

# Second Quarter Report

STERLING RESOURCES LTD.

*For the Six Months ended June 30, 2004*

## Message to Shareholders

Sterling's major activities during the second quarter concentrated on making applications for additional offshore UK licenses, furthering the technical work on its UK offshore and Romanian onshore holdings, and completing a private placement of common shares that raised gross proceeds of CDN \$4.9 million.

Based on encouraging results from the analysis of 2D seismic on Blocks 210/30, 210/25b offshore the UK, (Sterling 60% and operator) existing 3D seismic was purchased and results from its analysis and mapping to date include four potential Brent Formation closures and two high amplitude events within the Upper Jurassic overlying two of the Brent highs. Depth conversion and mapping of the Brent anomalies will be completed shortly and IKON Science (a noted UK based geoscience technology developer) is undertaking further amplitude analyses on the Upper Jurassic events.

On June 4, Sterling made multiple applications for promote licenses in the UK 22nd Offshore Licensing Round. Most of the licenses applied for have some 3D seismic coverage, can benefit from the use of new technology and are close to existing infrastructure. License awards by the UK Department of Trade and Industry are expected to be announced towards the end of August.

Onshore the United Kingdom in the Wessex Basin, a confirmation test will be performed on the lower zone in the Waddock Cross discovery well (Sterling 18.75%) drilled earlier this year. If the test results are positive, the well will be dually completed to allow for the production of oil as well as disposal of any produced water. In the Weald Basin, the operator is scheduling an appraisal well, Avington 3, in September. This will be a vertical well to test the oil water contact within the better reservoir layers. If the results are as prognosed, it will confirm the large amount of oil in place and justify further activity to recover the associated reserves. In the Cleveland Basin, the Kirkleatham and Westerdale gas prospects are on schedule to be drilled in the fourth quarter.

Final interpretation and mapping of the recent seismic over the northeast portion of the Craiova concession, onshore Romania, (Sterling 100%) was completed and a location selected to test a multi-target prospect identified by the seismic with shallower Sarmatian (Miocene) and deeper Middle Triassic objectives.

At the Annual and Special Meeting of Shareholders held on June 29, shareholders approved the private placement to Meridian Capital C.I.S. Fund of 15,350,000 common shares at a price of CDN \$0.32 a share for gross proceeds of CDN \$4,912,000. Also at the meeting, the Board of Directors was increased to seven members, and three new directors were elected. The new directors elected were Mr. Ian Connor and Mr. Teck Soon Kong, representing Meridian, and Mr. Robert Carter. These gentlemen bring a wealth of international business experience to Sterling. Mr. J.R. Harris, a long time Sterling director, did not stand for re-election at the meeting. Sterling is extremely grateful to Mr. Harris for his wise counsel and the many contributions he made during his tenure, which have been instrumental in the growth of the Company.

On June 30, the private placement was completed. Proceeds will be used to fund Sterling's ongoing programs and to augment working capital.

On behalf of the Board of Directors,

"signed"

Robert G. Welty  
Chairman & Chief Executive Officer

August 19, 2004

"signed"

Stewart G. Gibson  
President & Chief Operating Officer

# Management's Discussion and Analysis

The following Management's Discussion and Analysis (MD&A) is dated August 19, 2004 and should be read in conjunction with the accompanying unaudited consolidated interim financial statements and the audited consolidated financial statements and MD&A for the year ended December 31, 2003.

The Company's financial statements and the financial data included in the MD&A have been prepared in accordance with Canadian generally accepted accounting principles (GAAP). All financial amounts are expressed in Canadian dollars, except as otherwise indicated.

## *Forward-looking Statements*

Certain statements contained in the MD&A are forward-looking statements. Forward-looking statements are based on current expectations, estimates and projections that involve a number of risks and uncertainties, which could cause actual results to differ materially from those anticipated by the Company and described in the forward-looking statements. These risks and uncertainties include:

- the risks of the oil and gas industry, such as operational risks in exploring for, developing and producing crude oil and natural gas;
- risks and uncertainties involving geology of oil and gas deposits;
- potential delays or changes in plans with respect to exploration or development projects or capital expenditures;
- uncertainties as to the availability and cost of financing;
- risks in conducting foreign operations; and
- the possibility that government policies or laws may change or governmental approvals may be delayed or withheld.

Forward-looking statements are based on the estimates and opinions of the Company's management at the time the statements are made. The Company assumes no obligation to update forward-looking statements should circumstances or management's estimates or opinions change.

## *Corporate Strategy*

Sterling Resources Ltd. is a Calgary, Canada based energy company actively engaged in the exploration 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 reserves. High initial working interests are taken where possible, and financial exposure and risk are managed by obtaining industry participations. Current landholdings are focused in the United Kingdom and Romania.

