Annual Report 1971

Pan Ocean Oil Corporation

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Adam A. W. Kryczka, Vice President
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William H. Price, Vice President-Production
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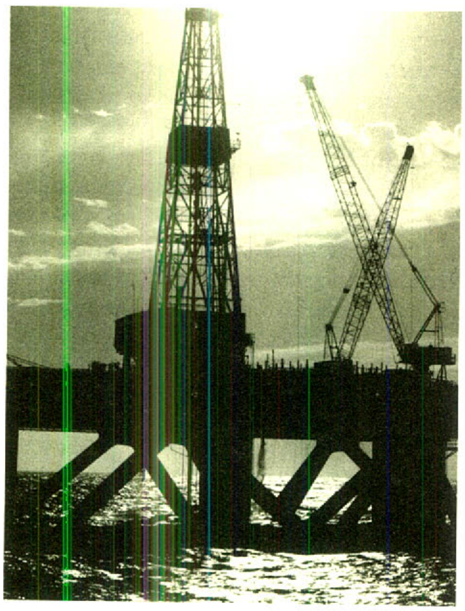


Front Cover: North Sea drilling rig Neptune 7.

Corporate Headquarters

Pan Ocean Building
645 Madison Avenue
New York, New York 10022

Transfer Agent and Registrar

Bankers Trust Company
New York, New York

Legal Counsel

Breed, Abbott & Morgan
New York, New York

Independent Accountants

Price Waterhouse & Co.
New York, New York

Dear Shareholder:

We are pleased to have this opportunity to review the developments of Pan Ocean during the past year and to communicate the direction of the Company's present activities. This annual report for 1971 covers our second full year as a public company.

The year was marked by the initiation of major exploration programs on Company holdings, and by important additions to our exploratory acreage.

In December 1971, Pan Ocean concluded a merger with eight public Canadian companies known as the Dynamic Group. This expanded Pan Ocean's interest in the energy field to encompass uranium and coal.

Pan Ocean reported consolidated revenues of $8,946,479 in 1971 as compared to $3,235,087 in 1970. Income before extraordinary items was $103,252 in 1971 compared to a loss of $5,032,411 in 1970.

As a result of an engineering study received in February 1972 on the Ozona properties in Texas, the properties were written down in the amount of $8,757,273. The wells failed to respond to stimulation experiments and performance has continued to decline. This write-down, combined with $2,604,175 in extraordinary gains, resulted in an overall loss from extraordinary items of $6,153,098, and a net loss for the period of $6,049,846 or $.61 per share.

Cash flow provided by operations in 1971 was $2,155,224 and cash flow including funds provided by extraordinary items totaled $4,759,399. These items are described more fully in the Statement of Changes in Financial Position.

Last month we were pleased to announce that arrangements have been concluded between the Pan Ocean Group, the Petronord Group, and the Norwegian State to assure the drilling this Spring of the first test well on our Block 25/4 in the Norwegian North Sea. Late in 1971 the Company began its exploratory drilling program onshore Nigeria. In the Arabian Gulf offshore Abu Dhabi, additional test drilling is anticipated later this year. As discussed further in this report, the level of Canadian activity has markedly increased—in mineral as well as hydrocarbon exploration. In Indonesia, the results of a seismic program presently being conducted in the Malacca Straits are encouraging and a more intensive program has been prepared for the balance of the year.

In January 1972, Pan Ocean and its partners were awarded exploration rights on a highly prospective 2.5 million acre block in the Amazon jungle region of Peru. The round of awards announced last month in Britain gave Pan Ocean and its partners three high-priority blocks in the U. K. North Sea. We were also recently awarded a concession offshore Thailand and an interest in a concession offshore Tunisia.

Your Company has developed a strong economic base through long-term reserves of natural resources. Cash flow will be positively affected beginning in the mid-1970's through the pre-contracted sale of presently proven energy reserves. As a result, our future cash flow should increase significantly, independent of results from exploration developments.

It was with sincere regret that the Board accepted the resignation of Dan W. Lufkin last year, necessitated by his entry into public service. We wish him continued success in his new endeavors.

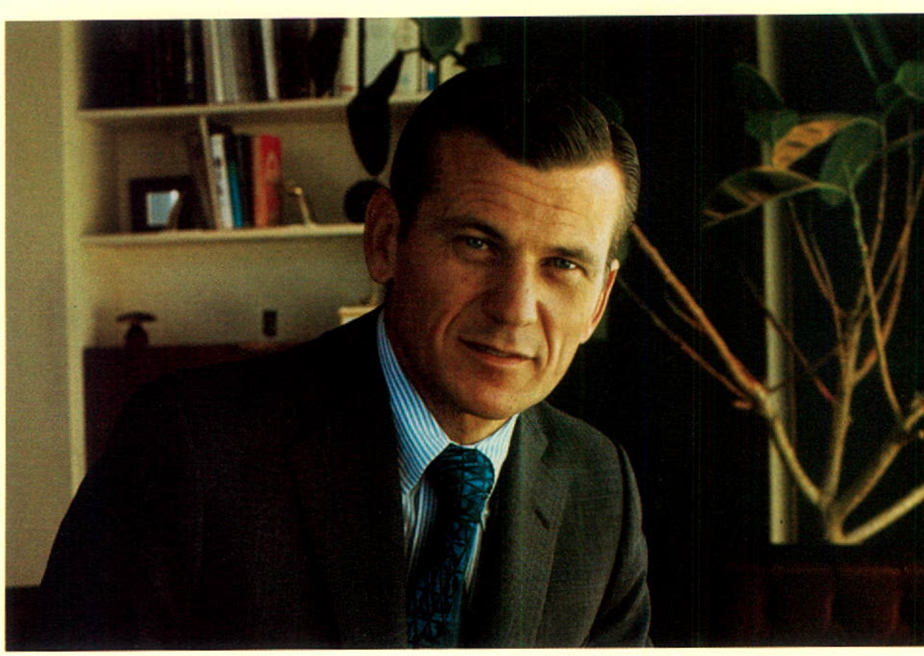
We welcome our many new shareholders and express our appreciation to all of our shareholders and personnel for their support. We look forward with all of you to the opportunities and developments of the coming year.

Respectfully submitted on
behalf of the Board of Directors,

Stanley R. Rawn, Jr.

