



## **Annual Report and Financial Statements 2005**

**Karelian Diamond Resources PLC**



## Contents

Chairman's Statement	2
Company Information	9
Board of Directors	10
Directors' Report	11
Independent Auditors' Report	13
Profit and Loss account	15
Balance Sheet	16
Cash Flow Statement	17
Statement of Accounting Policies	18
Notes to the Financial Statements	20

# Chairman's Statement



Professor Richard Conroy  
Chairman

Dear Shareholder,

I have great pleasure in presenting your Company's first Annual Report and Financial Statements.

Karelian Diamond Resources P.l.c. (KDR) is the holding company of a diamond exploration group focused on the discovery of potential world-class diamond deposits on the Finnish side of the Karelian Craton.

The Karelian Craton, a block of ancient crustal rocks in North West Europe, shows all the characteristics of diamond producing cratons found elsewhere in the world. The potential of the Karelian Craton to host diamond deposits is indicated by major discoveries by other companies on the Russian side of the same Craton. These include two world class deposits, the Grib pipe which is estimated to contain a resource of 98 million tonnes at an average grade of 69 cpht with an estimated in situ value of US\$3.7 billion and the Lomonosova diamond deposit whose diamond reserves are estimated to be worth US\$12.0 billion.

The regional geology of Finland is also similar to that of Canada's Slave Lake Craton, where diamonds were first discovered in 1991. BHP Billiton's Ekati mine opened in 1998 and produced over 7 million carats in 2003, worth approximately US\$800 million. Rio Tinto's Diavik mine opened in early 2003 and produced some 3.8 million carats in its first year, worth around US\$380 million. Two further diamond mines (Jericho and Snap Lake) are planned to come into production in the region in the near future.

KDR holds a total of 58 diamond claims in Finland, 21 of which were acquired in July 2004, when the Company purchased Nordic Diamonds Limited from Conroy PLC and Karelian Diamonds Limited from Conroy Diamonds and Gold PLC., together with all intellectual property and confidential proprietary data relating to the diamond exploration

programmes in Finland of those two companies. KDR has subsequently applied for and been awarded a further 37 claims under claim reservation exclusivity, including claims covering a diamondiferous kimberlite pipe at Seitaperä in the Kuhmo area.

KDR's licences in Finland are divided on a geographical basis into four separate claim blocks (Lapland, Western Finland, Kuhmo and South-eastern Finland) all four of which have been independently assessed as "highly prospective for diamonds".

Diamondiferous kimberlites are largely confined to ancient stable cratons where the thickness of the earth's crust is sufficient to minimise heat loss and preserve the high temperatures necessary for diamond formation. The Kuhmo area of the Karelian Craton is characterised by a particularly thick crustal zone.

KDR management has developed a close working relationship with the Geological Survey of Finland ("GTK") and is able to draw on its expertise, its extensive knowledge of the geology of Finland and its excellent technical and laboratory services. KDR employs GTK staff as local consultants and to carry out fieldwork and has benefited greatly from this relationship, which has extended over many years. In addition KDR's senior consultant, Dr Bert Gerryts, is an internationally respected diamond geologist who pioneered the use of



*(L to R) Dr Teigist Chernet (GTK), Dr Hugh O'Brien (GTK), Dr Jukka Marmo (GTK), Roger Chaplin and Professor Richard Conroy on-site in Kuhmo.*

indicator minerals and geophysics in diamond exploration.

KDR's exploration programme will include further drilling of the known diamondiferous pipe at Seitaperä in the Kuhmo block, ground geophysics in the adjacent area to select further drilling targets and till sampling up ice, followed where appropriate by ground geophysics and drilling. Work will also continue on the other three highly prospective blocks.

Your Company is undertaking its diamond exploration programme at a time of buoyant market conditions for diamonds due to the tightness of supply and growing demand. Diamond prices are now rising faster than at any time since the late 1980s.

The management of your Company, together with its staff and consultants, have a track record of success in mineral exploration and look to enhance this record with a major commercial diamond discovery in Finland.

### **Finland and Diamonds**

Finland has a long mining history, principally as a base metals producer providing raw materials for the nation's smelting industry. Prior to joining the EU in 1995, the industry was largely State-controlled and exploration and mining was restricted to Finnish companies. On joining the EU, Finland opened its borders to explorers and miners of other nationalities, but the country is still relatively under-explored compared to other diamond producing countries, though its potential for diamond recovery is becoming increasingly recognised. Finland is a mining friendly country with a well-developed infrastructure, a high standard of education and a high level of industrial development. The climate and terrain are suitable for year round mining and exploration.

The diamond prospective area in Finland is defined as the area where the rocks are Archaean in age,

the heat flow is very low and the lithospheric mantle is thick – greater than 200km. (This area is almost the same size as, and has a similar geology to, the Slave Craton in Canada, where two diamond mines are currently operating and a third is under development). The Archaean terrain that comprises much of eastern and northern Finland is contiguous with the Karelian and Kola cratons in Russia. These cratons in Russia contain the Arkhangelsk kimberlite province with substantial diamond deposits, at the easternmost edge of the shield, and the diamond-bearing lamproites at Kostamuksha, near the Finnish border. The Karelian craton in Finland is under-explored, given its size and potential, and by analogy with other shield areas has the possibility for significant diamond discoveries.

Kimberlite was first discovered in Finland in 1964, although it was not identified as kimberlite at the time. It was not until 1984, when Ashton Mining Limited of Australia began working with Malmikaivos Oy, a small Finnish mining company and discoverer of Pipe 1, that intensive exploration for diamonds in Finland began. Malmikaivos Oy and Ashton Mining Limited ("M/A") were quite successful, and of the 20 kimberlite-related intrusions they discovered in the Kaavi-Kuopio area, all are Group 1 kimberlites and nearly all of these are diamondiferous. DiaMet Minerals Limited, Finnsearch Oy (De Beers Group) and RTZ Mining Exploration Limited are the other big diamond companies which operated in Finland before 2000, but none has been as successful as M/A.

