Sterling
RESOURCES LTD.

ANNUAL REPORT 2006

Corporate Profile

Sterling Resources Ltd. is a Calgary, Canada based energy company actively engaged in the exploration, appraisal and development of crude oil and natural gas in selected areas of the world. The Company's strategy for achieving growth is to source and initiate international projects with the potential for larger, lower-cost reserves. High initial working interests are taken where possible, and financial exposure and technical risk are managed by obtaining industry participations. The Company currently has landholdings in three countries, the United Kingdom offshore and onshore, Romania offshore and onshore, and France. The major focus areas, the United Kingdom and Romania, both have established hydrocarbon basins, extensive infrastructure and excellent contractual and fiscal terms. The common shares of Sterling Resources Ltd. trade on the TSX Venture Exchange under the symbol SLG.

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ABBREVIATIONS – CRUDE OIL AND NATURAL GAS

Bcf	billions of cubic feet
Bopd	barrels of oil per day
Mbbl	thousands of barrels
Mmbbl	millions of barrels
Mscf/d	thousands of standard cubic feet of gas per day
Mmscf/d	millions of standard cubic feet of gas per day
Tcf	trillions of cubic feet

ANNUAL GENERAL MEETING

May 23, 2007, 10:00 A.M.
Cardium Room, Calgary Petroleum Club
319 – Fifth Avenue SW, Calgary, Alberta
Canada

Message to Shareholders

Following our gas discovery onshore UK at Kirkleatham early in the year, we had our first offshore discovery in Block 21/23a, now known as Sheryl. Subsequent appraisal of Sheryl indicated a small, complex accumulation albeit with sufficient potential to result in our first probable reserves. In Romania, the results of the “Boar” well were disappointing but the results of the new seismic acquired towards year-end show continued prospectivity across this large concession. The year concluded with the successful acquisition of the remaining interest in the offshore Romania blocks taking us to 100-percent working interest, transfer of certain UK licenses from promote to traditional status and, most recently, the confirmation of success in the UK Offshore 24th License Round.

We now hold interests in 15 licenses offshore UK (27 blocks or part blocks). In addition to adding to our significant presence in the Southern North Sea, the new licenses give us a presence in the “Mid North Sea High”, which is currently the subject of exploration interest by several of the major companies.

In the Central North Sea, the probable reserves booked for Sheryl relate to a potential one-well development of the main north-west sector of the field. In addition, oil is known to exist on the eastern flank and further potential, as yet undrilled, may exist in identified southern and northern lobes. Continued activity in 2007 will focus on additional exploration in Block 21/23a with drilling of the Constance prospect. We also hold an interest in the neighbouring Block 21/22 where we have identified a further two significant Tay Sandstone prospects.

In the Southern North Sea, the Breagh well has been farmed out and brought to drill-ready status. Rig contract discussions are progressing to allow drilling to commence in the second half of 2007, and mapping in the greater Breagh area has firmed up many prospects. New blocks have also been added both in the Breagh area and further south in the Rotliegendes play fairway

Onshore Romania, mapping of the recent seismic continues towards identifying firm drilling locations in the western and central parts of the South Craiova concession. We still have access to a rig and tubulars have been purchased. Since becoming operator of the offshore Black Sea blocks in December 2006, we have completed the technical work to confirm a planned three-well drilling campaign. The associated environmental studies, rig discussions and planned farm-out processes are progressing in parallel to enable a fourth quarter 2007 first well target.

In July 2006, we concluded an equity issue of 13.8-million common shares and raised net proceeds of $ 27.1-million. The funds enabled us to appraise the Sheryl discovery, progress our exploration program and provide working capital for our 2007 operations.

In August, the Board was reduced to seven members when Mr. Paul Maxwell, Meridian Capital's representative resigned following Meridian's disposition of its remaining shareholdings.

By following our strategy we continue to add new licenses and increase the number of drill-ready prospects within our portfolio. Farm-outs have been achieved, despite the inflated cost regime and the offshore Romania interest was added at modest cost. In addition to the Probable oil reserves reported, the Company now also has 144-Bcf of Contingent Gas Resource Volumes. These are to be the subject of the planned 2007 work program which, together with additional drilling planned in the Central North Sea and ongoing progress in the South Craiova block present the potential for significant value addition during 2007.

Mr. Bob Welty, a long time director and our Chairman, will not be standing for re-election to the Board this year. We are extremely grateful to Bob for his invaluable contribution which has been instrumental in our growth.

Finally on behalf of the Board, I would like to express our thanks to all our shareholders for their continued support.

On Behalf of the Board of Directors,

(Signed)

"Stewart G. Gibson"
Chief Executive Officer

April 4, 2007

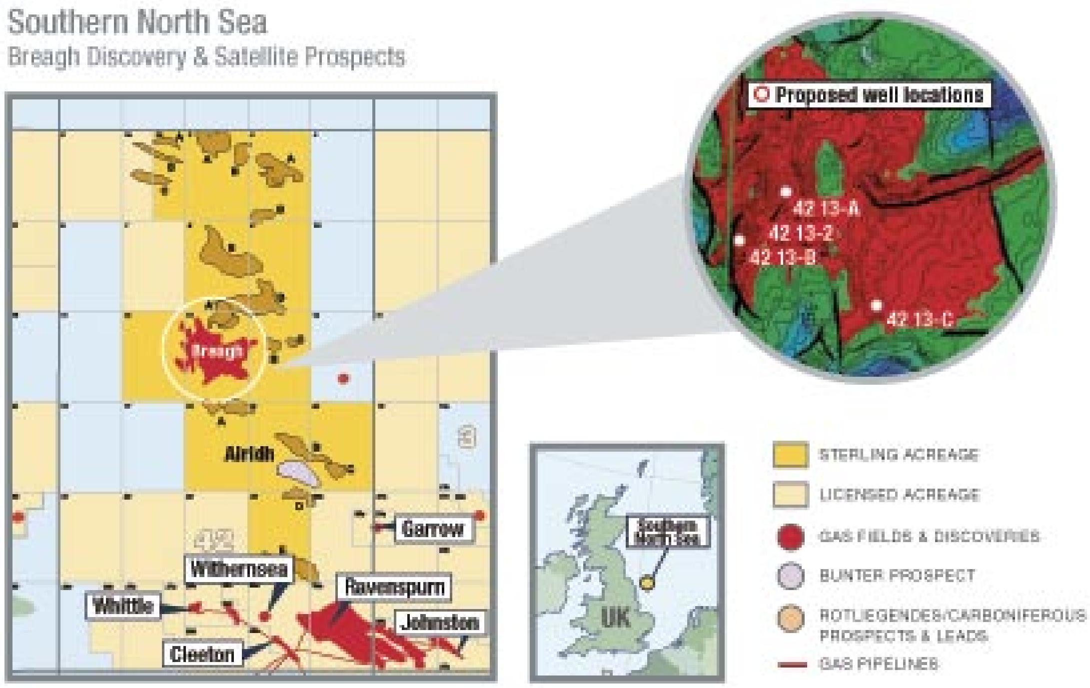
Operations Review

UNITED KINGDOM OFFSHORE

The United Kingdom offshore remains a vibrant area for operations for Sterling. During 2006, we continued to expand our position in each of the Southern, Central and Northern North Sea operating areas with the following key achievements:

- The announcement of the Sheryl discovery;
- Further farm-out of the Breagh discovery and progress towards drilling;
- Conversion of certain 22nd Round blocks to Traditional licenses; and
- Further awards in the 24th UK Offshore Licensing Round, which were announced shortly after year-end.

Following success in the UK offshore 24th Licensing Round, we now have interests in 15 licenses covering 27 blocks or part blocks (Sterling's interests range from 35-percent to 100-percent), and we look forward to further drilling in 2007, including our first operated offshore well.



Southern North Sea

We continue to improve our acreage position in the Southern North Sea area with four blocks awarded during the 24th Licensing Round. Our acreage in this area now comprises 12 blocks surrounding the BREAGH[1] gas discovery. The 22nd Round Promote Blocks 42/13 and Blocks 42/19, 42/20 and 42/24 have been successfully converted to Traditional licenses carrying a commitment to drill two wells within the next two years. The first well, targeting the Carboniferous zone at approximately 2,450-meters on Block 42/13 is planned as a Breagh appraisal well for 2007 and the second well on the AIRIDH[2] prospect targeting the Triassic Bunter zone at approximately 1,525-meters is planned on Block 42/19 for 2008.