Stanley R. Rawn, Jr.
Chairman of the Board
and
Chief Executive Officer

April 10, 1972

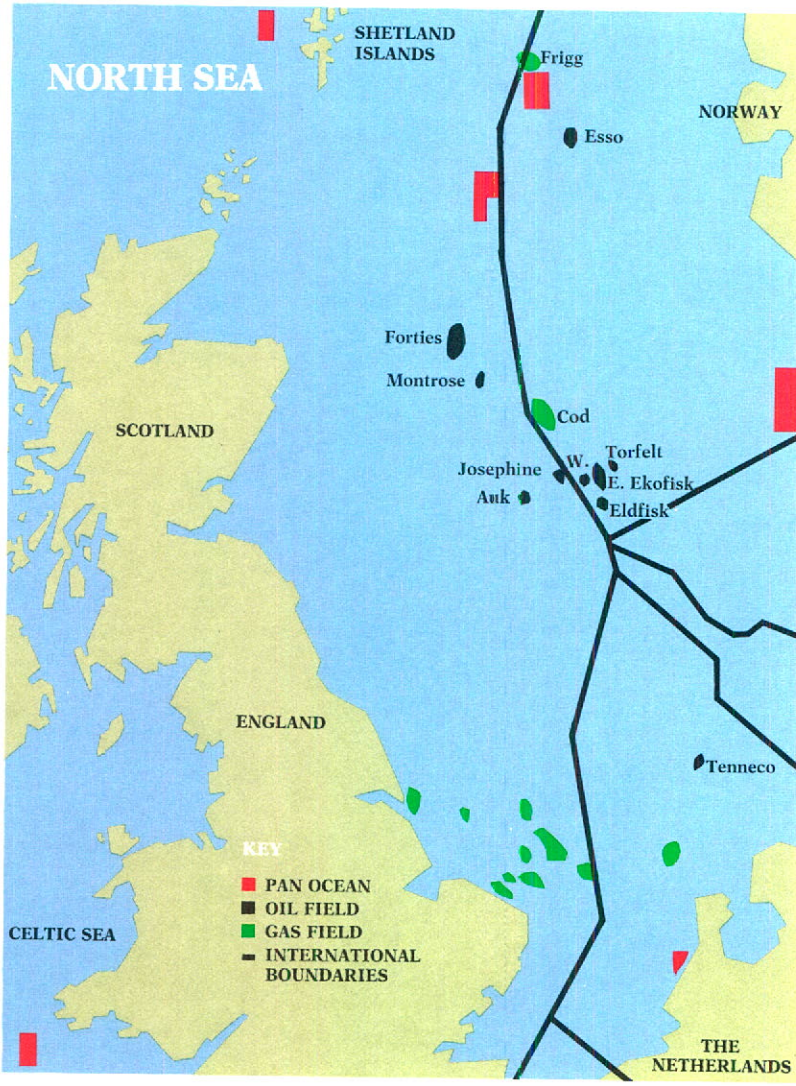


Exploration

Our primary corporate aim is exploration for major reserves in the more promising hydrocarbon basins around the world. Pan Ocean has acquired interests totaling 95 million gross acres, or 31 million net acres, located in 23 countries. These include substantial holdings in areas where the industry is currently concentrating much of its exploration activity. During the past year extensive geophysical work was accomplished in a number of areas preparatory to commencing exploratory drilling programs. Sufficient seismic work was completed to permit some exploratory drilling to begin in 1971. A more active drilling program is underway for 1972, and other areas are scheduled for initial exploratory drilling in 1973.

Pan Ocean's involvement in the **North Sea** pre-dates the Ekofisk discovery and the subsequent confirmation of the North Sea tertiary basin as an area of major hydrocarbon accumulation. As a result, Pan Ocean holds substantial interests in a number of blocks which are valuable because of both their particular location in the basin and their seismic indications.

The Pan Ocean Group recently concluded arrangements with the Petronord Group and the Norwegian State to provide for the drilling of the first test well on Block 25/4 in the Norwegian North Sea. The operator for the Petronord Group is the French State-owned oil company Elf-Erap. At least two test wells will be drilled on the Block. The first well, expected to commence in May, will be drilled with the semi-submersible rig, Neptune 7. This rig has been used to drill three wells for the Petronord Group in the Frigg Field, located 10 miles north in the adjoining Block 25/1. In the event of a discovery, the Norwegian State has the right to purchase a 40%



Neptune 7 under contract for drilling on Norwegian Block 25/4.

working interest in Block 25/4, which would reduce Pan Ocean's interest to 19.375%.

Extensive seismic has been shot in the United Kingdom portion of the North Sea on our Blocks 16/3 and 16/7, as well as certain surrounding blocks. No drilling is anticipated on these blocks in the current year because of the unavailability of suitable drilling equipment. In the recent round of U.K. awards, Pan Ocean and its partners were awarded the adjoining Block 16/2. Pan Ocean is the operator for these three blocks. In additional awards, the Company is a participant in Block 206/14 in the Shetland Islands area and in Block 103/22 in the Celtic Sea. Aquitaine Oil (U.K.) Ltd. is the operator for these latter two blocks.

Pan Ocean now has interests in ten blocks in the North Sea area, aggregating 664,799 gross acres, or 177,030 net acres, and has broad seismic coverage in both the U.K. and Norwegian sectors.

The Company has conducted detailed seismic work on its license areas, OPL 51 and OPL 71, onshore **Nigeria.** Exploratory drilling operations commenced in late December. The first two test wells were suspended as gas wells. The drilling site is now being prepared for the third exploratory well, which is expected to commence drilling next month. The Nigerian National Oil Company has been awarded all onshore license areas which had not been previously issued, including OPL 99 for which an application had been pending. Delta Oil (Nigeria) Ltd., a Nigerian company, in partnership with Pan Ocean is resubmitting an application to the Nigerian National Oil Company. Seismic work is presently continuing on OPL 71.

In January 1972, Pan Ocean signed an agreement in **Peru** with the State oil company, Petroperu, for exploration rights over a highly

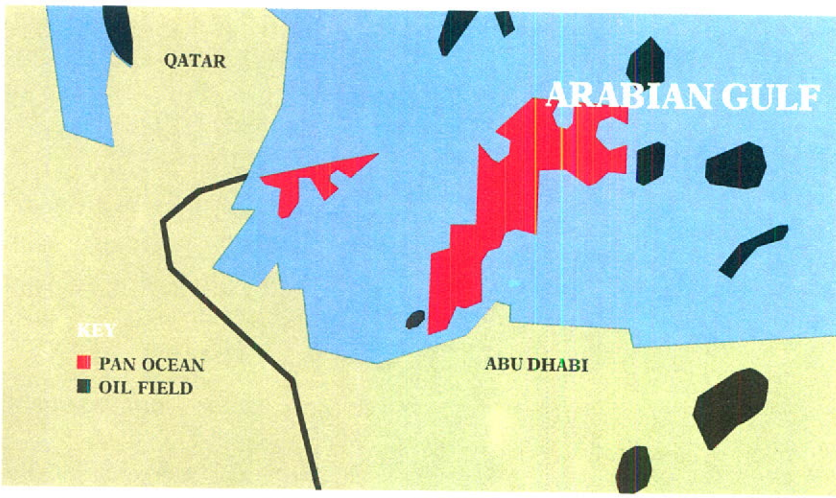
Drilling operations on OPL 51, Nigeria.

prospective 2.5 million acre area in the Amazon jungle. A series of major oil fields have been discovered in the Oriente Basin in Ecuador, indicating that this vast Basin, which extends southward into Peru, could become one of the major oil producing regions in the world. The first two exploratory wells in the Peruvian portion of the Basin were drilled by Petroperu in November 1971 and February 1972 less than 30 miles from the Pan Ocean block. Both wells were discoveries and confirm the extension of oil into the Peruvian sector of the Basin. Pan Ocean was among the first to recognize and act on this possibility some twenty months ago when it opened negotiations with Petroperu. Pan Ocean has a 25% working interest in the Peruvian block. Getty Oil Company, with a 50% interest, is the operator. Seismic work is commencing this month on the block.