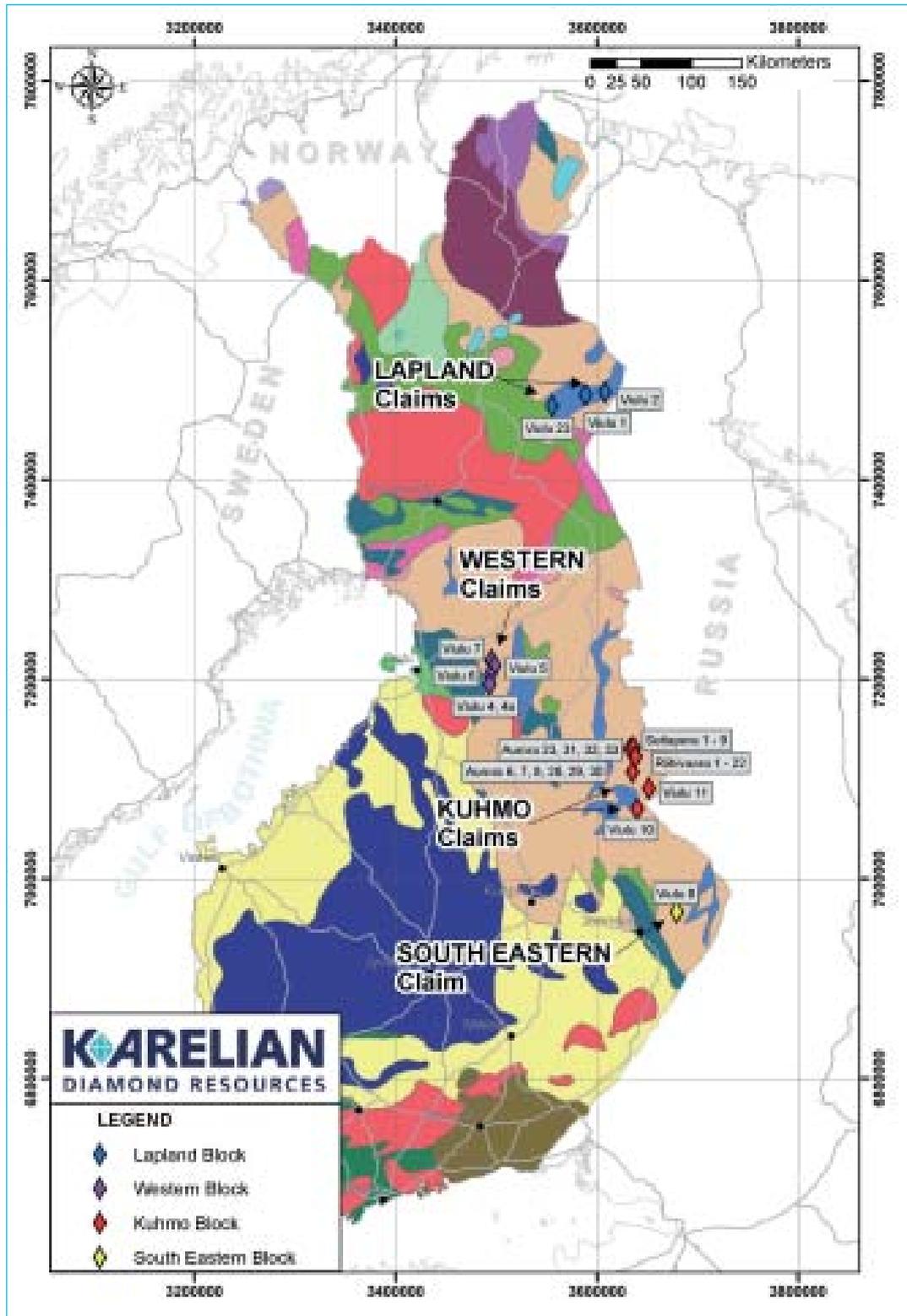
Other companies exploring for diamonds in Finland include European Diamonds PLC at Lentiira to the northeast of KDR's diamond exploration acreage, Nordic Diamonds Limited at Kuopio Kaavi to the southwest and Sunrise Diamonds at Kuusamo to the north.

### **Strategy and Prospects**

Your Company's strategy is to apply up-to-date diamond exploration techniques in the Finnish

# Chairman's Statement

(L to R) Kevin McNulty, David Furlong, Hugh O'Brien  
(GTK) Richard Conroy, Jukka Marmo (GTK)





(L to R) Richard Conroy, Jukka Marmo (GTK), Marja Lehtonen (GTK), Charles Dampney (City Capital Securities), Matti Tyni, Hugh O'Brien (GTK)

Karelian Craton with a view to the discovery in Finland of major diamond deposits similar to those which have been found in the same Craton across the border in Russia. KDR has developed a model for diamond prospectivity in Finland. Key elements in the model include:

- the identification of thick Archaean crust (45km to 240km);
- the identification of favourable structural zones for emplacement of kimberlites, including activation zones and broad zones of deep seismic activity indicating the presence of these zones; and
- the identification of diamondiferous rocks in target areas of the craton, e.g. kimberlites, lamproites and various hybrids.

The extensive aeromagnetic and electromagnetic data available in Finland has therefore been useful in your Company's regional exploration. Kimberlite pipes, because of their geological composition, may exhibit a geophysical signature different to that of the surrounding rock, however, similar geophysical anomalies may arise from other causes. The interpretation of the geophysical data has, therefore, been followed by extensive regional deep till sampling in the course of which over a thousand samples were collected and analysed. A number of these samples yielded both kimberlitic and diamond indicator minerals, including G9 and G10 garnets. These garnets are particularly important as they are formed at similar temperatures and pressures to diamonds.

A number of potential diamond targets have been identified using this strategy. This led to the selection of four blocks of licences grouped geographically and referred to as the Lapland, Kuhmo, Western Finland and South-eastern Finland licence blocks. All four blocks are highly prospective for diamonds.