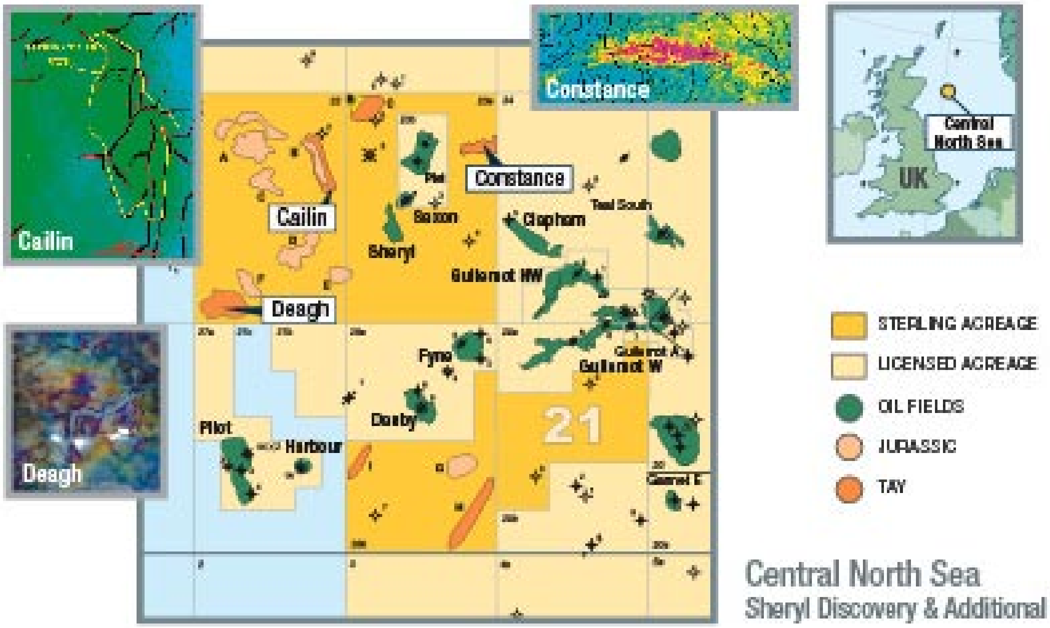
In our Operations Review for 2005, we discussed the challenges of securing a suitable jack-up rig to work our acreage in a rig market which was forecast to approach almost 100-percent for jack-ups during 2006. The rig market continues to show high rates of utilization, but we are pleased to announce our success towards contracting the ENSCO 100 jack-up rig, due on location for the Breagh appraisal drilling in the second half of 2007. The ENSCO rig will drill an up-dip location 1,500-meters from the discovery well 42/13-2 drilled by Mobil Oil in 1997.

We have completed certain farm-out arrangements for drilling the appraisal well and with the completion of a further farm-out prior to drilling we will be carried on the majority of costs of the well, and will retain a 50-percent working interest. This will be our first offshore operated well and we eagerly await the drilling results and further drilling during 2008. Successful appraisal drilling during 2007 and 2008 could enable commitment to a significant, new development in the area.

We continue to add acreage surrounding the Breagh area and building our core area understanding continues to yield results. During the 23rd Licensing Round, we were awarded four new blocks surrounding the Breagh field – 42/8, 42/9, 42/12 and 42/14. These blocks also show promise for extensions and satellites from the Breagh field.

In the recent 24th Licensing Round, we were awarded a further four blocks (42/2b, 42/3, 42/4 and 42/18). These blocks contain a number of further Carboniferous prospects.

[1] [brèagha] a. fine, splendid, beautiful (L.Sc. braw)
[2] [airidh] a. worthy, deserving, meriting



Central North Sea
Sheryl Discovery & Additional Prospects

Central North Sea

In our Central North Sea core area we were pleased to announce our first offshore discovery with the results of the 21/23a-8z well during the second quarter 2006 (Sterling 35-percent). The discovery well in the Sheryl field encountered a 30-meter oil column within the Eocene Tay formation. The well marks the first discovery to be announced from the UK Department of Energy Promote Licensing initiative.

We appraised the Sheryl field with a second well drilled in the third quarter of 2006. In total, seven well penetrations have been drilled into the Tay sandstone to appraise the Sheryl field at various locations around the structure. A drillstem test (DST) on the 21/23a-9u well-bore produced 1,915-Bopd of 23° API medium gravity oil. However, sand production from a suspected ruptured sand screen prevented producing the well at higher flow-rates. The sands encountered in the well were excellent quality and our analysis indicates that a production well with artificial lift is capable of producing up to 10,000-Bopd. Sheryl appraisal drilling has resulted in our first reporting of Probable reserves of 1.071-million barrels of recoverable oil, currently based on a single-well development from the western sector of the field.The two main well-bores used for the temporary appraisal penetrations have been suspended for future use.

Given that the closest pipeline system to the Sheryl area does not have spare capacity until 2009, the activity planned for 2007 will focus on additional exploration in the block. We are pleased that the operator has committed to drill the Constance prospect in the second half of 2007. The Constance prospect is located approximately 10-kilometers to the northeast of the Sheryl discovery. The main target is also the Eocene Tay sand formation. Our mapping indicates the Constance prospect is considerably larger than the Sheryl discovery and if successful, could greatly improve the economics of developing the two fields.

We continue to develop our Central North Sea core area, expanding our expertise in the Eocene Tay sandstone play into surrounding blocks. During the 23rd and 24th Licensing Rounds, we were awarded three further blocks, 21/22, 21/28b (Sterling 50-percent) and 21/29d (Sterling 100-percent). Our analysis has already identified two substantial prospects CAILIN[3] and DEAGH[4]. We are completing our work on these blocks and are actively pursuing farming out these opportunities.

Following geological and geophysical analysis two of our higher risk 22nd Round blocks, 19/5b and 22/26b, were relinquished during 2006 at the end of their promote term.

[3] [cailin] nf. pl.+ean, girl, damsel
[4] [deagh] a. good, fine, excellent

Northern North Sea

In the Northern North Sea, we are continuing to refine our understanding of a significant Upper Jurassic play which extends across Blocks 210/29 and 210/30 (Sterling 60-percent). The prospect is clearly evident on seismic over several intervals with a single well having the capability of testing multiple horizons. As part of our work commitment we acquired 850-kilometers of new long-offset seismic across the prospect to complete additional work on the amplitudes relating to the quality of the reservoir and indications of hydrocarbon.

Parts of Blocks 210/29 and 210/30 were relinquished at the end of 2006, but the retained areas cover the main prospects. The new area is held under a Traditional license and our interest in Block 210/25b has been relinquished.

Further north, we have completed our evaluation of the 211/11b block situated due east of the Magnus Field and west of the Otter Field. Our evaluation has identified several prospects in the Middle Jurassic Brent and Upper Jurassic Magnus formations. We are actively pursuing farm-outs of both of the Northern North Sea areas.

UNITED KINGDOM ONSHORE

Our UK onshore acreage progresses towards initial production during 2007 from a series of small discoveries. Further exploration drilling is also planned this year, with the first well on PEDL 071 having been successfully farmed-out.

Cleveland Basin

In PEDL068, we were pleased to announce our Kirkleatham gas discovery early in the year with a production test of the well achieving 5-Mmscf/d of gas from 19-meters of net-pay in the Lower Permian, Cadeby Formation. Following the success of the well, further seismic was acquired and is currently being interpreted to define additional well locations. Gas sales from the well to a nearby industrial site are being discussed, together with the potential for short term gas storage. The well is completed and ready for production.

Further to the drilling of the Westerdale-1 well, which tested 130-Mscf/d of gas, we are planning a new well site location nearer the old Ralph Cross-1 discovery well which tested 7-Mmscf/d of gas. The new location will enable drilling up-dip of the old well. We retain a 47-percent working interest in PEDL 068, after farming out the Kirkleatham and Westerdale wells.

In PEDL 071, we have successfully farmed out a new well planned to drill a sizeable structure within the Rotliegendes reservoir. The well is scheduled for the second quarter of 2007 and we will retain a 20-percent working interest after being carried through the drilling and any testing of the well.

Weald and Wessex Basins

In the Weald Basin, we have completed testing of the Avington-3 well (Sterling 8.3-percent), proving up the oil water contact in the southern portion of the accumulation. During 2007, two development wells are planned and first production is expected from the field later in the year.

In the Wessex Basin, production testing of the Waddock Cross-3 well (Sterling 18.75-percent) was completed during the first quarter of 2006. During 2007, the operator is planning extended testing from the Waddock Cross-2 and 3 wells with trial injections of chemicals in an effort to decrease the water cut.

FRANCE ONSHORE

St Laurent License

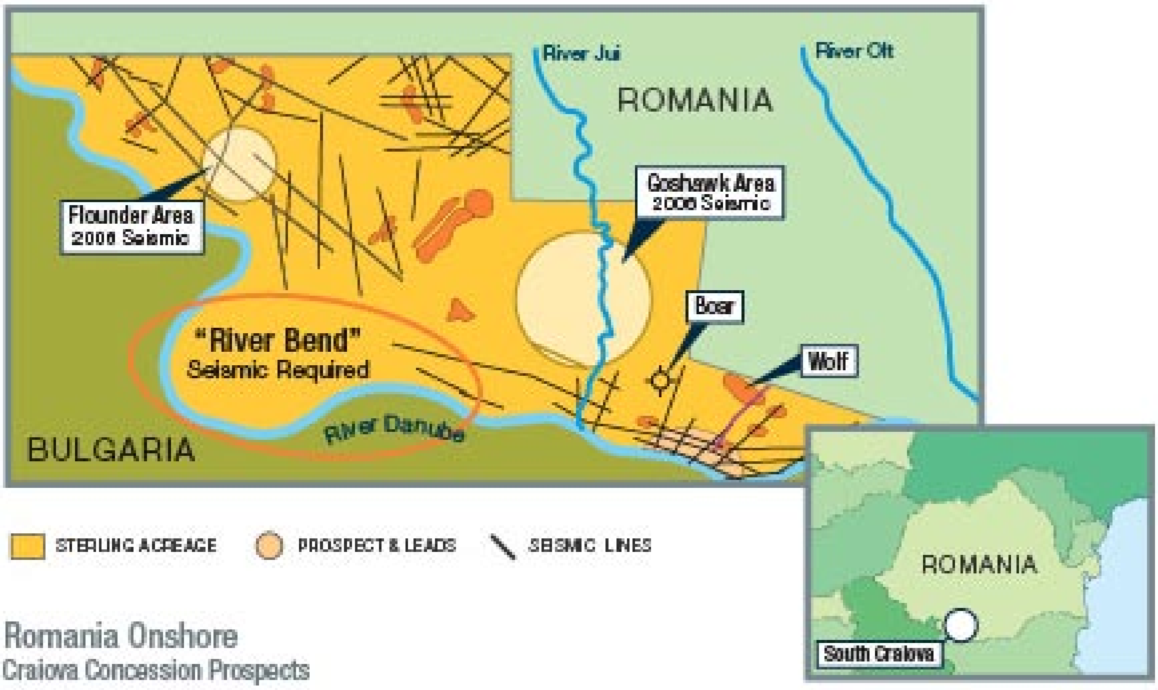
New 3-D seismic acquired during 2005 over the Grenade heavy oil discovery has now been interpreted. The seismic was acquired to design a new high-angle well with the dual objectives of confirming the geological model away from the original discovery well and proving increased well production rates using current completion techniques. The original vertical well produced 70-Bopd compared to the 200 to 300-Bopd now anticipated. The well is planned for the third quarter and we currently hold a 33.4-percent working interest in the license.