Pan Ocean holds a 31.5% interest in a 778,000 acre concession offshore **Abu Dhabi** in the Arabian Gulf. The first test well was drilled last summer and was abandoned as a non-commercial gas well. An intensive seismic program is being conducted on the concession during 1972 and it is expected that a second test well will commence later this year. Amerada Hess is the operator for the concession.

In July of last year Atlantic Richfield acquired a portion of Pan Ocean's interest in **Indonesia.** The Pan Ocean area encompasses ten million acres in the Malacca Straits located off the northeast coast of central Sumatra. Atlantic Richfield, as operator, has to date conducted 1500 miles of shallow and deep marine seismic. An extensive and more detailed marine seismic program is now underway and a land program involving the offshore island area is planned to commence in June. Test drilling is expected to begin in 1973.

Huasaga River in Peru, approach to base camp.



Seismic base camp, Peru.

In **Turkey,** Pan Ocean is doing additional seismic evaluation preparatory to drilling a test well later this year. Your Company holds a 100% working interest in approximately one half million acres of exploration licenses in Turkey. A second seismic program was recently completed in the **Maldive Islands.** In March 1972, the Government of **Tunisia** awarded Pan Ocean a one-third interest in an offshore license on and around the Kuriate Islands.

In December 1971, Pan Ocean was awarded a concession offshore **Thailand.** The award, which was the first offshore concession granted to an independent oil company under the Government Petroleum Act, covers 1.7 million acres in the Gulf of Andaman. The Company has submitted an application to the Government of Thailand in the most recent round of bids for a second concession immediately north of the first.

In **Canada,** Pan Ocean now holds working interests in more than 18.6 million exploratory acres, or 3.6 million acres net to the Company's interest.

In the latter part of 1971 a $3 million oil and gas exploration program was commenced utilizing both outside and internal funds. This program, which is still in progress, has involved the Company in 43 wells to date, resulting in nine discoveries—six gas wells and three oil wells. A second program, involving an additional $3 million of outside funds, has been provided for in 1972.

In the Arctic Islands, the Company has entered into separate agreements with Sun Oil Company, Gulf Oil Canada Limited, Panarctic Oils Ltd. and others during the past year. Under these agreements, the Company has recovered substantial deposit monies and has obtained work credit commitments while retaining from 40% to 90%

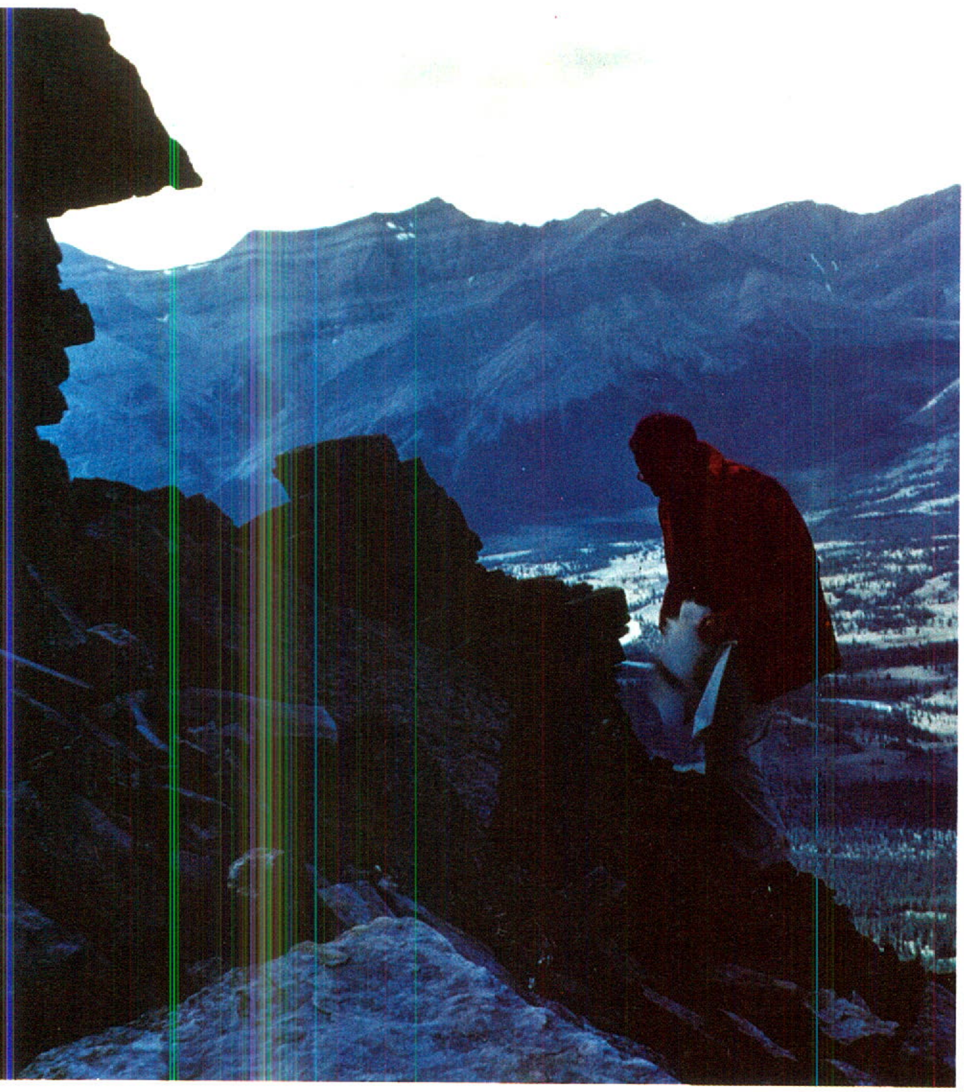
Pan Ocean exploratory test, Alberta foothills.

of its original interest in the relevant areas. The Company's 5.51% interest in Magnorth Petroleum's 14.2 million Canadian Arctic acres was highlighted in 1971 by Magnorth's agreement with Northern Natural Gas Company of Omaha, whereunder Northern will expend some $9.8 million over the next five years to explore Magnorth's acreage to earn a 25% working interest. Through the Dynamic Group, Pan Ocean acquired further Arctic interests, including a participation in the Domex Group, which has farmed out its acreage to Panarctic Oils Ltd.

