



2012 ANNUAL REPORT

Sterling Resources Ltd. is a Calgary, Canada-based energy company engaged in the exploration and development of crude oil and natural gas in the United Kingdom (offshore and onshore), Romania (offshore and onshore), France and the Netherlands. Each country has established hydrocarbon basins, extensive infrastructure and excellent contractual and fiscal terms.

Sterling common shares trade on the TSX Venture Exchange under the symbol SLG.

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OPERATIONS SUMMARY AND MESSAGE TO SHAREHOLDERS

As 2012 began we looked forward with great anticipation to the commencement of production from the Breagh gas field in the UK North Sea. To our great disappointment, the operator RWE Dea has announced four delays over the past year and production is now expected to begin this summer, between mid-July and end August. The delayed start-up and cost increases at Breagh have severely disrupted Sterling's operational and financial plans for the past year as we had to raise additional funds, contain costs and reduce or defer capital investments in other portions of the portfolio.

In spite of the frustrating and disappointing news regarding Breagh, the underlying economic potential of the field remains very attractive. Proved and Probable Reserves for the field as reported by RPS Energy have been maintained at

31 million barrels of oil equivalent and initial production is anticipated to range from 150 to 180 million standard cubic feet per day (MMscf/d) with five or six production wells on-stream. We have drilled four wells on the platform with the fifth well in progress and have tested the first three wells at a combined rate of 88 MMscf/d. Average production for the last five months of 2013, assuming production begins during the first week of August, is expected to be 180 MMscf/d.

With all construction complete, the onshore and offshore pipelines dewatered, the focus is now towards the full commissioning of the onshore facilities at the Teesside Gas Processing Plant.

Phase 2 of the Breagh development targets reserves in the eastern area of the field and is currently being evaluated. Our expectation is that this will comprise a second platform to the east of the field from which eight development wells will be drilled, reducing the number of wells required from the first platform to seven. That being the case, the remaining cost for Phase 1 from April 1, 2013 will drop to £34 million (\$53 million) net to Sterling and incremental capital costs of Phase 2 are expected to be around £85 million (\$133 million) net to Sterling. We expect to fund these remaining Breagh development costs from the proceeds of the senior secured bond and from production revenues generated from Phase 1 at Breagh.

CORPORATE ACTIVITIES

As the ongoing delays in start-up at Breagh continued through the year, Sterling's financial flexibility was impeded and at the end of the year the Company arranged a US\$12 million bridging loan advanced by Vitol. A Special Committee of the Sterling Board of Directors was formed in order to consider various strategic options. On February 12, 2013 Vitol announced their intention to make an unsolicited bid for all the outstanding common shares of the Company at \$0.85 per share. A bought deal equity financing was arranged in March 2013, raising approximately \$59 million net through a short form prospectus offering and a private placement with the proceeds used to repay the Vitol bridge financing, commit further funding to the Breagh development and to meet other group costs. Subsequent to accusations made by Vitol in a news release of April 15th, the Special Committee of the Sterling Board responded that it regarded the Vitol approach to be an opportunistic attempt to take advantage of the Company's short term financing constraints in order to coerce shareholders into believing that their inadequate offer was the only viable alternative.

With the continued restrictions of the Breagh lending facility loan covenants, the delay of production start-up to August and the need to secure financial capability for Breagh Phase 2 we were pleased to close the book for the senior secured bond issue of US\$225 million on April 17, 2013. The bond financing will allow the Company immediate access to Breagh cash flow, providing the financial resources to service debt and to pursue a disciplined and focused capital program across the attractive international portfolio of assets. The Special Committee is still in place and will consider potential alternatives, should they emerge, from the review of strategic options that was previously underway that will be in the best interests of Sterling and its shareholders.

UNITED KINGDOM

Activities in the Cladhan area included the drilling of an exploration well in block 210/29c to the Upper Jurassic sands similar to those already appraised in the Cladhan field to the north. The well, which was drilled at no cost to Sterling pursuant to a farm-out agreement with TAQA Bratani ("TAQA"), encountered porous sands; however those sands were not hydrocarbon bearing, and the well was plugged and abandoned.

To reduce our equity position to a more appropriate level going into the field development phase, Sterling signed an agreement with TAQA for the sale of a 13.5 percent interest for an initial consideration of US\$47 million, payable in three instalments. The first two instalments totalling US\$26.6 million were conveyed in cash, with the third instalment composed of a combination of cash or carry at Sterling's election. Sterling chose the carry alternative, which adjusted for tax will amount to a maximum of US\$53.6 million (first carry).

Earlier this month, we concluded a further farm down agreement with TAQA which will enable Sterling to continue to participate in the development of the field without having to expend further cash resources. At the conclusion of the arrangement with TAQA, assuming pay-out of a second carry expected in mid 2015 from production revenues, Sterling will hold a 13.8 percent interest in the Cladhan field. This has been a prudent course of action as it has not only provided DECC with the necessary financial confirmation for our participation, it reduces our risk exposure to potential higher development costs, project delay costs and the potential consequent funding requirements caused by such events. As part of the farm-out agreement for Cladhan, Sterling's remaining 12.5 percent interest in the South Cladhan field was sold to TAQA for a nominal amount.

Sterling finished the Cladhan field development plan for a 3 well subsea system to be tied back to the Tern platform to the North, transferred operatorship to TAQA and the Field Development Plan was submitted to DECC for which approval was received on April 23, 2013.

In November, Sterling farmed out 40 of its 60 percent participating interest in UK Licence P1792 containing the Beverley prospect and the Belinda and Evelyn discoveries in blocks 21/30f and 22/26c in the Central North Sea, to Shell U.K. Limited. In exchange, Shell will cover Sterling's 20 percent remaining participating interest of 3D seismic costs across the two blocks and Sterling's share of the costs of an exploration well on the Beverley prospect.

ROMANIA

In the Romanian Black Sea Sterling obtained approval from the regulator National Agency for Mineral Resources (NAMR) to procure a 40 percent interest in the block 27 (Muridava) concession. This highly prospective shallow water block, immediately to the east of Sterling's Pelican block, contains an existing hydrocarbon discovery which was drilled in 2001, multiple exploration plays and has existing 2D seismic coverage.

Sterling further expanded its offshore acreage in Romania with the procurement of a 50 percent interest and Operatorship in block 25 (Lucafural), a shallow water block immediately to the west of Sterling's Midia block. Block 25 contains an existing gas discovery, multiple exploration plays and has 2D seismic coverage.

In October 2012, we entered into the sale and purchase agreement with ExxonMobil and OMV Petrom for the sale of its 65 percent interest in a portion of block 15 Midia in the Romanian Black Sea. The consideration for the transaction payable to Sterling comprises US\$29.25 million (\$30 million) upon closing, a contingent payment of US\$29.25 million (\$30 million) upon satisfaction of certain conditions relating to any hydrocarbon discovery made on the portion sold, and a further contingent payment of US\$19.5 million (\$20 million) upon first commercial production from the portion sold. Completion is subject amongst other things to governmental approvals. This is due to be completed in June 2013

During the fall of 2012, the Company commenced drilling of two exploration wells in the Romanian Black Sea.

The loana-1 well in the Midia block targeted a Pontian sandstone formation in the upper section of the prospect and from a surface location at the water depth limit of the jack up drilling unit. Although the gas saturations encountered were very encouraging, the reservoir development was poor. While this well was not deemed commercial, the extensive gas shows confirmed the presence of an active gas system within the loana prospect. Seismic indications suggest better quality gas-bearing sands may exist downdip of the loana-1 location. A follow up program for loana is planned for 2013, including the acquisition of 3D seismic.

The Eugenia-1 in the Pelican block (70 kilometres north of loana) was drilled immediately thereafter. Log analysis of the Eugenia well indicated a total 22 metres of gas-bearing Late Cretaceous sandstones, mainly within two intervals. In addition to these Late Cretaceous sandstones, a 20 metre zone of interest was evident within an Eocene limestone section. Another objective of the well was to test the stratigraphy of a large Oligocene slump or fan structure. Although the well was drilled at a downdip location to target the deeper primary targets, 100 metres of good quality sandstone was encountered, and the Oligocene structure remains an interesting prospect updip of the current well.

These wells provide us with excellent information to now continue our exploration and appraisal operations in the Romanian Black Sea where new licence holders are contributing to a significantly increased overall activity level.

The Company intends to Farm down a portion of its relatively large equity position in its offshore licences and has had a formal sales process in place for a number of months which is ongoing.

NETHERLANDS

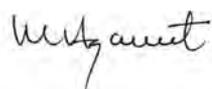
Sterling completed the drilling of an appraisal well F17-09 in block F17a of the Dutch North Sea. Although the well encountered porous sands, it did not prove up further resources at the well location. However, we gained useful information of the oil water contact hence providing a better understanding of the trapping mechanism, which will assist in optimizing development of the greater F-Quad area. In December 2012, Wintershall reported a discovery of 30 million barrels of oil in the Late Cretaceous chalk in the same block (a formation in which Sterling does not have an interest), which may open the potential for a combined development of the various oil discoveries in the F-Quad area including Sterling's Barkentijn and Korvet accumulations.

In addition to this activity on F17a, Sterling was jointly awarded licences E3 and F1 located in the northern sector of the Dutch North Sea where the Company hopes to apply its experience and knowledge from its UK Southern North Sea assets.

During May 2012, the Company concluded an agreement with Enquest PLC under the terms of which Sterling acquired a further 10 percent interest in the previously acquired F-Quad and L-Quad licences in the Dutch North Sea in exchange for Sterling's 50 percent interest in block 16/3d in the UK North Sea containing the Cairngorm prospect.

The past year has been an extremely frustrating and challenging one for all of Sterling's stakeholders as we faced severe financial pressures as a result of the delay of production start-up at Breagh. The performance of Breagh is key to our success and we will therefore take cautious steps towards future expenditures until the field starts to deliver revenues this year. With the bond issue in place, Sterling is well positioned to move forward to develop its extensive asset base, with the potential to create significant value for its shareholders. As we move towards this transformational point in the Company's history I wish to thank our stakeholders for their ongoing support and thank the staff of Sterling for their perseverance under difficult conditions.

On Behalf of the Board of Directors,



President and Chief Executive Officer

April 29, 2013

MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis (MD&A) of the operating results and financial condition of Sterling Resources Ltd. ("Sterling" or the "Company") for the year ended December 31, 2012 is dated April 29, 2013, and should be read in conjunction with Sterling's audited consolidated financial statements and accompanying notes for the years ended December 31, 2012 and 2011, which have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

Financial figures throughout this MD&A are stated in Canadian dollars (\$) unless otherwise indicated.

CORPORATE OVERVIEW AND STRATEGY

Sterling is a publicly-traded, international energy company engaged in the acquisition of petroleum and natural gas rights, and the exploration for, and the development and production of, crude oil and natural gas. The Company operates primarily in the United Kingdom, Romania, the Netherlands and France, and is domiciled in Calgary, Alberta.

The Company's primary strategy for achieving growth is to source and initiate international projects with the potential to yield large, low-cost reserves. It concentrates on accumulating, exploring and exploiting licences and prospects in selected core areas of the world. Sterling's strategy includes seeking licences or concessions with high initial working interests where possible. Financial exposure and technical risk are managed by obtaining partner participation through farm-out and other arrangements. Under these arrangements, a portion of the Company's interest is given up in exchange for the partner paying a share of the costs of exploration, appraisal or development of the licence. A secondary strategy is to acquire interests in discoveries where the Company believes that its technical and operational expertise can accelerate development, especially where there are multiple development candidates or significant exploration prospectivity nearby.

FORWARD-LOOKING STATEMENTS AND BUSINESS RISKS

Certain statements in this MD&A are forward-looking statements. These statements relate to future events or the Company's 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", "would", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential", "continue", "intend", 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 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 which are not endorsed or adopted by Sterling expressly or implicitly. 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 their nature, forward-looking statements involve 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 prove inaccurate.

Forward-looking statements in this MD&A include, but are not limited to, statements with respect to:

- Capital expenditure programs, including without limitation the timing of, the sources of capital and expenses related to, and the nature of, the development of the Breagh, Cladhan and Ana/Doina fields;
- Development activities in the greater Breagh area, particularly the Phase 2 development of Breagh;
- Expectations regarding the Company's cost structure;
- Factors upon which the Company will decide whether to undertake a specific course of action;
- The quantity and timing of hydrocarbon production from the Company's development projects, including Breagh, Cladhan and Ana/Doina;
- The sale, partial sale, farming-in or farming-out of certain properties, particularly offshore Romania and Cladhan;
- The realization of anticipated benefits of acquisitions and dispositions;
- The possible impact of changes in government policy with respect to onshore and offshore drilling and development requirements;
- The Company's ability to obtain certain government and regulatory approvals;
- The Company's cash requirements and funding for the next year;
- The Company's expectations regarding its ability to raise additional financing;
- The Company's drilling plans and plans for completion and installation of production platforms or other infrastructure, on any of its licences;
- The Company's tax horizon;
- The Company's strategies, the criteria to be considered in connection therewith and the benefits to be derived therefrom;
- The Company's expectations regarding government policies with respect to concerns about climate change and the protection of the environment;
- The settlement and disbursement of the US\$225 million (\$231 million) senior secured bond ("Bond") on or around April 30, 2013; and
- The Company's plans and expectations that are described on page 22 under "2013 Plans".

With respect to forward-looking statements in this MD&A the Company has assumed, among other things, that the Company:

- Will, together with its subsidiaries, be able to satisfy the undertakings and conditions under the Breagh credit facility agreement until such credit facility is repaid from proceeds of the Bond;
- The Company will be able to satisfy the undertakings and conditions under the Bond;
- Will produce hydrocarbons and receive cash flows in connection therewith which are consistent with the production and cash flows as estimated in the reserves report, prepared by RPS Energy evaluating the reserves of the Breagh field as at December 31, 2012;
- Operates in an environment of political stability;
- Will be able to obtain all necessary regulatory approvals for its operations on satisfactory terms;
- Operates in an environment of increasing competition;

- Is able to obtain additional financing or farm-out, sell or partially sell licence interests on satisfactory terms;
- Is able to continue to attract and retain qualified personnel either as staff or consultants;
- Is able to continue to obtain services and equipment in a timely manner;
- Is able to obtain necessary approvals from partners for a particular course of action.
- Does not undergo a change of control pursuant to a takeover offer made by Vitol (or any other party); and
- Does not sell any major asset or subsidiary pursuant to the review of strategic options being conducted by the special committee.

Although the Company believes that the expectations reflected in the forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. The Company cannot guarantee future results, levels of activity, performance, or achievements. These risks and other factors, some of which are beyond the Company's control, which could cause results to differ materially from those expressed in the forward-looking statements contained in this MD&A include, but are not limited to:

- Recoverable reserves and resources estimates may prove incorrect;
- The finding, determination, evaluation, assessment and measurement of oil and gas deposits or reserves may vary materially from the estimates, plans and assumptions of the Company;
- Exploration and development activities are capital-intensive and involve a high degree of risk and accordingly future appraisal of potential oil and natural gas properties may involve unprofitable efforts;
- Oil and natural gas prices fluctuate;
- Without the addition of reserves through exploration, acquisition or development activities, the Company's reserves and production will decline over time as reserves are exploited;
- Production operations may prove more difficult or costly than planned;
- All modes of transportation of hydrocarbons include inherent and significant risks;
- Interruptions in availability of exploration, production or supply infrastructure;
- Third party contractors and providers of capital equipment can be scarce;
- Reliance on other operators and stakeholders limits the Company's control over certain activities;
- Availability of joint venture partners and terms of agreement between them and the Company will depend upon factors beyond the Company's control;
- Permits, approvals, authorizations, consents and licences may be difficult to obtain, sustain or renew;
- Regulatory requirements can be onerous and expensive;
- The Company cannot completely protect itself against title disputes;
- The Company is substantially dependent on its executive management;
- Environmental legislation can have an impact on the Company's operations;
- Additional funding may be required to carry out the Company's business operations and to expand reserves and resources;

- The Company's operations are subject to the risk of litigation;
- Negative operating cash flow could increase the need for additional funding;
- Issuance or arrangement of debt to finance acquisitions would increase the Company's debt levels and further changes in circumstances may lead these debt levels to be beyond the Company's ability to service and repay that debt;
- Significant competition exists in attracting and retaining skilled personnel;
- Intense competition in the international oil and gas industry could limit the Company's ability to obtain licences and key supplies, such as drilling rigs;
- Future acquisitions may involve many common acquisition risks and may not meet expectations;
- Managing the Company's expected growth and development costs could be challenging;
- Insurance may not be sufficient to cover the full extent of all liabilities;
- Fluctuations in foreign exchange rates, interest rates and inflation may cause financial harm to the Company;
- Political or governmental changes in legislation or policy in the countries in which the Company operates may have a negative impact on those operations;
- Labour unrest could affect the Company's ability to explore for, produce and market its oil and gas production;
- Risks related to the countries in which the Company operates;
- Uncertainties of legal systems in jurisdictions in which the Company operates;
- Failure to meet contractual agreements may result in the loss of the Company's interests; and
- Failure to follow corporate and regulatory formalities may call into question the validity of the Company, its subsidiaries or its assets.

These factors should not be considered exhaustive. Readers should also carefully consider the matters discussed under "Risk Factors" beginning on page 20 of the Company's Annual Information Form.

