of grant) of all the shares under option under this scheme, will not exceed four times salary.

**Vesting:** These new options will vest, and can be exercised, in a manner identical to the annual plan options referred to in the "Option Vesting" and "Exercise Period" sections below.

**Awards:** Under the amended scheme the following awards were granted on 20 December 2010:-

Tim Bushell – 544,231 options at a price of 104p  
Colin More – 484,135 options at a price of 104p

### **Falkland Oil & Gas Long Term Incentive Plan (LTIP)**

Under the pre-existing scheme, options to acquire shares in the Company at par (0.002p per share) on the third anniversary of grant contingent upon the achievement of two performance conditions over that period, were granted in annual tranches. The performance conditions are:-

1) The achievement of an annually compounded increase in the share price of the Company of not less than 20% from the baseline price, being the average share price for a period before the grant. For the options to vest in full, the share price must increase by 50% annually from the baseline price.

2) If the above condition is satisfied, the relative performance of the Company's share price is then compared against the share price performance of a group of comparator oil exploration companies. For the options to vest at all, the Company's share price performance must exceed that achieved by at least half the members of the peer group.

LTIP options granted to the Executive Directors on 7 October 2007 over a total of 184,677 shares at a baseline price of 126.5p have lapsed, and this tranche has been replaced by a new tranche awarded under the re-designed scheme as follows:-

**Limits:** The annual award of restricted shares has been reduced to up to a maximum of 50% of annual salary, and options with a full market value exercise price, up to 100% of annual salary, have been added to the annual plan.

**Restricted Share Vesting:** Restricted shares will vest on the achievement of strategic objectives and operating milestones over a three-year performance period. Vesting is also conditional upon continued employment with FOGL.

**Option Vesting:** Options will vest according to absolute share price growth, calculated over three years. Growth under 33% will not be rewarded. The total award will be calculated by reference to a target number of days on which this target 33% share price growth is exceeded during the three year period, with a maximum award possible where the average growth reaches 73%. Continued employment with FOGL is required for vesting.

**Exercise Period:** Awards vested under either or both plans may be exercised up to ten years from the date of grant.

**Awards:** Under the amended scheme the following awards were granted on 20 December 2010:-

Tim Bushell – 96,154 restricted shares

Tim Bushell – 192,308 options at a price of 104p

Colin More – 86,538 restricted shares

Colin More – 173,077 options at a price of 104p

### **Options Granted to Non-executive Directors**

In order to reflect the work carried out prior to flotation of the Company in 2004 options were granted to Messrs Hudd and Jones. Of these options, 50% were exercisable at a 50% premium to the price at which shares were placed on flotation. In order to secure the services of Mr Liddell as Chairman, he was granted options in 2006 exercisable at the then ruling market price without a performance condition. Details of Directors interests in share options are disclosed in note 19.

### **General**

Amendments have been made to the rules of both Schemes to permit options or awards of restricted shares to be made at any time when the Company is not in a close period or when similar restrictions apply to prevent

## **Remuneration report for the year ended 31 December 2010**

such grants or awards.

All share options now have a ten-year term. Both incentive schemes are discretionary schemes subject to such changes in design and operation recommended by the Remuneration Committee.

### **Service contracts**

The Committee reviews and agrees Directors' service agreements. The Chief Executive's and the Exploration Director's contracts provide for a 12 month notice period. The Non-executive Directors' appointments are reviewed annually and are subject to 6 months' notice by either party.

By order of the Board



**Richard Liddell**

Chairman of the Remuneration Committee

14 March 2011

### **To the members of Falkland Oil and Gas Limited**

We have audited the financial statements of Falkland Oil and Gas Limited for the year ended 31 December 2010 which comprise the consolidated statement of comprehensive income, the consolidated and company statements of financial position, the consolidated and company statement of cash flows, the consolidated and company statements of changes in equity and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

This report is made solely to the Company's members, as a body, in accordance with the Falkland Islands Companies Act 1948 (as amended for the Companies (Amendment) Ordinance 2006). Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

### **Respective responsibilities of directors and auditors**

As explained more fully in the statement of Directors' responsibilities, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with Falkland Islands law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

### **Scope of the audit of the financial statements**

A description of the scope of an audit of financial statements is provided on the APB's website at [www.frc.org.uk/apb/scope/private.cfm](http://www.frc.org.uk/apb/scope/private.cfm)

### **Opinion on financial statements**

In our opinion the financial statements:

- give a true and fair view of, in all material respects, the state of the group's and the Company's affairs as at 31 December 2010 and of the group's and the Company's loss for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union;
- have been properly prepared in accordance with the Falkland Islands Companies Act 1948 (as amended for the Companies (Amendment) Ordinance 2006);

### **Opinion on other matters**

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.



**BDO LLP**

Chartered Accountants

London

United Kingdom

14 March 2011

## **Independent auditor's report to the Members of Falkland Oil and Gas Limited**

BDO LLP is a limited liability partnership registered in England and Wales (with registered number OC305127).

	Note	Group 2010 \$	Group 2009
Administrative expenses		(2,581,335)	(2,838,893)
<b>Loss from operations</b>	<b>3</b>	<b>(2,581,335)</b>	<b>(2,838,893)</b>
Finance income		711,096	115,183
Foreign exchange gains		38,223	-
<b>Total finance income</b>	<b>4</b>	<b>749,319</b>	<b>115,183</b>
Finance costs		(1,910,500)	(1,699,361)
Foreign exchange loss		-	(1,122,158)
<b>Total finance expense</b>	<b>4</b>	<b>(1,910,500)</b>	<b>(2,821,519)</b>
<b>Loss for the year before taxation</b>		<b>(3,742,516)</b>	<b>(5,545,229)</b>
Taxation	7	-	217,417
<b>Loss for the year attributable to owners of the parent</b>		<b>(3,742,516)</b>	<b>(5,327,812)</b>
<b>Total comprehensive expense for the year attributable to owners of the parent</b>		<b>(3,742,516)</b>	<b>(5,327,812)</b>
Loss for the year per ordinary share – Basic and diluted	9	(2.56c)	(5.16c)

The loss for the year arose from continuing operations.

The notes on pages 22 to 36 form part of these financial statements.