## *Discussion of Operations and Financial Results*

For the second quarter ended June 30, 2004, the Company recorded a loss of \$260,046 or \$0.01 per share, compared with a loss of \$706,577 or \$0.04 per share for the quarter ended June 30, 2003. The 2003 loss included a write off of \$555,871 of the Company's costs on exploration licenses relinquished.

There is no material revenue at the present time. Sterling participated in an oil discovery, Avington-2, onshore UK in August 2003. An extended well test was conducted and revenues and expenses during this period were offset against capital expenditures on the license.

Expenses for the quarter, were \$260,251 compared with \$151,548 (excluding the write off mentioned above) in 2003. The major increases in expenses were third party consulting fees, foreign exchange, primarily due to the strengthening of the British pound against the Canadian dollar, business travel, and stock based compensation.

### *Changes in Accounting Policy*

The Company adopted the intrinsic value method of accounting for stock options as of January 1, 2002 and as at December 31, 2003 adopted the new Canadian Institute of Chartered Accountants (“CICA”) standard for reporting. As permitted by this new pronouncement, the change has been applied retroactively for grants awarded after January 1, 2002. Results for the 2003 periods have been restated to conform to this new form of disclosure using the fair value method of accounting for stock options.

As of January 1, 2004 the Company adopted the CICA Handbook Section 3110, “Asset Retirement Obligations” and Accounting Guide AcG-6 “Oil and Gas Accounting – Full Cost”. The effect of adopting these policies is explained in Note 2 to the June 30, 2004 financial statements.

### *Petroleum Properties and Capital Expenditures*

Sterling had invested \$9,694,538 in its oil and gas properties to June 30, 2004, compared with \$9,227,590 as at December 31, 2003.

Cash capital expenditures on oil and gas activities for the quarter were \$243,548 compared with \$85,213 for the second quarter of 2003. Expenditures were primarily for well analysis on Avington 2, studies and data for the UK offshore promote license applications, geophysical analyses of the seismic acquired onshore Romania and technical studies offshore Romania. Expenditures during the second quarter of 2003 were for geological and geophysical work and pre-drilling costs primarily on Sterling’s properties located onshore UK and onshore Romania.

Sterling has elected to enter into Phase 3 of the initial Exploration Period of the Craiova concession agreement, onshore Romania. Phase 3 is from June 23, 2004 to December 24, 2005 and involves work commitments of one well plus 140 kilometers of 2D seismic.

### *Financing, Liquidity and Solvency*

As at June 30, 2004 Sterling had working capital of \$4,078,350 compared to a working capital of \$1,070,293 as at June 30, 2003.

On June 30, 2004 Sterling completed a private placement to an international investment fund, consisting of 15,350,000 common shares at a price of \$0.32, for gross proceeds of \$4,912,000. Proceeds will be used to fund Sterling’s ongoing work programs and to augment working capital. During the quarter, 1,314,075 warrants were exercised for proceeds of \$394,223.

As is typical of companies in Sterling’s stage, future exploration and development activities will require substantial amounts of additional capital which the Company 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. Successful completion of financings and farm outs of partial interests are required for Sterling to carry out its activities on each of its projects. Sterling may also raise capital by monetization of certain of its existing assets.

There are no material commitments on oil and gas properties other than those associated with Phase 3 onshore Romania, which Sterling elected to enter effective June 23, 2004. Phase 3 involves a well and seismic for a total estimated cost of US \$1,300,000. Although Sterling currently holds the concession with a 100% working interest, it plans to bring in an industry partner for Phase 3. Commitments on its offshore Romanian contract areas have been suspended with the agreement of the Romanian Government pending resolution of the Romanian/Ukrainian maritime boundary delineation. All licenses in the UK and France have only minor expenditure commitments for geological and geophysical activities.

### *Future Plans*

Sterling plans to continue with its growth strategy. Over the next two years the major initiatives will be to:

- appraise and develop the existing oil discoveries at Avington and Waddock Cross (onshore UK) and the gas discovery at Doina (offshore Romania). The Doina gas discovery awaits drilling of further nearby prospects on the Block and the privatization of Petrom, the Romanian national oil company, which was completed in July 2004 when OMV, the Austrian Oil Company, acquired control.