ROMANIA ONSHORE

During 2006, we continued the exploration of our large, under-explored South Craiova block located in the south-west part of Romania, in which we retain a 60-percent working interest. To put the size of the 1.5-million acre concession into context, it is larger than all of our 27 offshore UK Blocks put together. The current deep well density is less than one well per UK Block (approximately 55,000 acres) and more than 30-percent of the total area is devoid of digital seismic or wells. Despite the disappointing results of the 2942-Piscu Sadovei well drilled in 2006 (also referred to as Boar), we maintain our view that the area remains under-explored and still has significant potential.

During 2006, we completed two phases of new seismic acquisition. The first phase (156-kilometers) early in the year refined the Boar well location and provided initial data in the western (Flounder) and Central (Goshawk) areas. Given the positive results from this program, a second phase of seismic acquisition comprising 478-kilometers was conducted over the western and central areas before year-end.

The Boar well was drilled in the fourth quarter of 2006 to a depth of 2,673-meters. Although unsuccessful in finding hydrocarbons, the well encountered two excellent reservoir sections in the



Romania Onshore
Craiova Concession Prospects

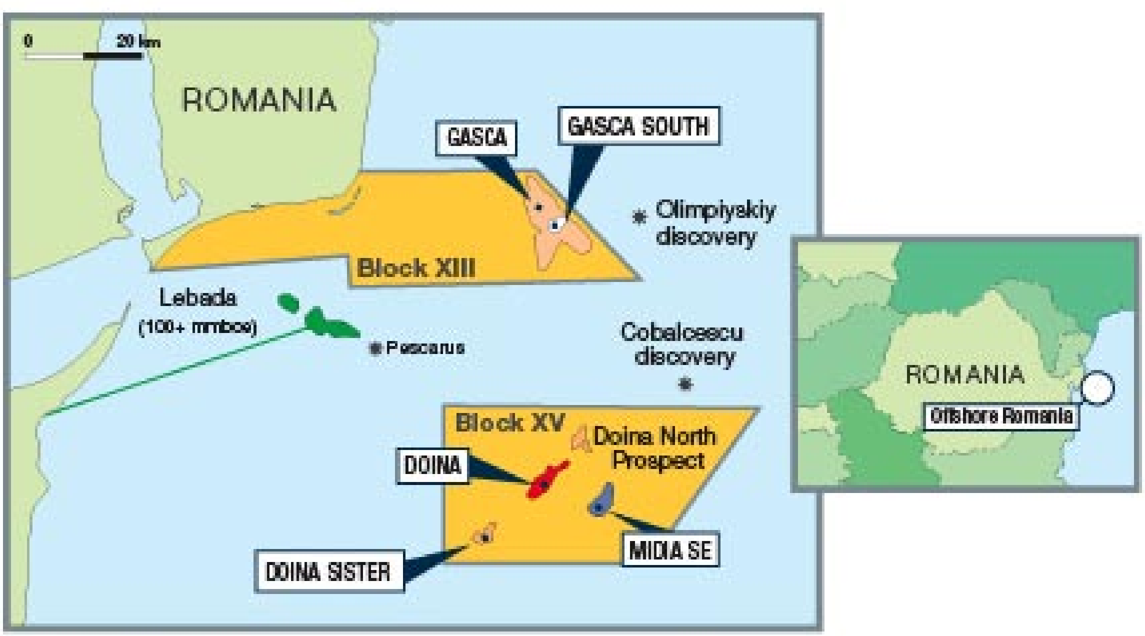
Jurassic Dogger and Upper Triassic intervals. The well is considered to have failed either due to a source and migration problem or failure of lateral seal. A source and migration study is ongoing prior to drilling any remaining prospects in the southeast corner of the concession. Given positive results from this study, the Wolf area remains a viable prospect.

The phase two seismic acquisition included parameter testing to ensure optimal data quality in the new areas. Mapping to date has identified a potential significant prospect in the Flounder area, which will be firmed up early in 2007. There is an older well (1152-Cetate) with hydrocarbon shows down-dip of Flounder and, together with shows in other wells in the vicinity, this lessens the risk of charge. The new data across Goshawk also demonstrates prospectivity which is being mapped in the deeper horizons and within the shallower Tertiary, the latter being related to potential Sarmatian gas traps identified by amplitude anomalies.

In addition to the prospects and leads identified in the Flounder and Goshawk areas, which are 2007 drilling candidates, consideration is being given to further acquisition of new seismic to include the large "river bend area" located near the Romanian/Bulgarian border, with a view to continually adding to the prospect inventory.

ROMANIA OFFSHORE

We had a very successful year relating to the Romanian Black Sea Pelican and Midia Blocks by concluding an agreement with Talisman Petroleum Ltd. in December 2006 to acquire its 80-percent working interest. Sterling is now the 100-percent owner and operator of the Pelican Block XIII and the Midia Block XV, which together cover approximately 1.1-million acres and contain several mapped prospects as well as the Doina gas discovery in the Midia Block.



Romania Offshore
Midia & Pelican Blocks
Doina Gas Discovery & Drillable Prospects

STERLING ACREAGE
PROSPECTS (JACK UP)
PROSPECTS (SEMI SUB)
GAS DISCOVERY
OIL FIELDS

We plan to actively explore the acreage which, over the past years, has been largely inactive due to frequent changes in operatorship of the blocks. All evaluations have been completed on the existing Doina gas discovery, and three firm drilling locations on additional prospects have been matured and are drill-ready. Two of these are Doina Sister and Midia South East in the southern Midia Block and the other is Gasca in the northern Pelican Block. Recent drilling just to the east of the Pelican Block resulted in reported oil and gas testing in the Olimipiyskiy well, proving hydrocarbons in close proximity to the Pelican Block. Environmental assessment programs have been initiated together with discussions with a drilling rig owner to enable a three-well program to commence in the fourth quarter of 2007. In parallel with the well planning, we have commenced farm-out discussions to bring in partners. The proposed well program is a mix of lower risk exploration and high impact but higher risk exploration. A review of the reservoir potential and development options for the Doina gas discovery has been completed and, in conjunction with strengthening local gas prices and the growing internal gas market, success with the Doina Sister well could lead to a joint development.

The previously reported discussions between Romania and the Ukraine concerning the border definition, which does not impact the Midia Block, are scheduled for a ruling in mid 2007. In addition, on acquiring the additional working interest, we initiated formal discussions with the National Agency for Mineral Resources to modify the original Exploration and Production Sharing Agreement terms to more closely follow the current legislation for onshore concessions, which is a tax/royalty agreement.

RESERVES

Sterling's net reserves, Contingent Resource Volumes and related Net Present Values of future net revenues before income taxes, were evaluated by RPS Energy at December 31, 2006 as follows:

			Net Present Value of Future Net Revenue[5] ($CDN – Millions)	
	Mmbbl	Bcf	Constant Prices	Forecast Prices
Probable oil reserves	1.071	–	15.3	10.9
Contingent Gas Resources Volumes[6]	–	144.1	–	–

There were no reserves or Contingent Resource Volumes reported for the year ended December 31, 2005.

Additional reserve information can be obtained from Sterling's Form 51-101F1 containing the Statement of Reserves and Other Oil and Gas Information which can be found on www.sedar.com, or by contacting the Company.

[5] Discounted at 10-percent per year
[6] Best estimate relating to Breagh, Doina and onshore UK

Management's Discussion & Analysis

This management's discussion and analysis of operations and financial condition (MD&A) is dated April 4, 2007 and should be read in conjunction with our audited consolidated financial statements and accompanying notes for the years ended December 31, 2006 and 2005.

The MD&A focuses on our long-term vision, strategy and growth opportunities as well as our historic performance for the two years ended December 31, 2006. All financial amounts are expressed in Canadian dollars, except as otherwise indicated.

OUR BUSINESS AND STRATEGY

Sterling Resources Ltd. ("Sterling" or the "Company") is an international energy company based in Calgary, Canada. We are engaged in the exploration for, and development of crude oil and natural gas in selected areas of the world outside Canada. Prior to 2005, the majority of our efforts and expenditures had been focused on assessing prospects, obtaining exploration rights and gathering and interpreting geological and geophysical data. In 2005 and 2006, we entered into the drilling phase of certain prospects in the United Kingdom (UK) and Romania.

