K2

ENERGY LIMITED

A.C.N. 115 310 560

Annual Report 2006

LETTER FROM THE MANAGING DIRECTOR

26th September 2006

Dear Shareholder,

I thank you again for your investment in K2 Energy Limited.

The company began operating in February 2006 and has established offices in the United States in Louisville, Kentucky and engaged the necessary geological and support staff.

The company intends to apply for ASX listing in the next few weeks, with the prospectus nearing completion. The company intends to issue 5,000,000 Shares at an issue price of 20 cents per share, to raise $1,000,000 with one free attaching option for every two shares subscribed, being the same terms on which the current shareholders, excluding the founders, have invested.

A copy of the prospectus will be forwarded to you shortly, containing detailed information on the company and including updates current projects.

I am pleased with progress of the company to date and I look forward to successfully listing the company on the ASX in the near future.

Yours sincerely,

PETER MOORE

Managing Director.

DIRECTORS' REPORT

Your directors present their report on the company and its controlled entity for the financial period ended 30 June 2006.

Directors

The names of directors in office at any time during or since the incorporation of the company on 29th August 2005 are:

Samuel M Gazal	(appointed 29th August 2005)
Peter Moore	(appointed 29th August 2005)
Bruce Moore	(appointed 29th August 2005)
Michael Reed	(appointed 18th October 2005)
Robert Kenneth Gaunt	(appointed 18th October 2005)
John Thompson	(appointed 20th July 2006)

Principal Activities

The principal activity of the economic entity during the financial period was commencement of activities as an investor in oil and gas exploration prospects.

Operating Results

The consolidated loss of the economic entity amounted to $418,032.

Dividends Paid or Recommended

There is no dividend paid, declared or recommended.

Significant Changes in State of Affairs

Other than as stated above and in the accompanying financial report, there were no significant changes in the state of affairs of the Company during the reporting period.

After Balance Date Events

The directors are not aware of any matter or circumstance that has arisen since the end of the period to the date of this report that has significantly affected or may affect:

(i) The operations of the company and the entity that it controls

(ii) The results of those operations

(iii) The state of affairs of the Company in subsequent years.

Future Developments

The company will continue to invest oil and gas exploration prospects in the United States. The company intends to issue a prospectus to raise a further $1million capital and subsequently list on the Australian Stock Exchange.

DIRECTORS' REPORT (CONTINUED)

Directors

Sam Gazal, BEc,

Non-executive Chairman

Sam has more than 35 years experience as a director of public and private companies. He graduated from Sydney University with a Bachelor of Economics. He has been a director and significant shareholder in a number of successful companies including Gazal Industries Limited, Winthrop Investments Limited, Country Television Services Limited and Sunshine Broadcasting Network Limited. He is the major shareholder and chairman of the Roslyndale group of companies.

Peter Moore, BA LLB.

Managing Director

Peter was formerly a commercial lawyer and is a director of Geoflite Inc. He has worked in the resource exploration industry since 1987, when Geoflite (Aust) Pty Ltd was first established to commercially apply the Geoflite Method on mineral and oil and gas exploration projects in Australia and the United States. He has wide commercial experience in the oil and gas exploration industry in the United States.

Professor Bruce Moore, BSc. MSc. PhD.

Non-executive Director

Professor Moore is an Emeritus Professor at the University of Kentucky where he was a Professor of Geology for 30 years. Since 1987 he has been technical director of Geoflite. Professor Moore has conducted research into airborne multi-spectral imaging techniques for fracture and joint detection and has expertise in joint and micro-fracture detection and their application to oil and gas and mineral exploration. He has also developed the proprietary Geoflite soil geochemistry Method over many years and has worked extensively in the oil and gas exploration industry. Professor Moore has over 40 years' experience in resource exploration.

Michael Reed, BSc, (Hons) CPG,AAPG

Non-executive Director

Michael is a 1982 honours graduate in geology from the University of Kentucky and a Certified Petroleum Geologist with the American Association of Petroleum Geologists. He has 24 years' experience in oil and gas exploration and investment, currently as President of Aspen Energy, Inc. and formerly as Vice President of Tenexco Inc. based in Louisville, Kentucky, USA. Mike has overseen in excess of 350 oil and gas drilling ventures, investing more than $50,000,000 over the past 10 years throughout the main oil and gas producing regions of the USA. He has highly specialized expertise in screening and evaluating the type of drilling opportunities that will be the focus of K2 Energy Ltd.

Robert Kenneth (Ken)Gaunt

Non-executive Director

Ken enjoyed significant commercial success since founding Electronic Banking Solutions Pty Ltd in 1998. As Managing Director, Ken developed the business before merging with Cash Card Australia Limited in 2003. Ken has been director of Cash Card Australia Limited and is an investor in many successful businesses in Australia and elsewhere. Ken was a board member and Australia's representative of the ATM industry association and was a member of the customer advisory board of National Cash Register Company Limited.

John Thompson, B.Com

Non-executive Director

John has strong experience in general management of resources and scientific companies. Most recently he led the Geochemistry Division of an international testing and verification business. He has also had general management responsibility for oil services companies. He has been a Director of Bank of Western Australia and at one time led the Stock Exchange in Perth. He is now a Director of several private and public companies involved in oil and mineral services. He has concentrated on private equity situations and has led successful buyout opportunities in the past. He was educated at University of Western Australia in Accounting and Commercial Law.

DIRECTORS' REPORT (CONTINUED)

Board Member's Directorships

Listed below are details of listed public company directorships held by Board Members over the last three years.

Director	Directorship of	Date Appointed	Date Resigned
Samuel Gazal	No other listed public company directorship	-	-
Peter Moore	No other listed public company directorship	-	-
Bruce Moore	No other listed public company directorship	-	-
Mike Reed	No other listed public company directorship	-	-
Robert Kenneth Gaunt	No other listed public company directorship	-	-
John Thompson	Pharmaust Limited	4th July 2005	-

Directors' Interests in Securities

As at the date of this report, details of Directors who hold shares or options in the company for their own benefit or who have an interest in holdings through a third party are detailed below.