	Note	Group 2010 \$	Group 2009 \$	Company 2010 \$	Company 2009 \$
<b>Non-current assets</b>					
Intangible assets	11	69,415,150	47,599,809	69,415,150	47,599,809
Property, plant and equipment	12	62,508	16,910	62,508	16,910
Investment in subsidiary	13	-	-	1	1
		69,477,658	47,616,719	69,477,659	47,616,720
<b>Current assets</b>					
Trade and other receivables	14	668,089	504,830	668,089	504,830
Cash and cash equivalents		69,819,625	93,535,653	69,819,625	93,535,653
<b>Total assets</b>		<b>139,965,372</b>	<b>141,657,202</b>	<b>139,965,373</b>	<b>141,657,203</b>
<b>Current liabilities</b>					
Trade and other payables	15	(983,522)	(873,146)	(983,523)	(873,147)
Loans and borrowings	16	(14,288,089)	-	(14,288,089)	-
<b>Net current assets</b>		<b>55,216,103</b>	<b>93,167,337</b>	<b>55,216,102</b>	<b>93,167,336</b>
<b>Non-current liabilities</b>					
Long term borrowings	16	-	(12,744,245)	-	(12,744,245)
<b>Total liabilities</b>		<b>(15,271,611)</b>	<b>(13,617,391)</b>	<b>(15,271,612)</b>	<b>(13,617,392)</b>
<b>Net assets</b>		<b>124,693,761</b>	<b>128,039,811</b>	<b>124,693,761</b>	<b>128,039,811</b>
<b>Capital and reserves attributable to equity shareholders of the Company</b>					
Share capital	17	5,458	5,452	5,458	5,452
Share premium	17	137,204,111	137,077,241	137,204,111	137,077,241
Other reserve		4,985,693	4,985,693	4,985,693	4,985,693
Retained deficit		(17,501,501)	(14,028,575)	(17,501,501)	(14,028,575)
<b>Total equity</b>		<b>124,693,761</b>	<b>128,039,811</b>	<b>124,693,761</b>	<b>128,039,811</b>

The financial statements were approved by the Board of Directors and authorised for issue on 14 March 2011 and were signed on its behalf by:

  
**Timothy Jones**  
 Director

  
**Tim Bushell**  
 Director

The notes on pages 22 to 36 form part of these financial statements.

**Consolidated Statement of Comprehensive Income for the year ended 31 December 2010**

**Consolidated and Company Statements of Financial Position at 31 December 2010**

	Group 2010 \$	Group 2009 \$	Company 2010 \$	Company 2009 \$
<b>Operating activities</b>				
Loss for the year	(3,742,516)	(5,327,812)	(3,742,516)	(5,327,812)
Finance income	(711,096)	(115,183)	(711,096)	(115,183)
Finance expense	1,910,500	2,821,519	1,910,500	2,821,519
Taxation expense	-	(217,417)	-	(217,417)
	<b>(2,543,112)</b>	<b>(2,838,893)</b>	<b>(2,543,112)</b>	<b>(2,838,893)</b>
Depreciation	17,689	65,157	17,689	65,157
Share based payment expense	269,590	325,743	269,590	325,743
<b>Net cash flow from operating activities before changes in working capital</b>	<b>(2,255,833)</b>	<b>(2,447,993)</b>	<b>(2,255,833)</b>	<b>(2,447,993)</b>
(Increase)/decrease in trade and other receivables	(76,855)	57,705	(76,855)	57,705
(Decrease)/increase in trade and other payables	(169,625)	219,303	(169,625)	219,303
<b>Cash used in operations</b>	<b>(2,502,313)</b>	<b>(2,170,985)</b>	<b>(2,354,185)</b>	<b>(2,170,985)</b>
Taxation received/(paid)	269,576	(269,576)	269,576	(269,576)
<b>Net cash flow from operating activities</b>	<b>(2,232,737)</b>	<b>(2,440,561)</b>	<b>(2,232,737)</b>	<b>(2,440,561)</b>
<b>Investing activities</b>				
Interest received	711,096	115,183	711,096	115,183
Purchases of property, plant and equipment	(63,287)	(2,956)	(63,287)	(2,956)
Expenditure in respect of intangible assets	(21,891,341)	(12,881,072)	(21,891,341)	(12,881,072)
<b>Cash used in investing activities</b>	<b>(21,243,532)</b>	<b>(12,768,845)</b>	<b>(21,243,532)</b>	<b>(12,768,845)</b>
<b>Financing activities</b>				
Issue of ordinary share capital (net of issue costs)	126,876	89,969,850	126,876	89,969,850
<b>Net cash from financing activities</b>	<b>126,876</b>	<b>89,969,850</b>	<b>126,876</b>	<b>89,969,850</b>
<b>Net (decrease)/ increase in cash and cash equivalents in the year</b>	<b>(23,349,393)</b>	<b>74,760,444</b>	<b>(23,349,393)</b>	<b>74,760,444</b>
Cash and cash equivalents at start of year	93,535,653	18,819,935	93,535,653	18,819,935
Effect of foreign exchange rate changes on cash and cash equivalents	(366,635)	(44,726)	(366,635)	(44,726)
<b>Cash and cash equivalents at end of year</b>	<b>69,819,625</b>	<b>93,535,653</b>	<b>69,819,625</b>	<b>93,535,653</b>

	Share capital \$	Share premium \$	Group and Company Retained deficit \$	Other Reserve \$	Total Equity \$
<b>Balance as at 1 January 2009</b>	<b>3,681</b>	<b>47,109,162</b>	<b>(9,026,506)</b>	<b>4,985,693</b>	<b>43,072,030</b>
Loss for the year	-	-	(5,327,812)	-	(5,327,812)
Shares issued	1,771	94,969,919	-	-	94,971,690
Costs associated with issue of share capital	-	(4,971,840)	-	-	(4,971,840)
Share based payments	-	-	325,743	-	325,743
<b>Balance as at 31 December 2009</b>	<b>5,452</b>	<b>137,077,241</b>	<b>(14,028,575)</b>	<b>4,985,693</b>	<b>128,039,811</b>
Loss for the year	-	-	(3,742,516)	-	(3,742,516)
Share based payments	-	-	269,590	269,590	-
Shares issued	6	126,870	-	-	126,876
<b>Balance as at 31 December 2010</b>	<b>5,458</b>	<b>137,204,111</b>	<b>(17,501,501)</b>	<b>4,985,693</b>	<b>124,693,761</b>

## Consolidated and Company Statements of Cash Flows for the year ended 31 December 2010

## Statements of Changes in Equity for the year ended 31 December 2010

## 1 General information

Falkland Oil and Gas Limited is a company incorporated in the Falkland Islands. The address of the registered office is given in the officers and advisors section of this report. The Company's administrative office is in London, UK. The nature of the Company's operations and its principal activities are set out in the Chief Executive's Statement, the Report of Directors and the Technical Review on pages 10 and 5.

## 2 Accounting policies

IAS 8 requires that management shall use its judgement in developing and applying accounting policies that result in information which is relevant to the economic decision-making needs of users; that are reliable, free from bias, prudent, complete and represent faithfully the financial position, financial performance and cash flows of the entity.

### Basis of preparation

The principal accounting policies adopted in the preparation of the financial statements are set out below. The policies have been consistently applied to all the years presented, unless otherwise stated. All amounts presented are in US dollars unless otherwise stated.

These financial statements have been prepared on the basis of a going concern and in line with International Financial Reporting Standards (IFRS) and IFRIC interpretations issued by the International Accounting Standards Board (IASB) adopted by the European Union and in accordance with applicable Falkland Islands Law. The adoption of all of the new and revised Standards and Interpretations issued by the IASB and the IFRIC of the IASB that are relevant to the operations and effective for annual reporting periods beginning on 1 January 2010 are reflected in these financial statements.

The financial statements are also prepared in accordance with the Statement of Recommended Practice "Accounting for Oil and Gas Exploration, Development, Production and Decommissioning Activities" and have been prepared in accordance with its provisions.