Our strategy for achieving growth is to source and initiate international projects with the potential for larger, lower-cost reserves. In the UK, we are accumulating licenses and prospects in selected core areas of the North Sea so that potential discoveries may take advantage of existing infrastructure and economies of scale from joint-development projects. Our strategy also targets blocks with high initial working interests where possible and financial exposure and technical risk are managed by obtaining partner participation through farm-out arrangements. Under these arrangements, a portion of our interest is given up in exchange for the partner paying a share of certain of our costs of drilling a well or other programs. Our current activities are focused in the UK and Romania.

ACCOUNTING POLICIES AND SIGNIFICANT ESTIMATES

It is important to understand our key accounting policies in order to understand our financial results and the extent to which estimates affect them. Our accounting policies as presented in Note 2 to the financial statements are in accordance with Canadian generally accepted accounting principles. However, management is required to make judgments, assumptions and estimates in the application of these policies, and these estimates can have a significant impact on our financial results.

Significant estimates in the financial statements include amounts recorded for the provision for future asset retirement obligations, stock based compensation expense and capital expenditure accruals. In addition, assumptions and estimates are made in assessing the requirement for possible impairment provisions. By their nature, these estimates are subject to measurement uncertainty and the effect on future consolidated financial statements from changes in such estimates could be significant.

No new accounting policies have been adopted during the years ended December 31, 2006 or 2005.

OUR FINANCIAL RESULTS

Consolidated financial highlights for the three years ended December 31, 2006 are presented below. This information should be read in conjunction with the consolidated financial statements.

Years ended December 31	2006	2005	2004
	($)	($)	($)
Oil and gas revenues, net of royalties	–	–	–
Interest and other income	1,001,993	745,975	38,176
Expenses	2,208,001	3,169,784	888,431
Net loss	(1,206,008)	(2,423,809)	(850,255)
– per common share, basic and diluted	(0.01)	(0.03)	(0.02)
Net working capital	21,133,295	24,026,972	3,295,157
Capital expenditures	30,082,217	5,613,180	1,272,806
Total assets	73,139,740	41,396,119	14,228,723
Share capital	75,719,452	48,108,289	19,691,149
Common shares outstanding – basic and diluted	94,403,634	79,746,967	43,448,042

OVERVIEW

We are primarily an exploration company at this stage and consequently have no commercial production. Any minor pre-commercial production revenues are netted against related expenses, and the net amount capitalized as test expenditures.

The following table provides a breakdown of our income statements for the eight quarters ended December 31, 2006. This table indicates that our financial results in this phase of our operations are not affected by seasonal considerations.

2006 (Quarter Ended)	Dec. 31 ($)	Sept. 30 ($)	June 30 ($)	March 31 ($)	Total ($)
Expenses					
General and administrative	322,154	323,178	450,151	544,346	1,639,829
Foreign exchange (gain) loss	(234,097)	17,472	134,450	(166,206)	(248,381)
Stock based compensation	122,201	225,437	176,468	193,533	717,639
Accretion expense	14,667	10,532	8,483	2,111	35,793
Depreciation	20,331	17,490	16,748	8,552	63,121
	245,256	594,109	786,300	582,336	2,208,001
Interest and other income	317,283	335,992	180,764	167,954	1,001,993
Net income (loss)	72,027	(258,117)	(605,536)	(414,382)	(1,206,008)
Net loss per common share – basic and diluted	0.00	0.00	(0.01)	(0.01)	(0.01)

2005 (Quarter Ended)	Dec. 31 ($)	Sept. 30 ($)	June 30 ($)	March 31 ($)	Total ($)
Expenses					
General and administrative	207,956	329,290	381,883	211,421	1,130,550
Foreign exchange loss	316,593	922,319	423,676	9,590	1,672,178
Stock based compensation	196,052	92,753	29,457	31,881	350,143
Accretion expense	414	300	300	300	1,314
Depreciation	7,704	4,552	1,673	1,670	15,599
	728,719	1,349,214	836,989	254,862	3,169,784
Interest and other income	185,638	218,323	247,594	94,420	745,975
Net loss	(543,081)	(1,130,891)	(589,395)	(160,442)	(2,423,809)
Net loss per common share – basic and diluted	(0.01)	(0.01)	(0.01)	0.00	(0.03)

The net loss per common share for each quarter is required to be calculated independently of the calculation for the year. Consequently the aggregate of the four quarters may differ from the total for each year due to rounding.

FOURTH QUARTER 2006 RESULTS

Net income for the fourth quarter of 2006 has been affected by the following:

- Net general and administrative expenses vary between quarters due largely to the level of exploration activity which impacts both recoveries from partners as well as the amount capitalized internally. The majority of expenses for the fourth quarter of 2006 were incurred in currencies other than the Canadian dollar, and were also affected by fluctuations in exchange rates when converted into Canadian dollars. Compared to the fourth quarter of 2005, general and administrative costs before recoveries and allocations have also increased due to the addition of senior personnel, and the opening of our office in Bucharest, Romania;
- Foreign exchange gains for the quarter relate primarily to conversion of monetary items denominated in UK Pounds, US dollars and Romanian Lei. During the quarter, the Canadian dollar depreciated against most currencies, resulting in modest gains. In 2005, a significant proportion of our cash balances were denominated in UK Pounds and US dollars and with the appreciation in the Canadian dollar during much of 2005, losses were incurred;
- Stock based compensation in each quarter reflects the timing of stock option grants and their related vesting periods. Similar to general and administrative expenses, the amount of stock based compensation capitalized is also affected by the level of exploration activity in each quarter. The fourth quarter of 2006 also includes certain adjustments increasing the portion of stock based compensation capitalized; and
- Interest and other income for the fourth quarter has declined slightly compared to the previous quarter due to the utilization of cash resources in our capital expenditure programs. Cash resources resulted from the 2006 and 2005 share issues.

GENERAL AND ADMINISTRATIVE EXPENSES

The following table provides a breakdown of general and administrative expenses for 2006 and 2005:

	2006	2005
	($)	($)
Employee costs	1,683,712	801,161
Office rent and expenses	548,960	102,304
Professional and other fees	652,220	389,064
Travel	316,886	152,354
Other	189,457	161,743
	3,391,235	1,606,626
Recoveries from partners	(576,126)	(145,059)
Charged to capital projects	(1,175,280)	(331,017)
	1,639,829	1,130,550

General and administrative expenses for 2006 have increased over 2005 levels due primarily to increased exploration activity levels, which have required us to establish an office in Bucharest, Romania and to expand our office in Aberdeen, Scotland, in the latter part of 2005. A portion of this increase in costs has been recovered from our joint interest partners, and the increase in activity has also resulted in higher levels of internal capitalization.

FOREIGN EXCHANGE

Foreign exchange gains in 2006 are related primarily to the impact of the decrease in the value of the Canadian dollar on the translation of foreign currency cash and other monetary items held in other currencies. In 2005, the Canadian dollar strengthened significantly against other currencies and consequently, losses were incurred. However, in 2005 a much higher proportion of working capital was denominated in currencies other than the Canadian dollar, and hence the impact of currency fluctuations was much higher.

STOCK BASED COMPENSATION

It is our policy that a significant proportion of employee and director remuneration should not only be geared to the success of our Company, but also not result in significant depletion of our cash resources. Stock based compensation expense is not recognized on options issued to consultants. To the extent that a portion of employee costs is capitalized against projects, a similar proportion of stock based compensation is also capitalized.

Stock based compensation expense of $717,639 in 2006 increased from $350,143 in 2005 due to the issue of stock options to directors, officers and employees during both 2005 and 2006. Stock based compensation capitalized was $362,417 in 2006 (2005 – $ nil).

In 2005, a total of 2,245,000 options were issued to directors, officers and employees, and a further 60,000 to external consultants. Because these options were issued part-way through the year, the full-year impact of the related stock based compensation expense related to options issued to directors, officers and employees was not reflected in the financial statements until 2006.

In addition, a total of 1,555,000 options were issued to directors, officers and employees in 2006, and a further 40,000 to consultants.

OTHER INCOME

Other income consists exclusively of interest income from the investment of surplus funds. For 2006, interest income of $1,001,993 has increased compared to $745,975 in 2005 due primarily to the investment of unused proceeds from the $27.0-million private placement issue in February of 2005, and the $29.0-million public equity issue in 2006.

NET LOSS

The net loss of $1,206,008 for 2006 compares to $2,423,809 in 2005. This represents a loss of $0.01 per common share, basic and diluted for 2006 (2005 – loss of $0.03 per share). The decrease in the loss for the year compared to 2005 is due to a reduction in foreign exchange losses and increased interest income in 2006, partially offset by increased general and administrative expenses and stock based compensation expense. On a per share basis, the loss has also been reduced by an increase in the weighted average common shares outstanding.

INCOME TAXES

The Company does not recognize the tax benefit of losses incurred at this time as no reserves have been classified as proven, and there is no assurance that the tax benefit will be realized. As at December 31, 2006, the Company has non-capital losses in Canada of approximately $4.3-million available, but subject to expiry over the next ten years, to reduce future taxable income, and approximately $3.0-million of subsidiary UK tax losses which are not subject to expiry. In addition, at December 31, 2006, the Company had approximately $50.9-million of deductions available to be claimed against future income taxes which are not subject to expiry.

