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Consolidated Financial Statements  
*(Expressed in US dollars)*

# **INTEROIL CORPORATION**

Years ended December 31, 2002 and 2001

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## AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of InterOil Corporation as at December 31, 2002 and 2001 and the consolidated statements of operations, cash flows and shareholders' equity for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2002 and 2001 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

A handwritten signature in black ink, appearing to read 'KPMG', is positioned above the printed name of the firm.

KPMG  
Sydney, Australia

April 30, 2003

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# InterOil Corporation

Consolidated Balance Sheets  
December 31, 2002 and 2001

(Expressed In United States dollars)

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	2002	2001
	\$	\$
<b>Assets</b>		
Current assets:		
Cash and cash equivalents (note 2)	3,288,539	667,435
Short-term investments (note 10)	7,105,701	17,000,000
Due from related parties (note 5)	0	313,599
Other receivables	503,859	927,185
Prepaid expenses	80,359	53,216
	10,978,458	18,961,435
Capital assets (note 4)	121,217,700	76,239,877
Oil and gas properties	2,878,703	2,096,271
	<b>135,074,861</b>	<b>97,297,583</b>

## Liabilities and shareholders' equity

Current liabilities:		
Accounts payable and accrued liabilities	6,744,515	1,725,438
Due to related parties (note 5)	2,784,560	762,836
Foreign currency forward contracts	678,648	1,703,089
	10,207,723	4,191,363
Secured loan (note 9)	31,000,000	0
Non-controlling interest (note 3)	6,490,398	6,495,779
Shareholders' equity:		
Share capital (note 6)	94,120,609	92,808,387
Other paid in capital (note 6)	769,964	0
Accumulated deficit	(7,513,833)	(6,197,946)
	87,376,740	86,610,441
	<b>135,074,861</b>	<b>97,297,583</b>

Commitments (note 11)

See accompanying notes to consolidated financial statements.

On behalf of the Board

Phil Mulacek..... Director

Christian Vinson..... Director

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## InterOil Corporation

Consolidated Statements of Operations  
Years ended December 31, 2002 and 2001

*(Expressed in United States dollars)*

	2002	2001
	\$	\$
<b>Income</b>		
Investment income	373,015	1,059,944
Other income	11,211	0
	384,226	1,059,944
<b>Expenses</b>		
Administrative and general	2,241,911	2,143,289
Exploration costs	92,673	0
Legal and professional fees	464,253	299,380
Foreign exchange	(1,094,787)	1,941,970
	1,704,050	4,384,639
(Loss) before income taxes and non-controlling interest	(1,319,824)	(3,324,695)
Income tax (expense) benefit (note 7)	(1,446)	12,647
(Loss) before non-controlling interest	(1,321,270)	(3,312,048)
Non-controlling interest share of losses	5,383	32,852
<b>Net (loss)</b>	<b>(1,315,887)</b>	<b>(3,279,196)</b>
<b>Basic (loss) per share</b> (note 8)	<b>(0.06)</b>	<b>(0.16)</b>
<b>Diluted (loss) per share</b> (note 8)	<b>(0.06)</b>	<b>(0.16)</b>

See accompanying notes to consolidated financial statements

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## InterOil Corporation

Consolidated Statements of Cash Flows  
Years ended December 31, 2002 and 2001

*(Expressed in United States dollars)*

	2002	2001
	\$	\$
Cash provided by (used in):		
<b>Operations</b>		
Net (loss)	(1,315,887)	(3,279,196)
Non-controlling interest	(5,383)	(32,852)
Change in non-cash operating working capital	189,140	2,315,973
	(1,132,130)	(996,075)
<b>Investments</b>		
Expenditure on oil and gas properties	(606,886)	(601,270)
Expenditure on capital assets	(38,765,401)	(7,580,634)
Redemption of cash on short term investment – certificates of deposit	9,894,299	0
Deposit refunded	0	2,100,000
	(29,477,988)	(6,081,904)
<b>Financing</b>		
Proceeds from borrowings	30,240,000	0
Other net advances from related party (note 5)	2,100,000	0
Proceeds from issue of securities	891,222	93,501
	33,231,222	93,501
Increase (decrease) in cash and cash equivalents	2,621,104	(6,984,478)
Cash and cash equivalents, beginning of year	667,435	7,651,913
<b>Cash and cash equivalents, end of year (note 2)</b>	<b>3,288,539</b>	<b>667,435</b>
<b>Supplemental cash flow information</b>		
Interest paid	1,820,404	0
Interest received	840,337	1,180,058

See accompanying notes to consolidated financial statements

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## InterOil Corporation

Consolidated Statements of Shareholders' Equity  
Years ended December 31, 2002 and 2001

