



GEOPETRO RESOURCES COMPANY

*Consolidated Financial Statements
For the Years Ended
December 31, 2005, 2004 and 2003
(US\$)*

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	<u>PAGE</u>
Independent Auditor's Report	2
Consolidated Balance Sheets — December 31, 2005 and 2004	3
Consolidated Statements of Operations — For the Years ended December 31, 2005, 2004 and 2003	5
Consolidated Statements of Shareholders' Equity — For the Years ended December 31, 2005, 2004 and 2003	6
Consolidated Statements of Cash Flows — For the Years ended December 31, 2005, 2004 and 2003	7
Notes to Consolidated Financial Statements	9



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors
GeoPetro Resources Company
San Francisco, California

We have audited the accompanying consolidated balance sheets of GeoPetro Resources Company and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of GeoPetro Resources Company and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

Hein & Associates LLP

HEIN & ASSOCIATES LLP

Irvine, California
March 20, 2006, except for Note 11 which is as of March 30, 2006

GEOPETRO RESOURCES COMPANY
CONSOLIDATED BALANCE SHEETS

	DECEMBER 31,	
	2005	2004
<u>ASSETS</u>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 914,826	\$ 1,010,660
Accounts receivable – oil and gas sales	691,564	452,369
Accounts receivable – other	8,392	90,000
Prepaid expenses	<u>104,111</u>	<u>26,359</u>
Total current assets	<u>1,718,893</u>	<u>1,579,388</u>
OIL AND GAS PROPERTIES, at cost (full cost method)		
Unevaluated properties	3,636,504	4,453,478
Evaluated properties	27,846,543	23,826,826
Less – accumulated depletion and impairment	<u>(9,130,869)</u>	<u>(7,319,557)</u>
Net oil and gas properties	<u>22,352,178</u>	<u>20,960,747</u>
FURNITURE, FIXTURES AND EQUIPMENT, at cost, less depreciation	56,013	75,232
OTHER ASSETS – deposits and other non-current assets	6,583	5,789
DEFERRED OFFERING COSTS	<u>881,159</u>	<u>150,255</u>
TOTAL ASSETS	<u>\$ 25,014,826</u>	<u>\$ 22,771,411</u>
<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>		
CURRENT LIABILITIES:		
Trade payables	\$ 1,928,169	\$ 1,265,378
Short-term notes payable	–	4,781,807
Interest payable	–	88,388
Dividends payable	133,438	133,077
Production taxes payable	310,186	337,980
Other taxes payable	24,766	46,288
Royalty owners payable	865,244	707,993
Net profits interest payable	<u>312,663</u>	<u>221,466</u>
Total current liabilities	<u>3,574,466</u>	<u>7,582,377</u>
ASSET RETIREMENT OBLIGATION	<u>26,641</u>	<u>24,705</u>
COMMITMENTS AND CONTINGENCIES (Note 10)		
SHAREHOLDERS' EQUITY:		
Series A preferred stock, no par value; 1,000,000 shares authorized 1,000,000 shares issued and outstanding at December 31, 2005 and 2004, respectively	674,425	674,425
Series AA preferred stock, no par value; 5,000,000 shares authorized 1,890,710 shares issued and outstanding at December 31, 2005 and 2004, respectively. Liquidation value is \$6,750,923 and \$6,750,562 at December 31, 2005 and 2004, respectively	5,924,068	5,924,068
Common stock, no par value; 100,000,000 shares authorized 21,171,923 and 19,868,272 shares issued and outstanding at December 31, 2005 and 2004, respectively	24,815,184	20,087,360
Additional paid-in capital	534,656	531,729
Treasury stock, at cost; 1,257,043 shares held at December 31, 2005 and 1,117,647 shares held at December 31, 2004, respectively	(1,152,435)	(560,000)
Accumulated deficit	<u>(9,382,179)</u>	<u>(11,493,253)</u>
Total shareholders' equity	<u>21,413,719</u>	<u>15,164,329</u>
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$ 25,014,826</u>	<u>\$ 22,771,411</u>

See accompanying notes to these consolidated financial statements.

Approved by the Board

(signed) *Stuart Doshi*

Stuart Doshi, Director, Chief Executive Officer and President

(signed) *J. Chris Steinhauser*

J. Chris Steinhauser, Director, Chief Financial Officer

See accompanying notes to these consolidated financial statements.

GEOPETRO RESOURCES COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS

	FOR THE YEARS ENDED DECEMBER 31,		
	2005	2004	2003
REVENUES:			
Oil and gas sales	\$ 7,975,990	\$ 5,825,072	\$ 2,452,648
COSTS AND EXPENSES:			
Lease Operating Expense	878,176	780,237	582,889
General and administrative	1,551,747	1,963,649	1,259,269
Net profits interest	856,837	579,590	225,869
Impairment expense	—	2,038,422	473,496
Depreciation and depletion expense	<u>1,832,693</u>	<u>2,077,004</u>	<u>798,555</u>
Total costs and expenses	<u>5,119,453</u>	<u>7,438,902</u>	<u>3,340,078</u>
INCOME (LOSS) FROM OPERATIONS	<u>2,856,537</u>	<u>(1,613,830)</u>	<u>(887,430)</u>
OTHER INCOME (EXPENSE):			
Interest expense	(217,768)	(402,958)	(802,031)
Debt conversion expense	—	(67,375)	—
Interest income	<u>18,969</u>	<u>6,548</u>	<u>4,769</u>
Total other expense	<u>(198,799)</u>	<u>(463,785)</u>	<u>(797,262)</u>
NET INCOME (LOSS) BEFORE TAXES	2,657,738	(2,077,615)	(1,684,692)
Income Tax Expense	<u>(17,267)</u>	<u>—</u>	<u>—</u>
NET INCOME (LOSS) AFTER TAXES	<u>2,640,471</u>	<u>(2,077,615)</u>	<u>(1,684,692)</u>
Preferred Stock Dividends	<u>(529,397)</u>	<u>(529,363)</u>	<u>(258,873)</u>
NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS	<u>\$ 2,111,074</u>	<u>\$ (2,606,978)</u>	<u>\$ (1,943,565)</u>
EARNINGS (LOSS) PER SHARE:			
Basic	<u>\$ 0.10</u>	<u>\$ (0.14)</u>	<u>\$ (0.12)</u>
Diluted	<u>\$ 0.09</u>	<u>\$ (0.14)</u>	<u>\$ (0.12)</u>
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING			
Basic	<u>20,890,841</u>	<u>18,901,607</u>	<u>16,497,898</u>
Diluted	<u>24,001,888</u>	<u>18,901,607</u>	<u>16,497,898</u>

See accompanying notes to these consolidated financial statements.

GEOPETRO RESOURCES COMPANY

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 and 2003

	PREFERRED STOCK SERIES A		PREFERRED STOCK SERIES AA		COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	TREASURY STOCK	ACCUMULATED DEFICIT	TOTAL SHAREHOLDERS' EQUITY
	SHARES	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT				
BALANCES, January 1, 2003	1,000,000	\$ 674,425	244,070	\$ 768,283	15,310,982	\$ 11,975,055	\$ -	\$ (60,000)	\$ (6,942,710)	\$ 6,415,053
Issuance of common stock for cash and services	-	-	-	-	2,345,968	2,534,906	-	-	-	2,534,906
Issuance of preferred stock for cash, net	-	-	1,646,640	5,155,785	-	-	-	-	-	5,155,785
Net loss	-	-	-	-	-	-	-	-	(1,684,692)	(1,684,692)
Dividends on Series AA Preferred	-	-	-	-	-	-	-	-	(258,873)	(258,873)
BALANCES, December 31, 2003	1,000,000	674,425	1,890,710	5,924,068	17,656,950	14,509,961	-	(60,000)	(8,886,275)	12,162,179
Issuance of common stock for cash	-	-	-	-	1,609,822	3,479,899	-	-	-	3,479,899
Conversion of notes payable	-	-	-	-	719,147	2,097,500	-	-	-	2,097,500
Treasury shares purchased	-	-	-	-	(117,647)	-	-	(500,000)	-	(500,000)
Stock compensation expense	-	-	-	-	-	-	500,000	-	-	500,000
Fair value of warrants issued with notes payable	-	-	-	-	-	-	31,729	-	-	31,729
Net loss	-	-	-	-	-	-	-	-	(2,077,615)	(2,077,615)
Dividends on Series AA Preferred	-	-	-	-	-	-	-	-	(529,363)	(529,363)
BALANCES, December 31, 2004	1,000,000	674,425	1,890,710	5,924,068	19,868,272	20,087,360	531,729	(560,000)	(11,493,253)	15,164,329
Issuance of common stock for cash	-	-	-	-	1,443,047	4,727,824	-	-	-	4,727,824
Treasury shares purchased	-	-	-	-	(139,396)	-	-	(592,435)	-	(592,435)
Fair value of warrants extension	-	-	-	-	-	-	2,927	-	-	2,927
Net income	-	-	-	-	-	-	-	-	2,640,471	2,640,471
Dividends on Series AA Preferred	-	-	-	-	-	-	-	-	(529,397)	(529,397)
BALANCES, December 31, 2005	1,000,000	\$ 674,425	1,890,710	\$ 5,924,068	21,171,923	\$ 24,815,184	\$ 534,656	\$ (1,152,435)	\$ (9,382,179)	\$ 21,413,719

See accompanying notes to these consolidated financial statements.

