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EASTGROUP PROPERTIES INC  
Form 10-Q  
May 08, 2009

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED MARCH 31, 2009

COMMISSION FILE NUMBER 1-07094

EASTGROUP PROPERTIES, INC.  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

MARYLAND  
(State or other jurisdiction  
of incorporation or organization)

13-2711135  
(I.R.S. Employer  
Identification No.)

190 EAST CAPITOL STREET  
SUITE 400  
JACKSON, MISSISSIPPI  
(Address of principal executive offices)

39201  
(Zip code)

Registrant's telephone number: (601) 354-3555

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES (x) NO ( )

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES ( ) NO ( )\* (\*Registrant is not subject to the requirements of Rule 405 of Regulation S-T at this time.)

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer (x) Accelerated Filer ( ) Non-accelerated Filer ( )  
Smaller Reporting Company ( )

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ( ) NO (x)

The number of shares of common stock, \$.0001 par value, outstanding as of May 6, 2009 was 25,207,655.

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EASTGROUP PROPERTIES, INC.

FORM 10-Q

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	March 31, 2009
	(Unaudited)
<b>ASSETS</b>	
Real estate properties.....	\$ 1,267,031
Development.....	151,437
	-----
	1,418,477
Less accumulated depreciation.....	(321,249)
	-----
	1,097,228
Unconsolidated investment.....	2,687
Cash.....	27
Other assets.....	61,891
	-----
TOTAL ASSETS.....	\$ 1,162,083
	=====
<b>LIABILITIES AND EQUITY</b>	
<b>LIABILITIES</b>	
Mortgage notes payable.....	\$ 549,977
Notes payable to banks.....	164,200
Accounts payable & accrued expenses.....	23,551
Other liabilities.....	15,441
	-----
Total Liabilities.....	753,169
	-----
<b>EQUITY</b>	
Stockholders' Equity:	
Common shares; \$.0001 par value; 70,000,000 shares authorized; 25,186,459 shares issued and outstanding at March 31, 2009 and 25,070,401 at December 31, 2008.....	529,331
Excess shares; \$.0001 par value; 30,000,000 shares authorized; no shares issued.....	(122,491)
Additional paid-in capital on common shares.....	49
Distributions in excess of earnings.....	-----
Accumulated other comprehensive loss.....	406,351
	-----
Total Stockholders' Equity.....	2,551
Noncontrolling interest in joint ventures.....	-----
Total Equity.....	408,911
	-----
TOTAL LIABILITIES AND EQUITY.....	\$ 1,162,083
	=====

See accompanying Notes to Consolidated Financial Statements (unaudited).

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(IN THOUSANDS, EXCEPT PER SHARE DATA)  
(UNAUDITED)

	Three Months March
	2009
<b>REVENUES</b>	
Income from real estate operations.....	\$ 43,310
Other income.....	15
	43,325
<b>EXPENSES</b>	
Expenses from real estate operations.....	12,591
Depreciation and amortization.....	13,044
General and administrative.....	2,561
	28,196
OPERATING INCOME.....	15,129
<b>OTHER INCOME (EXPENSE)</b>	
Equity in earnings of unconsolidated investment.....	81
Gain on sale of non-operating real estate.....	8
Gain on sales of securities.....	-
Interest income.....	124
Interest expense.....	(7,501)
	7,841
INCOME FROM CONTINUING OPERATIONS.....	7,841
<b>DISCONTINUED OPERATIONS</b>	
Income from real estate operations.....	-
	-
INCOME FROM DISCONTINUED OPERATIONS.....	-
NET INCOME.....	7,841
Net income attributable to noncontrolling interest in joint ventures.....	(163)
	7,678
NET INCOME ATTRIBUTABLE TO EASTGROUP PROPERTIES, INC.....	7,678
Dividends on Series D preferred shares.....	-
	-
NET INCOME AVAILABLE TO EASTGROUP PROPERTIES, INC.	
COMMON STOCKHOLDERS.....	\$ 7,678
	=====
<b>BASIC PER COMMON SHARE DATA FOR INCOME ATTRIBUTABLE TO EASTGROUP PROPERTIES, INC.</b>	
Income from continuing operations.....	\$ .31
Income from discontinued operations.....	.00
	-----
Net income available to common stockholders.....	\$ .31
	=====

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Weighted average shares outstanding.....	24,999
<hr/>	
DILUTED PER COMMON SHARE DATA FOR INCOME ATTRIBUTABLE TO EASTGROUP PROPERTIES, INC.	
Income from continuing operations.....	\$ .31
Income from discontinued operations.....	.00
<hr/>	
Net income available to common stockholders.....	\$ .31
<hr/>	
Weighted average shares outstanding.....	25,070
<hr/>	
AMOUNTS ATTRIBUTABLE TO EASTGROUP PROPERTIES, INC. COMMON STOCKHOLDERS	
Income from continuing operations.....	\$ 7,678
Income from discontinued operations.....	-
<hr/>	
Net income available to common stockholders.....	\$ 7,678
<hr/>	
Dividends declared per common share.....	\$ .52

See accompanying Notes to Consolidated Financial Statements (unaudited).

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EASTGROUP PROPERTIES, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY  
(IN THOUSANDS, EXCEPT FOR SHARE AND PER SHARE DATA)  
(UNAUDITED)

	EastGroup Properties, Inc.			
	Common Stock	Additional Paid-In Capital	Distributions In Excess Of Earnings	Accumu Oth Compreh Los
	<hr/>			
BALANCE, DECEMBER 31, 2008.....	\$ 3	528,452	(117,093)	(
Comprehensive income				
Net income.....	-	-	7,678	
Net unrealized change in fair value of interest rate swap.....	-	-	-	
Total comprehensive income.....				
Common dividends declared - \$.52 per share.....	-	-	(13,077)	
Stock-based compensation, net of forfeitures...	-	437	-	
Issuance of 25,000 shares of common stock, options exercised.....	-	509	-	
Issuance of 2,431 shares of common stock, dividend reinvestment plan.....	-	67	-	
3,628 shares withheld to satisfy tax withholding obligations in connection with				

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the vesting of restricted stock.....	-	(129)	-
Distributions to noncontrolling interest.....	-	-	-
<hr/>			
BALANCE, MARCH 31, 2009.....	\$ 3	529,336	(122,492)
<hr/>			

See accompanying Notes to Consolidated Financial Statements (unaudited).

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EASTGROUP PROPERTIES, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)  
(UNAUDITED)

OPERATING ACTIVITIES

Net income attributable to EastGroup Properties, Inc.....	
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization from continuing operations.....	
Depreciation and amortization from discontinued operations.....	
Noncontrolling interest depreciation and amortization.....	
Amortization of mortgage loan premiums.....	
Gain on sale of non-operating real estate.....	
Gain on sales of securities.....	
Amortization of discount on mortgage loan receivable.....	
Stock-based compensation expense.....	
Equity in earnings of unconsolidated investment, net of distributions.....	
Changes in operating assets and liabilities:	
Accrued income and other assets.....	
Accounts payable, accrued expenses and prepaid rent.....	

NET CASH PROVIDED BY OPERATING ACTIVITIES.....

INVESTING ACTIVITIES

Real estate development.....	
Purchases of real estate.....	
Real estate improvements.....	
Repayments on mortgage loans receivable.....	
Purchases of securities.....	
Proceeds from sales of securities.....	
Changes in other assets and other liabilities.....	

NET CASH USED IN INVESTING ACTIVITIES.....

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### FINANCING ACTIVITIES

Proceeds from bank borrowings.....  
Repayments on bank borrowings.....  
Proceeds from mortgage notes payable.....  
Principal payments on mortgage notes payable.....  
Debt issuance costs.....  
Distributions paid to stockholders.....  
Proceeds from exercise of stock options.....  
Proceeds from dividend reinvestment plan.....  
Other.....

NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES.....

DECREASE IN CASH AND CASH EQUIVALENTS.....

CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD.....

CASH AND CASH EQUIVALENTS AT END OF PERIOD.....

### SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest, net of amount capitalized of \$1,651 and \$1,705  
for 2009 and 2008, respectively.....  
Fair value of common stock awards issued to employees and directors,  
net of forfeitures.....

See accompanying Notes to Consolidated Financial Statements (unaudited).

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### (1) BASIS OF PRESENTATION

The accompanying unaudited financial statements of EastGroup Properties, Inc. ("EastGroup" or "the Company") have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In management's opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The financial statements should be read in conjunction with the financial statements contained in the 2008 annual report on Form 10-K and the notes thereto.

#### (2) PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of EastGroup Properties, Inc., its wholly-owned subsidiaries and its investment in any joint ventures in which the Company has a controlling interest. At December 31, 2008 and March 31, 2009, the Company had a controlling interest in two joint ventures: the 80% owned University Business Center and the 80% owned Castilian Research Center. The Company records 100% of the joint ventures' assets, liabilities, revenues and expenses with noncontrolling interests provided for in accordance with the joint venture agreements. The equity method of accounting is used for the Company's 50% undivided tenant-in-common interest in Industry Distribution Center II. All significant intercompany transactions and accounts have been eliminated in consolidation.

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### (3) USE OF ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses during the reporting period, and to disclose material contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

### (4) REAL ESTATE PROPERTIES

EastGroup has one reportable segment—industrial properties. These properties are concentrated in major Sunbelt markets of the United States, primarily in the states of Florida, Texas, Arizona and California, have similar economic characteristics and also meet the other criteria that permit the properties to be aggregated into one reportable segment. The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows (including estimated future expenditures necessary to substantially complete the asset) expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. As of March 31, 2009 and December 31, 2008, the Company determined that no impairment charges on the Company's real estate properties were necessary. Depreciation of buildings and other improvements, including personal property, is computed using the straight-line method over estimated useful lives of generally 40 years for buildings and 3 to 15 years for improvements and personal property. Building improvements are capitalized, while maintenance and repair expenses are charged to expense as incurred. Significant renovations and improvements that extend the useful life of or improve the assets are capitalized. Depreciation expense for continuing and discontinued operations was \$10,898,000 and \$10,222,000 for the three months ended March 31, 2009 and 2008, respectively. The Company's real estate properties at March 31, 2009 and December 31, 2008 were as follows:

	March 31, 2009	December
-----		
(In thousands)		
Real estate properties:		
Land.....	\$ 188,825	1
Buildings and building improvements.....	876,926	8
Tenant and other improvements.....	201,288	1
Development.....	151,438	1
	-----	-----
	1,418,477	1,4
Less accumulated depreciation.....	(321,249)	(3
	-----	-----
	\$ 1,097,228	1,0
	=====	=====

### (5) DEVELOPMENT

During the period in which a property is under development, costs associated with development (i.e., land, construction costs, interest expense, property taxes and other direct and indirect costs associated with development) are aggregated into the total capitalized costs of the property. Included in these costs are management's estimates for the portions of internal costs (primarily personnel costs) that are deemed directly or indirectly related to



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such development activities. As the property becomes occupied, costs are capitalized only for the portion of the building that remains vacant. When the property becomes 80% occupied or one year after completion of the shell construction (whichever comes first), capitalization of development costs ceases. The properties are then transferred to real estate properties, and depreciation commences on the entire property (excluding the land).

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### (6) BUSINESS COMBINATIONS AND ACQUIRED INTANGIBLES

Upon acquisition of real estate properties, the Company applies the principles of Statement of Financial Accounting Standards (SFAS) No. 141R, Business Combinations, which requires that acquisition-related costs be recognized as expenses in the periods in which the costs are incurred and the services are received. The Statement also provides guidance on how to properly determine the allocation of the purchase price among the individual components of both the tangible and intangible assets based on their respective fair values. The Company determines whether any financing assumed is above or below market based upon comparison to similar financing terms for similar properties. The cost of the properties acquired may be adjusted based on indebtedness assumed from the seller that is determined to be above or below market rates. Factors considered by management in allocating the cost of the properties acquired include an estimate of carrying costs during the expected lease-up periods considering current market conditions and costs to execute similar leases. The allocation to tangible assets (land, building and improvements) is based upon management's determination of the value of the property as if it were vacant using discounted cash flow models.

The remaining purchase price is allocated among three categories of intangible assets consisting of the above or below market component of in-place leases, the value of in-place leases and the value of customer relationships. The value allocable to the above or below market component of an acquired in-place lease is determined based upon the present value (using a discount rate which reflects the risks associated with the acquired leases) of the difference between (i) the contractual amounts to be paid pursuant to the lease over its remaining term, and (ii) management's estimate of the amounts that would be paid using fair market rates over the remaining term of the lease. The amounts allocated to above and below market leases are included in Other Assets and Other Liabilities, respectively, on the Consolidated Balance Sheets and are amortized to rental income over the remaining terms of the respective leases. The total amount of intangible assets is further allocated to in-place lease values and to customer relationship values based upon management's assessment of their respective values. These intangible assets are included in Other Assets on the Consolidated Balance Sheets and are amortized over the remaining term of the existing lease, or the anticipated life of the customer relationship, as applicable. Amortization expense for in-place lease intangibles was \$566,000 and \$742,000 for the three months ended March 31, 2009 and 2008, respectively. Amortization of above and below market leases was immaterial for all periods presented.

There were no acquisitions during the first quarter of 2009.

The Company periodically reviews the recoverability of goodwill (at least annually) and the recoverability of other intangibles (on a quarterly basis) for possible impairment. In management's opinion, no material impairment of goodwill and other intangibles existed at March 31, 2009, and December 31, 2008.

### (7) REAL ESTATE HELD FOR SALE/DISCONTINUED OPERATIONS

The Company considers a real estate property to be held for sale when it meets the criteria established under SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, including when it is probable that the

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property will be sold within a year. A key indicator of probability of sale is whether the buyer has a significant amount of earnest money at risk. Real estate properties that are held for sale are reported at the lower of the carrying amount or fair value less estimated costs to sell and are not depreciated while they are held for sale. In accordance with the guidelines established under SFAS No. 144, the results of operations for the properties sold or held for sale during the reported periods are shown under Discontinued Operations on the Consolidated Statements of Income. Interest expense is not generally allocated to the properties that are held for sale or whose operations are included under Discontinued Operations unless the mortgage is required to be paid in full upon the sale of the property.

The Company sold no real estate properties during the first quarter of 2009 and had no real estate properties that were considered to be held for sale at March 31, 2009.

### (8) OTHER ASSETS

A summary of the Company's Other Assets follows:

Leasing costs (principally commissions), net of accumulated amortization.....		\$
Straight-line rent receivable, net of allowance for doubtful accounts.....		
Accounts receivable, net of allowance for doubtful accounts.....		
Acquired in-place lease intangibles, net of accumulated amortization of \$5,699 and \$5,626 for 2009 and 2008, respectively.....		
Mortgage loans receivable, net of discount of \$77 and \$81 for 2009 and 2008, respectively.....		
Loan costs, net of accumulated amortization.....		
Goodwill.....		
Prepaid expenses and other assets.....		
		----- \$ =====

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### (9) ACCOUNTS PAYABLE AND ACCRUED EXPENSES

A summary of the Company's Accounts Payable and Accrued Expenses follows:

		March 31, 2009
		----- (In t
Property taxes payable.....	\$	8,554
Development costs payable.....		7,061
Interest payable.....		2,475
Dividends payable.....		1,236
Other payables and accrued expenses.....		4,226
		----- \$ 23,552 =====

### (10) OTHER LIABILITIES

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A summary of the Company's Other Liabilities follows:

	March 31, 2009
	(In thousands)
Security deposits.....	\$ 7,412
Prepaid rent and other deferred income.....	6,061
Other liabilities.....	1,969
	\$ 15,442

### (11) COMPREHENSIVE INCOME

Comprehensive income is comprised of net income plus all other changes in equity from non-owner sources. The components of accumulated other comprehensive loss for the three months ended March 31, 2009 are presented in the Company's Consolidated Statement of Changes in Equity and for the three months ended March 31, 2009 and 2008 are summarized below.

	Three Months Ended March 31, 2009
	(In thousands)
ACCUMULATED OTHER COMPREHENSIVE LOSS:	
Balance at beginning of period.....	\$ (522)
Change in fair value of interest rate swap.....	30
	\$ (492)

### (12) DERIVATIVES AND HEDGING ACTIVITIES

The Company's interest rate swap is reported at fair value and is shown on the Consolidated Balance Sheets under Other Liabilities. SFAS No. 157, Fair Value Measurements, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 also provides guidance for using fair value to measure financial assets and liabilities. The Statement requires disclosure of the level within the fair value hierarchy in which the fair value measurements fall, including measurements using quoted prices in active markets for identical assets or liabilities (Level 1), quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active (Level 2), and significant valuation assumptions that are not readily observable in the market (Level 3). The fair value of the Company's interest rate swap is determined by estimating the expected cash flows over the life of the swap using the mid-market rate and price environment as of the last trading day of the reporting period. This market information is considered a Level 2 input as defined by SFAS No. 157.

On January 1, 2009, the Company adopted the provisions of SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities, which requires all entities with derivative instruments to disclose information regarding how and why the entity uses derivative instruments and how derivative instruments

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and related hedged items affect the entity's financial position, financial performance, and cash flows. EastGroup has an interest rate swap agreement to hedge its exposure to the variable interest rate on the Company's \$9,365,000 Tower Automotive Center recourse mortgage, which is summarized in the table below. Under the swap agreement, the Company effectively pays a fixed rate of interest over the term of the agreement without the exchange of the underlying notional amount. This swap is designated as a cash flow hedge and is considered to be fully effective in hedging the variable rate risk associated with the Tower mortgage loan. Changes in the fair value of the swap are recognized in accumulated other comprehensive loss (see Note 11). The Company does not hold or issue this type of derivative contract for trading or speculative purposes.

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Type of Hedge	Current Notional Amount	Maturity Date	Reference Rate	Fixed Interest Rate	Effective Interest Rate
----- (In thousands)					
Swap	\$9,365	12/31/10	1 month LIBOR	4.03%	6.03%

(13) EARNINGS PER SHARE

Basic earnings per share (EPS) represents the amount of earnings for the period available to each share of common stock outstanding during the reporting period. The Company's basic EPS is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding.

Diluted EPS represents the amount of earnings for the period available to each share of common stock outstanding during the reporting period and to each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the reporting period. The Company calculates diluted EPS by dividing net income available to common stockholders by the weighted average number of common shares outstanding plus the dilutive effect of nonvested restricted stock and stock options had the options been exercised. The dilutive effect of stock options and their equivalents (such as nonvested restricted stock) was determined using the treasury stock method which assumes exercise of the options as of the beginning of the period or when issued, if later, and assumes proceeds from the exercise of options are used to purchase common stock at the average market price during the period.

Reconciliation of the numerators and denominators in the basic and diluted EPS computations is as follows:

	Three Months Ended	
	March 31, 2009	
	-----	
	2009	
	-----	
		(In thousands)
BASIC EPS COMPUTATION FOR INCOME ATTRIBUTABLE TO EASTGROUP PROPERTIES, INC.		
Numerator-net income available to common stockholders.....	\$	7,678
Denominator-weighted average shares outstanding.....		24,999
DILUTED EPS COMPUTATION FOR INCOME ATTRIBUTABLE TO		

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EASTGROUP PROPERTIES, INC.	
Numerator-net income available to common stockholders.....	\$ 7,678
Denominator:	
Weighted average shares outstanding.....	24,999
Common stock options.....	22
Nonvested restricted stock.....	49
Total Shares.....	25,070

### (14) STOCK-BASED COMPENSATION

#### Management Incentive Plan

The Company has a management incentive plan which was approved by the shareholders and adopted in 2004. This plan authorizes the issuance of up to 1,900,000 shares of common stock to employees in the form of options, stock appreciation rights, restricted stock (limited to 570,000 shares), deferred stock units, performance shares, stock bonuses, and stock. Total shares available for grant were 1,597,796 at March 31, 2009. Typically, the Company issues new shares to fulfill stock grants or upon the exercise of stock options.

Stock-based compensation was \$435,000 and \$603,000 for the three months ended March 31, 2009 and 2008, respectively, of which \$58,000 and \$184,000 were capitalized as part of the Company's development costs.

#### Restricted Stock

In the second quarter of 2008, the Company granted shares to executive officers contingent upon the attainment of certain annual performance goals. In March 2009, 31,811 shares were awarded at a grant date fair value of \$47.65 per share. These shares vested 20% on March 5, 2009, and will vest 20% per year on each January 1 for the subsequent four years.

In the second quarter of 2006, the Company granted shares to executive officers contingent upon the attainment of performance goals over a three-year period ended December 31, 2008. The weighted average grant date fair value for shares to be awarded under the multi-year market conditions was approximately \$2.1 million. In March 2009, 60,474 shares were awarded, and these shares will vest 25% per year on January 1, 2010, 2011, 2012 and 2013.

Following is a summary of the total restricted shares granted, forfeited and delivered (vested) to employees with the related weighted average grant date fair value share prices. Of the shares that vested in the first quarter of 2009, 3,628 shares were withheld by the Company to satisfy the tax obligations for those employees who elected this option as permitted under the applicable equity plan. As of the vesting date, the fair value of shares that vested during the first quarter of 2009 was \$747,000.

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#### Restricted Stock Activity:

	Three Months Ended March 31, 2009	
Shares	Weighted Average Grant Date Fair Value	
Nonvested at beginning of period.....	87,685	\$ 36.95

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Granted (1).....	92,555	39.40
Forfeited.....	(300)	20.50
Vested.....	(23,400)	31.93
	-----	
Nonvested at end of period.....	156,540	37.04
	=====	

(1) Primarily represents shares issued in March 2009 that were granted in 2008 subject to the satisfaction of annual performance goals and in 2006 subject to the satisfaction of performance goals over a three-year period.

### Directors Equity Plan

The Company has a directors equity plan that was approved by shareholders and adopted in 2005 and was further amended by the Board of Directors in May 2008, which authorizes the issuance of up to 50,000 shares of common stock through awards of shares and restricted shares granted to non-employee directors of the Company. Stock-based compensation expense for directors was \$61,000 and \$39,000 for the three months ended March 31, 2009 and 2008, respectively.

### (15) RISKS AND UNCERTAINTIES

The state of the overall economy can significantly impact the Company's operational performance and thus, impact its financial position. Should EastGroup experience a significant decline in operational performance, it may affect the Company's ability to make distributions to its shareholders and service debt or meet other financial obligations.

### (16) RECENT ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board (FASB) deferred for one year the fair value measurement requirements contained in SFAS No. 157, Fair Value Measurements, for nonfinancial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. These provisions, which are included in FASB Staff Position (FSP) FAS 157-2, were effective for fiscal years beginning after November 15, 2008. The adoption of these provisions in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), Business Combinations, which retains the fundamental requirements in SFAS No. 141 and requires the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree be measured at fair value as of the acquisition date. In addition, Statement 141R requires that any goodwill acquired in the business combination be measured as a residual, and it provides guidance in determining what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Statement also requires that acquisition-related costs be recognized as expenses in the periods in which the costs are incurred and the services are received. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The adoption of Statement 141R in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

Also in December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, which is an amendment of Accounting Research Bulletin (ARB) No. 51. Statement 160 provides guidance for entities that prepare consolidated financial statements that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. SFAS No. 160 was effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The adoption of Statement 160 in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

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In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities, which is an amendment of FASB Statement No. 133. SFAS No. 161 requires all entities with derivative instruments to disclose information regarding how and why the entity uses derivative instruments and how derivative instruments and related hedged items affect the entity's financial position, financial performance, and cash flows. The Company adopted SFAS No. 161 on January 1, 2009.

During 2008, the FASB issued FSP FAS 142-3, which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. FSP FAS 142-3 requires an entity to disclose information that enables financial statement users to assess the extent to which the expected future cash flows associated with the asset are affected by the entity's intent and/or ability to renew or extend the arrangement. The intent of this Staff Position is to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under Statement 141R and other U.S. generally accepted accounting principles. FSP FAS 142-3 was effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim

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periods within those fiscal years. The adoption of FSP FAS 142-3 in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

Also in 2008, the Emerging Issues Task Force (EITF) issued EITF 08-6, Equity Method Investment Accounting Considerations, which applies to all investments accounted for under the equity method and clarifies the accounting for certain transactions and impairment considerations involving those investments. EITF 08-6 was effective for financial statements issued for fiscal years beginning on or after December 15, 2008, and interim periods within those fiscal years. The adoption of EITF 08-6 in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

In April 2009, the FASB issued FSP FAS 107-1, which amends SFAS No. 107, Disclosures About Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This FSP also amends Accounting Principles Board (APB) No. 28, Interim Financial Reporting, to require those disclosures in summarized financial information at interim reporting periods. FSP FAS 107-1 is effective for interim reporting periods ending after June 15, 2009, and the Company anticipates that the adoption of this FSP will have an immaterial impact on the Company's overall financial position and results of operations.

### (17) SUBSEQUENT EVENTS

In March, EastGroup executed an application on a \$67 million, limited recourse first mortgage loan secured by properties containing 1.7 million square feet. The loan has a recourse liability of \$5 million which may be released based on the secured properties obtaining certain base rent amounts. The loan closed on May 5, 2009, and has a fixed interest rate of 7.5%, a 10-year term and a 20-year amortization schedule. The Company used the proceeds of this mortgage loan to reduce variable rate bank borrowings.

During the fourth quarter of 2008, EastGroup acquired 94.3 acres of developable land in Orlando for \$9.1 million. The Company is currently under contract to purchase an additional 35.9 acres in a second phase of this acquisition for \$5 million. This transaction is expected to close during the fourth quarter of 2009.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

## OVERVIEW

EastGroup's goal is to maximize shareholder value by being the leading provider in its markets of functional, flexible, and quality business distribution space for location sensitive tenants primarily in the 5,000 to 50,000 square foot range. The Company develops, acquires and operates distribution facilities, the majority of which are clustered around major transportation features in supply constrained submarkets in major Sunbelt regions. The Company's core markets are in the states of Florida, Texas, Arizona and California.