Director	Shares	Options over Ordinary Shares
Samuel Gazal*	3,250,000	2,250,000
Peter Moore**	18,500,000	18,500,000
Bruce Moore **	18,500,000	18,500,000
Mike Reed ***	3,000,000	3,000,000
Robert Kenneth Gaunt****	4,250,000	2,375,000
John Thompson*****	1,250,000	1,250,000

*Of which 2,950,000 shares and 2,100,000 options are held by Balander Pty Limited (Superannuation Fund account) of which Mr Gazal is a director and a beneficiary of the fund and 300,000 shares and 150,000 options are held by Roslyndale Pty Limited (Superannuation Fund account) of which Mr Gazal is a director and a beneficiary of the fund.

** Held by Edward Meadows Pty Limited (as trustee for The Moore Investment Trust) of which Mr Peter Moore is a director and Messrs P & B Moore are beneficiaries.

*** Held by Aspen Energy Inc. in which Mr Reed is a shareholder

****Held by Blazzed Pty Limited (as trustee for The Gaunt Management Trust) of which Mr Gaunt is a shareholder and is a director.

*****Held by Bookspan Pty Limited of which Mr Thompson is a shareholder and a director.

Meetings of Directors

The numbers of meetings o the Company's Board of Directors and each board committee held during the period to 30 June 2006 and the numbers of meetings attended by each director were:-

	DIRECTORS' MEETINGS	
	Number eligible to attend	Number Attended
Samuel Gazal	8	8
Peter Moore	8	8
Bruce Moore	8	2
Mike Reed	4	4
Robert Kenneth Gaunt	4	4
John Thompson	0	0

DIRECTORS' REPORT (CONTINUED)

Indemnifying Directors or Officers

Each Director has entered into a Deed with the Company under which the Director is given access to documentation and in addition is:

- indemnified by the Company to the full extent permitted by law against all liabilities sustained or incurred through acting as a Director (under the Corporations Act the indemnity does not extend to a liability owed to the Company or its related bodies corporate, or which arises out of conduct involving a lack of good faith, or is for a pecuniary penalty order under section 1317G of the Corporations Act or a compensation order under section 1317H of the Corporations Act);
- indemnified by the Company to the full extent permitted by law against legal costs and expenses incurred in defending an action for a liability incurred as an officer of the Company (under the Corporations Act the indemnity does not extend to costs incurred in circumstances where the Director is found to have a liability for which the Director cannot be indemnified, or costs of defending or resisting criminal proceedings in which the Director is found guilty or defending proceedings brought by ASIC or a liquidator for a court order where the court holds that the grounds for making the order are established, or costs of proceedings seeking relief for the Director under the Corporations Act where the court denies relief);
- entitled to a loan to meet the costs of defending or responding to any such claim or proceeding; and
- entitled to have the Company maintain and pay premiums in respect of directors' and officers' insurance.

Corporate Governance

In recognising the need for the highest standards of corporate behavior and accountability, the directors of K2 Energy Limited support and have adhered to key principles of corporate governance.

Environmental regulations

During the financial year, there were no incidents noted significant impact on the workplace, the community, the environment or any regulatory breaches.

The consolidation entity is committed to achieving a high standard of environmental performance and adherence to occupational health and safety ("OH&S") best practice.

Proceedings on Behalf of Company

No person has applied for leave of Court to bring proceedings on behalf of the company or intervene in any proceedings to which the company is a party for the purpose of taking responsibility on behalf of the company for all or any part of those proceedings.

The company was not a party to any such proceedings during the period.

DIRECTORS' REPORT (CONTINUED)

Options

At the date of this report, the unissued ordinary shares of K2 Energy Limited under option, including options that were granted over unissued shares during or since the end of the financial period by the company to directors or any of the five most highly remunerated officers as part of their remuneration are detailed below:

Optionholder	Exercise price (cents)	Options
Samuel Gazal *	20 cents	2,250,000
Peter Moore **	20 cents	18,500,000
Bruce Moore **	20 cents	18,500,000
Mike Reed ***	20 cents	3,000,000
Robert Kenneth Gaunt ****	20 cents	2,375,000
John Thompson *****	20 cents	1,250,000
		27,375,000

*Of which 2,950,000 shares and 2,100,000 options are held by Balander Pty Limited (Superannuation Fund account) of which Mr Gazal is a director and a beneficiary of the fund and 300,000 shares and 150,000 options are held by Roslyndale Pty Limited (Superannuation Fund account) of which Mr Gazal is a director and a beneficiary of the fund.

** Held by Edward Meadows Pty Limited (as trustee for The Moore Investment Trust) of which Mr Peter Moore is a director and Messrs P & B Moore are beneficiaries.

*** Held by Aspen Energy Inc. in which Mr Reed is a shareholder

****Held by Blazzed Pty Limited (as trustee for The Gaunt Management Trust) in which Mr Gaunt is a shareholder and is a director.

*****Held by Bookspan Pty Limited of which Mr Thompson is a shareholder and a director. At the date of this report there are 51,000,000 options on issue, each exercisable over 1 ordinary share on payment of 20 cents per share. These can be exercised between 1st October 2006 and 30th September 2009.

No person entitled to exercise the option had or has any right by virtue of the option to participate in any share issue of any other body corporate.

DIRECTORS' REPORT (CONTINUED)

REMUNERATION REPORT

This report details the nature and amount of remuneration for each director of K2 Energy Limited and for the executive receiving the highest remuneration.

Remuneration Policy

The remuneration policy of K2 Energy Limited has been designed to align director and executive objectives with shareholder and business objectives by providing a fixed remuneration component and offering specific long-term incentives based on key performance areas affecting the economic entity's financial results. The board of K2 Energy Limited believes the remuneration policy to be appropriate and effective in its ability to attract and retain the best executives and directors to run and manage the economic entity, as well as create goal congruence between directors, executives and shareholders.