These arrangements will facilitate and assure our long-term presence and interest in the frontier areas. The hydrocarbon potential of this region is growing clearer and the past year saw a significant acceleration in exploration activity.

In addition to its oil and gas leases in Canada, the Company now holds a total of approximately 1.7 million gross acres, or 500,000 net acres, of mineral permits and leases. The merger with the Dynamic Group has substantially broadened the Company's exposure in mineral exploration and provided a strong technical group to direct that work.

Through the Dynamic Group, the Company now holds substantial coal interests. A prime coking coal prospect covering 24,000 acres of leases lies north of the Montana border in the Flathead area of British Columbia. Under an agreement with Rio Tinto Canadian Exploration Limited, Rio Tinto has been conducting an extensive exploration and evaluation program on the property since 1970. Results to date support all the indications of a commercially feasible coking coal project. An active program of underground adits for evaluation purposes is planned for 1972. Upon completion of certain work requirements, Rio Tinto may acquire



Exploratory operations on Company coal leases.

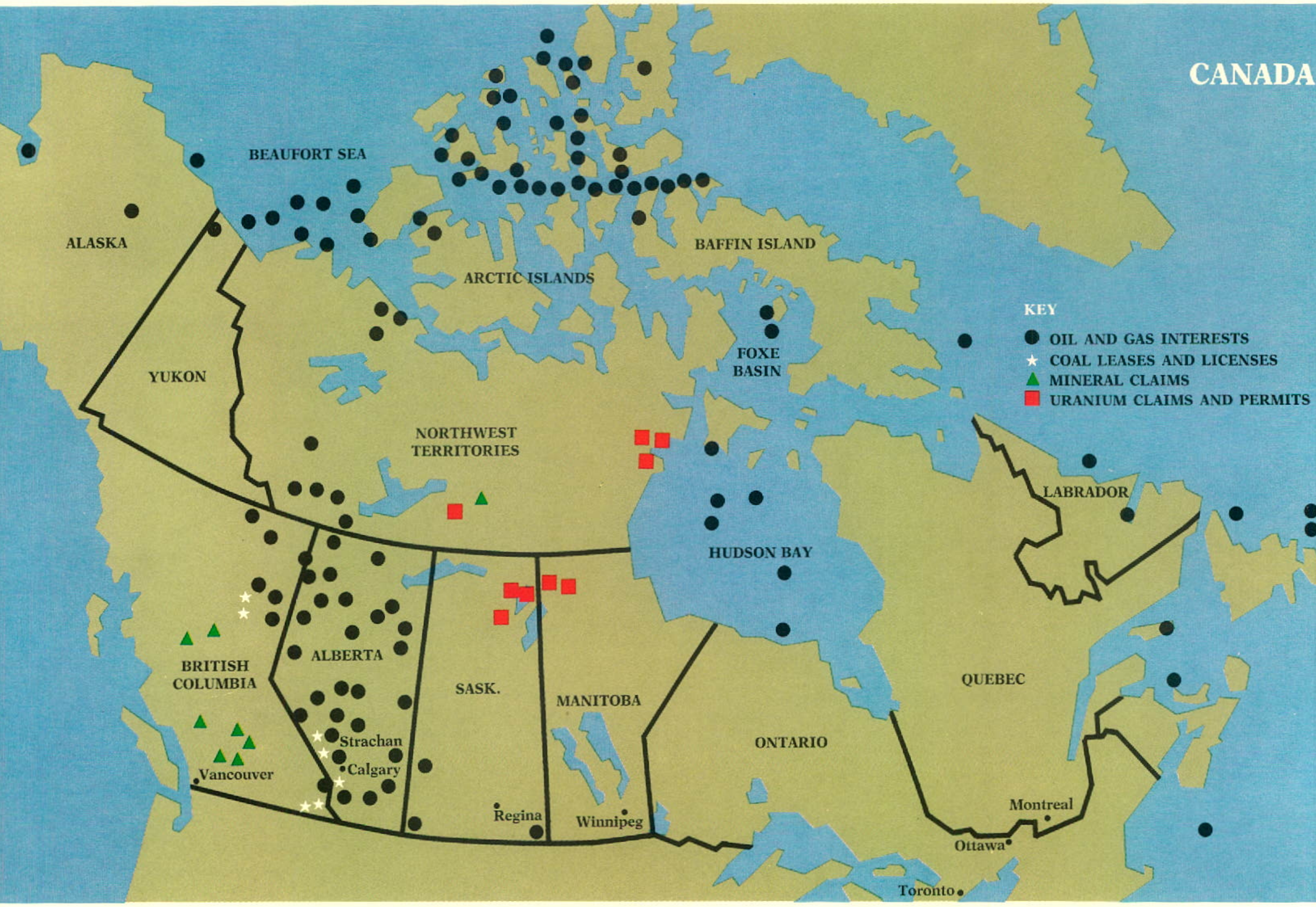
a 60% interest in the property.

In the Panther River area of Alberta, the Company has a 25% interest in approximately 33,000 acres of coal leases. Approximately $1 million of exploratory work has delineated extensive reserves of both coking and semi-anthracite coal. The project is operated by a subsidiary of American Metal Climax, Inc.

The Company holds a 100% interest in several other coal properties in earlier stages of exploration and is actively examining other areas both in Canada and the U. S.

Through the Dynamic Group, the Company holds a net profits interest (8.75% before payout and 17.5% after payout) in production that may be recovered from approximately 1.2 million gross acres in the Wollaston Lake uranium area of northern Saskatchewan. This area includes a uranium ore body discovered by Gulf Minerals Canada Limited. An independent engineering study prepared for Pan Ocean indicates that total undiscounted future cash flow to Pan Ocean from this ore body will approximate $25 million over a ten-year period commencing in 1975, the estimated date of production start-up. Uranerz Canada Ltd., composed of a German mining company and a German electric utility group, has entered into agreements with Gulf for the development of the mine-mill complex and the marketing of the uranium oxide. The awarding of a contract for the construction of the mill was announced this month. Extensive exploration for additional ore bodies in the Wollaston Lake area is being continued by Gulf at no cost to the Company.

In the Northwest Territories, and particularly the Baker Lake area, an active uranium exploration program has been conducted, including 74,000 miles of airborne radiometric surveys and a moder-



EXPLORATORY INTERESTS

LOCATION	PAN OCEAN INTEREST	ACREAGE GROSS	ACREAGE NET
1. Abu Dhabi	31.5%	778,000	245,070
2. Australia (New Guinea)	100	1,043,200	1,043,200
Canada			
3. Alberta, Saskatchewan and British Columbia	Various	1,084,353	579,577
4. Arctic (Foxe Basin)	25	493,356	123,339
5. Arctic Islands	Various	8,998,295	1,024,255
6. Baffin Island East	22.5	1,158,884	260,749
7. Beaufort Sea	25	285,821	71,455
8. East Coast Offshore	Various	3,635,774	865,339
9. Hudson Bay	Various	2,342,438	494,721
10. Labrador Onshore	33.3	380,400	126,800
11. Northwest Territories—Yukon	Various	235,046	76,192

LOCATION
12. Colombia
13. East China Sea*
14. Ecuador
15. Fiji Islands
16. Ghana
17. Indonesia
18. Italy
19. Maldive Islands

*Lease application—priority filing.