GEOPETRO RESOURCES COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS

	FOR THE YEARS ENDED DECEMBER 31,		
	2005	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$ 2,640,471	\$(2,077,615)	\$(1,684,692)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and depletion	1,832,693	2,077,004	798,555
Stock compensation expense	2,927	531,729	-
Non-cash interest expense	-	(17,304)	325,272
Impairment expense	-	2,038,422	473,496
Asset retirement obligation	1,936	1,237	-
Changes in operating assets and liabilities:			
(Increase) decrease in accounts receivable	(239,195)	179,159	(629,096)
(Increase) decrease in other receivables	81,608	(90,000)	35,178
(Increase) decrease in prepaid expenses	(77,752)	(15,945)	(1,401)
Deposits and other noncurrent assets	(794)	4,625	(6,914)
Increase (decrease) in trade payables	662,791	1,013,524	(233,393)
Increase (decrease) in interest payable	(88,388)	29,034	(113,918)
Increase (decrease) in dividends payable	361	20,769	99,905
Increase (decrease) in production taxes payable	(27,794)	337,980	-
Increase (decrease) in other taxes payable	(21,522)	46,288	-
Increase (decrease) in premiums payable	-	-	(12,443)
Decrease in related parties payable	-	-	(185,630)
Increase (decrease) in royalty owners payable	157,251	74,211	633,782
Increase in net profits interest payable	91,197	57,518	163,948
Increase in asset retirement obligation	-	11,094	12,374
Net cash provided by (used in) operating activities	5,015,790	4,221,730	(324,977)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Oil and gas property expenditures	(5,602,741)	(9,171,589)	(4,228,884)
Proceeds from sale of oil and gas interest	2,400,000	-	-
Acquisition of furniture, fixtures and equipment	(2,162)	(81,876)	(7,676)
Net cash used in investing activities	(3,204,903)	(9,253,465)	(4,236,560)

See accompanying notes to these consolidated financial statements.

GEOPETRO RESOURCES COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(continued)

	FOR THE YEARS ENDED DECEMBER 31,		
	2005	2004	2003
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from sale of common shares, option and warrant exercises, net	4,727,824	3,479,899	2,417,906
Proceeds from sale of preferred shares and warrants, net	—	—	5,155,785
Payments of preferred dividends	(529,397)	(529,363)	(258,873)
Proceeds from convertible note, net	—	—	50,000
Repayments of convertible note, net	—	—	(150,000)
Proceeds from promissory notes, net	—	2,075,000	1,000,000
Repayments of promissory notes	(4,781,807)	(1,158,569)	(748,229)
Repayments of related party notes	—	—	(490,000)
Repayments of Magness Injection note	—	—	(875,000)
Deferred offering costs	(730,906)	(150,255)	—
Purchase of treasury stock	(592,435)	—	—
Net cash provided by financing activities	(1,906,721)	3,716,712	6,101,589
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(95,834)	(1,315,023)	1,540,052
CASH AND CASH EQUIVALENTS:			
Beginning of period	1,101,660	2,325,683	785,631
End of period	\$ 914,826	\$ 1,010,660	\$ 2,325,683
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid for interest	\$ 291,731	\$ 297,266	\$ 590,677
Cash paid for income taxes	\$ —	\$ —	\$ —
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:			
Issuance of common stock for services capitalized in oil and gas properties	—	—	\$ 117,000
Issuance of common stock for conversion of notes payable and cancellation of common stock purchase warrants	—	\$ 2,097,500	—

See accompanying notes to these consolidated financial statements.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND NATURE OF OPERATIONS:

GeoPetro — GeoPetro Resources Company (“GeoPetro” or the “Company”) was originally incorporated as GeoPetro Company under the laws of the State of Wyoming in 1994 to participate in the oil and gas acquisition, exploration, development and production business in the United States and internationally. GeoPetro Company was subsequently merged into GeoPetro Resources Subsidiary Company, a California corporation, on June 28, 1996. GeoPetro’s name was then changed to GeoPetro Resources Company. GeoPetro’s corporate offices are in San Francisco, California. The accompanying consolidated financial statements include the accounts of GeoPetro and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Operations — Although GeoPetro is not a development stage enterprise, the company has a limited operating history upon which an evaluation of its business prospects can be based. The risks, expense, and difficulties encountered by early stage companies must be considered when evaluating GeoPetro’s business prospects. GeoPetro recorded net income of \$2,111,074 in 2005 but incurred net losses in 2004 and 2003, and had an accumulated deficit at December 31, 2005, of \$9,382,179. GeoPetro expects to make significant capital expenditures in the foreseeable future. Management believes that GeoPetro will be successful in obtaining adequate sources of cash to fund its anticipated capital expenditures through the end of 2006 and to follow through with plans for continued investments in oil and gas properties. GeoPetro’s success, in part, depends on its ability to generate additional financing, farm-out certain of its projects and manage its relations with the companies that provide exploration and development services. GeoPetro’s success also depends on its ability to effectively manage growth and develop proven reserves. Additionally, GeoPetro’s operations are subject to all of the environmental and operational risks normally associated with the oil and gas industry. GeoPetro maintains insurance that is customary in the industry.

Since its inception, GeoPetro has participated as a working interest owner in the acquisition of undeveloped leases, seismic options, lease options and foreign concessions and has participated in seismic surveys and the drilling of test wells on its undeveloped properties. Further leasehold acquisitions and seismic operations are planned for 2006 and future periods. In addition, exploratory and development drilling is scheduled during 2006 and future periods on GeoPetro’s undeveloped properties. It is anticipated that these exploration activities together with others that may be entered into may impose financial requirements which may exceed the existing working capital of GeoPetro. Management may raise additional equity and/or debt capital, and has farmed-out certain of its projects to finance its continued participation in planned activities. In the opinion of GeoPetro management, GeoPetro can continue as a going concern even if additional financing is unavailable. However, if additional financing is not available, GeoPetro may be compelled to reduce the scope of its business activities. If GeoPetro is unable to fund planned expenditures, it may be necessary to:

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. forfeit its interest in wells that are proposed to be drilled;
2. farm-out its interest in proposed wells;
3. sell a portion of its interest in prospects and use the sale proceeds to fund its participation for a lesser interest; and
4. reduce general and administrative expenses.

In order for GeoPetro to maintain its interest in the Indonesian and Australian contract and permit areas, certain work and expenditure commitments must be met or an extension must be granted by the applicable governing authority. In the event that GeoPetro does not meet the commitments and no extensions are granted for meeting the commitments, GeoPetro will forfeit its interest in the contract or permit areas requiring an impairment write-down equal to the capitalized costs recorded for the area forfeited. This could have a material adverse impact on GeoPetro's results of operations in future periods.

In July 2005, GeoPetro entered into agreements with unaffiliated companies that have purchased and are operating a dedicated gas treatment plant and related pipelines to process and transport GeoPetro's gas from the Madisonville Project in Madison County, Texas. These agreements are discussed in detail in Note 10. In connection with the Madisonville Project, GeoPetro re-completed an existing well for production from the Rodessa formation interval at approximately 11,800 feet of depth and completed an injection well for disposal of waste gasses from the production well. GeoPetro initiated gas sales from the Madisonville Project in May 2003. A second well was drilled, tested and completed during 2004 and is presently producing on a restricted rate awaiting a planned expansion of the gas treatment plant. Two additional development wells are planned for drilling during 2006 in the Madisonville Project.

Other than the above work and expenditure commitments, the timing of most of GeoPetro's capital expenditures is discretionary. GeoPetro has no material long-term commitments associated with its capital expenditure plans or operating agreements. Consequently, GeoPetro has a significant degree of flexibility to adjust the level of such expenditures as circumstances warrant. The level of capital expenditures will vary in future periods depending on the success of exploratory drilling activities, gas and oil price conditions and other related economic factors. See Note 11 for discussion of financing received subsequent to year end.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

U.S. GAAP— The Company's financial statements have been prepared in accordance with accounting principles generally accepted within the United States of America ("U.S. GAAP").

Use of Estimates and Significant Estimates— Certain amounts in GeoPetro's financial statements are based upon significant estimates, including oil and gas reserve quantities which form the basis for the calculation of depreciation, depletion, amortization and impairment of oil and gas properties. Actual results could materially differ from those estimates.

Oil and Gas Properties— GeoPetro follows the full cost method of accounting for oil and gas producing activities and, accordingly, capitalizes all costs incurred in the acquisition, exploration, and development of proved oil and gas properties, including the costs of abandoned properties, dry holes, geophysical costs, and annual lease rentals. All general corporate costs are expensed as incurred. In general, sales or other dispositions of oil and gas properties are accounted for as adjustments to capitalized costs, with no gain or loss recorded. Amortization of evaluated oil and gas properties is computed on the units of production method based on all proved reserves on a country by country basis. Unevaluated oil and gas properties are assessed for impairment either individually or on an aggregate basis. The net capitalized costs of evaluated oil and gas properties (full cost ceiling limitation) are not to exceed their related estimated future net revenues discounted at 10%, and the lower of cost or estimated fair value of unproved properties, net of tax considerations.

Joint Ventures— Some exploration and production activities are conducted jointly with others and, accordingly, the accounts reflect only GeoPetro's proportionate interest in such activities.

Revenue Recognition— Revenue is recognized upon delivery of oil and gas production and is shown net of applicable royalty payments, processing and transportation fees.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Asset Retirement Obligation — In accordance with Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (“SFAS 143”), the fair value of an asset retirement cost, and corresponding liability, should be recorded as part of the cost of the related long-lived asset and subsequently allocated to expense using a systematic and rational method. GeoPetro recorded an asset retirement obligation to reflect GeoPetro’s legal obligations related to future plugging and abandonment of its oil and gas wells. GeoPetro estimated the expected cash flow associated with the obligation and discounted the amount using a credit-adjusted, risk-free interest rate. At least annually, GeoPetro reassesses the obligation to determine whether a change in the estimated obligation is necessary. GeoPetro evaluates whether there are indicators that suggest the estimated cash flows underlying the obligation have materially changed. Should those indicators suggest the estimated obligation has materially changed, GeoPetro will accordingly update its assessment.

	December 31,		
	2005	2004	2003
Asset retirement obligation, beginning of period	\$ 24,705	\$ 12,374	\$ —
Liabilities incurred	—	11,094	12,374
Accretion expense	1,936	1,237	—
Asset retirement obligation, end of period	<u>\$ 26,641</u>	<u>\$ 24,705</u>	<u>\$ 12,374</u>

Furniture, Fixtures and Equipment — Furniture, fixtures and equipment are stated at cost. Depreciation is provided on furniture, fixtures and equipment using the straight-line method over an estimated service life of three to seven years.