The Kuhmo block is known to contain a diamondiferous kimberlite body with a reported grade of 1.09 cpht (the Seitaperä pipe). KDR's

exploration programme will include follow up drilling of the Seitaperä pipe. This pipe has a surface area of four hectares and to date has been the subject of only a limited drilling programme.

Diamond indicator minerals have been discovered by KDR elsewhere in the Kuhmo block, leading to the conclusion that multiple sources for diamonds may exist in this area. Ground geophysics and deep till sampling will be used to search for and define drilling targets for other kimberlite pipes in the Kuhmo area.

A follow up exploration programme will also be carried out on the other highly prospective blocks with a view to the location and drilling of potential diamondiferous kimberlite pipes.

## Claims

Your Company's claims are divided into four blocks.

### Kuhmo Block

The Kuhmo block in eastern Finland, which contains a known diamondiferous pipe at Seitaperä, comprises forty nine claims, which are believed to be highly prospective for diamondiferous kimberlites.

An extensive reconnaissance till sampling programme has been completed in the area, with samples from approximately 200 sites, on three north-south traverses, initially collected and processed and subsequently followed up by further localised traverses.

Some 28 diamond indicator pyrope garnets (including G9s and G10s) have been recovered as well as 15 chrome diopsides of kimberlitic composition. Sixteen separate indicator mineral anomalies have been identified. Drill targets have been highlighted by ground geophysics over one of the sixteen anomalies and the remaining fifteen similar anomalies are scheduled for systematic evaluation. Coupled with the presence of the known diamondiferous kimberlite pipe at Seitaperä, these findings suggest that multiple sources for diamonds may exist in the area.

# Chairman's Statement

(L to R) Jukka Marmo (GTK), Jeffrey Coburn (John East & Partners)



## Western Block

A group of five claims in an area of west-central Finland that is characterised by aeromagnetic anomalies. Preliminary basal till sampling from 34 sites located down-ice from selected anomalies has resulted in the identification of a number of kimberlitic indicator minerals, including a G9 garnet.

## Lapland Block

Three claims have been taken out in this area in the Kola portion of the Karelian Craton following a detailed examination of the aeromagnetic database and an extensive till sampling programme. Initial results have been encouraging with a kimberlite indicator mineral (chrome diopside) recovered from 1 claim following preliminary deep till sampling.

## Southeastern Block

This block comprises a single claim to the south-east of the Kuhmo block in an area of strong aeromagnetic anomalies.

## Independent Geologist's Report

An independent geologist's report was prepared by the CSA Group ("CSA") to provide an independent assessment of Karelian's diamond exploration properties and information portfolio in Finland in preparation for the listing of your Company on AIM.

CSA, in their summary and conclusions stated that, 'The Archaean Cratons (Kola and Karelia) of Finland are an area of thick lithosphere and low heat flow. Structural zones (activation zones) exist that provide pathways for Kimberlite emplacement. Significant and world class diamond occurrences have been found within the Craton, eg. Archangel Kimberlite Fields in Russia. Diamonds have also been found in the Karelian Craton, e.g. the Kuopio-Kaavi kimberlite clusters. The area has proven prospectivity for diamonds.'

CSA also commented that the 'comprehensive data package, exclusive survey results and a significant

portfolio of claims transferred into Karelian will provide Karelian with a significant advantage in its future operations.' They also stated that 'all four blocks of claims are highly prospective for diamonds.'

## Licence Regulations

The basic exploration permit under Finnish mining law is the claim reservation, which covers a maximum of 9km<sup>2</sup>. This gives the holder up to one year to delineate an area, or areas, of interest within the claim reservation and to prepare an application for a claim, or exploration licence, over that area. Although each claim covers a maximum area of only 1km<sup>2</sup>, the whole of a claim reservation can be covered by individual claims.

The claim reservation holder enjoys priority in applying for a claim within the reserved area, but this does not prevent others from prospecting the area. Individual claims are valid for up to five years and the holder pays a fee to both the landowner and the Ministry of Trade and Industry.

When a mineral deposit is found, a mining concession is granted to the claim holder, under certain conditions, if the deposit is shown to be technically and economically exploitable. The application must be made while the claims are still valid. The conditions for granting the mining concession are flexible and payment is made on an annual basis to the Ministry of Trade and Industry and the landowner.

## The Diamond Market

Diamond mines can be highly profitable operations, with annual revenues currently exceeding US\$1 billion and gross profit margins of 50 per cent or more. Many of the mines also have long lives and some South African mines have been operating for over 50 years.

The total value of rough diamond production is estimated to have been US\$9.4 billion in 2003 and the market grew further in 2004, with both



(L to R) Dr Bert Gerrys, Terry Beal, Dr Michael Smith

production increases in Canada and stronger diamond prices. The diamond market has traditionally been dominated by De Beers Group ("De Beers") through the Central Selling Organisation / Diamond Trading Company ("DTC") although in recent years non-De Beers companies have played an increasingly significant role. In 2003 De Beers' share of mine production was estimated to be 41 per cent by value, with sales through the DTC, including diamonds sold under contract from Russia, at around 48 per cent of the total rough diamond market.

Demand for diamonds has been strong in the past few years and rough (uncut) diamond prices increased by around 10 per cent in 2003, and have increased by a further 20 per cent from January 2004 to mid-2005. De Beers met some of the rising demand from its stockpile, but its stocks are now reported to be at low levels. The Russian stockpile of diamonds is also believed to be exhausted. Supplies of uncut diamonds are now struggling to keep pace with rising demand and, with little new supply coming on stream, most analysts forecast a growing supply shortage.

### Placing and Admission to AIM

Your Company's shares were admitted to trading on AIM on September 1st, 2005. On admission, KDR raised £500,000 (before expenses) through a placement of 10,000,000 ordinary shares at 5 pence each, representing 22.3 per cent of the enlarged issued share capital of 44,771,676 ordinary shares.