The forward-looking statements contained in this MD&A are expressly qualified by the foregoing cautionary statement. Subject to applicable securities laws, the Company is under no duty to update any of the forward-looking statements after the date hereof or to compare such statements to actual results or changes in the Company's expectations. Financial outlook information contained in this MD&A about prospective results of operations, financial position or cash flows is based on assumptions about future events, including economic conditions and proposed courses of action, based on management's assessment of the relevant information currently available. Readers are cautioned that such financial outlook information should not be used for purposes other than for which it is disclosed herein.

SIGNIFICANT ESTIMATES

Management is required to make judgments, assumptions and estimates in the application of IFRS that have a significant impact on the Company's financial results. Significant estimates in the financial statements include amounts recorded for the provision for future decommissioning obligations, income taxes, share-based compensation expense, exploration and evaluation assets, commitments, capital expenditure accruals and timing of production start-up. In addition, the Company uses estimates for numerous variables in the assessment of its assets for impairment purposes, including oil and natural gas prices, exchange rates, cost estimates and production profiles. By their nature, all of these estimates are subject to measurement uncertainty, may be beyond management's control and the effect on future consolidated financial statements from changes in such estimates could be significant and affect the going concern of the Company.

OPERATING HIGHLIGHTS

| <i>Years ended December 31,</i> | 2012 | 2011 | 2010 |
|---|-----------------|----------|----------|
| <i>\$000s except per share information</i> | | | |
| Revenue | 66 | 1,258 | – |
| Expenses | 48,936 | 55,175 | 21,604 |
| Income tax expense | 769 | – | – |
| Net financing income | (178) | (94) | 484 |
| Net loss | (49,461) | (53,823) | (22,088) |
| Per weighted average common share – basic and diluted | (0.22) | (0.27) | (0.15) |
| Property, plant and equipment and exploration and evaluation asset additions | 114,904 | 171,378 | 41,406 |

As at December 31,

| <i>\$000s except share information and acreage</i> | | | |
|---|----------------|---------|---------|
| Net working capital (excluding current portion of long-term debt) | 111 | 35,988 | 138,410 |
| Total assets | 413,026 | 370,879 | 267,948 |
| Total liabilities | 193,246 | 109,542 | 11,148 |
| Share capital | 338,221 | 337,711 | 290,444 |
| Net licence acreage (000s of acres) | 1,902 | 1,807 | 2,618 |
| Common shares outstanding (000s) – basic | 222,869 | 222,644 | 188,944 |
| Common share options outstanding (000s) | 12,803 | 14,865 | 11,949 |

Between the reporting date and the release of this MD&A, the Company issued an additional 86,751,834 shares: 2,418,500 by way of bonus shares issued pursuant to a loan provided by an affiliate of Vitol S.A., and 84,333,334 by way of a private placement and prospectus offering, bringing the total shares outstanding to 309,620,334 as at April 29, 2013. There was no change to the number of stock options outstanding over this period.

For the year ended December 31, 2012, the Company recorded a net loss of \$49,461,000 (\$0.22 per share) compared with a net loss of \$53,823,000 (\$0.27 per share) for the year ended December 31, 2011. The year-over-year decrease in the net loss is mostly due to the Company not incurring any bad debt or dry hole expense, though this was partly offset by the relinquishment of block 21/23a (Sheryl) exploration licence, and is largely comprised of the following elements:

BAD DEBT EXPENSE

For the year ended December 31, 2012 there was no bad debt expense.

For the year ended December 31, 2011 the Company made a write-off of \$6,792,000 against recovery of overdue amounts receivable from a co-venturer in the unsuccessful Grian well on block 48/28b in the UK Southern North Sea drilled in the first quarter of 2011.

DRY HOLE EXPENSE

For the year ended December 31, 2012, there were no dry hole costs. On April 12, 2012 the Company announced that the South Cladhan exploration well, 210/29c-5, was not believed to have encountered hydrocarbons; the well was subsequently plugged and abandoned. The well was drilled at no cost to the Company pursuant to farm-out agreements, and accordingly no dry hole costs were recorded.

For the year ended December 31, 2011, the Company expensed dry hole costs of \$9,733,000 relating to the unsuccessful Grian exploration well on block 48/28b (Sterling 57 percent) in the UK Southern North Sea.

IMPAIRMENT OF OIL AND GAS ASSETS

At December 31, 2011, the Kirkleatham UK onshore property was indicated to be impaired due to a reduction in its reserves following escalating water production. At December 31, 2012 the decision was taken to fully write down the asset's remaining value of \$2,647,000 following a reserves report update in which the reserves were moved to contingent resources.

PRE-LICENCE AND OTHER EXPLORATION COSTS

For the year ended December 31, 2012, pre-licence and other exploration costs expensed were \$31,379,000, an increase of \$18,178,000 over 2011. Of the total, \$20,000,000 (2011 – \$5,679,000) related to the Company's interests in its various licences in the UK, \$7,760,000 related to Romania (2011 – \$4,662,000) and \$3,619,000 (2011 – \$2,860,000) to the Netherlands and other international ventures. In December 2012, the Company relinquished its interest in UK block 21/23a (Sheryl), where despite finding oil in two wells drilled in prior years, no commercial plans for take-off could be formulated for the development. The two previously drilled wells will be abandoned during 2013 and the carrying value of the assets has been reduced to zero resulting in an expense of \$12,770,000. Also included in these amounts in 2012 were seismic data acquired on licence P1741 (Lochran prospect) in the UK, block 27 Muridava in Romania, and over the E3/F1 licences in the Netherlands. Employee expense and general and administrative expenditures charged to exploration licences and expensed as pre-licence costs were \$3,114,000 higher in 2012 than in 2011 due to increased costs and an increase in activity relating to exploration assets.

FOREIGN EXCHANGE

The Company's cash balances are largely maintained in the currencies in which they are expected to be utilized. Exchange gains and losses reflected in the income statement are then largely offset by corresponding reductions or increases in underlying capital and other expenditures. A foreign exchange loss of \$296,000 for the year ended December 31, 2012 occurred mainly in the UK and the Netherlands and arose due to the weakening of the US dollar during the period against the GB pound functional currency in those entities. Foreign exchange losses of \$6,563,000 for the year ended December 31, 2011 were primarily due to the same reason, in particular the translation of US dollar cash balance, which was significantly higher in 2011.

EMPLOYEE EXPENSE AND GENERAL AND ADMINISTRATION EXPENSE

| <i>Years ended December 31,</i> | 2012 | 2011 |
|--|-----------------|---------|
| | \$000s | \$000s |
| Gross employee, and general and administration expense | 22,376 | 20,836 |
| Recovered from third parties | (2,639) | (4,779) |
| Capitalized to assets | (6,316) | (3,717) |
| Expensed as pre-licence and other exploration expenditures | (3,405) | (291) |
| | (12,360) | (8,787) |
| Net employee expense | 7,152 | 8,975 |
| Net general and administration expense | 2,864 | 3,074 |

Employee Expense

For the year ended December 31, 2012, net employee expense was \$7,152,000, a decrease of \$1,823,000 from 2011. Of the total, \$3,275,000 relates to non-cash share-based compensation and \$3,877,000 relates to wages and salaries. The charge to non-cash share-based compensation was down from the 2011 figure of \$5,913,000 as certain options became fully amortized and no new options were issued. Recoveries from partners were down in the year following the passing of operatorship on the Cladhan licence to TAQA Bratani Limited ("TAQA") and lower operated drilling activity in 2012 than in 2011. Amounts capitalized to assets and amounts expensed to pre-licence costs were all considerably higher than in 2011 due to the different mix of projects being worked on during 2012 than in 2011.

General and Administration Expense

For the year ended December 31, 2012, net general and administration expense was \$2,864,000, \$210,000 lower than in 2011 after recoveries. This is due to increased amounts expensed as pre-licence and other exploration expenditures or capitalized to the assets through the allocations process despite increased office costs in the UK.

FINANCING COSTS

Financing costs relate to accretion of the discount on decommissioning obligations and have increased in the year due to greater decommissioning obligations on the Breagh development. Bank fees and costs pertaining to the set-up of the credit facility began to be amortized in the fourth quarter of 2011 after the first drawdown and were then capitalized to the Breagh asset. These costs will then be depleted along with the capital and interest costs of developing the asset when Breagh enters production.

INCOME TAXES

No deferred tax asset has yet been recognized in relation to the losses incurred because of the uncertainty regarding future taxable profits against which such losses can be offset, given the Company's lack of meaningful current production. The situation will be reviewed again, however, as the Company nears large-scale production in Breagh.

Sterling Resources (UK) Ltd. ("Sterling UK") is chargeable to UK ring-fence corporation tax ("CT") currently charged at 30 percent, and supplementary charge corporation tax ("SCT") currently charged at 32 percent, on its activities within the UK oil and gas ring-fence.

Sterling UK has very material tax losses available for corporation tax as a result of allowances generated principally by past exploration, appraisal and development costs and the application of ring fence expenditure supplement ("RFES") claims. CT losses at year-end 2012 are estimated at GBP 288 million (\$463 million) and SCT losses at GBP 282 million (\$453 million) (slightly lower than for CT, as financing costs are not allowable deductions for SCT).

In addition, Sterling UK expects to claim RFES, which is available as an additional allowance against CT and SCT at a rate of 10 percent per annum (compounded) on eligible losses, for 2013 to 2015 inclusive. In December 2012, the Company withdrew an earlier election to claim RFES for 2010 in order to be able to claim RFES instead for 2015, which it judged to be more valuable. Together with forecast UK ring fence expenditures over the next few years, Sterling is not expecting to pay UK tax prior to 2018 under management's base case assumptions, taking account of the anticipated tax relief on committed UK exploration expenditures and expected general and administration costs. The net value of the UK tax loss at year-end 2012 (together with future RFES available to claim on this loss) is estimated by management to be approximately GBP 170 million (\$224 million), on a discounted basis at 10 percent per annum using base case assumptions.

As at December 31, 2012, other principal tax losses and allowances available include tax pools of approximately \$60 million and non-capital losses of approximately \$35 million available to shield future income taxable in Canada; approximately \$75 million of remaining cumulative past costs available and expected to shield future taxable income of the Company in Romania; and approximately \$16 million of tax deductible expenses and losses available to shield future

taxable income in the Netherlands. The Canadian non-capital losses expire over the next twenty years, the Romanian unused cumulative past costs and losses expire over the next seven years and the Netherlands losses expire over the next nine years from year of claim (for Dutch corporate income tax purposes only, no expiry for Dutch State Profit Share). There is no fixed time limit for the expiry of UK ring-fence tax losses for CT and SCT.

UNREALIZED LOSS ON DERIVATIVE FINANCIAL INSTRUMENTS

In 2011, as a requirement of its credit facility, the Company purchased monthly cash-settled put options to hedge 40 percent of its forecast natural gas production volumes from proved reserves (P90) for the first phase of Breagh development, for a 24-month period starting on October 1, 2012. The strike price for the options is 55 pence per 100,000 British thermal units (therm) and the total volume hedged is 10.1 billion cubic feet (Bcf). Half of the put options were purchased for an upfront cash premium of £2,195,000 – (\$3,543,000), and the other half were purchased on a deferred premium basis for a total cost of £2,713,000 (\$4,368,000).

The Company has recognized the up-front premium paid for the put options as a derivative financial asset. The derivatives are then revalued to their fair value at each period end. For the deferred premium put options the Company has recognized a derivative financial liability for the discounted cost of those premiums, offset by their revaluation at period-ends. Any gain or loss arising is recorded through the income statement in the period in which it arises. For the year ended December 31, 2012, the Company recognized an unrealized loss of \$4,182,000 (2011 – \$2,499,000).

As at December 31, 2012 the forward curve for the period covered by the options ranges between 59 pence and 72 pence per therm and, as a result, the options purchased are currently out-of-the-money.

OVERVIEW AND SUMMARY OF RESULTS FOR THE EIGHT MOST RECENTLY COMPLETED QUARTERS

The Company had only minor commercial production in 2012 and 2011. The following table summarizes the Company's income statements for the eight most recently completed quarters.

| Quarters Ended | 2012 | | | | 2011 | | | |
|-------------------------------------|----------|----------|---------|----------|----------|----------|----------|----------|
| | Dec. 31 | Sept. 30 | June 30 | March 31 | Dec. 31 | Sept. 30 | June 30 | March 31 |
| \$000s except per share information | | | | | | | | |
| Revenues | – | – | – | 66 | 136 | 793 | 329 | – |
| Net (loss) income | | | | | | | | |
| Canada | (919) | (1,060) | (1,450) | (1,932) | (1,946) | (1,945) | (1,784) | (2,955) |
| United Kingdom | (19,563) | (4,072) | (3,365) | (4,230) | (8,015) | (4,513) | (9,311) | (12,540) |
| Romania | (2,611) | (3,822) | (1,490) | (695) | (1,165) | (1,608) | (1,732) | (2,945) |
| Other International | (1,712) | (1,013) | (737) | (790) | (1,246) | 980 | (530) | (2,568) |
| Net loss | (24,805) | (9,967) | (7,042) | (7,647) | (12,372) | (7,086) | (13,357) | (21,008) |
| Net loss per share | | | | | | | | |
| Basic | (0.12) | (0.04) | (0.03) | (0.03) | (0.06) | (0.03) | (0.07) | (0.11) |
| Diluted | (0.12) | (0.04) | (0.03) | (0.03) | (0.06) | (0.03) | (0.07) | (0.11) |

Note: The net income or loss per common share for each quarter is required to be calculated independently of the calculation for the year. Consequently, due to the issuance of shares in a given year, the aggregate of the four quarters may differ from the year's total.

Under the Company's successful efforts accounting policy for exploration and appraisal activity, its results from quarter to quarter are affected significantly by the level and success of its drilling program.

FOURTH QUARTER 2012 RESULTS

Comparability of the net loss for the fourth quarter of 2012 to the results of the other seven quarters of 2012 and 2011 was affected by the following key factors:

- In the first quarter of 2011, the Company expensed dry-hole costs of \$9,733,000 relating to the unsuccessful Grian exploration well on block 48/28b (Sterling 57 percent) in the UK Southern North Sea;
- During the second quarter of 2011, the Company wrote off \$6,792,000 relating to overdue amounts receivable from a co-venturer in the unsuccessful Grian well, drilled on block 48/28b in the UK Southern North Sea in the first quarter of 2011;
- Since the third quarter of 2011 the Company has recognized unrealized losses relating to its derivative financial instrument agreements. The total unrealized loss recognized in the income statement for the third and fourth quarters of 2011 was \$2,499,000 and a further \$1,716,000 in the first quarter of 2012, partially offset by an unrealized gain of \$930,000 in the second quarter of 2012, followed by an unrealized loss of \$3,396,000 in the third and fourth quarters of 2012;
- In the fourth quarter of 2011, the Company recognized an impairment of Kirkleatham, its producing UK onshore asset, of \$2,930,000, and in the fourth quarter of 2012, the Company decided to fully write down the remaining value of \$2,647,000. Also in the fourth quarter of 2012, the Company relinquished block 21/23a (Sheryl) exploration licence in the UK North Sea, resulting in a charge to pre-licence and other exploration expenditures of \$12,770,000;
- Over the two-year period ended December 31, 2012, the Company increased staffing levels commensurate with its high proportion of operated licences, and the requirement to manage not only exploration and appraisal activities but also development planning. These increases have had a progressive impact over the quarters on employee expense; and
- Foreign exchange gains and losses varied significantly from quarter to quarter based on prevailing foreign exchange rates as well as amounts of monetary assets held by various Company entities in currencies other than their functional currency.

DEVELOPMENT ACTIVITY

BREAGH DEVELOPMENT

Since sanction of the Breagh development (July 2011), the operator RWE Dea UK SNS Limited ("RWE") and the Company has been progressing the first phase of the development of the field. Phase 1 establishes the infrastructure to access the gas reserves of the western area of the Breagh field and ship the produced gas to shore for processing prior to sale. The point of sale is the entry flange to the UK national transmission system at the Teesside Gas Processing Plant "TGPP" located on the north side of the Tees estuary at Middlesbrough.

The significant individual elements that make up the infrastructure of Phase 1 comprise:

- 1. Offshore Platform.** A new 12 well slot Breagh Alpha ("BA") wellhead platform in 65 metres of water located in the Southern North Sea some 100 kilometres offshore east of Middlesbrough was installed in October 2011. The platform is designed as a normally unmanned installation capable of remote operation from a control room located onshore at the TGPP gas plant. Routine visits to the platform are conducted for maintenance and operational reasons. Communication and data links to the operations control station at TGPP are up and running and monitoring of operations is ongoing.
- 2. Development Drilling.** Development drilling of seven deviated wells from the BA platform to an array of locations approximately 2 kilometres from the platform is in progress. The wells are drilled through the platform structure, and are planned to be drilled in a radial pattern to access the reserves of the western area of the Breagh structure and are completed with dry Christmas trees located in the well bay of the platform. The drilling campaign is in progress using the Ensco 70 jack-up drilling rig:

- Three wells drilled, completed and tested (A01, A02 & A03) and ready for production with a combined flow capacity of 90 MMscf/d, in line with pre-drill expectations
- Well A04 is completed but not yet perforated
- Well A05 drilling is in progress
- Two firm wells are yet to be drilled (A06 & A07)
- One optional well (A08) being considered

3. Export pipeline. Produced gas is shipped onshore for processing via a new-built, dedicated 110 km long, 20" export pipeline installed from the BA platform to the TGPP; a separate 3" pipeline for supply of Mono-Ethylene Glycol ("MEG") hydrate suppressant to the platform and fibre-optic cable ("FOC") for control and communications of the platform is laid alongside the main gas pipeline. The offshore pipeline is fully commissioned and has been placed in gas-service. Similarly, the 3" pipeline has been filled with MEG awaiting production operations to commence. The FOC has been commissioned with communications/control established with the platform.