Income Taxes — GeoPetro accounts for income taxes using the asset and liability method wherein deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the temporary differences are expected to be recovered or settled. Because management has determined that realization of deferred tax assets is not more likely than not, the net deferred tax assets are fully reserved.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Concentrations of Credit Risk — Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. Concentrations of credit risk (whether on or off balance sheet) that arise from financial instruments exist for groups of customers or counterparties when they have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions described below. The credit risk amounts for cash and accounts receivable do not take into account the value of any collateral or security.

GeoPetro maintains several cash accounts with three financial institutions. Accounts at each institution are insured by the Federal Deposit Insurance Corporation up to \$100,000. As of December 31, 2005, the uninsured bank balance was \$1,026,573. GeoPetro has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk.

During 2005, 2004 and 2003, the Company had sales to customers exceeding 10% of total sales as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Customer A	99.7%	99.6%	98.7%

At December 31, 2005, 2004 and 2003, the Company had accounts receivable balances from this customer of \$691,564, or 100%, \$449,947, or 99.5%, and \$626,090, or 99.1% of total accounts receivable respectively.

Allowance for Doubtful Accounts — Trade accounts receivable are recorded at net realizable value. If the financial condition of GeoPetro's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Delinquent trade accounts receivable are charged against the allowance for doubtful accounts once uncollectibility has been determined. The allowance is determined through an analysis of the past-due status of accounts receivable and assessments of risk that are based on historical trends and an evaluation of the impact of current and projected economic conditions. There was no activity in the allowance for doubtful accounts as of December 31, 2005 and 2004.

Fair Value of Financial Instruments — The estimated fair values for financial instruments are determined at discrete points in time based on relevant market information. These estimates involve uncertainties and cannot be determined with precision. For certain of GeoPetro's financial instruments, including cash, accounts receivable, accounts payable and current portion of notes payable, the carrying amounts approximate fair value due to their maturities.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Stock-Based Compensation — Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (“SFAS 123”), encourages, but does not require, companies to record compensation cost for stock-based employee compensation at fair value. GeoPetro has elected to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25 (“APB 25”), *Accounting for Stock Issued to Employees*, and related interpretations.

In accordance with SFAS 123, GeoPetro discloses the impact of the fair value accounting of employee stock options. Transactions in equity instruments with non-employees for goods or services have been accounted for using the fair value method as prescribed by SFAS 123.

The following table illustrates the effect on GeoPetro’s net loss and loss per share as if GeoPetro had applied the fair value recognition provisions of SFAS 123 to its stock-based employee compensation awards granted in 2003 and in 2005, and recognized expense over the applicable award vesting period. There were no stock-based employee compensation awards granted in 2004.

	As at and for the Years Ended December 31,		
	2005	2004	2003
Net income (loss) available to common shareholders – as reported	\$ 2,111,074	\$(2,606,978)	\$(1,943,565)
Compensation – FAS 123	(98,870)	(63,655)	(94,495)
Pro forma income (loss)	<u>\$ 2,012,204</u>	<u>\$(2,670,633)</u>	<u>\$(2,038,060)</u>
Income (loss) per share – as reported	<u>\$ 0.09</u>	<u>\$ (0.14)</u>	<u>\$ (0.12)</u>
Pro forma income (loss) per share	<u>\$ 0.08</u>	<u>\$ (0.14)</u>	<u>\$ (0.12)</u>

The assumptions made for purposes of estimating the fair value of the stock options are included in Note 8.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Income (Loss) Per Common Share — Basic earnings per share excludes dilution and is calculated by dividing net income or loss by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared from the earnings of the entity. Potential common shares for the periods ended December 31, 2004 and 2003 were excluded from the earnings per share computation because the Company incurred a net loss and were anti-dilutive. At December 31, 2005, 1,506,064 outstanding warrants and 20,000 outstanding options to purchase common stock were not included in the diluted EPS calculation because the warrants' and options' exercise prices were greater than the average market price of the common shares. 1,890,710 shares of Series AA Stock were not included in the diluted EPS calculation at December 31, 2005 because they were anti-dilutive.

	For the Years Ended December 31,		
	2005	2004	2003
Net income (loss) and adjustments:			
Net income (loss) available to common shareholders	\$ 2,111,074	\$ (2,606,978)	\$ (1,943,565)
Adjustments	<u>Anti-dilutive</u>	<u>Anti-dilutive</u>	<u>Anti-dilutive</u>
Net earnings (loss) for diluted calculation	<u>\$ 2,111,074</u>	<u>\$ (2,606,978)</u>	<u>\$ (1,943,565)</u>
Shares:			
Weighted average shares outstanding	20,890,841	18,901,607	16,497,898
Outstanding options	1,927,660	Anti-dilutive	Anti-dilutive
Series A convertible preferred stock	1,000,000	Anti-dilutive	Anti-dilutive
Outstanding warrants	<u>183,387</u>	<u>Anti-dilutive</u>	<u>Anti-dilutive</u>
Average number of shares for diluted calculation	<u>24,001,888</u>	<u>N/A</u>	<u>N/A</u>
Diluted EPS	<u>\$ 0.09</u>	<u>N/A</u>	<u>N/A</u>

Segment Reporting — GeoPetro has oil and gas exploration, development and production operations in the United States, Canada, Australia and Indonesia. All revenues and related costs are associated with operations in the United States. A summary of assets and capital expenditures by geographical segment is included in Note 3.

Cash Equivalents — Cash and cash equivalents include cash on hand, amounts held in banks and highly liquid investments purchased with an original maturity of three months or less.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. SUMMARY OF OIL AND GAS OPERATIONS:

Capitalized costs at year end and costs incurred relating to GeoPetro's oil and gas activities are summarized as follows:

	<u>United States</u>	<u>Australia</u>	<u>Indonesia</u>	<u>Canada</u>	<u>Totals</u>
2005 Capitalized costs:					
Evaluated properties	\$ 25,019,314	\$ 2,388,051	\$ -	\$ 439,178	\$ 27,846,543
Unevaluated properties	1,646,282	1,697,718	183,589	108,915	3,636,504
Less- accumulated depletion and impairment	<u>(6,303,640)</u>	<u>(2,388,051)</u>	<u>-</u>	<u>(439,178)</u>	<u>(9,130,869)</u>
Net capitalized costs	<u>\$ 20,361,956</u>	<u>\$ 1,697,718</u>	<u>\$ 183,589</u>	<u>\$ 108,915</u>	<u>\$ 22,352,178</u>
Costs incurred:					
Property acquisition	\$ 1,220,150	\$ -	\$ -	\$ -	\$ 1,220,150
Exploration	1,246,550	-	(2,090,089)	26,564	(816,975)
Development	<u>2,799,567</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>2,799,567</u>
Total costs incurred	<u>\$ 5,266,267</u>	<u>\$ -</u>	<u>\$ (2,090,089)</u>	<u>\$ 26,564</u>	<u>\$ 3,202,742</u>
	<u>United States</u>	<u>Australia</u>	<u>Indonesia</u>	<u>Canada</u>	<u>Totals</u>
2004 Capitalized costs:					
Evaluated properties	\$ 20,999,597	\$ 2,388,051	\$ -	\$ 439,178	\$ 23,826,826
Unevaluated properties	399,732	1,697,718	2,273,678	82,350	4,453,478
Less- accumulated depletion and impairment	<u>(4,492,328)</u>	<u>(2,388,051)</u>	<u>-</u>	<u>(439,178)</u>	<u>(7,319,557)</u>
Net capitalized costs	<u>\$ 16,907,001</u>	<u>\$ 1,697,718</u>	<u>\$ 2,273,678</u>	<u>\$ 82,350</u>	<u>\$ 20,960,747</u>
Costs incurred:					
Property acquisition	\$ -	\$ -	\$ -	\$ 13,475	\$ 13,475
Exploration	23,400	1,203,225	235,600	508,052	1,970,277
Development	<u>7,187,836</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>7,187,836</u>
Total costs incurred	<u>\$ 7,211,236</u>	<u>\$ 1,203,225</u>	<u>\$ 235,600</u>	<u>\$ 521,527</u>	<u>\$ 9,171,588</u>

Generally, sales or dispositions of oil and gas properties, including sales of partial interests in prospects, are treated as adjustments to capitalized costs, with no gain or loss recorded.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Evaluated Oil and Gas Properties — In periods prior to 2003 it was determined that the total net costs in the U.S. and Australian evaluated cost pool exceeded their net realizable value. Accordingly, impairment write-downs of \$1,953,030 were recorded in the prior periods. During 2004 and 2003 it was determined that the total net costs in the Australian evaluated cost pool exceeded their net realizable value. Accordingly, impairment write-downs of \$1,599,244 and \$473,496 were recorded for the years ended December 31, 2004 and 2003, respectively. In addition, an impairment write-down associated with the Canadian evaluated cost pool of \$439,178 was recorded for the year ended December 31, 2004. No impairment charges were recorded for the year ended December 31, 2005.

Unevaluated Oil and Gas Properties — United States — As GeoPetro's properties are evaluated through exploration, they will be included in the amortization base. Costs of unevaluated properties in the United States at December 31, 2005 and 2004 represent exploration costs in connection with GeoPetro's California and Alaska prospects. The prospects and their related costs in unevaluated properties have been assessed individually and no impairment charges were considered necessary for the United States properties for any of the periods presented. The current status of these prospects is that seismic data is being interpreted on an on-going basis on the subject lands within the prospects.

Drilling in California prospects is expected to commence as early as 2006 and will continue in future periods. As the prospects are evaluated through drilling in future periods, the property acquisition and exploration costs associated with the wells drilled will be transferred to evaluated properties where they will be subject to amortization.