The Directors believe that Admission to AIM will have a number of benefits, including the following:

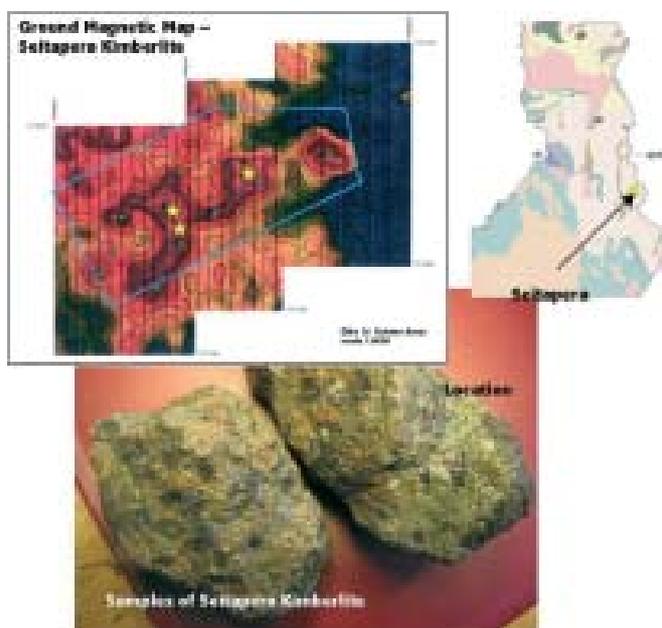
- raising the profile of the Company, both amongst the investment community and within the mining industry;
- facilitating the raising of further equity capital should it become required or desirable, thereby assisting the Company's ability to grow;

- the Company will be better able to enter into negotiations with vendors of target businesses or assets, to whom the issue of publicly traded shares as consideration is potentially more attractive than shares in a private company;
- the provision of share based incentive schemes involving quoted shares should assist in the recruitment, incentivisation, reward and retention of high calibre employees; and
- an AIM listing will provide liquidity for current and future Shareholders.

### Appointment of Broker and Nominated Advisor

City Capital Securities Limited, a part of City Capital Corporation (3C), have been appointed as your Company's Broker, and John East & Partners Limited as your Company's Nominated Advisor.

I have great pleasure in welcoming them and thanking them for the recent successful placing and admission of your Company to AIM.



# Chairman's Statement

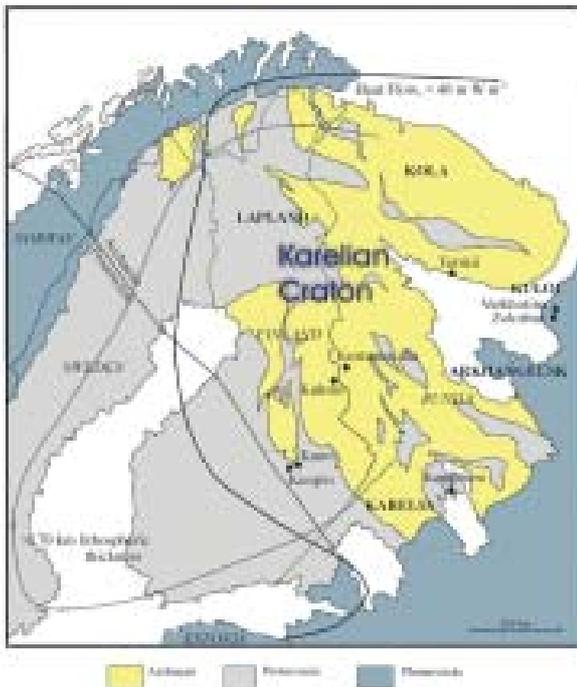
(L to R) Richard Conroy, Hugh O'Brien (GTK),  
David Furlong, Maureen Jones, Jukka Marmo (GTK)



## Corporate Governance

The Directors intend, in so far as is practicable given your Company's size, to comply with the main provisions of the Combined Code of Corporate Governance.

The Directors have established an audit committee and a remuneration committee. The audit committee, consisting of Seamus FitzPatrick as chairman, Louis Maguire, Maureen Jones and Roger Chaplin, has primary responsibility for monitoring the quality of internal control and ensuring that the financial performance of your Company is properly measured and reported on and for reviewing reports from your Company's auditors relating to your Company's accounting and internal controls, in all cases having due regard for the interests of Shareholders. The remuneration committee, consisting of Louis Maguire as chairman, Seamus FitzPatrick, and James Jones, will review the scale and structure of the Executive Director's remuneration and the terms of their employment.



The Directors will comply with Rule 1 of the AIM Rules relating to Directors' dealings as applicable to AIM companies and will also take all reasonable steps to ensure compliance by the Company's applicable employees.

## Environmental Issues

The Group recognises the importance of environmental issues and observes environmental requirements in accordance with Finnish Law.

## Finance

The Financial Statements refer to the period from date of incorporation, 1 March 2004 to 31 May 2005. The Financial Statements were previously published in the admission document to AIM.

The Company recorded a loss for the period of €98,941. Since the accounts were completed the Company has raised €735,294 in the placing on admission to AIM referred to above.

The Directors intend to raise additional equity financing from time to time, as required in order to continue your Company's activities and/or make such other joint venture, farm-out, or other arrangements as are appropriate in the interests of the Company.

## Directors, Management and Consultants

I would also like to express my appreciation of the support and dedication of Directors, Management and Consultants, which has made possible the excellent progress, and significant success which your Company has already achieved. I look forward with confidence to the future.