The preparation of financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and factors that are believed to be reasonable under the circumstances, the results of which form the basis of making judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision only affects that period or in the period of revision and future periods if the revision affects both current and future periods.

In common with many exploration companies, the Group raises finance for its exploration and appraisal activities in discrete tranches. Further funding is raised as and when required.

### Going concern

The Directors are of the opinion that the Group has adequate financial resources to enable it to undertake its planned programme appraisal and drilling activities over the forthcoming 12 months.

### New Accounting Standards

The following new standards and amendments to standards are mandatory for the first time for the Group for financial year beginning 1 January 2010. Except as noted, the implementation of these standards has not had a material effect on the group.

Standard	Effective date	Impact on initial application
IAS 27 - Amendment - Consolidated and Separate Financial Statements	1 Jul 2009	The amendment affects the acquisition of subsidiaries achieved in stages and disposals of interests. Amendment does not require the restatement of previous transactions.
IFRS 3 - Revised - Business Combinations	1 Jul 2009	The revision to IFRS 3 introduced a number of changes in accounting for acquisition costs and recognition of intangible assets in business combinations. The revised standard does not require the restatement of previous business combinations.
IAS 39 - Amendment - Financial Instruments: Recognition and Measurement: Eligible Hedged Items	1 Jul 2009	The amendment clarifies the principles for determining eligibility of hedged items.
IFRS 2 - Amendment - Group Cash-settled Share-based Payment Transactions	1 Jan 2010	The amendments clarifies that where a parent (or another group entity) has an obligation to make a cash-settled share-based payment to another group entity's employees or suppliers, the entity receiving the goods or services should account for the transaction as equity - settled.
'Additional exemptions for first-time adopters' (Amendment to IFRS 1)	1 Jan 2010	The Group did not previously prepare or report financial information as a combined reporting entity in any other GAAP and therefore this is not relevant to the Group.
Improvements to IFRSs (2009)	Generally 1 January 2010	The improvements in this Amendment clarify the requirements of IFRSs and eliminate inconsistencies within and between

Standard	Effective date	Description
IFRIC 17 - Distributions of Non-cash Assets to Owners	1 Jan 2010	The interpretation provides guidance on how to measure distribution of assets other than cash.
IFRIC 18 - Transfer of Assets from Customers	1 Jan 2010	The interpretation clarifies the treatment of agreements in which an entity receives from a customer an item of property that it must use to provide the customer with an on-going access to goods or services.
IFRIC 9/IAS 39 - Amendment - Embedded Derivative	1 Jan 2010	The amendment clarifies the treatment of embedded derivatives in host contracts that are classified out of fair value through profit or loss.
IFRIC 16 - Hedges of a Net Investment in a Foreign Operation	1 Jan 2010	The interpretation provides guidance for application of hedge accounting in foreign operations.

No other IFRS issued and adopted but not yet effective are expected to have an impact on the Group's financial statements.

Standards, amendments and interpretations, which are effective for reporting periods beginning after the date of these financial statements which have not been adopted early:

Standard	Description	Effective date
IAS 32	Amendment - Classification of Right Issues	1 Feb 2010
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments	1 Jul 2010
IFRS 1	Amendment - First Time Adoption of IFRS	1 Jul 2010
IAS 24	Revised - Related Party Disclosures	1 Jan 2011
IFRIC 14	Amendment - IAS 19 Limit on a defined benefit asset	1 Jan 2011
IFRS 7*	Amendment - Transfer of financial assets	1 Jul 2011
IFRS 1*	Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters	1 Jul 2011
	Improvements to IFRSs (2010)*	1 Jan 2011
IAS 12*	Deferred Tax: Recovery of Underlying Assets	1 Jan 2012
IFRS 9*	Financial instruments	1 Jan 2013

The Group has not yet assessed the impact of IFRS 9. Except for the amended disclosure requirements of IAS 24 (the above revised standards), amendments and interpretations are not expected to materially affect the Group's reporting or reported numbers.

\* Not yet endorsed by European Union.

### Basis of consolidation

The consolidated financial statements incorporate the financial statements of Falkland Oil and Gas Limited and its wholly-owned subsidiary made up to the end of the reporting period each year. Control is achieved where Falkland Oil and Gas Limited has the power to govern the financial and operating policies of an investee entity so as to obtain benefits from its activities.

The results of the subsidiary are included in the consolidated statement of comprehensive income from the date of incorporation. Where necessary, adjustments are made to the financial statements of subsidiary to bring the accounting policies used into line with those used by the Parent Company.

All significant intercompany transactions and balances between group entities are eliminated on consolidation.

As a consolidated Group statement of comprehensive income is published, a statement of comprehensive

# Notes forming part of the Financial Statements

income for the Parent Company is omitted from the Group financial statements by virtue of the Falkland Islands Companies Act 1948 (as amended for the Companies (Amendment) Ordinance 2006).

### Intangible Assets

Oil and gas assets: exploration and appraisal  
The Group has continued to apply the full cost method of accounting for Exploration and Appraisal ("E&A") costs, having regard to the requirements of IFRS 6 'Exploration for and Evaluation of Mineral Resources'. Under the full cost method of accounting, costs of exploring and evaluating oil and gas properties are accumulated and capitalised by reference to appropriate cost pools. For E&A asset purposes the Group has one cost pool being the Falkland Islands.

E&A costs are initially capitalised within 'Intangible assets'. Such E&A costs may include costs of licence acquisition, technical services and studies, seismic acquisition, exploration drilling and testing, but do not include costs incurred prior to having obtained the legal rights to explore an area, which are expensed directly to the statement of comprehensive income as they are incurred.

Intangible E&A assets related to each exploration licence/prospect are not depreciated and are carried forward until the existence (or otherwise) of commercial reserves has been determined. The Group's definition of commercial reserves for such purpose is proven and probable reserves on an entitlement basis.

If commercial reserves have been discovered, the related E&A assets are assessed for impairment.

E&A assets are assessed for impairment when facts and circumstances suggest that the carrying value of the E&A cost pool to which they relate may exceed its future recoverable amount. Such indicators include the point at which a determination is made as to whether or not commercial reserves exist.

Where there are deemed to be no commercial reserves the E&A assets concerned will generally be written off in full.

Any material impairment loss is recognised in the statement of comprehensive income and separately disclosed.

#### Jointly controlled assets

Jointly controlled assets are arrangements in which the Group holds an interest on a long term basis which are jointly controlled by the Group and one or more venturers under a contractual arrangement. The Group's exploration, development and production activities are generally conducted jointly with other companies in this way. Since these arrangements do not constitute entities in their own right, the consolidated financial statements reflect the relevant proportion of costs, revenues, assets and liabilities applicable to the Group's interests.

#### Taxation

Income tax expense represents the sum of the current tax and deferred tax charge for the period.

The tax currently payable is based on taxable profit for the year. Taxable profit differs from profit as reported in the statement of comprehensive income because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

Deferred tax is recognised on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases, and is accounted for using the balance sheet liability method. Deferred tax liabilities are recognised for all taxable temporary differences except for differences arising on:

- The initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction affects neither accounting or taxable profit; and
- Investments in subsidiaries and jointly controlled entities where the group is able to control the timing of the reversal of the difference and it is probable that the difference will not reverse in the foreseeable future.

Deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised.

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

Deferred tax is calculated at the tax rates that have been enacted or substantively enacted and are expected to apply in the period when the liability is settled or the asset realised. Deferred tax is charged or credited to the statement of comprehensive income, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to off set current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Group intends to settle its current tax assets and liabilities on a net basis.

#### Foreign currencies

Monetary assets and liabilities denominated in foreign currencies are translated into dollars at the rates of exchange prevailing at the reporting date. Transactions in foreign currencies are translated at the exchange rate ruling at the date of the transaction. Exchange differences are taken to the statement of comprehensive income.

On consolidation, assets and liabilities of subsidiary undertakings and representative offices which are denominated in foreign currencies are translated into Dollars at the rate ruling at the reporting date. Income and cash flow statements are translated at average rates of exchange prevailing during the year. Exchange differences resulting from the translation at closing rates of net investments in subsidiary undertakings and of foreign currency representative offices, together with differences between earnings for the year translated at average and closing rates, are dealt with in the foreign currency translation reserve.

The functional currency of the Company and presentational currency of the Group is United States Dollars and accordingly the financial statements have been prepared in this currency.

#### Property, plant and equipment and depreciation

Property, plant and equipment are recorded at historical cost less accumulated depreciation. Property, plant and equipment are depreciated using the straight line method over their estimated useful lives, as follows:

Fixtures, fittings and equipment - 4 years

#### Investments

In its separate financial statements, the Company recognises its investments in subsidiaries at cost less any provision for impairment.

#### Leases

Rent paid on operating leases is charged to the statement of comprehensive income on a straight line basis over the term of the lease.

#### Share based payments

The share option programme allows Directors and Employees to acquire shares of the Company. The fair value of options granted is recognised as an expense with a corresponding increase in equity. The fair value is measured at grant date and spread over the period during which the directors and employees become unconditionally entitled to the options. The fair value of the options granted is measured using an option pricing model, taking into account the terms and conditions upon which the options were granted. The amount recognised as an expense is adjusted based on time based conditions to reflect the actual number of share options that will vest. The actual number of share options expected to vest is not adjusted for market vesting conditions. Where the terms and conditions of options are modified before they vest, the increase in the fair value of the options, measured immediately before and after the modification, is also charged to the consolidated statement of comprehensive income over the remaining vesting period. Further details of the treatment of share based payments can be found in note 19.

#### Segmental disclosures

The Group's operations are entirely focused on oil and gas exploration activities in the Falkland Islands with its corporate head office in the UK. Based on risks and returns the directors consider that there is only one business segment that they use to assess the Group's performance and allocate resources being oil and gas exploration activities in the Falkland Islands and therefore the segmental disclosures for the Group have already been given in these financial statements.

#### Financial instruments

The Group's financial assets consist of current account or short term deposits at variable interest rates, loans and other receivables. Any interest earned is accrued and classified as interest. Trade and other receivables are stated initially at fair value and subsequently at amortised cost.

The Group's financial liabilities consist of convertible Loan Notes, trade and other payables. All are non derivative assets. The trade and other payables are stated initially at fair value and subsequently at amortised cost. Convertible Loan Notes are treated as described below.

#### Convertible Loan Notes

In accordance with IAS 32, the Group has classified the convertible debt in issue as a compound financial instrument. Accordingly, the Group presents the liability and equity component separately on the statement of financial position. The classification of the liability and equity component is not reversed as a result of a change in the likelihood that the conversion option will be exercised. No gain or loss arises from initially recognising the components of the instrument separately. Interest on the debt element of the loan is accreted over the term of the loan at the effective interest rate. In the event of conversion the equity component relating to the conversion rights and the warrants issued will be transferred to share capital and share premium (for any amount over the nominal value of each share).

The assessment of the equity and debt components of the convertible instrument was made on inception and was not revisited as a result of the change in functional currency.

#### Derivatives

Derivatives are recognised initially, and subsequently re-measured, at fair value. Changes in value are recognised in the statement of comprehensive income.

Derivatives may be embedded in other instruments. Embedded derivatives are treated as separate derivatives

and measured at fair value, with changes in value being recognised in the statement of comprehensive income, when:

- their terms would meet the definition of a stand alone derivative if they were contained in a separate contract;
- their economic characteristics and risks are not clearly and closely related to those of the host contract; and
- the combined contract is not measured at fair value with changes in value being recognised in the statement of comprehensive income.

Conversion features of convertible debt issued by the Group which do not meet the definition of an equity instrument are accounted for as derivatives over the company's own equity and are recognised initially, and subsequently remeasured, at fair value. Changes in value are recorded in the statement of comprehensive income.

**Notes forming part of the  
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#### Critical accounting estimates and judgments

The Group makes estimates and assumptions regarding the future. Estimates and judgements are continually evaluated based on historical experiences and other factors, including expectations of future events that are believed to be reasonable under the circumstances. In the future, actual experience may deviate from these estimates and assumptions. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are as follows:

#### Recoverability of intangible assets

Under the full cost based method of accounting, the Group capitalises exploration and appraisal costs until it is capable of determining whether its exploration efforts were successful and, if they were successful, whether any impairment charges may be required to bring the net book values of assets in line with their economic values.

This assessment involves judgement as to the likely future commerciality of the asset and when such commerciality should be determined as well as future revenues and costs pertaining to the utilisation of the licence rights to which such capitalised costs relate and the discount rate to be applied to such future revenues and costs in order to determine a recoverable value

#### Impairment review

The carrying amounts of the Group's E&A assets are reviewed at each reporting date and, if there is any indication that an asset may be impaired, its recoverable amount is estimated. The recoverable amount is the higher of its net selling price and its value in use.

Impairment assessments are carried out by the Directors if there has been an event or a change in circumstance that would indicate that the carrying value of the asset may not be recoverable.

While conducting an impairment review of its assets, the Group exercises judgement in making assumptions about future oil and gas prices, oil and gas reserves/resources and future development and production costs. By their nature, impairment reviews include significant estimates regarding future financial resources and commercial and technical feasibility to enable the successful realisation of the exploration expenditure. Changes in the estimates used can result in significant charges to the statement of comprehensive income as any impairment loss arising from the review is charged to the statement of comprehensive income whenever the carrying amount of the asset exceeds its recoverable amount.

#### Convertible Loan Notes

The fair value of the liability component on initial recognition is the present value of the stream of future cash flows (including both coupon payments and redemption) discounted at the market rate of interest that would have been applied to an instrument of comparable credit quality with substantially the same cash flows, on the same terms, but without the conversion option. The applicable rate of interest is estimated at 15%.

#### Share based payments

Directors best estimate of the valuations underlying the share based payments are based on assumptions made by directors using updated models previously prepared by external consultants. Those assumptions are described in the Notes to the accounts and include, among others, the dividend growth rate, expected volatility, expected life of the options and number of options expected to vest. See note 19 for further details of these assumptions.