The board's policy for determining the nature and amount of remuneration for board members and senior executives of the economic entity is as follows:

The remuneration policy, setting the terms and conditions for the executive director was developed by the remuneration committee which currently is the entire board, with the exception of the Managing Director. The Managing Director receives a total remuneration package, which may include a base salary (commensurate with his expertise and experience), superannuation, and fringe benefits. The remuneration committee reviews executive packages annually by reference to the economic entity's performance, executive performance and comparable information from industry sectors and other listed companies in similar industries.

The performance of executives is measured with each executive and is based predominantly on the forecast growth of the company financial performance and shareholders' value. All bonuses and incentives must be linked to predetermined performance criteria. Any changes must be justified by reference to measurable performance criteria. The policy is designed to attract the highest calibre of executives and reward them for performance that results in long-term growth in shareholder wealth.

The executive director receives a superannuation contribution of 9% as part of this package, and does not receive any other retirement benefits.

All remuneration paid to directors and executives is valued at the cost to the company and expensed.

The remuneration committee determines payments to the non-executive directors and reviews their remuneration annually, based on market practice, duties and accountability. The maximum aggregate amount of fees that can be paid to non-executive directors is subject to approval by shareholders at the Annual General Meeting. At present no fees have been approved.

Performance Based Remuneration

There is currently no performance based remuneration.

Company Performance, Shareholder Wealth and Directors' and Executives' Remuneration

The remuneration policy has been tailored to increase goal congruence between shareholders and directors and executives. Currently all directors hold shares and options in the company, which provides an incentive to increase shareholder wealth over the medium term.

The board will review its remuneration policy annually to ensure it is effective.

Performance Income as a Proportion of Total Remuneration

There is currently no performance based remuneration.

Options Issued as Part of Remuneration for the period ended 30 June 2006

No options were issued to directors and executives as part of their remuneration.

Employment Contracts of Directors and Senior Executives

The employment conditions of the managing director, Peter Moore, the executive director is formalised in a contract of employment. No contract is for a fixed term. The contract states he can be terminated by the company by giving up to three months notice and by paying a redundancy of three months.

DIRECTORS' REPORT (CONTINUED)

Directors' and Key Management Personnel remuneration

The following table discloses the remuneration of Directors and Key Management Personnel of the company and the consolidated entity for the period ended 30 June 2006.

Key Management Person	Short-term Benefits		Post-employment Benefits	Total	Performance Related
	Salary and commissions	Non-cash benefit	Super-annuation		
	$	$	$	$	%
Samuel Gazal	-	-	-	-	-
Peter Moore	50,968	-	4,587	55,555	-
Bruce Moore	-	-	-	-	-
Mike Reed	-	-	-	-	-
Robert Kenneth Gaunt	-	-	-	-	-
	50,968	-	4,587	55,555	-

Other than the directors there were no key management personnel for the consolidated entity for the period ended 30th June 2006.

Payments made to Director Related entities

During the period the group paid amounts to directors or director related entities as follows:-

- Amount of $55,555 was paid to Winchester Associates Pty Limited (a company associated with Mr Gazal) for advisory services.
- Amounts of $83,949 for advisory services and $6,447 for rent were paid to Aspen Energy Inc (a company associated with Mr Reed).
- Amount of $83,949 was paid to Geoflite Inc (a company associated with Messrs B and P Moore) for technical and advisory services.
- Amount of $167,898 was paid to Bruce Moore for licensing fees in relation to the Geoflite technology.

Other Information

Non-audit Services

The board of directors, in accordance with advice from the audit committee, is satisfied that the provision of non-audit services during the period is compatible with the general standard of independence for auditors imposed by the *Corporations Act 2001*. The directors are satisfied that the services disclosed below did not compromise the external auditor's independence for the following reasons:

- all non-audit services are reviewed and approved by the audit committee prior to commencement to ensure they do not adversely affect the integrity and objectivity of the auditor; and
- the nature of the services provided do not compromise the general principles relating to auditor independence as set out in the Institute of Chartered Accountants in Australia and CPA Australia's Professional Statement F1: Professional Independence.

The following fees for non-audit services were paid/payable to the external auditors during the period ended 30 June 2006:

	$
Taxation services	-
Due diligence investigations	-
	-

Auditor’s Independence Declaration

The auditor’s independence declaration for the period ended 30 June 2006 is set out on page 27 of this annual report.

Signed in accordance with a resolution of the Board of Directors.

Samuel M Gazal

Chairman

Dated 26th September 2006

INCOME STATEMENT
FOR THE PERIOD ENDED 30 JUNE 2006

	Note	Economic Entity 2006 $	Parent Entity 2006 $
Revenue	2	214,076	214,076
Other income	2	60,701	60,701
Administrative expenses		(341,358)	(168,425)
Depreciation and amortisation expense		(1,056)	-
Employee benefits expense		(60,701)	(55,555)
Exploration and evaluation expenditure written off		(106,557)	-
Licence fees		(167,898)	-
Profit /(loss) before income tax		(402,793)	50,797
Income tax (expense)/benefit	3	(15,239)	(15,239)
Profit/ (loss) attributable to members of the parent entity		(418,032)	35,558
Basic earnings per share (cents)	19	(1.0)	
Diluted earnings per share (cents)	19	(1.0)	

The accompanying notes form part of these financial statements.