PETROLEUM PROPERTIES ACTIVITIES AND CAPITAL EXPENDITURES

Capital expenditures are categorized as petroleum and natural gas properties and capitalized in country-by-country cost-centres. The following is a summary of capital expenditures by cost-centre for the years ended December 31, 2006 and 2005:

Years ended December 31	2006	2005
	($)	($)
United Kingdom	18,963,578	2,825,262
Romania	10,893,977	2,494,920
Other International	49,655	184,535
Total petroleum and natural gas expenditures	29,907,210	5,504,717
Furniture and fixtures	175,007	108,463
	30,082,217	5,613,180

In the UK, 2006 capital expenditures of $18,963,578 included:

- Drilling and appraisal costs of the Sheryl discovery (formerly named Disraeli) on Block 21/23a in the UK Central North Sea. A side-track to the initial exploration well intersected 25-meters of net pay in the Eocene Tay Sand. This well was sidetracked up-dip to gather further information before being temporarily abandoned for potential future re-entry. The rig returned to Sheryl later in 2006 to drill an additional well and appraise the initial discovery. This part of the appraisal program provided further data points on the eastern, south eastern and south western parts of the structure. Following some initial operational difficulties, the final sidetrack location was tested at a restricted rate of 1,915-barrels of oil per day. The program has added probable reserves of 1.071-million barrels (net to the Company) and both main well-bores have been left temporarily abandoned as potential future producers;
- Preliminary site survey and other costs relating to the proposed drilling of the Breagh prospect in 2007 on Block 42/13 in the Southern North Sea;
- Costs for the Kirkleatham-4 onshore well and subsequent seismic on Petroleum Exploration and Development License (PEDL) 068 in the Cleveland Basin. The well tested gas at rates up to 5-million standard cubic feet of gas per day, and the well was completed for future production and the site has been retained to enable further drilling as may be dictated by the results of the seismic program. The operator is considering various gas sales options with production planned to start in 2007; and
- Other testing and geological and geophysical costs for evaluating the Westerdale, Waddock Cross and Avington onshore discoveries as well as evaluating and working up drilling prospects on offshore blocks awarded in the UK 22nd and 23rd Licensing Rounds, and making application for additional blocks in the 24th Licensing Round.

In Romania capital expenditures of $10,893,977 for 2006 included the following major items:

- Costs of the Piscu Sadovei well on the 1.5-million acre Craiova concession onshore Romania. The well failed to encounter hydrocarbons and has been abandoned;
- An extensive seismic program activity over other prospects and areas which have been identified on the block; and

- The acquisition of the remaining 80-percent interest in the Pelican and Midia Blocks offshore Romania. We now own 100-percent of these blocks.

For 2005, major expenditures included:

- The Cetatuia-1 well, and the completion of a 185-kilometer seismic program over the remainder of the Craiova block onshore Romania; and
- Our share of the drilling costs of the Waddock Cross and Kirkleatham-4 wells onshore the UK, as well as geological and geophysical costs for evaluating and working up drilling prospects on offshore blocks awarded in the UK 22nd Licensing Round, and making application for additional blocks in the 23rd Licensing Round.

We have now invested a total of $46,804,092 in our oil and gas properties to December 31, 2006, compared with $16,068,685 as at December 31, 2005. As at December 31, 2006 we had interests in petroleum licenses and contracts as follows:

Acres	Gross	Net
Romania	2,645,000	2,027,000
United Kingdom	1,003,631	596,729
France	151,969	50,792
Total	3,800,600	2,674,521

Geological and geophysical work on the properties to date has resulted in many prospects and leads other than those specifically referred to above. Several of these prospects have been brought to the drillable stage, and we continue to pursue our farm-out strategy of bringing in industry partners to manage technical and financial risk.

FINANCING, LIQUIDITY & SOLVENCY

Net Working Capital

The following is a summary of net working capital as at December 31, 2006 and 2005:

Years ended December 31	2006	2005
	($)	($)
Cash and cash equivalents	23,801,861	23,538,376
Other non-cash working capital		
Accounts receivable and prepaid expenses	2,297,187	1,493,170
Inventory	–	171,174
Accounts payable and accrued liabilities	(4,965,753)	(1,175,748)
	(2,668,566)	488,596
Net working capital	21,133,295	24,026,972

Cash and cash equivalents of $23,801,061 at the end of 2006 are at similar levels to the end of 2005. Included in the total are term deposits of $18,867,000 (2005 – $11,112,000) with maturities greater than 30 days. These deposits have cashable options and are therefore considered cash equivalents by management.

Our other non-cash working capital deficiency of $2,668,566 at December 31, 2006 has increased over 2005 due to increased activity in Romania, and offshore the UK, including associated value added taxes recoverable.

Financing

On July 27, 2006 we completed a bought deal financing of 12,000,000 common shares at $2.10 per share with a syndicate of underwriters. In addition, an "Over-Allotment Option" to purchase an additional 1,800,000 shares at $2.10 was granted to the underwriters, and on August 3, 2006, the underwriters exercised this option for additional proceeds of $3,780,000. The total gross proceeds from the initial issue and the exercise of the Over-Allotment Option were $28,980,000. After underwriter's commissions and expenses of the issue of $1,882,237, net proceeds were $27,097,763.

On February 10, 2005, we raised $27,000,000 ($25,534,424 net of share issue expenses) through the issue of 30,000,000 common shares at a price of $0.90 per common share. Commissions and other cash expenses of $1,465,576 were paid on the issue, and 1,200,000 warrants were issued to the agent. The agent's warrants were exercisable at $0.90 per share for a period of nine months from close of the private placement, and were exercised in full on October 11, 2006 for proceeds of $1,080,000. Other warrants and options exercised during 2005 resulted in proceeds of $1,787,324.

As at December 31, 2006 there were 94,403,634 (2005 – 79,746,967) common shares outstanding and 5,145,000 (2005 – 4,610,000) options issued under our stock option plan. As at April 4, 2007 there were 94,583,634 common shares and 4,965,000 options outstanding.

Commitments and Obligations

As at December 31, 2006, our share of estimated commitments under our license obligations and outstanding work programs was approximately $16.5-million. Of this total, $15.8-million relates to commitment wells and seismic programs which are subject to farm-out negotiations, and will be substantially reduced or eliminated upon conclusion of negotiations.

In addition, we had commitments under operating leases for office premises and storage facilities as follows:

	($)
2007	100,052
2008	51,772
2009	53,796
2010	35,864
	241,484

Liquidity and Solvency

As is typical of companies at our stage of development, future exploration and development activities will require substantial amounts of additional capital which we may raise through debt or equity financing and by farming out of partial interests in certain properties. Financings and farm-outs are subject to prevailing market conditions at the time, but will be necessary for us to carry out all activities on each of our projects until such time as we establish production and cash flow. We may also consider raising funds from time to time by monetization of certain of our existing non-core assets.

We consider our current cash reserves to be sufficient to meet our existing license obligations and commitments and to fund ongoing operations for the next year.

FUTURE PLANS

For 2007, we plan to continue our strategy of farming out a portion of our licenses to outside partners. This strategy has been successful for us over the last several years, allowing us to increase our holdings of exploration lands, and increase their prospectivity through geological and geophysical work prior to farm-out. The majority of exploration prospects brought to the drillable stage have been successfully farmed-out on a promoted basis. Plans include:

- Drill the Breagh appraisal well on offshore Block 42/13 in the UK Southern North Sea;
- Drill one exploration well on Block 21/23a in the UK Central North Sea. This block contains the 2006 Sheryl discovery, and the new well will target a separate structure;
- Drill one exploration well in the western section of the Craiova block;
- Drill one well on the Midia block offshore Romania;
- Continue geological and geophysical work to evaluate our licenses, including the six new licenses awarded in the UK 24th Offshore Licensing Round, and the many other prospects and leads that exist on them. This work will focus on offshore UK and offshore and onshore Romania; and
- Continue our strategy of farming out a portion of our licenses in order to reduce costs.

These plans depend on rig availability, farm-out terms and conditions and partner approval, and are subject to change.

Capital expenditures and general and administrative expenditures for 2007 are expected to be in the range of $8-million to $15-million, based on planned farm-outs on certain properties. This includes the 2007 portion of the $16.5-million of license commitments and obligations referred to above, but excludes the cost of testing and appraising successful wells. We have some flexibility over most of our capital expenditures and as to the percentage of our working interests farmed out.

RECENT ACCOUNTING PRONOUNCEMENTS

The Canadian Institute of Chartered Accountants (CICA) has issued a number of accounting pronouncements, some of which may impact our reported results and financial position in future periods.

Comprehensive Income, Financial Instruments and Hedges

The CICA issued new standards in early 2005 for Comprehensive Income (CICA 1530), Financial Instruments (CICA 3855) and Hedges (CICA 3865), which will be effective for the reporting year-end 2007. The new standards will bring Canadian rules into line with current rules in the United States. The standards will introduce the concept of "Comprehensive Income" to Canadian GAAP and will require that an enterprise: a) classify items of comprehensive income by their nature in a financial statement and b) display the accumulated balance of comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a statement of financial position. Derivative contracts will be carried on the balance sheet at their mark-to-market value, with the change in value flowing to either net income or comprehensive income. Gains and losses on instruments that are identified as hedges will flow initially to comprehensive income and be brought into net income at the time the underlying hedged item is settled. Any instruments that do not qualify for hedge accounting will be marked-to-market with the tax-effected adjustment flowing through the income statement.

We do not anticipate these standards will have a significant impact on our financial statements.