TOTAL ACREAGE: Gross-

PAN OCEAN INTEREST	ACREAGE	
	GROSS	NET
2.5	556,030	13,900
70	10,000,000	7,000,000
66.25	606,000	401,475
12.5	1,920,000	240,000
2.095	1,885,440	39,450
Various	11,160,683	3,772,887
Various	337,673	167,947
22.5	30,201,173	6,795,264

–94,694,620; Net—31,542,838

LOCATION	PAN OCEAN INTEREST	ACREAGE	
		GROSS	NET
20. New Zealand	12.5	1,276,000	159,500
21. Nigeria	100	480,979	480,979
22. North Sea			
Dutch Sector	Various	55,000	13,997
Norwegian Sector	Various	332,695	88,420
U.K. Sector	Various	277,104	74,613
23. Peru	25	2,510,536	627,634
24. Sierra Leone	50	2,560,000	1,280,000
25. South Africa	40.9	6,890,240	2,817,420
26. Thailand	100	1,779,120	1,779,120
27. Tunisia	33.3	185,819	61,939
28. Turkey	100	494,200	494,200
29. United States	Various	750,361	323,396

ate amount of test drilling. In addition, the Company is engaged in exploration for copper, nickel, and molybdenum, principally in British Columbia where we have interests in 25 properties. A number of these are located in some of the currently active exploration areas, such as Highland Valley, Iron Mask, and East and North Barrier Lake.

Production

The gas wells in the Ozona field in Texas have failed to demonstrate predicted performance, and stimulation experiments to improve flow rates have not been successful. In early 1972, the gasoline plant began processing additional gas from the wells of other operators in the area. However, we expect these wells also to decline rapidly. A revised engineering report was received in February 1972. This report indicated severe declines in future production and on this basis the properties were substantially written down.

Production from the Strachan gas plant, which commenced in late February 1971, exceeded expectations for the year. Pan Ocean's share of the gas (15.2 billion cubic feet) and condensate (430,141 net barrels) generated $2,740,000 in 1971 after direct operating costs. Over 51,000 tons of sulphur were produced net to Pan Ocean's interest, and were stockpiled pending improvement in market conditions. A proposal to construct LPG recovery facilities at the plant is currently under study.

Acquisition of Dynamic Group Companies

In November 1971, Pan Ocean proposed a plan to effect a merger with the eight Dynamic Group companies—Dynamic Petroleum Products Ltd., Mill City Petroleums Limited, Permo Gas & Oil Limited, Consolidated East Crest Oil Company Limited, Royal Can-

Pan Ocean Officers in London and Canada

(Right) F. William Popp, Vice President-International Operations; (Far right) William H. Price, Vice President-Production; (Below) Adam A.W. Kryczka, Vice President.

Facing page: (Top) Victor E. Trudel, Executive Vice President; (Below) Alaster G. Swanson, Vice President-Mining.

adian Ventures Ltd., Dynalta Oil & Gas Co. Ltd., Crusade Petroleum Corporation Limited, and New Continental Oil Company of Canada Limited. The Plan and Agreement of Reorganization was overwhelmingly approved by the shareholders of each of the Dynamic Group companies at eight separate Special General Meetings held on December 6, 1971.

For share exchange purposes, the total net asset value of the Dynamic Group companies was appraised by independent engineers at approximately $34 million. As in the case of United Bata Resources Limited (N.P.L.), the acquisition was treated as a pooling of interests, which means that the net assets of the Dynamic Group are carried for accounting purposes on Pan Ocean's books on an historical cost basis of approximately $8 million rather than on the basis of appraised value. Similarly, the net assets of United Bata carry a book value of approximately $3 million whereas independent engineering appraisals indicate a value of approximately $40 million.

With the merger of the eight Dynamic companies, Pan Ocean's total shareholders of record now exceed 22,000.

Management

Pan Ocean has recently formed a Mining Division operating out of Calgary. This Division will be headed by Alaster G. Swanson, who formerly served in that capacity with the Dynamic Group. Mr. Swanson was also recently named Vice President of the parent company. William H. Price, an officer of Pan Ocean Oil Ltd. in Canada, has also been named Vice President-Production of the parent company.

Financial

Pan Ocean's consolidated financial statements for 1971 include the operations of the Dynamic Group companies, and our financial statements for 1970 have been restated to include the Dynamic Group operating results.

Total revenues increased from $3,235,087 in 1970 to $8,946,479 in 1971. Pan Ocean reported income before extraordinary items of $103,252 in 1971, compared to a loss before extraordinary items of $5,032,411 in 1970. Depletion charges were substantially increased over those shown in Pan Ocean's nine-months statement after the retroactive application of Pan Ocean's accounting policy for exploration and development costs to the results of operations of the Dynamic Group companies. The write-off of several mineral exploration projects, together with the expenses relating to the Dynamic merger, both occurring during the fourth quarter, also contributed to the reduction of income before extraordinary items for the year 1971. The writedown of the Ozona properties in Texas by $8,757,273 was partially offset by an extraordinary gain of $1,122,713 from the sale of securities, and by $1,481,462 reduction of income taxes payable, resulting in a total extraordinary loss of $6,153,098. Net loss after extraordinary items was $6,049,846 or $.61 per share for the year.

Cash flow provided by operations during 1971 was $2,155,224, and cash flow provided by extraordinary items totaled $2,604,175, resulting in a total of $4,759,399.

The balance sheet reflects a current asset position at year end of $15.8 million, $11.1 million of which is represented by cash and near-cash assets, and a working capital position of $7.4 million.

The Company is considering the possibility of a public financing in 1972 to further strengthen its financial position.