BALANCE SHEET
AS AT 30 JUNE 2006

	Note	Economic Entity 2006 $	Parent Entity 2006 $
CURRENT ASSETS			
Cash and cash equivalents	4	9,498,659	9,237,942
Trade and other receivables	5	3,682	828,746
TOTAL CURRENT ASSETS		9,502,341	10,066,688
NON-CURRENT ASSETS			
Investment	6	-	137,596
Property, plant and equipment	7	15,688	-
Exploration and evaluation expenditure	8	584,037	-
Deferred tax assets	11	2,162	2,162
TOTAL NON-CURRENT ASSETS		601,887	139,758
TOTAL ASSETS		10,104,228	10,206,446
CURRENT LIABILITIES			
Payables	9	368,731	23,487
TOTAL CURRENT LIABILITIES		368,731	23,487
NON-CURRENT LIABILITIES			
Provisions	10	9,749	-
Deferred tax liabilities	11	17,401	17,401
TOTAL NON-CURRENT LIABILITIES		27,150	17,401
TOTAL LIABILITIES		395,881	40,888
NET ASSETS		9,708,347	10,165,558
EQUITY			
Issued capital	12	10,130,000	10,130,000
Foreign currency translation reserve		(3,621)	-
Retained earnings/ (accumulated losses)		(418,032)	35,558
TOTAL EQUITY		9,708,347	10,165,558

The accompanying notes form part of these financial statements.

STATEMENT OF CHANGES IN EQUITY
FOR THE PERIOD ENDED 30 JUNE 2006

Economic Entity

	Note	Issued Capital	Foreign Currency Translation Reserve	Accumulated Losses	Total
		$	$	$	$
Shares issued during the year	12	10,130,000	-	-	10,130,000
Adjustments from translation of foreign controlled entities		-	(3,621)	-	(3,621)
Profit/(loss) attributable to members of parent entity		-	-	(418,032)	(418,032)
Balance at 30 June 2006		10,130,000	(3,621)	(418,032)	9,708,347

Parent Entity

	Note	Issued Capital	Retained Earnings	Total
		$	$	$
Shares issued during the year		10,130,000	-	10,130,000
Profit/(loss) attributable to members of parent entity		-	35,558	35,558
Balance at 30 June 2006		10,130,000	35,558	10,165,558

The accompanying notes form part of these financial statements.

CASH FLOW STATEMENT
FOR THE PERIOD ENDED 30 JUNE 2006

	Note	Economic Entity 2006 $	Parent Entity 2006 $
Cash flows from operating activities			
Payments to suppliers and employees		(138,080)	(143,474)
Interest received		214,076	214,076
Net cash inflow/(outflow) from operating activities	17	75,996	70,602
Cash flows from investing activities			
Investment in subsidiary company		-	(137,596)
Payments for exploration and evaluation		(690,594)	-
Payments for property, plant and equipment		(16,743)	-
Net cash inflow/(outflow) from investing activities		(707,337)	(137,596)
Cash flows from financing activities			
Advance to subsidiary company		-	(825,064)
Proceeds from issue of shares (net of issue costs)		10,130,000	10,130,000
Net cash inflow/(outflow) from financing activities		10,130,000	9,304,936
Net increase/(decrease) in cash held		9,498,659	9,237,942
Cash at the end of the financial period	16	9,498,659	9,237,942

The accompanying notes form part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE PERIOD ENDED 30 JUNE 2006

1. STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

The financial report is a general purpose financial report that has been prepared in accordance with Australian Accounting Standards, Urgent Issues Group Interpretations, other authoritative pronouncements of the Australian Accounting Standards Board and the Corporations Act 2001.

The financial report covers the economic entity of K2 Energy Limited and its controlled entity, and K2 Energy Limited as an individual parent entity. K2 Energy Limited is a listed public company, incorporated and domiciled in Australia.

The financial report of K2 Energy Limited and controlled entities, and K2 Energy Limited as an individual parent entity comply with all Australian equivalents to International Financial Reporting Standards.

The following is a summary of the material accounting policies adopted by the economic entity in the preparation of the financial report. The accounting policies have been consistently applied, unless otherwise stated.

The financial report has been prepared on an accruals basis and is based on historical costs and does not take into account changing money values or, except where stated, current valuations of non-current assets.

(a) Principles of Consolidation

A controlled entity is any entity K2 Energy Limited has the power to control the financial and operating policies of so as to obtain benefits from its activities. A list of controlled entities is contained in Note 15 to the financial statements.

All inter-company balances and transactions between entities in the economic entity, including any unrealised profits or losses, have been eliminated on consolidation.

Where controlled entities have entered or left the economic entity during the period, their operating results have been included from the date control was obtained or until the date control ceased.

(b) Income Tax

The charge for current income tax expense is based on the profit for the period adjusted for any non-assessable or disallowed items. It is calculated using the tax rates that have been enacted or are substantially enacted by the balance date.

Deferred tax is accounted for using the balance sheet liability method in respect of temporary differences between the tax bases of assets and liabilities and their carrying amounts in the financial statements. No deferred income tax will be recognised from the initial recognition of an asset or liability, excluding a business combination, where there is no effect on accounting or taxable profit or loss.

Deferred tax is calculated at the tax rates that are expected to apply to the period when the asset or liability is settled. Deferred tax is credited in the income statement except where it relates to items that may be credited directly to equity, in which case the deferred tax is adjusted directly against equity.

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

The amounts of benefits brought to account or which may be realised in the future is based on the assumption that no adverse change will occur in income tax legislation and the anticipation that the economic entity will derive future assessable income to enable the benefit to be realised and comply with the conditions of deductibility imposed by the law.

(c) Plant and equipment

Plant and equipment are recorded at cost less, where applicable, any accumulated depreciation and impairment losses.

The carrying amount of plant and equipment is reviewed annually by directors to ensure it is not in excess of the recoverable amount from these assets. The recoverable amount is assessed on the basis of the expected net cash flows which will be received from the assets employment and subsequent disposal. The expected net cash flows have been discounted to their present values in determining recoverable amounts.

(d) Depreciation

The depreciable amount of all fixed assets including capitalised leased assets, is depreciated on a straight line basis over their useful lives to the economic entity commencing from the time the asset is held ready for use. Leasehold improvements are depreciated over the shorter of either the unexpired period of the lease or the estimated useful lives of the improvements.

1. STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

(e) Interest in Joint Ventures

Within the oil and gas industry it is common practice to conduct joint operations within unincorporated joint venture structures to spread risks, preserve taxation allowances and provide flexibility for entry and exit.

As a non-operator participant in joint ventures, the economic entity incurs and recognises its share of costs for the joint ventures. The financial performance and position of the economic entity therefore only recognises the economic entity's interest in the assets, liabilities, revenue and expenses of the joint venture operation.

(f) Exploration, Evaluation, Development and Restoration Costs

Exploration and Evaluation Expenditure

Exploration and evaluation expenditure incurred by the economic entity is accumulated and recorded as an asset for each area of interest if either:

(i) Such costs are expected to be recouped through successful development and exploitation of the area or alternatively by their sale, or

(ii) Exploration and evaluation activities in the area have not yet reached the stage which permits a reasonable assessment of the existence of economically recoverable reserves, and active and significant operations are continuing.

The directors review the carrying value of each area of interest bi-annually and expenditure which no longer satisfies the above policy is written off. Accumulated costs in relation to an abandoned area are written off to the income statement in the period in which the decision to abandon the area is made.

Once an area of interest enters a production phase, historically capitalised expenditure is transferred to Producing Projects in the Statement of Financial Position.

In an area of interest which is in the production phase, all capitalised exploration, evaluation and development costs are amortised on a unit of production basis over recoverable reserves. Recoverable reserves are subject to review annually.

Rehabilitation, Restoration and Environmental Costs

The provision for future restoration costs is recognised over the useful life of the proved and probable reserves.

Restoration costs include the estimated cost of restoration work required at the end of the useful life of the producing fields. The costs will include removal of pipework, oil handling equipment, platforms, conductors, meter station, together with abandonment of production wells.

To arrive at the provision amount, costs of restoration work will be provided for on the basis of production to date as a percentage of total recoverable reserves, and are treated as production costs. Where a restoration obligation is assumed as part of the acquisition of an asset or obligation, the liability is initially measured at the fair value of the obligation as at acquisition date.

Impairment

The carrying values of exploration, evaluation and development costs are reviewed for impairment when events or changes in circumstances indicate the carrying value may not be recoverable.

For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs. If any such indication exists and where the carrying values exceed the estimated recoverable amount, the assets or cash-generating units are written down to their recoverable amount.

The recoverable amount of exploration, evaluation and development costs is the greater of the fair value less costs to sell and value in use. In assessing the value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessment of the time value of money and the risks specific to the asset.

(h) Foreign Currency Transactions

Foreign currency transactions are translated into functional currency using the exchange rates prevailing at the date of the transaction. Foreign currency monetary items are translated at the period-end exchange rate. Non-monetary items measured at historical cost continue to be carried at the exchange rate at the date of the transaction. Non-monetary items measured at fair value are reported at the exchange rate at the date when fair values were determined.

1. STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

Exchange differences arising on the translation of monetary items are recognised in the income statement, except where deferred in equity as a qualifying cash flow or net investment hedge.

Exchange differences arising on the translation of non-monetary items are recognised directly in equity to the extent that the gain or loss is directly recognised in equity, otherwise the exchange difference is recognised in the income statement.

(i) Employee Benefits

Provision is made for the company's liability for employee benefits arising from services rendered by employees to balance date. Employee benefits expected to be settled within one year together with entitlements arising from wages and salaries, annual leave and sick leave which will be settled after one year, have been measured at the amounts expected to be paid when the liability is settled plus related on-costs. Other employee benefits payable later than one year have been measured at the present value of the estimated future cash outflows to be made for those benefits.

Contributions are made by the economic entity to employee superannuation funds and are charged as expenses when incurred.

(j) Cash

For the purpose of the statement of cash flows, cash includes cash on hand and at call deposits with banks or financial institutions, net of bank overdrafts and investments in money market instruments with less than 30 days to maturity.

(k) Revenue

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the economic entity and revenue can be reliably measured.

Interest revenue is recognised on a proportional basis taking into account the interest rates applicable to the financial assets.

(l) Leases

Lease payments for operating leases, where substantially all the risks and benefits remain with the lessor, are charged as expenses in the periods in which they are incurred.

(m) Goods and Services Tax (GST)

Revenues, expenses and assets are recognised net of the amount of GST, except where the amount of GST incurred is not recoverable from the Australian Tax Office. In these circumstances the GST is recognised as part of the cost of acquisition of the asset or as part of an item of the expense. Receivables and payables in the statement of financial position are shown inclusive of GST.

	Economic Entity	Parent Entity
	2006	2006
2. REVENUE	$	$
Operating activities		
Interest received - other persons	214,076	214,076
Total Revenue	214,076	214,076
Non-operating activities		
Foreign currency translation gain	60,701	60,701
Total Other Income	60,701	60,701

3. INCOME TAX EXPENSE

	Economic Entity 2006 $	Parent Entity 2006 $
a. The components of tax expense comprise:		
Current tax	-	-
Deferred tax	15,239	15,239
	15,239	15,239
b. The prima facie tax on profit/(loss) before income tax is reconciled to the income tax expense as follows:		
Prima facie tax on profit /(loss)before tax at domestic tax rate of 30%	(120,838)	15,239
Add / (less) tax effect of:		
Overseas tax rate differential	(18,144)	-
Deferred Tax asset not recognised	154,221	-
	15,239	15,239

4. CASH AND CASH EQUIVALENTS

	Economic Entity 2006 $	Parent Entity 2006 $
Cash at bank and on deposit	9,498,659	9,237,942
	9,498,659	9,237,942

5. TRADE AND OTHER RECEIVABLES (Current)

	Economic Entity 2006 $	Parent Entity 2006 $
Other debtors	3,682	3,682
Loan to related company	-	825,064
	3,682	828,746