4. Reception facilities. New reception facilities at the TGPP terminal dedicated to Breagh, allow the handling of liquid slugs and the initial separation of gas and liquids. Gas is taken off the reception facilities and treated to sales specification through liquid knockout, dew pointing and metering prior to sale. Liquids knocked out at the reception facilities comprise condensate plus water and recovered MEG. Condensate is separated and stabilized before being shipped to bulk storage prior to seaborne export. Water and MEG is treated to recover and recycle MEG for reuse and waste water is sent for treatment prior to disposal.

RWE as operator, has completed a review of overall progress of works on the modifications being performed at the Teesside Gas Processing Plant ("TGPP") and has reported the earliest estimate for first sales gas is mid-July 2013 with a best estimate of early August and a late case of the final week of August, 2013.

Initial production at Breagh is anticipated to range from 150 to 180 million standard cubic feet per day (MMscf/d) with five or six of the seven planned production wells on-stream. Average production for the last five months of 2013, assuming production starts in the first week of August, is expected to be 180 MMscf/d.

Forecast costs for the first phase of the development are now estimated to be £648 million (\$1,037 million) for 100 per cent of the field, £194 million (\$311 million) net to Sterling for Phase 1 with 10 wells; of which £55 million (\$87 million) for 100 percent of field, £17 million (\$27 million) net to Sterling remains from April 1, 2013 until first gas in August 2013. In the alternative proposal of only drilling seven wells from the BA platform, current forecast costs are now estimated to be £545 million (\$877 million) for 100 percent of the field, £164 million (\$264 million) net to Sterling.

Phase 2 of the Breagh development targeting reserves in the field's eastern area is being evaluated as part of development planning activity and is likely to comprise the following:

- 1.** Installation of the Breagh Bravo ("BB") normally unmanned installation in 65 metres of water situated approximately 6 kilometres east of BA with 12 well slots. Front-end engineering and design ("FEED") work on the platform is considering the capability to man up the platform intermittently for maintenance purposes. This is expected to be done with minimal change to the BA platform design and construction.
- 2.** Installation of a 6 kilometre, 20-inch diameter pipeline from the BB platform to the BA platform.
- 3.** Development drilling of seven to eight deviated wells from the BB platform to locations arrayed approximately 2-3 kilometres from the platform.
- 4.** Control of the Phase 2 facilities will be centred at the onshore TGPP control room.

Incremental Phase 2 development expenditures are expected to be £284 million (\$457 million) (£85 million (\$137 million) net to Sterling). The Company intends to fund estimated incremental Phase 2 expenditures out of proceeds of the bond issue (refer to "Financing Activities") and from production revenues.

A short-term extension of the Second Term for licences P1230 and P1328 (covering the Breagh field) has been granted by the UK Department of Energy and Climate Control ("DECC") until December 31, 2013 subject to the submission of a field development plan ("FDP") addendum by June 30, 2013, and submission of evidence of financing capability by September 30, 2013. This should enable studies relating to the optimum Phase 2 development to be completed, and development plans to be optimised and agreed between the partners in a timely manner.

CLADHAN DEVELOPMENT

Subsequent to the 2011 appraisal programme, the Company worked towards a development plan for the field as Operator. A draft of the FDP was prepared by Sterling, at which time a 13.5 percent interest was purchased by TAQA who then became operator and submitted an updated version of the FDP to DECC. Following comments received from DECC, a final version of the FDP was submitted to DECC at the beginning of February 2013, and approval was received April 23, 2013.

The planned development calls for two subsea producers and one subsea water injector tied back 18 kilometres to the Tern platform operated by TAQA. Export of oil is planned via the Brent Pipeline System and then onto Sullom Voe in the Shetland Islands, with first oil expected during the first quarter of 2015. Subsea christmas trees, linepipe, wellheads and subsea controls have been procured. Drilling is due to commence with the Transocean, John Shaw drilling unit in late 2013.

Pursuant to recent agreements entered into with TAQA, the Company's share of development costs will be carried through two separate carry arrangements resulting in a final working interest of 13.8 percent (see "Financing Activities").

EXPLORATION AND EVALUATION ACTIVITY

During the year ended December 31, 2012 and to the date of this report, key operational activity and expenditures included:

- In January, the award of 100 percent of two additional licences in the UK Southern North Sea Gas Basin (covering blocks 43/15a, 43/20a, 49/18b and 49/19b), and a 50 percent interest in a licence in the Central North Sea (covering block 16/3d) which contains the Cairngorm discovery, partnered with Stratic Energy Corporation (now Enquest plc);
- In February, the completion of the F17-09 well in block F17 of the Dutch North Sea at a cost of \$6,763,000. The well encountered hydrocarbons, with results suggesting an oil-water contact at approximately 2,000 metres subsea, but no testing was performed;
- In March, the award of the exploration licences E3 and F1 in the Dutch North Sea jointly with Wintershall Noord Zee BV (operator). Each company will have a 50 percent interest. These licences cover an area of 792 square kilometres and were awarded for a period of four years with a commitment to acquire approximately 600 square kilometres of 3D seismic, which has now been completed;
- In April, the plugging and abandoning of the South Cladhan exploration well, 210/29c-5, after no hydrocarbons were encountered. The well was drilled at no cost to the Company, pursuant to farm-out agreements;
- In June, the acquisition of 3D seismic over the Lochran prospect to the south of the Breagh field;
- In June, July and August, the acquisition of 1,000 square kilometres of 3D seismic over block 27 Muridava in Romania. The data have been processed and several Eocene and Triassic formation targets have been identified. Petroceltic International plc (formerly Melrose Resources plc) as operator has been progressing various regulatory and environmental permits for drilling, procuring long-lead items, planning wells and securing a drilling rig, with drilling of one exploration well on the licence anticipated to commence during the third quarter of 2013;

- In November, conclusion of the drilling of the Ioana-1 well in the Romanian Black Sea. Management was encouraged by the gas shows in the primary objective, but no reservoir quality sands were present at this location. To assist with further evaluation of the location of possible gas bearing reservoir quality sands and reassessing the remaining gas potential on this prospect, 3D seismic is being planned;
- In December, relinquishment of the Company's interest in UK block 21/23a (Sheryl) where, despite finding oil in two wells drilled in previous years, no commercial plans could be formulated for the development. The two previously drilled wells will be abandoned during 2013 and the carrying value of the assets was reduced to zero, resulting in an expense of \$12,770,000; and
- Also in December, a natural gas discovery made by the Eugenia-1 well drilled in block 13 Pelican in the Romanian Black Sea. Formation pressure data and recovered gas samples from open-hole logging tools confirmed moveable gas. Further detailed analysis of logs, pressure data and samples has been ongoing in the first four months of 2013;

In 2011 the Company's exploration and evaluation activity included:

- The four-well Cladhan drilling program costing \$26,968,000;
- The drilling of the non-operated East Breagh appraisal well 42/13a-6 costing \$6,626,000; and
- The drilling of the operated Grian 48/28b-2 exploration well, costing a total of \$9,733,000.

During the year ended December 31, 2011 the Company relinquished its interest in blocks 42/2b, 42/3 and 42/4 containing the Darach prospect in the UK Southern North Sea, following the operator's decision not to proceed with future work after the evaluation of seismic data acquired in 2010.

FINANCING ACTIVITIES

In April 2013, the Company announced the successful closing of the book for a US\$225 million (\$231 million) senior secured bond issue (the "Bond") issued by its UK subsidiary Sterling Resources (UK) Ltd (the "Issuer"). The net proceeds of US\$218.6 million (\$224 million) from the Bond will be used (i) to prepay the entire senior secured credit facility with a group of lending banks (approximately \$140 million), (ii) towards funding ongoing development costs of the Breagh field, including development of the eastern portion of the field (Phase 2), (iii) to prefund the first interest payment on the Bond due October 2013, and (iv) for general corporate purposes (\$20 million). The Bond has a wide-ranging security package including a charge over the Issuer's interest in the Breagh and Cladhan fields and the shares of the Issuer, as well as a parent company guarantee.

The settlement date for the Bond is expected to be April 30, 2013 (the "Settlement Date"). The Bond has a tenor of six years, and matures on April 30, 2019 based on the estimated Settlement Date. The Bond carries an interest coupon of 9 percent payable semi-annually and is callable at the option of the Issuer at any time with a call premium of 105 percent for the first three years and a roll-up of outstanding interest for the first two years. Commencing 18 months after the Settlement Date, the Bond will amortize 10 percent of the issue amount every six months, securing a rapid deleveraging of Sterling in coming years. The amortizations will be performed at a price of 105 percent of par value except for the final installment which shall be repaid at 100 percent of par value. An application will be made for the Bond to be listed on the Oslo stock exchange or the Nordic Alternative Bond Market (Oslo), which will require the UK subsidiary to be re-registered as a public limited company. The Bond is governed under Norwegian Law and the trustee for the Bond is Norsk Tillitsmann ASA.

The Company currently has a senior secured credit facility for up to £105 million (\$169 million) with BNP Paribas, Commonwealth Bank of Australia, GE Energy Financial Services and Societe Generale (the "Senior Lenders") to fund the Phase 1 development of the Breagh gas field (Sterling 30 percent) and related costs (the "Credit Facility"). As

noted above, this facility will be repaid out of the proceeds of the Bond. The Credit Facility comprises a main tranche of £95 million (\$153 million) and a cost-overrun tranche of £10 million (\$16 million). The interest rate on the main tranche currently has a margin of 4 percent over LIBOR, which will drop to 3.5 percent over LIBOR in the period following project completion, and for the cost-overrun tranche the margin is 4.5 percent over LIBOR. In common with most other asset-secured financings of this type, no proceeds of natural gas sales from the field will be available to the Company until the satisfaction of project completion tests following the successful drilling and testing of all the Phase 1 wells.

The loan repayment schedule runs from January 1, 2014 to December 31, 2017, but the Credit Facility contains a cash sweep mechanism whereby a proportion of surplus cash (after meeting capital and operating costs and debt service requirements as defined in the Credit Facility agreement) is used to pay down the loan ahead of scheduled loan repayment. The security package provided to the Senior lenders includes a fixed and floating charge over the assets of Sterling's wholly-owned UK subsidiary, a charge of the shares of that subsidiary, a parent guarantee and other security arrangements common for a loan of this nature.

Availability under the two tranches is normally recalculated every six months with reference to the future cash flows expected to be generated by the Breagh gas field and certain cover ratios and other loan parameters. At the end of December 2012, a redetermination indicated a reduction of main tranche availability of £15.0 million (\$24 million) (availability under the cost overrun tranche was unaffected), leading to a requirement to repay this amount of the loans. The Credit Facility was amended on December 31, 2012 to defer the partial loan repayment date, which (after several other amendments) was subsequently extended to the earlier of: (1) the completion of the Romanian Carve-out Transaction (see below) and (2) June 30, 2013. The amendments also provided that the proportion of surplus cash used to pay down the loan ahead of scheduled loan repayment in the cash sweep mechanism referred to above was increased from 75 percent to 100 percent. As of December 31, 2012, the main tranche of the Credit Facility was £77.9 million (\$125.4 million) drawn and the cost overrun tranche of the Credit Facility was £10.0 million drawn (\$16.1 million), with no further availability under either tranche.

Subsequent to the year ended December 31, 2012, in early January 2013, the Company received a waiver from the Senior Lenders of a default arising from a partial repayment of an inter-company loan to Sterling UK in December 2012. This partial repayment was subsequently reversed, upon which the breach was waived by a waiver and amendment letter effective January 7, 2013. As a result of the breach not being waived prior to December 31, 2012, the Company's long-term debt is presented as a current liability in the financial statements.

The Credit Facility originally had a requirement for the Company to prepare cash flow statements (the "Cash Flow Statements") at the end of every quarter demonstrating a minimum aggregate cash balance within the Company of at least £20 million (\$32 million) at the end of each of the following 12 months. A waiver was received by the Company from the Senior Lenders removing this requirement in any Cash Flow Statements submitted before June 30, 2013. Any cash balance accumulating in the Company's restricted account used to receive and hold net cash flows from the Breagh field does not count towards this minimum cash balance. An amount of £10 million (\$16 million) had previously been held in a restricted account and reported as "non-current restricted cash" in the Company's financial statements, but as a result of the size of the cost overrun, pursuant to the Credit Facility agreement this amount is now available to fund Breagh Costs.

In 2012 the Company entered into the following asset and financing transactions:

- In March, approval was obtained from the Romanian National Agency for Mineral Resources ("NAMR") for acquiring of a 40 percent interest in the Romanian Black Sea Muridava block. The shallow water block, adjacent to the Company's Pelican block, contains multiple exploration plays, has 2D seismic coverage and contains a hydrocarbon discovery, Olimpiyskaya, drilled in 2001;

- In April TAQA earned a 12.5 percent interest in blocks 210/29c and 210/30b through a farm-in agreement as a result of which TAQA funded Sterling's remaining equity interest in the recently drilled well 210/29c-5 on the South Cladhan prospect.
- In May, the Company exchanged its 50 percent interest in UK block 16/3d (Cairngorm) for a 10 percent interest in the Netherlands F and L Quad licences held by Enquest plc;
- In July, the Company gained a 50 percent interest in the 1,000 square kilometre Romanian Black Sea Luceafarul block. The Company will be operator, with the current concession owner Petro Ventures Europe BV holding the remaining 50 percent interest;
- In August, the Company completed the sale of a 13.5 percent interest in the North Cladhan area (blocks 210/29a and 210/30a) for initial consideration of US\$47 million (\$46.8 million) to be received in three installments: US\$22.6 million (\$22.4 million) was received in August 2012, with a further US\$0.8 million (\$0.8 million) of working capital adjustments and US\$4.3 million (\$4.3 million) was received in January 2013 upon enactment of secondary legislation providing for the application of Small Field Allowance, a tax allowance for UK supplementary corporation tax, as set out in the UK government's budget announcement in March 2012 (the "First Carry"). As the legislation was passed in 2012 and all the conditions precedent to this part of the sale were complete, this amount has been reflected in the financial statements. The balance is a carry of a portion of the Company's Cladhan development expenditures up to US\$53.6 million (\$53.4 million), which was subsequently amended to be available for pre-development expenditures;
- In October, the Company announced that it had entered into a sale and purchase agreement with ExxonMobil Exploration and Production Romania ("ExxonMobil") and OMV Petrom for the sale of its 65 percent interest (the "Sale Portion") in a portion of block 15 Midia in the Romanian Black Sea (the "Carve-out Transaction"). The Sale Portion is on the southeastern margin of the block and covers 125,000 gross acres, or 11 percent of the total area of the Midia and Pelican Concession. The consideration for the transaction payable to Sterling is US\$29.25 million (\$30 million) upon closing, a contingent payment of US\$29.25 million (\$30 million) upon satisfaction of certain conditions relating to any hydrocarbon discovery made on the Sale Portion, and a further contingent payment of US\$19.5 million (\$20 million) upon first commercial production from the Sale Portion. Net proceeds after tax and related fees of the first payment due on closing, is expected to be US\$22.6 million (\$23.2 million). Closing is subject, amongst other things, to governmental approvals;
- In November, the Company announced the signing of an agreement with Shell U.K. Limited ("Shell") to farm out a 40 percent participating interest in UK licence P1792 covering blocks 21/30f and 22/26c in the Central North Sea containing the Beverley prospect and the Belinda and Evelyn discoveries. Sterling was awarded these blocks in the UK 26th Offshore Licensing Round. Under the agreement, Shell will cover Sterling's 20 percent remaining participating interest share of 3D seismic costs across the two blocks and Sterling's share of the costs of an exploration well on the Beverley prospect to a maximum of £15.8 million (\$25.4 million) gross. Sterling will continue as operator of the exploration well. Subject to approval by DECC, the joint venture interests will be Sterling UK 20 percent, Shell 40 percent, and Valiant Petroleum plc 40 percent; and

Subsequent to year-end, the following financing transactions took place:

- In January 2013, the Company and Midia Resources entered into a US\$12 million (\$12 million) bridging loan agreement with a subsidiary of Vitol (the "Vitol Loan"), an existing shareholder. The Vitol Loan was used to fund the remaining costs of the Ioana and Eugenia wells in offshore Romania, certain other exploration costs on Sterling's Romanian oil and gas licences, and ordinary course of business corporate costs in Canada and Romania, as well as to repay funds temporarily advanced from Sterling UK to Midia Resources to fund Romanian exploration costs in December, 2012. The Vitol Loan was completed on January 7, 2013 and was repaid on March 22, 2013 ahead of its contractual maturity date of March 31, 2013. The Vitol Loan was secured by a first-ranking security package over the Company's offshore and onshore licences in Romania, a pledge of the shares of Midia Resources and a pledge of the consideration received from proceeds of the Carve-Out Transaction. In addition, Midia Resources had guaranteed the Company's obligations under the Vitol Loan. The Vitol Loan bore interest at LIBOR plus 1.0 percent, payable in arrears, subject to a maximum LIBOR rate of 2.0 percent per annum during the loan's term. As consideration for the Vitol Loan, Vitol was issued with

2,418,500 common shares of Sterling. As a condition for consenting to the creation of financial indebtedness and the granting of security pursuant to the Vitol Loan, the Senior Lenders were granted a second-ranking charge over the same security package as was granted to Vitol;

- In February 2013, the Company entered into an agreement to sell an aggregate of 73,333,333 common shares of Sterling to a syndicate of underwriters led by Casimir Capital Ltd. (the "Underwriters") on a bought deal basis at a price of \$0.75 per share for gross proceeds of \$55 million (the "Equity Offering"). The Equity Offering was structured as a combination of a short form prospectus offering and a private placement pursuant to applicable exemptions from prospectus requirements. Sterling granted to Casimir and the Underwriters options to acquire up to an additional 11,000,000 common shares at a price of \$0.75 per share, which were exercised in full in March 2013. Consequently, an aggregate of 84,333,334 common shares were issued pursuant to the Equity Offering, representing aggregate gross proceeds of \$63.25 million. The net proceeds of approximately \$59.1 million, after fees and expenses, are intended to be used for Breagh Phase 1 development costs, interest and hedging primarily related to Sterling's existing senior Credit Facility, repayment of the US\$12 Vitol Loan (\$12 million) and certain exploration, appraisal and pre-development expenditures in Romania, the UK and the Netherlands with a small contingency for other corporate purposes; and
- In April 2013, the Company also announced that it had signed agreements with TAQA which ensured that the Company was in a position, regardless of the closing of the then contemplated Bond, to submit evidence of funding ability for its share of the development costs of Cladhan (the "Financing Condition") to DECC by April 17, 2013 to enable FDP approval (the "Cladhan Farm-Down"). These agreements also provide a full carry of development capital costs until first oil, anticipated in 2015. The agreements provide for a permanent transfer in stages of a 12.6 percent interest in the Cladhan field to TAQA and a repayable carry by TAQA of development expenditures on an 11.8 percent interest in Cladhan (the "Second Carry"), which will be transferred to TAQA for the duration of the carry. The 12.6 percent interest is to be transferred in three stages, such that if the Company provides evidence of its funding ability to DECC and/or TAQA by different dates a smaller interest is permanently transferred. A 3.0 percent interest was transferred on April 17, 2013, a further 3.0 percent interest if the Financing condition is not satisfied by May 31, 2013 and the remaining 6.6 percent if not satisfied by June 30, 2013. The consideration for the transfers is the provision by TAQA of the Second Carry.