The Company believes that the slowdown in the economy has affected and will continue to affect its operations. The Company is projecting a continued decrease in occupancy, and there are no plans for development starts. The current economic situation is also impacting lenders, and it is more difficult to obtain financing. Loan proceeds as a percentage of property value is decreasing, and long-term interest rates are increasing. The Company believes that its current lines of credit provide the capacity to fund the operations of the Company for the remainder of 2009 and 2010. The Company also believes that it can obtain mortgage financing from insurance companies and financial institutions as evidenced by the executed loan application for \$67 million described in Liquidity and Capital Resources.

The Company's primary revenue is rental income; as such, EastGroup's greatest challenge is leasing space. During the three months ended March 31, 2009, leases on 1,286,000 square feet (5.0%) of EastGroup's total square footage of 25,757,000 expired, and the Company was successful in renewing or re-leasing 73% of the expiring square feet. In addition, EastGroup leased 342,000 square feet of other vacant space during this period. During the three months ended March 31, 2009, average rental rates on new and renewal leases decreased by 5.0%.

EastGroup's total leased percentage was 93.4% at March 31, 2009, compared to 94.9% at March 31, 2008. Leases scheduled to expire for the remainder of 2009 were 9.7% of the portfolio on a square foot basis at March 31, 2009, and this figure was reduced to 7.0% as of May 6, 2009. Property net operating income (PNOI) from same properties decreased 2.6% for the quarter ended March 31, 2009, as compared to the same period in 2008.

EastGroup continues to see targeted development as a major contributor to the Company's long-term growth. The Company mitigates risks associated with development through a Board-approved maximum level of land held for development and by adjusting development start dates according to leasing activity. EastGroup's development activity has slowed considerably as a result of current market conditions. The Company had no development starts in the first quarter of 2009 and currently does not have any plans to start construction on new developments for the remainder of 2009. During the first quarter of 2009, the Company transferred two properties (145,000 square feet) with aggregate costs of \$10.2 million at the date of transfer from development to real estate properties. These properties, which were collectively 82.9% leased as of May 6, 2009, are located in Phoenix, Arizona, and San Antonio, Texas.

During the first quarter of 2009, the Company funded its development program through its \$225 million lines of credit (as discussed in Liquidity and Capital Resources). As market conditions permit, EastGroup issues equity, including preferred equity, and/or employs fixed-rate, non-recourse first mortgage debt to replace the short-term bank borrowings.

EastGroup has one reportable segment—industrial properties. These properties are primarily located in major Sunbelt regions of the United States, have similar economic characteristics and also meet the other criteria that



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permit the properties to be aggregated into one reportable segment. The Company's chief decision makers use two primary measures of operating results in making decisions: property net operating income (PNOI), defined as income from real estate operations less property operating expenses (before interest expense and depreciation and amortization), and funds from operations available to common stockholders (FFO), defined as net income (loss) computed in accordance with U.S. generally accepted accounting principles (GAAP), excluding gains or losses from sales of depreciable real estate property, plus real estate related depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. The Company calculates FFO based on the National Association of Real Estate Investment Trusts' (NAREIT) definition.

PNOI is a supplemental industry reporting measurement used to evaluate the performance of the Company's real estate investments. The Company believes that the exclusion of depreciation and amortization in the industry's calculation of PNOI provides a supplemental indicator of the properties' performance since real estate values have historically risen or fallen with market conditions. PNOI as calculated by the Company may not be comparable to similarly titled but differently calculated measures for other real estate investment trusts (REITs). The major factors that influence PNOI are occupancy levels, acquisitions and sales, development properties that achieve stabilized operations, rental rate increases or decreases, and the recoverability of operating expenses. The Company's success depends largely upon its ability to lease space and to recover from tenants the operating costs associated with those leases.

Real estate income is comprised of rental income, pass-through income and other real estate income including lease termination fees. Property operating expenses are comprised of property taxes, insurance, utilities, repair and maintenance expenses, management fees, other operating costs and bad debt expense. Generally, the Company's most significant operating expenses are property taxes and insurance. Tenant leases may be net leases in which the total operating expenses are recoverable, modified gross leases in which some of the operating expenses are recoverable, or gross leases in which no expenses are recoverable (gross leases represent only a small portion of the Company's total leases). Increases in property operating expenses are fully recoverable under net leases and recoverable to a high degree under modified gross leases. Modified gross leases often include base year amounts and expense increases over these amounts are recoverable. The Company's exposure to property operating expenses is primarily due to vacancies and leases for occupied space that limit the amount of expenses that can be recovered.

The Company believes FFO is a meaningful supplemental measure of operating performance for equity REITs. The Company believes that excluding depreciation and amortization in the calculation of FFO is appropriate since real estate values have historically increased or decreased based on market conditions. FFO is not considered as an alternative to net income (determined in accordance with

GAAP) as an indication of the Company's financial performance, nor is it a measure of the Company's liquidity or indicative of funds available to provide for the Company's cash needs, including its ability to make distributions. The Company's key drivers affecting FFO are changes in PNOI (as discussed above), interest rates, the amount of leverage the Company employs and general and administrative expense. The following table presents on a comparative basis for the three months ended March 31, 2009 and 2008 reconciliations of PNOI and FFO Available to Common Stockholders to Net Income Attributable to EastGroup Properties, Inc.

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Income from real estate operations.....	\$
Expenses from real estate operations.....	
PROPERTY NET OPERATING INCOME.....	
Equity in earnings of unconsolidated investment (before depreciation).....	
Income from discontinued operations (before depreciation and amortization).....	
Interest income.....	
Gain on sales of securities.....	
Other income.....	
Interest expense.....	
General and administrative expense.....	
Noncontrolling interest in earnings (before depreciation and amortization).....	
Gain on sale of non-operating real estate.....	
Dividends on Series D preferred shares.....	
FUNDS FROM OPERATIONS AVAILABLE TO COMMON STOCKHOLDERS.....	
Depreciation and amortization from continuing operations.....	
Depreciation and amortization from discontinued operations.....	
Depreciation from unconsolidated investment.....	
Noncontrolling interest depreciation and amortization.....	
NET INCOME AVAILABLE TO EASTGROUP PROPERTIES, INC.	
COMMON STOCKHOLDERS.....	
Dividends on preferred shares.....	
NET INCOME ATTRIBUTABLE TO EASTGROUP PROPERTIES, INC.....	\$
Net income available to common stockholders per diluted share.....	\$
Funds from operations available to common stockholders per diluted share.....	
Diluted shares for earnings per share and funds from operations.....	

The Company analyzes the following performance trends in evaluating the progress of the Company:

- o The FFO change per share represents the increase or decrease in FFO per share from the same quarter in the current year compared to the prior year. FFO per share for the first quarter of 2009 was \$.83 per share, the same as the first quarter of 2008. Excluding gain on sales of securities of \$435,000 and gain on involuntary conversion of \$175,000 in the first quarter of 2008, FFO increased by 2.5% over the first quarter of 2008. PNOI increased 5.1% primarily due to additional PNOI of \$1,787,000 from newly developed properties and \$414,000 from 2008 acquisitions, offset by a decrease of \$745,000 from same property growth.
- o Same property net operating income change represents the PNOI increase or decrease for operating properties owned during the entire current period and prior year reporting period. PNOI from same properties decreased 2.6% for the first quarter of 2009 as compared to the same quarter last year. Occupancy for same properties decreased from 94.4% to 93.1%.
- o Occupancy is the percentage of leased square footage for which the lease

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term has commenced as compared to the total leasable square footage as of the close of the reporting period. Occupancy at March 31, 2009, was 92.8%. Quarter-end occupancy ranged from 92.8% to 95.0% over the period from March 31, 2008 to March 31, 2009.

- o Rental rate change represents the rental rate increase or decrease on new and renewal leases compared to the prior leases on the same space. Rental rate decreases on new and renewal leases (5.0% of total square footage) averaged 5.0% for the first quarter of 2009.

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### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company's management considers the following accounting policies and estimates to be critical to the reported operations of the Company.

#### Real Estate Properties

The Company allocates the purchase price of acquired properties to net tangible and identified intangible assets based on their respective fair values. Factors considered by management in allocating the cost of the properties acquired include an estimate of carrying costs during the expected lease-up periods considering current market conditions and costs to execute similar leases. The allocation to tangible assets (land, building and improvements) is based upon management's determination of the value of the property as if it were vacant using discounted cash flow models. The remaining purchase price is allocated among three categories of intangible assets consisting of the above or below market component of in-place leases, the value of in-place leases and the value of customer relationships. The value allocable to the above or below market component of an acquired in-place lease is determined based upon the present value (using a discount rate which reflects the risks associated with the acquired leases) of the difference between (i) the contractual amounts to be paid pursuant to the lease over its remaining term and (ii) management's estimate of the amounts that would be paid using fair market rates over the remaining term of the lease. The amounts allocated to above and below market leases are included in Other Assets and Other Liabilities, respectively, on the Consolidated Balance Sheets and are amortized to rental income over the remaining terms of the respective leases. The total amount of intangible assets is further allocated to in-place lease values and to customer relationship values based upon management's assessment of their respective values. These intangible assets are included in Other Assets on the Consolidated Balance Sheets and are amortized over the remaining term of the existing lease, or the anticipated life of the customer relationship, as applicable.

During the period in which a property is under development, costs associated with development (i.e., land, construction costs, interest expense, property taxes and other direct and indirect costs associated with development) are aggregated into the total capitalized costs of the property. Included in these costs are management's estimates for the portions of internal costs (primarily personnel costs) that are deemed directly or indirectly related to such development activities.

The Company reviews its real estate investments for impairment of value whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If any real estate investment is considered permanently impaired, a loss is recorded to reduce the carrying value of the property to its estimated fair value. Real estate assets to be sold are reported at the lower of the carrying amount or fair value less selling costs. The evaluation of real estate investments involves many subjective assumptions dependent upon future economic events that affect the ultimate value of the property. Currently, the Company's management is not aware of any impairment issues nor has it experienced any significant impairment issues in recent years.

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EastGroup currently has the intent and ability to hold its real estate investments and to hold its land inventory for future development. In the event of impairment, the property's basis would be reduced and the impairment would be recognized as a current period charge on the Consolidated Statements of Income.

### Valuation of Receivables

The Company is subject to tenant defaults and bankruptcies that could affect the collection of outstanding receivables. In order to mitigate these risks, the Company performs credit reviews and analyses on prospective tenants before significant leases are executed. On a quarterly basis, the Company evaluates outstanding receivables and estimates the allowance for doubtful accounts. Management specifically analyzes aged receivables, customer credit-worthiness, historical bad debts and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. The Company believes that its allowance for doubtful accounts is adequate for its outstanding receivables for the periods presented. In the event that the allowance for doubtful accounts is insufficient for an account that is subsequently written off, additional bad debt expense would be recognized as a current period charge on the Consolidated Statements of Income.

### Tax Status

EastGroup, a Maryland corporation, has qualified as a real estate investment trust under Sections 856-860 of the Internal Revenue Code and intends to continue to qualify as such. To maintain its status as a REIT, the Company is required to distribute at least 90% of its ordinary taxable income to its stockholders. The Company has the option of (i) reinvesting the sales price of properties sold through tax-deferred exchanges, allowing for a deferral of capital gains on the sale, (ii) paying out capital gains to the stockholders with no tax to the Company, or (iii) treating the capital gains as having been distributed to the stockholders, paying the tax on the gain deemed distributed and allocating the tax paid as a credit to the stockholders. The Company distributed all of its 2008 taxable income to its stockholders and expects to distribute all of its taxable income in 2009. Accordingly, no provision for income taxes was necessary in 2008, nor is it expected to be necessary for 2009.

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## FINANCIAL CONDITION

EastGroup's assets were \$1,162,086,000 at March 31, 2009, an increase of \$5,881,000 from December 31, 2008. Liabilities increased \$10,346,000 to \$753,175,000 and equity decreased \$4,465,000 to \$408,911,000 during the same period. The paragraphs that follow explain these changes in detail.

### ASSETS

#### Real Estate Properties

Real estate properties increased \$14,757,000 during the three months ended March 31, 2009, primarily due to the transfer of two properties from development, as detailed under Development below.

The Company made capital improvements of \$3,515,000 on existing and acquired properties (included in the Capital Expenditures table under Results of Operations). Also, the Company incurred costs of \$1,061,000 on development properties subsequent to transfer to Real Estate Properties; the Company records these expenditures as development costs on the Consolidated Statements of Cash Flows during the 12-month period following transfer.

#### Development

The investment in development at March 31, 2009, was \$151,438,000 compared to \$150,354,000 at December 31, 2008. Total capital invested for development during the first three months of 2009 was \$12,327,000, which consisted of costs

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of \$11,266,000 as detailed in the development activity table and costs of \$1,061,000 on developments transferred to Real Estate Properties during the 12-month period following transfer.

The Company transferred two developments to Real Estate Properties during the first quarter of 2009 with a total investment of \$10,182,000 as of the date of transfer.

DEVELOPMENT	Size	Costs Transferred in 2009 (1)	Costs Inc For Three Ended
	(Square feet)		
<b>LEASE-UP</b>			
Beltway Crossing VI, Houston, TX.....	128,000	\$ -	
Oak Creek VI, Tampa, FL.....	89,000	-	
Southridge VIII, Orlando, FL.....	91,000	-	
Techway SW IV, Houston, TX.....	94,000	-	
SunCoast III, Fort Myers, FL.....	93,000	-	
Sky Harbor, Phoenix, AZ.....	264,000	-	
World Houston 26, Houston, TX.....	59,000	-	
12th Street Distribution Center, Jacksonville, FL...	150,000	-	
Beltway Crossing VII, Houston, TX.....	95,000	-	
Country Club III & IV, Tucson, AZ.....	138,000	-	1,
Oak Creek IX, Tampa, FL.....	86,000	-	
<b>Total Lease-up.....</b>	<b>1,287,000</b>	<b>-</b>	<b>3,</b>
<b>UNDER CONSTRUCTION</b>			
Blue Heron III, West Palm Beach, FL.....	20,000	-	
World Houston 28, Houston, TX.....	59,000	-	1,
World Houston 29, Houston, TX.....	70,000	-	1,
World Houston 30, Houston, TX.....	88,000	-	2,
<b>Total Under Construction.....</b>	<b>237,000</b>	<b>-</b>	<b>6,</b>
<b>PROSPECTIVE DEVELOPMENT (PRIMARILY LAND)</b>			
Tucson, AZ.....	70,000	-	
Tampa, FL.....	249,000	-	
Orlando, FL.....	1,254,000	-	
Fort Myers, FL.....	659,000	-	
Dallas, TX.....	70,000	-	
El Paso, TX.....	251,000	-	
Houston, TX.....	1,064,000	-	
San Antonio, TX.....	595,000	-	
Charlotte, NC.....	95,000	-	
Jackson, MS.....	28,000	-	
<b>Total Prospective Development.....</b>	<b>4,335,000</b>	<b>-</b>	
	<b>5,859,000</b>	<b>\$ -</b>	<b>11,</b>

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DEVELOPMENT	Size (Square feet)	Costs Inc	
		Costs Transferred in 2009 (1)	For Three Ended
DEVELOPMENTS COMPLETED AND TRANSFERRED TO REAL ESTATE PROPERTIES DURING 2009			
40th Avenue Distribution Center, Phoenix, AZ.....	90,000	\$ -	
Wetmore II, Building B, San Antonio, TX.....	55,000	-	
Total Transferred to Real Estate Properties.....	145,000	\$ -	

- (1) Represents costs transferred from Prospective Development (primarily land) to Under Construction during the period.
- (2) Represents cumulative costs at the date of transfer.

Accumulated depreciation on real estate properties increased \$10,898,000 during the first three months of 2009 due to depreciation expense on real estate properties.

A summary of Other Assets is presented in Note 8 in the Notes to the Consolidated Financial Statements.

LIABILITIES

Mortgage notes payable decreased \$35,834,000 during the three months ended March 31, 2009, as a result of the repayment of one mortgage of \$31,357,000, regularly scheduled principal payments of \$4,447,000 and mortgage loan premium amortization of \$30,000. In addition, on January 2, 2009, the Company's mortgage note payable of \$9,365,000 on the Tower Automotive Center was repaid and replaced with another mortgage note payable for the same amount. See Liquidity and Capital Resources for further discussion of this mortgage note.

Notes payable to banks increased \$54,323,000 during the three months ended March 31, 2009, as a result of advances of \$80,267,000 exceeding repayments of \$25,944,000. The Company's credit facilities are described in greater detail under Liquidity and Capital Resources.

See Note 9 in the Notes to the Consolidated Financial Statements for a summary of Accounts Payable and Accrued Expenses. See Note 10 in the Notes to the Consolidated Financial Statements for a summary of Other Liabilities.

EQUITY

Distributions in excess of earnings increased \$5,399,000 as a result of dividends on common stock of \$13,077,000 exceeding net income for financial reporting purposes of \$7,678,000. See Note 14 in the Notes to the Consolidated Financial Statements for information related to the changes in additional paid-in capital resulting from stock-based compensation.

RESULTS OF OPERATIONS

(Comments are for the three months ended March 31, 2009, compared to the three months ended March 31, 2008.)

Net income available to common stockholders for the three months ended March 31, 2009, was \$7,678,000 (\$.31 per basic and diluted share) compared to \$7,435,000 (\$.31 per basic and diluted share) for the same period in 2008.

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PNOI increased by \$1,479,000, or 5.1%, for the first quarter of 2009 as compared to the same period in 2008. The increase was primarily attributable to \$1,787,000 from newly developed properties and \$414,000 from 2008 acquisitions, offset by a decrease of \$745,000 from same property growth. The Company recorded gains on sales of securities of \$435,000 and a gain on an involuntary conversion of \$175,000 during the first quarter of 2008.

Expense to revenue ratios were 29.1% for the three months ended March 31, 2009, compared to 27.0% for the same period in 2008. The increase was primarily due to increased bad debt expense and lower occupancy in the first quarter of 2009 as compared to the same period last year. The Company's percentages leased and occupied were 93.4% and 92.8%, respectively, at March 31, 2009, compared to 94.9% and 94.4%, respectively, at March 31, 2008.

General and administrative expense increased \$480,000 for the three months ended March 31, 2009, as compared to the same period in 2008. The increase was primarily attributable to a decrease in capitalized development costs due to a slowdown in the Company's development program.

The following table presents the components of interest expense for the three months ended March 31, 2009 and 2008:

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	Three Months ----- 2009 ----- (In thousands)
Average bank borrowings.....	\$ 133,5
Weighted average variable interest rates (excluding loan cost amortization).....	1.4
 VARIABLE RATE INTEREST EXPENSE	
Variable rate interest (excluding loan cost amortization).....	\$ 4
Amortization of bank loan costs.....	-----
Total variable rate interest expense.....	5 -----
 FIXED RATE INTEREST EXPENSE	
Fixed rate interest (excluding loan cost amortization).....	8,4
Amortization of mortgage loan costs.....	1 -----
Total fixed rate interest expense.....	8,5 -----
Total interest.....	9,1
Less capitalized interest.....	(1,6) -----
TOTAL INTEREST EXPENSE.....	\$ 7,5 =====

Interest costs incurred during the period of construction of real estate properties are capitalized and offset against interest expense. The Company's weighted average variable interest rates and average bank borrowings in the first three months of 2009 were lower than in 2008, thereby decreasing variable rate interest expense.

The increase in mortgage interest expense in 2009 was primarily due to the

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Company's new mortgages detailed in the table below.

NEW MORTGAGES IN 2008 AND 2009	INTEREST RATE	DATE
Beltway II, III & IV, Eastlake, Fairgrounds I-IV, Nations Ford I-IV, Techway Southwest III, Westinghouse, Wetmore I-IV and World Houston 15 & 22.....	5.500%	03/19/09
Southridge XII, Airport Commerce Center I & II, Interchange Park, Ridge Creek III, World Houston 24, 25 & 27 and Waterford Distribution Center.....	5.750%	12/09/08
Tower Automotive Center (1).....	6.030%	01/02/09
Weighted Average/Total Amount.....	5.635%	=====

(1) The Company repaid the previous mortgage note on the Tower Automotive Center and replaced it with this new mortgage note for the same amount. See the table below for details on the previous mortgage.

These increases were offset by regularly scheduled principal payments and the repayments of two mortgages in 2009 as shown in the following table:

MORTGAGE LOANS REPAID IN 2009	INTEREST RATE	DATE REPAID
Tower Automotive Center (1).....	8.020%	01/02/09
Dominguez, Kingsview, Walnut, Washington, Industry Distribution Center I and Shaw.....	6.800%	02/13/09
Weighted Average/Total Amount.....	7.081%	=====

(1) The Tower Automotive Center mortgage was repaid and replaced with another mortgage note payable for the same amount. See the new mortgage detailed in the new mortgages table above.

Depreciation and amortization for continuing operations increased \$669,000 for the three months ended March 31, 2009, as compared to the same period in 2008. This increase was primarily due to properties transferred from development during 2008 and 2009 and properties acquired during the first quarter of 2008.

NAREIT has recommended supplemental disclosures concerning straight-line rent, capital expenditures and leasing costs. Straight-lining of rent for continuing operations increased income by \$66,000 in the first quarter of 2009 compared to \$280,000 in the same period of 2008.

### Capital Expenditures

Capital expenditures for operating properties for the three months ended March 31, 2009 and 2008 were as follows:

Three Months Ended March 31



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	Estimated Useful Life	----- 2009	----- 2008
(In thousands)			
Upgrade on Acquisitions.....	40 yrs	\$ -	31
Tenant Improvements:			
New Tenants.....	Lease Life	1,375	2,088
New Tenants (first generation) (1)..	Lease Life	60	3
Renewal Tenants.....	Lease Life	284	512
Other:			
Building Improvements.....	5-40 yrs	810	182
Roofs.....	5-15 yrs	696	108
Parking Lots.....	3-5 yrs	64	538
Other.....	5 yrs	226	71
Total capital expenditures.....		\$ 3,515	3,533

(1) First generation refers to space that has never been occupied under EastGroup's ownership.

Capitalized Leasing Costs

The Company's leasing costs (principally commissions) are capitalized and included in Other Assets. The costs are amortized over the terms of the associated leases and are included in depreciation and amortization expense. Capitalized leasing costs for the three months ended March 31, 2009 and 2008 were as follows:

	Estimated Useful Life	----- Three Months Ended March 31 2009	----- 2008
(In thousands)			
Development.....	Lease Life	\$ 344	833
New Tenants.....	Lease Life	487	471
New Tenants (first generation) (1).....	Lease Life	4	7
Renewal Tenants.....	Lease Life	780	239
Total capitalized leasing costs..		\$ 1,615	1,550
Amortization of leasing costs (2).....		\$ 1,580	1,454

(1) First generation refers to space that has never been occupied under EastGroup's ownership.

(2) Includes discontinued operations.

Discontinued Operations

The results of operations, including interest expense (if applicable), for the operating properties sold or held for sale during the periods reported are shown under Discontinued Operations on the Consolidated Statements of Income. The following table presents the components of revenue and expense for the properties sold or held for sale during the three months ended March 31, 2009 and 2008. There were no sales of properties during the first three months of 2009 or 2008; however, the Company has reclassified the operations of North Stemmons I and Delp Distribution Center III, which were sold during 2008, to

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Discontinued Operations as shown in the following table.

	Three Months Ended March 31,	
Discontinued Operations	2009	2008
	(In thousands)	
Income from real estate operations.....	\$ -	167
Expenses from real estate operations.....	-	(42)
Property net operating income from discontinued operations.....	-	125
Depreciation and amortization.....	-	(43)
Income from real estate operations.....	\$ -	82

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### RECENT ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board (FASB) deferred for one year the fair value measurement requirements contained in SFAS No. 157, Fair Value Measurements, for nonfinancial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. These provisions, which are included in FASB Staff Position (FSP) FAS 157-2, were effective for fiscal years beginning after November 15, 2008. The adoption of these provisions in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), Business Combinations, which retains the fundamental requirements in SFAS No. 141 and requires the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree be measured at fair value as of the acquisition date. In addition, Statement 141R requires that any goodwill acquired in the business combination be measured as a residual, and it provides guidance in determining what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Statement also requires that acquisition-related costs be recognized as expenses in the periods in which the costs are incurred and the services are received. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The adoption of Statement 141R in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

Also in December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, which is an amendment of Accounting Research Bulletin (ARB) No. 51. Statement 160 provides guidance for entities that prepare consolidated financial statements that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. SFAS No. 160 was effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The adoption of Statement 160 in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities, which is an amendment of FASB Statement No. 133. SFAS No. 161 requires all entities with derivative instruments to disclose

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information regarding how and why the entity uses derivative instruments and how derivative instruments and related hedged items affect the entity's financial position, financial performance, and cash flows. The Company adopted SFAS No. 161 on January 1, 2009.

During 2008, the FASB issued FSP FAS 142-3, which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. FSP FAS 142-3 requires an entity to disclose information that enables financial statement users to assess the extent to which the expected future cash flows associated with the asset are affected by the entity's intent and/or ability to renew or extend the arrangement. The intent of this Staff Position is to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under Statement 141R and other U.S. generally accepted accounting principles. FSP FAS 142-3 was effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of FSP FAS 142-3 in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

Also in 2008, the Emerging Issues Task Force (EITF) issued EITF 08-6, Equity Method Investment Accounting Considerations, which applies to all investments accounted for under the equity method and clarifies the accounting for certain transactions and impairment considerations involving those investments. EITF 08-6 was effective for financial statements issued for fiscal years beginning on or after December 15, 2008, and interim periods within those fiscal years. The adoption of EITF 08-6 in 2009 had an immaterial impact on the Company's overall financial position and results of operations.