NOTES TO THE FINANCIAL STATEMENTS
FOR THE PERIOD ENDED 30 JUNE 2006

	Economic Entity 2006 $	Parent Entity 2006 $
6. INVESTMENTS (Non - Current)		
Shares in related company – at cost	-	137,596
	-	137,596

The parent entity is the sole shareholder and entitled to 100% of the issued capital of K2 Energy USA Inc which was incorporated on 24th January 2006

	Economic Entity 2006 $	Parent Entity 2006 $
7. PROPERTY, PLANT AND EQUIPMENT		
Plant and equipment - at cost	16,743	-
Accumulated depreciation	(1,056)	-
	15,688	-
Movements in the carrying amounts of plant and equipment during the current financial period:		
Balance at the beginning of the period	-	-
Additions	16,743	-
Disposals	-	-
Depreciation expense	(1,056)	-
Carrying amount at the end of the period	15,688	-
8. EXPLORATION AND EVALUATION EXPENDITURE		
Costs carried forward in respect of areas of interest - at cost	584,037	-
Accumulated amortisation	-	-
	584,037	-
9. PAYABLES		
Payable to key management personnel related entities	147,909	-
Other creditors and accruals	220,822	23,487
	368,731	23,487
10. PROVISIONS		
Asset retirement obligations	9,749	-
	9,749	-

	Economic Entity 2006 $	Parent Entity 2006 $
11. TAX		
Liabilities		
Deferred tax liability comprises:		
Foreign currency translation gain	17,401	17,401
	17,401	17,401
Assets		
Deferred tax assets comprise:		
Provisions and accruals	1,200	1,200
Tax losses	962	962
	2,162	2,162
Reconciliation of movements		
The overall movement in deferred tax accounts is as follows:		
Opening balance	-	-
(Charge)/credit to income statement	(15,239)	(15,239)
Charge to equity	-	-
Closing balance	(15,239)	(15,239)

Unrecognised net deferred tax asset

Deferred tax assets and liabilities have not been reconsigned for the foreign subsidiary, as follows;

Deferred tax asset re tax losses not recognised	283,950	-
Deferred tax liability for temporary differences offset	(129,729)	-
Net deferred tax asset not recognised	154,221	-

The tax losses carried forward begin to expire in 2026 for US federal tax purposes. The benefits of deferred tax assets not brought to account will only be obtained if the conditions for the deductibility set out in Note 1b occur.

12. ISSUED CAPITAL

Issued and fully paid ordinary shares		
76,000,000 ordinary shares	10,130,000	10,130,000
Shares issued during period:		
- 500 in August 2005 at $1 per share pre two hundred for one share split in September 2005	500	500
- 25,900,000 in September/October 2005 at 0.5 cents per share	129,500	129,500
- 50,000,000 between January and June 2006 at 20 cents per share	10,000,000	10,000,000
Balance at end of period	10,130,000	10,130,000

Ordinary shares participate in dividends and the proceeds on winding up of the Company in proportion to the number of shares held.

At shareholders meetings each ordinary share is entitled to one vote when a poll is called, otherwise each shareholder has one vote on a show of hands.

At 30th June 2006 there were 51,000,000 unissued ordinary shares for which options were outstanding.

	Economic Entity	Parent Entity
13. REMUNERATION OF AUDITORS	2006 $	2006 $
Remuneration of the parent entity's auditors for:		
Auditing or reviewing the financial report	4,000	4,000
Other services	-	-
Remuneration of other auditors of subsidiary for:		
Auditing or reviewing the financial report of the subsidiary	18,805	-
Total auditors' remuneration	22,805	4,000

14. SEGMENT OPERATIONS

Primary Reporting – Business Segments

The economic entity's operations during the period related to investment in oil and gas exploration prospects, which is the only business segment.

Secondary Reporting – Geographical Segments

The parent entity holds deposit accounts in Australia. Oil and gas exploration prospects are in the USA.

	Segment Revenues from External Customers	Carrying Amount of Segment Assets	Acquisitions of Non-current Segment Assets
Geographical location:	2006 $	2006 $	2006 $
Australia	214,076	9,243,786	-
USA	-	860,442	707,337
	214,076	10,104,228	707,337

15. PARTICULARS RELATING TO CONTROLLED ENTITIES

Details of controlled entities are reflected below

	Country of Incorporation	Ownership Interest
Company		
K2 Energy Limited	Australia	
Entity controlled by K2 Energy Limited		
K2 Energy USA Inc	Australia	100%

	Economic Entity	Parent Entity
16. RECONCILIATION OF CASH	2006 $	2006 $
Cash at the end of the financial period as shown in the statement of cash flows is reconciled to the related items in the balance sheet as follows:		
Cash at bank and on deposit	9,498,659	9,237,942

NOTES TO THE FINANCIAL STATEMENTS
FOR THE PERIOD ENDED 30 JUNE 2006

	Economic Entity	Parent Entity
17. RECONCILIATION OF PROFIT/ (LOSS) AFTER INCOME TAX TO NET CASH OUTFLOW FROM OPERATING ACTIVITIES	**2006** **$**	**2006** **$**
Profit (Loss) after income tax	(418,032)	35,558
Depreciation and amortisation	1,056	-
Exploration and evaluation expenditure written off	106,557	-
Net exchange differences	(3,621)	
Change in assets and liabilities		
(Increase)/Decrease in trade and other receivables	(3,682)	(3,682)
Increase/(Decrease) in payables	368,730	23,487
Increase/(Decrease) in deferred taxes payable	15,239	15,239
Increase/(Decrease) in provisions	9,749	-
	75,996	70,602

18. FINANCIAL INSTRUMENTS

a. Interest Rate Risk	Fixed Interest Rate	Floating Interest Rate	Non Interest Bearing	Weighted Average Effective Rate
	2006	2006	2006	2006
	$	$	$	%
Financial Assets:				
Cash	-	9,498,659	-	5.1%
Receivables	-	-	3,682	
Financial Liabilities				
Payables	-	-	368,731	
	-	9,498,659	(365,049)	

b. Credit Risk Exposure

The credit risk exposure of the economic entity to financial assets, which have been recognised on the balance sheet, is generally the carrying amount, net of any provisions for doubtful debts.

c. Net Fair Values of Financial Assets and Liabilities

The carrying amounts of cash, cash equivalents and non-interest bearing financial assets and liabilities (for example accounts receivable and payable) approximate fair value.