RISKS AND UNCERTAINTIES

The following is a summary of the principal risks facing our business, and the strategies we take to mitigate these risks. It should not be assumed that this list is exhaustive or that material loss could not occur as a result of other unforeseen risks.

Operational Risks

The international oil and gas industry is exposed to a variety of business risks, including, but not limited to:

- The finding, determination, evaluation, assessment and measurement of oil and gas deposits or reserves;
- Developing those reserves and finding markets for them;
- Potential delays or changes in plans with respect to exploration or development projects or capital expenditures;
- The availability and performance of joint venture partners with whom we conduct our business;
- The performance of contractors and consultants that we engage;
- Competition from others in obtaining exploration licenses or access to drilling equipment;
- Reliance on key individuals; and
- Title to oil and gas interests.

We also have a growing exploration portfolio and several undrilled prospects. Our ability to grow profitably will depend on our ability to drill successfully and develop these properties, as well as to obtain additional prospects.

We work to mitigate these risks by employing highly skilled personnel, focusing exploration efforts in areas where we have existing knowledge and expertise and access to such expertise, using current technology to enhance methods and control costs. We also maintain a corporate insurance program consistent with industry practice to protect against losses due to accidental destruction of assets, well blowouts and other operating accidents and disruptions.

Financial Risks

Financial risks include the impact of fluctuations in commodity prices, foreign exchange rates, interest rates and inflation over which we have limited control. These factors also affect:

- Anticipated future cash flows;
- The fair value of our oil and gas reserves and assets;
- The availability and cost of financing for our projects;
- The economics underlying our project decisions; and
- The underlying value of the business on which our share price is based.

Political or Government Risks

We explore for oil and gas in various international jurisdictions with varying degrees of political or governmental risk including:

- The risk of changes in government policy, regulation or fiscal terms;
- The risk of changes in conditions under which exploration licenses are awarded, including related work commitments;
- The risks of required government approvals being delayed or withheld;
- Risks associated with the fiscal terms prevailing in the jurisdictions in which we operate; and
- Risks relating to any known or future international border disputes in jurisdictions where we are active.

We are also subject to extensive and varying environmental regulations imposed by governments related to the protection of the environment. We are committed to operate safely in an environmentally sensitive manner and to safeguard the health and welfare of our employees, contractors, suppliers and the public, in every area of operation.

In order to balance our exposure to risk and reward in these areas, we conduct our activities in a number of jurisdictions that we consider to range from low to medium risk.

Further discussion of the risks and uncertainties facing our Company and our business is contained in the Company's Annual Information Form for the year-ended December 31, 2006.

FORWARD-LOOKING STATEMENTS

Certain statements contained in this MD&A are forward-looking statements. These statements relate to future events or our future performance. All statements other than statements of historical fact may be forward-looking statements. In some cases, forward-looking statements can be identified by terminology such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential", "continue", or the negative of these terms or other comparable terminology. In addition, statements relating to reserves or resources are deemed to be forward-looking statements as they involve the implied assessment, based on certain estimates and assumptions, that the reserves and resources described can be profitably produced in the future.

These statements are only predictions. Actual events or results may differ materially. In addition, this MD&A may contain forward-looking statements attributed to third party industry sources. Undue reliance should not be placed on these forward-looking statements, as there can be no assurance that the plans, intentions or expectations upon which they are based will occur. By its nature, forward-looking information involves numerous assumptions, known and unknown risks and uncertainties, both general and specific, that contribute to the possibility that the predictions, forecasts, projections and other forward-looking statements will not occur. Forward-looking statements in this MD&A include, but are not limited to, statements with respect to:

- Capital expenditure programs, including the success or otherwise, of exploration and appraisal initiatives;
- Commodity prices;
- Factors upon which we will decide whether or not to undertake a specific course of action;
- Expectations regarding our ability to raise capital;
- The sale, farming-in, farming-out or development of certain exploration properties using third party resources;

- The use of development activity and acquisitions to replace and add to reserves;
- Drilling plans;
- Our tax horizon;
- Oil and natural gas production levels and the quantity of reserves;
- Supply and demand for oil and natural gas;
- The performance and characteristics of our oil and natural gas properties;
- The impact of governmental regulation on us relative to other oil and gas issuers of similar size;
- The emergence of accretive growth opportunities;
- Realization of the anticipated benefits of acquisitions and dispositions;
- Our ability to benefit from the combination of growth opportunities and the ability to grow through the capital markets; and
- Treatment under government taxation regimes.

With respect to forward-looking statements in this MD&A, we have made assumptions regarding, among other things:

- The impact of increasing competition;
- Our ability to obtain additional financing on satisfactory terms; and
- Our ability to attract and retain qualified personnel.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. We can not guarantee future results, levels of activity, performance, or achievements. Moreover, we do not assume responsibility for the accuracy and completeness of the forward-looking statements.

In our MD&A for the year ended December 31, 2005, we made certain statements with respect to future plans to drill six additional exploration wells on key prospects in the UK North Sea and onshore Romania. As a result of the capital required to appraise the Sheryl discovery, as well as the difficulties in obtaining a suitable rig, two planned wells were deferred. In addition, two follow-up wells to the Piscu-Sadovei well onshore Romania, which were planned for 2006, were deferred pending additional seismic work and other studies.

Similarly, the Corporation's actual results and future plans could differ materially from those anticipated in similar forward-looking statements in this MD&A as a result of the risks described above. The forward-looking statements contained in this MD&A are expressly qualified by the foregoing cautionary statement.

DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed is recorded, processed, summarized and reported within the time periods specified by securities regulations and that information required to be disclosed is accumulated and communicated to management.

The Chief Executive Officer and the Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures and have concluded that they are adequate and effective to ensure accurate and complete disclosure.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

Sterling's Chief Executive Officer and Chief Financial Officer are responsible for designing internal controls over financial reporting or causing them to be designed under their supervision. Such controls are intended to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles.

Management has assessed the design of controls over financial reporting, and has identified the following key weaknesses in controls:

- Due to Sterling's limited number of permanent staff, it is not feasible to achieve optimum segregation of incompatible duties;
- Sterling's information systems are subject to general control deficiencies including the lack of effective controls over system access, spreadsheets, and other documentation.

These weaknesses in internal controls over financial reporting result in the possibility that a material misstatement may not be detected or prevented. Management and the Board of Directors work to mitigate the risks of material misstatement through close scrutiny of all related activities, and the Company's Chief Executive Officer and Chief Financial Officer have concluded the internal controls over financial reporting have been designed to provide reasonable assurance regarding the reliability of the Company's financial reporting.

ADDITIONAL INFORMATION

Additional information about Sterling Resources Ltd. and its business activities is available on SEDAR at www.sedar.com.

Management's Report

The accompanying consolidated financial statements and all information in the annual report are the responsibility of management. The consolidated financial statements have been prepared by management in accordance with generally accepted accounting principles outlined in the notes to the consolidated financial statements. Other financial information appearing throughout the report is presented on a basis consistent with the consolidated financial statements.

Management maintains appropriate systems of internal controls. Policies and procedures are designed to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded and financial records properly maintained to provide reliable information for the presentation of financial statements.

Ernst & Young LLP, an independent firm of Chartered Accountants, has been engaged, as approved by the shareholders, to examine the consolidated financial statements in accordance with auditing standards generally accepted in Canada and to provide an independent professional opinion.

The Audit Committee and the Board of Directors have reviewed the consolidated financial statements with management and with Ernst & Young LLP. The Board of Directors has approved the consolidated financial statements on the recommendation of the Audit Committee.

(Signed)

"Stewart G. Gibson"
Chief Executive Officer

(Signed)

"Ian Hornby-Smith"
Chief Financial Officer

April 4, 2007

Auditors' Report

To the Shareholders of Sterling Resources Ltd.

We have audited the consolidated balance sheets of Sterling Resources Ltd. as at December 31, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(Signed)

"Ernst & Young LLP"
Chartered Accountants

Calgary, Canada
April 4, 2007

Consolidated Balance Sheets

As at December 31	2006	2005
	($)	($)
ASSETS		
Current		
Cash and cash equivalents [note 3]	23,801,861	23,538,376
Accounts receivable	2,268,998	1,455,456
Inventory – at cost	–	171,174
Prepaid expenses	28,189	37,714
	26,099,048	25,202,720
Capital assets [note 4]		
Petroleum and natural gas properties and equipment	46,804,092	16,068,685
Furniture and fixtures	236,600	124,714
	47,040,692	16,193,399
	73,139,740	41,396,119
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	4,965,753	1,175,748
Asset retirement obligations [note 5]	656,798	84,693
Commitments [note 6]		
Shareholders' equity		
Share capital [note 7]	75,719,452	48,108,289
Contributed surplus [note 8]	1,512,955	536,599
Deficit	(9,715,218)	(8,509,210)
	67,517,189	40,135,678
	73,139,740	41,396,119

See accompanying notes

On behalf of the Board:

(Signed) (Signed)

"Robert G. Welty" "Robert B. Carter"

Director Director

Consolidated Statements of Operations & Deficit

For the years ended December 31	2006	2005
	($)	($)
EXPENSES		
General and administrative	1,639,829	1,130,550
Foreign exchange (gain) loss	(248,381)	1,672,178
Stock based compensation [notes 7, 8]	717,639	350,143
Accretion [note 5]	35,793	1,314
Depreciation	63,121	15,599
	2,208,001	3,169,784
OTHER INCOME		
Interest	1,001,993	745,975
Net loss for the year	(1,206,008)	(2,423,809)
Deficit, beginning of year	(8,509,210)	(6,085,401)
Deficit, end of period	(9,715,218)	(8,509,210)
Net loss per common share – basic and diluted [note 9]	(0.01)	(0.03)