*Richard Conroy*  
Professor Richard Conroy

# Company Information

## **Directors**

**Professor Richard Conroy**  
Chairman

**Maureen T.A. Jones**  
Managing Director

**James P. Jones FCA**  
Finance Director

**Louis J. Maguire**  
Non-Executive Director

**Seamus P. Fitzpatrick**  
Non-Executive Director

**Roger I. Chaplin**  
Non-Executive Director

## **Company Secretary and Registered Office**

**James P. Jones FCA**  
10 Upper Pembroke Street  
Dublin 2  
Ireland

## **Auditors**

**KPMG**  
**Chartered Accountants**  
1 Stokes Place  
St. Stephen's Green  
Dublin 2

## **Registrars**

**Capita Corporate  
Registrars PLC**  
Manor St Business Pk  
Manor Street  
Dublin 7

## **Legal Advisors**

**William Fry Solicitors**  
Fitzwilton House  
Wilton Place  
Dublin 2

## **Roschier-Holmberg**

Keskuskatu 7A  
00 100 Helsinki  
Finland

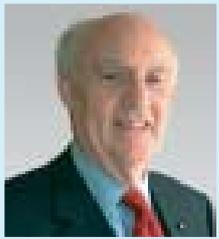
## **Nominated Advisor**

**John East & Partners Ltd**  
Crystal Gate  
28-30 Worship Street  
London EC2A 2AH

## **Broker**

**City Capital Securities Ltd**  
2 John Carpenter Street  
London EC4Y 2AH

# Board of Directors



**Professor Richard Conroy**  
Chairman

**Professor Richard Conroy** has been involved in natural resources for many years. He established Trans-International Oil in 1974. He also founded Conroy Petroleum and Natural Resources, which in 1986 discovered the Galmoy zinc deposit in Co. Kilkenny, Ireland, which is now in production as a major base metals mine. Conroy Petroleum was also a founding member of the Stoneboy Consortium, an exploration group that discovered the POGO gold field in Alaska. He was chairman and chief executive of ARCON International Resources from 1980-1994.

He is Emeritus Professor of the Royal College of Surgeons in Ireland and also served in the Irish Parliament as a member of the Senate. He is also chairman of Conroy Diamonds and Gold, an AIM listed company which has outlined a potential new gold mining province in the Longford-Down Massif in Ireland.



**Louis Maguire**  
Non-Executive Director

**Louis Maguire** is an Auctioneer by profession and a land valuation expert with particular expertise in the purchase of mineral rights and in land acquisition for mining. He is also a Director of Conroy Diamonds and Gold.



**Seamus FitzPatrick**

**Seamus FitzPatrick** has worked in both corporate finance and private equity in London and New York with Morgan Stanley, JP Morgan and Banker's Trust. In 1999 he co-founded CapVest which has over €1.2 billion assets under management. He is chairman of Young's Bluecrest Limited, and Vaasan & Vaasan OY in Finland.



**Maureen Jones**  
Managing Director

**Maureen Jones** has over 20 years experience of the natural resources industry. She was a member of the board of ARCON International Resources from 1986-1994. She was one of the founders of Conroy Diamonds and Gold, an AIM listed company and remains Managing Director of that company.



**Roger Chaplin**  
Non-Executive Director

**Roger Chaplin** has some 25 years experience in mining analysis, gained initially in a major South African mining house and latterly in the City of London. Mr Chaplin was senior Vice President and Mining Analyst at T. Hoare and Co/Canaccord Capital (Europe) Limited in London from 1993-2003 and has a particular interest in precious metals and diamonds.



**James Jones**  
Finance Director

**James Jones** is a chartered accountant. He became Company Secretary of Conroy Petroleum at its foundation and subsequently Finance Director from 1980-1994. He is also a founding Director of Conroy Diamonds and Gold and remains Finance Director of that company.

# Directors' Report

For the period from date of incorporation, 1 March 2004 to 31 May 2005

The Directors present their annual report together with the audited financial statements of Karelian Diamond Resources PLC ('the Company') for the period from date of incorporation, 1 March 2004 to 31 May 2005.

On 26 May 2004 the Company changed its name from Nordic Diamond Resources PLC to Karelian Diamond Resources PLC.

## Principal Activities and Business Review

The Company was incorporated on 1 March 2004 as an exploration company and is currently involved in the development of mineral exploration opportunities, principally in Finland. Exploration rights for certain areas have been applied for and obtained and sampling has been undertaken.

## Future Development of the Business

It is the intention of the Directors to continue to develop the activities of the Company.

## Results for the Period and State of Affairs at 31 May 2005

The profit and loss account for the period from date of incorporation, 1 March 2004 to 31 May 2005 and the balance sheet at that date are set out on pages 7 and 8 respectively. The Company recorded a loss for the financial period of €98,941.

No dividends or transfers to reserves are recommended by the Directors.

## Important Events since the Period End

No significant events affecting the Company have taken place between 31 May 2005 and the date of the Board approval of these financial statements.

## Directors' and Secretary

The Directors who served during the period are as follows:

R.T.W.L. Conroy (appointed 1 March 2004)  
M.T.A. Jones (appointed 1 March 2004)  
J.P. Jones (appointed 1 March 2004)  
L.J. Maguire (appointed 15 July 2004)  
S.P. FitzPatrick (appointed 15 July 2004)  
R.I. Chaplin (appointed 29 April 2005)

In accordance with the Company's Articles of Association, Mr J.P. Jones and Mr L.J. Maguire will retire by rotation and, being eligible, will offer themselves for re-election at the Annual General Meeting.

## Directors' and Secretary's Shareholdings and Other Interests

The interests of the Directors and Secretary, all of which were beneficially held, in the ordinary share capital of the Company at 31 May 2005 were as follows:

### Ordinary Shares of €0.01

R.T.W.L. Conroy	25,231,701*
J.P. Jones	58,335
M.T.A. Jones	125,836
L.J. Maguire	51,668
S.P. FitzPatrick	666

\* of the 25,231,701 Ordinary Shares beneficially held by Professor Richard Conroy, 24,515,030 are held by Conroy P.I.c., a company in which Professor Conroy has a controlling interest and 83,336 are held in the name of his wife Dr Pamela Conroy.

Other than the acquisition of the diamond interests as set out in Note 2 to the financial statements there have been no contracts or arrangements during the financial period in which a Director of the Company was materially interested and which were significant in relation to the Company's business.

# Directors' Report

For the period from date of incorporation, 1 March 2004 to 31 May 2005

## Political Donations

The Company did not make any political donations during the period.

## Books of Account

The measures which the Directors have taken to ensure that proper books of account are kept are the adoption of suitable policies for recording transactions, assets and liabilities, the employment of suitably qualified staff and the use of computer and documentary systems. The Company's Books of Account are kept at 10 Upper Pembroke Street, Dublin 2.