The Company retains a 2.0 percent interest in Cladhan throughout, which is funded through the budgeted development cost out of a portion of the First Carry. The rest of the First Carry, which is not repayable, is available to fund development costs on the 11.8 percent interest into approximately the second quarter of 2014, at which point the Second Carry starts funding the ongoing development costs. A 17 percent per annum uplift is applicable to such carried costs. After pay-out of the Second Carry, which is expected to occur in the second or third quarter of 2015, the 11.8 percent interest is returned to Sterling whose equity interest would then be 13.8 percent. In a downside case of higher capital expenditures, low oil prices or low production, the timing for pay-out would be delayed but Sterling would have no further liability to TAQA. Should the 12.6 percent interest be transferred and the Second Carry received, the overall economics of this transaction are improved considerably by the fact that Sterling does not lose any of the significant historical capital allowances (approximately \$20 million as at January 1, 2013) associated with the 12.6 percent interest. As a condition of the Bond, Sterling has undertaken to complete the Cladhan farm-down transaction and hence will not satisfy the Financing Condition prior to June 30, 2013, and the farm-down of equity and the Second Carry will be triggered. At the conclusion of this arrangement, assuming pay-out, the partnership interests will be Sterling 13.8 percent, TAQA (operator) 52.7 percent and Wintershall 33.5 percent. As part of this agreement, Sterling will transfer its 12.5 percent interest in South Cladhan to TAQA for nominal consideration. Sterling retains the contingent upside payments linked to future reserves pursuant to the 2012 sale and purchase agreement ("SPA"). The Cladhan farm-down agreements are subject to regulatory and partner approvals. Consent of the Senior Lenders to the Credit Facility has been granted.

During the year ended December 31, 2012, the Company issued 225,000 common shares as a result of share options exercised by employees and directors under the Company's share option plan. The weighted-average exercise price of the underlying options was \$1.52 per option and aggregate proceeds were \$343,000.

FINANCING, LIQUIDITY AND SOLVENCY

Net Working Capital (excluding current portion of long-term debt)

| As at | December 31, 2012 | December 31, 2011 |
|--------------------------------|-------------------|-------------------|
| | \$000s | \$000s |
| Cash and cash equivalents | 9,438 | 49,963 |
| Restricted cash | 21,913 | 5,492 |
| Trade and other receivables | 12,443 | 8,419 |
| Derivative financial asset | 189 | – |
| Prepaid expenses | 408 | 158 |
| Trade and other payables | (40,381) | (26,881) |
| Derivative financial liability | (1,921) | – |
| Decommissioning obligations | (790) | – |
| Provisions | (1,188) | (1,163) |
| | 111 | 35,988 |

Net working capital (excluding current portion of long-term debt) of \$111,000 at December 31, 2012 represents a reduction in working capital from year-end 2011 mainly due to the continued operational activity at Breagh, the drilling campaigns in Romania and Netherlands, and amounts relating to the derivatives and decommissioning obligations moving into current liabilities, partly offset by the funds received from the partial divestment of Cladhan. The current portion of long-term debt of \$137,591,000 is due to be refinanced in the first half of 2013 and has been excluded from the above net working capital calculation.

Cash and cash equivalents at December 31, 2012 include term deposits of \$4,035,000 (December 31, 2011 – \$25,562,000).

Restricted cash of \$21,913,000 at December 31, 2012 (December 31, 2011 – \$5,492,000) comprised cash held in escrow, chiefly \$3,957,000 relating to the Netherlands F17-09 well, \$2,742,000 held in joint venture bank accounts in Romania for the drilling campaign, and \$15,214,000 to be used for expenditure on Breagh. In accordance with the terms of the Company's Credit Facility, the £10 million (\$16 million) previously held in a restricted account and reported as "non-current restricted cash" in the Company's financial statements is available to fund Breagh cost overruns and was included in current restricted cash at December 31, 2012.

As at December 31, 2012, the Company had approximately \$2.6 million of receivables due from two joint venture partners. There were no other material concentrations of receivables with joint venture partners at December 31, 2012.

Trade and other payables of \$40,381,000 at December 31, 2012 were comprised mainly of accrued expenditures related to the Breagh development project and the drilling campaign in Romania. This figure is indicative of the continued high level of activity in exploration and development assets.

A provision of \$1,188,000 at December 31, 2012 was reduced from \$1,900,000 at December 31, 2010. This provision was set up in 2010 to provide for an underpayment of employment taxes, associated interest and possible penalties relating to the Company's share option plan for UK employees. In the first quarter of 2011, certain affected individuals were determined to be non-resident and, therefore, unaffected by the UK regulations, and the provision was reduced accordingly.

Commitments and Contingencies

Commitments for the years 2013 through 2017 and thereafter, excluding amounts held in escrow and shown as restricted cash are comprised of the following:

| | 2013 | 2014 | 2015 | 2016 | 2017 | Thereafter | Total |
|----------------------------------|---------------|---------------|---------------|--------------|--------------|--------------|----------------|
| | \$000s | \$000s | \$000s | \$000s | \$000s | \$000s | \$000s |
| Facilities, oil and gas drilling | 55,115 | 38,418 | 19,318 | – | – | – | 112,851 |
| Seismic | 4,223 | 2,254 | – | – | – | – | 6,477 |
| Licence fees | 1,418 | 1,414 | 1,814 | 2,412 | 3,102 | – | 10,160 |
| Other operating | 758 | 336 | 294 | 561 | 466 | 522 | 2,937 |
| Office and other leases | 1,136 | 721 | 648 | 606 | 605 | 2,423 | 6,139 |
| | 62,650 | 43,143 | 22,074 | 3,579 | 4,173 | 2,945 | 138,564 |

The above facilities, and oil and natural gas drilling commitments in 2013 relate to the firm development wells contracted to be drilled and the additional facilities required as part of the Breagh Phase 1 development, plus drilling obligations in Romania.

Liquidity and Solvency

As at December 31, 2012, the Company's net working capital (excluding current portion of long-term debt) totaled \$111,000. The significant increase in the Phase 1 development cost of Breagh and the extensive delay in the timing of first revenues from the field have resulted in the Company fully utilizing its Credit Facility and subsequent to the year ended December 31, 2012, making an Equity Offering in February 2013 and, the bond issuance in April 2013. During 2013, operating cash flow after general and administration costs and financing costs are estimated to be approximately \$35 million. This is estimated to increase to approximately \$120 million in 2014 due to a full year of production from the Breagh field, with further significant increases in 2015 and 2016.

Capital expenditures in 2013 could be approximately \$110 million, of which approximately \$60 million is related to the UK Breagh field development and the balance is largely exploration and appraisal expenditure. In 2014, capital investments are expected to be approximately \$80 million. These are subject to approval.

The net proceeds of the Bond, amounting to US\$218.6 million (\$224 million) after fees and expenses, are expected to be received into an escrow account on or around April 30, 2013 and disbursed to the Company shortly thereafter following perfection of security. Following settlement of the Bond issue and the Cladhan Farm-Down, together with access to Breagh cash flow, the Company expects to be fully financed for all of its planned activities during the life of the Bond. Adjusting for the Bond Issue and repayment of the bank debt, management estimates pro forma group cash (including restricted cash) at March 31, 2013 to be approximately \$129 million. By the end of 2013, assuming Breagh starts production in August 2013, in accordance with reserves assumptions and assuming commitment E&A expenditure and no further farm-downs, management expects group cash to be approximately \$70 million providing a healthy buffer even in the event that Breagh production is further delayed or proceeds from the Carve-out Transaction (see "Financing Activities") are delayed.

The Company monitors and manages its liquidity through comparisons of working capital with budgets and regular forecasts of cash requirements, and by adjusting discretionary expenditures when appropriate.

DECOMMISSIONING OBLIGATIONS

The Company's decommissioning obligations result from net ownership interests in petroleum and natural gas interests in which there has been exploration, appraisal and development activity. The provision is the discounted present value of the estimated cost, using existing technology at current prices. The Company estimates the total undiscounted amount of cash flows required to settle its decommissioning obligations as at December 31, 2012 to be approximately \$24,928,000, which will be incurred between 2013 and 2036. This figure increased during 2012 due to the Breagh facilities development and the drilling campaign, partly offset by a reduction in the obligation due to the Company's sale of equity in Cladhan. During 2011 the increase was due to the development of the Breagh facilities. Two wells on the Sheryl licence will be abandoned during 2013 and this portion of the decommissioning obligation, \$790,000, has been made a current liability. Risk-free interest rates based on UK long-term government bond rates varying from 3.75 percent to 4.75 percent (December 31, 2011 – 3.75 to 4.75 percent) and an inflation rate of 2 percent (December 31, 2011 – 2 percent) were used to calculate the decommissioning obligations at December 31, 2012.

| | 2012 | 2011 |
|--------------------------------|--------|--------|
| | \$000s | \$000s |
| Balance, beginning of the year | 7,056 | 1,814 |
| Arising during the year | 3,406 | 3,865 |
| Obligation disposal | (131) | – |
| Revisions to estimates | – | 1,134 |
| Foreign exchange differences | 178 | 55 |
| Accretion of discount | 301 | 188 |
| Balance, end of the year | 10,810 | 7,056 |

PROGRESS AGAINST PLANS PREVIOUSLY ANNOUNCED FOR 2012

The Company outlined its plans for 2012 in its Annual Report for the year ended December 31, 2011. Several of the plans were completed by year-end 2012 or shortly thereafter:

- An appraisal well to the existing oil discovery in block F17 offshore the Netherlands was drilled. This well, designated F17-09, (originally planned to have been completed in 2011), was spudded in late 2011 and completed in the first quarter of 2012;
- An exploration well, 210/29c-5, was drilled on the South Cladhan prospect in the UK Northern North Sea block but did not encounter hydrocarbons and was subsequently plugged and abandoned.
- The Company stated in its 2011 Annual Report its plan to sell down the Company's interests in one or more of the Cladhan, Breagh and offshore Romania licences in order to release cash for reinvestment in these or other projects or to meet liquidity requirements under the Credit Facility. In April 2012, the Company signed a SPA with TAQA for the sale of a 13.5 percent interest in the Cladhan area. On October 19, 2012, the Company entered into a SPA with ExxonMobil and OMV Petrom for the sale of its interest in a portion of block 15 Midia in the Romanian Black Sea. Further sales processes are underway for part of the offshore Romanian licences;
- 3D seismic has been acquired over the E3/F1 blocks offshore the Netherlands.
- Two exploration wells were drilled offshore Romania. The Company commenced drilling the Ioana gas prospect well in September 2012, finishing drilling and abandoning the well in early November, and announced the Eugenia gas discovery in December;

- Partner approval was obtained for a development scheme for the Cladhan field; and
- Seismic was acquired over the Beverley oil prospect in the UK Central North Sea. This was completed as part of the farm-out agreement with Shell in January 2013.

Other plans in the 2011 Annual Report have been revised:

- Completion of four to five production wells as part of the Breagh Phase 1 development. At the end of 2012 only three wells were completed, with the fourth well being drilled.

Several of the plans stated in the 2011 Annual Report and/or subsequent quarterly reports either continue into 2013 or have been revised such that they are continuing into 2013; such plans are noted under "2013 Plans".

2013 PLANS

In the UK:

- Complete activities and achieve first gas from Breagh in August;
- Agree with RWE on a development plan for Breagh Phase 2 and present a draft FDP Addendum for this to DECC by mid-year, provide evidence of funding ability by end Q3 2013 and receive development approval by year-end;
- Obtain approval from DECC for the FDP for the Cladhan development followed by progressing the development with purchase of long-lead items, with the aim of beginning drilling by late 2013;
- Drill one exploration well on the Beverley oil prospect on block 22/26c. This well will be fully carried under a farm out arrangement; and
- Drill an appraisal well on the Crosgan blocks 42/10 and 42/15.

In Romania:

- Acquire 3D seismic over parts of the Midia and Pelican blocks in the second half of the year, so as to better define the prospects;
- Conduct Ana and Doina pre-FEED work;
- Purchase land required for onshore pipeline and gas processing terminal for future Midia gas development;
- Complete 3D seismic survey, over part of the Luceafarul block in the second half of the year; and
- Drill one exploration well in the Muridava block in the second half of the year;
- The Company intends to farm down a portion of its equity position in its offshore licences and has had a formal sales process in place for a number of months which is ongoing.

These plans remain contingent on partner approval as well as availability of suitable financing and (if appropriate) farm-out partners or purchasers of licence interests.

Corporately:

- As announced on February 12, 2013, the Company is reviewing a range of strategic options that may be accretive for shareholder value, including business combinations, sales of subsidiaries and assets, and any offer to be made for the outstanding common shares of the Company by Vitol. A review of financing options as part of this strategic review process is no longer required following the recent closing of the book for the US\$225 million (\$231 million) senior secured bond issue.

- The Company is still considering graduation to the main board of the Toronto stock exchange (“TSX”) and a listing on the main board of the London Stock Exchange. The timing of graduation to TSX is dependent upon satisfaction of a requirement to have a minimum of \$3 million in proved developed reserves which will not occur prior to first production from Breagh. The timing of a possible London listing depends on several factors including finalization of appraisal and development plans for Breagh Phase 2, progress on exploration and development activities offshore Romania, and wider equity market conditions.

RELATED PARTY AND OFF-BALANCE SHEET TRANSACTIONS

The Company had no related party or off-balance sheet transactions in the years ended December 31, 2012 or 2011. From January 8, 2013 until March 22, 2013 the Vitol Loan was in place (see “Financing Activities”).

ADDITIONAL INFORMATION

Additional information about Sterling Resources Ltd. and its business activities, including Sterling’s Annual Information Form, is available via SEDAR at www.sedar.com.

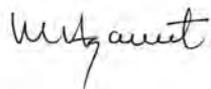
MANAGEMENT'S REPORT

The accompanying consolidated financial statements and all information in the annual report are the responsibility of management. The consolidated financial statements were prepared by management in accordance with International Financial Reporting Standards 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.

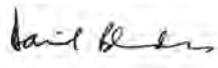
Management maintains appropriate systems of internal controls. Policies and procedures are designed to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded and financial records properly maintained to provide reliable information for the presentation of consolidated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

Ernst & Young LLP, an independent firm of chartered accountants, was 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 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.



Michael J. Azancot
Chief Executive Officer



David Blewden
Chief Financial Officer

April 29, 2013

INDEPENDENT AUDITORS' REPORT

To the Shareholders of Sterling Resources Ltd.