- drill at least six exploration wells on the key prospects, which have been matured within the currently held acreage. It is intended to continue the successful farm out strategy adopted to date for the majority of these wells.
- continue geological and geophysical work to evaluate the many other prospects and leads that exist on the current licenses, in addition to those identified in the drilling program. In particular, this work will focus on offshore UK and both onshore and offshore Romania, where significant additional prospectivity exists.
- acquire more blocks through promote license applications in the UK North Sea and pursue the acquisition of “Fallow Blocks” and “Fallow Discoveries”. Generally, these are license areas that have been so designated by the Department of Trade and Industry where the initial term of the license has expired and there has been no drilling or dedicated seismic or other significant activity for four years.

Estimated minimum capital expenditures and general administrative expenditures for 2004 are \$2,300,000 net of planned farmouts on certain properties. Sterling has flexibility over most of its capital expenditures and as to the percentage of its working interests farmed out.

For the past four years, Sterling’s strategy for growth and financing has proved to be a workable one. Furthermore, during this time the Company has increased the geological prospectivity of many of its lands and accordingly plans to increase the amount of drilling activity over the next two years. Successful drilling would result in production and cash flow with which to finance further activity.

### *Business Risks*

The Company’s business risks have not changed materially from the disclosure presented in the 2003 year end MD&A.

### *Outstanding Shares*

As at June 30, 2004 there were 42,268,042 common shares outstanding and a further 2,805,000 common shares reserved for the issuance of stock options. In addition, warrants attached to common share issues completed in 2002 reserved 1,694,000 common shares for issuance at \$0.60 per share which expired July 31, 2004, and issues in 2003 reserve 5,988,925 common shares at \$0.35 per share until June 6 and 16, 2005.

Additional information about Sterling Resources Ltd. and its business activities, including the Company’s Annual Information Form, is available on SEDAR at [www.sedar.com](http://www.sedar.com).

# Consolidated Balance Sheets

<i>Unaudited</i>	<b>June 30</b>	December 31
	<b>2004</b>	2003
	<b>\$</b>	<b>\$</b>
<b>Assets</b>		
<b>Current</b>		
Cash and short term investments	4,421,622	17,227
Accounts receivable and prepaid expenses	124,490	84,390
	<b>4,546,112</b>	<b>101,617</b>
<b>Capital assets</b>		
Petroleum and natural gas properties <i>(note 2)</i>	9,694,538	9,227,590
Furniture, fixtures and other	25,160	20,155
	<b>9,719,698</b>	<b>9,247,745</b>
	<b>14,265,810</b>	<b>9,349,362</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current</b>		
Bank indebtedness <i>(note 4)</i>	–	75,000
Accounts payable and accrued liabilities	467,762	350,451
	<b>467,762</b>	<b>–</b>
		425,451
Asset retirement obligation <i>(note 2)</i>	11,461	–
<b>Shareholders' equity</b>		
Share capital <i>(note 3)</i>	19,331,225	14,052,083
Contributed surplus	135,929	105,988
Deficit	(5,680,567)	(5,234,160)
	<b>13,786,587</b>	<b>8,923,911</b>
	<b>14,265,810</b>	<b>9,349,362</b>

*See accompanying notes*

# Consolidated Statements of Operations and Deficit

Unaudited

	Three Months Ended June 30		Six Months Ended June 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
	<i>(Restated—see note 2)</i>		<i>(Restated—see note 2)</i>	
<b>EXPENSES</b>				
General and administrative	236,496	155,678	392,653	281,866
Foreign exchange (gain) loss	7,040	(8,570)	21,660	(42,758)
Stock-based compensation	15,428	3,263	29,941	5,888
Depreciation, depletion and accretion	1,287	1,177	2,574	2,354
Exploration licenses relinquished	—	555,871	—	555,871
	260,251	707,419	446,828	803,221
<b>OTHER INCOME</b>				
Interest	205	842	421	1,253
<b>Net loss for the period</b>	<b>260,046</b>	<b>706,577</b>	<b>446,407</b>	<b>801,968</b>
Deficit, beginning of period	5,420,521	4,162,999	5,234,160	4,067,608
<b>Deficit, end of period</b>	<b>5,680,567</b>	<b>4,869,576</b>	<b>5,680,567</b>	<b>4,869,576</b>
<b>Net loss attributable per common share</b>				
Basic	(0.01)	(0.04)	(0.01)	(0.05)
Diluted	(0.01)	(0.04)	(0.01)	(0.05)