## Directors' Responsibility Statement

Company law requires the Directors to prepare financial statements for each financial period which give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing the financial statements, the Directors have:

- selected suitable accounting policies and then applied them consistently;
- made judgements and estimates that are reasonable and prudent;
- comply with applicable accounting standards, subject to any material departures disclosed and explained in the financial statements;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the financial statements comply with the Companies Acts, 1963 to 2003. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

As explained in Note 1 to the financial statements, the Directors have reviewed internal budgets and other relevant information and are satisfied that the Company will be able to continue in operation for the foreseeable future. Accordingly, the financial statements have been prepared on the going concern basis.

## Companies (Auditing and Accounting) Act, 2003

The Directors note that the Companies (Auditing and Accounting) Act, 2003 has been issued and are assessing its implications for the Company.

## Auditors

The auditors, KPMG, Chartered Accountants, were appointed and have expressed their willingness to continue in office in accordance with Section 160 (2) of the Companies Act, 1963.

On behalf of the Board

**R.T.W.L. Conroy**  
*Director*

**J.P. Jones**  
*Director*

7 July 2005

# Independent Auditors' Report

## to the Shareholders of Karelian Diamond Resources PLC

We have audited the financial statements of Karelian Diamond Resources PLC for the period from date of incorporation, 1 March 2004 to 31 May 2005 on pages 15 to 23.

This report is made solely to the Company's members, as a body, in accordance with Section 193 of the Companies Act, 1990. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body for our audit work, for this report or for the opinions we have formed.

### Respective Responsibilities of Directors and Auditors

The Directors are responsible for preparing the Annual Report. As described on page 12, this includes responsibility for preparing the financial statements in accordance with applicable law and Irish accounting standards. Our responsibilities, as independent auditors, are established in Ireland by statute, the Auditing Practices Board, and by our profession's ethical guidance.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Acts. As also required by the Acts, we state whether we have obtained all the information and explanations we require for our audit, whether the Company's financial statements are in agreement with the books of account and report to you our opinion as to whether

- the Company has kept proper books of account;
- the Directors' report is consistent with the financial statements;

- at the balance sheet date a financial situation existed that would require the Company to hold an extraordinary general meeting, on the grounds that the net assets of the Company, as shown in the financial statements, are less than half of its share capital.

We also report to you if, in our opinion, information specified by law regarding Directors' remuneration and transactions with the Company is not disclosed and, where practicable, include such information in our report.

We read the Directors' Report and consider whether it is consistent with the financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

### Basis of Opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the circumstances of the Company, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

# Independent Auditors' Report

to the Shareholders of Karelian Diamond Resources PLC

## Mineral Interests

In forming our opinion, we considered the adequacy of the disclosures made in the financial statements, particularly in Note 6 in relation to the Directors' assessment of the carrying value of the Company's mineral interests held outside the cost pools of €2,885,831. In view of the significance of this uncertainty, we consider that this should be drawn to your attention. Our opinion is not qualified in this respect.

## Opinion

In our opinion, the financial statements give a true and fair view of the state of affairs of the Company at 31 May 2005 and of the loss and cashflows of the Company for the period then ended and have been properly prepared in accordance with the Companies Acts, 1963 to 2003 and all Regulations to be construed as one with those Acts.

We have obtained all the information and explanations we consider necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the Company. The Company's financial statements are in agreement with the books of account.

In our opinion, the information given in the Directors' Report on pages 11 to 12 is consistent with the financial statements.

The net assets of the Company, as stated in the balance sheet on page 16, are more than half of the amount of its called up share capital and, in our opinion, on that basis there did not exist at 31 May 2005 a financial situation which, under Section 40 (1) of the Companies (Amendment) Act, 1983, would require the convening of an extraordinary general meeting of the Company.

## KPMG

*Chartered Accountants  
and Registered Auditors, Dublin*

7 July 2005

---

## Profit and Loss Account

For the period from date of incorporation, 1 March 2004 to 31 May 2005

	Notes	€
Operating Expenses	3	(98,941)
<b>Loss for the Financial Period</b>	<b>4</b>	<b>(98,941)</b>
<b>Profit and Loss Account at beginning of period</b>		-
<b>Profit and Loss Account at end of period</b>		<b>(98,941)</b>
Loss per share		€0.0028

There are no recognised gains or losses other than the loss for the period.

The accompanying notes form an integral part of this profit and loss account.

**R.T.W.L. Conroy**  
Director

**J.P. Jones**  
Director

Approved by the Directors on 7 July, 2005

---

## Balance Sheet

31 May 2005

	Notes	€
<b>Fixed Assets</b>		
Mineral interests	6	2,885,831
Financial assets	7	4
		<hr/>
		2,885,835
		<hr/>
<b>Current Assets</b>		
Debtors	8	660
Cash at bank and in hand		3
		<hr/>
		663
<b>Creditors: Amounts falling due within one year</b>	9	(397,747)
		<hr/>
<b>Net Current Liabilities</b>		(397,084)
		<hr/>
<b>Net Assets</b>		2,488,751
		<hr/> <hr/>
<b>Capital and Reserves</b>		
Called up share capital	10	347,716
Share premium account	10	2,239,976
Profit and loss account		(98,941)
		<hr/>
<b>Shareholders' Funds</b>	11	2,488,751
		<hr/> <hr/>

The accompanying notes form an integral part of this balance sheet.

**R.T.W.L. Conroy**  
Director

**J.P. Jones**  
Director

Approved by the Directors on 7 July, 2005

---

## Cash Flow Statement

For the period from date of incorporation, 1 March 2004 to 31 May 2005

	Notes	€
<b>Net Cash Inflow from Operating Activities</b>	<b>12A</b>	139,978
<b>Capital Expenditure and Financial Investments</b>	<b>12B</b>	(225,835)
<b>Net Cash Outflow before Financing</b>		<u>(85,857)</u>
<b>Financing</b>	<b>12B</b>	85,860
<b>Increase in Cash</b>	<b>12C</b>	<u><u>3</u></u>

The accompanying notes and statement of accounting policies form an integral part of this cash flow statement.