In April 2009, the FASB issued FSP FAS 107-1, which amends SFAS No. 107, Disclosures About Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This FSP also amends Accounting Principles Board (APB) No. 28, Interim Financial Reporting, to require those disclosures in summarized financial information at interim reporting periods. FSP FAS 107-1 is effective for interim reporting periods ending after June 15, 2009, and the Company anticipates that the adoption of this FSP will have an immaterial impact on the Company's overall financial position and results of operations.

### LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operating activities was \$17,995,000 for the three months ended March 31, 2009. The primary other sources of cash were from bank borrowings and mortgage note proceeds. The Company distributed \$13,098,000 in common stock dividends during the three months ended March 31, 2009. Other primary uses of cash were for mortgage note repayments, bank debt repayments, construction and development of properties, and capital improvements at various properties.

Total debt at March 31, 2009 and December 31, 2008 is detailed below. The Company's bank credit facilities have certain restrictive covenants, such as maintaining debt service coverage and leverage ratios and maintaining insurance coverage, and the Company was in compliance with all of its debt covenants at March 31, 2009 and December 31, 2008.

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March 31, 2009      December 31, 2008

-----  
(In thousands)

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Mortgage notes payable - fixed rate.....	\$	549,972	585,806
Bank notes payable - floating rate.....		164,209	109,886
		-----	-----
Total debt.....	\$	714,181	695,692
		=====	=====

The Company has a four-year, \$200 million unsecured revolving credit facility with a group of seven banks that matures in January 2012. The interest rate on the facility is based on the LIBOR index and varies according to total liability to total asset value ratios (as defined in the credit agreement), with an annual facility fee of 15 to 20 basis points. The interest rate on each tranche is usually reset on a monthly basis and is currently LIBOR plus 70 basis points with an annual facility fee of 20 basis points. The line of credit has an option for a one-year extension at the Company's request. Additionally, there is a provision under which the line may be expanded by \$100 million contingent upon obtaining increased commitments from existing lenders or commitments from additional lenders. At March 31, 2009, the weighted average interest rate was 1.230% on a balance of \$162,000,000. At May 6, 2009, the Company's weighted average interest rate was 1.143% on a balance of \$92,000,000. The Company had an additional \$108,000,000 remaining on this line of credit on May 6, 2009.

The Company also has a four-year, \$25 million unsecured revolving credit facility with PNC Bank, N.A. that matures in January 2012. This credit facility is customarily used for working capital needs. The interest rate on this working cash line is based on the LIBOR index and varies according to total liability to total asset value ratios (as defined in the credit agreement). Under this facility, the Company's current interest rate is LIBOR plus 75 basis points with no annual facility fee. At March 31, 2009, the interest rate was 1.251% on a balance of \$2,209,000. At May 6, 2009, the interest rate was 1.145% on a balance of \$4,363,000. The Company had an additional \$20,637,000 remaining on this line of credit on May 6, 2009.

The current economic situation is impacting lenders, and it is more difficult to obtain financing. Loan proceeds as a percentage of property value is decreasing, and long-term interest rates are increasing. The Company believes that its current lines of credit provide the capacity to fund the operations of the Company for the remainder of 2009 and 2010. The Company also believes that it can obtain mortgage financing from insurance companies and financial institutions. In March 2009, EastGroup executed an application on a \$67 million, limited recourse first mortgage loan secured by properties containing 1.7 million square feet. The loan has a recourse liability of \$5 million which may be released based on the secured properties obtaining certain base rent amounts. The loan closed on May 5, 2009, and has a fixed interest rate of 7.5%, a 10-year term and a 20-year amortization schedule. The Company used the proceeds of this mortgage loan to reduce variable rate bank borrowings.

As market conditions permit, EastGroup issues equity, including preferred equity, and/or employs fixed-rate first mortgage debt to replace the short-term bank borrowings.

On January 2, 2009, the mortgage note payable of \$9,365,000 on the Tower Automotive Center was repaid and replaced with another mortgage note payable for the same amount. The previous recourse mortgage was a variable rate demand note, and EastGroup had entered into a swap agreement to fix the LIBOR rate. In the fourth quarter of 2008, the bond spread over LIBOR required to re-market the notes increased from a historical range of 3 to 25 basis points to a range of 100 to 500 basis points. Due to the volatility of the bond spread costs, EastGroup redeemed the note and replaced it with a recourse mortgage with a bank on the same payment terms except for the interest rate. The effective interest rate on the previous note was 5.30% until the fourth quarter of 2008 when the weighted average rate was 8.02%. The effective rate on the new note, including the swap, is 6.03%.

The Company anticipates that its current cash balance, operating cash flows, borrowings under its lines of credit, proceeds from new mortgage debt and/or proceeds from the issuance of equity instruments will be adequate for (i)

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operating and administrative expenses, (ii) normal repair and maintenance expenses at its properties, (iii) debt service obligations, (iv) distributions to stockholders, (v) capital improvements, (vi) purchases of properties, (vii) development, and (viii) any other normal business activities of the Company, both in the short- and long-term.

### Contractual Obligations

EastGroup's fixed, noncancelable obligations as of December 31, 2008, did not materially change during the three months ended March 31, 2009, except for the decrease in mortgage notes payable and the increase in bank borrowings discussed above.

### INFLATION AND OTHER ECONOMIC CONSIDERATIONS

Most of the Company's leases include scheduled rent increases. Additionally, most of the Company's leases require the tenants to pay their pro rata share of operating expenses, including real estate taxes, insurance and common area maintenance, thereby reducing the Company's exposure to increases in operating expenses resulting from inflation.

EastGroup's financial results are affected by general economic conditions in the markets in which the Company's properties are located. An economic recession, or other adverse changes in general or local economic conditions, could result in the inability of some of the Company's existing tenants to make lease payments and may impact our ability to (i) renew leases or re-lease space as leases expire, or (ii) lease development space. In addition, an economic downturn or recession could also lead to an increase in overall vacancy rates or decline in rents we can charge to re-lease properties upon expiration of current leases. In all of these cases, our cash flow would be adversely affected.

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### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The Company is exposed to interest rate changes primarily as a result of its lines of credit and long-term debt maturities. This debt is used to maintain liquidity and fund capital expenditures and expansion of the Company's real estate investment portfolio and operations. The Company's objective for interest rate risk management is to limit the impact of interest rate changes on earnings and cash flows and to lower its overall borrowing costs. To achieve its objectives, the Company borrows at fixed rates but also has several variable rate bank lines as discussed under Liquidity and Capital Resources. The table below presents the principal payments due and weighted average interest rates for both the fixed rate and variable rate debt.

	Apr-Dec 2009	2010	2011	2012	2013	Thereafter
Fixed rate debt (1) (in thousands)....	\$ 13,150	18,185	84,971	62,117	53,232	318,000
Weighted average interest rate.....	5.95%	5.89%	7.00%	6.61%	5.06%	5.00%
Variable rate debt (in thousands)....	\$ -	-	-	164,209	-	-
Weighted average interest rate.....	-	-	-	1.23%	-	-

- (1) The fixed rate debt shown above includes the Tower Automotive mortgage. See below for additional information on the Tower mortgage.
- (2) The fair value of the Company's fixed rate debt is estimated based on the quoted market prices for similar issues or by discounting expected cash flows at the rates currently offered to the Company for debt of the same

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- remaining maturities, as advised by the Company's bankers.
- (3) The fair value of the Company's variable rate debt is estimated by discounting expected cash flows at current market rates.

As the table above incorporates only those exposures that existed as of March 31, 2009, it does not consider those exposures or positions that could arise after that date. If the weighted average interest rate on the variable rate bank debt as shown above changes by 10% or approximately 12 basis points, interest expense and cash flows would increase or decrease by approximately \$202,000 annually.

The Company has an interest rate swap agreement to hedge its exposure to the variable interest rate on the Company's \$9,365,000 Tower Automotive Center recourse mortgage, which is summarized in the table below. Under the swap agreement, the Company effectively pays a fixed rate of interest over the term of the agreement without the exchange of the underlying notional amount. This swap is designated as a cash flow hedge and is considered to be fully effective in hedging the variable rate risk associated with the Tower mortgage loan. Changes in the fair value of the swap are recognized in accumulated other comprehensive loss. The Company does not hold or issue this type of derivative contract for trading or speculative purposes.

Type of Hedge	Current Notional Amount	Maturity Date	Reference Rate	Fixed Interest Rate	Effective Interest Rate
-----					
(In thousands)					
Swap	\$9,365	12/31/10	1 month LIBOR	4.03%	6.03%

### FORWARD-LOOKING STATEMENTS

Certain statements contained in this report may be deemed "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," variations of such words and similar expressions are intended to identify such forward-looking statements, which generally are not historical in nature. All statements that address operating performance, events or developments that the Company expects or anticipates will occur in the future, including statements relating to rent and occupancy growth, development activity, the acquisition or sale of properties, general conditions in the geographic areas where the Company operates and the availability of capital, are forward-looking statements. Forward-looking statements are inherently subject to known and unknown risks and uncertainties, many of which the Company cannot predict, including, without limitation: changes in general economic conditions; the extent of tenant defaults or of any early lease terminations; the Company's ability to lease or re-lease space at current or anticipated rents; changes in the supply of and demand for industrial/warehouse properties; increases in interest rate levels; increases in operating costs; the availability of financing; natural disasters and the Company's ability to obtain adequate insurance; changes in governmental regulation, tax rates and similar matters; and other risks associated with the development and acquisition of properties, including risks that development projects may not be completed on schedule, development or operating costs may be greater than anticipated, or that acquisitions may not close as scheduled, and those additional factors discussed under "Item 1A. Risk Factors" in this report and in the Company's Annual Report on Form 10-K. Although the Company believes that the expectations reflected in the forward-looking statements are based upon reasonable assumptions at the time made, the Company can give no assurance that such expectations will be achieved. The Company assumes no obligation whatsoever to publicly update or revise any forward-looking statements. See also the information contained in the Company's

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reports filed or to be filed from time to time with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934.

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### ITEM 4. CONTROLS AND PROCEDURES.

#### (i) Disclosure Controls and Procedures.

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of March 31, 2009, the Company's disclosure controls and procedures were effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings.

#### (ii) Changes in Internal Control Over Financial Reporting.

There was no change in the Company's internal control over financial reporting during the Company's first fiscal quarter ended March 31, 2009, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

### PART II. OTHER INFORMATION.

#### ITEM 1A. RISK FACTORS.

There have been no material changes to the risk factors disclosed in EastGroup's Form 10-K for the year ended December 31, 2008. For a full description of these risk factors, please refer to "Item 1A. Risk Factors" in the 2008 Annual Report on Form 10-K.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

#### Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Public Announced Plans or Programs
01/01/09 thru 01/31/09	3,607 (1)	\$ 35.58	-
02/01/09 thru 02/28/09	-	-	-
03/01/09 thru 03/31/09	21 (1)	26.55	-
<b>Total</b>	<b>3,628</b>	<b>\$ 35.53</b>	<b>-</b>

(1) As permitted under the Company's equity compensation plans, these shares were withheld by the Company to satisfy the tax withholding obligations for those employees who elected this option in connection with the vesting of

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shares of restricted stock. Shares withheld for tax withholding obligations do not affect the total number of remaining shares available for repurchase under the Company's common stock repurchase plan.

- (2) EastGroup's Board of Directors has authorized the repurchase of up to 1,500,000 shares of its outstanding common stock. The shares may be purchased from time to time in the open market or in privately negotiated transactions. Under the common stock repurchase plan, the Company has purchased a total of 827,700 shares for \$14,170,000 (an average of \$17.12 per share) with 672,300 shares still authorized for repurchase. The Company has not repurchased any shares under this plan since 2000.

### ITEM 6. EXHIBITS.

(a) Form 10-Q Exhibits:

- (31) Rule 13a-14(a)/15d-14(a) Certifications (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002)

(a) David H. Hoster II, Chief Executive Officer

(b) N. Keith McKey, Chief Financial Officer

- (32) Section 1350 Certifications (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002)

(a) David H. Hoster II, Chief Executive Officer

(b) N. Keith McKey, Chief Financial Officer

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### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 8, 2009

EASTGROUP PROPERTIES, INC.

By: /s/ BRUCE CORKERN

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Bruce Corkern, CPA  
Senior Vice President, Controller and  
Chief Accounting Officer

By: /s/ N. KEITH MCKEY

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N. Keith McKey, CPA  
Executive Vice President, Chief Financial Officer,  
Treasurer and Secretary

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compares to a working capital surplus of \$10.6 million as of December 31, 2002. Current liabilities as of December 31, 2003 consisted approximately of trade payables of \$0.5 million, \$1.4 million in a partial receipt of funds from a farm-in partner in respect of an agreement on the Norio project, \$3.2 million in revenues due third parties; advanced proceeds, less costs of the sale of subsidiary \$1.9m; advanced proceeds from the sale of other assets \$0.3m, accrued liabilities \$0.3m, income taxes payable \$0.1m and loans payable \$0.1m. CAPITAL EXPENDITURES Capital expenditures in 2003, 2002 and 2001 were \$5.9 million, \$10.7 million and \$6.3 million, respectively. The table below sets forth the components of these capital expenditures for the three years ended December 31, 2003 2002 and 2001.

DECEMBER 31, EXPENDITURE CATEGORY:	2003	2002	2001
Development	\$ 5,200,614	\$ 543,280	\$ 2,054,989
Exploration	324,467	12,167,238	5,851,306
Facilities and other	412,772	(1,975,366)	(1,589,908)
Total	5,937,853	10,735,152	6,316,376

The negative expenditures recorded in facilities and other recorded in 2002 and 2001 is principally as a result of expenditures being reclassified to development and exploration expenditure from facilities and other when actual work is performed. During 2003, 2002 and 2001 capital expenditures were primarily for the development and exploration of existing properties. During 2002, capital expenditures were primarily related to the exploration activity. We currently have a contingent planned minimum capital expenditure budget of \$10 million subject to financing being available for 2004, of which all is allocated to Georgian development and appraisal projects. We plan to participate in the drilling of at least three horizontal sidetracks from existing wells on the Ninotsminda Field, complete the testing of the Manavi oil discovery well, M11, and drill at least one appraisal well on the Manavi structure. Further capital expenditures may be required following the conclusion of the Samgori farm-in. We have no material long-term capital commitments and are consequently able to adjust the level of our expenditures as circumstances dictate. Additionally, the level of capital expenditures will vary during future periods depending on market conditions and other related economic factors. Should the prices of crude oil and natural gas decline from current levels; our cash flows will decrease which may result in a reduction of the capital expenditures budget. If we

decrease our capital expenditures budget, we may not be able to offset crude oil and natural gas production volume decreases caused by natural field declines and sales of producing properties.

**36 SOURCES OF CAPITAL** The net funds provided by and/or used in each of the operating, investing and financing activities are summarized in the following table and discussed in further detail below:

	DECEMBER 31, 2003	2002	2001	-----	-----	-----
Net cash generated (used in) operating activities	\$ 4,430,921	1,634,629	(6,287,721)	Net cash used in investing activities	(3,883,233)	(8,431,282)
		(12,388,739)	Net cash provided in financing	1,529,791	3,174,870	3,085,563
			Net cash flows from assets and liabilities held for sale	(190,227)	(683,308)	(8,215,666)
			Total	1,887,252	(4,305,091)	(23,806,563)

Operating activities for the year ended December 31, 2003 provided us with \$4.4 million of cash. Investing activities used \$3.9 million during 2003. Financing activities provided us \$1.5 million during 2003. Most of these funds were used to continue to fund and develop our Georgian projects. In 2003, cash generated from operating activities (\$4.4m) was principally due to improved production resulting from our successful horizontal well program on the Ninotsminda Field in Georgia. In 2003, cash used in investing activities was due to capital expenditures principally in Georgia (\$5.9m) partially offset by the proceeds from disposals of CanArgo Standard Oil Products (\$1.4m), Boryslaw Oil Company (\$1.0m) and other assets (\$0.3m); and receipts from Georgian Oil in respect of the Norio farm-in (\$1.4m).

**FUTURE CAPITAL RESOURCES** We will have five principal sources of liquidity going forward: (i) cash on hand, (ii) cash from operating activities, (iii) funding under the Cornell Capital Equity Facility, (iv) industry participation in our projects, and (v) sales of producing properties. We may also attempt to raise additional capital through the issuance of additional debt or equity securities in public offerings or through private placements.

**BALANCE SHEET CHANGES** All balances represent results from continuing operations, unless disclosed otherwise. Cash and cash equivalents increased \$1,887,000 to \$3,472,000 at December 31, 2003 from \$1,585,000 at December 31, 2002. The increase was primarily due to an increase in cash generated from operating activities, receipts in respect of the disposal of CanArgo Standard Oil Products and Boryslaw Oil Company, and receipt from the farm-in partner in respect of the Norio exploration program, partially offset by capital expenditures on the Ninotsminda project.

**37 Accounts receivable** decreased from \$251,000 at December 31, 2002 to \$162,000 at December 31, 2003 primarily as a result of an allowance against a number of historic receivables. Inventory increased from \$159,000 at December 31, 2002 to \$469,000 at December 31, 2003 primarily as result of increased production of oil by Ninotsminda Oil Company. Ninotsminda Oil Company held approximately 97,000 barrels of oil in storage at December 31, 2003 for sale to the Georgian domestic, regional or international market. Prepayments increased from \$212,000 at December 31, 2002 to \$962,000 at December 31, 2003 as a result of prepayment for materials and services related to CanArgo's exploration activities to be transferred to capital assets upon receipt. This increase is included in the statement of cash flows as an investing activity. Assets held for sale, consisting of assets of CanArgo Standard Oil Products operations, a 3-megawatt duel fuel power generator, the assets of the refinery and the capital assets of the Bugruvativske Field project, decreased by \$2,907,000 to \$10,346,000 at December 31, 2003 from \$13,253,000 at December 31, 2002 primarily due to a net write-down of \$4,126,151 in 2003 of which \$4,790,727 represented the write down of unproved oil and gas properties to reflect the estimated recoverable amount from the disposal of our interest in the Bugruvativske Field following an approved plan to sell our interest in the project and \$667,576 represented a gain on disposal from the sale of CanArgo's interest in the Boryslaw Oil Company, the joint venture in West Ukraine currently operating the Stynawske oilfield. This was partially offset by activity at CanArgo Standard Oil Products relating to the addition of new petrol stations in Georgia. Other currents assets increased from \$176,000 at December 31, 2002 to \$207,000 at December 31, 2002 as a result of a deposit to secure professional services. Capital assets, net increased from \$54,642,000 at December 31, 2002 to \$58,323,000 at December 31, 2003, primarily as a result of investment of \$5,938,000 in capital assets including oil and gas properties and equipment, principally related to the Ninotsminda PSC. During 2002, we wrote down our oil and gas properties in the Ninotsminda Field by an aggregate \$1,600,000 on application of the full cost ceiling test as a result of lower reserve quantities following production declines in 2002 and reduced development plans. If oil prices or production levels were to decline in the future, we may experience an additional impairment of this property. Investments in and advances to oil and gas and other ventures, net decreased from \$459,000 at December 31, 2002 to \$75,000 at December 31, 2003. The decrease reflects our announcement in 2003, that we had reached conditional agreement to sell our interest in Boryslaw Oil Company, the joint venture in West Ukraine currently operating the Stynawske Oil Field. Fountain Oil Boryslaw, CanArgo's wholly owned subsidiary which holds our 45% interest in Boryslaw Oil Company, was sold for \$1,000,000 payable in eight equal tranches. Payment in full was received in December 2003.

Accounts payable increased to \$483,000 at December 31, 2003 from \$405,000 at December 31, 2002 primarily due to an absolute increase in corporate payables. Advance from joint venture partner of \$1,428,000 at December 31, 2003 relates to an initial receipt from Georgian Oil in accordance with the Norio farm-in agreement. Loans payable of \$102,179 at December 31, 2003 relates to a short-term secured loan facility maturing on February 27, 2004, which a subsidiary of CanArgo entered into, locally in Georgia, at an annual interest rate of 20% in order to fund the drilling of a new horizontal well, N4H, at the Ninotsminda Field in Georgia. No parent company guarantees have been provided by CanArgo with respect to this loan. The loan matured and was paid off in full in February 2004. Other Liabilities increased from \$1,500,000 at December 31, 2002 to \$5,474,000 at December 31, 2003 due to advance proceeds received for the sale of CanArgo Standard Oil Products in the period, advance proceeds received for the sale of a 3-megawatt dual fuel power generator and security received resulting from an oil sales agreement entered into during the period whereby the buyer provided a security payment of \$1.75 million in return for the right 38 to lift up to 5,000 metric tons of oil per month for the 12 month period commencing August 2003 and a further security payment of \$550,000 under an additional oil sales agreement in return for the rights to lift 2,500 metric tons of oil up to the end of December 2004. Proceeds received in respect of CanArgo Standard Oil Products sale are \$2,000,000 at December 31, 2003. Income taxes payable increased from \$61,000 from at December 31, 2002 to \$97,000 at December 31, 2003 due to the final assessment of income tax payable for Ninotsminda Oil Company Ltd, a CanArgo subsidiary. Accrued liabilities increased to \$349,000 at December 31, 2003 from \$204,000 at December 31, 2002 primarily due to an increase in accrued professional fees. Liabilities held for sale increased by \$1,629,000 from \$2,819,000 at December 31, 2002 to \$4,448,000 at December 31, 2003 due to liabilities held for sale, in respect of discontinued operations, that increased by \$1,614,000 to \$3,774,000 at December 31, 2003 from \$2,160,000 at December 31, 2002 primarily due to additional bank loans drawn by CanArgo Standard Oil Products in Tbilisi at an effective interest rate of 18% per annum, in order to fund the construction of new petrol stations in Georgia. Minority interest in continuing and discontinued subsidiaries increased by \$1,254,000 to \$4,773,000 at December 31, 2003 from \$3,519,000 at December 31, 2002 due to due to the write down of \$1,274,895 of the minority interest share of losses relating to the refinery, minority interest share of income in the period, partially offset by CanArgo purchasing some of the minority interests in CanArgo Norio by a share swap for shares in CanArgo in the period. The foreign currency translation is due to the Company adopting the self-sustaining method of accounting for CanArgo Standard Oil Products. The fact that CanArgo Standard Oil Products was no longer financially and operationally dependant upon its parent company necessitated the adoption of the self-sustaining method. Under the self-sustaining method of foreign currency translation, assets and liabilities are translated into US dollars at period end exchange rates and income and expenses are translated into US dollars at average rates in effect during the period. Exchange gains and losses on translation are reflected as a separate component of shareholders' equity. On March 23, 2004 at a duly convened special meeting of our stockholders held in Oslo, Norway the requisite majority of our stockholders approved an amendment to Article 4 of our Certificate of Incorporation to increase the number of shares of common stock, par value \$.10 per share, that we are authorized to issue from 150,000,000 to 300,000,000. RESULTS OF CONTINUING OPERATIONS Year Ended December 31, 2003 Compared to Year Ended December 31, 2002 CanArgo recorded operating revenue of \$8,105,000 during the year ended December 31, 2003 compared with \$5,486,000 for the year ended December 31, 2002. The increase is primarily attributable to higher oil and gas revenues, being partially offset by lower other revenue being recorded in the twelve month period ended December 31, 2003. Other revenue for the twelve month period ended December 31, 2003 and 2002 represented the provision of drilling services in Georgia. Ninotsminda Oil Company generated \$7,881,000 of oil and gas revenue in the year ended December 31, 2003 compared with \$4,163,000 for the year ended December 31, 2002 due to higher volume of sales resulting from increased production from the successful horizontal wells completed in 2003 and a higher average net sales price achieved in 2003. Its net share of the 695,174 barrels (273 barrels per day) of gross oil production for sale from the Ninotsminda Field in the period amounted to 451,863 barrels. In 2003, 64,142 barrels of oil were added to storage. For the year ended December 31, 2002, Ninotsminda Oil Company's net share of the 292,289 barrels (801 barrels per day) of gross oil production was 189,988 barrels. The increase in production is due to the successful horizontal development wells completed at the Ninotsminda Field in 2003. Ninotsminda Oil Company's entire share of production was sold locally in Georgia under both national and international contracts. Net sale prices for Ninotsminda oil sold during 2003 averaged \$20.07 per barrel as compared 39 with an average of \$17.09 per barrel in 2002. Its net share of the 108,630 thousand cubic feet (mcf) of gas delivered was 82,156 mcf at an average net sale price of \$1.25 per mcf of gas. For the year ended

December 31, 2002, Ninotsminda Oil Company's net share of the 212,499 mcf of gas delivered was 138,124 mcf at an average net sales price of \$1.25 per mcf of gas. CanArgo had other revenue of \$224,000 for the year ended December 31, 2003 compared to other revenue of \$1,323,000 for the year ended December 31, 2002. In 2003 and 2002, other revenue consisted of the provision of drilling services. In September 2001, CanArgo entered into an agreement to provide drilling services to a third party using one of CanArgo's rigs. Commercial drilling operations commenced in October 2001 and continued through February 2002. The Company subsequently established a wholly owned well services subsidiary (Argonaut Well services Limited) and at the end of March 2003 concluded a new drilling services contract with an operating company in Georgia. It will continue to bid in appropriate tenders for drilling contracts in order to utilize drilling equipment not otherwise used in its own operations. The operating loss from continuing operations for the year ended December 31, 2003 amounted to \$159,000 compared with an operating loss of \$4,902,000 for 2002. The decrease in operating loss is attributable primarily to a reduction in field operating expenses, reduced selling, general and administration expense, reduced direct project costs in the period, and an impairment of oil and gas properties in 2002; partially offset by an increase in depletion and amortization in the period; and stock compensation in expense in 2003. Field operating expenses decreased to \$1,052,000 (\$2.59 per BOE) for the year ended December 31, 2003 as compared to \$1,538,000 (\$4.69 per BOE) for 2002. The decrease is primarily a result of a cost reduction program initiated in the last quarter of 2002 at the Ninotsminda Field and costs relating to increase of oil storage in the year. Operating costs per BOE decreased as day-to-day field operations in Georgia include a proportionately higher fixed to variable cost component combined with a cost reduction program initiated in the last quarter of 2002 at the Ninotsminda Field and higher production rates. Direct project costs decreased to \$1,029,000 for the year ended December 31, 2003, from \$1,429,000 for the year ended December 31, 2002, primarily due to costs associated with the provision of drilling services in Georgia in 2002. Selling, general and administrative costs decreased to \$3,229,000 for the year ended December 31, 2003, from \$3,494,000 for the year ended December 31, 2002. The decrease is primarily as a result of a corporate cost reduction program initiated in the last quarter of 2002. Non cash stock compensation expense increased to approximately \$277,000 for the year ended December 31, 2003, from nil for the year ended December 31, 2002 due to the Company, effective January 1, 2003, adopting the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," prospectively to all employee awards granted, modified, or settled after December 31, 2002. The increase in depreciation, depletion and amortization expense to \$3,294,000 for the year ended December 31, 2003 from \$2,317,000 for the year ended December 31, 2002 is attributable principally to higher production resulting from the successful horizontal wells at the Ninotsminda Field completed in 2003. We wrote down our oil and gas properties in the Ninotsminda Field by an aggregate \$1,600,000 on application of the full cost ceiling test as a result of lower reserve quantities following production declines in 2002. The write-down was a non-cash write-down. If oil prices or production levels declined in the future, we may experience an additional impairment of this property. During 2003, CanArgo also announced it had reached conditional agreement to sell its interest in Boryslaw Oil Company, the joint venture in West Ukraine currently operating the Stynawske Oil Field. Fountain Oil Boryslaw, CanArgo's wholly owned subsidiary which holds our 45% interest in Boryslaw Oil Company, was sold for \$1,000,000 and a gain on disposal of \$665,000 was also recorded in gain on disposition of investments during the period. 40 CanArgo recorded net other expenses of \$605,000 for the year ended December 31, 2003, as compared to net other expense of \$576,000 during the year ended December 31, 2002. The increase is primarily due to foreign exchange translation losses during 2003 partially offset by CanArgo's adjusted interest in its share of the carrying net asset value of its subsidiary CanArgo Norio Limited (Norio) giving rise to a non-operating loss of \$444,000, in accordance with the application of SAB 51, following agreement with the minority shareholders on the finalization of respective equity interest in Norio in 2002, and a bad debt allowance of \$275,000 being recorded in 2002. Equity income from investments decreased to \$66,000 for the year ended December 31, 2003 from an equity income of \$86,000 for the year ended December 31, 2002 primarily as a result of only nine months of equity income recorded from production and sales of crude oil by Boryslaw Oil Company prior to its disposal in the last quarter of 2003. The net loss from continuing operations of \$756,000 or \$0.01 per share for the year ended December 31, 2003 compares to a net loss from continuing operations of \$5,478,000 or \$0.06 per share for the year ended December 31, 2002. The weighted average number of common shares outstanding was higher during the year ended December 31, 2003 than during the year ended December 31, 2002, due in large part to share issues in respect of agreements relating to of Norio and Manavi projects during 2003. The cumulative effect of change in accounting principle of \$41,290 at December 31, 2003 relates to the adoption of FASB Statement No.