*(Expressed in United States dollars)*

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	2002	2001
	\$	\$
<b>Share capital</b>		
At beginning of year	92,808,387	92,714,886
Issue of capital stock	1,312,222	93,501
At end of year (note 6)	94,120,609	92,808,387
<b>Additional paid in capital</b>		
At beginning of year	0	0
Stock compensation (note 6)	769,964	0
At end of year	769,964	0
<b>Accumulated deficit</b>		
At beginning of year	(6,197,946)	(2,918,750)
Net loss for year	(1,315,887)	-
At end of year	(7,513,833)	(6,197,946)
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Shareholders' equity at end of year	87,376,740	86,610,441

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See accompanying notes to consolidated financial statements

# InterOil Corporation

Notes to Consolidated Financial Statements  
Expressed in U.S dollars

Years ended December 31, 2002 and 2001

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InterOil Corporation's (the "Company" or "InterOil") primary business interest is the development of an oil refinery (the "Project") in Papua New Guinea ("PNG"). The capital assets, primarily the refinery, are currently located in Port Arthur, TEXAS. The refinery assets are being refurbished and will be transported to Napa Napa, Port Moresby in PNG. The Company is engaged in oil and gas exploration and development activity in PNG.

## 1. Significant accounting policies

### (a) Basis of presentation

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

The consolidated financial statements of the Company include the accounts of SP InterOil, LDC ("SPI") (99.9%), EP InterOil Limited ("EPI") (98.55%), SPI Exploration & Production Corporation (100%), SPI Distribution Limited (100%), InterOil Australia Pty Ltd (100%) and their subsidiaries.

### (b) Cash and cash equivalents

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

### (c) Capital assets

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

### (d) Oil and gas properties

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

# InterOil Corporation

Notes to Consolidated Financial Statements  
Expressed in U.S dollars

Years ended December 31, 2002 and 2001

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

(e) Foreign currency

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

(f) Derivative financial instruments

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

(g) Income taxes

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

(h) Use of estimates

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

# InterOil Corporation

Notes to Consolidated Financial Statements  
Expressed in U.S dollars

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(i) Earnings per share

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

(j) Change in accounting policy – stock options

The Company has the ability to grant stock options. No expense is recognised when stock options are granted provided the market value at the date of grant is not lower than the exercise price. For stock options granted to employees, the Company applies the settlement basis of accounting whereby the consideration paid to the Company on the exercise of stock options is recorded as share capital. Effective January 1, 2002, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants in Handbook Section 3870, "Stock-based compensation and other stock-based payments". Section 3870 was applied prospectively to all stock-based compensation to non-employees granted on or after January 1, 2002. The Company has disclosed the pro forma effect of accounting for stock option awards granted to employees subsequent to January 1, 2002, under the fair value based method.

## 2. Cash and cash equivalents

The components of cash and cash equivalents are as follows:

	2002	2001
	\$	\$
Cash on deposit	3,206,084	268,568
Bank demand deposits	3,131	294,768
Bank term deposits	79,324	104,099
	3,288,539	667,435

Included in the 2002 bank term deposits and bank demand deposits are 308,896 Kina (2001 – 553,179 Kina) (the currency of PNG) representing a US dollar equivalent of \$79,324 (2001 - \$145,984).

## 3. Non-controlling interest

On September 11, 1998 Enron Papua New Guinea Ltd ("Enron"), SPI's former joint venture partner exercised its option (pursuant to a January 1997 joint venture agreement with SPI) to terminate the joint venture agreement. Consequently, SPI purchased Enron's voting, non-participating shares in EPI for a nominal amount. The capital structure of the joint venture was composed of voting, non-participating shares and non-voting, participating shares. Enron no longer actively participates in the development of

# InterOil Corporation

Notes to Consolidated Financial Statements  
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Years ended December 31, 2002 and 2001

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the Project but continues to be a non-voting participating shareholder in EPI. SPI now holds all voting non-participating shares issued from EPI and has sole responsibility for managing the project. Enron does not hold any transfer or conversion rights into shares of InterOil Corporation.

At December 31, 2002 SPI holds 98.55% (2001 – 97.00%) of the non-voting participating shares issued from EPI.

# InterOil Corporation

Notes to Consolidated Financial Statements  
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Years ended December 31, 2002 and 2001

## 4. Capital assets

	2002	2001
	\$	\$
Plant and equipment, at cost	48,048,167	47,243,458
Project development costs, at cost	71,349,129	28,996,419
Capitalised borrowing costs, at cost	1,820,404	0
	121,217,700	76,239,877

Included in plant and equipment above are barges with a carrying amount of \$5,599,467 at December 31, 2002. On December 20, 2001, the Company arranged a US\$3 million loan facility secured by the barges and assets held by PIE Corporation and Mr. Phil Mulacek. At December 31, 2002 the total owing under this facility amounted to \$2,100,000. Interest rates applicable to amounts drawn on this loan facility are 5.75%.