### 3 Loss from operations

	Group 2010 \$	Group 2009 \$
Loss from operations is stated after charging:		
Depreciation	17,689	65,157
Share based payments	269,590	325,744
Operating lease payments	190,692	171,322
Auditors' remuneration:		
Audit fee	41,763	38,223
Tax services - current year	12,031	11,743
- in respect of prior years	14,770	10,000

### 4 Finance income and expense

	Group 2010 \$	Group 2009 \$
Bank interest receivable	711,096	115,183
Foreign exchange gains	38,223	-
Total Finance income	749,319	115,183
Interest expense on convertible loan notes	(1,910,500)	(1,699,361)
Foreign exchange losses	-	(1,122,158)
Total finance expense	(1,910,500)	(2,821,519)
Net finance expense	(1,161,181)	(2,706,336)

### 5 Employees

	Group 2010 \$	Group 2009 \$	Company 2010 \$	Company 2009 \$
Employment costs (excluding directors) consist of:				
Wages and salaries	193,910	381,755	193,910	381,755
Share based payments	26,606	34,888	26,606	34,888
Pension costs	13,256	4,104	13,256	4,104
Social security costs	23,145	26,690	23,145	26,690
	256,917	447,437	256,917	447,437

The average monthly number of Employees (including Directors) during the year was 7 (2009-8).

#### Pension costs

The Group does not operate a pension plan for Directors or Employees but does, at the Directors' and Employees' option, contribute to the personal pension plans of each Director and Employee, up to a specified percentage of salary. The pension cost charge for employees (excluding Directors) for the year amounted to \$ 13,256 (2009 - \$4,104).

The average monthly number of Employees (including only Executive Directors) of the Group during the year was:

	Group 2010 Number	Group 2009 Number	Company 2010 Number	Company 2009 Number
Technical	1	1	1	1
Administration	3	3	3	3
	4	4	4	4

**Notes forming part of the  
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## 6 Directors' remuneration

	Group 2010 \$	Group 2009 \$	Company 2010 \$	Company 2009 \$
Directors' remuneration consists of:				
Directors' fees and benefits	1,077,069	1,204,435	1,077,069	1,204,435
Share based payments	242,984	290,856	242,984	290,856
Pension costs	82,734	130,116	82,734	130,116
Social security costs	130,813	174,756	130,813	174,756
	<u>1,533,600</u>	<u>1,800,163</u>	<u>1,533,600</u>	<u>1,800,163</u>

Amounts attributable to the highest paid director:

Director's fees and benefits	459,612	583,678	459,612	583,678
Share based payments	129,217	118,355	129,217	118,355
Pension costs	55,765	56,185	55,765	56,185
Social security costs	56,321	108,236	56,321	108,236
	<u>700,915</u>	<u>866,454</u>	<u>700,915</u>	<u>866,454</u>

Key management and personnel are considered to be the Directors. No Directors or key management exercised any share options during either year. The Company provides Directors & Officers liability insurance at a cost of \$22,953 (2009: \$ 22,007). This cost is not included in the above table.

## 7 Taxation

	Group 2010 \$	Group 2009 \$
Current year UK corporation tax at 28%	-	-
Adjustment in respect of prior period	-	(217,417)
	-	<u>(217,417)</u>

Factors affecting the tax charge for the current period.

The tax charge for the year is higher than the standard rate of corporation tax in the UK (28%) (2009 - 28%).

The differences are explained below:

	Group 2010 \$	Group 2009 \$
<b>Tax reconciliation</b>		
Loss for the year before tax	(3,742,516)	(5,545,229)
Current tax credit at 28% (2009, 28%)	(1,047,904)	(1,552,664)
Effects of:		
Expenses not deductible for tax purposes	109,988	91,532
Depreciation	4,953	18,244
Loss carry back to prior year	-	308,376
Realised losses carried forward	429,747	550,710
Pre-trading losses carried forward	503,217	583,802
Adjustment in respect of prior period	-	(217,417)
	-	<u>(217,417)</u>

### Factors that may affect future current and total tax charges

The Group had tax losses carried forward on which no deferred tax asset is recognised. This may affect future tax charges should the Group produce taxable trading profits in future periods. No deferred tax asset is recognised in respect of losses carried forward to future periods due to the uncertainty of the timing of future taxable profits.

## 8 Deferred taxation

	Group 2010 \$	Group 2009 \$	Company 2010 \$	Company 2009 \$
The elements of deferred taxation are as follows:				
Depreciation in excess of capital allowances	4,953	90,308	4,953	90,308
Pre-trading expenditure carried forward	4,541,969	3,958,310	4,541,969	3,958,310
Unexpired Share options	467,216	863,312	467,216	863,312
	<u>5,014,138</u>	<u>4,911,930</u>	<u>5,014,138</u>	<u>4,911,930</u>

Total tax allowances available to claim in future periods in respect of pre-trading capital expenditure for which a deferred tax asset has not been recognised are \$13,853,764 (2009: \$12,056,561).

Pre-trading expenditure expires after seven years. Deferred Tax assets have not been recognised in respect of these items because at this point in the Group's development it is uncertain that future taxable profits will be available against which the Company can utilise the benefits of tax losses.

Financial Year	Expire (year)	\$
2005	2012	694,927
2006	2013	4,989,350
2007	2014	2,716,158
2008	2015	1,990,880
2009	2016	1,665,246
2010	2017	1,797,203

## 9 Loss per share

The calculation of basic loss per ordinary share is based on a loss of \$3,742,516 (2009 - loss of \$5,327,812) and on 146,330,198 ordinary shares (2009 - 102,801,956), being the weighted average number of ordinary shares in issue during the year. There is no difference between the diluted loss per share and the basic loss per share presented as the Group reported a loss for the year.

The effect of all potential ordinary shares arising from the exercise of options going forward is considered to be anti-dilutive 2,204,601 (2009: 2,657,398) potential ordinary shares have been excluded from the above calculation as they are anti-dilutive.

## 10 Loss for the financial year

The Company has taken advantage of the exemption allowed under section 230 of the United Kingdom Companies Act 1985, as it applies in the Falkland Islands, by virtue of section 2(1)(c) of the Companies (Amendment) Ordinance 2006 and has not presented its own statement of comprehensive income in these financial statements. The Company loss for the year was \$3,742,516 (2009 Loss: \$5,327,812).

## 11 Intangible assets

Group and Company Exploration and appraisal costs 2010		\$
Cost		
At 1 January 2010		47,599,809
Additions during the year		21,815,341
		<u>69,415,150</u>
Group and Company Exploration and appraisal costs 2009		\$
Cost		
At 1 January 2009		38,643,981
Additions during the year		8,955,828
		<u>47,599,809</u>

Intangible assets represent exploration expenditure on the Group's licences offshore the Falkland Islands. The Company holds all the intangible assets of the Group.