See accompanying notes

Consolidated Statements of Cash Flows

For the years ended December 31	2006	2005
	($)	($)
OPERATING ACTIVITIES		
Net loss for the year	(1,206,008)	(2,423,809)
Add items not affecting cash		
Foreign exchange (gain) loss	(363,162)	1,697,358
Stock based compensation [notes 7, 8]	717,639	350,143
Accretion [note 5]	35,793	1,314
Depreciation	63,121	15,599
	(752,617)	(359,395)
Change in non-cash working capital [note 11]	(202,636)	(77,074)
Cash used in operating activities	(955,253)	(436,469)
INVESTING ACTIVITIES		
Petroleum and natural gas properties and equipment additions	(29,907,210)	(5,504,717)
Furniture and fixtures additions	(175,007)	(108,463)
Change in non-cash working capital [note 11]	3,359,798	(638,495)
Cash used in investing activities	(26,722,419)	(6,251,675)
FINANCING ACTIVITIES		
Issue of common shares, net of share issue costs	27,507,463	28,401,748
Cash provided by financing activities	27,507,463	28,401,748
Effect of translation on foreign currency cash	433,694	(1,697,358)
Increase in cash, during the year	263,485	20,016,246
Cash and cash equivalents, beginning of year	23,538,376	3,522,130
Cash and cash equivalents, end of year	23,801,861	23,538,376

See accompanying notes

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Sterling Resources Ltd. (the "Company") is a publicly traded energy company engaged in the exploration, appraisal and development of crude oil and natural gas in selected areas of the world.

2. SIGNIFICANT ACCOUNTING POLICIES

Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of financial statements involves the use of estimates and approximations which have been made using careful judgment. The consolidated financial statements have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

Revenue Recognition

The Company does not recognize revenues from petroleum and natural gas assets until such time as a project becomes commercially viable. Prior to this stage, any production is considered test production, and is capitalized net of related costs.

Per Share Amounts

The Company follows the treasury stock method for the computation of diluted per share amounts. Under this method, the diluted weighted average number of common shares is calculated assuming the proceeds from the exercise of dilutive securities are used to purchase common shares at the average market price.

Cash and Cash Equivalents

Cash and cash equivalents include term deposits, guaranteed investment certificates and operating bank accounts with maturities, if applicable, of 30-days or less or have cashable options and are therefore considered cash equivalents by management.

Inventories

Inventories of supplies are carried at the lower of actual cost and net realizable value.

Petroleum and Natural Gas Properties and Equipment

The Company follows the full cost method of accounting for petroleum and natural gas operations whereby all costs relating to the acquisition of, exploration for and development of, petroleum and natural gas properties and equipment are capitalized in cost centres on a country-by-country basis. Such costs include lease acquisition costs, geological and geophysical expenditures, lease rentals, and costs of drilling and equipping productive and non-productive wells.

All cost centres are in the exploration or "pre-development" stage and as such the costs in each centre are not subject to depletion. An assessment is performed at every reporting date to determine whether the aggregate net costs in each pre-development stage cost centre are recoverable. Costs which are unlikely to be recovered are written off. The recovery of the costs incurred to date is ultimately dependent upon discovering commercial quantities of hydrocarbons. The likelihood of such a discovery is not determinable at this time.

Furniture and Fixtures

Furniture and fixtures are carried at cost less accumulated depreciation. Depreciation is calculated on a declining balance basis at an annual rate of 30-percent.

Asset Retirement Obligations

The Company recognizes the fair value of an asset retirement obligation (ARO) in the period in which it is incurred when a reasonable estimate of the fair value can be made. The fair value is determined through a review of engineering studies, industry guidelines and management's estimate on a site-by-site basis. The fair value is recorded as a liability with a corresponding increase in the carrying amount of the related asset. The capitalized amount is depleted on the unit-of-production method based on proved reserves. The liability amount is increased each reporting period due to the passage of time and the amount is expensed during the period. Actual costs incurred upon the settlement of the ARO are charged against the liability.

Joint Operations

Substantially all of the Company's exploration activities are conducted jointly with others and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

Foreign Currency Translation

Operations in foreign countries are translated using the temporal method. Foreign currency denominated monetary assets and liabilities and asset retirement obligations are translated at exchange rates in effect at the balance sheet date, and non-monetary assets and liabilities denominated in foreign currencies are translated at rates in effect on the dates the assets were acquired or liabilities were assumed. Revenues and expenses are translated at rates of exchange prevailing on the transaction dates. Translation gains and losses are included in the consolidated statement of operations.

Income Taxes

The Company follows the liability method of accounting for income taxes. Under this method, the Company records future income taxes for the effect of any differences between the accounting and income tax basis of an asset or liability. Future income taxes are measured using income tax rates expected to apply in the years in which differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in net income in the period in which the change is substantively enacted. Future income tax assets are calculated, and if realization is not considered to be "more likely than not", a valuation allowance is provided.

Stock Based Compensation

Under the Company's stock option plan, options to purchase common shares are granted to directors, officers, and employees at the market price on the date of the grant. Options issued by the Company are accounted for in accordance with the fair value method of accounting for stock based compensation, and as such the cost of the options is charged to operations over the vesting period, with an offsetting amount recorded to contributed surplus, based on an estimate of the fair value of the options at the grant date determined using a Black-Scholes options pricing model.

Measurement Uncertainty

The amounts recorded for asset retirement obligations, stock based compensation and capital expenditure accruals, and the assumptions used in the determination of potential asset impairments are based on estimates. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements of changes in such estimates in future periods could be material.

3. CASH AND CASH EQUIVALENTS

As at December 31, 2006, cash and cash equivalents included cash of $3,880,980 (2005 – $1,343,373) and cash equivalents of $19,920,881 (2005 – $22,195,000) bearing interest at rates between 3.7-percent and 4.0-percent (2005 – rates between 2.25-percent and 4.21-percent). As at December 31, 2006 and 2005, these funds were maintained in the following currencies:

	2006	2005
	($)	($)
Canadian Dollars	19,931,050	13,102,817
US Dollars	2,821,347	1,040,608
UK Pounds Sterling	653,245	9,394,951
Romanian Lei	396,219	–
	23,801,861	23,538,376

4. CAPITAL ASSETS

The Company's investments in capital assets are as follows:

(A) PETROLEUM AND NATURAL GAS PROPERTIES AND EQUIPMENT

	2006	2005
	($)	($)
United Kingdom	26,818,749	7,026,975
Romania	19,707,310	8,813,332
Other	278,033	228,378
	46,804,092	16,068,685

In order for the Company to maintain its working interests in its oil and gas properties in the pre-development stage, the Company has commitments to complete various seismic, geological, geophysical and other exploration drilling and work programs, none of which are of a material amount except those disclosed in note 6. The continuation of this work is dependent upon the ability of the Company to obtain continued financing or farm out any of its existing working interests. During the year-ended December 31, 2006, the Company capitalized salaries and related benefits, including stock based compensation, of $1,537,697 (2005 – $331,017).

(B) FURNITURE AND FIXTURES

	2006	2005
	($)	($)
Furniture, fixtures and equipment	373,738	198,732
Less: accumulated depreciation	(137,138)	(74,018)
	236,600	124,714

5. ASSET RETIREMENT OBLIGATIONS

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas exploration stage activity. The Company estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations to be approximately $1,557,243, which will be incurred between 2010 and 2015. A credit adjusted risk-free discount rate of 10-percent and an inflation rate of 4-percent were used to calculate the fair value of asset retirement obligations.

	2006	2005
	($)	($)
Balance, January 1	84,693	12,061
Additions	536,312	63,598
Revisions to estimates	–	7,720
Accretion	35,793	1,314
Balance, December 31	656,798	84,693

6. COMMITMENTS

The Company has commitments and obligations totaling $16.5-million under the terms of its exploration licenses which are expected to be incurred over the next two years. Of this total, $15.8-million relates to commitment wells or seismic programs which are subject to farm-out negotiations, and may be substantially reduced or eliminated upon conclusion of negotiations.

In addition the Company has commitments under operating leases for office premises and storage facilities as follows:

	($)
2007	100,052
2008	51,772
2009	53,796
2010	35,864
	241,484

7. SHARE CAPITAL

(A) AUTHORIZED

Unlimited common shares without nominal or par value

(B) ISSUED AND OUTSTANDING COMMON SHARES

	Number of Shares	Amount
		($)
Balance, December 31, 2004	43,448,042	19,691,149
Issued for cash		
– private placement	30,000,000	27,000,000
– exercise of stock options	140,000	51,700
– exercise of warrants	6,158,925	2,815,624
Share issue costs	–	(1,465,576)
Transferred from contributed surplus on exercise of options		15,392
Balance, December 31, 2005	79,746,967	48,108,289
Issued for cash		
– public issue	13,800,000	28,980,000
– exercise of stock options	856,667	409,700
Share issue costs	–	(1,882,237)
Transferred from contributed surplus on exercise of options	–	103,700
Balance, December 31, 2006	94,403,634	75,719,452

During 2006 the Company completed a bought deal financing of 13,800,000 common shares at $2.10 per share with a syndicate of underwriters. The total gross proceeds from the issue were $28,980,000. After underwriter's commissions and expenses of the issue totaling $1,882,237, net proceeds were $27,097,763.