The Cook Inlet Alaska CBM Project — The Company has entered into an agreement with Pioneer Oil Company, Inc. ("Pioneer") dated April 20, 2005, wherein it has secured an option (the "Option") to acquire a 100% working interest (81% net revenue interest) in approximately 116,000 acres onshore in Cook Inlet, Alaska. The terms of the Option provide for the Company to pay total consideration of \$20 per acre, or approximately \$2.3 million, for the leases. The Option provides that the Company will pay the total lease consideration in two installments. The Company paid the first installment totaling \$1,068,063 on August 17, 2005 and has received assignment of the 100% working interest in the leases. Within three years from the date of receipt of assignment of the 100% working interest in the leases, the Company has the option to conduct a \$2.5 million work program consisting of, but not limited to, a multiple test well drilling program on the leases over a three-year period, and, after completion of the work program and an evaluation of the results, to remit the final additional acreage consideration of \$10 per acre for the leases. The Option provides that if the Company fails to pay the lease consideration when due, fails to perform the work program or otherwise defaults under the Option, it shall forfeit its interest and reassign the leases to Pioneer with no further liability to GeoPetro.

Unevaluated Oil and Gas Properties — Australia — Unevaluated costs incurred in Australia represent costs in connection with the exploration of two exploration permit areas in Australia. The prospects and their related costs in unevaluated properties have been assessed individually and no impairment charges were considered necessary for the Australian properties for any of the periods presented. The current status of these prospects is that appraisal wells have been drilled and are being evaluated for commerciality on the subject lands within the prospects.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unevaluated Oil and Gas Properties — Indonesia — Unevaluated costs incurred in Indonesia represent costs in connection with one production sharing contract area in Indonesia. The prospect and its related costs in unevaluated properties have been assessed individually and no impairment charges were considered necessary for the Indonesian property for any of the periods presented. The current status of this prospect is that seismic data is being interpreted on an on-going basis to identify drilling locations on the subject lands within the prospect. In October 2005, the Company sold its interest in another Indonesian production sharing contract for cash consideration of \$2,400,000. The proceeds realized were credited to the Indonesian unevaluated cost pool.

Drilling is expected to commence on the prospect as early as 2006 and 2007 and is expected continue in future periods. As the prospect is evaluated through drilling in future periods, the property acquisition and exploration costs associated with the wells drilled will be transferred to evaluated properties where they will be subject to amortization.

The Company's interest in one of the production sharing contract areas is subject to prior work commitments, for the eight-year period ended December 3, 2005, requiring total expenditures of \$9,200,000 net to the Company's 40% working interest in the contract area. The Company has met approximately \$2,100,000 of the \$9,200,000 required expenditures. The applicable governing authority has granted the Company a deferral of prior years' commitments until December 2006. While there is no assurance, the Company believes it will receive approval for additional deferral of the commitments from the applicable governing authority beyond December 2006 and plans to farm out a portion of its interest in the Bengara II PSC to third parties so that the work program commitments discussed above, or a portion thereof, will be borne by such third parties.

In addition, the Company has future work program commitments associated with its 40% working interest participation in the production sharing contracts as follows:

<u>Year Ending December 31,</u>	<u>Amount of Commitment</u>
2006.....	\$400,000
2007.....	<u>400,000</u>
Total.....	<u>\$800,000</u>

In the event that the Company does not meet the work program commitments and provided that no extensions are granted for meeting the commitments, the Company must forfeit its interest in the production sharing contract. If the Company forfeits its interest, it will be necessary to record an impairment write-down equal to the capitalized costs recorded for the area forfeited.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Breakdown of Unevaluated Oil and Gas Properties — The following table sets forth a summary of oil and gas property costs not being amortized at December 31, 2005, by the period in which the costs were incurred:

	Totals	Year Ended December 31, 2005	Year Ended December 31, 2004	Year Ended December 31, 2003	2002 and Prior Years
Unproved property acquisition	\$ 1,502,142	\$ —	\$ 13,475	\$ —	\$ 1,488,667
Exploration	2,134,362	(816,974)	(68,144)	870,764	2,148,716
Total	<u>\$ 3,636,504</u>	<u>\$ (816,974)</u>	<u>\$ (54,669)</u>	<u>\$ 870,764</u>	<u>\$ 3,637,383</u>

Management expects that planned activities for the year 2006 will enable the evaluation of approximately 5% of the costs as of December 31, 2005. Evaluation of 30% of the remaining costs is expected to occur in 2007 with the remaining 65% in 2008 and beyond.

4. SHORT AND LONG-TERM DEBT:

Short and long-term non-convertible debt at December 31, 2005 and 2004 consisted of the following:

	2005	2004
Amounts Due Unrelated Parties:		
Unsecured promissory note dated April 24, 2003, payable to G. Carter Sednaoui; payable December 31, 2008, including interest at 8% ^{(a)(c)}	\$ —	\$ 251,460
Promissory note dated October 18, 2002, payable to Rolling Hill Investors, LLC; collateralized with an undivided 25% interest in GeoPetro's Madisonville Project; payable on or before December 31, 2008, including interest at 8% ^{(b)(c)}	—	2,369,772
Unsecured promissory note dated September 30, 2004, payable to Patricia S. Cayce; payable July 31, 2005, including interest at 8% ^(d)	—	570,951
Unsecured promissory note dated July 19, 2004, payable to G. Carter Sednaoui; payable July 31, 2005, including interest at 8% ^(e)	—	1,489,624
	—	<u>4,681,807</u>
Less current portion	—	<u>(4,681,807)</u>
	<u>\$ —</u>	<u>\$ —</u>

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

- (a) Since start-up of production from the Madisonville Project, GeoPetro has dedicated 6% of the net monthly proceeds from its interest in the Madisonville Project located in Madison County, Texas towards repayment of the G. Carter Sednaoui note dated April 24, 2003. The repayments were applied toward (i) accrued but unpaid interest, and (ii) the outstanding principal balance. Net proceeds are defined as gross proceeds received by GeoPetro which are attributable to GeoPetro's interests in the Madisonville Project less royalties, overriding royalties, production payments, net profits interest payments, carried working interests, and all other payments out of production which burden the leases. This note was repaid in 2005.
- (b) Since start-up of production from the Madisonville Project, GeoPetro has dedicated 25% of the net monthly proceeds from its interest in the Madisonville Project located in Madison County, Texas towards repayment of the Rolling Hill Investors, LLC note. The repayments were applied toward (i) accrued but unpaid interest, and (ii) the outstanding principal balance. Net proceeds are defined as gross proceeds received by GeoPetro which are attributable to GeoPetro's interests in the Madisonville Project less royalties, overriding royalties, production payments, net profits interest payments, carried working interests, and all other payments out of production which burden the leases. This note was repaid in 2005.
- (c) *Conversion of Notes and Cancellation of Common Stock Warrants* — Effective March 22, 2004, GeoPetro issued 539,000 shares of common stock to the following note holders pursuant to the partial conversion of promissory notes and cancellation of 539,000 common stock warrants. Concurrently, the note holders agreed to a \$1,347,500 reduction in the principal balance of certain of GeoPetro's promissory notes. The common stock warrants were exercisable at a price of \$2.50 and had an expiration date of December 31, 2008. The interest rate on the G. Carter Sednaoui note dated April 24, 2003 was reduced from 11% to 8%. GeoPetro incurred a fee of \$67,375 payable to a director of GeoPetro in connection with the conversion.

The principal reductions were applied as follows:

	March 22, 2004 Principal <u>Balance</u>	Principal <u>Reduction</u>	Remaining Principal <u>Balance after</u> <u>Reduction</u>
Rolling Hill Investors, LLC Promissory Note Dated October 18, 2002.....	\$ 3,915,407	\$ 849,700	\$ 3,065,707
G. Carter Sednaoui Promissory Note Dated April 24, 2003.....	<u>932,282</u>	<u>497,800</u>	<u>434,482</u>
	<u>\$ 4,847,689</u>	<u>\$ 1,347,500</u>	<u>\$ 3,500,189</u>

- (d) This Note was repaid in 2005.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

- (e) The original principal balance of this note was \$2,000,000. On September 30, 2004, the note was partially converted whereby the Company issued 117,648 shares of common stock to the note holder; in exchange for the shares, the principal balance of the note was reduced by \$500,000. The balance of the Note was repaid in 2005.

Short and long-term convertible debt at December 31, 2005 and 2004 are as follows:

	<u>2005</u>	<u>2004</u>
Convertible Promissory note dated April 30, 2002, payable to Warren Jones on April 30, 2005; interest at 8% per annum payable quarterly	\$ _____	\$ 100,000
Total current portion	<u>\$ _____</u>	<u>\$ 100,000</u>

The Note was repaid in 2005; all amounts current.

5. INCOME TAXES (rounded to the nearest thousand):

The provision for income taxes consist of the following:

	<u>2005</u>	<u>2004</u>
Current		
Federal	\$ 16,000	\$ _____
State.....	1,000	_____
Total.....	<u>17,000</u>	<u>_____</u>
Deferred		
Federal	_____	_____
State.....	_____	_____
Total.....	<u>_____</u>	<u>_____</u>
Total Income Tax Provision	<u>\$ 17,000</u>	<u>\$ _____</u>

The actual income tax benefit (expense) differs from the expected tax benefit (expense) as computed by applying the US Federal corporate income tax rate of 34% for each period as follows:

	<u>2005</u>	<u>2004</u>
Amount of expected tax benefit (expense).....	\$ 930,000	\$ 727,000
Non-deductible expenses	5,000	(5,000)
Alternative minimum tax	17,000	_____
Expiration of net operating loss.....	(49,000)	_____
Other	5,000	(22,000)
Valuation allowance adjustments	<u>(891,000)</u>	<u>(700,000)</u>
	<u>\$ 17,000</u>	<u>\$ _____</u>

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Deferred income taxes reflect the net tax effects of temporary differences between carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets (liabilities) are as follows:

	<u>2005</u>	<u>2004</u>
Deferred tax assets (liabilities):		
Net operating loss carry forwards	\$ 6,061,000	\$ 4,392,000
Oil and gas property basis differences	(2,018,000)	561,000
Credit carryforwards	16,000	—
Other	<u>6,000</u>	<u>3,000</u>
 Total deferred tax assets	 4,065,000	 4,956,000
Valuation allowance	<u>(4,065,000)</u>	<u>(4,956,000)</u>
 Total net deferred taxes	 <u>\$ —</u>	 <u>\$ —</u>

As of December 31, 2005, GeoPetro had net operating loss (NOL) carryforwards of approximately \$15,900,000 for federal beginning to expire in 2010 and \$8,400,000 for state which began to expire in 2005. A significant change in ownership of GeoPetro may limit GeoPetro's ability to use these NOL carryforwards.