19. LOSS PER SHARE

The following reflects the loss and share data used in the calculations of basic and diluted loss per share.

	Economic Entity
	2006
Net loss used in calculating basic and diluted earnings per share	(418,032)
Basic and diluted (loss) per share (cents per share)	(1.0)
Weighted average number of shares used in the calculation of basic and diluted loss per share	43,988,361
Shares on issue at period end	76,000,000
Number of options on issue at period end – each option is exercisable at 20 cents per share and converts to one ordinary share	51,000,000

No adjustment has been made for the options on issue to the diluted loss per share or the weighted average number of shares used in calculating diluted loss per share, because the options are not dilutive.

20. CAPITAL AND OTHER COMMITMENTS	Economic Entity 2006 $	Parent Entity 2006 $
Consulting, Licencing, and Management Agreements		
Consulting, Licencing, and Management Agreements contracted for but not capitalised in the financial statements		
Payable		
— not later than 1 year	806,777	-
— later than 1 year but not later than 5 years	1,277,397	-
— later than 5 years	-	-
	2,084,174	

	Economic Entity 2006 $	Parent Entity 2006 $
Exploration Commitments		
Commitments for exploration expenditure contracted for but not capitalised in the financial statements		
Payable		
not later than 1 year	1,144,432	-
later than 1 year but not later than 5 years	-	-
later than 5 years	-	-
	1,144,432	

21. EVENTS SUBSEQUENT TO BALANCE DATE

Since the end of the financial period, the directors are not aware of any matter that has significantly affected or may significantly affect the operations of the economic entity in subsequent financial years.

22. CONTINGENT LIABILITIES

At 30th June 2006 no contingent liabilities existed.

Environmental matters

The group is engaged in oil and gas exploration and production and may become subject to certain liabilities as they relate to environmental cleanup of well sites or other environmental restoration procedures as they relate to the drilling of oil and gas wells, and the operation thereof. The group is subject to certain laws and regulations relating to environmental redemption activities associated with past operations, such as the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") and similar United States state statutes. In response to liabilities associated with these activities, accruals have been established when reasonable estimates are possible. Such accruals primarily include estimated costs associated with redemption. The group has not used discounting in determining accrued liabilities for environmental redemption, and no material claims for possible recovery from third party insurers or other parties related to environmental costs have been recognised in the financial statements. The group adjusts the accruals when new redemption responsibilities are discovered and probable costs become estimable, or when current redemption estimates must be adjusted to reflect new information.

23. RELATED PARTY DISCLOSURES

Related party transactions fall into the following categories:

(a) Controlled entity

Interest in a controlled entity is disclosed in Note 15. Ordinary shares held in the controlled entity are shown in Note 6 and any amount receivable from the controlled entity is shown in note 5. No interest is charged on inter-company loans. These transactions are eliminated on consolidation. K2 Energy USA Inc was reimbursed by K2 Energy Limited for services provided by Messrs Reed and B Moore.

(b) Director related entities

During the period the company paid amounts to directors or director related entities as follows:

- Amount of $55,555 was paid to Winchester Associates Pty Limited (a company associated with Mr Gazal) for financial advisory services.

During the period the controlled entity paid amounts to directors or director related entities as follows:

- Amounts of $83,949 for advisory services and $6,447 for rent were paid to Aspen Energy Inc (a company associated with Mr Reed).
- Amount of $83,949 was paid to Geoflite Inc (a company associated with Messrs B and M Moore) for technical and advisory services.
- Amount of $167,898 was paid to Bruce Moore for licensing fees in relation to the Geoflite technology.

(c) Transactions in securities of the Company

During the period directors or entities related to directors acquired under normal commercial terms shares or options in the company as detailed in note 25. Directors acquired these shares through direct issue.

24. KEY MANAGEMENT PERSONNEL COMPENSATION

(a) Names and positions held of Parent Entity and Economic Entity key management personnel in office at any time during the financial period are:

Key Management Person	Position
Samuel Gazal	Chairman - Non-Executive (appointed 29 August 2005)
Peter Moore	Managing Director (appointed 29 August 2005)
Bruce Moore	Managing Director (appointed 29 August 2005)
Mike Reed	Director - Non-Executive (appointed 18 October 2005)
Robert Kenneth Gaunt	Director - Non-Executive (appointed 18 October 2005)

The Company had no persons employed (other than directors) who were deemed to be key management personnel. On 20th July 2006 John Thompson was appointed as a Non-Executive Director.

(b) Compensation Practices and Key Management Personnel Compensation

Details of compensation practices and key management personnel compensation are disclosed in the Directors' Report which accompanies these financial statements.

(c) Options and Rights Holdings

Number of options held by Key Management Personnel including options held by entities associated with Key Management Personnel.

	Granted as Remuneration	Other options acquired	Balance 30.6.06	Total Vested 30.6.06	Total Exercisable	Total Un-exercisable
Samuel Gazal*	-	2,250,000	2,250,000	2,250,000	-	2,250,000
Peter Moore**	-	18,500,000	18,500,000	18,500,000	-	18,500,000
Bruce Moore**	-	18,500,000	18,500,000	18,500,000	-	18,500,000
Mike Reed***	-	3,000,000	3,000,000	3,000,000	-	3,000,000
Robert Kenneth Gaunt****	-	2,375,000	2,375,000	2,375,000	-	2,375,000
Total	-	26,125,000	26,125,000	26,125,000	-	26,125,000

(d) Shareholdings

Number of Shares held by Key Management Personnel, including shares held by entities associated with Key Management Personnel:

	Net Change /Other	Balance 30.6.06
Samuel Gazal*	3,250,000	3,250,000
Peter Moore **	18,500,000	18,500,000
Bruce Moore **	18,500,000	18,500,000
Mike Reed***	3,000,000	3,000,000
Robert Kenneth Gaunt****	4,250,000	4,250,000
Total	29,000,000	29,000,000

*Of which 2,950,000 shares and 2,100,000 options are held by Balander Pty Limited (Superannuation Fund account) of which Mr Gazal is a director and a beneficiary of the fund and 300,000 shares and 150,000 options are held by Roslyndale Pty Limited (Superannuation Fund account) of which Mr Gazal is a director and a beneficiary of the fund.