We have audited the accompanying consolidated financial statements of Sterling Resources Ltd., which comprise the consolidated balance sheets as at December 31, 2012 and 2011, and the consolidated income statements, statements of comprehensive loss, changes in equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Sterling Resources Ltd. as at December 31, 2012 and 2011, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

Calgary, Canada
April 29, 2013

Ernst + Young LLP
Chartered Accountants

CONSOLIDATED BALANCE SHEETS

| As at | December 31, 2012 | December 31, 2011 |
|--|----------------------|----------------------|
| | \$000s | \$000s |
| ASSETS (note 11) | | |
| Current assets | | |
| Cash and cash equivalents (note 4) | 9,438 | 49,963 |
| Restricted cash (note 5) | 21,913 | 5,492 |
| Trade and other receivables (note 6) | 12,443 | 8,419 |
| Prepaid expenses | 408 | 158 |
| Derivative financial asset (note 9) | 189 | – |
| | 44,391 | 64,032 |
| Non-current assets | | |
| Restricted cash (note 5) | – | 15,763 |
| Exploration and evaluation assets (note 7) | 112,557 | 121,152 |
| Property, plant and equipment (note 8) | 255,712 | 167,346 |
| Derivative financial asset (note 9) | 366 | 2,586 |
| | 368,635 | 306,847 |
| | 413,026 | 370,879 |
| LIABILITIES AND EQUITY | | |
| Current liabilities | | |
| Trade and other payables | 40,381 | 26,881 |
| Derivative financial liability (note 9) | 1,921 | – |
| Decommissioning obligations (note 10) | 790 | – |
| Provisions (note 10) | 1,188 | 1,163 |
| Current portion of long-term debt (note 11) | 137,591 | – |
| | 181,871 | 28,044 |
| Non-current liabilities | | |
| Derivative financial liability (note 9) | 1,355 | 1,624 |
| Decommissioning obligations (note 10) | 10,020 | 7,056 |
| Long-term debt (note 11) | – | 72,818 |
| | 11,375 | 81,498 |
| Commitments and contingencies (note 12) | | |
| Equity | | |
| Share capital (note 13) | 338,221 | 337,711 |
| Contributed surplus | 16,965 | 13,857 |
| Accumulated other comprehensive loss | (22,684) | (26,970) |
| Deficit | (112,722) | (63,261) |
| | 219,780 | 261,337 |
| | 413,026 | 370,879 |

The accompanying notes are an integral part of the consolidated financial statements as at and for the years ended December 31, 2012 and 2011 ("the Financial Statements").

CONSOLIDATED INCOME STATEMENTS

| Years ended December 31, | 2012 | 2011 |
|---|----------------------------|----------------------------|
| | \$000s except per share | \$000s except per share |
| Revenue | 66 | 1,258 |
| Expenses | | |
| Operating expense | – | 202 |
| Pre-licence and other exploration expenditures (note 7) | 31,379 | 13,201 |
| Dry-hole expense (note 7) | – | 9,733 |
| Depletion, depreciation and amortization (note 8) | 416 | 1,206 |
| Impairment of oil and gas properties (note 8) | 2,647 | 2,930 |
| Unrealized loss on derivative financial instruments (note 9) | 4,182 | 2,499 |
| Bad debt expense (note 14) | – | 6,792 |
| Employee expense (note 16) | 7,152 | 8,975 |
| General and administration expense | 2,864 | 3,074 |
| Foreign exchange loss | 296 | 6,563 |
| Total expenses | 48,936 | 55,175 |
| Financing income | (479) | (282) |
| Financing costs (note 17) | 301 | 188 |
| Loss before income taxes | 48,692 | 53,823 |
| Current income tax expense (note 19) | 769 | – |
| Net loss for the year | 49,461 | 53,823 |
| Net loss per common share (note 18) | | |
| Basic | 0.22 | 0.27 |
| Diluted | 0.22 | 0.27 |

The accompanying notes are an integral part of the Financial Statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

| <i>Years ended December 31,</i> | 2012 | 2011 |
|---|----------------|---------|
| | \$000s | \$000s |
| Net loss | 49,461 | 53,823 |
| Foreign currency translation adjustment | (4,286) | (6,519) |
| Comprehensive loss | 45,175 | 47,304 |

The accompanying notes are an integral part of the Financial Statements.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

| | Share Capital | Contributed Surplus | Accumulated Other Comprehensive Loss | Deficit | Total |
|--|------------------|------------------------|---|------------------|-----------------|
| | \$000s | \$000s | \$000s | \$000s | \$000s |
| Balance at January 1, 2011 | 290,444 | 9,283 | (33,489) | (9,438) | 256,800 |
| Exercise of stock options (note 13) | 3,408 | – | – | – | 3,408 |
| Public equity issuances (note 13) | 45,000 | – | – | – | 45,000 |
| Share issuance costs (note 13) | (2,480) | – | – | – | (2,480) |
| Transferred from contributed surplus on exercise of options | 1,339 | (1,339) | – | – | – |
| Share-based compensation (note 16) | – | 5,913 | – | – | 5,913 |
| Foreign currency translation into presentation currency | – | – | 6,519 | – | 6,519 |
| Loss for the year | – | – | – | (53,823) | (53,823) |
| Balance at December 31, 2011 | 337,711 | 13,857 | (26,970) | (63,261) | 261,337 |
| Balance at January 1, 2012 | 337,711 | 13,857 | (26,970) | (63,261) | 261,337 |
| Exercise of stock options (note 13) | 343 | – | – | – | 343 |
| Transferred from contributed surplus on exercise of options | 167 | (167) | – | – | – |
| Share-based compensation (note 16) | – | 3,275 | – | – | 3,275 |
| Foreign currency translation into presentation currency | – | – | 4,286 | – | 4,286 |
| Loss for the year | – | – | – | (49,461) | (49,461) |
| Balance at December 31, 2012 | 338,221 | 16,965 | (22,684) | (112,722) | 219,780 |

The accompanying notes are an integral part of the Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

| <i>Years ended December 31,</i> | 2012 | 2011 |
|--|-----------------|-----------|
| | \$000s | \$000s |
| Cash flows from operating activities | | |
| Loss for the year | (49,461) | (53,823) |
| Adjustments for non-cash items | | |
| Unrealized foreign exchange loss (gain) | 308 | (23) |
| Unrealized loss on derivative financial instruments | 4,182 | 2,499 |
| Exploration assets relinquished (note 7) | 12,770 | 5,715 |
| Impairment of oil and gas properties (note 8) | 2,647 | 2,930 |
| Depletion, depreciation and amortization (note 8) | 416 | 1,206 |
| Share-based compensation (note 16) | 3,275 | 5,913 |
| Accretion (note 17) | 301 | 188 |
| Change in non-cash working capital | (2,282) | (238) |
| Cash flows (used in) operating activities | (27,844) | (35,633) |
| Cash flows from investing activities | | |
| Increase in restricted cash (note 5) | (658) | (4,529) |
| Exploration and evaluation asset additions (note 7) | (31,155) | (160,960) |
| Property, plant and equipment additions (note 8) | (83,749) | (10,418) |
| Proceeds from sale of assets (note 7) | 23,445 | – |
| Change in non-cash working capital | 11,399 | 14,528 |
| Cash flows (used in) investing activities | (80,718) | (161,379) |
| Cash flows from financing activities | | |
| Decrease / (increase) in restricted cash (note 5) | – | (15,763) |
| Premium paid on derivative financial instruments | (386) | (3,543) |
| Proceeds from loan funds (note 11) | 64,116 | 77,392 |
| Increase in transaction costs on debt (note 11) | (41) | (4,766) |
| Proceeds from public equity issuance (note 13) | – | 42,520 |
| Proceeds from exercise of share options (note 13) | 343 | 3,408 |
| Change in non-cash working capital | 135 | – |
| Cash flows provided by financial activities | 64,167 | 99,248 |
| Effect of translation on foreign currency cash and cash equivalents | | |
| | 3,870 | 5,103 |
| Decrease in cash and cash equivalents during the year | (40,525) | (92,661) |
| Cash and cash equivalents, beginning of the year | 49,963 | 142,624 |
| Cash and cash equivalents, end of the year | 9,438 | 49,963 |

The accompanying notes are an integral part of the Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the years ended December 31, 2012 and 2011

1. CORPORATE INFORMATION

Sterling Resources Ltd. (the “Company”) is a publicly traded energy company incorporated and domiciled in Canada. The Company is engaged in the exploration, appraisal and development of crude oil and natural gas in the United Kingdom, Romania, the Netherlands and France. The registered office is located at Suite 1450, 736 Sixth Avenue S.W., Calgary, Alberta, Canada.

The Company’s consolidated financial statements comprise the financial statements of the Company and the wholly-owned group of companies: Sterling Resources (UK) Ltd. (“Sterling UK”), Sterling Resources Netherlands B.V., and Midia Resources SRL.

These audited consolidated financial statements (“the Financial Statements”) were approved for issuance at a meeting of the Company’s Board of Directors on April 29, 2013, on the recommendation of the Audit Committee.

2. BASIS OF PREPARATION

Statement of Compliance

The Financial Statements for the years ended December 31, 2012 and 2011 were prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) on a going-concern basis, under the historical cost convention.

The presentation currency of these Financial Statements is the Canadian dollar.

Certain amounts in prior years’ financial statements have been reclassified to conform to the current year’s financial statement presentation.

Basis of Consolidation

The Financial Statements comprise the financial statements of the Company and its subsidiaries as at December 31, 2012. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company’s, using consistent accounting policies.

Substantially all of the Company’s exploration activities are conducted jointly with others, including through farm-in and farm-out arrangements. Under these arrangements a portion of the Company’s interest is given up in exchange for the partner paying a share of certain of the costs of drilling a well or other programs. These Financial Statements include the Company’s proportionate share of the assets, liabilities, revenue and expenses with items of a similar nature presented on a line-by-line basis, from the date the joint arrangement commences until it ceases.

Inter-company balances and transactions, and any unrealized gains arising from inter-company transactions with the Company’s subsidiaries, are eliminated in preparing the Financial Statements.

Use of Accounting Assumptions, Estimates and Judgments

The preparation of the Company's consolidated Financial Statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and other factors that are considered relevant. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the same period if the revision affects only that period or in the period of the revision and future periods if the revision affects current and future periods.

Critical judgments in applying accounting policies that have the most significant effect on the amounts recognized in these financial statements comprise the following:

Exploration and Evaluation Assets

The accounting for exploration and evaluation ("E&E") assets requires management to make certain estimates and assumptions, including whether exploratory wells have discovered economically recoverable quantities of reserves. Designations are sometimes revised as new information becomes available. If an exploratory well encounters hydrocarbons, but further appraisal activity is required in order to conclude whether the hydrocarbons are economically recoverable, the well costs remain capitalized as long as sufficient progress is being made in assessing the economic and operating viability of the well. Criteria used in making this determination include evaluation of the reservoir characteristics and hydrocarbon properties, expected additional development activities, commercial evaluation and regulatory matters. The concept of "sufficient progress" is an area of judgment, and it is possible to have exploratory costs remain capitalized for several years while additional drilling is performed or the Company seeks government, regulatory or partner approval of development plans.

Impairment Indicators

The Company monitors internal and external indicators of impairment relating to E&E assets and property, plant and equipment. For E&E assets the following are examples of the types of indicators used:

- The entity's right to explore in an area has expired or will expire in the near future without renewal;
- No further exploration or evaluation is planned or budgeted;
- The decision to discontinue exploration and evaluation in an area because of the absence of commercial reserves; or
- Sufficient data exists to indicate that the book value will not be fully recovered from future development and production.

For development oil and gas properties, the following are examples of the indicators used:

- A significant and unexpected decline in the asset's market value;
- A significant change in the asset's reserves assessment;
- Significant changes in the technological, market, economic or legal environments for the asset; or
- Evidence is available to indicate obsolescence or physical damage of an asset, or that it is underperforming expectations.

The assessment of impairment indicators requires the exercise of judgment. If an impairment indicator exists, then the recoverable amounts of the cash-generating units and/or individual assets are determined based on the higher of value-in-use and fair values less costs to sell calculations. These require the use of estimates and assumptions, such as future oil and natural gas prices.

Decommissioning Obligation

Decommissioning obligations will be incurred by the Company at the end of the operating life of wells. The ultimate asset decommissioning costs and timing are uncertain and cost estimates can vary in response to many factors including changes to relevant legal requirements and their interpretation, the emergence of new restoration techniques, the prevailing rig rates or experience at other production sites. As a result, there could be significant adjustments to the provisions established which could materially affect future financial results.

Commitments

Commitment disclosure includes estimates of the total cost of long-term projects, in which there are many contingent factors and which could be revised either upwards or downwards based on the actual results of operations.

Recognition of Deferred Tax Assets

Accounting for income and profit taxes is a complex process requiring management to interpret frequently changing laws and regulations and make judgments related to the application of tax law, estimate the timing of temporary difference reversals, and estimate the realization of tax assets. All tax filings are subject to subsequent government audits and potential reassessment. These interpretations and judgments and changes related to them can potentially impact current and deferred tax provisions, deferred income tax assets and liabilities and net post-tax profit or loss.

Accordingly, in common with other international oil and gas companies conducting their business through government licences to operate, the provision for income tax, profits tax and other tax liabilities is subject to a degree of measurement uncertainty. The recognition of deferred tax assets requires a determination of the likelihood that they will be realized from the future taxable earnings.

Significant Accounting Policies

a. Oil and Natural Gas Exploration, Evaluation and Development Expenditures

Pre-Licence and Other Exploration Expenditures

All pre-exploration expenditures and other exploration costs, including geological and geophysical costs and annual lease rentals, are charged to exploration expense when incurred.

E&E Expenditures

During the geological and geophysical exploration phase, expenditures are charged against income as incurred. Once the legal right to explore has been acquired, expenditures directly associated with an exploration well are capitalized as E&E intangible assets and are reviewed at each reporting date to confirm that there is no indication of impairment and that drilling is still underway or is planned. If no future exploration or development activity is planned in the licence area, the exploration licence and leasehold property acquisition costs are written off.

Petroleum and Natural Gas Properties and Equipment

Once a project is commercially feasible and technically viable, which in practice is when the asset has been approved for development by the appropriate regulatory authorities, the carrying values of the associated exploration licence and leasehold property acquisition costs and the related costs of exploration wells are transferred to development oil and gas properties. Further expenditures incurred after the commerciality of the field has been established, including the costs of drilling unsuccessful wells, are capitalized within petroleum and natural gas properties and equipment. Repairs and maintenance costs are charged as an expense when incurred.

Depletion

Depletion of capitalized development and production assets is calculated on a field or a concession basis as appropriate. The calculation is based on proved and probable reserves using the unit-of-production method. Depletion begins on commencement of commercial production following the completion of any testing phase. E&E assets are not subject to depletion.

Decommissioning

Expected decommissioning costs of a property are provided for on the basis of the net present value of the liability, discounted at a pre-tax, risk-free interest rate. The costs are recorded as a liability with a corresponding increase in the carrying amount of the related asset and charged to the income statement along with the depreciation of the related asset. The liability is determined through a review of engineering studies, industry guidelines and management's estimate on a site-by-site basis, and is subsequently adjusted for changes in expected costs, asset life, inflation or the risk-free rate. Subsequent to initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time, changes in the estimated future cash flows underlying the obligation and changes in discount rates. The increase in the obligation due to the passage of time is recognized as a financing cost whereas changes due to revisions in the estimated future cash flows and discount rate are capitalized. Actual costs incurred upon settlement of the obligation are charged against the provision to the extent the provision was established.

b. Impairment of Non-Financial Assets

E&E expenditures which are held as an intangible asset and development oil and gas properties are reviewed at each reporting date for indicators of impairment at the level of cash generating units (CGUs). A CGU is defined as a field, licence area, or group of adjacent licences. If there are impairment indicators then the assets or CGUs are tested for impairment. Any impairment is recognized in the income statement. Impairment tests are also carried out on any assets held for sale when a decision is made to sell such assets and before transferring assets to development and production assets following a declaration of commercial reserves.

Impairment tests are calculated by comparing the net capitalized cost with the fair value less the costs to sell the assets. This is determined by the present value of the future pre-tax cash flows expected to be derived from the licence discounted at an appropriate annual discount rate. Any impairment loss is the difference between the carrying value of the asset and its recoverable amount.

c. Corporate and Other Assets

Corporate and other assets are carried at cost less accumulated depreciation and impairment losses, if any. Depreciation is calculated on a declining-balance basis at an annual rate of 30 percent. The assets' residual values, useful lives and amortization methods are reviewed, and adjusted if appropriate, at each financial year-end. An item of plant and equipment is derecognized upon disposal or when no further future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in profit and loss in the year the asset is derecognized.

d. Cash and Cash Equivalents

Cash and cash equivalents include term deposits, guaranteed investment certificates and operating bank accounts with maturities from inception or cashable options, if applicable, of 90 days or less.

e. Restricted Cash

Restricted cash includes cash set aside for a specific use or future event and is not available for general operating purposes.

f. Financial Assets

Financial assets are classified among the following categories, with subsequent measurement of the instruments based upon their classification.

Financial assets at fair value through profit or loss: With the exception of derivative financial instruments as described below, a financial asset is classified at fair value through profit or loss if it is classified as held for trading or is designated as such upon initial recognition. It is measured at fair value with changes to that fair value recognized in financing income or financing costs in the income statement. Cash and cash equivalents and restricted cash are designated as “held-for-trading” and are measured at carrying value, which approximates fair value due to the short-term nature of these instruments. The Company has not designated any financial assets upon initial recognition at fair value through profit and loss.

Loans and receivables: Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are measured initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition loans and receivables are measured at amortized cost using the effective interest rate (EIR) method with any EIR amortization included in financing income in the income statement.