**R.T.W.L. Conroy**  
Director

**J.P. Jones**  
Director

Approved by the Directors on 7 July, 2005

---

## Statement of Accounting Policies

The financial statements have been prepared under the historical cost convention. The Company's principal accounting policies are set out below. All of these policies have been applied consistently throughout the period.

### A. Mineral Interests

(i) *Exploration, appraisal and development expenditure*

The Company accounts for mineral expenditure under the 'full cost' method of accounting.

Exploration, appraisal and development expenditure is incurred on acquiring, exploring or testing exploration prospects. All lease, licence and property acquisition costs, geological and geophysical costs and other direct costs of exploration, appraisal and development are capitalised. The amount capitalised includes other operating expenses directly related to these activities.

(ii) *Cost Pools*

Costs relating to the exploration and appraisal of mineral interests which the Directors consider to be unevaluated are initially held outside the cost pool. Costs held outside the cost pool are reassessed at each period end. When a decision to develop these interests is taken, or if there is evidence of impairment, the related costs will be transferred to the cost pool or amortised to the profit and loss account as necessary. Costs will be capitalised within geographic cost pools which initially comprise Finland and the rest of the world.

Proceeds from any disposal of part or all of an interest which is outside the cost pool will be credited to that interest with any excess being credited to the cost pool.

(iii) *Ceiling Test*

When a decision to develop mineral interests is taken, and the related costs are transferred to the cost pool a ceiling test will be carried out at each balance sheet date to assess whether the net book value of capitalised costs in the pool, together with the future costs of development of undeveloped reserves, is covered by the discounted future net revenues from the reserves within the pool, calculated at prices prevailing at the period end. Any deficiency arising will be provided for to the extent that, in the opinion of the Directors, it is considered to represent a permanent diminution in the value of the related asset, and where arising, will be dealt within the profit and loss account as additional depreciation.

(iv) *Depreciation*

Expenditure within the cost pool will be depreciated using the unit of production method based on commercial reserves. Costs used in the unit of production calculation will comprise the net book value of capitalised costs plus the anticipated future costs of development of the undeveloped reserves at current year end unescalated prices. Changes in cost and reserve estimates are dealt with prospectively.

### B. Other Tangible Fixed Assets

Other tangible fixed assets are stated at cost, net of depreciation. Depreciation is provided on a straight line basis to write off the cost (net of estimated residual value) over the expected useful economic lives.

### C. Financial Fixed Assets

Financial fixed assets are stated at cost, less provision for any permanent diminution in value.

### D. Foreign Currency

Transactions denominated in foreign currencies are recorded at actual exchange rates at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated using the rates of exchange prevailing at the balance sheet date.

---

**E. Issue Expenses and Share Premium Account**

Issue expenses arising on the issue of equity securities are written off against the share premium account.

**F. Taxation**

Current tax is provided on the Company's taxable profits at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantially enacted by the balance sheet date.

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date. Provision is made at the rates expected to apply when the timing differences reverse. Timing differences are differences between the Company's taxable profits and its results as stated in the financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in the financial statements.

A net deferred tax asset is regarded as recoverable and therefore recognised only when, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits from which future reversal of underlying timing differences can be deducted.

**G. Consolidation**

These financial statements present information about the Company as an individual undertaking and not about its group. The subsidiary undertakings have not been consolidated as their inclusion is not material for the purpose of giving a true and fair view.

---

# Notes to the Financial Statements

31 May 2005

## 1. Operations and Going Concern

The Company, which was incorporated on 1 March 2004, is currently involved in the development of mineral exploration opportunities principally in Finland.

On the basis of their review of projected cash flow information including in particular the assumptions regarding the proceeds from the funding, existing commitments, taking into account the high potential of the acreage under licence and the continued support of the major shareholder, the Directors consider it appropriate to prepare the financial statements on a going concern basis.

## 2. Related Party Transactions

The Company shares accommodation with Conroy Diamonds and Gold Plc., which has certain common shareholders and directors. The Company bears its appropriate share of the related costs directly.

In July 2004, under a Scheme of Arrangement approved by the High Court of Ireland on 26 July 2004, the Company acquired the diamond interests of Conroy Diamonds and Gold Plc, which held a number of claims (licence areas) in Finland which have potential diamond prospects. The purchase consideration of €784,661 was satisfied by the issue of 10,256,639 ordinary shares of €0.01 each.

In July 2004 the Company also acquired the diamond interests of Conroy Plc, which held a number of claims in Finland which have potential diamond prospects. The purchase consideration of €1,875,339 was satisfied by the issue of 24,515,030 ordinary shares of €0.01 each.

The Company has been financed during the period by advances from its principal shareholder, Conroy Pl.c. (Note 9).

## 3. Operating Expenses

	€
Management services and operating expenses	182,246
Transfer to Mineral Interests (Note 6)	(83,305)
	<hr/>
	98,941
	<hr/> <hr/>

## 4. Loss on Ordinary Activities before Taxation

The loss on ordinary activities before taxation is arrived at after charging the following items, which are stated at amounts prior to the re-allocation to mineral interests:

	€
Auditors' remuneration	8,500
Directors' emoluments	
- fees	65,683
	<hr/> <hr/>

All losses arose from continuing operations.

## 5. Tax on profit on Ordinary Activities

No taxation charge arises in the financial period due to tax losses forward. There was no unprovided deferred taxation at 31 May 2005.

---

## 6. Mineral Interests

Costs held outside cost pool:

	€
Cost	
Diamond interests acquired (Note 2)	2,660,000
Expenditure during the period	
- licences and appraisal	142,526
- other operating costs (Note 3)	83,305
	<u>                    </u>
At 31 May 2005	<u>2,885,831</u>

The Directors have considered the proposed work programmes for these mineral interests, presently held outside the cost pools. They are satisfied that there are no indications of impairment, but recognise that future realisation of the mineral interests, held outside the cost pools, is dependent on further successful exploration and appraisal activities and the subsequent economic production of the mineral reserves.