## 5. Due to (from) related parties

Amounts due from related parties of nil (2001 - \$313,599) represent advances made to Direct Employment Services Corporation (DESC) that are non-interest bearing and have no fixed term of repayment. These parties are related by virtue of common ownership.

SPI does not have a Board of Directors. Instead, its articles of association provide for the business and affairs of SPI to be managed by a General Manager appointed by the shareholders of SPI and is the US sponsor under the OPIC loan. Petroleum Independent and Exploration Corporation ("P.I.E.") has been appointed as the General Manager of SPI. Under the laws of the Commonwealth of The Bahamas, the General Manager exercises all powers which would typically be exercised by a Board of Directors, being those which are not required by laws or by SPI's constituting documents to be exercised by the members (shareholders) of SPI. P.I.E also acts as a sponsor for the Company's oil refinery project.

During 2002, P.I.E. was reimbursed for sponsors legal, accounting and reporting costs of \$150,000 relating to SPI. Amounts due to related parties of \$2,784,560 (2001 - \$762,836) are amounts due to P.I.E. P.I.E advanced \$2,900,000 to the InterOil Group in the quarter ended March 31, 2002 and the Company has repaid \$800,000 of this loan as at December 31, 2002. The remainder of the amount due to P.I.E is non-interest bearing, has no repayment terms and relates to management fees accrued prior to the current year.

Amounts due to Directors at December 31, 2002 totalled \$26,000 (2001 - \$30,500) and are included in accounts payable and accrued liabilities.

# InterOil Corporation

Notes to Consolidated Financial Statements  
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## 6. Share capital

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

	Number of shares	\$
Balance, January 1, 2001	20,152,870	92,714,886
Shares issued for cash	34,000	93,501
Balance, December 31, 2001	20,186,870	92,808,387
Shares issued for cash	399,073	1,312,222
Balance, December 31, 2002	<b>20,585,943</b>	<b>94,120,609</b>

## Stock options

Options are exercisable on a 1:1 basis. Options are issued to directors, staff and contractors. Options vest at various dates in accordance with the applicable option agreement, have an exercise period of three to five years assuming continuous employment by the Group and may be exercised at any time after issue within the exercise period. Upon resignation or retirement, options must be exercised within 30 days for employees and 90 days for Directors under the current options plan.

The following summarises the stock options outstanding:

	2002		2001	
	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
Outstanding at the beginning of year	1,165,600	4.00	673,125	2.97
Granted	762,585	6.53	854,600	4.28
Exercised	(393,000)	3.26	(34,000)	2.75
Expired	(25,100)	5.68	(328,125)	2.75
Outstanding at the end of year	1,510,085	5.48	1,165,600	4.00

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Range of exercise prices \$	Options outstanding			Options exercisable	
	Number of options	Weighted average exercise price \$	Weighted average remaining term (years)	Number of options	Weighted average exercise price \$
\$2.75 to \$3.50	250,500	3.15	3	250,500	3.
\$4.00 to \$5.50	951,000	4.95	2	866,000	5
\$5.50 to \$8.00	173,585	6.88	3	73,585	7
\$8.00 to \$12.00	135,000	11.68	3	0	n/a
2.75 to \$12.00	1,510,085	5.48	3	1,190,085	5

The fair value of the 762,585 options granted subsequent to January 1, 2002 has been estimated at the date of grant in the amount of \$976,900 using a Black-Scholes option pricing model with the following assumptions: risk-free interest rate of 4%; dividend yield of nil; volatility factor of the expected market price of the Company's common stock of 20%; and a weighted average expected life of the options of three years. An amount of \$769,964 has been recognized as compensation in the financial statements and \$206,936 as a pro forma compensation expense. For purposes of pro forma disclosure, the estimated fair value of the options is expensed over the options' vesting period, which is estimated as three years.

The following is the Company's pro forma earnings with the fair value method applied to all options issued during the year:

	2002	
	Loss \$	Loss per share \$
Loss for the year	1,315,887	(0.06)
Pro forma compensation expense related to fair value of stock options issued	206,936	(0.01)
Pro forma loss for the year	1,522,823	(0.07)

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

# InterOil Corporation

Notes to Consolidated Financial Statements  
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Years ended December 31, 2002 and 2001

## 7. Income taxes

Income tax expense differs from the amount that would be computed by applying the Federal and provincial statutory income tax rates of 38.62% (2001 – 41.75%) to income before income taxes and non-controlling interest. The reasons for the differences are as follows:

	2002	2001
	\$	\$
Computed tax (benefit)	(509,716)	(1,388,060)
Increase (Decrease) resulting from:		
Tax rate differential on foreign subsidiaries	188,788	137,293
Non-taxable items	(183,802)	57,715
Future income tax benefit not brought to account for:		
Tax losses	346,526	606,039
Timing differences	158,204	574,366
Over provision for tax in prior years	(332)	(12,647)
Other taxes	1,778	0
	1,446	(12,647)

The tax effects of temporary differences that give rise to significant portions of the future tax assets and future tax liabilities at December 31, 2002 and 2001 are presented below:

	2002	2001
	\$	\$
Future tax assets:		
Carried forward tax losses	1,366,190	827,426
Timing differences	671,323	587,441
	2,037,513	1,414,867
Less valuation allowance	(2,037,513)	(1,414,867)
Net future tax asset (liability)	-	-

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

Carried forward tax losses in PNG expire within seven years.  
During the year the Company paid withholding taxes in PNG of \$1,077 (4,193 Kina)

An amount of \$1,778 (Can\$2,807) was paid to the Ontario Ministry of Finance for Corporations Tax in the State of Ontario, Canada.

There were no taxes paid in other jurisdictions.

# InterOil Corporation

Notes to Consolidated Financial Statements  
Expressed in U.S dollars

Years ended December 31, 2002 and 2001

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## 8. Loss per share

Loss per share is computed on the weighted average number of shares on issue during the year of 20,462,167. (2001 – 20,178,859). Had the shares under option, referred to in note 6, been exercised in 2002 and 2001 loss per share would not have changed. There were 1,430,085 potentially dilutive shares outstanding at 31 December 2002.

## 9. Secured loan:

On June 12, 2001, EPI entered into a loan agreement with the Overseas Private Investment Corporation ("OPIC") to secure an \$85 million project financing facility. The first drawdown of this loan facility for \$31 million occurred on March 28, 2002. The loan is secured over the assets of the project. EPI has committed to pay OPIC an annual commitment fee of 0.5% of the undrawn amount, and a one time facility fee in the amount of 1.0% of the total project financing facility.

The loan expires June 30, 2013 and half yearly repayments of \$4.5 million commence on June 30, 2004. The agreement contains certain financial covenants including the maintenance of minimum levels of tangible net worth and limitations on the incurrence of additional indebtedness. The interest rate is equal to the treasury cost applicable to each promissory note outstanding plus the OPIC spread. The OPIC spread is 3.0% per annum prior to project completion and 3.5% per annum on and after project completion. The weighted average interest rate for the year ended December 31, 2002 was 7.71%.

## 10. Financial instruments

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

With the exception of cash and cash equivalents and short term investments, all financial assets are non interest bearing. Cash and cash equivalents earned average interest rates of 3.5% (2001 – 5%). The Company has invested \$7,105,701 million in short term investments at December 31, 2002 in the form of certificates of deposit. These funds are recorded as short term investments and earn an average rate of interest of 1.2%.

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

The Company has foreign currency forward contracts totalling \$62 million (2001-\$81 million) at December 31, 2002 to acquire Australian dollars to hedge Australian dollars amounts payable pursuant to the refinery construction. These contracts mature during 2003. The Company would have been required to pay a total of \$4,001,462 (2001 - \$12,746,164) to settle the contracts at December 31, 2002. An unrealised exchange loss of \$678,648 (2001- \$1,703,089) has been recognised on the balance sheet, which relates to that portion of the foreign currency forward contracts which is excess to specific commitments.

# InterOil Corporation

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As a requirement of the hedging contracts a collateral arrangement has been entered into whereby an amount of US\$7.1 million (2001 - \$17 million) is held on deposit at December 31, 2002 and has been pledged in favour of the provider of the hedge. Funds required to be held on deposit as collateral are reducing over time as project expenditure is undertaken and the foreign currency forward contracts are closed out.

## 11. Commitments

InterOil has committed to pay OPIC an annual commitment fee of 0.5% of the undrawn amount.

InterOil has Petroleum Prospecting and Retention Licence expenditure commitments of US\$4,100,000 which relate to various holdings in PNG for the next two years.

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

## 12. Subsequent event

Subsequent to year end, the Company issued new capital consisting of 862,500 ordinary common shares at Can\$13.75 per share equating to a net injection of new capital of Can\$11,859,375 (USD equivalent US\$7,781,683) on February 7, 2003 and 755,000 ordinary common shares at C\$15.00 per share equating to new capital C\$11,325,000 on April 29, 2003.

The Corporation received a second tranche of its loan with OPIC on February 25, 2003 in the amount of US\$6,500,000. A third tranche of US\$6,000,000 was received on March 25, 2003.

The Directors and other interested parties of InterOil Corporation exercised 250,000 fully paid share options in January and February 2003. This resulted in a net injection of new capital of US\$1,115,700.