6. RELATED PARTY TRANSACTIONS:

On June 6, 2005, the Company purchased 139,396 shares of common stock from an officer and director at a price of \$4.25 per share. On May 31, 2005, an officer and director exercised 200,000 common stock options having an exercise price of \$2.00 per share. The Company received cash proceeds of \$400,000 resulting from the exercise. In addition, on April 29, 2005, a director of the Company exercised 100,000 common stock options having an exercise price of \$2.00 per share resulting in proceeds of \$200,000 to the Company. GeoPetro has paid finder's fees to a non-employee director of the Company in the amounts of \$165,670 and \$142,633 for the years ended December 31, 2004 and 2003, respectively.

7. SHAREHOLDERS' EQUITY:

GeoPetro's articles of incorporation allow for the issuance of 100,000,000 shares of common stock, 1,000,000 shares of Series A preferred stock ("Series A Stock"), 5,000,000 shares of Series AA preferred stock ("Series AA Stock"), and an additional 44,000,000 shares of preferred stock which may be issued from time to time in one or more series.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Common Stock — The holders of common stock are entitled to one vote per share. Subject to preferences on outstanding preferred stock, the holders of common stock are entitled to receive ratably such dividends as may be declared by the board of directors. In the event of a liquidation, the holders of common stock and Series A preferred stock are entitled to share ratably in all assets remaining after payment of liabilities, subject to prior distribution rights of preferred stock.

Preferred Stock — Significant rights and preferences attaching to the Series A Stock are as follows:

Dividends — The holders of Series A Stock are entitled to receive quarterly dividends out of any funds legally available, equal to a percentage of after tax net cash flows resulting from the cash received from the sale of oil and gas for interests owned by GeoPetro as of May 30, 1996. GeoPetro's obligation to pay dividends will terminate upon the payment of an aggregate amount of dividends equaling \$1.50 per share or the closing of a public offering of GeoPetro's common stock. To date, no dividends have been declared.

Preference in Liquidation — In the event of any liquidation, dissolution, or winding up of GeoPetro, the holders of Series A Stock are entitled to receive, prior and in preference to any distribution of any assets or surplus funds to the holders of common stock and subject to prior distribution rights of Series AA Stock, an amount equal to any dividends declared but unpaid on such shares. Subsequent to this distribution, the holders of common stock and Series A Stock are entitled to share ratably in all remaining assets.

Voting Rights — The holders of Series A Stock are entitled to the number of votes equal to the number of shares of common stock into which each share of preferred stock is convertible on the record date for the vote.

Conversion — Each share of Series A Stock is convertible, at the option of the holder, into the number of fully paid and nonassessable shares of common stock on a one-for-one basis, subject to certain adjustments. All preferred stock will convert upon the payment of an aggregate amount of dividends equaling \$1.50 per share or the listing on a national or regional exchange of GeoPetro's common stock.

Significant rights and preferences attaching to the Series AA Stock are as follows:

Dividends — The holders of Series AA Stock are entitled to receive ratably such cash dividends, if any, as may be declared from time to time by the board of directors out of funds legally available therefore and when declared, dividends shall be paid at the rate of \$0.07 per share each calendar quarter. Any quarterly dividends not paid when due shall be accrued and shall accumulate until paid.

Preference in Liquidation — In the event of a liquidation, dissolution or winding up of GeoPetro, the holders of Series AA Stock are entitled to receive, prior and in preference to any distribution of any assets or surplus funds to the holders of Series A Stock and common stock, an amount equal to \$3.50 per share plus any dividends declared but unpaid on such shares, but no more.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Voting Rights — The holders of Series AA Stock are entitled to the number of votes equal to the number of shares of common stock into which each share of preferred stock is convertible on the record date for the vote.

Conversion — Each share of Series AA Stock is convertible, at the option of the holder, into fully paid and nonassessable shares of common stock on a one-for-one basis, subject to certain adjustments. If GeoPetro's common stock is listed on a national or regional exchange, including the NASD Over-the-Counter Bulletin Board, the Series AA Stock will automatically convert into shares of GeoPetro common stock on a one-for-one share basis effective the first trading day after the reported high selling price for GeoPetro's common stock is at least \$5.25 per share for any consecutive ten trading days. If an automatic conversion occurs within one year after issuance of the Series AA Stock, a holder will receive, on the one year anniversary date of the issuance of the Series AA Stock, a final cash dividend equivalent to a full year of dividends less any dividends paid before such conversion.

8. COMMON STOCK OPTIONS:

Effective as of September 10, 2001, the board of directors approved an incentive stock plan, providing for awards under the terms and provisions of such plan of incentive stock options, stock appreciation rights and restricted stock awards to officers, directors and employees of GeoPetro and its consultants (the "Stock Incentive Plan"). The plan provides, among other provisions, the following:

The maximum number of Common Shares which may be awarded, optioned and sold under the plan is 5,000,000 (subject to adjustment for stock splits, stock dividends and certain other adjustments to GeoPetro's common stock); and the per share exercise price for Common Shares to be issued pursuant to the exercise of an option shall be no less than the fair market value of GeoPetro's Common Shares as of the date of grant.

The Stock Incentive Plan provides for the granting to employees of incentive stock options within the meaning of Section 422 of the United States Internal Revenue Code of 1986, as amended, and for the granting of non-statutory stock options to directors who are not employees and consultants. In the case of employees who receive incentive stock options which are first exercisable in a particular calendar year and the aggregate fair market value of which exceeds \$100,000, the excess of the \$100,000 limitation shall be treated as a nonstatutory stock option under the Stock Incentive Plan.

The Stock Incentive Plan is being administered by the compensation committee appointed by the Board of Directors. This committee consists of three directors: Stuart Doshi, Kevin Delehanty and Thomas D. Cunningham. Messrs. Delehanty and Cunningham are not employees of GeoPetro. This committee has the power, subject to the approval of the board of directors, to determine the terms of the options granted, including the number of Common Shares subject to each option, the exercisability and vesting requirements of each option, and the form of consideration payable upon the exercise of such option (i.e., whether cash or exchange of existing Common Shares in a cashless transaction or a combination thereof).

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Stock Incentive Plan will continue in effect for 10 years from September 10, 2001 (i.e., the date first adopted by the Board), unless sooner terminated by the board of directors. The Company has implemented a new 2004 Stock Option and Appreciation Rights Plan (the "Stock Option Plan") for the issuance of options to purchase Common Shares and/or stock appreciation rights in 2004 or thereafter to directors, officers, employees and consultants of the Company and its subsidiaries. The Stock Option Plan has replaced the Stock Incentive Plan. Outstanding options issued under the Stock Incentive Plan will continue to be outstanding in accordance with their terms and the terms of the Stock Incentive Plan, but will count toward the limits in the amount of Common Shares available to be issued under the Stock Option Plan.

GeoPetro accounts for stock options granted to employees and directors under APB 25. During 2004 no options were issued to employees or directors. No stock-based compensation was recognized for the years ended December 31, 2005, 2004 and 2003. During 2003, 1,750,000 stock options and 175,125 common stock warrants were issued to employees and directors and during 2005, 20,000 stock options were issued to employees.

A summary of the status of GeoPetro's stock option plan is as follows:

	Options	Exercise Prices	Weighted Average Exercise Price
Outstanding at January 1, 2003	3,089,750	\$0.50 to \$3.00	\$
Granted	1,750,000	\$2.10	2.10
Exercised	—	\$0.50 to \$3.00	—
Outstanding at December 31, 2003	4,839,750	—	1.66
Granted	—		—
Exercised	(584,000)	\$1.00 to \$1.25	1.00
Expired	(100,000)	\$1.00	1.00
Outstanding at December 31, 2004	4,155,250	\$0.50 to \$3.00	1.77
Granted	20,000	\$4.25 to \$6.25	5.25
Exercised	(300,000)	\$2.00	6.25
Outstanding at December 31, 2005	<u>3,875,250</u>	\$0.50 to \$6.25	<u>\$ 1.77</u>

The weighted average fair value of options granted during the year ended December 31, 2003, as calculated under the Black-Scholes pricing model is \$0.18 and for the weighted average fair value of options granted in 2005, as calculated under the same method is \$0.70

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 2003 and 2005: risk-free, weighted-average interest rates ranging from 2.52 to 3.75 percent, expected dividend yield of 0 percent, expected life of 5 years from the date of grant, and expected volatility of 10 and 25 percent.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The options outstanding as of December 31, 2005 have the following contractual lives:

<u>Number of Options Outstanding</u>	<u>Exercise Prices</u>	<u>Weighted Average Remaining Contractual Life</u>
750,000	0.50	0.33
45,250	1.25	1.16
1,290,000	2.00	1.99
1,750,000	2.10	7.37
20,000	3.00	3.93
10,000	4.25	4.01
<u>10,000</u>	6.25	4.44
<u>3,875,250</u>		

As of December 31, 2005, there are 2,805,250 options which are exercisable. The remaining 1,070,000 options will become exercisable ratably over the next four years.