Consolidated Balance Sheet

	December 31, 1971	December 31, 1970 (Restated Note 1)
ASSETS		
Current assets:		
Cash	$ 4,207,329	$ 4,224,253
Time deposits	6,887,129	14,559,821
Marketable securities, at cost (approximate market value —1971, $1,610,000; 1970, $1,790,000)	1,507,281	1,361,441
Accounts receivable	1,611,023	1,126,069
Prepaid expenses and other assets	75,198	97,641
Income tax refund (Note 6)	1,481,462	—
Total current assets	15,769,422	21,369,225
Properties and equipment, at cost (Notes 5, 6 and 7):		
Developed oil and gas properties	18,737,507	24,661,425
Furniture and fixtures	603,387	366,247
	19,340,894	25,027,672
Less—Accumulated depletion, depreciation and amortization	4,218,035	3,378,635
	15,122,859	21,649,037
Undeveloped leaseholds, mineral rights and mining claims	17,003,041	12,690,651
	32,125,900	34,339,688
Other assets:		
Investments, at cost	92,249	1,204,944
Loan to officer (Note 8)	106,667	160,000
Other	651,223	500,018
	850,139	1,864,962
Total assets	$48,745,461	$57,573,875
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 2,323,757	$ 1,981,381
Notes and other payables to banks	—	202,725
Income taxes payable (Notes 6 and 9)	—	1,609,813
Long-term debt due within one year (Note 7)	6,085,863	1,051,200
Total current liabilities	8,409,620	4,845,119
Long-term debt (Note 7)	15,925,710	21,638,802
Minority interest in consolidated subsidiaries	90,000	—
Shareholders' equity (Notes 1, 7 and 8):		
Common stock $.01 par value—authorized 30,000,000 shares; issued and outstanding 9,831,136 shares in 1971 and 9,589,755 shares in 1970	98,311	95,898
Preferred stock $1.00 par value—authorized 5,000,000 shares; issued—none		
Capital in excess of par value	45,445,975	46,168,365
Deficit	(21,224,155)	(15,174,309)
Total shareholders' equity	24,320,131	31,089,954
Commitments and contingencies (Note 11)	—	—
Total liabilities and shareholders' equity	$48,745,461	$57,573,875

The accompanying notes are an integral part of these statements.

Consolidated Statement of Loss and Deficit

	For the year ended December 31, 1971	1970 (Restated Note 1)
Revenues:		
Sales and other operating revenue	$ 5,914,952	$ 2,300,021
Interest and dividend income	733,181	715,741
Gain (loss) on sales of interest in undeveloped properties	2,177,411	(20,352)
Other income	120,935	239,677
	8,946,479	3,235,087
Cost and expenses:		
Production and lease operating expenses	1,689,285	1,047,847
Depletion, depreciation and amortization	1,399,603	760,594
Abandonments of undeveloped properties	652,369	2,567,941
Interest expense	1,656,356	797,061
Deferred preoperating expenses	—	556,934
General and administrative expenses	3,445,614	2,537,121
	8,843,227	8,267,498
Income (loss) before extraordinary items	103,252	(5,032,411)
Extraordinary items (Note 6):		
Write-down of developed properties	(8,757,273)	
Gain on sale of securities	1,122,713	
Reduction in income taxes payable arising from above items and realization of prior years' tax losses	1,481,462	
	(6,153,098)	—
Net loss	(6,049,846)	(5,032,411)
Deficit, beginning of year, as previously reported (Note 1):	(5,958,758)	(1,261,125)
Adjustments to give effect to the combination of The Dynamic Group of Companies and United Bata	(9,215,551)	(8,880,773)
Deficit, beginning of year, as restated	(15,174,309)	(10,141,898)
Deficit, end of year, as restated	($21,224,155)	($15,174,309)
Per average share of common stock and common stock equivalents (Note 10):		
Income (loss) before extraordinary items	$.01	($.54)
Extraordinary items	(.62)	—
Net loss	($.61)	($.54)

Statement of Common Stock and Capital in Excess of Par Value

	Common stock	Capital in excess of par value
Balance at December 31, 1969 as previously reported	$ 66,255	$17,763,607
Credit resulting from pooling of interests with The Dynamic Group of Companies (Note 1)	19,672	17,710,363
Balance at December 31, 1969 as restated	85,927	35,473,970
For the period January 1, 1970 to December 31, 1970:		
Issuance of 479,943 shares of common stock in connection with the acquisition of Vaneil Properties, Inc., Pocantico Oil & Gas Corp. and Ocean Platinum Company (Note 4)	4,799	6,450,436
Exchange of 247,878 shares of common stock for developed natural gas properties (Note 4)	2,479	2,685,321
Credit resulting from gain on purchase and sale of Bata common shares	—	90,803
Proceeds from various sales of 1,691 shares of common stock for cash	17	21,133
Issuance of Bata common shares converted to equivalent number of Pan Ocean common shares (Notes 1 and 8):		
Proceeds from sales of 261,667 shares of common stock relating to exercise of stock options and warrants	2,617	1,288,901
Exchange of 5,923 shares of common stock for oil and gas interests	59	157,801
Balance at December 31, 1970 (restated—Note 1)	95,898	46,168,365
For the period January 1, 1971 to December 31, 1971:		
Issuance on 92,715 shares of common stock in connection with the acquisition of Interocean Oil Company, Inc. (Note 4)	927	2,039,073
Exchange of 142,874 shares of common stock for undeveloped leaseholds and mineral rights	1,429	2,141,681
Issuance of 5,792 shares of common stock in connection with acquisition of Tur-Kan Petrol, Ltd. (Note 4)	57	69,446
Purchase of the Dynamic Group of Companies common stock, cancelled pursuant to merger agreement	—	(4,972,590)
Balance at December 31, 1971	$ 98,311	$45,445,975

The accompanying notes are an integral part of these statements.

Consolidated Statement of Changes in Financial Position

	For the year ended December 31, 1971	1970 (Restated Note 1)
Financial resources were provided by:		
Income (loss) before extraordinary items	$ 103,252	($ 5,032,411)
Add—Charges not requiring the outlay of funds:		
Depreciation, depletion and amortization	1,399,603	760,594
Abandonments of undeveloped properties	652,369	2,567,941
Deferred preoperating expenses	—	556,934
Working capital provided (used) by operations	2,155,224	(1,146,942)
Working capital provided by extraordinary items:		
Gain on sale of securities	1,122,713	—
Reduction in income taxes payable arising from realization of current and prior years' tax losses	1,481,462	—
Issuances of common stock:		
For developed and undeveloped properties	2,143,110	2,845,660
Acquisition of certain subsidiaries	2,109,503	6,455,235
Proceeds from sales of common stock	—	1,403,471
Decrease in investments	1,112,695	—
Increase in long-term debt	—	20,948,442
Total source of funds	10,124,707	30,505,866
Financial resources were used for:		
Additions to properties and equipment:		
Developed oil and gas properties	2,790,071	11,237,817
Undeveloped oil and gas properties	5,568,246	7,655,950
Furniture and fixtures	237,140	277,356
	8,595,457	19,171,123
Increase in investments	—	1,204,944
Purchase of minority interest in The Dynamic Group of Companies (Note 1)	4,972,590	—
Reduction of long-term debt	5,713,092	—
Other items, net	7,872	(681,763)
Total application of funds	19,289,011	19,694,304
(Decrease) increase in working capital	(9,164,304)	10,811,562
Working capital at beginning of period	16,524,106	5,712,544
Working capital at end of period	$ 7,359,802	$16,524,106
Changes in components of working capital:		
Increase (decrease):		
Current assets—		
Cash	($ 16,924)	$ 1,062,870
Time deposits	(7,672,692)	11,037,810
Marketable securities	145,840	1,151,225
Accounts receivable	484,954	191,177
Prepaid expenses and other assets	(22,443)	118,018
Income tax refund	1,481,462	—
Total current assets	(5,599,803)	13,561,100
Current liabilities—		
Accounts payable and accrued liabilities	342,376	590,745
Notes and other payables to banks	(202,725)	(502,220)
Income taxes payable	(1,609,813)	1,609,813
Long-term debt due within one year	5,034,663	1,051,200
Total current liabilities	3,564,501	2,749,538
(Decrease) increase in working capital	($ 9,164,304)	$10,811,562

The accompanying notes are an integral part of these statements.