143 "Accounting for Asset Retirement Obligations" ("SFAS 143") on January 1, 2003. SFAS 143 requires companies to record the discounted fair value of a liability for an asset retirement obligation in the period in which the liability is incurred concurrent with an increase in the long-lived assets carrying value. The increase and subsequent adjustments in the related long-lived assets carrying value is amortised over its useful life. Upon settlement of the liability a gain or loss is recorded for the difference between the settled liability and the recorded amount. The discount associated with the liability is accreted into income over the related asset's useful life. Upon adoption of this standard an entity is required to record the fair value of its existing asset retirement obligations as if the liabilities had been initially accounted for in accordance with SFAS 143 using assumptions present at the date of adoption. The income statement effect of the treatment is recorded as a cumulative effect in accounting principle in the period of adoption, no retroactive restatement is permitted. Year Ended December 31, 2002 Compared to Year Ended December 31, 2001 CanArgo recorded operating revenue of \$5,486,000 during the year ended December 31, 2002 compared with \$4,575,000 for the year ended December 31, 2001. The increase is primarily attributable to other revenue, representing provision of drilling services in Georgia. Ninotsminda Oil Company generated \$4,163,000 of oil and gas revenue in the year ended December 31, 2002 compared with \$3,967,000 for the year ended December 31, 2001 due principally to a lower average net sales price achieved in 2002. Its net share of the 292,289 barrels (801 barrels per day) of gross oil production for sale from the Ninotsminda Field in the period amounted to 189,988 barrels. In 2002, 44,483 barrels of oil were removed from storage and sold. For the year ended December 31, 2001, Ninotsminda Oil Company's net share of the 413,724 barrels (1,133 barrels per day) of gross oil production was 247,179 barrels. The decline in production is due to limited workover investment resulting in a natural reservoir rate of decline. Ninotsminda Oil Company's entire share of production was sold locally in Georgia under both national and international contracts. Net sale prices for Ninotsminda oil sold during 2002 averaged \$17.09 per barrel as compared with an average of \$19.43 per barrel in 2001. Its net share of the 212,499 thousand cubic feet (mcf) of gas delivered was 138,124 mcf at an average net sale price of \$1.25 per mcf of gas. For the year ended December 31, 2001, Ninotsminda Oil Company's net share of the 1,110,390 mcf of gas delivered was 721,754 mcf at an average net sales price of \$1.14 per mcf of gas. Gas deliveries for the year ended December 31, 2002 declined significantly due to lower oil and gas production and the temporary shutdown by AES of its thermal power generating station following an accident at the facility. Although AES has now re-opened, CanArgo has not sold any further gas to AES since their demand for gas was too great for CanArgo to meet from production. 41 CanArgo had other revenue of \$1,323,000 for the year ended December 31, 2002 compared to other revenue of \$608,000 for the year ended December 31, 2002. In 2002 and 2001, all other revenue consisted of the provision of drilling services. In September 2001, CanArgo entered into an agreement to provide drilling services to a third party using one of CanArgo's rigs. Commercial drilling operations commenced in October 2001 and continued through February 2002. No new drilling service contracts have been signed, although the company has established a well services subsidiary, which will bid in local tenders for drilling contracts. The operating loss from continuing operations for the year ended December 31, 2002 amounted to \$4,902,000 compared with an operating loss of \$11,838,000 for 2001. The decrease in operating loss is attributable primarily to reduced impairment of oil and gas properties in 2002, profit generated from a drilling services contract, and a reduced depreciation, and reduced depletion and amortization in the period. Field operating expenses decreased to \$1,538,000 (\$4.69 per BOE) for the year ended December 31, 2002 as compared to \$1,568,000 (\$2.62 per BOE) for 2001. The decrease is primarily a result of decreased activity at the Ninotsminda Field offset partially by costs relating to sales of oil from storage in the year. Operating costs per BOE increased as day-to-day field operations in Georgia include a proportionately higher fixed to variable cost component combined with lower production rates. Direct project costs increased to \$1,429,000 for the year ended December 31, 2002, from \$1,300,000 for the year ended December 31, 2001, reflecting additional costs associated with the provision of drilling services in Georgia. Selling, general and administrative costs increased to \$3,494,000 for the year ended December 31, 2002, from \$3,483,000 for the year ended December 31, 2001. The increase was primarily as a result of the impact of increased costs resulting from business development activity offset partially the impact of a corporate cost reduction program initiated in the last quarter of 2002. The decrease in depreciation, depletion and amortization expense to \$2,317,000 for the year ended December 31, 2002 from \$2,746,000 for the year ended December 31, 2001 is attributable principally to lower production, due to limited workover investment resulting in a natural reservoir rate of decline. During 2002, CanArgo wrote down its oil and gas properties in the Ninotsminda Field by an aggregate \$1,600,000 on application of the full cost ceiling test as a result of lower reserve quantities following production declines in 2002. The write-down was a

non-cash write-down. In 2001, CanArgo wrote down its oil and gas properties in the Ninotsminda Field by an aggregate \$7,300,000 on application of the full cost ceiling test as a result of a decline in Brent oil prices at December 31, 2001, lower reserve quantities following production declines in 2001 and reduced development plans. If oil prices or production levels decline further, CanArgo may experience additional impairment of this property. CanArgo recorded net other expenses of \$576,000 for the year ended December 31, 2002, as compared to net other income of \$525,000 during the year ended December 31, 2001. This is primarily due to CanArgo's adjusted interest in its share of the carrying net asset value of its subsidiary CanArgo Norio Limited (Norio) giving rise to a non-operating loss of \$444,000, in accordance with the application of SAB 51, following agreement with the minority shareholders on the finalization of respective equity interest in Norio. Additional movements are explained by lower cash balances in 2002, an allowance for doubtful accounts of \$275,000 from previous gas sales, and a bad debt write-off of \$93,000 relating to the provision of drilling services in Georgia. Equity income from investments increased to \$86,000 for the year ended December 31, 2002 from an equity loss of \$160,000 for the year ended December 31, 2001 as a result of increased equity income from production and sales of crude oil by Boryslaw Oil Company and 2001 expenses relating to operation by East Georgian Pipeline Company of the gas pipeline from Ninotsminda to the Gardabani power station. The net loss from continuing operations of \$5,478,000 or \$0.06 per share for the year ended December 31, 2002 compares to a net loss from continuing operations of \$11,313,000 or \$0.16 per share for the year ended December 31, 2001. The weighted average number of common shares outstanding was substantially higher during the year 42 ended December 31, 2002 than during the year ended December 31, 2001, due in large part to private placements in July 2001, February and May 2002.

**RESULTS OF DISCONTINUED OPERATIONS** Year Ended December 31, 2003 Compared to Year Ended December 31, 2002 The net income from discontinued operations, net of taxes and minority interest for the year ended December 31, 2003 amounted to \$6,608,000 compared with net income of \$150,000 for the corresponding period in 2002. The increase in net loss from discontinued operations, net of taxes and minority interest relates to the activities of LVR and GAOR, offset partially by the activities of CanArgo standard Oil Products. Losses increased at GAOR as there was no income in the year ended December 31, 2003. During 2003, CanArgo approved a plan to sell its interest in the Bugruvativske Field and recorded a write-down of \$4,790,727 in 2003 of unproved oil and gas properties to reflect the estimated recoverable amount from disposal. An impairment of other assets of \$1,355,000 for the year ended December 31, 2003, from nil for the year ended December 31, 2002 was due to a write-down of the minority interest share of losses relating to GAOR of \$1,274,895 and the a write- down of a generator in the period to its net realizable value by \$80,000. During 2003, a debit balance of \$1,274,895 in minority interest was written-off due to a change in the intentions of our minority interest owner and a plan to dispose of the asset. In 2004, CanArgo came to an agreement to sell the refinery. Increased income at CanArgo standard Oil Products is due to higher sales volume during 2003 offset partially by more competitive operating margins for the year ended December 31, 2003 compared with the corresponding period in 2002. Increased income at LVR related to foreign exchange gains in the period for the year ended December 31, 2003 compared with the corresponding period in 2002

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001 The net income from discontinued operations, net of taxes and minority interest for the year ended December 31, 2002 increased to \$150,000 compared with net loss of \$1,905,000 for the corresponding period in 2001. The increase in net income from discontinued operations, net of taxes and minority interest relates mainly to the activities of GAOR and the impairment of a power-generating unit in 2001, offset partially by the activities of CanArgo standard Oil Products and LVR. During 2001, Georgian American Oil Refinery ("GAOR") was producing operating losses. Only naphtha, diesel and mazut can be produced and of these products, an excise tax on both naphtha and diesel sales remains in place. In the fourth quarter 2001, GAOR deemed the production of naphtha as commercially uneconomic and suspended refining activity. In 2002, GAOR entered into a short-term lease of the refinery to a third party for nominal revenue. During the lease period, all operating costs of the refinery were borne by the lessee. This lease expired in May 2002 and has not been renewed. In 2003, CanArgo approved a plan to dispose of its interest in GAOR. In 2001, as a result of both product instability and continued difficulties addressing excise taxes on refined products, refinery and related equipment was written-down by \$3,360,000 to reflect, under current conditions, the estimated net recoverable amount of the refinery. In 2001, CanArgo wrote down other oil and gas related equipment by \$500,000 following a decision to dispose of a power-generating unit. In 2002, a plan was agreed to sell this equipment and it is included in assets held for sale as at December 31, 2002. CanArgo standard Oil Products income decreased for the year ended December 31, 2002 due to more competitive operating margins for the year ended December 31, 2002

compared with the corresponding period in 2001 and interest on additional bank loans drawn by CanArgo Standard Oil Products in Tbilisi at an effective interest rate of 18% per annum, in order to fund the construction of new petrol stations in Georgia. 43 LVR corporate costs for the year ended December 31, 2002 were lower than the corresponding period in 2001 due to less corporate activity. **CONTRACTUAL OBLIGATIONS AND COMMERCIAL TERMS** Our principal business and assets are derived from production sharing contracts in the Republic of Georgia. The legislative and procedural regimes governing production sharing contracts and mineral use licenses in Georgia have undergone a series of changes in recent years resulting in certain legal uncertainties. Our production sharing contracts and mineral use licenses, entered into prior to the introduction in 1999 of a new Petroleum Law governing such agreements have not, as yet, been amended to reflect or ensure compliance with current legislation. As a result, despite references in the current legislation grandfathering the terms and conditions of our production sharing contracts, conflicts between the interpretation of our production sharing contracts and mineral use licenses and current legislation could arise. Such conflicts, if they arose, could cause an adverse effect on our rights under the production sharing contracts. However the Norio PSA and the Tbilisi PSC were concluded after enactment of the Petroleum Law, and under the terms and conditions of this legislation. To confirm that the Ninotsminda production sharing contract and the mineral usage license issued prior to the introduction in 1999 of the Petroleum Law were validly issued, in connection with its preparation of the Convertible Loan Agreement with us, the International Finance Corporation, an affiliate of the World Bank received in November 1998 confirmation from the State of Georgia, that among other things: - The State of Georgia recognizes and confirms the validity and enforceability of the production sharing contract and the license and all undertakings the State has covenanted with Ninotsminda Oil Company thereunder; - the license was duly authorized and executed by the State at the time of its issuance and remained in full force and effect throughout its term; and - the license constitutes a valid and duly authorized grant by the State, being and remaining in full force and effect as of the signing of this confirmation and the benefits of the license fully extend to Ninotsminda Oil Company by virtue of its interest in the license holder and the contractual rights under the production sharing contract. Despite this confirmation and the grandfathering of the terms of existing production sharing contracts in the Petroleum Law, subsequent legislative or other governmental changes could conflict with, challenge our rights or otherwise change current operations under the production sharing contract. In 2002, the Participation Agreement for the three well exploration program on the Ninotsminda area with AES was terminated without AES earning any rights to any of the Ninotsminda area reservoirs. The Company therefore has no present obligations in respect of AES. However, under a separate Letter of Agreement, if gas from the Sub Middle Eocene is discovered and produced from the exploration area covered by the Participation Agreement, AES will be entitled to recover at the rate of 15% of future gas sales from the Sub Middle Eocene, net of operating costs, approximately \$7.5 million, representing their prior funding under the Participation Agreement. CanArgo has contingent obligations and may incur additional obligations, absolute or contingent, with respect to the acquisition and development of oil and gas properties and ventures in which it has interests that require or may require CanArgo to expend funds and to issue shares of its Common Stock. At December 31, 2003, CanArgo had a contingent obligation to issue 187,500 shares of common stock to Fielden Management Services PTY, Ltd (a third party management services company) upon satisfaction of conditions relating to the achievement of specified Stynawske Field project performance standards. Under the Norio and North Kumisi PSA the shareholders agreement with the other shareholder of Norio calls for a bonus payment of \$800,000 to be paid by CanArgo should commercial production be obtained from the Middle Eocene or older strata and a second bonus payment of \$800,000 should production from the Block from the Middle Eocene or older strata exceed 250 tons of oil per day over any 90 day period. 44 In September 2003, CanArgo Norio signed a farm-in agreement relating to the Norio Production Sharing Agreement ("Norio PSA") with a wholly owned subsidiary of Georgian Oil. CanArgo Norio had previously been in negotiations with a large third party energy company to farm-in to the Norio PSA, but Georgian Oil exercised its pre-emption rights under the Norio PSA. Georgian Oil is already a party to the PSA as the commercial representative of the State. The agreement obligates Georgian Oil to pay up to US\$ 2.0 million to complete the MK-72 well on the Norio prospect in return for a 15% interest in the contractor share of the Norio PSA. Georgian Oil will also have an option (the "Option") exercisable for a limited period after completion of the well, to increase its interest to 50% of the contractor share of the Norio PSA on payment to CanArgo Norio of US\$ 6.5 million. The well was suspended in 2002 due to lack of available funding at that time. Drilling recommenced on the well in December 2003 and the current depth is approximately 4,200 meters. It is expected that the well will be finished within three months. Co-incident with the Georgian Oil farm-in, CanArgo concluded a deal to purchase some

of the minority interests in CanArgo Norio by a share swap for shares in CanArgo. Through this CanArgo has acquired an additional 10.8% interest in CanArgo Norio, giving CanArgo a 75% interest in CanArgo Norio at present. This approximately maintains CanArgo's effective interest in the Norio PSA after Georgian Oil has completed the first stage of the farm-in at 63.7%. The purchase was achieved by issuing 6 million restricted CanArgo shares to the minority interest holders in CanArgo Norio. 4.0% of these minority interests were owned by Provincial Securities Limited, a company which J.F. Russell Hammond, a non-executive director of CanArgo, is an Investment Advisor. In the event that Georgian Oil exercises the Option and pays the required \$6.5 million, CanArgo (which would have received some \$4.8 million of this payment with its previous interest) would receive a further \$1.2 million, resulting in a total payment to CanArgo of approximately \$6 million. If the Option is exercised CanArgo would issue a further 3 million restricted shares to the minority interest holders. In May 2003, NOC entered into a new 12-month crude oil sales agreement whereby the buyer will provide a security payment of \$1.75 million in return for the right to lift up to 5,000 metric tons of oil per month for the 12-month period commencing August 2003. At the end of the 12 months, the security payment will be repaid through the delivery of additional crude oil equal to the value of the security. This agreement replaces an existing crude oil sales agreement, where the buyer had already provided \$1 million security. Following the success of the N100H well, NOC entered into a further oil sales agreement with the buyer for an additional monthly quantity of 2,500 metric tons of oil. The agreement runs to the end of 2004 and as security for payment and for having the option to lift oil on a monthly basis the buyer will provide additional security in the amount of \$550,000. The security will be repaid in oil at the end of the contract period. NOC has a total commitment to repay \$2.3m arising from security payments under oil sales agreements signed in May 2003 and October 2003. On July 2, 2003 CanArgo announced that its subsidiary CanArgo Norio had entered into a new Production Sharing Contract (PSC) for Blocks XI(G) and XI(H) (Mtskheta, Tetrtskaro and Gardabani areas), named the "Tbilisi PSC" in the Republic of Georgia. The licence was subsequently issued on 9 July 2003 for a period of 25 years. These areas are located adjacent to CanArgo's existing acreage close to Tbilisi and cover in total approximately 119,843 acres (485 km<sup>2</sup>). Under the terms of the Tbilisi PSC, CanArgo Norio will evaluate existing seismic and geological data during the first year and acquire additional seismic data within four years of the effective date of the Agreement which is September 29, 2003. The total commitment over the next four years is \$350,000. The commercial terms of the Tbilisi PSC are similar to those governing CanArgo Norio's other exploration areas. The following table sets forth information concerning the amounts of payments due under specified contractual obligations for periods of less than one year, one to three years, three to five years and more than five years as at December 31, 2003.

DUE IN LESS THAN 1 YEAR	440,000	220,000	Loans payable	102,179	Other long-term liabilities (1)	- - - 152,000
DUE IN 1 TO 3 YEARS	683,183	440,000	Operating lease obligations	\$261,400	683,183	440,000
DUE IN 3 TO 5 YEARS	683,183	440,000				372,000
DUE IN MORE THAN 5 YEARS	683,183	440,000				372,000
	\$363,579	683,183				440,000

===== 45 (1) Other long-term liabilities represent costs provided for future site restoration. (2) CanArgo has no contractual obligations in respect of long-term debt, capital leases or purchase obligations. RELATED PARTY TRANSACTIONS Of the 50% of CanArgo Standard Oil Products not held by CanArgo, 41.65% is held by Standard Oil Products, an unrelated third party entity, and 8.35% is held by an individual, Mr Levan Pkhakadze, who is one of the founders of Standard Oil Products and is an officer and director of CanArgo Standard Oil Products. The majority of refined product purchased by CanArgo Standard Oil Products for resale at its petrol stations is purchased from a company controlled by Standard Oil Products who together with an individual shareholder, own the 50% interest in CanArgo Standard Oil Products not held by CanArgo. Total product purchases from the related company in 2003 were \$7,229,000 (2002 \$5,263,000). A company owned by significant employees of Georgian British Oil Company Ninotsminda provides certain equipment to Georgian British Oil Company Ninotsminda. Total rental payments for this equipment in 2003 were \$183,428 (\$125,729 in 2002). In 2003, the same company provided additional services to Georgian British Oil Company Ninotsminda in accordance with the farm-in agreement in respect of the Manavi well for the value of \$450,000. Dr. David Robson, Chief Executive Officer, provides all of his services to CanArgo through Vazon Energy Limited of which he is the Managing Director. Mr. Russell Hammond, a non-executive director of CanArgo, is also an Investment Advisor to Provincial Securities who became a minority shareholder in the Norio and North Kumisi Production Sharing Agreement through a farm-in agreement to the Norio MK72 well. Transactions with affiliates are reviewed and voted on solely by non-interested directors. CRITICAL ACCOUNTING POLICIES NATURAL GAS



**AND OIL PROPERTIES** We utilize the full cost method of accounting for costs related to our natural gas and oil properties. We review the carrying value of our natural gas and oil properties under the full cost accounting rules of the SEC. Under these rules, all such costs (productive and non-productive) are capitalized and amortized on an aggregate basis over the estimated lives of the properties using the units-of-production method. These capitalized costs are subject to a ceiling test, however, which limits such pooled costs to the aggregate of the present value of future net revenues attributable to proved gas and oil reserves discounted at 10 percent plus the lower of cost or market value of unproved properties. If the net capitalized costs of natural gas and oil properties exceed the ceiling, we will record a ceiling test write-down to the extent of such excess. A ceiling test write-down is a non-cash charge to earnings. If required, it reduces earnings and impacts shareholders' equity in the period of occurrence and results in lower depreciation, depletion and amortization expense in future periods. The write-down may not be reversed in future periods, even though higher natural gas and oil prices may subsequently increase the ceiling. The risk that we will be required to write-down the carrying value of our natural gas and oil properties increases when natural gas and oil prices are depressed or if there are substantial downward revisions in estimated proved reserves. Application of these rules during periods of relatively low natural gas or oil prices due to seasonality or other reasons, even if temporary, increases the probability of a ceiling test write-down. Based on natural gas and oil prices in effect on December 31, 2003, the unamortized cost of our natural gas and oil properties did not exceed the ceiling of proved natural gas and oil reserves. Natural gas pricing has historically been unpredictable and any significant declines could result in a ceiling test write-down in subsequent quarterly or annual reporting periods. 46 Natural gas and oil reserves used in the full cost method of accounting cannot be measured exactly. Our estimate of natural gas and oil reserves requires extensive judgments of reservoir engineering data and is generally less precise than other estimates made in connection with financial disclosures. Assigning monetary values to such estimates does not reduce the subjectivity and changing nature of such reserve estimates. The uncertainties inherent in the disclosure are compounded by applying additional estimates of the rates and timing of production and the costs that will be incurred in developing and producing the reserves. We engage the services of an independent petroleum consulting firm to calculate reserves.

**Use of Estimates in the Preparation of Financial Statements** The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Concentration of Credit Risk** Although CanArgo's cash and temporary investments and accounts receivable are exposed to potential credit loss, CanArgo does not believe such risk to be significant. Even though a substantial amount of funds were in accounts at financial institutions which were not covered under bank guarantees, management does not believe that maintaining balances in excess of bank guarantees resulted in a significant risk to the Company.

**Foreign Operations** CanArgo's future operations and earnings will depend upon the results of CanArgo's operations in the Republic of Georgia. There can be no assurance that CanArgo will be able to successfully conduct such operations, and a failure to do so would have a material adverse effect on the CanArgo's financial position, results of operations and cash flows. Also, the success of CanArgo's operations will be subject to numerous contingencies, some of which are beyond management control. These contingencies include general and regional economic conditions, prices for crude oil and natural gas, competition and changes in regulation. Since CanArgo is dependent on international operations, specifically those in the Republic of Georgia, CanArgo will be subject to various additional political, economic and other uncertainties. Among other risks, CanArgo's operations may be subject to the risks and restrictions on transfer of funds, import and export duties, quotas and embargoes, domestic and international customs and tariffs, and changing taxation policies, foreign exchange restrictions, political conditions and regulations.