9. COMMON STOCK WARRANTS:

In conjunction with the issuance of units of equity securities during 2005, GeoPetro issued warrants to purchase 37,000 shares of GeoPetro's common stock at exercise prices of \$5.00 per share. The purchase rights under the warrants have expiration dates from June 30, 2006 to February 28, 2008 unless terminated earlier in accordance with the stock warrant purchase agreement. The Company agreed to extend the warrants by a period of one year for a total of 143,334 shares. The fair value of the warrants on the date of extension, \$32,404, was disclosed and combined with compensation expense, FAS 123 in Note 2 and \$2,927 was recorded as consulting expense.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes the number of shares reserved for the exercise of common stock purchase warrants as of December 31, 2005:

	Expiration Date	Exercise Price	12/31/04 Shares	Warrants Exercised	Warrants Granted	Warrants Extended (expired)	12/31/05 Shares
Common Stock	03/31/05	\$2.00	37,500	(37,500)	-	-	-
Common Stock	03/31/05	\$3.00	10,000	(10,000)	-	-	-
Common Stock	04/30/05	\$2.50	10,000	(10,000)	-	-	-
Common Stock	07/31/05	\$2.00	37,500	(37,500)	-	-	-
Common Stock	07/31/05	\$3.00	10,000	-	-	(10,000)	-
Common Stock	12/31/05	\$5.00	50,000	-	-	(50,000)	-
Common Stock	06/30/06	\$5.00	-	-	10,000	-	10,000
Common Stock	11/01/06	\$3.00	20,000	-	-	-	20,000
Common Stock	12/31/06	\$4.00	10,000	-	-	-	10,000
Common Stock	12/31/06	\$2.00	75,000	-	-	-	75,000
Common Stock	05/01/07	\$5.25	5,000	-	-	-	5,000
Common Stock	02/28/06	\$5.00	-	-	27,000	-	27,000
Common Stock	03/31/08	\$3.50	25,000	-	-	-	25,000
Common Stock	07/19/08	\$5.00	50,000	-	-	-	50,000
Common Stock	09/30/08	\$5.00	14,375	-	-	-	14,375
Common Stock	12/15/08	\$3.50	1,161,356	(30,000)	-	(1)	1,131,355
Common Stock	03/31/09	\$5.25	100,000	-	-	-	100,000
<u>Related Party:</u>							
Common Stock	06/18/06	\$2.00	150,000	-	-	-	150,000
Common Stock	06/18/06	\$3.00	33,333	-	-	-	33,333
Common Stock	12/31/06	\$4.00	66,667	-	-	-	66,667
Common Stock	06/18/07	\$4.00	33,333	-	-	-	33,333
Common Stock	06/18/07	\$5.00	33,334	-	-	-	33,334
Common Stock	12/31/08	\$2.00	185,125	-	-	-	185,125
			<u>2,117,523</u>	<u>125,000</u>	<u>37,000</u>	<u>(60,001)</u>	<u>1,969,522</u>

In conjunction with the issuance of units of equity securities during 2004, GeoPetro issued warrants to purchase 155,000 shares of GeoPetro's common stock at exercise prices ranging from \$5.00 to \$5.25 per share. The purchase rights under the warrants have expiration dates from December 31, 2005 to March 31, 2009 unless terminated earlier in accordance with the stock warrant purchase agreement.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

During 2004, in conjunction with the issuance of promissory notes, GeoPetro issued warrants to purchase 64,375 shares of GeoPetro's common stock at an exercise price of \$5.00 per share. The purchase rights under the warrants have expiration dates from July 19 to September 30, 2008, unless terminated earlier in accordance with the stock warrant purchase agreement. The fair value of the warrants on the date of issuance, \$31,729, was recorded as a debt discount and is being amortized over the life of the promissory notes.

The following table summarizes the number of shares reserved for the exercise of common stock purchase warrants as of December 31, 2004:

	Expiration Date	Exercise Price	12/31/03 Shares	Warrants Exercised	Warrants Granted	Warrants Extended (canceled)	12/31/04 Shares
Common Stock	09/17/04	\$2.50	100,000	—	—	(100,000)	—
Common Stock	03/31/05	\$2.00	37,500	—	—	—	—
Common Stock	03/31/05	\$3.00	10,000	—	—	—	—
Common Stock	04/30/05	\$2.50	10,000	—	—	—	—
Common Stock	07/31/05	\$2.00	37,500	—	—	—	—
Common Stock	07/31/05	\$3.00	10,000	—	—	—	10,000
Common Stock	12/31/05	\$4.00	10,000	—	—	—	10,000
Common Stock	12/31/05	\$5.00	—	—	50,000	—	50,000
Common Stock	11/01/06	\$3.00	20,000	—	—	—	20,000
Common Stock	12/31/06	\$2.00	75,000	—	—	—	75,000
Common Stock	05/01/07	\$5.25	—	—	5,000	—	5,000
Common Stock	03/31/08	\$3.50	25,000	—	—	—	25,000
Common Stock	07/19/08	\$5.00	—	—	50,000	—	50,000
Common Stock	09/30/08	\$5.00	—	—	14,375	—	14,375
Common Stock	12/15/08	\$3.50	1,161,356	—	—	—	1,161,356
Common Stock	12/31/08	\$2.50	439,000	—	—	(439,000)	—
Common Stock	03/31/09	\$5.25	100,000	—	100,000	—	100,000
<u>Related Party:</u>							
Common Stock	08/30/04	\$1.00	100,000	(100,000)	—	—	—
Common Stock	06/18/06	\$2.00	150,000	—	—	—	150,000
Common Stock	06/18/06	\$3.00	33,333	—	—	—	33,333
Common Stock	12/31/06	\$4.00	66,667	—	—	—	66,667
Common Stock	06/18/07	\$4.00	33,333	—	—	—	33,333
Common Stock	06/18/07	\$5.00	33,334	—	—	—	33,334
Common Stock	12/31/08	\$2.00	185,125	—	—	—	185,125
			<u>2,537,148</u>	<u>100,000</u>	<u>219,375</u>	<u>(539,000)</u>	<u>2,117,523</u>

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. COMMITMENTS AND CONTINGENCIES:

Employment Agreements — The Company entered into a contract of employment with Stuart J. Doshi, Founder, President, Chief Executive Officer and Chairman of the Board of Directors, dated July 28, 1997 (effective July 1, 1997) and amended on January 11, 2001, July 1, 2003, April 20, 2004, May 9, 2005, July 28, 2005 and January 30, 2006. The contract as amended provides for a five-year term commencing May 1, 2005 which term is automatically extended for successive two-year renewal terms unless: (a) the board of directors elects not to renew the contract and the Company provides notice to Mr. Doshi of such non-renewal at least six months prior to the expiry of his employment term or any renewal term, or (b) Mr. Doshi attains age 75, in which case the term ends upon the completion of the calendar year in which he becomes 75 years old unless the Company and Mr. Doshi mutually agree to one-year extensions. The contract of employment currently provides for an annual base salary of \$300,000 and further provides that in the event of a change of control of the Company or if Mr. Doshi is terminated without cause, he is entitled to receive (a) in exchange for all of his vested stock options and vested restricted shares, such number of Common Shares having a market value equal to the difference between (x) the aggregate total market value of all vested restricted shares and Common Shares he would receive upon exercise of all vested stock options less (y) the aggregate total exercise price for all of his vested stock options; provided, however, that if the Common Shares to be delivered to Mr. Doshi upon such change of control or termination have not been registered so as to permit immediate public resale, Mr. Doshi shall instead receive a cash payment equal to the market value on the date of termination of all vested stock options and restricted shares without any discount for liquidity or minority position against cancellation of such options and restricted shares, (b) a cash payment equal to the greater of (i) his compensation for the remainder of his term, including salary and the aggregate amount of his bonuses in respect of the last four fiscal years and (ii) four times his compensation in the current year, including his then-current salary and the average amount of his bonuses for the last four fiscal years, and (c) an additional cash payment representing his employment benefits equal to 20% of the amount of salary he is entitled to receive under (b)(i) or (b)(ii) above, as applicable. In addition, in the event of a change of control or termination without cause, all unvested options issued by the Company to Mr. Doshi will vest.

GeoPetro has executed an employment contract dated April 28, 1998 and amended on June 15, 2000, May 12, 2003 and January 1, 2005 with its Vice President of Exploration, David V. Creel. The contract provides an annual salary of \$150,000 and may be terminated by GeoPetro without cause upon the payment to Mr. Creel of cash payments equal to the lesser of three months' base salary or base salary during the remainder of the employment term, and, in the event of termination without cause, all unvested options issued by GeoPetro to Mr. Creel will vest.

GeoPetro has executed an employment contract dated June 19, 2000 and amended on December 12, 2002 and January 1, 2005 with its Vice President of Finance and Chief Financial Officer, J. Chris Steinhauser. The contract provides for an annual salary of \$150,000 and may be terminated by GeoPetro without cause upon the making of cash payments equal to the lesser of three months' base salary or base salary during the remainder of the employment term, and, in the event of termination without cause, all unvested warrants issued by GeoPetro to Mr. Steinhauser will vest.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

GeoPetro has executed an employment contract dated October 1, 2003 and amended on April 9, 2004 and January 1, 2005 with its Treasurer and Manager of Planning, Eric S. Doshi. The contract provides for a term of employment until October 1, 2009 at an annual salary of \$120,000 effective January 1, 2005. The contract may be terminated by the Company without cause upon the payment to Mr. Doshi of cash payments equal to the lesser of three months' base salary or base salary during the remainder of the employment term, and, in the event of termination without cause, all unvested options issued by GeoPetro to Mr. Doshi will vest.

Office Lease — Effective March 1, 2004, GeoPetro is committed under an office sublease which provides for a sixty month term. The sublease is cancelable by either party after thirty-six months. The sublease provides for minimum monthly lease payments of \$5,788 during the first thirty-six months of the lease term and \$6,527 per month from the thirty-seventh month to the sixtieth month. Minimum annual rentals due under this agreement are as follows:

<u>Year</u>	<u>Amount</u>
2006.....	\$ 69,466
2007.....	76,856
2008.....	78,334
2009.....	13,056

Rent expense for the years ended December 31, 2005, 2004 and 2003, was approximately \$69,466, \$67,138, and \$48,000, respectively, and is included in general and administrative expenses in the accompanying statements of operations.

Madisonville MGP Agreement — GeoPetro owns a 95.3125% working interest in the Magness Well and a 100% working interest in adjacent leases located in Madisonville (Rodessa) Field in Madison County, Texas. GeoPetro's working interest covers the Rodessa formation interval at approximately 11,800 feet of depth. The Rodessa reserves are being developed through the re-entry and recompletion of the Ruby Magness No. 1 well (originally drilled in 1994) and the drilling of additional well locations. The natural gas in the Rodessa formation contains 28% impurities which must be removed in order to meet pipeline quality specifications.