Held-to-maturity financial assets: If the Company has the intention and ability to hold debt securities to maturity, then such non-derivative financial assets are classified as held-to-maturity. They are measured at amortized cost using the EIR method.

Available-for-sale financial assets: Available-for-sale assets include equity and debt securities. Equity securities classified as available-for-sale are non-derivative financial assets that are neither classified as held-for-trading nor designated as fair value through profit and loss. These assets are measured at fair value with changes to fair value recognized in other comprehensive income, net of tax until the investment is derecognized, at which time the cumulative gain or loss is recognized in other operating income, or determined to be impaired, at which time the cumulative loss is reclassified to the income statements in financing costs and removed from the available-for-sale reserve. The Company did not have any available-for-sale investments during the years ended December 31, 2012 or December 31, 2011.

The Company derecognizes a financial asset when the contractual rights to the cash flows from the asset expire, or it transfers the rights to receive the contractual cash flow of the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred.

The Company assesses at each reporting date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset and that loss event has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

g. Derivative Financial Instruments

Derivative financial instruments are used to reduce commodity price risk associated with the Company's future production of natural gas. The Company does not enter into derivative financial instruments for trading or speculative purposes.

The Company currently uses only put options to partially offset or mitigate the wide price swings commonly encountered in natural gas markets and in so doing protects a minimum future level of cash flow in the event of low commodity prices. The Company considers these financial risk management contracts to be effective on

an economic basis but has decided not to designate these contracts as hedges for accounting purposes and, accordingly, an unrealized gain or loss is recorded based on the change in fair value ("mark-to-market") of the contracts at each reporting period end. These instruments are recorded as derivative financial instruments in the consolidated balance sheet.

h. Financial Liabilities

Financial liabilities are classified among the following categories, with subsequent measurement of the instruments based upon their classification.

Financial liabilities at fair value through profit or loss: Financial liabilities are classified as held-for-trading if they are acquired for the purpose of selling in the near term. Gains or losses on liabilities held-for-trading are recognized in the income statement.

Other financial liabilities: After initial recognition, interest-bearing loans and borrowing are subsequently measured at amortized cost using the EIR method. Gains and losses are recognized in the income statement when the liabilities are derecognized as well as through the EIR method amortization process. Amortized cost is calculated by taking into account any discount or premium on acquisition and fees or costs integral to the EIR. The EIR amortization is included in financing cost in the income statement.

Long-term debt transaction costs, which may include but are not limited to bank fees, legal costs and time-writing are capitalized at inception and are amortized over the life of the loan using the EIR method. When the assets to which borrowing costs relate are deemed major development projects, but are not yet ready for their intended use, the borrowing costs are capitalized to the asset and then depleted as the asset enters production.

A financial liability is derecognized when the obligation under the liability is discharged, cancelled or expires.

When a financial liability is replaced by another from the same lender on substantially different terms, or the terms of a liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognized in the income statement.

i. Offsetting of Financial Instruments

Financial assets and liabilities are offset and the net amount reported in the consolidated balance sheet only if there is a currently enforceable legal right to offset the recognized amounts and there is an intention to settle on a net basis, or to realize the assets and settle the liabilities simultaneously.

j. Revenue

The Company recognizes revenue from petroleum and natural gas production at the fair value of the consideration received or receivable when the significant risks and rewards of ownership are transferred to the buyer and it can be reliably measured and only at such time as a project becomes commercially viable and development approval is received. Prior to this stage, any production is considered test production and related revenue is capitalized net of applicable costs.

k. Earnings per Share

The Company presents basic and diluted earnings per share (EPS) data for its common shares. Basic EPS is calculated by dividing the net profit or loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period. Diluted EPS is determined by dividing the net profit or loss attributable to common shareholders by the weighted average number of common

shares outstanding during the year, plus the weighted average number of common shares that would be issued on conversion of all dilutive potential common shares into common shares. Those potential common shares comprise share options granted.

i. Financing Income and Expense

Financing income comprises interest earned on funds on deposit.

Financing expense comprises accretion of the discount on decommissioning obligations, interest expense on borrowing and amortization of debt issuance costs.

Borrowing costs that are not directly attributable to the acquisition, construction or production of a qualifying asset are recognized in profit or loss using the effective interest rate method.

m. Foreign Currency Translation

Transactions and Balances

Transactions in foreign currencies are translated into the functional currency using the exchange rate on the transaction date. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognized in the income statement.

Foreign Operations

Each subsidiary in the group is measured using the currency of the primary economic environment in which the entity operates, which is its functional currency. Foreign currency transactions are translated into functional currency using the exchange rates on the transaction date. Foreign exchange gains and losses resulting from the settlement of such transactions and from translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognized in the income statement.

For the purpose of the consolidated financial statements, the results and financial position are reported in Canadian dollars, the presentation currency. On consolidation of subsidiaries with a non-Canadian-dollar functional currency, balance sheets are translated into Canadian dollars at the closing rate and income and expenses at the average monthly rate. Resulting exchange differences arising in the period are recognized in other comprehensive income. Such translation differences are reclassified to profit or loss in the period in which any such foreign operation is disposed of.

n. Income Taxes

The income tax expense represents the sum of the current income tax and deferred tax.

Current tax is provided at amounts expected to be paid (or recovered) using the tax rates and laws enacted or substantively enacted by the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognized for all taxable temporary differences, with the exception of temporary differences on investments in subsidiaries, which are not recognized for wholly-owned subsidiaries as the Company controls the timing of reversal and they are not expected to be reversed for the foreseeable future. Deferred tax assets are recognized to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilized. The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available

to allow all or part of the asset to be recovered. Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realized. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

o. Share-Based Compensation

Under the Company's share option plan, options to purchase common shares are granted to directors, officers and employees at then-current market prices. The cost of share option transactions, which is considered to be the fair value of the option as determined using the Black-Scholes model, is recognized together with a corresponding increase in other capital reserves in equity, over the period in which the performance and/or service conditions are fulfilled. The cumulative expense recognized for share option transactions at each reporting date until the vesting date reflects the extent to which the vesting period has expired and the Company's best estimate of the number of options that will ultimately vest. The income statement expense or credit for a period represents the movement in cumulative expense recognized at the beginning and end of that period and is recognized in employee benefits expense.

No expense is recognized for awards that do not ultimately vest, except for share option transactions in which vesting is conditional upon a market or non-vesting condition, which are treated as vesting irrespective of whether the market or non-vesting condition is satisfied, provided that all other performance and/or service conditions are satisfied.

When the terms of a share option transaction award are modified, the minimum expense recognized is the expense as if the terms had not been modified, if the original terms of the award are met. An additional expense is recognized for any modification that increases the total fair value of the share-based compensation transaction, or is otherwise beneficial to the employee as measured at the date of modification.

The dilutive effect of outstanding options is reflected as additional share dilution in the computation of diluted earnings per share.

p. Leases

The determination of whether an arrangement is, or contains, a lease is based on the substance of the arrangement, which involves assessing whether its fulfillment depends on the use of a specific asset or assets or it conveys a right to use the asset.

The classification of leases as financing or operating leases requires the Company to determine, based on an evaluation of the terms and conditions, whether it retains or acquires the significant risks and rewards or ownership of these assets and accordingly, whether the lease requires an asset and liability to be recognized on the balance sheet.

The Company leases assets, all of which have been determined to be operating leases. Operating lease payments are recognized as an expense in the income statement on a straight-line basis over the lease term. Financing charges are reflected in the income statement.

q. Asset Swaps and Farm-Out Arrangements

Exchanges of assets are measured at fair value unless the exchange transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up is reliably measurable. The cost of the acquired asset is measured at the fair value of the asset given up, unless the fair value of the asset received is more clearly evident. When fair value is not used, the cost of the acquired asset is measured at the carrying amount of the asset given up. The gain or loss arising is recognized in net income.

Farm-outs generally occur in the exploration phase and are characterized by the transferor giving up future economic benefits, in the form of reserves, in exchange for reduced future funding obligations. In the exploration phase, the Company accounts for farm-outs on a historical cost basis. As such, no gain or loss is recognized; any consideration received is credited against the carrying value of the related asset.

3. New Accounting Standards and Interpretations Not Yet Adopted

The following pronouncements from the IASB are applicable to the Company and will become effective for future reporting periods, but have not yet been adopted:

- IFRS 9, *Financial Instruments* – Deals with the classification and measurement of financial assets. In October 2010 the IASB updated IFRS 9 by incorporating requirements for the accounting for financial liabilities. The Company will be required to adopt IFRS 9 on January 1, 2015 and is currently assessing the impact;
- IFRS 10, *Consolidated Financial Statements* – Establishes the accounting principles for consolidated financial statements when one entity controls other entities. This standard establishes a new control model that applies to all entities and replaces International Accounting Standard (IAS) 27 *Consolidated and Separate Financial Statements* and the related provisions of Standing Interpretations Committee (SIC) 12 *Consolidation – Special Purpose Entities*;
- IFRS 11, *Joint Arrangements* – Establishes the accounting principles for parties to a joint arrangement and replaces IAS 31 *Interest in Joint Ventures* and SIC 13 *Jointly Controlled Entities: Non-Monetary Contributions by Venturers*. This standard requires a party to assess its rights and obligations from the arrangement in order to determine the type of joint arrangement. The choice of proportionate-consolidation accounting is prohibited for joint ventures as equity accounting is required;
- IFRS 12, *Disclosure of Interests in Other Entities* – Establishes comprehensive disclosure requirements for subsidiaries, joint arrangements, associates, and unconsolidated structured entities and replaces existing disclosure requirements in related standards; and
- IFRS 13, *Fair Value Measurement* – Establishes a single framework for fair value measurement and disclosure when fair value is required or permitted under IFRS;

Except as noted above, all of the above pronouncements are effective for annual periods beginning on or after January 1, 2013. The Company has reviewed the implications of IFRS 10, 11, 12 and 13; the adoption of these standards is not expected to have significant impact on the Company's consolidated financial statements.

4. CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following:

| As at | December 31, 2012 | December 31, 2011 |
|---------------------------|-------------------|-------------------|
| | \$000s | \$000s |
| Cash | 5,403 | 24,401 |
| Cash equivalents | 4,035 | 25,562 |
| | 9,438 | 49,963 |
| Balances held in: | | |
| Canadian dollars | 280 | 3,914 |
| US dollars | 3,734 | 3,744 |
| UK pounds | 4,017 | 37,306 |
| Other | 1,407 | 4,999 |
| Cash and cash equivalents | 9,438 | 49,963 |

As at December 31, 2012, cash equivalents carried annual interest rates between 0.05 percent and 0.50 percent (December 31, 2011 – between 0.03 percent and 1.75 percent).

5. RESTRICTED CASH

Restricted cash of \$21,913,000 at December 31, 2012 (December 31, 2011 – \$5,492,000) comprised cash held in escrow, chiefly \$3,957,000 relating to the Netherlands F17-09 well, \$2,742,000 held in joint venture bank accounts in Romania for the drilling campaign, and \$15,214,000 to be used for expenditure on Breagh. In accordance with the terms of the Company's credit facility, the £10 million (\$16 million) previously reported as "non-current restricted cash" in the Company's financial statements is available to fund Breagh cost overruns and is included in current restricted cash at December 31, 2012.

6. FINANCIAL INSTRUMENTS

The Company's financial instruments, including cash and cash equivalents, restricted cash, trade and other receivables, derivative financial instruments, trade and other payables and long-term debt have been categorized as follows:

- Cash and cash equivalents and restricted cash – held for trading;
- Trade and other receivables – loans and receivables;
- Derivative financial instruments – held for trading; and
- Trade and other payables and long-term debt – other financial liabilities.

The fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's-length transaction between knowledgeable, willing parties who are under no compulsion to act. The fair value of derivative financial instruments is discussed in note 9. The carrying values of all other financial assets and liabilities approximate their fair values due to their relatively short-term maturities or variable interest rates.

The Company is exposed to various financial risks arising from normal-course business exposure as well as its use of financial instruments. These risks include market risks relating to foreign exchange rate fluctuations and interest rate risk, as well as liquidity risk, commodity price risk and credit risk as described below.

Foreign Exchange Rate Risk

The Company's functional currencies for the UK and Netherlands, Canadian and Romanian operations are the UK pound, Canadian dollar and US dollar, respectively. Foreign exchange gains or losses can occur on translation of working capital denominated in currencies other than the functional currency of the jurisdiction which holds the working capital item. Excluding the impact of changes in the cross-rates, a 1 percent fluctuation in translation rates would have the following impact on net income or loss, based on foreign currency balances held at December 31, 2012.

| | \$000s |
|-------------------------------|--------|
| Canadian dollar vs. UK pound | (16) |
| Canadian dollar vs. US dollar | 8 |
| UK pound vs. Euro | – |
| UK pound vs. US dollar | (90) |

Interest Rate Risk

The interest rate charged under the credit facility is LIBOR plus a margin that varies at different stages of the life of the loan. Based on the balance at December 31, 2012, a 1 percentage point change over a 12-month period in the average LIBOR interest rate on the loan amount would increase or decrease net income or loss by approximately \$1,416,000.

In addition, from time to time the Company may have significant cash or cash-equivalent balances invested at prevailing short-term interest rates. Accordingly, cash flows are sensitive to changes in interest rates on these investments. Based on total cash and cash equivalents and restricted cash at December 31, 2012, a 1 percentage point change in average interest rates over a 12-month period would increase or decrease net income or loss by approximately \$314,000.

Liquidity Risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. The significant increase in the Phase 1 development cost of Breagh and the extensive delay in the timing of first revenues from the field have resulted in the Company fully utilizing its credit facility and, subsequent to the year ended December 31, 2012, making an equity offering in February 2013 and, a bond issuance in April 2013 (see note 21).

The net proceeds of the bond issuance (see note 21), amounting to approximately US\$218.6 million (\$224.0 million) after fees and expenses, are expected to be received into an escrow account on or around April 30, 2013 and disbursed to the Company shortly thereafter following perfection of security. Following the settlement of the bond issue and the Cladhan farm-down (see note 21), together with access to Breagh cash flow, the Company expects to be fully financed for all of its planned activities during the life of the Bond.

The Company expects that it will have completed the Carve-out Transaction (see note 7) raising approximately US\$22.6 million (\$23.2 million) net of tax and related expenses around the end of the second quarter of 2013.

All financial liabilities are due within one year other than derivatives which mature up to October 2014.

Commodity Price Risk

The Company is exposed to the risk of commodity price fluctuations on its natural gas production. For Breagh, the Company will sell gas produced at a price linked to the UK spot market, which is a liquid market. The Company's policy is to manage downside price risk as required under its existing credit facility and otherwise in support of debt service obligations, through the use of derivative commodity contracts. The Company was required under

its credit facility to purchase monthly cash-settled put options to hedge 40 percent of its forecast gas production volumes from proved reserves (P90) from the first phase of Breagh development, for a 24-month period starting on October 1, 2012 (see note 9).

Credit Risk

Credit risk is the risk that a customer or counterparty will fail to perform an obligation or fail to pay amounts due causing a financial loss to the Company. The Company's trade and other receivables are primarily with governments for recoverable amounts of value added taxes ("VAT") or joint venture partners in the oil and natural gas industry. At December 31, 2012, the Company had approximately \$2.6 million of receivables due from two joint venture partners. There were no other material concentrations of receivables with joint venture partners at December 31, 2012.

Impairment to a financial asset is only recorded when there is objective evidence of impairment and the loss event has an impact on future cash flow and can be reliably estimated. Evidence of impairment may include default or delinquency by a debtor or indicators that the debtor may enter bankruptcy. Where aged debtors are present, these are secured by the partner's interest in the underlying oil and gas properties the value of which exceeds any debts. At December 31, 2012, approximately \$1.4 million of receivables in the UK operating segment and approximately \$1.4 million of receivables in the Romanian operating segment related to joint venture receivables were considered to be overdue; however, management expects these to be collected upon completion of the licence assignments and other agreements. Also at year-end, approximately \$2.5 million of receivables in the Romanian operating segment related to VAT receivable; these amounts are expected to be recovered through a reduction in future VAT payments in 2013 as part of the normal course of business and for VAT due upon the closing of the Romanian Carve-Out Transaction (see note 7). In the second quarter of 2011, \$6,792,000 had been written off against a receivable due from a partner. Collection efforts are continuing.

Other than the overdue amounts described above, the Company's receivables are subject to normal industry risk, and management believes collection risk is minimal.

The Company has entered into derivative financial instruments and deposited its cash, cash equivalents and restricted cash with reputable financial institutions, with which management believes the risk of loss to be remote. The maximum credit exposure associated with financial assets is their carrying value. At December 31, 2012 the cash, cash equivalents and restricted cash were held with six different institutions from five countries. The derivative contracts were held with three of the same financial institutions providing the credit facility, thereby further mitigating credit risk.

Capital Management

The primary objective of the Company's capital management is to ensure sufficient funds are available for operational purposes while retaining flexibility to cope with adverse movements in production rates, commodity prices and interest rates. A secondary objective is to have a capital structure broadly comparable with the Company's peer group of international exploration and production companies, in order to contribute towards an efficient market valuation. In addition, the Company must comply with the terms of its credit facility which include a cash sweep, a loan repayment schedule and undertakings relating to minimum consolidated Company cash levels (refer to note 11).

The Company may amend its capital structure to fit with its corporate objectives by issuing equity or equity-linked instruments and by issuing debt or entering into, or extending, credit facilities with banks. No dividend payment or return of capital to shareholders is contemplated for the foreseeable future.