**Notes forming part of the  
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## 12 Property, plant and equipment

Group and Company Fixtures, fittings and equipment 2010	
	\$
Cost	
At 1 January 2010	327,858
Additions during the year	63,287
At 31 December 2010	391,145
Depreciation	
At 1 January 2010	310,948
Charge for the year	17,689
At 31 December 2010	328,637
Net book value	
At 31 December 2010	62,508

Group and Company Fixtures, fittings and equipment 2009	
	\$
Cost	
At 1 January 2009	324,902
Additions during the year	2,956
At 31 December 2009	327,858
Depreciation	
At 1 January 2009	245,791
Charge for the year	65,157
At 31 December 2009	310,948
Net book value	
At 31 December 2009	16,910
Net book value	
At 31 December 2008	79,111

## 13 Investment in subsidiary

The principal subsidiary of Falkland Oil and Gas Limited is FOGL Finance Limited, a company incorporated in the United Kingdom, which is 100% owned by the Company and which has been included in these consolidated financial statements.

## 14 Trade and other receivables

	Group 2010	Group 2009	Company 2010	Company 2009
	\$	\$	\$	\$
Other receivables	415,056	416	415,056	416
Prepayments	253,033	234,818	253,033	234,818
Corporation tax receivable	-	269,596	-	269,596
	668,089	504,830	668,089	504,830

All above amounts are due within one year.

## 15 Trade and other payables

	Group 2010	Group 2009	Company 2010	Company 2009
	\$	\$	\$	\$
Trade and other payables	551,333	309,696	551,333	309,696
Other taxes and social security costs	92,956	87,057	92,956	87,057
Accruals	339,233	476,393	339,234	476,394
	983,522	873,146	983,523	873,147

Trade payables and accruals principally comprise amounts outstanding for trade purchases, staff bonuses and ongoing costs.

## 16 Loans and borrowings

	Group 2010	Group 2009	Company 2010	Company 2009
	\$	\$	\$	\$
<b>Non-current liabilities</b>				
Brought forward from prior year	12,744,245	10,041,624	12,744,245	10,041,624
Exchange rate revaluation	(366,656)	1,003,260	(366,656)	1,003,260
Accrued interest	1,910,500	1,699,361	1,910,500	1,699,361
Reclassified to current liabilities	(14,288,089)	-	(14,288,089)	-
Carrying amount of liability at 31 December	-	12,744,245	-	12,744,245
<b>Current liabilities</b>				
Reclassified from non-current liabilities	14,288,089	-	14,288,089	-
Carrying amount of liability at 31 December	14,288,089	-	14,288,089	-

On 22 December 2006, the Company entered into a financing agreement with RAB Special Situations (Master) Fund Limited (RAB) under which RAB would advance £8 million under Convertible Loan Notes (Notes). These funds were made available over four tranches between December 2006 and September 2007. No further Notes were issued during the year ended 31 December 2010 (2009: nil).

The Notes are for a term of 5 years and bear interest at 6 per cent per annum. They carry the right to be converted at any time at the discretion of RAB in whole or in part into ordinary shares of 0.002 pence each in the Company shares at a price of 80 pence per share (subject to adjustment). Interest can be paid in cash or Notes at the option of the Note holder and the Notes convert into shares in the Company on the same basis as stated above. Full conversion of the Notes issued would lead to the issue of 10,000,000 new shares in the Company. The Notes are not redeemable / repayable by the Company until the expiry of the term. On issue of the first tranche of Notes RAB received 6,000,000 warrants, exercisable in whole or in part over a 6 year term, to acquire one Company share per warrant at a price of 94.9 pence (2009:94.9 pence per share) (subject to adjustment) (Warrants).

The conversion price for the Notes will, in the event that the Company issues shares or securities convertible into shares at a price lower than 80 pence per share, be adjusted to the lower of 80 pence and a 10 per cent premium to the price at which such shares are issued. The exercise price for the Warrants will, in the event that the Company issues shares or securities convertible into shares at a price lower than 94.9 pence per share, be adjusted to the lower of 94.6 and a 30 per cent premium to the price at which such shares are issued.

The fair value of the liability component of the transaction is the present value of cash flows relating to the carrying value of the Notes as at maturity date discounted at the prevailing market rate of 15%. The amount of the Convertible Notes classified as equity is \$ 4,985,693 (2009 - \$4,985,693).

A tripartite contract was signed on the 28 April 2009 between the Company, RAB and FOGL Finance Limited (a wholly owned subsidiary of the Company). The essence of this agreement was to substitute the Group's wholly-owned subsidiary, FOGL Finance Limited, as the Note holder and subsequently list the Notes on the Channel Islands Stock Exchange. FOGL Finance Limited is a UK registered company and the obligations of the subsidiary are guaranteed by Falkland Oil and Gas Limited.

The Notes are secured against the assets of the Company.

**Notes forming part of the  
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## 17 Share capital

	Company 2010 Number £	Company 2009 Number £
<b>Authorised</b> 245,000,000 ordinary shares of 0.002p each (2009: 195,000,000)	4,900	3,900
	\$	\$
Allotted, called up and fully paid 146,417,066 ordinary shares of 0.002p each (2009 – 146,252,066)	5,458	5,452

The shares are legally 0.002p shares. The share capital has therefore been translated at the historic rate of raising.

Details of the ordinary shares issued during the period are given in the table below:

Date	Description	Price (£)	No. of shares
14 April 2010	Share option exercise	60p	90,000
7 October 2010	Share option exercise	40p	75,000

The following describes the nature and purpose of each reserve within owners' equity.

**Share premium** Amount subscribed for share capital in excess of nominal value.

**Other reserve** Amount of proceeds on issue of convertible debt relating to the equity component (i.e. option to convert the debt into share capital) and the fair value of warrants issued.

**Retained deficit** Cumulative net gains and losses recognised in the financial statements.

## 18 Financial instruments

The Board of Directors determine, as required, the degree to which it is appropriate to use financial instruments or other hedging contracts or techniques to mitigate risk. The main risk affecting such instruments is foreign currency risk which is discussed below. Throughout the period ending 31 December 2010 no trading in financial instruments was undertaken (2009 - Nil).

There is no material difference between the book value and fair value of the Group cash balances, and the short term receivables and payables because of their short maturities.

### Market risk

Market risk arises from the Group and Company's use of interest bearing and foreign currency financial instruments. It is the risk that future cash flows of a financial instrument will fluctuate because of changes in interest rates (interest rate risk), and foreign exchange rates (currency risk).

### Currency risk

The Group and Company have potential currency exposures in respect of items denominated in foreign currencies comprising transactional exposure in respect of operating costs and capital expenditure incurred in currencies other than the functional currency of operations.

At the year end, the Group and Company had cash balances of \$69,819,625 (2009:\$ 93,535,653) comprising the following currencies:

	Group 2010 \$	Group 2009 \$	Company 2010 \$	Company 2009 \$
Sterling	10,675,011	13,848,801	10,675,011	13,848,801
US dollars	59,144,614	79,686,852	59,144,614	79,686,852
	69,819,625	93,535,653	69,819,625	93,535,653

As well as the Sterling cash balance the Convertible Loan Note instruments are denominated in a currency other than US Dollars.

A 10% increase or decrease in the dollar/sterling exchange rate would result in reported losses being \$1,069,235 higher or lower respectively (2009 - \$1,384,193) on cash balances.

A 10% increase or decrease in the dollar/sterling exchange rate would result in reported Convertible Loan liability of \$1,426,074 higher or lower respectively (2009 - \$1,274,425).