In this connection, GeoPetro entered into agreements with a subsidiary of a NYSE listed company, Hanover Compressor Company ("Hanover"), that funded, constructed, installed and operated a dedicated gas treatment plant to process the Rodessa gas. The gas treatment plant is presently capable of treating and bringing up to pipeline specifications approximately 18 million cubic feet of inlet gas per day from the UMC Ruby Magness No. 1 well. Gateway Processing Company ("Gateway") has installed field gathering pipelines and a sales pipeline with an estimated capacity of at least 70 million cubic feet of gas per day to transport the treated natural gas to a major pipeline in the area.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Effective July 25, 2005, Madisonville Gas Processing, LP (“MGP”) purchased the natural gas treatment plant from Hanover. Concurrent with MGP’s purchase of the gas treatment plant, the Company, Gateway and MGP terminated the Hanover/Gateway agreements and entered into a new agreement, (the “MGP Agreement”), to treat and transport the Company’s gas production from the Madisonville Project. As a result of the MGP Agreement, MGP has committed to install and make operational additional treating facilities capable of treating 50 MMcf/d, which combined with the capacity of the current in-service treating facilities will represent a total treating capacity of 68 MMcf/d for the Madisonville treatment plant.

The term of the MGP Agreement commenced August 1, 2005 and continues so long as the Company owns any oil and gas leases in the Madisonville Field, provided that it shall terminate 30 years from the effective date unless extended. Under the terms of the MGP Agreement, the Company has committed all natural gas production from its interest in the Madisonville Project to MGP. MGP purchases the untreated natural gas from the Company at the well site point of delivery for a net price equal to the weighted average price per MMBTU that MGP receives for the natural gas delivered to the sales pipeline less certain gathering, treatment and transportation charges. The gathering, treatment and transportation price adjustments are described below. All proceeds from MGP’s sale of Rodessa Formation gas are deposited in an escrow account and then disbursed in accordance with the joint direction of the Company and MGP.

The MGP Agreement provides that certain gathering, treating and transportation fees shall be paid to MGP from the escrow account. The MGP Agreement provides that MGP will receive a gathering and marketing fee of \$0.07 and \$0.01 per Mcf, respectively, of gas measured and delivered to the natural gas treatment plant. In addition, for the first 18,000 Mcf/d of gas measured and delivered to the inlet flange of the gas treatment plant, MGP will receive a treating fee of \$1.50 per Mcf. This treating fee will remain in effect until September 30, 2010. For any gas volumes in excess of 18,000 Mcf/d of gas delivered to the inlet flange of the gas treatment plant, MGP will receive a treating fee of \$1.10 per Mcf. Beginning October 1, 2010, this fee of \$1.10 per Mcf shall be charged for all gas measured and delivered to the plant. One-quarter ($\frac{1}{4}$) of the foregoing treating fees will be adjusted using the Producer Price Index for Industrial Commodities (“PPI”) and one-quarter ($\frac{1}{4}$) using the Consumer Price Index (“CPI”) commencing January 1, 2006. One-half ($\frac{1}{2}$) of the foregoing gathering and marketing fees will be adjusted using the Consumer Price Index (“CPI”) commencing January 1, 2006. The Company has the right, upon giving 60 days’ notice, to terminate the marketing fee whereupon it shall assume the sole responsibility of marketing the natural gas sold.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the first 18,000 Mcf/d of gas measured and delivered to the inlet flange of the gas treatment plant, Gateway will receive a transportation fee of \$0.10 per Mcf. This fee will remain in effect for 36 months from the effective date of the MGP Agreement. Beginning in the 37th month and terminating at the end of the 60th month from the effective date of the MGP Agreement, the fee shall be reduced to \$0.08 per Mcf for the first 18,000 Mcf/d of gas measured and delivered to the inlet flange of the gas treatment plant. For any gas volumes in excess of 18,000 Mcf/d of gas measured and delivered to the inlet flange of the gas treatment plant, Gateway will receive a transportation fee of \$0.12 per Mcf measured and delivered from the outlet flange of the plant. This fee will remain in effect 36 months from the effective date of the MGP Agreement and shall be reduced to \$0.10 per Mcf thereafter. After 60 months, this transportation fee shall be \$0.10 per Mcf for all volumes delivered from the outlet flange of the plant.

The foregoing gathering, treatment and transportation price adjustments, are inclusive of all costs and expenses to gather, separate, treat, dehydrate and transport natural gas produced and delivered from the Company's well(s).

The Company has committed to a three well drilling program to facilitate the expansion of the gas treatment plant. The commitment, subject to events of force majeure, including, but not limited to rig availability, requires the Company to commence the drilling of a well sufficient to test the Rodessa Formation and complete the well if commercial on or before March 1, 2006 and the drilling and completion, if commercial, of a second Rodessa Formation well on or before August 1, 2006. The commitment further requires the Company to commence the drilling of a third well sufficient to test the Smackover Formation (estimated to be encountered at approximately 18,000 feet) on or before September 30, 2008. The Company has granted MGP a security interest in the Madisonville Field properties to secure the three well commitment. The security interest shall be subordinated to any third party lender in the event the Company secures future debt against the property. MGP has granted the Company a similar security interest in the gas treatment plant to secure its obligation to expand the treatment plant on a timely basis.

Madisonville Net Profits Interest — GeoPetro's 95.3125% to 100% working interest is subject to a net profits interest in favor of an unrelated third party. The net profits interest is 12.5% (proportionately reduced) of the net operating profits until payout is achieved. After payout, the net profits interest increases to 30% (proportionately reduced). Payout, for purposes of the net profits interest, is defined and achieved at such time as GeoPetro has recouped from net operating cash flows its total net investment in the project plus a 33% cash on cash return.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Pending Litigation — Miller Lawsuit — On December 27, 2002, Greg R. Miller, Robert L. Hixon, and Madisonville Field, L.L.C. (collectively, the “Miller Plaintiffs”) filed a lawsuit in the State Civil District Court of Harris County, Texas against Redwood LP and other defendants (the “Miller Lawsuit”). Redwood LP was served with the lawsuit on June 26, 2003. The Miller Lawsuit arises out of agreements by and among the Miller Plaintiffs and third parties. These agreements include a February 12, 1997 Participation Agreement (the “Participation Agreement”) by and among Nova Corporation, the Miller Plaintiffs, and various third parties, and an October 6, 2000 Settlement Agreement by and among Newstar Energy USA, Inc. (“Newstar”), successor in part to Nova Corporation, and the Miller Plaintiffs (the “Settlement Agreement”) that purports to resolve disputes between the Miller Plaintiffs and Newstar relating to the Participation Agreement. In their “Original Complaint,” the Miller Plaintiffs alleged that Panther Resources Corporation, Panther Rodessa, L.P. (together “Panther Defendants”), Newstar, and Redwood LP each breached certain obligations under the Participation Agreement and the Settlement Agreement. The Miller Plaintiffs generally complain that the defendants failed to fulfill their obligation to drill certain wells under the Participation Agreement or the Settlement Agreement. The Miller Plaintiffs also allege that Redwood LP breached the Participation Agreement by not including the Miller Plaintiffs in Redwood LP’s negotiations of gas processing and purchase agreements relating to Redwood LP’s interest in the Ruby Magness Well.

Defendant Newstar moved to compel arbitration of the Miller Plaintiffs’ claims against it. The Miller Plaintiffs agreed and moved to sever into a separate lawsuit their claims against Redwood LP. In their motion to sever, the Miller Plaintiffs clarified that they are not attempting to hold Redwood LP responsible for any damages that may have been incurred as a result of the alleged failure of Newstar or the Panther Defendants to drill wells pursuant to the Participation Agreement or the Settlement Agreement. The Miller Plaintiffs further stated that they did not hold Redwood LP responsible for any damages that they may be entitled to for Newstar’s alleged improper rework of the Magness Well. Pursuant to the motion to sever, the court severed the Miller Plaintiffs’ claims against Redwood LP on November 19, 2003. The court also entered an order, pursuant to the parties’ agreement, that granted Newstar’s motion to compel arbitration of the claims asserted against Newstar and the Panther Defendants in the Miller Lawsuit. The court also ordered that the claims against the Panther Defendants were abated until the resolution of the claims against Newstar. To date, the Miller Plaintiffs have not initiated an arbitration against Newstar.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Miller Plaintiffs have filed supplemental and amended petitions that added numerous causes of action and seek as remedies judicial declarations of their rights and money damages. The Miller Plaintiffs' current live pleading is their Third Amended Petition in which they assert several duplicative claims, alleging that: (i) Redwood LP is a joint venture with the Miller Plaintiffs and owes a variety of fiduciary duties that Redwood LP allegedly breached, (ii) Redwood LP is obligated under provisions in the agreement between Newstar and the Panther Defendants, Redwood LP's agreement with the Panther Defendants and Newstar, and the Settlement Agreement to offer the Miller Plaintiffs interests in leases acquired by Redwood LP in the prospect, (iii) the Miller Plaintiffs' interest in the Magness Well is not burdened by a non-consent penalty because no joint operating agreement exists between the parties; (iv) the Participation Agreement does not require the Miller Plaintiffs to pay for the disposal well that Redwood LP drilled; (v) under the Participation Agreement and Settlement Agreement, the Miller Plaintiffs are entitled to a carried working interest in the Fannin Well; (vi) Redwood LP breached the Participation Agreement by not including the Miller Plaintiffs in Redwood LP's negotiations for the gas processing and purchase contracts; (vii) Redwood LP breached its statutory duty to pay overriding royalties to the Miller Plaintiffs; (viii) Redwood LP violated in various ways its purported duty to act as a reasonably prudent operator; (ix) Redwood LP conspired with Newstar and/or the Panther Defendants to defraud the Miller Plaintiffs from obtaining the benefit of the Settlement Agreement; (x) Redwood LP conspired with Newstar and/or the Panther Defendants to defraud the Miller Plaintiffs by structuring the contracts to invalidate any obligations or duties owed to the Miller Plaintiffs; (xi) Redwood LP tortiously interfered with the Miller Plaintiffs' agreements with Newstar and the Panther Defendants by purchasing the Magness Well and related leases allegedly leaving Newstar and/or the Panther Defendants unable to perform their obligations to the Miller Plaintiffs; and (xii) Redwood LP converted the Miller Plaintiffs' property by selling Respondents' proportionate share of the hydrocarbons from the Magness Well and Fannin Well. The Miller Plaintiffs' lawyer, George O. Mejlaender, has intervened in the Miller Lawsuit to assert all of these same claims against Redwood LP.