**NEW ACCOUNTING STANDARDS** In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 ("FIN 46"). In December 2003, the FASB modified FIN 46 to make certain technical corrections and address certain implementation issues that had arisen. FIN 46 provides a new framework for identifying variable interest entities ("VIEs") and determining when a company should include the assets, liabilities, noncontrolling interests and results of activities of a VIE in its consolidated financial statements. In general, a VIE is a corporation, partnership, limited-liability corporation, trust, or any other legal structure used to conduct activities or hold assets that either: (1) has an insufficient amount of equity to carry out its principal activities without additional subordinated financial support; (2) has a group of equity owners that are unable to make significant decisions about its activities; or (3) has a group of equity owners that do not have the

obligation to absorb losses or the right to receive returns generated by its operations. FIN 46 requires a VIE to be consolidated if a party with an ownership, contractual or other financial interest in the VIE ("a variable interest holder") is obligated to absorb a majority of the risk of loss from the VIEs activities, is entitled to receive a majority of the VIEs residual returns (if no party absorbs a majority of the VIEs losses), or both. A variable interest holder that consolidates the VIE is called the primary beneficiary. Upon consolidation, the primary beneficiary generally must initially record all the VIEs assets, liabilities and noncontrolling interests at fair value and subsequently account for the VIE as if it were consolidated based on majority voting interest. FIN 46 47 also requires disclosures about VIEs that the variable interest holder is not required to consolidate but in which it has a significant variable interest. On October 9, 2003, the FASB issued Staff Position No. 46-6 which deferred the effective date for applying the provisions of FIN 46 for interests held by public entities in variable interest entities or potential variable interest entities created before February 1, 2003. On December 24, 2003, the FASB issued a revision to FIN 46. Under the revised interpretation, the effective date was delayed to periods ending after March 15, 2004 for all variable interest entities, other than SPEs. The adoption of FIN 46 is not expected to have an impact on the Company's financial condition, results of operations or cash flows. The Company does not have an interest in any special purpose entity that is required to be consolidated under FIN 46. The Company's is currently evaluating its involvement in other entities pursuant to the revised guidance; however, the Company does not anticipate a significant effect as a result of its application. In April 2003, the FASB issued SFAS No. 149, Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities. This statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 requires that contracts with comparable characteristics be accounted for similarly. The statement is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The provisions of SFAS No. 149 generally are to be applied prospectively only. The adoption of SFAS No. 149 did not have a material impact on the Company's results of operations or financial position. In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for classification and measurement by an issuer of certain financial instruments with characteristics of both liabilities and equity. The statement requires that an issuer classify a financial instrument that is within its scope as a liability (or asset in some circumstances). Many of those instruments were previously classified as equity. This Statement also addresses questions about the classification of certain financial instruments that embody obligations to issue equity shares. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except as it relates to consolidated limited-life subsidiaries. The FASB indefinitely deferred the effective date of this statement as it relates to certain mandatory redeemable non-controlling interests in consolidated limited-life subsidiaries. The adoption of the effective provisions of SFAS No. 150 did not have a material impact on the Company's results of operations or financial position. On December 17, 2003, the Staff of the Securities and Exchange Commission (or SEC) issued Staff Accounting Bulletin No. 104 ("SAB 104"), Revenue Recognition, which supersedes Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements ("SAB 101"). SAB 104's primary purpose is to rescind the accounting guidance contained in SAB 101 related to multiple-element revenue arrangements that was superseded as a result of the issuance of EITF 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. Additionally, SAB 104 rescinds the SEC's related Revenue Recognition in Financial Statements Frequently Asked Questions and Answers issued with SAB 101 that had been codified in SEC Topic 13, Revenue Recognition. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104, which was effective upon issuance. The adoption of SAB 104 did not have a material effect on the Company's financial position or results of operations. Management has been made aware of a reporting issue regarding the application of provisions of SFAS 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142) to companies in the extractive industries, including oil and gas companies. The issue is whether SFAS 142 requires registrants to reclassify costs associated with mineral rights, including both proved and unproved leasehold acquisition costs, as intangible assets in the balance sheet, apart from other capitalized oil and gas property costs. Historically, the Company's and other oil and gas companies have included the cost of these oil and gas leasehold interests as part of oil and gas properties and provided the disclosures required by SFAS No. 69, Disclosures

about Oil and Gas Producing Activities (SFAS 69). Also under consideration is whether SFAS 142 requires registrants to provide the additional disclosures prescribed by SFAS 142 for intangible assets for costs associated with mineral rights. 48 The Emerging Issues Task Force ("EITF") has recently decided to consider this issue. If the EITF determines that SFAS 142 requires the Company to reclassify costs associated with mineral rights from property and equipment to intangible assets, the Company currently believes that its results of operations and financial condition would not be materially affected, since such intangible assets would continue to be depleted and assessed for impairment in accordance with existing full cost accounting rules and impairment standards. In addition, cost associated with mineral rights would continue to be characterized as oil and gas property costs in the Company's required disclosures under SFAS 69.

**FORWARD-LOOKING STATEMENTS** The forward-looking statements contained in this Item 7 and elsewhere in this Annual Report on Form 10-K are subject to various risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated in such forward-looking statements. Included among the important risks, uncertainties and other factors are those hereinafter discussed. Few of the forward-looking statements in this Annual Report deal with matters that are within our unilateral control. Joint venture, acquisition, financing and other agreements and arrangements must be negotiated with independent third parties and, in some cases, must be approved by governmental agencies. These third parties generally have objectives and interests that may not coincide with ours and may conflict with our interests. Unless we are able to compromise these conflicting objectives and interests in a mutually acceptable manner, agreements and arrangements with these third parties will not be consummated. Operating entities in various foreign jurisdictions must be registered by governmental agencies, and production licenses for development of oil and gas fields in various foreign jurisdictions must be granted by governmental agencies. These governmental agencies generally have broad discretion in determining whether to take or approve various actions and matters. In addition, the policies and practices of governmental agencies may be affected or altered by political, economic and other events occurring either within their own countries or in a broader international context. Finally, due to the developing nature of the legal regimes in many former Soviet Union countries where we operate, our contractual rights and remedies may be subject to certain legal uncertainties. We do not have a majority of the equity in the entity that is the licensed developer of some projects, that we may pursue in the former Soviet Union, even though we may be the designated operator of the oil or gas field. In these circumstances, the concurrence of co-venturers may be required for various actions. Other parties influencing the timing of events may have priorities that differ from ours, even if they generally share our objectives. As a result of all of the foregoing, among other matters, any forward-looking statements regarding the occurrence and timing of future events may well anticipate results that will not be realized. Demands by or expectations of governments, co-venturers, customers and others may affect our strategy regarding the various projects. Failure to meet such demands or expectations could adversely affect our participation in such projects or our ability to obtain or maintain necessary licenses and other approvals. Our ability to finance all of its present oil and gas projects and other ventures according to present plans is dependent upon obtaining additional funding. An inability to obtain financing could require us to scale back or abandon part of all of our project development, capital expenditure, production and other plans. The availability of equity or debt financing to us or to the entities that are developing projects in which we have interests is affected by many factors, including: - world economic conditions; - the state international relations; - the stability and policies of various governments located in areas in which we currently operate or intend to operate; - fluctuations in the price of oil and gas, the general outlook for the oil and gas industry and competition for available funds; and - an evaluation of us and specific projects in which we have an interest. 49

Rising interest rates might affect the feasibility of debt financing that is offered. Potential investors and lenders will be influenced by their evaluations of us and our projects and comparisons with alternative investment opportunities.

**COMMITMENTS** CanArgo has not filed any of its required 2002 or 2003 income tax or information returns required by various governmental authorities. Failure to file these returns carries significant penalties. CanArgo is taking steps to rectify the matter. CanArgo has not accrued for any penalties it may be required to pay. **ITEM 7A.**

**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK** Our principal exposure to market risk is due to changes in oil and gas prices and currency fluctuations. As indicated elsewhere in this Report, as a producer of oil and gas we are exposed to changes in oil and gas prices as well as changes in supply and demand which could affect our revenues. We do not engage in any commodity hedging activities. Due to the ready market for our production in the Republic of Georgia, we do not believe that any current exposures from this risk will materially affect our financial position at this time, but there can be no assurance that changes in such market will not affect us

adversely in the future. Also as indicated elsewhere in this Report, because all of our operations are being conducted in the former Soviet Union, we are potentially exposed to the market risk of fluctuations in the relative values of the currencies in areas in which we operate. At present we do not engage in any currency hedging operations since, to the extent we receive payments for our production and marketing activities in local currencies, we are utilizing such currencies to pay for our local operations. In addition, we currently have contracts to sell our production from the Ninotsminda Field in the Republic of Georgia which provide for payment in dollars, although we may not always be able to continue to demand payment in U.S. dollars. While CanArgo Standard Oil Products marketing revenue was denominated in Lari, the local Georgian currency, and was used to pay Lari denominated operating costs, its long term debt was denominated in dollars. As a result, had we retained our interest in CSOP, changes in the exchange rate could have a material adverse effect on its ability to pay off non-Lari denominated indebtedness such as its existing credit facility. However, since we have sold our interest in CSOP, such changes in exchange rates insofar as their effect on CSOP will not affect our financial condition in the future. CanArgo had no material interest in investments subject to market risk during the period covered by this report. Because the majority of all revenue to CanArgo is from the sale of production from the Ninotsminda Field then a change in the price of oil or a change in the production rates have a substantial effect on this revenue and therefore profits. Assuming the same production in 2004 as 2003 but decreasing the net oil price the Company receives from sales by \$5.00 and \$10.00 respectively would change the total annual revenue from oil sales as follows. The total annual revenue from oil sales for 2003 based on an average net oil price received of \$20.07 was \$7,778,356. If the average net oil price received was \$5.00 less at \$15.05 then the total annual revenue from oil sales would be reduced by \$1,938,605 to \$5,842,955. If the average net oil price received was reduced by \$10/barrel then the total annual revenue from oil sales realised would be reduced by \$3,877,210 to \$3,904,350, assuming all other factors are constant. Assuming constant oil prices but a reduction in annual production by 20% and 50% would have the following effect on total annual revenues. In 2003 the total oil sales were 387,721 barrels of oil producing revenue of \$7,778,356. If this was reduced by 20% then the annual revenue from oil sales would be reduced to \$6,225,248. If the total annual oil sales were reduced by 50% or 193,861 barrels then the total annual revenue from oil sales would be \$3,883,026. Assuming all other factors are constant.

50 ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA The Financial Statements required to be filed in this Report begin at Page F-1 of this Report. ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE As noted in the Form 8-K filed in July 2003, our Board of Directors engaged the accounting firm of L.J. Soldinger Associates LLP as our certifying accountant for the year ended December 31, 2003. The engagement of L J Soldinger Associates LLC was approved by the Audit Committee of the Board of Directors. The Audit Committee of the Board of Directors approved the dismissal of PricewaterhouseCoopers LLP. The reports of PricewaterhouseCoopers LLP ("PwC") on the Company's financial statements for the two fiscal years ended December 31, 2001 and 2002 did not contain any adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles but PwC's report on the financial statements for the fiscal year ended December 31, 2002 did contain an explanatory paragraph for an uncertainty regarding the Company's ability to continue as a going concern. In connection with the audits of the Company's financial statements for each of the two fiscal years ended December 31, 2001 and 2002, there were no disagreements with PricewaterhouseCoopers LLP on any matters of accounting principles, financial statement disclosure or audit scope and procedures which, if not resolved to the satisfaction of PricewaterhouseCoopers LLP, would have caused the firm to make reference to the matter in their report. ITEM 9A. CONTROLS AND PROCEDURES Based upon an evaluation within the 90 days prior to the filing date of this report, our Chief Executive Officer and Chief Financial Officer have each concluded that our disclosure controls and procedures as defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934, as amended, are effective, as of the evaluation date, in timely alerting them to material information relating to our Company required to be included in our reports filed or submitted under the Exchange Act. In designing and evaluating the disclosure controls and procedures, the company's management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, and management necessarily was required to apply its judgment in designing and evaluating the controls and procedures. Since the date of the evaluation, there have been no significant changes in our internal controls over financial reporting (as required by the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) or in other factors that have materially affected, or are reasonably likely to materially affect such controls, including any corrective actions

with regard to significant deficiencies and material weaknesses. 51 PART III ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT The information required by this Item is hereby incorporated by reference from our definitive proxy statement to be mailed to stockholders in connection with our 2004 annual meeting of stockholders and filed with the SEC within 120 days after the close of our fiscal year. ITEM 11. EXECUTIVE COMPENSATION The information required by this Item is hereby incorporated by reference from our definitive proxy statement to be mailed to stockholders in connection with our 2004 annual meeting of stockholders and filed with the SEC within 120 days after the close of our fiscal year. ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT The information required by this Item is hereby incorporated by reference from our definitive proxy statement to be mailed to stockholders in connection with our 2004 annual meeting of stockholders and filed with the SEC within 120 days after the close of our fiscal year. ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS The information required by this Item is hereby incorporated by reference from our definitive proxy statement to be mailed to stockholders in connection with our 2004 annual meeting of stockholders and filed with the SEC within 120 days after the close of our fiscal year. ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES The information required by this Item is hereby incorporated by reference from our definitive proxy statement to be mailed to stockholders in connection with our 2004 annual meeting of stockholders and filed with the SEC within 120 days after the close of our fiscal year. 52 PART IV ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K (a)(1) FINANCIAL STATEMENTS The following financial statements and related notes of the Company contained on pages F-1 through F- 44 are filed as part of this Report: Reports of Independent Auditors Consolidated Statements of Operations - Years Ended December 31, 2003, 2002, and 2001. Consolidated Balance Sheets - December 31, 2003 and 2002. Consolidated Statements of Cash Flows - Years Ended December 31, 2003, 2002, and 2001. Consolidated Statements of Stockholders' Equity - Years ended December 31, 2003, 2002 and 2001. Notes to Consolidated Financial Statements (2) FINANCIAL STATEMENTS SCHEDULES None All other schedules are omitted because of the absence of conditions under which they are required or because the required information is included in the consolidated financial statements or notes thereto. (b) REPORTS ON FORM 8-K: The following Current Reports on Form 8-K were filed during the quarter ended December 31, 2003. On December 11 2003, CanArgo issued a statement that operations in the Republic of Georgia are unaffected by the current political changes in the country. On December 11 2003, CanArgo announced the initial test results of horizontal production well N96H, in the Ninotsminda Field, Georgia. On December 11 2003, CanArgo announced that it had filed its results for the nine months ended September 30th 2003 on November 14th 2003. (c) EXHIBITS Management Contracts, Compensation Plans and Arrangements are identified by an asterisk (\*) Documents filed herewith are identified by a cross (+). 1(6) Engagement Agreement with Sundal Collier & Co ASA dated August 13, 2001. (Incorporated herein by reference from Post-Effective Amendment No. 2 to Form S-1 Registration Statement, File No. 333-85116 filed on September 10, 2002). 2(4) Memorandum of Agreement between Fielden Management Services Pty, Ltd., A.C.N. 005 506 123 and Fountain Oil Incorporated dated May 16, 1995 (Incorporated herein by reference from December 31, 1997 Form 10-K/A). 53 3(1) Registrant's Certificate of Incorporation and amendments thereto (Incorporated herein by reference from July 15, 1998 Form 8-K). 3(2) Registrant's Bylaws (Incorporated herein by reference from Post-Effective Amendment No. 1 to Form S-1 Registration Statement, File No. 333-72295 filed on July 29, 1999). \*10(2) Amended and Restated 1995 Long-Term Incentive Plan (Incorporated herein by reference from Post-Effective Amendment No. 1 to Form S-1 Registration Statement, File No. 333-72295 filed on July 29, 1999). \*10(3) Amended and Restated CanArgo Energy Inc. Stock Option Plan (Incorporated herein by reference from September 30, 1998 Form 10-Q). 10(6) Production Sharing Contract between (1) Georgia and (2) Georgian Oil and JKX Ninotsminda Ltd. dated February 12, 1996 (Incorporated herein by reference from Form S-1 Registration Statement, File No. 333-72295 filed on September 7, 1999). \*10(14) Management Services t Agreement between CanArgo Energy Corporation and Vazon Energy Limited concerning the provision of services by Dr. David Robson dated June 29, 2000 (Incorporated herein by reference from September 30, 2000 Form 10-Q). 10(15) Tenancy Agreement between CanArgo Services (UK) Limited and Grosvenor West End Properties dated September 8, 2000 (Incorporated herein by reference from September 30, 2000 Form 10-Q). 10(19) Production Sharing Contract between (1) Georgia and (2) Georgian Oil and CanArgo Norio Limited dated December 12, 2000 (Incorporated herein by reference from December 31, 2000 Form 10-K). \*10(22) Employment Agreements between CanArgo Energy Corporation and Vincent McDonnell dated December 1, 2000 (Incorporated herein by reference from December 31, 2001 Form 10-K). 10(23) Agreement

Number 1 dated March 20, 1998 on Joint Investment Production Activity for further development and further exploration of Bugruvativske Field (Incorporated herein by reference from September 30, 2001 Form 10-Q). 10(25) Covenant on terms and conditions of participation in investment activity under the Joint Investment Production Activity agreement dated of March 20, 1998, dated July 23, 2002. (Incorporated herein by reference from September 30, 2002 Form 10-Q). 10(26) Amendments of and Additions to Joint Investment Production Activity agreement of March 20, 1998, dated August 8, 2002. (Incorporated herein by reference from September 30, 2002 Form 10-Q). 10(27) Amendment of Clause 9.3.1 of Amendments of and Additions to the Joint Investment Production Activity agreement of March 20, 1998, dated September 17, 2002. (Incorporated herein by reference from September 30, 2002 Form 10-Q). 10(28) Stock sale purchase contract of IPEC between Lateral Vector Resources Inc. and Lystopad dated September 24, 2002. (Incorporated herein by reference from September 30, 2002 Form 10-Q). 54 10(29) Stock sale purchase contract of IPEC between Lateral Vector Resources Inc. and Lyutyi dated September 24, 2002. (Incorporated herein by reference from September 30, 2002 Form 10-Q). 10(30) Sale agreement of CanArgo Petroleum Products Limited between CanArgo Limited and Westrade Alliance LLC dated October 14, 2002. (Incorporated herein by reference from September 30, 2002 Form 10-Q). 10(31) Crude Oil Sales Agreement dated May 5, 2003 (Incorporated herein by reference from September 30, 2003 Form 10-Q). 10(32) Farm-in Agreement dated September 4, 2003 relating to the Norio (Block XI(C)) and North Kumisi Production Sharing Agreement in the Republic of Georgia with a wholly owned subsidiary of Georgian Oil, the Georgian State Oil Company (Incorporated herein by reference from September 30, 2003 Form 10-Q). 10(33) Farm-in Agreement dated September 7, 2003 relating to the M11 well on the Manavi Cretaceous prospect within the Ninotsminda PSC area between Ninotsminda Oil Company Limited and Georgian British Oil Services Company Limited (Incorporated herein by reference from September 30, 2003 Form 10-Q). 10(34) Stock Purchase Agreement dated September 24, 2003 regarding the sale of all of the issued and outstanding stock of Fountain Oil Boryslaw (Incorporated herein by reference from September 30, 2003 Form 10-Q). +10(36) Manavi Termination Agreement dated December 5, 2003. 21 List of Subsidiaries (Incorporated herein by reference from September 30, 2001 Form 10-Q) +23(a) Consent of L.F. Soldingier & Associates, LLP, Independent Public Accountants. +23(b) Consent of PricewaterhouseCoopers LLP, Independent Public Accountants. +31(1) Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer of CanArgo Energy Corporation. +31(2) Rule 13a-14(c)/15d-14(a) Certification of Chief Financial Officer of CanArgo Energy Corporation. +32 Section 1350 Certifications. 55 SIGNATURES Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized. CANARGO ENERGY CORPORATION (Registrant) By: /s/Vincent McDonnell Date: April 8, 2004 ----- Chief Financial Officer Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated. By: /s/David Robson Date: April 8, 2004 ----- David Robson, Chairman of the Board and Chief Executive Officer and Director Principal Executive Officer By: /s/Vincent McDonnell Date: April 8,2004 ----- Vincent McDonnell, Chief Financial Officer and Director Principal Accounting Officer By: /s/Michael Ayre Date: April 8, 2004 ----- Michael Ayre, Director By: /s/Russell Hammond Date: April 8, 2004 ----- Russell Hammond, Director By: /s/Nils N. Trulsvik Date: April 8, 2004 ----- Nils N. Trulsvik, Director 56 CANARGO ENERGY CORPORATION INDEX TO FINANCIAL STATEMENTS Report on Management's Responsibilities F-2 Independent Auditors' Report F-3 Consolidated Balance Sheets F-4 Consolidated Statements of Operations F-5 Consolidated Statements of Stockholders' Equity F-6 Consolidated Statements of Cash Flows F-7 Notes to Financial Statements F-10 F-1 REPORT ON MANAGEMENT'S RESPONSIBILITIES To the Stockholders of CanArgo Energy Corporation: CanArgo's management is responsible for the integrity and objectivity of the financial information contained in this Annual Report. The financial statements included in this report have been prepared in accordance with accounting principles generally accepted in the United States and, where necessary, reflect the informed judgements and estimates of management. Management maintains and is responsible for systems of internal accounting control designed to provide reasonable assurance that all transactions are properly recorded in the Company's books and records, that procedures and policies are adhered to, and that assets are safeguarded from unauthorized use. The financial statements for 2003 have been audited by the independent accounting firm of L J Soldingier Associates LLC, as indicated in their report. The financial statements for 2002 and 2001 were audited by the independent accounting firm of PricewaterhouseCoopers, LLP as indicated in their report. Management has made

available to its outside auditors' all the Company's financial records and related data and minutes of directors' and audit committee meetings. CanArgo's audit committee, consisting solely of directors who are not employees of CanArgo, is responsible for: reviewing the Company's financial reporting; reviewing accounting and internal control practices; recommending to the Board of Directors and shareholders the selection of independent accountants; and monitoring compliance with applicable laws and company policies. The independent accountants have full and free access to the audit committee and meet with it, with and without the presence of management, to discuss all appropriate matters. On the recommendation of the audit committee, the consolidated financial statements have been approved by the Board of Directors. /s/Dr. David Robson /s/Vincent McDonnell Chief Executive Officer Chief Financial Officer April 8, 2004 F-2 INDEPENDENT AUDITORS' REPORT Board of Directors and Shareholders CanArgo Energy Corporation St Peter Port, Guernsey, British Isles We have audited the accompanying consolidated balance sheet of CanArgo Energy Corporation as of December 31, 2003, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion. In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of CanArgo Energy Corporation as of December 31, 2003, and the consolidated results of operations, changes in stockholders' equity and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. As discussed in Note 2 to the financial statements, the Company changed its method of accounting for stock-based compensation. Effective January 1, 2003 the Company voluntarily commenced recording stock based compensation, on a prospective basis, using the fair value method as allowed by the provisions of Statement of Financial Accounting Standards No. 148 "Accounting for Stock-Based Compensation -- Transition and Disclosure -- an Amendment of FASB Statement No. 123". Also as discussed in Note 2 to the financial statements, the Company changed its method of accounting for asset retirement obligations effective January 1, 2003, and implemented the accounting required under the provisions of Statement of Financial Accounting Standards No. 143 "Accounting for Asset Retirement Obligations. L J SOLDINGER ASSOCIATES LLC Deer Park, Illinois, USA March 11, 2004 F-3 REPORT OF INDEPENDENT ACCOUNTANTS To the Directors and Shareholders of CanArgo Energy Corporation: In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, stockholders' equity and cash flows present fairly, in all material respects, the financial position of CanArgo Energy Corporation and its subsidiaries at 31 December 2002, and the results of their operations and their cash flows for the each of the two years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. The accompanying financial statements have been prepared assuming the Group will continue as a going concern. As discussed in Note 1, Basis of Presentation, to the consolidated financial statements, the Group is reliant on raising additional significant financing from external sources in order to recover the carrying value of its undeveloped and unproved properties and without additional financing there is substantial doubt about the Group's long term ability to continue as a going concern. Management's plans in regard to these matters are described in Note 1, Basis of Presentation. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. PricewaterhouseCoopers LLP London, England March 24, 2003, except for Note 17 paragraph 7, as to which the date is April 9, 2004 F-4 CANARGO ENERGY CORPORATION Consolidated Balance Sheets (Expressed in United States dollars) December 31,

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----- 2003 2002 ----- ASSETS Current assets Cash and cash equivalents \$ 3,472,252 \$ 1,585,000 Accounts receivable 161,772 250,603 Inventory 468,793 158,896 Prepayments 961,588 211,623 Assets held for sale 10,346,077 13,252,529 Other current assets 206,532 175,951 ----- Total current assets 15,617,014 15,634,602 Capital assets, net (including unevaluated amounts of \$26,592,260 and \$31,882,906, respectively) 58,322,699 54,642,008 Investments in and advances to oil and gas and other ventures, net 75,000 459,308 ----- Total assets \$ 74,014,713 \$ 70,735,918 =====