The Company assesses its capital structure on a forward-looking basis by modelling net cash flows over the next few years and considering the economic conditions and operational factors which could lead to financial stress. A range

of measurement tools is used, including gearing (net debt divided by the sum of equity and net debt), net cash flow coverage of net interest payments, and the time to repay net debt from net cash flow. No specific numerical range for each of these parameters is targeted, as the overall assessment reflects a consideration of a wide range of factors.

No changes were made in the Company's capital management objectives, policies or processes during the year ended December 31, 2012.

7. EXPLORATION AND EVALUATION ASSETS

During the year ended December 31, 2012, \$4,189,000 of directly attributable general and overhead costs were capitalized to E&E assets (2011 – \$3,392,000).

The exploration assets' relinquished figure of \$12,770,000 relates to the Sheryl area (block 21/23a) after relinquishment of the licence in December 2012. In 2011, an amount of \$5,715,000 was expensed relating to relinquishment of licences in the UK. The dry hole expense in 2011 related to a well drilled on the Grian licence.

In August 2012, the Company completed the sale of a 13.5 percent interest in the North Cladhan area (blocks 210/29a and 210/30a) for an initial consideration of US\$47 million (\$46.8 million) to be received in three installments: US\$22.6 million (\$22.4 million) was received in August 2012, with a further US\$0.8 million (\$0.8 million) of working capital adjustments and US\$4.3 million (\$4.3 million) was received in January 2013 upon enactment of secondary legislation providing for the application of Small Field Allowance, a tax allowance for UK supplementary corporation tax, as set out in the UK government's budget announcement in March 2012. As the legislation was passed in 2012 and all the conditions precedent to this part of the sale were complete, this amount has been reflected in the financial statements; and the balance as a carry of a portion of the Company's Cladhan development expenditures up to US\$53.6 million (\$54.9 million), subsequent to field development plan (FDP) approval.

In October 2012, the Company announced that it had entered into the sale and purchase agreement with ExxonMobil and OMV Petrom for the sale of its 65 percent interest in a portion of block 15 Midia in the Romanian Black Sea (the "Carve-out Transaction"). The consideration for the transaction payable to Sterling comprises US\$29.25 million (\$30 million) upon closing, a contingent payment of US\$29.25 million (\$30 million) upon satisfaction of certain conditions relating to any hydrocarbon discovery made on the portion sold, and a further contingent payment of US\$19.5 million (\$20 million) upon first commercial production from the portion sold. Completion is subject amongst other things to governmental approvals.

The field development program for Phase 1 of the Breagh gas field received approval from the UK Department of Energy and Climate Change ("DECC") on July 25, 2011 and, consequently, the Breagh carrying values were transferred from E&E assets to property, plant and equipment. The asset was tested for impairment on transfer and none was found.

| <i>Years ended December 31,</i> | 2012 | 2011 |
|---|-----------------|-----------|
| | \$000s | \$000s |
| Balance, beginning of the year | 121,152 | 119,991 |
| Additions | | |
| Cash expenditures | 31,155 | 170,693 |
| Non cash decommissioning costs | – | 1,216 |
| Dry hole expense | – | (9,733) |
| Disposal of assets | (27,680) | – |
| Exploration assets relinquished | (12,770) | (5,715) |
| Transfers to producing oil and gas properties | – | (156,786) |
| Foreign exchange | 700 | 1,486 |
| Balance, end of the year | 112,557 | 121,152 |

8. PROPERTY, PLANT AND EQUIPMENT

Within the development oil and gas properties category is the amount transferred from E&E assets for Breagh. This is not subject to depletion as the asset is not ready for its intended use. During the year ended December 31, 2012, \$2,127,000 directly attributable general and overhead costs were capitalized to development oil and gas properties (2011 – \$325,000).

Development oil and gas properties are assessed for indicators of impairment at each reporting date. At December 31, 2011, the Kirkleatham UK onshore property was indicated to be impaired due to a reduction in its reserves following escalating water production. At December 31, 2012 the remaining costs associated with Kirkleatham were written down, following a reserves report update in which the reserves were moved to contingent resources.

| Years ended December 31, | 2012 | | | 2011 | | |
|---|--|-------------------------------|-----------------|--|-------------------------------|-----------------|
| | Development Oil & Gas Properties \$000s | Corporate and Other \$000s | Total \$000s | Development Oil & Gas Properties \$000s | Corporate and Other \$000s | Total \$000s |
| Cost | | | | | | |
| Balance, beginning of the year | 170,790 | 1,118 | 171,908 | – | 615 | 615 |
| Additions | | | | | | |
| – Cash expenditures | 83,196 | 553 | 83,749 | 9,922 | 496 | 10,418 |
| – Non-cash decommissioning costs | 3,406 | – | 3,406 | 3,783 | – | 3,783 |
| Transfers from E&E assets | – | – | – | 156,786 | – | 156,786 |
| Foreign exchange differences | 4,273 | 19 | 4,292 | 299 | 7 | 306 |
| Balance, end of the year | 261,665 | 1,690 | 263,355 | 170,790 | 1,118 | 171,908 |
| Accumulated depreciation and depletion | | | | | | |
| Balance, beginning of the year | (4,002) | (560) | (4,562) | – | (402) | (402) |
| Depreciation and depletion | (40) | (376) | (416) | (1,053) | (153) | (1,206) |
| Impairment of oil and gas properties | (2,647) | – | (2,647) | (2,930) | – | (2,930) |
| Foreign exchange differences | (8) | (10) | (18) | (19) | (5) | (24) |
| Balance, end of the year | (6,697) | (946) | (7,643) | (4,002) | (560) | (4,562) |
| Net book value | | | | | | |
| Balance, beginning of the year | 166,788 | 558 | 167,346 | – | 213 | 213 |
| Balance, end of the year | 254,968 | 744 | 255,712 | 166,788 | 558 | 167,346 |

9. DERIVATIVE FINANCIAL INSTRUMENTS

As a requirement of the credit facility, described below, the Company has purchased monthly cash-settled put options to hedge 40 percent of the originally forecast gas production volumes from proved reserves (P90) from the first phase of Breagh development, for a 24-month period starting on October 1, 2012. The strike price for the options is 55 pence per 100,000 British thermal units (therm) and the total volume hedged is 10.1 billion cubic feet (Bcf). Half of the put options were purchased for an upfront cash premium of £2,195,000, (\$3,543,000) and the other half on a deferred premium basis for a total cost of £2,713,000 (\$4,368,000), to be settled on a monthly basis during the option exercise period.

The Company has recognized the up-front premium paid for the put options as a derivative financial asset. The derivatives are then revalued to their fair value at period-ends. For the deferred-premium put options, the Company has recognized a derivative financial liability for the discounted cost of those premiums, offset by their revaluation at period-ends. Any gain or loss arising is recorded through the income statement in the same period. For the year ended December 31, 2012, the Company has recognized an unrealized loss of \$4,182,000 (2011 – \$2,499,000), resulting in an unrealized loss on derivative financial instruments.

As at December 31, 2012 the forward curve for the period covered by the options ranges between 59 pence and 72 pence per therm, and as a result the options purchased are currently out-of-the-money.

Disclosure levels:

All of the Company's transactions for derivative financial instruments are conducted in active markets. The Company classifies their fair value according to the following hierarchy, based on the nature of observable inputs used to value the instrument.

Level I

Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide continuous pricing information.

Level II

Pricing inputs are other than quoted prices in active markets included in Level I. Prices in Level II are either directly or indirectly observable as of the reporting date. Level II valuations are based on inputs, including quoted forward prices for commodities, time value, credit risk and volatility factors, which can be substantially observed or corroborated in the marketplace.

Level III

Valuations are made using inputs for the asset or liability that are not based on observable market data.

The Company's derivative financial instruments have been classified as Level II. Assessment of the significance of a particular input into the fair-value measurement requires judgment and may affect the placement within the fair value hierarchy.

10. PROVISIONS

The following is a continuity of provisions:

| Years ended December 31, | 2012 | | | 2011 | | |
|--------------------------------|---------------------------|-----------------|-----------------|---------------------------|-----------------|-----------------|
| | Decommissioning \$000s | Other \$000s | Total \$000s | Decommissioning \$000s | Other \$000s | Total \$000s |
| Balance, beginning of the year | 7,056 | 1,163 | 8,219 | 1,814 | 1,900 | 3,714 |
| Arising during the year | 3,406 | – | 3,406 | 3,865 | – | 3,865 |
| Obligation disposal | (131) | – | (131) | – | – | – |
| Revisions to estimates | – | – | – | 1,134 | (653) | 481 |
| Foreign exchange differences | 178 | 25 | 203 | 55 | (84) | (29) |
| Accretion of discount | 301 | – | 301 | 188 | – | 188 |
| Balance, end of the year | 10,810 | 1,188 | 11,998 | 7,056 | 1,163 | 8,219 |

Decommissioning Obligations

The Company's decommissioning obligations result from net ownership interests in petroleum and natural gas interests in which there has been exploration, appraisal and development activity. The provision is the discounted present value of the estimated cost, using existing technology at current prices. The Company estimates the total undiscounted amount of cash flows required to settle its decommissioning obligations as at December 31, 2012 to be approximately \$24,928,000, which will be incurred between 2013 and 2036. This figure increased during 2012 due to the Breagh facilities development and the drilling campaign, though was partly offset by a reduction in the obligation due to the Company's sale of equity in Cladhan. Two wells on the Sheryl licence are to be abandoned during 2013 and this portion of the decommissioning obligation, \$790,000, has been made a current liability. Risk free interest rates based on UK long-term government bond rates varying from 3.75 percent to 4.75 percent (December 31, 2011 – 3.75 to 4.75 percent) and an inflation rate of 2 percent (December 31, 2011 – 2 percent) were used to calculate the decommissioning obligations at December 31, 2012.

Other Provisions

Provisions of \$1,188,000 at December 31, 2012 have been reduced from \$1,900,000 at December 31, 2010. This provision was set up in 2010 to provide for an underpayment of employment taxes, associated interest and possible penalties relating to the Company's share option plan for UK employees. In the first quarter of 2011, certain affected individuals were determined to be non-resident and, therefore unaffected by the UK regulations, and the provision was reduced accordingly. The Company believes that resolution with the relevant parties will be reached early in 2013.

11. LONG-TERM DEBT

The Company has a senior secured credit facility for up to £105 million (\$169 million) with BNP Paribas, Commonwealth Bank of Australia, GE Energy Financial Services and Societe Generale (the "Senior Lenders") to fund the Phase 1 development of the Breagh gas field (Sterling 30 percent) and related costs (the "Credit Facility"). The Credit Facility comprises a main tranche of £95 million (\$153 million) and a cost-overflow tranche of £10 million (\$16 million). The interest rate on the main tranche currently has a margin of 4 percent over LIBOR, which will drop to 3.5 percent over LIBOR in the period following project completion, and for the cost-overflow tranche the margin is 4.5 percent over LIBOR. In common with most other asset-secured financings of this type, no proceeds of natural gas sales from the field will be available to the Company until the satisfaction of project completion tests following the successful drilling and testing of all the Phase 1 wells.

The loan repayment schedule runs from January 1, 2014 to December 31, 2017, but the Credit Facility contains a cash sweep mechanism whereby a proportion of surplus cash (after meeting capital and operating costs and debt service requirements as defined in the Credit Facility agreement) is used to pay down the loan ahead of scheduled loan repayment. The security package provided to the Senior lenders includes a fixed and floating charge over the assets of Sterling's wholly-owned UK subsidiary, a charge of the shares of that subsidiary, a parent guarantee and other security arrangements common for a loan of this nature.

Availability under the two tranches is normally recalculated every six months with reference to the future cash flows expected to be generated by the Breagh gas field and certain cover ratios and other loan parameters. At the end of December 2012, a redetermination indicated a reduction of main tranche availability of £15.0 million (\$24 million) (availability under the cost overrun tranche was unaffected) leading to a requirement to repay this amount of the loans. The Credit Facility was amended on December 31, 2012 to defer the partial loan repayment date, which (after several other amendments) was subsequently extended to the earlier of: (1) the completion of the Romanian Carve-out Transaction (see note 7) and (2) June 30, 2013. The amendments also provided that the proportion of surplus cash used to pay down the loan ahead of scheduled loan repayment in the cash sweep mechanism referred

to above was increased from 75 percent to 100 percent. As of December 31, 2012, the main tranche of the Credit Facility was £77.9 million (\$125.4 million) drawn and the cost overrun tranche of the Credit Facility was £10.0 million (\$16.1 million) drawn, with no further availability under either tranche.

The credit facility also contains restrictions on the ability of Sterling UK to move cash to the parent company Sterling Resources Ltd. Subsequent to the year ended December 31, 2012, in early January 2013, the Company received a waiver from the Senior Lenders of a default arising from a partial repayment of an inter-company loan by Sterling UK in December 2012. This partial repayment was subsequently reversed, upon which the breach was waived by a waiver and amendment letter effective January 7, 2013. As a result of the breach not being waived prior to December 31, 2012, the Company's long-term debt is presented as a current liability at the reporting date.

The Credit Facility originally had a requirement for the Company to prepare cash flow statements (the "Cash Flow Statements") at the end of every quarter demonstrating a minimum aggregate cash balance within the Company of at least £20 million (\$32 million) at the end of each of the following 12 months. A waiver was received by the Company from the Senior Lenders removing this requirement in any Cash Flow Statements submitted before June 30, 2013. For Cash Flow Statements prepared on or after project completion, the minimum cash balance is reduced to £7 million (\$11 million). Any cash balance accumulating in the Company's restricted account used to receive and hold net cash flows from the Breagh field does not count towards this minimum cash balance. An amount of £10 million (\$16 million) had previously been held in a restricted account and reported as "non-current restricted cash" in the Company's financial statements, but as a result of the size of the cost overrun, pursuant to the Credit Facility agreement this amount is now available to fund Breagh Costs.

| <i>Years ended December 31</i> | 2012 | 2011 |
|-----------------------------------|----------------|---------|
| <i>\$000s</i> | | |
| Balance, beginning of the year | 72,818 | – |
| Proceeds from loan funds | 64,116 | 77,392 |
| Transaction costs | (41) | (4,766) |
| Amortization of transaction costs | 823 | 192 |
| Foreign exchange differences | (125) | – |
| Balance, end of the year | 137,591 | 72,818 |

12. COMMITMENTS AND CONTINGENCIES

Commitments as of December 31, 2012 for the years 2013 through 2017 and thereafter, excluding amounts held in escrow and shown as restricted cash are comprised of the following:

| | 2013 | 2014 | 2015 | 2016 | 2017 | Thereafter | Total |
|----------------------------------|---------------|---------------|---------------|---------------|---------------|-------------------|----------------|
| | <i>\$000s</i> | <i>\$000s</i> | <i>\$000s</i> | <i>\$000s</i> | <i>\$000s</i> | <i>\$000s</i> | <i>\$000s</i> |
| Facilities, oil and gas drilling | 55,115 | 38,418 | 19,318 | – | – | – | 112,851 |
| Seismic | 4,223 | 2,254 | – | – | – | – | 6,477 |
| Licence fees | 1,418 | 1,414 | 1,814 | 2,412 | 3,102 | – | 10,160 |
| Other operating | 758 | 336 | 294 | 561 | 466 | 522 | 2,937 |
| Office and other leases | 1,136 | 721 | 648 | 606 | 605 | 2,423 | 6,139 |
| | 62,650 | 43,143 | 22,074 | 3,579 | 4,173 | 2,945 | 138,564 |

The above facilities and oil and natural gas drilling commitment in 2013 relates to the firm development wells contracted to be drilled and the additional facilities required as part of the Breagh Phase 1 development and drilling obligations in Romania.

13. SHARE CAPITAL

Authorized share capital consists of an unlimited number of common shares without nominal or par value. The holders of common shares are entitled to one vote per share and are entitled to receive dividends as recommended by the Board of Directors. Share capital issued and outstanding is as follows:

| Years ended December 31, | 2012 | | 2011 | |
|---|----------------|------------------|----------------|------------------|
| | Shares 000s | Amount \$000s | Shares 000s | Amount \$000s |
| Continuity of Common Shares | | | | |
| Balance, beginning of the year | 222,644 | 337,711 | 188,944 | 290,444 |
| Issued for cash: | | | | |
| – public equity issuances | – | – | 32,143 | 45,000 |
| – exercise of stock options | 225 | 343 | 1,557 | 3,408 |
| Share issuance costs | – | – | – | (2,480) |
| Transferred from contributed surplus on exercise of options | – | 167 | – | 1,339 |
| Balance, end of the year | 222,869 | 338,221 | 222,644 | 337,711 |

On August 16, 2011 the Company completed a bought-deal financing arrangement with a syndicate of underwriters for the issuance of 32,143,000 common shares at a price of \$1.40 per common share for net proceeds of \$42,520,000, after fees and expenses.

14. BAD DEBT EXPENSE

During the second quarter of 2011, the Company made a provision of \$6,792,000 against recovery of overdue amounts receivable from a co-venturer in the unsuccessful Grian well on block 48/28b in the UK Southern North Sea, drilled in the first quarter of 2011.