See accompanying notes

# Consolidated Statements of Cash Flow

Unaudited

	Three Months Ended June 30		Six Months Ended June 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
	<i>(Restated—see note 2)</i>		<i>(Restated—see note 2)</i>	
<b>OPERATING ACTIVITIES</b>				
Net loss for the period	(260,046)	(706,577)	(446,407)	(801,968)
Items not affecting cash				
Depreciation, depletion and accretion	1,287	1,177	2,574	2,345
Stock-based compensation	15,428	3,263	29,941	5,888
Exploration licenses relinquished	—	555,871	—	555,871
Cash loss from operations	(243,331)	(146,266)	(413,892)	(237,864)
Change in non-cash working capital	(37,984)	(985,287)	77,210	(696,963)
<b>Cash used in operating activities</b>	<b>(281,315)</b>	<b>(1,131,553)</b>	<b>(336,682)</b>	<b>(934,827)</b>
<b>INVESTING ACTIVITIES</b>				
Petroleum and natural gas properties	(243,548)	(85,213)	(456,086)	(321,416)
Other	(6,979)	—	(6,979)	—
<b>Cash used in investing activities</b>	<b>(250,527)</b>	<b>(85,213)</b>	<b>(463,065)</b>	<b>(321,416)</b>
<b>FINANCING ACTIVITIES</b>				
Issue of common shares net of share issue costs	5,267,892	1,671,416	5,279,142	1,671,037
Bank indebtedness	(225,000)	—	(75,000)	—
Due to related party	(115,000)	—	—	—
<b>Cash provided by financing activities</b>	<b>4,927,892</b>	<b>1,671,416</b>	<b>5,204,142</b>	<b>1,671,037</b>
<b>Increase in cash</b>	<b>4,396,050</b>	<b>454,650</b>	<b>4,404,395</b>	<b>414,794</b>
<b>Cash and short term investments, beginning of period</b>	<b>25,572</b>	<b>244,818</b>	<b>17,227</b>	<b>284,674</b>
<b>Cash and short term investments, end of period</b>	<b>4,421,622</b>	<b>699,468</b>	<b>4,421,622</b>	<b>699,468</b>

See accompanying notes

# Selected Notes to Consolidated Financial Statements

Unaudited

Six Months Ended June 30, 2004

## 1. Basis of Presentation

The interim consolidated financial statements of Sterling Resources Ltd. have been prepared by management in accordance with Canadian generally accepted accounting principles. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal year ended December 31, 2003. The disclosures included below are incremental to those included with the annual consolidated financial statements. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto in the Company's annual report for the year ended December 31, 2003.

## 2. Changes in Accounting Policies

As of January 1, 2002, the Company adopted the recommendations of the Canadian Institute of Chartered Accountants (CICA) on accounting for stock-based compensation. As permitted by this new pronouncement, the Company has applied this change retroactively for grants awarded after January 1, 2002, and restated the 2003 results to conform to this new form of disclosure using the fair value method of accounting for stock options.

As of January 1, 2004, the Company adopted CICA Handbook Section 3110 "Asset Retirement Obligations" to account for future costs of abandonment of existing facilities. As a result of this change, the Consolidated Financial Statements at March 31, 2004 were changed as follows: petroleum and natural gas properties was increased by \$10,861 with a corresponding amount recorded as a liability, asset retirement obligation. The change was applied retroactively. The Company estimates the undiscounted cash flows related to asset retirement obligations, adjusted for inflation, to be incurred over the estimated reserve life of the underlying assets will total approximately \$49,915. The fair value at January 1, 2004 was \$10,861, using a discount rate of 10% and an inflation rate of 4%.

As of January 1, 2004, the Company adopted guideline AcG-16 "Oil and Gas Accounting - Full Cost" issued by the CICA. Under AcG-16 impairment is recognized if the carrying amount of the capital assets exceeds the sum of the undiscounted cash flows expected to result from the Company's proved reserves. Previously impaired was tested based on undiscounted future net revenues using proved reserves, and providing for future general and administrative expenses, carrying costs and taxes. The adoption of AcG-16 had no effect on the Company's financial results.

## 3. Share Capital

### a) Authorized

Unlimited common shares without nominal or par value

### b) Issued and outstanding

	Number of shares	Amount \$
Common shares		
Balance outstanding as at December 31, 2003	24,041,467	14,052,083
Issued during period	18,226,575	5,774,974
Share issue costs	–	(495,832)
Balance, June 30, 2004	42,268,042	19,331,225

In June of 2004 the Company issued 15,350,000 common shares for an aggregate cash consideration of \$4,912,000. Commissions in the amount of 1,500,000 common shares were paid to finders in connection with the placement and the value has been included in share issue costs. During the period, 1,376,575 warrants were exercised for proceeds of \$412,974.

### c) Stock options

The Company has a stock option plan under which employees, directors, officers and consultants are eligible to receive grants. On June 30, 2004 there were 2,805,000 common shares reserved for issuance under the plan with exercise prices between \$0.32 and \$0.60. Stock options granted prior to June 30, 2004 have a five year term and vested in full on June 30, 2004. Options granted on June 30, 2004 have a term of three years and vest as to one third after 12 months, 24 months and 35 months.