LIABILITIES AND STOCKHOLDERS' EQUITY Current liabilities Accounts payable - trade \$ 483,282 \$ 405,234 Advance from joint venture partner 1,427,612 - Loans payable 102,179 - Other liabilities 5,473,823 1,500,000 Income taxes payable 97,500 61,000 Accrued liabilities 349,487 204,045 Liabilities held for sale 4,447,706 2,818,727 ----- Total current liabilities 12,381,589 4,989,006 Provision for future site restoration 152,000 122,290 Minority interest in subsidiaries 4,772,683 3,519,342 Commitments and contingencies Stockholders' equity: Common stock, par value \$0.10 ; authorized - 150,000,000 shares; shares issued and outstanding - 105,617,988 at 2003 and 97,356,206 at 2002 10,561,798 9,735,620 Capital in excess of par value 146,401,804 145,151,475 Accumulated other comprehensive income (deficit) (146,463) 4,668 Accumulated deficit (100,108,698) (92,786,483) ----- Total stockholders' equity 56,708,441 62,105,280 ----- Total liabilities and stockholders' equity \$ 74,014,713 \$ 70,735,918 =====

The accompanying notes are an integral part of the consolidated financial statements F-5 CANARGO ENERGY CORPORATION Consolidated Statements of Operations (Expressed in United States dollars) For the Years Ended December 31,

----- 2003 2002 2001 ----- Operating revenues from continuing operations: Oil and gas sales \$ 7,881,172 \$ 4,163,201 \$ 3,967,078 Other 223,608 1,322,554 608,032 ----- 8,104,780 5,485,755 4,575,110 ----- Operating expenses: Field operating expenses 1,051,905 1,537,917 1,568,011 Direct project costs 1,028,682 1,428,638 1,300,423 Selling, general and administrative 3,228,982 3,493,828 3,482,574 Non cash stock compensation expense 276,507 - - Depreciation, depletion and amortization 3,294,086 2,316,774 2,745,934 Impairment of oil and gas properties - 1,600,000 7,300,000 Gain on disposition of investment (664,576) - - Loss on disposition of assets 47,835 10,725 16,130 ----- 8,263,421 10,387,882 16,413,072 ----- Operating Loss from continuing operations (158,641) (4,902,127) (11,837,962) Other income (expense) Interest, net (35,386) 32,413 677,559 Foreign exchange gains (losses) (511,370) 128,579 28,948 Other (123,541) (822,908) (21,646) Equity income (loss) from investments 65,544 86,059 (160,000) ----- Total other income (expense) (604,753) (575,857) 524,861 ----- Loss from continuing operations before minority interest and taxes (763,394) (5,477,984) (11,313,101) Minority interest in loss of consolidated subsidiaries 7,406 58 - ----- Loss from continuing operation (755,988) (5,477,926) (11,313,101) Net income (loss) from discontinued operations, net of taxes and minority interest (6,607,517) 150,225 (1,905,245) Cumulative effect of change in accounting principle 41,290 - - ----- Net Loss \$ (7,322,215) \$ (5,327,701) \$(13,218,346) =====

Weighted average number of common shares outstanding 99,432,000 96,643,744 83,869,579 ----- Net loss per common share - basic and diluted before cumulative effect of change in accounting principle From continuing operations \$ (0.01) \$ (0.06) \$ (0.14) From discontinued operations (0.07) - (0.02) Cumulative effect of change in accounting principle, net of income tax - - - ----- Net loss per common share - basic and diluted \$ (0.08) \$ (0.06) \$ (0.16) =====

Other comprehensive income (loss): Foreign currency translation (151,131) 4,668 - Net loss (7,322,215) (5,327,701) (13,218,346) ----- Comprehensive loss \$ (7,473,346) \$ (5,323,033) \$(13,218,346) =====

The accompanying notes are an integral part of the consolidated financial statements F-6 CANARGO ENERGY CORPORATION Consolidated Statements of Cash Flows (Expressed in United States dollars) For the Years Ended December 31, ----- 2003 2002 2001 ----- Operating activities: Loss from continued operations \$ (755,988) \$ (5,477,926) \$(11,313,101) Non-cash stock compensation expense 276,507 - - Non-cash interest expense 14,000 - - Depreciation, depletion and amortization 3,294,085 2,316,775 2,745,934 Impairment of oil and gas properties - 1,600,000 7,300,000 Equity income from investments (65,544) (86,059) 160,000 Gain on disposition of investment (664,576) - - Loss on disposition of assets 47,835 10,725 16,130 Allowance for doubtful accounts 170,000 275,000 200,000 Minority interest in (loss) income of consolidated subsidiaries (7,406) (58) - Changes in assets and liabilities: Accounts receivable (81,169) 893,086 (1,035,443)



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Inventory (309,897) 214,922 294,519 Prepayments 54,767 29,713 (130,300) Other current assets (30,581) (13,578) 38,690 Accounts payable 78,047 568,205 (4,343,832) Deferred revenue 2,228,899 1,500,000 - Income taxes payable 36,500 - 61,000 Accrued liabilities 145,442 (196,176) (281,318) ----- Net cash generated by operating activities 4,430,921 1,634,629 (6,287,721) ----- Investing activities: Capital expenditures (5,937,853) (10,735,152) (6,316,387) Proceeds from disposition of assets - - 19,383 Acquisitions, net of cash acquired - (50,000) (4,044,973) Proceeds from disposition of investments 1,000,000 13,435 125,000 Repayments from (investments in and advance to) oil and gas and other ventures 114,428 346,059 (831,403) Advance proceeds from the sale of CanArgo Standard Oil Products 1,443,729 - - Advance proceeds from the sale of CanArgo Petroleum Refining Limited 301,195 - - Change in non cash working capital items (804,732) 1,994,376 (1,340,359) ----- Net cash used in investing activities (3,883,233) (8,431,282) (12,388,739) ----- Financing activities: Proceeds from sale of common stock - 1,790,948 7,235,337 Share issuance costs - (162,215) (643,075) Minority shareholder advances - - 450,000 (Repayment of) Advances from minority interest - 1,546,137 1,931,874 Advances from joint venture partner 1,427,612 - (5,888,573) Proceeds from loans 380,000 - - Repayment of loans (277,821) - - ----- Net cash provided by financing activities 1,529,791 3,174,870 3,085,563 ----- Net cash flows from assets and liabilities held for sale (190,227) (683,308) (8,215,666) ----- Net increase (decrease) in cash and cash equivalents 1,887,252 (4,305,091) (23,806,563) Cash and cash equivalents, beginning of year 1,585,000 5,890,091 29,696,654 ----- Cash and cash equivalents, end of year \$ 3,472,252 \$ 1,585,000 \$ 5,890,091 =====

===== The accompanying notes are an integral part of the consolidated financial statements F-7 CANARGO ENERGY CORPORATION Page 1 of 2 Consolidated Statements of Stockholders' Equity (Expressed in United States dollars) Common Stock ----- Accumulated Number of Additional Other Total Shares Issued Paid-In Comprehensive Accumulated Stockholders' and Issuable Par Value Capital Income (Loss) Deficit Equity ----- Balance, December 31, 2000

75,526,890 \$ 7,552,690 \$138,275,319 \$ - \$ (74,240,436) \$ 71,587,573 ----- Shares issuable upon exchange of CanArgo Oil & Gas, Inc. Exchangeable Shares without receipt of further consideration 423,791 42,379 795,712 - - 838,091 ----- Total, December 31, 2000 75,950,681 7,595,069 139,071,031 - (74,240,436) 72,425,664 -----

----- Less shares issuable at beginning of year (423,791) (42,379) (795,712) - - (838,091) Issuance of common stock pursuant to July private placement 16,057,765 1,605,776 5,629,561 - - 7,235,337 Issuance of common stock upon exchange of CanArgo Oil & Gas, Inc. Exchangeable Shares 274,965 27,496 516,276 - - 543,772 Share issuance costs - - (643,075) - - (643,075) Net loss - - - - (13,218,346) (13,218,346) ----- Balance, December 31, 2001 91,859,620 9,185,962 143,778,081 - (87,458,782)

65,505,261 ----- Shares issuable upon exchange of CanArgo Oil & Gas, Inc. Exchangeable Shares without receipt of further consideration 148,826 14,883 279,436 - - 294,319 ----- Total, December 31, 2001 92,008,446 9,200,845

144,057,517 - (87,458,782) 65,799,580 ----- Less shares issuable at beginning of year (148,826) (14,883) (279,436) - - (294,319) Issuance of common stock upon exchange of CanArgo Oil & Gas, Inc. Exchangeable Shares 148,826 14,883 279,436 - - 294,319 Shares issued pursuant to private placement February 2002 5,210,000 521,000 1,241,433 - - 1,762,433 Shares issued pursuant to private placement May 2002 137,760 13,775 14,740 - - 28,515 Share issuance costs - - (162,215) (162,215) Current year adjustment - - - - 4,668 - 4,668 Net loss - - - - (5,327,701) (5,327,701) ----- Total, December 31, 2002 97,356,206 \$ 9,735,620 \$145,151,475 \$ 4,668 \$ (92,786,483) \$ 62,105,280 -----

----- The accompanying notes are an integral part of the consolidated financial statements F-8 CANARGO ENERGY CORPORATION Page 2 of 2 Consolidated Statements of Stockholders' Equity (Expressed in United States dollars) Common Stock ----- Accumulated Number of Additional Other Total Shares Issued Paid-In Comprehensive Accumulated Stockholders' and Issuable Par Value Capital Income (Loss) Deficit Equity ----- Total, December 31, 2002

97,356,206 \$ 9,735,620 \$145,151,475 \$ 4,668 \$ (92,786,483) \$62,105,280 ----- Shares issued pursuant to Norio buy-out September 2003 6,000,000 600,000 540,000 - - 1,140,000 Shares issued pursuant to Manavi buy-out December 2003 2,000,000 200,000 460,000 - - 660,000 Shares issued pursuant to Standby Equity Distribution Agreement 261,782 26,178 (26,178) - - - Change in accounting policy

pursuant to the Company electing to utilize the "prospective" method of transitioning to fair value method of accounting for stock-based compensation under SFAS No. 148 - - 276,507 - - 276,507 Current year adjustment - - - (151,131) - (151,131) Net loss - - - - (7,322,215) (7,322,215) -----  
 ----- Total, December 31, 2003 105,617,988 \$10,561,798 \$146,401,804 \$ (146,463) \$(100,108,698) \$56,708,441  
 =====

The accompanying notes are an integral part of the consolidated financial statements F-9 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 1 - NATURE OF OPERATIONS CanArgo Energy Corporation, headquartered in Guernsey, British Isles, and its consolidated subsidiaries (collectively "CanArgo"), is an integrated oil and gas company operating predominately within the Republic of Georgia. The principal activity of CanArgo is the acquisition of interests in and development of crude oil and natural gas fields. In 2002 and 2003, CanArgo approved a plan to sell CanArgo Standard Oil Products, the Ukrainian development projects, the refinery and a generating power unit. The corresponding assets and liabilities of these entities have been classified as "Assets held for sale" and "Liabilities held for sale" for all periods presented and the results of operations have been classified as discontinued for all periods presented. The minority interest related to CanArgo Standard Oil Products and the refinery has not been reclassified for any of the periods presented, however net income from discontinued operations is disclosed net of taxes and minority interest. CanArgo has incurred recurring operating losses, and its operations did not generate positive cash flows in 2001. Although its operations did generate positive cash flows in 2002, the ability of CanArgo to continue as a going concern as at December 31, 2002 and to pursue its principal activities of acquiring interests in and developing oil and gas fields depended upon CanArgo reducing costs, generating funds from internal sources including the sale of certain non-core assets, external sources and, ultimately, achieving sufficient positive cash flows from operating activities. NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Basis of Presentation The consolidated financial statements and notes thereto are prepared in accordance with accounting principles generally accepted in the United States. All amounts are in U.S. dollars. Consolidation The consolidated financial statements include the accounts of CanArgo Energy Corporation and its majority owned subsidiaries. All significant intercompany transactions and accounts have been eliminated. Investments in less than majority owned corporations and corporate like entities in which the Company exercises significant influence are accounted for using the equity method. Entities in which the Company does not have significant influence are accounted for using the cost method. Use of Estimates in the Preparation of Financial Statements The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Cash and Cash Equivalents Cash and cash equivalents include all liquid investments with an original maturity of three months or less to be cash equivalents. Fair Value of Financial Instruments The carrying amount of cash and other current assets and liabilities approximates fair value because of the short term maturity of these items. CanArgo does not hold or issue financial instruments for trading purposes. F-10 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued) Concentration of Credit Risk Although CanArgo's cash and temporary investments and accounts receivable are exposed to potential credit loss, CanArgo does not believe such risk to be significant. Even though a substantial amount of funds were in accounts at financial institutions which were not covered under bank guarantees, management does not believe that maintaining balances in excess of bank guarantees resulted in a significant risk to the Company. Reclassification Certain items in the consolidated financial statements have been reclassified to conform to the current year presentation. There was no effect on reported net loss as a result of these reclassifications. Allowance for Doubtful Debts Accounts receivable are carried at the amount owed by customers, reduced by an allowance for estimated amounts that may not be collectible in the future. The allowance for doubtful accounts is estimated based upon historical write-off percentages, known problem accounts, and current economic conditions. Accounts are written off against the allowance for doubtful accounts when the Company determines that amounts are not collectable and recoveries of previously written-off accounts are recorded when collected. Inventories Inventories of crude oil refined products and supplies are valued at the lower of average cost and net realizable value. Capital Assets Capital assets are recorded at cost less accumulated provisions for depreciation, depletion and amortization unless the carrying amount is viewed as not recoverable in which case the carrying value of the assets is reduced to the

estimated recoverable amount. See "Impairment of Long-Lived Assets" below. Expenditures for major renewals and betterments, which extend the original estimated economic useful lives of applicable assets, are capitalized. Expenditures for normal repairs and maintenance are charged to expense as incurred. The cost and related accumulated depreciation of assets sold or retired are removed from the accounts and any gain or loss thereon is reflected in operations. Unproved properties are not deemed to be impaired until the right to drill on those properties is lost and planned development has ceased. Oil And Gas Properties - CanArgo and the unconsolidated entities (for which it accounts using the equity method) account for oil and gas properties and interests under the full cost method. Under this accounting method, costs, including a portion of internal costs associated with property acquisition and exploration for and development of oil and gas reserves, are capitalized within cost centers established on a country-by-country basis. Capitalized costs within a cost center, as well as the estimated future expenditures to develop proved reserves and estimated net costs of dismantlement and abandonment, are amortized using the unit-of-production method based on estimated proved oil and gas reserves. All costs relating to production activities are charged to expense as incurred. All other costs directly attributable to a project are expensed as incurred as direct project costs when such costs are considered recurring in nature. Capitalized oil and gas property costs, less accumulated depreciation, depletion and amortization and related deferred income taxes, are limited to an amount (the ceiling limitation) equal to (a) the present value (discounted at 10%) of estimated future net revenues from the projected production of proved oil and gas reserves, calculated at prices in effect as of the balance sheet date (with consideration of price changes only to the extent provided by fixed and determinable contractual arrangements), plus (b) the lower of cost or estimated fair value of unproved and unevaluated properties, less (c) income tax effects related to differences in the book and tax basis of the oil and gas properties.

F-11 CANARGO ENERGY CORPORATION  
Notes to Consolidated Financial Statements NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES  
(Continued) Property and Equipment - Depreciation of property and equipment is computed using the straight-line method over the estimated useful lives of the assets ranging from three to five years for office furniture and equipment to three to fifteen years for oil and gas related equipment. Discontinued Operations - CanArgo Standard Oil Products petrol stations and additions thereto were depreciated over the estimated useful lives of the assets ranging from ten to fifteen years until operations were reclassified as discontinued. Revenue Recognition CanArgo recognizes revenues when goods have been delivered, when services have been performed, or when hydrocarbons have been produced and delivered and payment is reasonably assured. Where crude oil or natural gas production is sold to or used for internal consumption by the refinery, on consolidation revenues from these sales are eliminated from sales and other operating revenues and operating expenses. Advances Advances received by CanArgo from joint venture partners, which are to be spent by CanArgo on behalf of the joint venture partners, are classified within finance activities. When the cash advances are spent, the payable is reduced accordingly. These advances do not contribute to CanArgo's operating profits and are accounted for/disclosed as balance sheet entries only within cash and payable to joint venture partner.

Foreign Operations CanArgo's future operations and earnings will depend upon the results of CanArgo's operations in the Republic of Georgia. There can be no assurance that CanArgo will be able to successfully conduct such operations, and a failure to do so would have a material adverse effect on the CanArgo's financial position, results of operations and cash flows. Also, the success of CanArgo's operations will be subject to numerous contingencies, some of which are beyond management control. These contingencies include general and regional economic conditions, prices for crude oil and natural gas, competition and changes in regulation. Since CanArgo is dependent on international operations, specifically those in the Republic of Georgia, CanArgo will be subject to various additional political, economic and other uncertainties. Among other risks, CanArgo's operations may be subject to the risks and restrictions on transfer of funds, import and export duties, quotas and embargoes, domestic and international customs and tariffs, and changing taxation policies, foreign exchange restrictions, political conditions and regulations.

Foreign Currency Translation The U.S. dollar is the functional currency for CanArgo's upstream and refining operations and the Lari is the functional currency for marketing operations. All monetary assets and liabilities denominated in foreign currency are translated into U.S. dollars at the rate of exchange in effect at the balance sheet date and the resulting unrealized translation gains or losses are reflected in operations. Non-monetary assets are translated at historical exchange rates. Revenue and expense items (excluding depreciation and amortization which are translated at the same rates as the related assets) are translated at the average rate of exchange for the year. Income Taxes CanArgo recognizes deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax liabilities and assets are determined based on the

difference between the financial statement and the tax bases of assets and liabilities using enacted rates in effect for the years in which the differences are expected to reverse. Valuation allowances are established, when appropriate, to reduce deferred tax assets to the amount expected to be realized. F-12 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued) Impairment of Long-Lived Assets The Company evaluates its long-lived assets for impairment using the guidance of Statement of Financial Accounting Standard ("SFAS") No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 establishes a single accounting model for long-lived assets to be disposed of by sale and requires that those long-lived assets be measured at the lower of carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations. Asset Retirement Obligations On January 1, 2003 CanArgo adopted FASB Statement No. 143 "Accounting for Asset Retirement Obligations" ("SFAS 143"). SFAS 143 requires companies to record the discounted fair value of a liability for an asset retirement obligation in the period in which the liability is incurred concurrent with an increase in the long-lived assets carrying value. The increase and subsequent adjustments in the related long-lived assets carrying value is amortised over its useful life. Upon settlement of the liability a gain or loss is recorded for the difference between the settled liability and the recorded amount. The discount associated with the liability is accreted into income over the related asset's useful life. Upon adoption of this standard an entity is required to record the fair value of its existing asset retirement obligations as if the liabilities had been initially accounted for in accordance with SFAS 143 using assumptions present at the date of adoption. The income statement effect of the treatment is recorded as a cumulative effect in accounting principle in the period of adoption, no retroactive restatement is permitted. During 2003, CanArgo recorded a credit to income for the cumulative effect of change in accounting principle of \$41,290, increased long-term liabilities to recognise its total obligation and increased net capital assets in accordance with the provisions of SFAS No. 143 to the amount of \$82,000. No deferred tax expense has been recognised on the SFAS 143 credit as the group is in a net deferred tax asset position against which full allowance has been made as it is considered more likely than not that the deferred tax asset will not be realised. There was no impact on the Company's cash flows as a result of adopting SFAS No. 143. The pro forma asset retirement obligation would have been \$138,000 at December 31, 2002 had the Company adopted SFAS No. 143 on January 1, 2002. The asset retirement obligation, which is included on the Consolidated Balance Sheet in Provision for Future site restoration, was \$152,000 at December 31, 2003. The pro-forma amounts assuming the new method of determination under SFAS 143 were not materially different to the amounts shown in the income statement and the balance sheet for the prior year. Stock-Based Compensation Plans In August 2003, the Company adopted SFAS No. 123 Accounting For Stock-Based Compensation ("SFAS 123"), as amended by SFAS No. 148 Accounting for Stock-Based Compensation--Transition and Disclosure -- an amendment of FASB Statement No. 123, effective as of January 1, 2003. The Company has elected to utilize the "prospective" method of transitioning from the intrinsic value to the fair value method of accounting for stock-based compensation as allowed by SFAS No. 148. This change is estimated to decrease 2003 net income by approximately \$276,507. Stock based awards in existence prior to 2003 will continue to be accounted for under APB Opinion No. 25, "Accounting for Stock Issued to Employees," unless they are re-priced or modified. Prior to 2003, the Company applied APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for stock-based compensation. Under Opinion No. 25, stock-based employee compensation cost was not recognized in net income when stock options granted had an exercise price equal, or greater, to the market value of the underlying common stock on the date of grant. The pro forma information regarding net loss and net loss per share is required by SFAS 123 and has been determined as if CanArgo had accounted for its employee stock options under the fair value method of that statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions for 2003, 2002 and 2001, respectively; risk free interest rates of 2.91%; dividend yields of 0%; volatility factors of the expected market price of CanArgo common stock of 80.47; and a weighted-average expected life of the options of four years. The following table illustrates the pro F-13 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements forma effect on net loss and net loss per share if the fair value based method had been applied to all outstanding and unvested awards for the years ended December 31, 2003, 2002 and 2001: NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued) For the Years Ended December 31, ----- 2003 2002 2001 ----- Net Loss as reported \$ (7,322,215) \$ (5,327,701) \$ (13,218,347) Add: Stock-based compensation cost, net of related tax effects,

included in the determination of net income reported 276,507 - - Less: Stock-based compensation cost, net of related tax effects, that would have been included in the determination of net income reported if the fair value based method had been applied to all awards 786,783 925,339 1,334,339 Pro forma net loss (7,832,491) (6,253,040) (14,552,686) Loss per share Basic and diluted - as reported (0.08) (0.06) (0.16) Basic and diluted - pro forma (0.08) (0.06) (0.17)

Recently Issued Pronouncements In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 ("FIN 46"). In December 2003, the FASB modified FIN 46 to make certain technical corrections and address certain implementation issues that had arisen. FIN 46 provides a new framework for identifying variable interest entities ("VIEs") and determining when a company should include the assets, liabilities, noncontrolling interests and results of activities of a VIE in its consolidated financial statements. In general, a VIE is a corporation, partnership, limited-liability corporation, trust, or any other legal structure used to conduct activities or hold assets that either: (1) has an insufficient amount of equity to carry out its principal activities without additional subordinated financial support; (2) has a group of equity owners that are unable to make significant decisions about its activities; or (3) has a group of equity owners that do not have the obligation to absorb losses or the right to receive returns generated by its operations. FIN 46 requires a VIE to be consolidated if a party with an ownership, contractual or other financial interest in the VIE ("a variable interest holder") is obligated to absorb a majority of the risk of loss from the VIEs activities, is entitled to receive a majority of the VIEs residual returns (if no party absorbs a majority of the VIEs losses), or both. A variable interest holder that consolidates the VIE is called the primary beneficiary. Upon consolidation, the primary beneficiary generally must initially record all the VIEs assets, liabilities and noncontrolling interests at fair value and subsequently account for the VIE as if it were consolidated based on majority voting interest. FIN 46 also requires disclosures about VIEs that the variable interest holder is not required to consolidate but in which it has a significant variable interest. On October 9, 2003, the FASB issued Staff Position No. 46-6 which deferred the effective date for applying the provisions of FIN 46 for interests held by public entities in variable interest entities or potential variable interest entities created before February 1, 2003. On December 24, 2003, the FASB issued a revision to FIN 46. Under the revised interpretation, the effective date was delayed to periods ending after March 15, 2004 for all variable interest entities, other than SPEs. The adoption of FIN 46 is not expected to have an impact on the Company's financial condition, results of operations or cash flows. F-14

CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements The Company does not have an interest in any special purpose entity that is required to be consolidated under FIN 46. The Company is currently evaluating its involvement in other entities pursuant to the revised guidance; however, the Company does not anticipate a significant effect as a result of its application. NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued) In April 2003, the FASB issued SFAS No. 149, Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities. This statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 requires that contracts with comparable characteristics be accounted for similarly. The statement is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The provisions of SFAS No. 149 generally are to be applied prospectively only. The adoption of SFAS No. 149 did not have a material impact on the Company's results of operations or financial position. In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for classification and measurement by an issuer of certain financial instruments with characteristics of both liabilities and equity. The statement requires that an issuer classify a financial instrument that is within its scope as a liability (or asset in some circumstances). Many of those instruments were previously classified as equity. This Statement also addresses questions about the classification of certain financial instruments that embody obligations to issue equity shares. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except as it relates to consolidated limited-life subsidiaries. The FASB indefinitely deferred the effective date of this statement as it relates to certain mandatorily redeemable non-controlling interests in consolidated limited-life subsidiaries. The adoption of the effective provisions of SFAS No. 150 did not have a material impact on the Company's results of operations or financial position. On December 17, 2003, the Staff of the Securities and Exchange Commission (or SEC) issued Staff Accounting Bulletin No. 104 ("SAB 104"), Revenue Recognition, which supersedes Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements

("SAB 101"). SAB 104's primary purpose is to rescind the accounting guidance contained in SAB 101 related to multiple-element revenue arrangements that was superseded as a result of the issuance of EITF 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. Additionally, SAB 104 rescinds the SEC's related Revenue Recognition in Financial Statements Frequently Asked Questions and Answers issued with SAB 101 that had been codified in SEC Topic 13, Revenue Recognition. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104, which was effective upon issuance. The adoption of SAB 104 did not have a material effect on the Company's financial position or results of operations. Other. Management has been made aware of a reporting issue regarding the application of provisions of SFAS 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets ( SFAS 142 ) to companies in the extractive industries, including oil and gas companies. The issue is whether SFAS 142 requires registrants to reclassify costs associated with mineral rights, including both proved and unproved leasehold acquisition costs, as intangible assets in the balance sheet, apart from other capitalized oil and gas property costs. Historically, the Company's and other oil and gas companies have included the cost of these oil and gas leasehold interests as part of oil and gas properties and provided the disclosures required by SFAS No. 69, Disclosures about Oil and Gas Producing Activities ( SFAS 69 ). Also under consideration is whether SFAS 142 requires registrants to provide the additional disclosures prescribed by SFAS 142 for intangible assets for costs associated with mineral rights. The Emerging Issues Task Force ("EITF") has recently decided to consider this issue. If the EITF determines that SFAS 142 requires the Company to reclassify costs associates with mineral rights from property and equipment to intangible assets, the Company currently believes that its results of operations and financial condition would not be materially affected, since such intangible assets would continue to be depleted and assessed for impairment in accordance with existing full cost accounting rules and impairment standards. In addition, cost associated with mineral rights would continue to be characterized as oil and gas property costs in the Company's required disclosures under SFAS 69.