Notes to Consolidated Financial Statements

Note 1—Organization and Reporting:

Pan Ocean Oil Corporation was incorporated on September 4, 1968. On February 5, 1971 Pan Ocean and United Bata Resources Limited (N.P.L.)(Bata) effected a merger whereby a total of 3,080,487 shares of Pan Ocean common stock were issued for the common shares of Bata.

On December 22, 1971 Pan Ocean effected a merger with eight Canadian companies known as The Dynamic Group of Companies (Dynamic). Pursuant to the combination terms Pan Ocean issued 1,967,152 shares of its common stock in exchange for more than 90% of the outstanding shares of The Dynamic Group of Companies.

These mergers were treated as poolings of interest for accounting purposes and the accompanying consolidated financial statements have been adjusted retroactively to include the operations of Bata and Dynamic. As permitted by Opinion No. 16 of the Accounting Principles Board of the American Institute of Certified Public Accountants, the company elected last year to account for the merger with Bata under previous pronouncements. Accordingly, the previously reported consolidated statements of income and loss for the years prior to 1971 were adjusted retroactively to include the operations of Bata.

The following presents the adjustments made in 1971 to the previously reported results of operations for 1970 to give effect to (1) the pooling of interests with Dynamic and (2) certain restatements to the 1970 accounts of Bata relating to a change in the method of accounting for exploration and development costs to conform to the accounting policies followed by Pan Ocean:

	Year ended December 31, 1970		
	Revenues	Costs and Expenses	Net Loss
As previously reported (includes operations of Bata)	$1,817,229	$6,514,862	$4,697,633
Adjustments—			
Dynamic	1,417,858	2,138,202	720,344
Bata	—	(385,566)	(385,566)
As restated	$3,235,087	$8,267,498	$5,032,411

For financial reporting purposes, operations were deemed to have commenced on December 20, 1968 for Bata and on January 1, 1970 for Pan Ocean. For the year 1970, Bata had revenues of $57,000 and a net loss of $1,703,000. Dynamic had revenues of $1,354,271 and net income of $88,689 for the period January 1, 1971 through December 22, 1971, the effective date of the merger.

Note 2—Operations:

Pan Ocean, including the companies combined through poolings of interest described in Note 1, is engaged primarily in the acquisition and exploration of interests in undeveloped oil, gas and mineral acreage in the United States, Canada and various other countries throughout the world. Income results from periodic sales of fractional interests in these undeveloped properties as well as from the production of discovered reserves where a decision is taken that development and production of discoveries present a more attractive exploitation alternative. To date, Pan Ocean has significant producing natural gas and oil properties only in Canada and limited production in the United States.

Note 3—Accounting Policies:

The consolidated financial statements include the accounts of the company and its majority-owned subsidiaries.

The company follows the total cost method of accounting for its oil and gas interests. Under this method of accounting, all direct costs of acquisition, exploration and development are initially capitalized. Undeveloped properties acquired for stock are valued at fair market value of the properties when acquired. A proportionate share of such costs is included in income when fractional interests are sold. Depreciation, depletion and amortization of the capitalized costs are provided for generally on a unit-of-production basis as removable oil and gas reserves are produced. Costs associated with unsuccessful properties are written off at the time such properties are abandoned or surrendered.

Note 4—Acquisitions:

In a series of transactions over the past several years Pan Ocean acquired certain developed natural gas properties and several companies having assets consisting primarily of proven or producing oil and gas properties, interests in undeveloped properties, marketable securities and minority holdings of common stock in certain oil and gas companies. As reported in prior years' annual reports the acquisitions of properties in Crockett County, Texas (Note 6), Vaneil Properties, Inc. and Pocantico Oil & Gas Corp. were undertaken to establish a basis for future cash flow. All such acquisitions were accounted for as purchases and recorded at the fair value of assets acquired. The statement of income and loss includes the operations of such companies from their respective dates of acquisition.

These acquisitions are summarized as follows:

Acquisition date	Property acquired	Pan Ocean shares issued
1969/1970	Developed Natural Gas Properties in Crockett County, Texas	454,366
February 9, 1970	Vaneil Properties, Inc.	326,531
June 30, 1970	Pocantico Oil & Gas Corp.	140,000
July 2, 1970	Ocean Platinum Company	13,412
February 26, 1971	Interocean Oil Company, Inc.	92,715
September 30, 1971	Tur-Kan Petrol Ltd.	5,792

The net assets of Vaneil at date of acquisition had an estimated fair value of $4,870,000 after recognition of the tax effect of the difference between tax and financial statement basis of certain assets. During the period from February 9, 1970 to April 30, 1970 the marketable securities of Vancil were sold for cash of $4,786,000. No gain or loss resulted for financial reporting purposes after provision for taxes payable of $1,465,000. The agreement relating to the acquisition of Interocean Oil Company, Inc. provides for the possible issuance of an additional 57,285 common shares if, to the company's satisfaction, title matters involving certain undeveloped properties are resolved.

Note 5—Developed Oil and Gas Properties:

Developed oil and gas properties are summarized as follows:

	December 31, 1971	December 31, 1970
Producing lands and leases	$10,444,323	$14,507,148
Lease and well equipment	2,748,288	3,397,868
Pipelines	50,000	1,216,105
Processing plants and related equipment	4,906,336	4,777,127
Other	588,560	763,177
	$18,737,507	$24,661,425

Producing proven reserves valued on a present value basis substantially exceed the carrying value of the company's investment in developed oil and gas properties.

Note 6—Extraordinary Items:

Nonrecurring write-down of acquired reserves and related facilities:

Included in the acquired properties described in Note 4 were certain natural gas wells and related facilities in Crockett County, Texas (acquired during 1969 and 1970). The net assets received were recorded at their estimated fair value based on an independent appraisal engineer's projection of future cash flow discounted at 8%. Certain shareholders of the company held significant interests in the Texas properties prior to their acquisition by Pan Ocean.