Redwood LP denies the claims asserted by the Miller Plaintiffs and has filed an answer in the Miller Lawsuit. On October 5, 2005, Redwood LP and the Miller Plaintiffs agreed to have the claims asserted in the Miller Lawsuit and the Mejlaender Lawsuit, discussed below, resolved by a single arbitrator in an arbitration proceeding to take place in Houston, Texas. The date of the arbitration has not been determined. In the opinion of management based on consultation with legal counsel, the Miller Lawsuit is without merit and is not expected to have a material adverse effect upon the Company's financial condition or results of operations.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Pending Litigation — Redwood vs. George Mejlaender — On March 15, 2004, Redwood LP intervened in a lawsuit involving George O. Mejlaender, doing business as Texas Land Company, and Madisonville Field, L.L.C. as plaintiffs (the "Mejlaender Lawsuit"). Redwood LP's petition in intervention seeks a declaratory judgment that Redwood LP's leases with the defendant, Jeff Farris, are valid and fully enforceable. The petition in intervention also seeks a determination that a letter of intent executed by Mr. Farris is neither a lease of Mr. Farris' mineral interests nor a binding agreement by Mr. Farris to lease his mineral interests to the plaintiffs. On April 5, 2004, the plaintiffs filed their first amended original petition for declaratory relief and a counterclaim. The amended petition asserts claims against Redwood LP for tortious interference and conspiracy based on Redwood LP's alleged interference with the plaintiffs' alleged lease with Mr. Farris.

On October 5, 2005, Redwood LP and the plaintiffs agreed to have the claims asserted in the Mejlaender Lawsuit and the Miller Lawsuit, discussed above, resolved by a single arbitrator in an arbitration proceeding to take place in Houston, Texas. The date of the arbitration has not been determined. In the opinion of management based on consultation with legal counsel, the Mejlaender Lawsuit is not expected to have a material adverse effect upon the Company's financial condition or results of operations.

11. SUBSEQUENT EVENTS:

Private Placements of Common Stock — Subsequent to December 31, 2005, GeoPetro has issued 927,314 shares of its common stock for cash proceeds of \$3,245,600 (net after expenses \$3,123,408) in connection with private placements to accredited investors.

Proceeds from Notes — The Company issued a \$1,000,000 short term Note payable on January 31, 2006 with a maturity date on January 31, 2007. The note may be repaid at any time without penalty. In the event the note is not repaid by the maturity date, the Company has agreed to dedicate 5% of the net cash flow from the Madisonville Project in Texas toward the repayment of the note and any accrued interest thereon. In connection with the note, the Company paid a loan origination fee of \$30,000 and granted a three-year exercisable warrant to purchase 150,000 Common Shares at \$3.50 per share.

Initial Public Offering — On March 30, 2006, the Company completed an initial public offering pursuant to a final prospectus under the securities laws of each of the provinces of Canada, which consisted of 3,730,021 common shares from the Company's treasury at an issue price of \$3.50 per common share and 519,500 common shares issued on a "flow-through" basis under the *Income Tax Act* (Canada) at an issue price of \$3.85 per common shares for aggregate gross proceeds of \$15,055,149. The Company intends to use the net proceeds of the offering to fund development drilling of proven natural gas reserves associated with the Madisonville Project and to conduct exploration and appraisal activities on the Company's other projects in the United States, Canada and Indonesia.

Conversion of Series A Stock — Upon completion of the Company's initial public offering on March 30, 2006, all of the 1,000,000 shares of Series A Stock automatically converted into a like number of common shares.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

12. CANADIAN ACCOUNTING PRINCIPLES AND REPORTING:

The Company's consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") which, in most respects, conform to accounting principles generally accepted in Canada ("Canadian GAAP"). Significant differences between U.S. and Canadian GAAP are described in this note.

Full Cost Accounting — In accordance with Canadian GAAP, petroleum and natural gas properties are evaluated at least annually to determine whether the carrying amount in each cost center, on a country by country basis, is recoverable and that it does not exceed the fair value of the properties in the cost center.

The carrying amounts are assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves plus the lower of cost and market of unproved properties exceeds the carrying amount of the cost center. When the carrying amount is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost center exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties that contain no probable reserves. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate and are on a before tax basis. Under U.S. GAAP, a similar ceiling test calculation is performed with the exception that future net operating revenues are discounted at 10 percent and are on an after tax basis.

Under Canadian GAAP, depletion charges are calculated by reference to proved reserves estimated using future prices and costs. Under U.S. GAAP, depletion charges are calculated by reference to proved reserves estimated using constant prices.

Effective January 1, 2004, the Canadian Institute of Chartered Accountants ("CICA") amended the Full Cost Accounting Guideline. Prior to 2004, under Canadian GAAP, the prices and costs were based upon the period end prices and costs were not discounted. Estimated future general and administrative costs, financing charges and income taxes were deducted from the estimated future cash flows. There were no charges to net income (loss), oil and gas properties, or any other reported amounts in the consolidated financial statements as a result of adopting the amended standard.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

There is no material difference between U.S. GAAP and Canadian GAAP on the consolidated financial statements of GeoPetro as a result of the differing ceiling test calculations and depletion test calculations. Benchmark gas prices for the December 31, 2005 ceiling test are as follows (GeoPetro has no oil reserves):

	<u>Gas Benchmark</u>
2006	\$11.59
2007	\$9.96
2008	\$8.25
2009	\$7.25
2010	\$6.90

Subsequent to 2010, gas prices are held constant. Adjustments were made to benchmark prices, for purposes of the ceiling test, to reflect varied delivery points and quality differentials in the products delivered.

Income Taxes — Under Canadian GAAP, substantially enacted tax rates are used to calculate future taxes, whereas under U.S. GAAP, enacted tax rates are used. There is no difference between U.S. GAAP and Canadian GAAP on the consolidated financial statements as a result of this difference.

Canadian GAAP required GeoPetro to record potential future taxes using the deferral method prior to January 1, 2002. However, the Canadian standard is now similar to U.S. GAAP. Upon implementation of the new Canadian standard, there was no impact on the consolidated financial statements of GeoPetro and there was no difference between U.S. GAAP and Canadian GAAP on the consolidated financial statements as a result of this difference.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Asset Retirement Obligations — On January 1, 2003, GeoPetro adopted U.S. SFAS No. 143, effective for fiscal periods beginning on or after January 1, 2003. This standard is equivalent to the CICA new standard on Asset Retirement Obligations. The Canadian standard is similar to U.S. GAAP except that additional disclosures are required as follows:

	December 31,		
	2005	2004	2003
Asset retirement obligation, beginning of period	\$ 24,705	\$ 12,374	\$ —
Liabilities incurred	—	11,094	12,374
Accretion expense	1,936	1,237	—
Asset retirement obligation, end of period	\$ 26,641	\$ 24,705	\$ 12,374

The total estimated, undiscounted cash flows required to settle the obligations at December 31, 2005 is \$26,641 (December 31, 2004 — \$24,705; December 31, 2003 — \$12,374). These costs have been discounted using a credit-adjusted risk free rate of 10.0%. The Company expects these obligations to be settled, on average, in 7 years, the majority of which is expected to be incurred in 2013. At December 31, 2005, no funds have been set aside to settle these obligations.

Stock-Based Compensation — Effective January 1, 2004, GeoPetro retroactively adopted the new Canadian standard with respect to stock-based compensation for employees and directors for purposes of this footnote disclosure. Under the amended standard, GeoPetro must account for all stock options issued at fair value and are expensed over the vesting period with a corresponding increase in contributed surplus. When stock options are exercised, the cash proceeds along with the amount previously recorded as contributed surplus is recorded as share capital. Previously, Canadian GAAP allowed companies to account for stock-based compensation for employees and directors using the intrinsic value method, with pro forma disclosure reflecting the impact of the fair value method being used.

Under the transitional provisions of the standard, the Company has elected to apply the amended standard retroactively, with restatement to all stock options issued after the effective date of implementation being January 1, 2002. The fair value of the options issued by GeoPetro during 2003 was estimated under Canadian GAAP using the same assumptions as under U.S. GAAP, as disclosed in Note 8.

GEOPETRO RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The effect on the consolidated statements of operations for the year ended December 31, 2005, 2004 and 2003 as a result of this change in policy under Canadian GAAP is as follows:

	<u>As at and for the Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net income (loss) available to common shareholders – as reported	\$ 2,111,074	\$(2,606,978)	\$(1,943,565)
Compensation – FAS 123	<u>(98,870)</u>	<u>(63,655)</u>	<u>(94,495)</u>
Pro forma income (loss)	<u>\$ 2,012,204</u>	<u>\$(2,670,633)</u>	<u>\$(2,038,060)</u>
Income (loss) per share – as reported	<u>\$ 0.09</u>	<u>\$(0.14)</u>	<u>\$(0.12)</u>
Pro forma income (loss) per share	<u>\$ 0.08</u>	<u>\$(0.14)</u>	<u>\$(0.12)</u>

The only effect on the consolidated balance sheets as at December 31, 2005, 2004 and 2003 as a result of this change in policy under Canadian GAAP is as follows:

	<u>December 31, 2005</u>		<u>December 31, 2004</u>		<u>December 31, 2003</u>	
	Canadian		Canadian		Canadian	
	<u>As Reported</u>	<u>GAAP</u>	<u>As Reported</u>	<u>GAAP</u>	<u>As Reported</u>	<u>GAAP</u>
Shareholder's Equity						
Contributed Surplus	\$ —	\$ 257,020	\$ —	\$ 158,150	\$ —	\$ 94,495
Accumulated Deficit	<u>\$ (9,382,179)</u>	<u>\$ (9,639,200)</u>	<u>\$ (11,493,253)</u>	<u>\$ (11,651,403)</u>	<u>\$ (8,886,275)</u>	<u>\$ (8,890,770)</u>