F-15 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 3 - ACCOUNTS RECEIVABLE Accounts receivable consisted of the following at December 31:

2003	2002	-----	-----	Accounts Receivable before allowance for doubtful debts	\$ 983,693	\$ 902,524
				Allowance for doubtful debts (821,921) (651,921)	\$ 161,772	\$ 250,603

Bad debt expense for 2003, 2002 and 2001 was \$170,000, \$250,000 and \$275,000, respectively, and is reflected under other income in the statement of operations. NOTE 4 - INVENTORY Inventory consisted of the following at December 31:

2003	2002	-----	-----	Crude oil	\$ 468,793	\$ 158,896
					\$ 468,793	\$ 158,896

NOTE 5 - CAPITAL ASSETS Capital assets, net of accumulated depreciation and impairment, include the following at December 31, 2003: Accumulated Net Depreciation Capital Cost And Impairment Assets

		-----	-----	Oil and Gas Properties Proved properties	\$ 44,327,133	\$
(21,084,230)	\$ 23,242,903			Unproved properties	26,592,260	26,592,260
		-----	-----		70,919,393	
(21,084,230)	49,835,163			Property and Equipment Oil and gas related equipment	12,350,840	(4,240,698)
		-----	-----	Office furniture, fixtures and equipment and other	1,235,876	(858,482)
					377,394	
		-----	-----		13,586,716	(5,099,180)
					8,487,536	
		-----	-----		\$ 84,506,109	\$
(26,183,410)	\$ 58,322,699					

F-16 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 5 - CAPITAL ASSETS (Continued) Capital assets, net of accumulated depreciation and impairment, include the following at December 31, 2002: Accumulated Net Depreciation Capital Cost And Impairment Assets

		-----	-----	Oil and Gas Properties Proved properties	\$ 32,443,742	\$ (18,422,771)
				Unproved properties	31,882,908	31,882,908
		-----	-----		64,326,650	(18,422,771)
				Property and Equipment Oil and gas related equipment	11,991,991	(3,788,028)
		-----	-----	Office furniture, fixtures and equipment and other	1,187,526	(653,360)
					534,166	
		-----	-----		13,179,517	(4,441,388)
					8,738,129	
		-----	-----		\$ 77,506,167	\$ (22,864,159)
					\$ 54,642,008	

Oil and Gas Properties Ultimate realization of the carrying value of CanArgo's oil and gas properties will require production of oil and gas in sufficient quantities and marketing such oil and gas at sufficient prices to provide positive cash flow to CanArgo, which is dependent upon, among other factors, achieving significant production at costs that provide acceptable margins, reasonable levels of taxation from local authorities, and the ability to market the oil and gas produced at or near world prices. In addition, CanArgo must mobilize drilling equipment and personnel to initiate drilling, completion and production activities. If one or more of the above factors, or other factors, are different than

anticipated, CanArgo may not recover its carrying value. In the fourth quarter of 2003, CanArgo approved a plan to sell its interest in the Bugruvativske field and recorded a write-down of \$4,790,727 in 2003 of unproved oil and gas properties to reflect the estimated recoverable amount from disposal. The asset was subsequently reclassified to assets held for sale. In the third quarter of 2003, CanArgo announced it had reached conditional agreement to sell its interest in Boryslaw Oil Company, the joint venture in West Ukraine currently operating the Stynawske oilfield. Fountain Oil Boryslaw, CanArgo's wholly owned subsidiary which holds its 45% interest in Boryslaw Oil Company, was sold for \$1,000,000 payable in eight equal tranches. A gain on disposal of the investment of Boryslaw Oil Company of \$664,576 was recorded with the write down of the Bugruvativske field. The net impairment to oil and gas properties in 2003 was therefore \$4,126,151. As a result of application of the ceiling test limitation, CanArgo recorded a write-down in 2002 of oil and gas properties of \$1,600,000. In 2003, CanArgo did not need to write-down oil and gas properties due to the ceiling test. CanArgo generally has the principal responsibility for arranging financing for the oil and gas properties and ventures in which it has an interest. There can be no assurance, however, that CanArgo or the entities that are developing the oil and gas properties and ventures will be able to arrange the financing necessary to develop the projects being undertaken or to support the corporate and other activities of CanArgo or that such financing as is available will be on terms that are attractive or acceptable to or are deemed to be in the best interests of CanArgo, such entities or their respective stockholders or participants.

F-17 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 5 - CAPITAL ASSETS (Continued) The consolidated financial statements of CanArgo do not give effect to any additional impairment in the value of CanArgo's investment in oil and gas properties and ventures or other adjustments that would be necessary if financing cannot be arranged for the development of such properties and ventures or if they are unable to achieve profitable operations. Failure to arrange such financing on reasonable terms or failure of such properties and ventures to achieve profitability would have a material adverse effect on the financial position, including realization of assets, results of operations, cash flows and prospects of CanArgo. Unproved property additions relate to CanArgo's exploration activity in the period. Oil and gas related equipment includes new or refurbished drilling rigs and related equipment, all of which are located in the Republic of Georgia. Property and Equipment Oil and gas related equipment includes drilling rigs and related equipment currently in use by CanArgo in the development of the Ninotsminda field.

NOTE 6 - INVESTMENT IN AND ADVANCES TO OIL AND GAS AND OTHER VENTURES CanArgo has acquired interests in oil and gas and other ventures through less than majority interests in corporate and corporate-like entities. A summary of CanArgo's net investment in and advances to oil and gas and other ventures consisted of the following at December 31:

2003	2002	
-----	-----	
Investments in and Advances to Oil and Gas and Other Ventures Ukraine - Stynawske Field, Boryslaw Through 45% ownership of Boryslaw Oil Company	\$ -	\$ 6,524,121
Other Investments	75,000	75,000
Total Investments in and Advances to Oil and Gas and Other Ventures	\$ 75,000	\$ 6,599,121
Equity in Profit (Loss) of Oil and Gas and Other Ventures Ukraine - Stynawske Field, Boryslaw - (680,020)	-----	-----
Cumulative Equity in Profit (Loss) of Oil and Gas and other ventures - (680,020)	-----	-----
Impairment - Stynawske Field, Boryslaw - (5,459,793)	-----	-----
Disposition of investment - Stynawske Field, Boryslaw - (5,459,793)	-----	-----
Total Investments in and Advances to Oil and Gas and Other Ventures, Net of Equity Loss and Impairment	\$ 75,000	\$ 459,308

===== In September 2003, CanArgo announced it had reached conditional agreement to sell its interest in Boryslaw Oil Company, the joint venture in West Ukraine currently operating the Stynawske oilfield. Fountain Oil Boryslaw, CanArgo's wholly owned subsidiary which holds its 45% interest in Boryslaw Oil Company, was sold for \$1,000,000 payable in eight equal tranches. The buyer has also acknowledged Boryslaw Oil Company's debts to CanArgo for earlier loans in the total amount of \$160,000. On November 10, 2003 CanArgo announced that the full F-18 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements payment had been received early and that CanArgo's interest in Fountain Oil Boryslaw had been transferred to the buyer. Other investments represent CanArgo's 10% interest in a Caspian Sea exploration project.

NOTE 7 - ADVANCE FROM JOINT VENTURE PARTNER In 2003, CanArgo received \$1,427,612 from Georgian Oil in accordance with the Norio farm-in agreement. In the third quarter of 2003, CanArgo Norio signed a farm-in agreement relating to the Norio Production Sharing Agreement ("Norio PSA") with a wholly owned subsidiary of Georgian Oil, the Georgian State Oil Company. The farm-in agreement obligates Georgian Oil to pay up to \$2.0 million to deepen, to a planned depth of 16,400 feet (5,000 metres) the MK-72 well in return for a 15% interest in the contractor share of the Norio PSA. Georgian Oil also has an option, exercisable for a limited period after completion of the well, to increase its interest to 50% of the contractor share of

the Norio PSA on payment to CanArgo Norio of US\$ 6.5 million. If Georgian Oil exercises this Option under the farm-in agreement, it loses its rights to exercise the Production Sharing Agreement Option under the Norio PSA itself.

NOTE 8 - LOANS PAYABLE Loans payable of \$102,179 at December 31, 2003 relates to a short-term secured loan facility maturing on February 27, 2004, which a subsidiary of CanArgo entered into, locally in Georgia, at an annual interest rate of 20% in order to fund the drilling of a new horizontal well, N4H, at the Ninotsminda Field in Georgia. No parent company guarantees have been provided by CanArgo with respect to this loan. The loan matured and was paid off in full in February 2004.

NOTE 9 - OTHER LIABILITIES Other liabilities consisted of the following at December 31: 2003 2002 -----  
 Prepaid sales \$3,228,899 \$1,000,000 Advanced proceeds, less costs of the sale of subsidiary 1,943,729 500,000 Advanced proceeds from the sale of other assets 301,195 - -----  
 \$5,473,823 \$1,500,000 ===== See Note 17 for details of the sale of the subsidiary classified as discontinued operation.

NOTE 10 - ACCRUED LIABILITIES Accrued liabilities consisted of the following at December 31: 2003 2002 -----  
 Professional fees \$231,396 \$105,000 Other 118,091 99,045 -----  
 \$349,487 \$204,045 ===== F-19 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements

NOTE 11 - MINORITY INTEREST In November 2002, CanArgo reached agreement with the other shareholder in CanArgo's subsidiary, CanArgo Norio Limited ("CanArgo Norio"), and with third party investors on a financing arrangement to enable CanArgo Norio to commence drilling the MK-72 well on the Norio prospect. This agreement resulted in CanArgo's interest increasing from 50% to 64.2% in CanArgo Norio and in its existing Norio PSA in the Republic of Georgia (the "Norio PSA"). As a result of the finalization of respective equity interest, CanArgo's interest was adjusted to reflect its share of \$6,031,070, the carrying net asset value of CanArgo Norio. The nominal value of the final shares issued in CanArgo Norio were \$1,250 per share which gives a nominal value for CanArgo Norio of \$11,328,928 of which CanArgo's share is \$7,269,023 and the minority shareholders share was \$4,059,905. In September 2003 CanArgo Norio signed a Farm-In agreement (the "Agreement") relating to the Norio PSA with a wholly owned subsidiary of Georgian Oil, the Georgian State Oil Company ("Georgian Oil"). CanArgo Norio had previously been in negotiations with a large third party energy company to farm-in to the Norio PSA, but Georgian Oil exercised its pre-emption right under the Norio PSA. Georgian Oil is already a party to the Norio PSA as the commercial representative of the State. The Agreement obligates Georgian Oil to pay up to US\$2,000,000 to complete the MK-72 well on the Norio prospect in return for a 15% interest in the contractor share of the Norio PSA. Georgian Oil will also have an option (the "Option") exercisable for a limited period after completion of the well, to increase its interest to 50% of the contractor share of the Norio PSA on payment to CanArgo Norio of US\$6,500,000. Co-incident with the Georgian Oil farm-in CanArgo concluded a deal to purchase some of the minority interests in CanArgo Norio by a share swap for shares in CanArgo. Through this CanArgo has acquired an additional 10.8% interest in CanArgo Norio, giving CanArgo a 75% interest in CanArgo Norio at present. This approximately maintains CanArgo's effective interest in the Norio PSA after Georgian Oil has completed the first stage of the farm-in at 63.7%. The purchase was achieved by issuing 6,000,000 restricted CanArgo shares to the minority interest holders in CanArgo Norio. Of the interests in CanArgo Norio, 4% were owned by Provincial Securities Limited, a company which J.F. Russell Hammond, a non-executive director of CanArgo, is an investor advisor. Provincial Securities Limited received 2,273,523 shares of common stock in return for their interest. In the event that Georgian Oil exercises the Option and pays the required \$6,500,000, CanArgo (which would have received some \$4,800,000 of this payment with its previous interest) would receive a further \$1,200,000, resulting in a total payment to CanArgo of approximately \$6,000,000. If the Option is exercised CanArgo would issue a further 3,000,000 restricted shares to the minority interest holders. As well as the Norio PSA, CanArgo Norio also owns 100% of the contractor interest in the recently signed Block XI(G) and XI(H) Production Sharing Contract ("Tbilisi PSC"). Georgian Oil is not currently farming in to the Tbilisi PSC, which will remain solely with CanArgo Norio. CanArgo Norio is consolidated in the accounts of CanArgo. In September 1998, CanArgo purchased for \$1,000,000 a 12.9% equity interest in GAOR, a company which owns a small refinery located at Sartichala, Georgia. On November 12, 2000, CanArgo acquired a further 38.1% of the common stock of GAOR for Common Stock consideration valued at \$1,666,575. On completion of the acquisition, CanArgo held 51% of the common stock of GAOR and GAOR became a subsidiary of CanArgo. GAOR's results have been included in CanArgo's consolidated financial statements since the date of acquisition. The refinery began operations in July 1998 and has a potential design capacity of approximately 4,000 barrels per day. Since 2001 the refinery has not been operating. Since its acquisition, sales from the refinery have been negatively impacted by the imposition of restrictions and subsequent excise tax on feedstock and refined products. Currently only



naphtha, diesel and mazut can be produced and of these products, an excise tax on naphtha and diesel sales remain in place. As a result of these taxes and the local market for naphtha in the Republic of Georgia, GAOR deemed production of naphtha as commercially uneconomic and suspended refining activity in the fourth quarter of F-20 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements 2001. In January 2002, GAOR entered into a short-term lease of the refinery to a third party for nominal revenue. During the lease period, all operating costs of the refinery were borne by the lessee. This lease expired in May 2002 and has not been renewed. As a result of the uncertainty as to the ultimate recoverability of the carrying value of the NOTE 11 - MINORITY INTEREST (Continued) refinery, CanArgo recorded in 2001 a write-down of the refinery's property, plant and equipment of approximately \$3.5 million. During 2003, a debit balance of \$1,274,895 in minority interest was written-off due to a change in the intentions of our minority interest owner and a plan to dispose of the asset. In 2004, CanArgo came to an agreement to sell the refinery. NOTE 12 - COMMITMENTS AND CONTINGENCIES CanArgo has not filed any of its required 2002 or 2003 income tax or information returns required by various governmental authorities. Failure to file these returns carries significant penalties. CanArgo is taking steps to rectify the matter. CanArgo has not accrued for any penalties it may be required to pay. CanArgo has contingent obligations and may incur additional obligations, absolute or contingent, with respect to the acquisition and development of oil and gas properties and ventures in which it has interests that require or may require CanArgo to expend funds and to issue shares of its Common Stock. At December 31, 2003, CanArgo had a contingent obligation to issue 187,500 shares of common stock to Fielden Management Services PTY, Ltd (a third party management services company) upon satisfaction of conditions relating to the achievement of specified Stynawske field project performance standards. Under the Norio PSA the shareholders agreement with the other shareholder of Norio calls for a bonus payment of \$800,000 to be paid by CanArgo should commercial production be obtained from the Middle Eocene or older strata and a second bonus payment of \$800,000 should production from the Block from the Middle Eocene or older strata exceed 250 tons of oil per day over any 90 day period. If Georgian Oil exercises the Option available to it under the terms of the Norio farm-in agreement signed in September 2003, CanArgo would issue a further 3 million restricted shares to the minority interest holders from whom CanArgo acquired an additional 10.8% interest in CanArgo Norio. In May 2003, NOC entered into a new 12-month crude oil sales agreement whereby the buyer will provide a security payment of \$1,750,000 in return for the right to lift up to 5,000 metric tons of oil per month for the 12-month period commencing August 2003. At the end of the 12 months, the security payment will be repaid through the delivery of additional crude oil equal to the value of the security. This agreement replaces an existing crude oil sales agreement, where the buyer had already provided \$1,000,000 security. Following the success of the N100H well, NOC entered into a further oil sales agreement with the buyer for an additional monthly quantity of 2,500 metric tons of oil. The agreement runs to the end of 2004 and as security for payment and for having the option to lift oil on a monthly basis the buyer will provide additional security in the amount of \$550,000. The security will be repaid in oil at the end of the contract period. NOC has a total commitment to repay \$2,300,000 arising from security payments under oil sales agreements signed in May 2003 and October 2003. On July 2, 2003 CanArgo announced that its subsidiary CanArgo Norio had entered into a new Production Sharing Contract (PSC) for Blocks XI(G) and XI(H) (Mtskheta, Tetrtskaro and Gardabani areas), named the "Tbilisi PSC" in the Republic of Georgia. The license was subsequently issued on 9 July 2003 for a period of 25 years. These areas are located adjacent to CanArgo's existing acreage close to Tbilisi and cover in total some 485 km(2). Under the terms of the Tbilisi PSC, CanArgo Norio will evaluate existing seismic and geological data during the first year and acquire additional seismic data within four years of the effective date of the Agreement which is September 29, 2003. The total commitment over the next four years is \$350,000. The commercial terms of the Tbilisi PSC are similar to those governing CanArgo Norio's other exploration areas. F-21 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 12 - COMMITMENTS AND CONTINGENCIES (Continued) Lease Commitments - CanArgo leases office space under non-cancelable operating lease agreements. Rental expense for the years ended December 31, 2003, 2002 and 2001 was \$395,355, \$327,254 and \$353,594 respectively. Future minimum rental payments over the next five years for the Company's lease obligations as of December 31, 2003, are as follows: 2004 \$ 261,400 2005 240,750 2006 222,243 2007 220,000 2008 220,000 Thereafter 440,000\* ----- \$1,604,393 ===== \* This represents aggregate payments for 2 years. No parent company guarantees have been provided by CanArgo with respect to its contingent obligations and commitments. NOTE 13 - CONCENTRATIONS OF CREDIT RISK CanArgo's financial instruments that are exposed to concentrations of credit risk consist primarily of cash and cash equivalents, accounts

receivable and advances to oil and gas and other ventures. CanArgo places its temporary cash investments with high credit quality financial institutions. Accounts receivable relates primarily to entities active in the energy and manufacturing sectors. The concentration of credit risk associated with accounts receivable is reduced as CanArgo's debtors are spread across several countries and industries. NOTE 14 - STOCKHOLDERS' EQUITY On July 8, 1998, at a Special Meeting of Stockholders, the stockholders of CanArgo approved the acquisition of all of the common stock of CanArgo Oil and Gas ("CAOG") for Common Stock of the Company pursuant to the terms of an Amended and Restated Combination Agreement between those two companies (the "Combination Agreement"). Upon completion of the acquisition on July 15, 1998, CAOG became a subsidiary of CanArgo, and each previously outstanding share of CAOG common stock was converted into the right to receive 0.8 shares (the "Exchangeable Shares") of CAOG which are exchangeable generally at the option of the holders for shares of CanArgo's Common Stock on a share-for-share basis. On January 24, 2002 CanArgo announced that it had established May 24, 2002 as the redemption date for all of the Exchangeable Shares of CAOG since the number of outstanding Exchangeable Shares had fallen below the minimum 853,071 share threshold. Each Exchangeable Share was purchased by CanArgo for shares of CanArgo Common Stock on a share-for-share basis resulting in the issuance of an aggregate of 148,826 shares of Common Stock. No cash consideration was issued by CanArgo and the purchase did not increase the total number of shares of Common Stock of CanArgo deemed issued and issuable. The total number of shares of common stock authorized was 150,000,000 for 2003, 2002 and 2001. F-22 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements As of December 31, 2003, CanArgo had 5,000,000 shares of \$0.10 par value preferred stock authorized, of which none were outstanding. The Board of Directors may at any time issue additional shares of preferred stock and may designate the rights and privileges of a series of preferred stock without any prior approval by the stockholders. NOTE 14 - STOCKHOLDERS' EQUITY (Continued) During the years ended December 31, 2003 and 2002, the following transactions regarding CanArgo's Common Stock were consummated pursuant to authorization by CanArgo's Board of Directors or duly constituted committees thereof. Year Ended December 31, 2003 - In September 2003, CanArgo issued 6,000,000 shares at \$0.19 per share for purchase some of an additional 10.8% interest in CanArgo Norio. - In December 2003, CanArgo issued 2,000,000 shares at \$0.33 per share upon completion of the purchase of the interest of the farm-in partner in the Minavi well. - In December 2003, CanArgo issued 261,782 shares at \$0.33 per share upon completion of a Standby Equity Distribution Agreement that allows CanArgo, at its option, to issue shares to US-based investment fund Cornell Capital Partners LP up to a maximum value of \$6 million. Under the terms of the Agreement, CanArgo may, at its discretion, issue shares to Cornell at any time over the next two years. The maximum aggregate amount of the equity placements pursuant to the Agreement is \$6 million. Subject to this limitation, CanArgo may draw down up to \$200,000 in any seven-day period. The facility may be used in whole or in part entirely at CanArgo's discretion, subject to an effective registration. Shares issued to Cornell will be priced at a 3% discount to the lowest daily Volume Weighted Average Price ("VWAP") of CanArgo Energy Corporation shares traded on each of the five days following a drawdown notice by CanArgo. A commission of 5% will apply to each issue of CanArgo shares under the Agreement and will be payable to Cornell at the time of issue. The net effect of the 5% commission and the 3% discount is that Cornell shall pay 92.15% of the applicable lowest weighted price for each share of the Company's common stock. This facility was terminated on February 11, 2004 when the Company entered into a further standby equity distribution agreement with Cornell ("New Cornell Facility"). No funds had been drawn down under the original facility when it was terminated. In terms of the New Cornell Facility, Cornell will provide the CanArgo with an equity line of credit for 24 months. The New Cornell Facility allows CanArgo at its discretion to periodically issue and sell to Cornell up to \$20 million of shares of its common stock. The terms of the New Cornell Facility are materially the same as those for the original facility, with the exception that the New Cornell Facility has been extended to \$20 million and the maximum amount of each advance is set at \$600,000. No exercise of a Put will be made until the SEC has declared a Registration Statement effective. By way of fees and expenses, the Company shall issue Cornell a restricted stock certificate evidencing restricted shares of Common Stock in an amount equal to 2.07% of the Commitment Amount (\$20,000,000) based upon the Market Price for the Common Stock. The total amount of shares to be issued to Cornell is 850,000 of which 425,000 were issued upon execution of the agreement. Cornell will earn the remaining 425,000 in restricted shares of Common Stock once the SEC declares the Registration Statement effective. Year Ended December 31, 2002 - In February 2002, CanArgo issued 5,210,000 shares at \$0.34 per share upon completion of a private placement. - In May 2002, CanArgo issued 137,760 shares at \$0.21 to David Robson, CanArgo's Chief Executive

Officer, for gross proceeds of approximately \$29,000 upon completion of a private placement. F-23 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 14 - STOCKHOLDERS' EQUITY (Continued) - In May, 2002 CanArgo redeemed all of the Exchangeable Shares of CAOG since the number of outstanding Exchangeable Shares had fallen below the minimum 853,071 share threshold. Each Exchangeable Share was purchased by CanArgo for shares of CanArgo Common Stock on a share-for-share basis resulting in the issuance of an aggregate of 148,826 shares of Common Stock. No cash consideration was issued by CanArgo and the purchase did not increase the total number of shares of Common Stock of CanArgo deemed issued and issuable. Year Ended December 31, 2001 - In 2001, CanArgo issued 274,965 shares upon exchange by holders of Exchangeable Shares. - In July 2001, CanArgo issued 16,057,765 shares at \$0.41 per share upon completion of a private placement. NOTE 15 - NET LOSS PER COMMON SHARE Basic and diluted net loss per common share for the years ended December 31, 2003, 2002 and 2001 were based on the weighted average number of common shares outstanding during those periods. The weighted average number of shares used was 99,432,000, 96,643,744 and 83,869,579 respectively. Options to purchase CanArgo's Common Stock were outstanding during the years ended December 31, 2003, 2002 and 2001 but were not included in the computation of diluted net loss per common share because the effect of such inclusion would have been anti-dilutive. The total number of such shares excluded from diluted net loss per common share were 7,986,167, 6,734,501 and 7,092,001 for each of the years ended December 31, 2003, 2002 and 2001 respectively. NOTE 16 - INCOME TAXES CanArgo and its domestic subsidiaries file U.S. consolidated income tax returns. No benefit for U.S. income taxes has been recorded in these consolidated financial statements because of CanArgo's inability to recognize deferred tax assets under provisions of SFAS 109. Due to the implementation of the quasi-reorganization as of October 31, 1988, future reductions of the valuation allowance relating to those deferred tax assets existing at the date of the quasi-reorganization, if any, will be allocated to capital in excess of par value. A reconciliation of the differences between income taxes computed at the U.S. federal statutory rate of 34% and CanArgo's reported provision for income taxes is as follows: Year Ended December 31,

-----	2003	2002	2001	-----	-----	-----	Income tax benefit at statutory rate
-----	\$(2,386,000)	\$(1,811,418)	\$(4,494,238)	Benefit of losses not recognized	2,386,000	1,811,418	4,494,238
-----	-----	-----	-----	Provision for income taxes	\$ -	\$ -	\$ -
=====	Effective tax rate	0%	0%	0%	=====	=====	=====