## 7. Financial Fixed Assets

	<b>Investments</b>
	€
At 31 May 2005	4
	<u>                    </u>

Financial fixed assets represent investments of €2 in each of the Company's wholly owned subsidiary undertakings, Karelian Diamonds Limited and Nordic Diamonds Limited. The net assets of each entity is €2. Certain diamond claims in Finland are held in the name of the Company's subsidiaries.

## 8. Debtors

	€
VAT recoverable	660
	<u>                    </u>
	<u>660</u>

## 9. Creditors: Amounts falling due within one year

	€
Trade creditors and accruals	239,579
Due to Conroy P.l.c.	158,168
	<u>                    </u>
	<u>397,747</u>

Pending the flotation of the Company on the AIM market, the immediate funding requirements of the Company have been financed by short term advances from the principal shareholder, Conroy P.l.c.

---

## 10. Called up Share Capital and Share Premium

### Authorised:

	€
500,000,000 ordinary shares of €0.01 each	5,000,000

### Issued and Fully Paid:

	Number	Share Capital €	Share Premium €
At incorporation	7	—	—
Share issue (a)	24,515,030	245,150	1,630,189
Share issue (b)	10,256,639	102,566	682,095
Issue expenses			(72,308)
	<u>34,771,676</u>	<u>347,716</u>	<u>2,239,976</u>

#### Share issue (a)

Under the terms of an agreement dated 9 July 2004 between Conroy P.l.c. and the Company, Conroy P.l.c. transferred the entire issued share capital of Nordic Diamonds Limited which held exploration licences in Finland, together with all related information and exploration data and results to the Company in consideration for the issue by the Company of 24,515,030 Ordinary Shares.

#### Share issue (b)

Pursuant to the terms of the Scheme of Arrangement, which was sanctioned by the High Court of Ireland on the 26 July 2004 and pursuant to the terms of a share purchase agreement dated 30 July 2004, the entire issued share capital of Karelian Diamonds Limited which held exploration licences in Finland, together with all related information and exploration data and results were transferred by Conroy Diamonds and Gold P.l.c. to the Company in consideration for the issue by the Company of 10,256,639 Ordinary Shares to the shareholders of Conroy Diamonds and Gold P.l.c. on the basis that for every six ordinary shares held by a member of Conroy Diamonds and Gold P.l.c. that member received one Ordinary Share. The Scheme also provided for the Admission of the Company's shares on the AIM market in due course.

## 11. Reconciliation of Movement in Shareholders' Funds

	€
Shares issued, net	2,587,692
Loss for period	(98,941)
At 31 May 2005	<u>2,488,751</u>

## 12. Notes to the Cash Flow Statement

### A. Reconciliation of Profit to Net Cash Inflow from Operating Activities:

	€
Operating Loss	(98,941)
Increase in Creditors	239,579
Increase in Debtors	(660)
<b>Net Cash Inflow from Operating Activities</b>	<u>139,978</u>

---

**B. Analysis of Cash Flows:**

	€
<b>Capital expenditure and Financial Investment</b>	
Investment in mineral interests	(225,835)
	<u>(225,835)</u>

	€
<b>Financing</b>	
Shareholder's loan	158,168
Share issue expenses	(72,308)
	<u>85,860</u>

**C. Analysis and Reconciliation of Net Funds:**

	<b>1 March 2004</b>	<b>Cash Flow</b>	<b>31 May 2005</b>
	€	€	€
Cash at bank	—	3	3
	<u>—</u>	<u>3</u>	<u>3</u>

**13. Commitments and Contingencies**

At 31 May 2005 there were no capital commitments or contingent liabilities.

**14. Approval of Financial Statements**

These financial statements were approved by the Board on 7 July 2005.

---

## Notice of Annual General Meeting

NOTICE is hereby given that the Annual General Meeting of Karelian Diamond Resources PLC (the "Company") will be held at the Westbury Hotel, Grafton Street, Dublin 2 on Monday 14 November 2005 at 12.00 noon for the purposes of transacting the following business:

1 To receive and consider the Financial Statements for the period from date of incorporation, 1 March 2004 to 31 May 2005 together with the Directors' and Auditors' Reports thereon (Resolution No. 1).

2 To re-elect as Directors the following persons:

Mr James P Jones (Resolution No.2 (a))

Mr Louis J Maguire (Resolution No.2 (b))

3 To authorise the Directors to fix the remuneration of the Auditors (Resolution No.3).

4 To consider and, if thought fit, pass the following resolution as a Special Resolution (Resolution No.4):

"That, for the purposes of Section 24 of the Companies (Amendment) Act, 1983 and subject to the Directors being authorised pursuant to Article 10 of the Articles of Association of the Company, the Directors be empowered to allot equity securities for cash pursuant to and in accordance with Article 11 of the Articles of Association of the Company. The authority hereby conferred shall expire at the close of business on the date of the next Annual General Meeting of the Company unless previously revoked or renewed in accordance with the provisions of the Companies (Amendment) Act, 1983."

5 To transact any other business.

By Order of the Board

Dated this 19th day of October 2005

### **James P Jones**

Secretary

### **Registered Office**

10 Upper Pembroke Street

Dublin 2

### **Notes:**

*The holders of the Ordinary Shares are entitled to attend and vote at the above General Meeting of the Company. A holder of Ordinary Shares may appoint a proxy or proxies to attend, speak and vote instead of him/her. A proxy need not be a member of the Company.*

*A Form of Proxy is enclosed for use by shareholders unable to attend the meeting. Proxies to be valid must be lodged with the Company's Registrars, Capita Corporate Registrars Plc, Unit 5, Manor Street Business Park, Manor Street, Dublin 7 not less than 48 hours before the time appointed for the holding of the meeting.*



**KARELIAN**  
DIAMOND RESOURCES

10 Upper Pembroke Street  
Dublin 2

Tel: 353-1-661 8958  
Fax: 353-1-662 1213  
Email: [info@kareliandiamondresources.com](mailto:info@kareliandiamondresources.com)