A 10% increase or decrease in the dollar/sterling exchange rate would result in a reported trade receivables balance \$31,202 higher or lower respectively (2009 - \$50,483).

## Capital

The Group and Company considers its capital to comprise its ordinary share capital, share premium and retained deficit as well as the Convertible Loan Notes.

In managing its capital, the Group and Company's primary objective is to maintain a sufficient funding base to enable the Group and Company to meet its working capital and strategic investment needs. In making decisions to adjust its capital structure to achieve these aims, through new share issues, the Group and Company considers not only their short-term position but also their long-term operational and strategic objectives.

	Group 2010 \$	Group 2009 \$	Company 2010 \$	Company 2009 \$
<b>Capital and reserves attributable to shareholders</b>				
Share capital	5,458	5,452	5,458	5,452
Share premium	137,204,111	137,077,241	137,204,111	137,077,241
Other reserve	4,985,693	4,985,693	4,985,693	4,985,693
Retained deficit	(17,501,501)	(14,028,575)	(17,501,501)	(14,028,575)
<b>Total equity</b>	<b>124,693,761</b>	<b>128,039,811</b>	<b>124,693,761</b>	<b>128,039,811</b>

There have been no significant changes to the Group and Company's capital management objectives, policies and processes in the year nor has there been any change in what the Company considers to be its capital.

### Interest risk

The Group and Company's fixed-rate loan note borrowings are not exposed to a risk of changes in interest rates. The Group and Company's cash and cash equivalents are subject to interest rate exposure due to changes in interest rates. The following table shows the period in which interest-bearing financial assets and liabilities reprice.

	Contractual %	Average interest rate Effective %	0-6 mths \$	6-12 mths \$	2-4 years \$	Total \$
<b>Financial Assets classified as Loans and Receivables</b>						
Cash and cash equivalents	0.88	0.88	69,819,625	-	-	69,819,625
Other financial assets	-	-	361,038	-	-	361,038
<b>Comparative information</b>						
Cash and cash equivalents	0.25	0.25	93,535,653	-	-	93,535,653
Other financial assets	-	-	416	-	-	416
<b>Liabilities</b>						
Convertible loan notes	(6)	(15.69)	-	16,527,935	-	16,527,935
Other financial liabilities	-	-	437,834	-	-	437,834
<b>Comparative Information</b>						
Convertible loan notes	(6)	(15.69)	-	-	17,050,175	17,050,175
Other financial liabilities	-	-	783,914	-	-	783,914

A 1% increase or decrease in the floating rate attributable to the cash balances held at the year end would result in interest receivable being \$698,196 higher or lower respectively (2009 - \$935,357).

# Notes forming part of the Financial Statements

### Liquidity risk

The liquidity risk of the Group is managed centrally by the Group treasury function. The Group and Company's practice is to regularly review cash needs and to place excess funds on fixed term deposits for periods not exceeding three months or short term deposits for periods between daily and one month.

All Trade and other payables are due for payment within three months of the reporting date.

The Loan Notes issued to date (see note 16) are redeemable 5 years from date of issue (22 December 2006) and bear a fixed interest rate of 6% per annum. Adjustments to the Loan Note payable represent the possible future interest payment based on the current year end foreign exchange rate.

The carrying values of cash and bank balances, other financial assets, and trade and other financial liabilities approximate their respective fair values because of their short maturities. The carrying amount of the Convertible Loan Note approximates its fair value at both the reporting dates.

### Credit risk

Credit risk arises from cash and cash equivalents and deposits held at bank. The majority of the Group and Company's deposits are held within the UK and 52% are held with AA Fitch rated institutions with the remainder at BBB to A rated Fitch institutions. The Group continues to monitor its treasury management to ensure an appropriate balance of the safety of funds and the maximisation of yield.

### 19 Share based payments

During the year, the Company operated two share plans (the "current plans"), the Falkland Oil and Gas Share Option Plan (Share Option Scheme) and the Falkland Oil and Gas Long-Term Incentive Plan (LTIP).

Under IFRS 2, an expense is recognised in the statement of comprehensive income for share based payments, calculated on their fair value at the date of grant. The application of IFRS 2 gave rise to a charge of \$269,590, for the year ended 31 December 2010. The equivalent charge for the year ended 31 December 2009 was \$325,744.

The Group recognised total expenses (all of which related to equity settled share-based payment transactions) under the current plans of:

	Group 2010 \$	Group 2009 \$	Company 2010 \$	Company 2009 \$
Share Option Scheme	90,475	128,210	90,475	107,057
LTIP	179,115	197,534	179,115	197,534
	269,590	325,744	269,590	304,591

### Share Option Scheme

The Option Plan provides for an exercise price equal to the closing market price of the Company shares on the date of the grant. The vesting period is three years. The options expire if they remain unexercised after the exercise period has lapsed and have been valued using the Black Scholes model. The options which are subject to the satisfaction of performance criteria relating to the compound annual increase in share price of the Company and comparing the Company share price to a similar selected group of companies are valued using the Monte Carlo model (see below).

The following table sets out details of all outstanding options granted under the Share Option Scheme.

	2010 Options	2010 Exercise price weighted average	2009 Options	2009 Exercise price weighted average
Outstanding at beginning of period	2,657,398	£0.84 (\$1.33)	2,474,257	£0.73 (\$1.06)
Granted during the period	1,393,751	£1.04 (\$1.61)	203,141	£1.21 (\$1.96)
Forfeited during the period	653,182	£1.16 (\$1.79)	20,000	£1.24 (\$1.96)
Exercised during the period	165,000	£0.49 (\$0.76)	-	-
Lapsed during the period	-	-	-	-
Outstanding at the end of the period	3,232,967	£1.12 (\$1.73)	2,657,398	£0.84 (\$1.33)
Exercisable at the end of the period	1,593,047	£0.68 (\$1.05)	2,360,877	£0.78 (\$1.24)

The range of the exercise price of share options exercisable at the year end falls between £ 0.4 (\$0.61) - £1.42 (\$2.19), (2009 - (£ 0.655 (\$0.95) - £1.35 (\$2.24))

The estimated fair values of options which fall under IFRS 2, and the inputs used in the Monte Carlo models and the Black-Scholes Option model to calculate those fair values are as follows:

Date of grant	Estimated fair value	Share price	Exercise price	Expected volatility	Expected life	Risk free rate	Expected dividends
13 October 2004*	£0.16 (\$0.29)	£0.40 (\$0.72)	£0.40 (\$0.72)	50.0%	3.5	4.61%	0.00%
13 October 2004*	£0.11 (\$0.20)	£0.40 (\$0.72)	£0.60 (\$1.07)	50.0%	3.5	4.61%	0.00%
24 March 2005*	£0.52 (\$0.97)	£1.27 (\$2.37)	£1.27 (\$2.37)	50.0%	3.5	4.78%	0.00%
3 June 2005*	£0.37 (\$0.67)	£0.92 (\$1.67)	£0.92 (\$1.67)	50.0%	3.5	4.18%	0.00%
5 January 2006*	£0.49 (\$0.85)	£1.24 (\$2.14)	£1.24 (\$2.14)	50.0%	3.5	4.12%	0.00%
23 January 2006°	£0.35 (\$0.62)	£1.18 (\$2.09)	£1.18 (\$2.09)	50.0%	3.5	4.23%	0.00%
11 September 2006°	£0.34 (\$0.63)	£1.13 (\$2.11)	£1.13 (\$2.11)	50.0%	3.5	4.80%	0.00%
27 December 2006°	£0.31 (\$0.61)	£0.96 (\$1.88)	£0.93 (\$1.82)	50.0%	3.5	5.12%	0.00%
5 October 2007*	£0.30 (\$0.61)	£1.42 (\$2.89)	£1.42 (\$2.89)	50.0%	3.5	5.50%	0.00%
14 April 2008*	£0.27 (\$0.53)	£1.25 (\$2.46)	£1.25 (\$2.46)	50.0%	3.5	5.50%	0.00%
21 October 2009*	£0.08 (\$0.13)	£1.21 (\$1.96)	£1.21 (\$1.96)	50.0%	3.5	1.45%	0.00%
20 December 2010*	£0.61 (\$0.94)	£1.04 (\$1.61)	£1.04 (\$1.61)	55.0%	3	3.48%	0.00%

\* Calculated using the Black Scholes model.

° Calculated using the Monte Carlo model.

Expected volatility was determined by calculating the annualised standard deviation of the daily changes in the share price.

### LTIP

The LTIP is an unapproved employee share option plan under which options over ordinary shares may be granted to any employee or director of the Company. There are currently two members of the plan; Tim Bushell and Colin More.

During the year Tim Bushell was granted an option over 96,154 ordinary shares of 0.002p each at an exercise price of 0.002p (0.003c) each. Colin More was granted an option over 86,538 ordinary shares of 0.002p (0.003c) each at an exercise price of 0.002p (0.003c) each. The options may be exercised after 20 December 2013 subject to the satisfaction of performance criteria relating to the compound annual increase in the share price of the Company and comparison to a similar selected group of companies.

	2010 Options	2010 Weighted average Exercise price	2009 Options	2009 Weighted average Exercise average
Outstanding at beginning of period	889,997	0.002p (0.003c)	850,926	0.002p (0.003c)
Granted during the period	182,692	0.002p (0.003c)	294,316	0.002p (0.003c)
Forfeited during the period	-	-	-	-
Exercised during the period	-	-	-	-
Lapsed during the period	184,677	0.002p (0.003c)	255,245	0.002p (0.003c)
Outstanding at the end of the period	888,012	0.002p (0.003c)	889,997	0.002p (0.003c)
Exercisable at the end of the period	-	-	-	-

## Notes forming part of the Financial Statements

The estimated fair value of the share award under the LTIP and the inputs used in the Monte Carlo Simulation model to calculate at fair values, are as follows:

Date of grant	Estimated fair value	Share price	Exercise price	Expected volatility	Expected life	Risk free rate	Expected dividends
5 October 2007	£0.41 (\$0.83)	£1.26 (\$2.57)	£0.00	50.0%	3	5.50%	0.00%
20 October 2008	£0.42 (\$0.73)	£0.79 (\$1.34)	£0.00	50.0%	3	5.50%	0.00%
21 October 2009	£1.29 (\$2.05)	£1.21 (\$1.92)	£0.00	50.0%	3	1.45%	0.00%
20 December 2010	£0.45 (\$0.69)	£1.04 (\$1.61)	£0.00	55.0%	3	3.48%	0.00%

Expected volatility was determined by calculating the annualised standard deviation of the daily changes in the share price.

Exchange rates at 31 December 2010 have been used to calculate the US\$ value of options, these are for indicative purposes only.

### Directors' share option scheme

The Directors who held office at the end of the financial year had the following interests in the share option scheme:

	Options held at 1 January 2010	Options granted in the year	Options forfeit in the year	Options held at 31 December 2010	Exercise price (p)	Exercisable from	Expiry date
Richard Liddell	118,100	-	-	118,100	127	24.03.2006	24.03.2015
Tim Bushell	457,627	-	457,627	-	118	23.01.2006	26.01.2016
	194,595	-	-	194,595	92.5	27.12.2009	26.12.2016
	43,028	-	-	43,028	125.5	14.04.2011	14.04.2018
	-	736,539	-	736,539	104	20.12.2013	20.12.2020
David Hudd	225,000	-	-	225,000	40	14.10.2004	14.10.2014
	225,000	-	-	225,000	60	14.10.2004	14.10.2014
Timothy Jones	150,000	-	-	150,000	40	14.10.2004	14.10.2014
	150,000	-	-	150,000	60	14.10.2004	14.10.2014
Colin More	195,555	-	195,555	-	112.5	11.09.2009	11.09.2016
	50,352	-	-	50,352	142	05.10.2010	05.10.2017
	119,835	-	-	119,835	121	21.10.2012	21.10.2019
	-	657,212	-	657,212	104	20.12.2013	20.12.2020
<b>Total</b>	<b>1,929,092</b>	<b>1,393,751</b>	<b>653,182</b>	<b>2,669,661</b>			

### 20 Commitments

Commitments at the reporting date that have not been provided for were as follows:

#### Operating lease commitments

At 31 December, the total of future minimum lease payments under non-cancellable operating leases for each of the following periods were:

	31 December 2010 \$	31 December 2009 \$
Within 1 year	190,000	170,000
Between 1 and 5 years	690,000	280,000
<b>Total</b>	<b>880,000</b>	<b>450,000</b>

The Group has entered into a longer-term contract over its premises in central London which is subject to rent reviews and which is included in the above.

#### Site survey contract

A Seismic survey contract has been undertaken in January 2011, with a minimum spend of \$1.6million.

### 21 Related party transactions

Fees of \$46,056 (2009 - \$7,762) were paid to Law Strategies Pty during the year, a company controlled by Mr Dighton, a Director of the Company in the prior year, for his services to the Company. There were no amounts outstanding at the end of the year (2009 - \$Nil)

Fees of \$1,182 (2009 -\$15,844) were paid to Timothy Jones and Co, a company controlled by Mr Jones during the year for his services to the company. There were no amounts outstanding at the end of the year (2009 - \$Nil)

During 2006 and 2007 RAB Special situations (Master) Fund Limited (RAB) subscribed for a total of £8 million Convertible Loan Notes. RAB also holds 6 million warrants exercisable in whole or part over 6 years to acquire one Company share per warrant at a price of 94.9 pence (2009: 94.9 pence) per share (subject to adjustment). RAB is a significant shareholder.

A tripartite contract was signed on the 28 April 2009 between the Company, RAB and FOGL Finance Limited (a wholly owned subsidiary of the Company). The essence of this agreement was to substitute the Group's wholly-owned subsidiary, FOGL Finance Limited, as the Note holder and subsequently list the Notes on the Channel Islands Stock Exchange. FOGL Finance Limited is a UK based company and the obligations of the subsidiary are guaranteed by Falkland Oil and Gas Limited.

Falkland Oil and Gas Limited has assumed a guarantee obligation to pay if FOGL Finance Limited defaults on its responsibilities under the loan note.

The Notes are secured against the assets of the Company.

**Notes forming part of the  
Financial Statements**