15. SEGMENTED INFORMATION

The Company has four geographical reporting segments. Canada is the location of the head office. The United Kingdom, Romania and other international locations are involved in exploration and development operations. Other international comprises operations in France and Netherlands.

| | Canada | United Kingdom | Romania | Other International | Consolidated |
|--------------------------------------|----------------|-----------------|----------------|---------------------|-----------------|
| Segmented Results | \$000s | \$000s | \$000s | \$000s | \$000s |
| Year ended December 31, 2012 | | | | | |
| Revenues | – | 66 | – | – | 66 |
| Impairment of oil and gas properties | – | (2,647) | – | – | (2,647) |
| Net loss | (5,361) | (31,230) | (8,619) | (4,251) | (49,461) |
| Year ended December 31, 2011 | | | | | |
| Revenues | – | 1,258 | – | – | 1,258 |
| Impairment of oil and gas properties | – | (2,930) | – | – | (2,930) |
| Bad debt expense | – | (6,792) | – | – | (6,792) |
| Dry hole expense | – | (9,733) | – | – | (9,733) |
| Net loss | (8,630) | (34,379) | (7,450) | (3,364) | (53,823) |

| | Canada | United Kingdom | Romania | Other International | Consolidated |
|--|--------|----------------|---------------|---------------------|----------------|
| Segmented Results | \$000s | \$000s | \$000s | \$000s | \$000s |
| Year ended December 31, 2012 | | | | | |
| E&E assets | – | 54,522 | 50,197 | 7,838 | 112,557 |
| E&E asset additions | – | 4,277 | 22,653 | 4,225 | 31,155 |
| Development properties | – | 254,968 | – | – | 254,968 |
| Development property additions | – | 83,196 | – | – | 83,196 |
| Year ended December 31, 2011 | | | | | |
| E&E assets | – | 89,995 | 27,544 | 3,613 | 121,152 |
| E&E asset additions (excluding transfers) | – | 40,128 | 296 | 3,428 | 43,852 |
| Development properties | – | 166,788 | – | – | 166,788 |
| Development property additions | – | 127,030 | – | – | 127,030 |

16. SHARE-BASED COMPENSATION

The Company has established a stock option plan whereby it may grant equity-settled options to its directors, officers, employees and consultants. On December 31, 2012 there were 12,803,000 (December 31, 2011 – 19,040,000) 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 grant date. An 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:

| Years ended December 31, | 2012 | | 2011 | |
|-------------------------------------|----------------|---------------------------------|---------|---------------------------------|
| | Options | Weighted Average Exercise Price | Options | Weighted Average Exercise Price |
| | 000s | \$ | 000s | \$ |
| Continuity of Common Share Options | | | | |
| Balance, beginning of the year | 14,865 | 2.07 | 11,949 | 2.18 |
| Granted during the year | 195 | 1.71 | 5,090 | 1.88 |
| Exercised/released during the year | (225) | 1.52 | (1,557) | 2.19 |
| Cancelled/forfeited during the year | (730) | 3.38 | (33) | 2.00 |
| Expired during the year | (1,302) | 1.89 | (584) | 2.27 |
| Outstanding, end of the year | 12,803 | 2.02 | 14,865 | 2.07 |
| Exercisable, end of the year | 7,636 | 2.04 | 5,070 | 2.11 |

The Black-Scholes option pricing model was used to calculate the fair value of the options granted during the period using the following weighted average assumptions:

| <i>Years ended December 31,</i> | 2012 | 2011 |
|---|------------------|-----------|
| Weighted average share price | \$1.71 | \$1.88 |
| Weighted average exercise price | \$1.71 | \$1.88 |
| Risk-free interest rate | 1.12% | 1.97% |
| Weighted-average forfeiture rate | 1.65% | 1.98% |
| Expected hold period to exercise | 3.5 years | 3.5 years |
| Volatility in the price of the Company's shares | 75.4% | 77.3% |
| Expected annual dividend yield | 0% | 0% |

Volatility in the price of the Company's shares is calculated using the daily average price quoted on the TSX Venture Exchange over the period immediately preceding the issue of the option which is equivalent to the expected hold period to exercise.

The calculation of the fair value of options granted assumes an option forfeiture rate based on the cumulative historical level of forfeitures at the time the option is issued.

The weighted average fair value of options granted during the year ended December 31, 2012 was \$0.90 per share (2011 – \$1.02 per share). For the year ended December 31, 2012, \$3,275,000 (2011 – \$5,913,000) of share-based compensation was expensed and was included in the employee expense figure of \$7,152,000 (2011 – \$8,975,000).

The following stock options were outstanding as at December 31, 2012:

| Exercise Price | | Options Outstanding | | | Options Exercisable | | |
|----------------|-------|---------------------|--------------------|---------------------------|---------------------|--------------------|---------------------------|
| | | Options | Remaining Contract | Weighted Average Exercise | Options | Remaining Contract | Weighted Average Exercise |
| From \$ | To \$ | 000s | Life (Days) | Price | 000s | Life (Days) | Price |
| 1.29 | 1.49 | 2,567 | 544 | 1.40 | 2,000 | 378 | 1.41 |
| 1.50 | 1.99 | 4,660 | 836 | 1.81 | 1,720 | 476 | 1.83 |
| 2.00 | 2.49 | 2,440 | 517 | 2.03 | 1,613 | 329 | 2.03 |
| 2.50 | 2.99 | 2,336 | 364 | 2.61 | 1,836 | 231 | 2.60 |
| 3.00 | 3.49 | 600 | 672 | 3.26 | 400 | 490 | 3.26 |
| 3.50 | 4.25 | 200 | 798 | 4.25 | 67 | 433 | 4.25 |
| 1.29 | 4.25 | 12,803 | 622 | 2.02 | 7,636 | 361 | 2.04 |

17. FINANCING COSTS

| <i>Years ended December 31,</i> | 2012 | 2011 |
|--|----------------|---------|
| | \$000s | \$000s |
| Interest expense | 6,876 | 2,015 |
| Amortization of debt issuance expense | 823 | 192 |
| Capitalization of interest and amortization of debt issuance expense | (7,699) | (2,207) |
| | - | - |
| Accretion (note 10) | 301 | 188 |
| Total financing costs | 301 | 188 |

As described in note 11, the Company entered into a Credit Facility and made its first drawdown on September 30, 2011. As the Credit Facility is used exclusively to fund the Breagh development, interest expense and the amortization of related transaction costs are capitalized to the Breagh CGU.

18. NET LOSS PER SHARE

The following reflects the loss and share data used in the computation of basic and diluted earnings per share:

| <i>Years ended December 31,</i> | 2012 | 2011 |
|--|----------------|---------|
| Weighted average shares outstanding (000s) | 222,804 | 202,418 |
| Net loss (\$000s) | 49,461 | 53,823 |
| Weighted average net loss per share (\$) | | |
| Basic | 0.22 | 0.27 |
| Diluted | 0.22 | 0.27 |

For the years ended December 31, 2012 and 2011, the dilutive effect of the Company's outstanding options was not included in diluted shares outstanding due to the net loss incurred in each period.

19. INCOME TAXES

Deferred 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, 2012, and December 31, 2011 the Company had not recognized a deferred income tax asset arising from tax pools in excess of the net book value of capital assets, share issuance costs and non-capital losses, provisions or other items.

| <i>Years ended December 31,</i> | 2012 | 2011 |
|---|-----------------|----------|
| | \$000s | \$000s |
| Loss before taxation for the year | (48,692) | (53,823) |
| Canadian statutory federal-provincial corporate tax rate | 25.0% | 26.5% |
| Computed income tax recovery at statutory rate | (12,173) | (14,263) |
| Increase (decrease) resulting from: | | |
| Share-based compensation | 819 | 1,567 |
| Other differences | 14 | 5 |
| Share issuance costs | – | (657) |
| Eligible ring fence expenditures | (26,083) | (550) |
| Rate adjustments and other | (7,039) | (26,646) |
| Derivatives and non-taxable foreign exchange | (4,625) | 266 |
| Adjustment from prior year's tax return | (5,818) | 932 |
| Change in deferred tax benefits deemed not probable to be recovered | 54,905 | 39,346 |
| Foreign tax on licence interest assignments | 769 | – |
| Income tax expense | 769 | – |

| <i>Deferred Tax Asset at December 31,</i> | 2012 | 2011 |
|--|------------------|-----------|
| | \$000s | \$000s |
| Net book value of assets in excess of tax pools | (184,881) | (157,020) |
| Share issuance costs | 1,156 | 1,915 |
| Domestic and foreign loss carry-forwards | 293,542 | 211,190 |
| Decommissioning obligations | 4,512 | 4,310 |
| Unrealized gains and losses | 1,641 | 669 |
| Less deferred tax benefits deemed not probable to be recovered | (115,970) | (61,064) |
| Deferred tax asset | - | - |

At December 31, 2012 the Company had non-capital losses of approximately \$35 million (December 31, 2011 – \$27 million) which may be applied against future income for Canadian tax purposes. These non-capital losses expire after twenty years, primarily between 2027-2032.

As at December 31, 2012 the Company also had non-expiring tax allowances of approximately \$60 million (December 31, 2011 – \$42 million) which may be applied against future income for Canadian tax purposes.

As at December 31, 2012 the Company had non-expiring non-capital losses of approximately \$463 million (December 31, 2011 – \$328 million) which may be applied against future oil and gas ring-fence income for UK tax purposes.

As at December 31, 2012 the Company had non-capital losses and other tax deductible costs of approximately \$16 million (December 31, 2011 – \$3 million) which may be applied against future income for Netherlands tax purposes. These expire after nine years from 2019 onwards.

No deferred tax asset has yet been recognized in relation to these losses because of the uncertainty regarding future taxable profits against which such losses can be offset, given the Company's lack of meaningful current production. However, the situation will be reviewed regularly.

20. RELATED-PARTY DISCLOSURE

Compensation of Key Management

Key management personnel are those persons having the authority and responsibility for planning, directing and controlling the activities of the Company as a whole. The Company determined that key management personnel consist of the Board of Directors and senior executive management of the consolidated group.

The remuneration of directors and other members of key management personnel during the years ended December 31, 2012 and 2011 was as follows:

| | 2012 | 2011 |
|---|--------------|--------|
| | \$000s | \$000s |
| Short-term employee benefits | 2,967 | 2,398 |
| Share-based payments | 1,989 | 4,115 |
| Total compensation paid to key management personnel | 4,956 | 6,513 |

There are no other related-party transactions.

21. SUBSEQUENT EVENTS

On January 8, 2013, the Company announced that it had closed on a secured US\$12 million (\$12 million) bridging loan agreement with a subsidiary of Vitol Holding B.V. ("Vitol"), an existing shareholder, (the "Loan"). The Loan bore interest at a rate of LIBOR plus 1.0 percent, payable in arrears, subject to a maximum of 2.0 percent per annum during its term. As consideration for the Loan, Vitol received 2,418,500 common shares of Sterling at a price of \$0.717 per common share. This loan was re-paid on March 22, 2013 ahead of its contractual maturity date of March 31, 2013.

On March 11, 2013 the Company announced the closing of the offering of 23,000,000 common shares in the capital of the Company by way of a short form prospectus and 61,333,334 common shares pursuant to a private placement, in each case on a bought deal basis at a price of \$0.75 per common share, which represented gross proceeds of \$63.25 million, net \$59.1 million.

On April 8, 2013, the Company announced that it had signed agreements with TAQA which ensured that the Company was in a position, regardless of the closing of the then contemplated Bond, to submit evidence of funding ability for its share of the development costs of Cladhan (the "Financing Condition") to the DECC by April 17, 2013 to enable FDP approval. These agreements also provide a full carry of development capital costs until first oil production at Cladhan, anticipated in 2015. The agreements provide for a permanent transfer in stages of a 12.6 percent interest in the Cladhan field to TAQA and a repayable carry by TAQA of development expenditures on an 11.8 percent interest in Cladhan (the "Second Carry"), which will be transferred to TAQA for the duration of the carry. The 12.6 percent interest is to be transferred in three stages, such that if the Company provides evidence of its funding ability to DECC and/or TAQA by various specified dates, a smaller interest is permanently transferred. A 3.0 percent interest was transferred on April 17, 2013, a further 3.0 percent interest if the Financing Condition is not satisfied by May 31, 2013 and the remaining 6.6 percent if not satisfied by June 30, 2013. The consideration for the transfers is the provision by TAQA of the Second Carry.

The Company retains a 2.0 percent interest in Cladhan throughout, which is funded through the budgeted development cost out of a portion of the First Carry. The rest of the First Carry, which is not repayable, is available to fund development costs on the 11.8 percent interest into approximately the second quarter of 2014, at which point the Second Carry starts funding the ongoing development costs. A 17 percent per annum uplift is applicable to such carried costs. After pay-out of the Second Carry, which is expected to occur in the second or third quarter of 2015, the 11.8 percent interest is returned to Sterling whose equity interest would then be 13.8 percent. In a downside case of higher capital expenditures, low oil prices or low production, the timing for pay-out would be delayed, but Sterling would have no further liability to TAQA. Should the 12.6 percent interest be transferred and the Second Carry received, the overall economics of this transaction are improved considerably by the fact that Sterling does not lose any of the significant historic capital allowances (approximately \$20 million as at January 1, 2013) associated with the 12.6 percent interest. As a condition of the Bond (see below), Sterling has undertaken to complete the Cladhan farm-down transaction and hence Sterling will not satisfy the Cladhan Financing Condition prior to June 30, 2013, and the farm-down of equity and the Second Carry will be triggered. At the conclusion of this arrangement, assuming pay-out, the partnership interests will be Sterling 13.8 percent, TAQA (operator) 52.7 percent and Wintershall 33.5 percent. As part of this agreement, Sterling will transfer its 12.5 percent interest in South Cladhan to TAQA for nominal consideration. Sterling retains the contingent upside payments linked to future reserves pursuant to the 2012 sale and purchase agreement.

These arrangements are subject to regulatory and partner approvals. Consent of the Senior Lenders to the Credit Facility has been granted.

On April 17, 2013, the Company announced the successful closing of the book for a US\$225 million (\$231 million) senior secured bond issue (the "Bond") issued by its UK subsidiary Sterling Resources (UK) Ltd (the "Issuer"). The net proceeds of US\$218.6 million (\$224 million) from the Bond will be used (i) to prepay the entire senior secured credit facility with a group of lending banks (approximately \$140 million), (ii) towards funding ongoing development costs of the Breagh field, including development of the eastern portion of the field (Phase 2), (iii) to prefund the first interest payment due October 2013, and (iv) for general corporate purposes (\$20 million). The Bond has a wide-ranging security package including a charge over the Issuer's interest in the Breagh and Cladhan fields and the shares of the Issuer, as well as a parent company guarantee. Under the terms of the bond, the Company is also required to maintain certain financial and non-financial covenants.

The settlement date for the Bond is expected to be April 30, 2013 (the "Settlement Date"). The Bond has a tenor of six years, and matures on April 30, 2019 based on the estimated Settlement Date. The Bond carries an interest coupon of 9 percent payable semi-annually and is callable at the option of the Issuer at any time with a call premium of 105 percent for the first three years and a roll-up of outstanding interest for the first two years. Commencing 18 months after the Settlement Date, the Bond will amortize 10 percent of the issue amount every six months, securing a rapid deleveraging of Sterling in coming years. The amortizations will be performed at a price of 105 percent of par value except for the final installment which shall be repaid at 100 percent of par value. An application will be made for the Bond to be listed on the Oslo Stock Exchange or the Nordic ABM (Oslo), which will require the UK subsidiary to be re-registered as a UK public limited company. The Bond is governed under Norwegian Law and the trustee for the Bond is Norsk Tillitsmann ASA.

CORPORATE INFORMATION

DIRECTORS

WALTER DEBONI ⁽¹⁾ ⁽⁵⁾ ⁽⁶⁾ ⁽⁷⁾ ⁽⁸⁾

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London, England

GRAEME G. PHIPPS ⁽¹⁾ ⁽²⁾ ⁽³⁾ ⁽⁸⁾
St. Helier, Jersey

⁽¹⁾ Reserves Committee

⁽²⁾ Chair of Reserves Committee

⁽³⁾ Audit Committee

⁽⁴⁾ Chair of Audit Committee

⁽⁵⁾ Governance and Compensation Committee

⁽⁶⁾ Chair of Governance and Compensation Committee

⁽⁷⁾ Chair of Special Committee

⁽⁸⁾ Special Committee

MANAGEMENT

MICHAEL J. AZANCOT
President and Chief Executive Officer

MARK BEACOM
Vice President and General Manager
Romania

DAVID M. BLEWDEN
Chief Financial Officer

STEPHEN BIRRELL
Vice President and General Manager
Netherlands and France

SHERRY L. CREMER
Treasurer and Corporate Secretary

DAVID DAVIES
Vice President Business Development

DAVID A. FINDLATER
Vice President Exploration

GRAEME HETHERINGTON
Group Financial Controller

GEORGE KESTEVEN
Manager, Corporate and Investor
Relations

JOHN M. RAPACH
Chief Operating Officer

PATRICK WHITLEY
Vice President Exploration International

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LEGAL COUNSEL

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RPS ENERGY

REGISTRAR AND TRANSFER AGENT

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

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STOCK EXCHANGE LISTING

THE TSX VENTURE EXCHANGE
Stock Exchange Trading Symbol: SLG

ANNUAL GENERAL AND SPECIAL MEETING

June 11, 2013, 10:00 a.m. MDT
The Royal Room
Metropolitan Conference Centre
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Calgary, Alberta, Canada

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