During 1971 these Texas properties demonstrated increasingly disappointing performances. The wells failed to respond to stimulation and performance continued to decline. Consequently, a new reserve study was commissioned and the report was received in February 1972. The study indicated that the previously estimated reserves required a significant downward adjustment and, accordingly, the properties have been written down in value by $8,757,273 to their estimated remaining residual value of approximately $1,200,000.

Reduction in income taxes payable and realization of current and prior years' tax losses:

As described in Note 4 the company provided in 1970 income taxes payable of $1,465,000 in connection with the sale of certain securities. The extraordinary credit to income in 1971 of $1,481,462 is substantially the benefit resulting from the utilization of current and prior years' tax losses to reduce this recorded income taxes payable.

Note 7—Long-term Debt:

Long-term debt at December 31, 1971 includes the following:

Convertible Subordinated Note, due July 1, 1985 with interest at 8%	$10,000,000
Secured bank loan, at ½% over Canadian prime rate	6,385,985
Notes payable to banks, interest averaging approximately 7¼% at December 31, 1971 and 8% at December 31, 1970	3,672,031
Other notes payable, due January 1, 1972 with interest at 5%	1,953,557
	22,011,573
Less—Estimated amounts to be paid within one year included in current liabilities	6,085,863
	$15,925,710

During 1970 the company received from Pioneer Lands Corporation $10,000,000 cash for an 8% Convertible Subordinated Note which is convertible into common stock of the company at $12.50 per share. Pioneer Lands and certain of its affiliated companies and individuals at that time owned approximately 50% of the outstanding common stock of Pan Ocean. If the note were fully converted 800,00 shares would be issued to a present shareholder of the company, who obtained title to the note upon the liquidation of Pioneer Lands Corporation in 1970.

The bank loan of $6,385,985 is secured by assignments of interests in certain Canadian hydrocarbon reserves. The terms of the loan agreement provide for repayment from production from the assigned reserves. The term of repayment is not to exceed seven years. The company estimates that approximately $460,000 of the loan will be repaid during 1972.

Note 8—Common Stock and Stock Option Plan:

On August 22, 1969, pursuant to a Stock Purchase Agreement dated as of May 31, 1969 between the company and an officer, the company issued 60,000 shares of common stock for $160,000 in cash. In connection with this transaction, the company on August 25, 1969 loaned such officer $160,000 with interest at 7% per annum to be repaid in equal instalments on June 1, 1971, 1972 and 1973. At December 31, 1971 the principal balance due on the loan is $106,667.

The company has a qualified stock option plan, ratified by the shareholders on March 5, 1969, to grant options for up to 300,000 shares. During 1971, 5,000 shares previously granted under the 1968 stock option plan were cancelled, reducing outstanding options granted under this plan to 294,500. On December 11, 1970, shareholders ratified a new plan to grant options to purchase up to 75,000 shares. No options have been granted under this new plan as of December 31, 1971. Both plans provide for the purchase of stock at 100% of its fair market value as of the date the option is granted. Options may not be exercised under either plan unless the grantee remains in the employ of the company for one year after the date of grant. The options expire up to five years from the date of grant.

During 1971 options have been granted to directors and employees of the company who are foreign nationals to purchase 124,500 shares at an option price of $12.00 per share and 10,000 shares at an option price of $9.50 per share which were the fair market values at the date of grants. Also during 1971 nonqualified options for 20,000 shares at $9.50 per share which was the fair market value at date of grant were issued to non-employees. The options expire up to five years from the date of grant.

Stock option transactions during the year ended December 31, 1971 are summarized as follows:

	Number of shares	Option price
Shares under option at December 31, 1971	279,000	$8-$21
Options which became exercisable in 1971	99,500	$8-$21
Options exercised	None	None

The agreement whereby Pan Ocean merged with Dynamic provided that stock options held by Dynamic employees at December 22, 1971 be assumed by Pan Ocean. The Dynamic options are exercisable into Pan Ocean stock at the same conversion rates used in effecting the merger between Pan Ocean and Dynamic. At December 31, 1971 approximately 28,200 Pan Ocean shares are subject to option by former Dynamic employees at an average exercise price of approximately $9.20 per share.

The excess of proceeds over par value of shares issued under stock options is credited to capital in excess of par value.

Note 9—Income Taxes:

Possible United States tax benefits relating to $7,000,000 of losses reported for financial statement purposes have not been recorded as at December 31, 1971. These losses have not been taken as yet for tax purposes and accordingly the company has not claimed this United States tax loss as a carry-forward on its returns through that date.

For Canadian income tax purposes, at December 31, 1971 the company's Canadian subsidiaries have expenditures relating to drilling, exploration and lease acquisition costs amounting to approximately $10,100,000 and expenditures relating to capital cost allowances amounting to approximately $5,500,000 available to be carried forward and applied against future Canadian taxes payable.

Note 10—Earnings Per Share:

Per share amounts are based on the average number of common shares outstanding during each year adjusted for the assumed exercise of all dilutive stock options computed by the application of the "treasury stock" method, after giving effect to the shares issued in connection with the mergers referred to in Note 1.

Fully diluted per share amounts have not been presented since the assumed conversion of the convertible debenture would have an antidilutive effect.

Note 11—Commitments and Contingencies:

The agreements, leases and permits through which the company holds direct and indirect interests in undeveloped leasehold and mineral rights involve various obligations in the form of exploratory work programs and drilling of wells in order to retain the rights to the acreage. At December 31, 1971 the company had commitments of approximately $5,200,000, $3,300,000, and $800,000 for the years 1972, 1973 and 1974. The company has a ten-year lease for office space at a yearly rental of approximately $225,000.

In 1971 the Canadian Department of National Revenue issued notices of reassessment disallowing certain deductions claimed by Dynamic in arriving at taxable income for its 1966 and 1967 fiscal years with the result that income taxes and interest totaling $234,165 have been paid. The company believes that the reassessments are without merit and is contesting them. Accordingly, the income taxes and interest paid have not been shown in the accompanying statement of income and deficit and the payments have been included in other assets at December 31, 1971.

The company has no knowledge of any other litigation of tax or other claims pending or considered likely or any other contingent liabilities of any important consequence.

Opinion of Independent Accountants

To the Shareholders and the
Board of Directors of
Pan Ocean Oil Corporation

In our opinion, based on our examination and the reports mentioned below of other independent accountants, the accompanying consolidated balance sheet, the related statement of consolidated loss and deficit, and the statements of common stock and capital in excess of par value and changes in financial position present fairly the financial position of Pan Ocean Oil Corporation and its subsidiaries at December 31, 1971, the results of their operations and the changes in financial position for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Our examination of these statements was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the consolidated financial statements of certain consolidated subsidiaries, principally Pan Ocean Oil Ltd. and The Dynamic Group of Companies, which statements reflect total assets and revenues constituting 41% and 55%, respectively, of the related consolidated totals; these statements were examined by other independent accountants whose reports thereon have been furnished to us.

Price Waterhouse & Co

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