During 2005, the Company completed a private placement financing consisting of 30,000,000 common shares at $0.90 per share and 1,200,000 agents warrants exercisable at $0.90 per share. The total gross proceeds from the issue and the subsequent exercise of the warrants were $28,080,000. After underwriter's commissions and expenses of the issue totaling $1,465,576, net proceeds were $26,614,424. In addition, 4,958,925 other warrants exercised during 2005 resulted in proceeds of $1,735,624.

(C) STOCK OPTIONS

The Company has established a stock option plan whereby it may grant options to its directors, officers, employees and consultants. On December 31, 2006 there were 7,000,000 (2005 – 7,000,000) common shares reserved for issuance under the plan. The exercise price of each option equals the market price of the Company's shares on the date of the grant less any applicable discount approved by the Board of Directors and the TSX Venture Exchange. The option's maximum term is five years, with the minimum vesting period to be 18 months. Stock options currently issued vest over the initial three years. The following is a continuity of outstanding stock options:

	2006		2005	
	Number of Options	Weighted Average Exercise Price ($)	Number of Options	Weighted Average Exercise Price ($)
Outstanding, January 1	4,610,000	0.91	2,445,000	0.38
Granted during the year	1,595,000	2.43	2,305,000	1.44
Exercised during the year	(856,667)	0.48	(140,000)	0.37
Cancelled during the year	(203,333)	1.51	–	–
Outstanding, December 31	5,145,000	1.43	4,610,000	0.91

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

Expiry Date	Exercise Price ($)	Number Outstanding	Number Exercisable
March 30, 2009	0.32	50,000	50,000
July 1, 2007	0.33	900,000	900,000
June 23, 2008	0.36	405,000	405,000
February 5, 2007	0.37	30,000	30,000
January 1, 2009	0.43	50,000	50,000
August 25, 2010	1.44	1,935,000	631,670
November 13, 2010	1.46	230,000	76,667
March 7, 2011	1.68	40,000	–
May 31, 2011	2.45	1,505,000	–
		5,145,000	2,143,337

As at December 31, 2006 the weighted average remaining contractual life of outstanding options was 1,138-days.

The Company has adopted the fair value method of accounting for all stock options granted to directors, officers and employees using the Black-Scholes option pricing model using the following weighted average assumptions:

	2006	2005
	($)	($)
Risk-free interest rate	3.73%	3.50%
Expected hold period to exercise	3 Years	3 Years
Volatility in the price of the Company's shares	82%	93%
Dividend yield	0%	0%

The risk-free interest rate represents the yield on 3-year Government of Canada bonds at the time the underlying options are awarded. Volatility in the price of the Company's shares is calculated based on the weekly average price for the 30-week period prior to the award of the options.

8. CONTRIBUTED SURPLUS

The following is a continuity of the Company's contributed surplus:

	2006	2005
	($)	($)
Balance, January 1	536,599	201,848
Stock based compensation expense for the year	717,639	350,143
Stock based compensation capitalized	362,417	–
Transferred to share capital on exercise of options	(103,700)	(15,392)
Balance, December 31	1,512,955	536,599

9. NET LOSS PER COMMON SHARE

The basic net loss per share is calculated based on net loss as the numerator in the calculation and the weighted average number of shares issued and outstanding during the year-ended December 31, 2006 of 86,165,460 (2005 – 73,300,153) as the denominator.

The Company follows the treasury stock method for the computation of diluted per share amounts. Under this method, the diluted weighted average number of common shares is calculated assuming the proceeds from the exercise of dilutive securities are used to purchase common shares at the average market price. The effect of the options outstanding using the treasury method would not be dilutive for the years ended December 31, 2006 and 2005.

10. INCOME TAXES

Income taxes differ from the amounts that would be obtained by applying the Canadian statutory income tax rate to the loss before income taxes as follows:

	2006	2005
	($)	($)
Net loss for the year	(1,206,008)	(2,423,809)
Canadian statutory income tax rate	32.49%	37.62%
Computed income tax recovery at the statutory rate	391,832	911,837
Tax rate differential on foreign operations	(24,603)	(40,728)
Permanent differences	(2,373)	(2,031)
Stock based compensation	(233,161)	(131,724)
Other	(20,483)	38,142
Tax benefit of losses not previously recognized in the financial statements	(111,212)	(775,496)
Income tax expense per financial statements	–	–

At December 31, 2006, the Company had the following approximate balances available to be claimed against future income for tax purposes:

	($)
Undepreciated capital cost	486,000
Canadian exploration expenditures	228,000
Canadian development expenditures	500,000
Canadian oil and gas property expenditures	269,000
United Kingdom deductible expenditures	39,956,000
Foreign exploration and development expenditures	6,813,000
Undeducted share issue costs	2,653,000
	50,905,000

In addition, at December 31, 2006, the Company had approximate non-capital losses available to reduce future Canadian taxable income expiring as follows:

	($)
2007	770,000
2008	392,000
2009	237,000
2010	247,000
2014	524,000
2015	1,904,000
2016	244,000
	4,318,000

The Company also has subsidiary UK tax losses carried forward of approximately $2,995,000 (2005 – $1,907,000), which are not subject to expiry. The benefit of these losses has not been recognized in these financial statements.

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for income tax purposes. As at December 31, 2006 and 2005, the Company has recognized a full valuation allowance against a future income tax asset arising from tax pools in excess of the net book value of capital assets, share issue costs and non-capital losses as follows:

	2006	2005
	($)	($)
Tax pools in excess of net book value of capital assets	468,829	501,356
Share issue costs	769,245	539,969
Domestic and foreign non-capital lossess	1,874,953	2,039,410
Unrealized foreign exchange gain	(40,666)	–
	3,072,361	3,080,735
Less: valuation allowance	(3,072,361)	(3,080,735)
Future tax asset	–	–

11. CHANGE IN NON-CASH WORKING CAPITAL

Changes in the Company's non-cash working capital for the years ended December 31, 2006 and 2005 are as follows:

	2006	2005
	($)	($)
OPERATING ACTIVITIES		
Accounts receivable	(176,500)	(69,546)
Prepaid expenses	9,525	(21,434)
Accounts payable and accrued liabilities	(35,661)	13,906
	(202,636)	(77,074)
INVESTING ACTIVITIES		
Accounts receivable	(637,042)	(1,220,097)
Inventory	171,174	(171,174)
Accounts payable and accrued liabilities	3,825,666	752,776
	3,359,798	(638,495)

12. FINANCIAL INSTRUMENTS

The fair market values of the Company's financial instruments, including cash and cash equivalents, accounts receivable and accounts payable approximate their carrying values.

13. SEGMENTED INFORMATION

The Company's activities are conducted in one operating segment and four geographic segments: Corporate, the United Kingdom, Romania and other international locations which include operations in France.

	Corporate	United Kingdom	Romania	Other International	Total
December 31, 2006	($)	($)	($)	($)	($)
Expenses	1,215,062	972,259	20,680	–	2,208,001
Other income	(1,001,993)	–	–	–	(1,001,993)
Net loss	(213,069)	(972,259)	(20,680)	–	(1,206,008)
Capital expenditures	11,442	19,045,037	10,976,083	49,655	30,082,217
Total assets	20,844,653	30,240,631	21,776,423	278,033	73,139,740
December 31, 2005					
Expenses	2,621,121	423,906	124,757	–	3,169,784
Other income	(745,975)	–	–	–	(745,975)
Net loss	(1,875,146)	(423,906)	(124,757)	–	(2,423,809)
Capital expenditures	97,775	2,825,854	2,505,016	184,535	5,613,180
Total assets	22,431,015	8,666,132	10,070,594	228,378	41,396,119

In the above table, prior year other income has been re-classified as Corporate in accordance with current presentation.

Corporate Information

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Directors

RAJ K. AGRAWAL (1) (2) (5)
President
NRG Engineering Ltd.

ROBERT B. CARTER (3) (4)
Independent Businessman

WALTER DEBONI (1) (5)
Independent Businessman

STEWART G. GIBSON
Chief Executive Officer
Sterling Resources Ltd.

TECK SOON KONG (3)
Independent Businessman

DAVID E. POWELL (1) (3)
Independent Businessman

ROBERT G. WELTY (5) (6)
Chairman
Sterling Resources Ltd.

(1) Reserves Committee
(2) Chairman Reserves Committee
(3) Audit Committee
(4) Chairman Audit Committee
(5) Governance and Compensation Committee
(6) Chairman Governance and Compensation Committee

Officers

ROBERT G. WELTY
Chairman

STEWART G. GIBSON
Chief Executive Officer

DAVID A. FINDLATER
Vice President Exploration

JOHN RAPACH
Vice President Operations

IAN C. HORNBY-SMITH
Chief Financial Officer

SHERRY L. CREMER
Treasurer & Corporate Secretary

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Banker

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Registrar & Transfer Agent

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The TSX Venture
Stock Exchange Trading Symbol: **SLG**

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TECK SOON KONG
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DAVID MILLER
London, England

ROBERT G. WELTY
Calgary, Canada

Officers

ROBERT G. WELTY
Chairman

STEWART G. GIBSON
Managing Director & Company Secretary

DAVID A. FINDLATER
Vice President Exploration & Business Development

JOHN RAPACH
Vice President Operations

STEPHEN BIRRELL
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