** Held by Edward Meadows Pty Limited (as trustee for The Moore Investment Trust) of which Mr Peter Moore is a director and Messrs P & B Moore are beneficiaries.

*** Held by Aspen Energy Inc. in which Mr Reed is a shareholder.

****Held by Blazzed Pty Limited (as trustee for The Gaunt Management Trust) in which Mr Gaunt is a shareholder and is a director.

DIRECTORS' DECLARATION

The directors of the company declare that:

1. the financial statements and notes, as set out on pages 10 to 24 are in accordance with the Corporations Act 2001 and:

    a. comply with Accounting Standards and the Corporations Regulations 2001; and

    b. give a true and fair view of the financial position as at 30 June 2006 and of the performance for the period ended on that date of the company and economic entity;

2. The Chief Executive Officer and Chief Finance Officer have each declared that:

    a. the financial records of the company for the financial period have been properly maintained in accordance with section 286 of the Corporations Act 2001;

    b. The financial statements and notes for the financial period comply with the Accounting Standards; and

    c. The financial statements and notes for the financial period give a true and fair view.

3. in the directors' opinion there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable.

This declaration is made in accordance with a resolution of the Board of Directors.

Samuel M Gazal
Chairman

Dated 26th September 2006

STIRLING SCI
CHARTERED ACCOUNTANTS

INDEPENDENT AUDIT REPORT TO THE MEMBERS OF K2 ENERGY LIMITED

Scope

The financial report and directors' responsibility

The financial report comprises the income statement, balance sheet, statement of changes in equity, cash flow statement, accompanying notes to the financial statements, and the directors' declaration for K2 Energy Limited (the company) and the consolidated entity for the period ended 30 June 2006. The consolidated entity comprises both the company and the entities it controlled during the period.

The company has disclosed information about the remuneration of key management personnel, including directors and executives ("remuneration disclosures"), as required by Accounting Standard AASB 124 Related Party Disclosures, under the heading "Remuneration Report" in the Directors' Report, as permitted by the Corporations Regulations 2001.

The directors of the company are responsible for the preparation and true and fair presentation of the financial report in accordance with the Corporations Act 2001. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report.

Audit Approach

We conducted an independent audit in order to express an opinion to the members of the company. Our audit was conducted in accordance with Australian Auditing Standards, in order to provide reasonable assurance as to whether the financial report is free of material misstatement and the remuneration disclosures comply with Accounting Standard AASB 124 and the Corporations Regulations 2001. The nature of an audit is influenced by factors such as the use of professional judgment, selective testing, the inherent limitations of internal control, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

We performed procedures to assess whether in all material respects the financial report presents fairly, in accordance with the Corporations Act 2001, including compliance with Accounting Standards and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the company's and the consolidated entity's financial position, and of their performance as represented by the results of their operations and cash flows.

We formed our audit opinion on the basis of these procedures, which included:

— examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial report, and

— assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the directors.

While we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our audit was not designed to provide assurance on internal controls.

Independence

In conducting our audit, we followed applicable independence requirements of Australian professional ethical pronouncements and the Corporations Act 2001.

STIRLING SCI
CHARTERED ACCOUNTANTS

INDEPENDENT AUDIT REPORT TO THE MEMBERS OF K2 ENERGY LIMITED

Audit Opinion

In our opinion:

1. The financial report of K2 Energy Limited is in accordance with:

a. the Corporations Act 2001, including:

  i. giving a true and fair view of the company's and consolidated entity's financial position as at 30 June 2006 and of their performance for the period ended on that date; and

  ii. complying with Accounting Standards in Australia and the Corporations Regulations 2001; and

b. other mandatory professional reporting requirements in Australia.

2. The remuneration disclosures that are contained in the "Remuneration Report" section of the Directors' Report comply with Accounting Standard AASB 124 and the Corporations Regulations 2001.

Stirling SCI

Chartered Accountants

P. Turner

Peter Turner

Partner

26th September 2006

St James Centre 111 Elizabeth St Sydney 2000

AUDITOR'S INDEPENDENCE DECLARATION UNDER SECTION 307C OF THE CORPORATIONS ACT 2001 TO THE DIRECTORS OF K2 ENERGY LIMITED

I declare that, to the best of my knowledge and belief, during the period ended 30 June 2006 there have been:

i. no contraventions of the auditor independence requirements as set out in the Corporations Act 2001 in relation to the audit; and

ii. no contraventions of any applicable code of professional conduct in relation to the audit.

Stirling SCI

Chartered Accountants

P. Turner

Peter Turner

Partner

26th September 2006

St James Centre 111 Elizabeth St Sydney 2000

CORPORATE DIRECTORY

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Telephone: (02) 9251 3311
Facsimile: (02) 9251 6550

Directors
Samuel M Gazal, Non-executive Chairman
Peter Moore, Managing Director and Chief Executive Officer
Robert Kenneth (Ken) Gaunt, Non-executive Director
Mike Reed, Non-executive Director
Professor Bruce Moore, Non-executive Director
John Thompson, Non-executive Director

Company Secretary
Terence A. Flitcroft

Legal Advisors
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Sydney NSW 2000

Share Registry
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Auditors
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Advisor to the Company
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