	Number of Options	Weighted Average Exercise Price \$
Outstanding as at December 31, 2003	1,642,500	0.47
Granted	1,210,000	0.33
Cancelled/Expired during the period	(47,500)	0.36
Outstanding at June 30, 2004	2,805,000	0.39
Exercisable at June 30, 2004	1,695,000	0.43

As mentioned in Note 2, the Company has adopted the fair value method of accounting for all stock options granted to directors, officers, employees and consultants retroactively to January 1, 2002 using the Black-Scholes option pricing model using the following assumptions.

	2004
Risk-free interest rate	3.28%
Expected hold period to exercise	3 Years
Volatility in the price of the Company's shares	69.94%
Dividend yield	0%

*d) Warrants Outstanding*

Expiry Date	Number Outstanding January 1, 2004	Exercised During Period	Number Outstanding June 30, 2004	Exercise Price \$
	July 31, 2004	1,694,000	–	1,694,000
June 6, 2005	4,115,000	824,000	3,291,000	0.35
June 16, 2005	3,250,500	552,575	2,697,925	0.35
	9,059,500	1,376,575	7,682,925	

*e) Weighted Average Shares*

The weighted average shares outstanding for the three months ended June 30, 2004 and June 30, 2003 were 21,682,366 and 17,472,879 respectively.

**4. Bank Indebtedness**

The Company has a revolving demand credit facility available up to \$250,000. This facility bears interest at the Royal Bank of Canada prime lending rate plus 0.25% and is guaranteed by a company owned by an officer and director of the Company. No amount was drawn at June 30, 2004 and the facility was cancelled on July 13, 2004.

# Corporate Information

## *Directors*

**Raj K. Agrawal**

*President*

*NRG Engineering Ltd.*

**Robert B. Carter** <sup>(1) (2)</sup>

*Independent Businessman*

**Ian Connor**

*Managing Director, Meridian*

*Capital Limited*

**Stewart G. Gibson**

*President & Chief Operating Officer*

*Sterling Resources Ltd.*

**Teck Soon Kong** <sup>(1)</sup>

*Independent Businessman*

**David E. Powell** <sup>(1)</sup>

*Independent Businessman*

**Robert G. Welty**

*Chairman & Chief Executive Officer*

*Sterling Resources Ltd.*

<sup>(1)</sup> Audit Committee

<sup>(2)</sup> Chairman, Audit Committee

## *Officers*

**Robert G. Welty**

*Chairman & Chief Executive Officer*

**Stewart G. Gibson**

*President & Chief Operating Officer*

**David A. Findlater**

*Vice President Exploration*

**Sherry L. Cremer**

*Treasurer & Corporate Secretary*

## *Corporate Headquarters*

**Sterling Resources Ltd.**

Suite 1450, 736 Sixth Avenue S.W.

Calgary, Alberta, Canada T2P 3T7

Telephone: (403) 237-9256

Facsimile: (403) 215-9279

E-Mail: [info@sterling-resources.com](mailto:info@sterling-resources.com)

Website: [www.sterling-resources.com](http://www.sterling-resources.com)

## *Auditors*

Ernst & Young LLP

## *Banker*

The Royal Bank of Canada

## *Legal Counsel*

Stikeman Elliott

## *Registrar and Transfer Agent*

Inquiries regarding change of address, registered shareholdings, stock transfers or lost certificates should be directed to:

**Computershare Investor Services Inc.**

100 University Avenue, 9th Floor

Toronto, Ontario, Canada M5J 2Y1

Telephone: (800) 564-6253

Facsimile: (888) 453-0330

(416) 263-9394

E-Mail: [service@computershare.com](mailto:service@computershare.com)

## *Stock Exchange Listing*

The TSX Venture Stock Exchange

Trading Symbol: SLG

## *Sterling Resources (UK) Ltd.*

(wholly owned)

## *Directors*

**Stewart G. Gibson**

*Aboyne, Scotland*

**David Miller**

*London, United Kingdom*

**Robert G. Welty**

*Calgary, Canada*

## *Officers*

**Robert G. Welty**

*Chairman*

**Stewart G. Gibson**

*Managing Director*

**Walter R. Roberts**

*Corporate Secretary*

## *United Kingdom Office*

Innesshewen House

Dess

Aboyne

Aberdeenshire

Scotland AB34 5BH

Telephone: 44-13398-84285

Facsimile: 44-13398-84092

## *Banker*

Bank of Scotland