===== F-24 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 16 - INCOME TAXES (Continued) The components of deferred tax assets consisted of the following as of December 31: 2003 2002 ----- Net operating loss carryforwards \$ 8,443,000 \$ 9,512,000 Foreign net operating loss carryforwards 5,953,000 5,142,000 Net timing differences on impairments and accelerated capital allowances 9,383,000 8,981,000 ----- 23,779,000 23,635,000 Valuation allowance (23,779,000) (23,635,000) ----- Net deferred tax asset recognized in balance sheet \$ - \$ - ===== On August 1, 1991, August 17, 1994, July 15, 1998 and June 28, 2000 CanArgo experienced changes in ownership as defined in Section 382 of the Internal Revenue Code ("IRC"). The effect of these changes in ownership is to limit the utilization of certain existing net operating loss carryforwards for income tax purposes to approximately \$413,000 per year on a cumulative basis. As of December 31, 2003, total U.S. net operating loss carryforwards were approximately \$24,833,000. Of that amount, approximately \$1,551,000 was incurred subsequent to the ownership change in 2000, \$26,426,000 was incurred prior to 2000 and therefore is subject to the IRC Section 382 limitation. See Note 2 of Notes to Consolidated Financial Statements. The net operating loss carryforwards expire from 2004 to 2022 The net operating loss carryforwards limited under the separate return limitation rules may only be offset against the separate income of the respective subsidiaries. CanArgo has also generated approximately \$13,628,000 of foreign net operating loss carryforwards. A significant portion of the foreign net operating loss carryforwards are subject to limitations similar to IRC Section 382. CanArgo's available net operating loss carryforwards may be used to offset future taxable income, if any, prior to their expiration. CanArgo may experience further limitations on the utilization of net operating loss carryforwards and other tax benefits as a result of additional changes in ownership. NOTE 17 - DISCONTINUED OPERATIONS CanArgo Standard Oil Products In September 2002, CanArgo approved a plan to sell CanArgo Standard Oil Products to finance Georgian and Ukrainian development projects and in October 2002, CanArgo agreed to sell its 50% holding to an unaffiliated company for \$4,000,000 in an arms-length transaction, with legal ownership being transferred upon receipt of final payment due originally in August 2003 and subsequently extended to June 2004. The agreed consideration to be exchanged does not result in an impairment of the carrying value of assets held for sale. The assets

and liabilities of CanArgo Standard Oil Products have been classified as "Assets held for sale" and "Liabilities held for sale" for all periods presented. The results of operations of CanArgo Standard Oil Products have been classified as discontinued for all periods presented. The minority interest related to CanArgo Standard Oil Products has not been reclassified for any of the periods presented, however net income from discontinued operations is disclosed net of taxes and minority interest. F-25 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 17 - DISCONTINUED OPERATIONS (Continued) The results of discontinued operations in respect of CanArgo Standard Oil Products consisted of the following for the years ending December 31: 2003 2002 2001 -----

Operating Revenues	\$ 9,837,445	\$ 7,390,138	\$ 6,607,489
Income Before Income Taxes and Minority Interest	392,411	366,556	733,335
Income Taxes (25,297)	(24,132)	(46,203)	
Minority Interest in Income	(183,557)	(171,212)	(343,566)
Net Income from Discontinued Operation	\$ 183,557	\$ 171,212	\$ 343,566

===== Gross consolidated assets and liabilities in respect of CanArgo Standard Oil Products that are included in "assets and liabilities held for sale" consisted of the following at December 31: 2003 2002 -----

Assets held for sale: Cash and cash equivalents	\$ 30,236	\$ 37,948
Accounts receivable	1,675,317	243,529
Inventory	247,758	224,733
Other current assets	174,049	155,079
Capital assets, net	6,629,450	6,326,478
Investment in other ventures, net	594,484	548,910
	\$9,351,294	\$7,536,677

===== Liabilities held for sale: Accounts payable \$ 174,506 \$ 143,296  
Current portion of long term debt 958,346 1,268,422  
Income taxes payable 261 48,880  
Long term debt 2,816,065 891,367  
----- \$3,949,178 \$2,351,965 =====

Investments in other ventures include three petrol station sites in Tbilisi, Georgia in which CanArgo has a 50% non-controlling interest. CanArgo accounts for its interest in the three petrol station sites using the equity method and consolidates the remaining sites in which it has controlling interest. In 2002, CanArgo purchased the remaining 50% of Petro-Invest, a petrol station site in which CanArgo previously held a 50% non-controlling interest. This site is now consolidated in the results of CanArgo Standard Oil Products, above. Cash consideration received as of December 31, 2003 in respect of this transaction was \$2,000,000 and has been recorded in other liabilities (see Note 10). The sale will be reflected on payment of the consideration in full plus any interest due which is now expected to be in June 2004. In any event, ownership in the asset will only transfer to Westrade Alliance on payment of the consideration in full. F-26 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 17 - DISCONTINUED OPERATIONS (Continued) In 2002, the three petrol station sites that CanArgo has a 50% non-controlling interest entered into credit facility agreements amounting to \$550,000 with a commercial lender in Georgia. As of December 31, 2003, \$261,824 under the facilities were outstanding. The loans bear interest at 18% per annum and are secured by the assets of the petrol stations. The full amount of the loans are to be repaid by June 2005. No company guarantees have been provided by CanArgo with respect to these loans. From November 2001 through December 2003, CanArgo Standard Oil Products Limited entered into eight credit facility agreements totaling \$5,640,000 with commercial lenders in Georgia and Greece to fund expansion of its petrol station network. As of December 31, 2003, CanArgo had outstanding balances of \$3,774,411 related to these credit facilities. The loans bear interest between 13% and 18% per annum and are secured by the assets of the petrol stations. The full amounts of the loans are to be repaid by August 2008. No guarantees have been provided by CanArgo with respect to these loans. The remaining 50% interest in CanArgo Standard Oil Products is held by Standard Oil Products of Georgia and an individual, Mr. Levan Pkhakazde, who is one of the founders of Standard Oil Products and the General Director of CanArgo Standard Oil Products. During 2003 CanArgo approved a plan to sell its interest in the Bugruvativske field and its interest in GAOR. The assets and liabilities of these companies have been classified as "Assets held for sale" and "Liabilities held for sale" for all period presented. The results of operations of the companies have been classified as discontinued operations for all period presented. Lateral Vector Resources Inc Lateral Vector Resources Inc. ("LVR"), a wholly-owned subsidiary of CanArgo, negotiated and concluded with Ukrnafta, the Ukrainian State Oil Company, a Joint Investment Production Activity ("JIPA") agreement in 1998 to develop the Bugruvativske Oil Field located in Eastern Ukraine. In 2003, due to the lack of progress with the implementation of the JIPA, and failure to reach a negotiated agreement with Ukrnafta, management reached the decision to dispose of its interest in the Bugruvativske project and withdraw from Ukraine. The company is currently in negotiations with a potential buyer for the disposal of its 100% interest in LVR. Consequently, CanArgo recorded in 2003 a write-down in respect to the LVR deal and the acquisition of the Bugruvativske Field of approximately \$4.8 million. The assets and liabilities of LVR have been classified as "Assets held for sale" and "Liabilities held for sale" for all periods presented. The results of operations of LVR have been

classified as discontinued for all periods presented. The results of discontinued operations in respect of LVR consisted of the following for the years ending December 31: 2003 2002 2001 ----- Income (Loss) Before Income Taxes and Minority Interest \$(4,732,418) \$ (12,735) \$ (38,792) Net Income (Loss) from Discontinued Operation \$(4,732,418) \$ (12,735) \$ (38,792) ===== F-27 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 17 - DISCONTINUED

OPERATIONS (Continued) Gross consolidated assets in respect of LVR that are included in "assets held for sale" consisted of the following at December 31: 2003 2002 ----- Assets held for sale: Capital assets, net \$ 250,000 \$ 4,960,517 ----- \$ 250,000 \$ 4,960,517 ===== There were no Gross consolidated liabilities in respect of LVR included in "liabilities held for sale" at December 31 2003 and 2002.

Georgian American Oil Refinery In 2003, CanArgo approved a plan to dispose of its interest in GAOR as the refinery had remained closed since 2001 and neither CanArgo nor its partners could find a commercially viable option to putting the refinery back into operation. In February 2004, management reached an agreement with a local Georgian company to sell CanArgo's 51% interest in GAOR for a nominal price of one US dollar and the assumption of all the obligations and debts of GAOR to the State of Georgia including deferred tax liabilities of approximately \$380,000. The assets and liabilities of GAOR have been classified as "Assets held for sale" and "Liabilities held for sale" for all periods presented. The results of operations of GAOR have been classified as discontinued for all periods presented. The minority interest related to GAOR has not been reclassified for any of the periods presented, however net income from discontinued operations is disclosed net of taxes and minority interest. During 2003, a debit balance of \$1,274,895 in minority interest was written-off due to a change in the intentions of our minority interest owner and a plan to dispose of the asset. The plan to dispose of the asset also led to the write-off of an inter-company payable relating to oil sales purchased from Ninotsminda Oil Company. These items have been respectively recorded in impairment of other assets and other income (expense) components of continuing operations. An impairment to the assets of GAOR in 2001 has also been recorded in the impairment of other assets component of continuing operations. The results of discontinued operations in respect of GAOR consisted of the following for the years ending December 31: 2003 2002 2001 ----- Operating Revenues \$ - \$ 90,187 \$ 2,595,763 Income (Loss) Before Income Taxes and Minority Interest (1,485,705) (16,180) (3,848,182) Minority Interest in Loss (492,951) 7,928 2,138,163 ----- Net Income from Discontinued Operation \$(1,978,656) \$ (8,252) \$(1,710,019) =====

F-28 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 17 - DISCONTINUED OPERATIONS (Continued) Gross consolidated assets and liabilities in respect of GAOR that are included in "assets and liabilities held for sale" consisted of the following at December 31: 2002 2003 ----- Assets held for sale: Cash and cash equivalents \$ 14,095 \$ 13,304 Accounts receivable - 55,733 Inventory 29,482 27,028 Other current assets 13,915 - Capital assets, net 100,000 100,000 ----- \$ 157,492 \$ 196,065 ===== Liabilities held for sale: Accounts payable \$ 498,528 \$ 466,762 ----- \$ 498,528 \$ 466,762 ===== 3-megawatt duel fuel power generator In 2003, CanArgo signed a sales agreement disposing of a 3-megawatt duel fuel power generator for \$600,000. Following receipt of a non-refundable deposit of \$300,000. The generator has been classified as "Assets held for sale" for all periods presented. The generator was impaired in 2003 and 2001 by \$80,000 and \$500,000 respectively to reflect its fair value less cost to sell. The results for the generator are the following for the years ending December 31: 2003 2002 2001 ----- Income (Loss) Before Income Taxes and Minority Interest \$ (80,000) \$ - \$ (500,000) ----- Net Income (Loss) from Discontinued Operation \$ (80,000) \$ - \$ (500,000) =====

Gross consolidated assets in respect of the generator included in "assets held for sale" consisted of the following at December 31: 2003 2002 ----- Assets held for sale: Capital assets, net \$ 587,291 \$ 559,270 ----- \$ 587,291 \$ 559,270 ===== NOTE 18 - SEGMENT AND GEOGRAPHICAL DATA During the year ended December 31, 2003 CanArgo's continuing operations operated through two business segments, oil and gas exploration and refining. F-29 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 18 - SEGMENT AND GEOGRAPHICAL DATA (Continued) Operating revenues from continuing operations by business segment and geographical area were as follows for the years ended December 31: 2003 2002 2001 ----- Operating Revenues from Continuing Operations: Oil and Gas Exploration, Development and Production Eastern Europe \$ 7,882,070 \$ 4,179,208 \$ 4,873,623 Other Eastern Europe 223,608 1,322,554 608,032 Intersegment Eliminations (898) (16,007) (906,545) ----- Total \$ 8,104,780 \$ 5,485,755 \$ 4,575,110 =====

===== In 2003, the Company sold its oil and gas production in Eastern Europe to thirty two (2002 - twenty two, 2001 - five) customers. In 2003 sales to three third party customers represented 42%, 32% and 17% of oil and gas revenue respectively. In 2002 sales to four third party customers represented 27%, 25%, 19% and 19% of oil and gas revenue respectively. In 2001 sales to three customers represented 67%, 12% and 12% of oil and gas revenue respectively. Operating profit (loss) from continuing operations for the business segment and geographical area were as follows for the years ending December 31: 2003 2002 2001 -----

Oil and Gas Exploration, Development and Production Eastern Europe	\$ 4,750,974	\$ 581,935	\$ (7,037,431)
Corporate and Other Expenses	(4,909,615)	(5,484,062)	(4,800,531)
			----- Total
	(4,902,127)	\$(11,837,962)	\$(158,641)

===== In the fourth quarter of 2003, CanArgo approved a plan to sell its interest in the Bugruvativske field and recorded a write-down of \$4,790,727 in 2003 of unproved oil and gas properties to reflect the estimated recoverable amount from disposal. The asset was subsequently reclassified to assets held for sale. In the third quarter of 2003, CanArgo announced it had reached conditional agreement to sell its interest in Boryslaw Oil Company, the joint venture in West Ukraine currently operating the Stynawske oilfield. Fountain Oil Boryslaw, CanArgo's wholly owned subsidiary which holds its 45% interest in Boryslaw Oil Company, was sold for \$1,000,000 payable in eight equal tranches. A gain on disposal of the investment of Boryslaw Oil Company of \$664,576 was recorded with the write down of the Bugruvativske field. The net impairment to oil and gas properties in 2003 was therefore \$4,126,151. F-30 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 18 - SEGMENT AND GEOGRAPHICAL DATA (Continued) As a result of application of the ceiling test limitation, CanArgo recorded a write-down in 2002 of oil and gas properties of \$1,600,000. The write-down of oil and gas properties and generating equipment was recorded in operating loss for oil and gas, exploration and production. The write-down of minority interest share of losses in the refinery was recorded in loss for refining. In 2001, an impairment of \$7,300,000 as a result of application of the ceiling test limitation was recorded in operating loss for oil and gas, exploration. In 2003 depreciation, depletion and amortization of \$3,087,127 and \$205,121 were recorded in operating loss for oil and gas, exploration and production and corporate and other expenses respectively. In 2002 depreciation, depletion and amortization of \$2,131,160 and \$185,761 were recorded in operating loss for oil and gas, exploration and production and corporate and other expenses respectively. Interest expense of \$35,387, interest income of \$32,413 and interest income \$642,216 was recorded on corporate and other expenses in 2003, 2002 and 2001. Identifiable assets by business segment and geographical area were as follows at December 31: 2003 2002 -----

Corporate Eastern Europe	\$ 5,185,020	\$ 107,226
Western Europe (principally cash)	463,312	2,274,847
		----- Total Corporate
	57,945,304	54,642,008
Oil and Gas Exploration, Development and Production Eastern Europe	57,945,304	54,642,008
Assets Held for Sale Eastern Europe	9,758,156	12,693,259
Western Europe	587,921	559,270
		----- Total Assets Held for Sale
	10,346,077	13,252,529
Other Energy Projects Eastern Europe	75,000	459,308
		----- Total Identifiable Assets
	\$ 74,014,713	\$ 70,735,918

===== F-31 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 19 - SUPPLEMENTAL CASH FLOW INFORMATION AND NONMONETARY TRANSACTIONS Supplemental cash flow information consists of the following for the years ended December 31: 2003 2002 2001 ----- Supplemental schedule of non-cash activities: Issuance of common stock in connection with acquisition of minority interest shareholders interest in subsidiary \$1,140,000 \$ - \$ - Issuance of common stock in connection with acquisition of farm-in interest in project 660,000 - - Corporate and Other Expenses - 29,000 - ----- Total \$1,800,000 \$ 29,000 \$ -

===== The cash paid for interest expense for the years ended December 31, 2003, 2002 and 2001 was \$35,387, \$734 and \$35,353, respectively. There was no cash paid for income taxes for the years ended December 31, 2003, 2002 and 2001. NOTE 20 - STOCK-BASED COMPENSATION PLANS Pursuant to the 1995 Long-Term Incentive Plan (the "1995 Plan") adopted by CanArgo in February 1996, 7,500,000 shares of the CanArgo's common stock have been authorized for possible issuance under the 1995 Plan. Stock options granted under the 1995 Plan may be either incentive stock options or non-qualified stock options. Options expire on such date as is determined by the committee administering the 1995 Plan, except that incentive stock options may expire no later than 10 years from the date of grant. Pursuant to the 1995 Plan, a specified number of stock options exercisable at the then market price are granted annually to non-employee directors of CanArgo, which become 100% vested six months from the date of grant. Stock appreciation rights entitle the holder to receive payment in cash or common stock equal in value to the excess of the fair market value of a specified number of shares of common stock on the date of exercise

over the exercise price of the stock appreciation right. No stock appreciation rights have been granted through December 31, 2003. The exercise price and vesting schedule of stock appreciation rights are determined at the date of grant. Under the 1995 Plan, 5,047,167 options were outstanding at December 31, 2003. Pursuant to the terms of the Combination Agreement, on July 15, 1998 each stock option granted under CAOG's existing Stock Option Plan (the "CAOG Plan") to purchase a CAOG common share was converted into an option to purchase 0.8 shares of the CanArgo's Common Stock. Pursuant to the CAOG Plan, which has been adopted by CanArgo, a total of 988,000 shares of CanArgo's Common Stock have been authorized for issuance. Stock options granted under the CAOG Plan expire on such date as is determined by the committee administering the CAOG Plan, except that the term of stock options may not exceed 10 years from the date of grant. Under the CAOG Plan, 719,000 options were outstanding at December 31, 2003. In 2000, special stock options and warrants to purchase 2,220,000 shares of CanArgo's common stock were issued to various individuals who were serving or were expected in the future to serve CanArgo as officers, directors and employees. At December 31, 2003, all 2,220,000 special stock options and warrants remained outstanding.

F-32 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 20 - STOCK-BASED COMPENSATION PLANS (Continued) In March 2003, CanArgo Energy Corporation resolved to issue 1,589,166 new options and amend the terms and conditions attaching to 5,117,501 of existing options. The exercise price for the newly issued options is US \$0.10 (approximately NOK 0.71) approximately 2.5 times the trading share price on the date of grant. All these options vested immediately and expire on March 4, 2008. With regards to individual officers and directors, details of existing and new options are as follows:

Options Total	David Robson	Vincent McDonnell	Russ Hammond	Nils Trulsvik	Liz Landles
2,666,667	333,333	300,000	346,250	346,250	172,000
3,000,000	500,000	500,000	153,750	153,750	28,000

The purpose of the Company's stock option plans is to further the interest of the Company by enabling officers, directors, employees, consultants and advisors of the Company to acquire an interest in the Company by ownership of its stock through the exercise of stock options and stock appreciation rights granted under its various stock option plans.

F-33 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 20 - STOCK-BASED COMPENSATION PLANS (Continued) A summary of the status of stock options granted under the 1995 Plan, CAOG Plan and special stock options and warrants is as follows:

Shares Issuable	Weighted Shares Under Average Available for Outstanding Exercise Issue Options Price
BALANCE, DECEMBER 31, 2000	468,000
Options (1995 Plan): Increase in shares available for issue	3,500,000
Granted at market (1,795,000)	1,795,000
Exercised - - Expired	123,335 (123,335)
CAOG Plan Authorization: Granted at market	(185,000) 185,000
Exercised - - Expired	- - - - -
BALANCE, DECEMBER 31, 2001	2,111,335
Options (1995 Plan): Increase in shares available for issue	7,092,001
Granted at market (130,000)	130,000
Exercised - - Expired	307,500 (307,500)
CAOG Plan Authorization: Granted at market - - Exercised - - Expired	180,000 (180,000)
BALANCE, DECEMBER 31, 2002	2,468,835
Options (1995 Plan): Increase in shares available for issue	6,734,501
Granted at market (1,291,833)	1,291,833
Exercised - - Expired	132,500 (132,500)
CAOG Plan Authorization: Granted at market (297,333)	297,333
Exercised - - Expired	205,000 (205,000)
BALANCE, DECEMBER 31, 2003	1,217,169

F-34 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 20 - STOCK-BASED COMPENSATION PLANS (Continued) Shares issuable upon exercise of vested options and the corresponding weighted average exercise price are as follows:

Options	Exercise Price	December 31, 2001	December 31, 2002	December 31, 2003
3,452,831	\$ 0.91	5,114,834	\$ 0.93	7,337,167
\$ 0.23				\$ 0.23

The weighted average fair value of options granted during the year was \$0.10, \$0.14 and \$0.71 for the years ended December 31, 2003, 2002 and 2001 respectively. The following table summarizes information about stock options outstanding at December 31, 2003:

Options Outstanding	Options Exercisable	Number	Number of Shares
Weighted	Weighted	Of Shares	Weighted
Outstanding at	Average	Average	Exercisable at
December 31, 2003	Exercise Price	2003 Term Price	2003 Price
\$0.10 to \$0.14	6,736,667	4.23	0.10
\$0.15 to \$0.69	625,000	1.44	1.44
\$0.10 to \$1.44	7,377,167	0.23	0.23

As discussed in Note 1, Summary of Significant Accounting Policies, in August 2003, the Company adopted SFAS No.

123 Accounting For Stock-Based Compensation, as amended by SFAS No. 148 Accounting for Stock-Based Compensation--Transition and Disclosure--an amendment of FASB Statement No. 123, effective as of January 1, 2003. The Company has elected to utilize the "prospective" method of transitioning from the intrinsic value to the fair value method of accounting for stock-based compensation as allowed by SFAS No. 148. This change decreased 2003 net income by approximately \$276,507. Stock based awards in existence prior to 2003 will continue to be accounted for under APB Opinion No. 25, "Accounting for Stock Issued to Employees," unless they are re-priced or modified. Prior to 2003, the Company applied APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for stock-based compensation. Under Opinion No. 25, stock-based employee compensation cost was not recognized in net income when stock options granted had an exercise price equal, or greater, to the market value of the underlying common stock on the date of grant.

F-35 CANARGO ENERGY CORPORATION Notes to Consolidated Financial Statements NOTE 21 - RELATED PARTY TRANSACTIONS Of the 50% of CanArgo Standard Oil Products not held by CanArgo, 41.65% is held by Standard Oil Products, an unrelated third party entity, and 8.35% is held by an individual, Mr Levan Pkhakadze, who is one of the founders of Standard Oil Products and is an officer and director of CanArgo Standard Oil Products. The majority of refined product purchased by CanArgo Standard Oil Products for resale at its petrol stations is purchased from a company controlled by Standard Oil Products who together with and an individual shareholder, own the 50% interest in CanArgo Standard Oil Products not held by CanArgo. Total product purchases from the related company in 2003 were \$7,229,000 (\$5,263,000 in 2002). Certain equipment is provided to Georgian British Oil Company Ninotsminda by a company owned by significant employees of Georgian British Oil Company Ninotsminda. Total rental payments for this equipment in 2003 were \$183,428 and \$125,729 in 2002. In 2003, the same company provided additional services to Georgian British Oil Company Ninotsminda in accordance with the farm-in agreement in respect of the Manavi well for the value of \$450,000. Vazon Energy is a company solely owned by Dr. Robson. A management services agreement exists between CanArgo Energy Corporation and Vazon Energy whereby the services of Dr. Robson, Mrs. Landles and Mr. Maroney are provided to CanArgo. J.F. Russell Hammond, a non-executive director of CanArgo, is also an investment advisor to Provincial Securities who became a minority shareholder in the Norio PSA through a farm-in agreement to the Norio MK72 well. On September 4, 2003, co-incident with the Georgian Oil farm-in to the Norio PSA, Provincial Securities was given 2,273,523 shares of CanArgo common stock in exchange for his interest in the Norio PSA (see Note 11). Transactions with affiliates are reviewed and voted on solely by non-interested directors.

F-36 CANARGO ENERGY CORPORATION Supplemental Financial Information

	2002	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER	YEAR
Operating revenue from continuing operations	\$ 1,141,458	\$ 1,859,995	\$ 2,494,029	\$ 2,609,298	\$ 8,104,780	
Operating income (Loss) from continuing operations	(965,818)	(165,838)	273,044	699,971	(158,641)	
Net income (loss) from continuing operations	(939,218)	(155,942)	281,551	57,621	(755,988)	
Net income (loss) from discontinued operations, net of taxes and minority interest	(9,142)	52,214	32,167	(6,682,756)	6,607,517	
Cumulative effect of change in accounting policy	41,290	- - -	41,290			
Net income (loss) (907,070)	(103,728)	313,718	(6,625,135)	(7,322,215)		
Comprehensive income (loss)	(876,905)	(157,974)	325,529	(6,763,996)	(7,473,346)	
Net loss per common share - basic and diluted from continuing operations	(0.01)	- - -	(0.01)			
Net loss per common share - basic and diluted from discontinued operations	- - -	(0.07)	(0.07)			
Net loss per common share - basic and diluted	(0.01)	- - -	(0.01)	- - -	(0.07)	(0.08)

2002 ----- FIRST SECOND THIRD FOURTH QUARTER QUARTER QUARTER QUARTER YEAR -----

	2002	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER	YEAR
Operating revenue from continuing operations	\$ 2,881,434	\$ 980,163	\$ 696,406	\$ 927,752	\$ 5,485,755	
Operating income (loss) from continuing operations	135,062	(1,719,662)	(462,237)	(2,855,290)	(4,902,127)	
Net income (loss) from continuing operations	(18,976)	(1,321,902)	(1,264,453)	(2,872,595)	(5,477,926)	
Net income (loss) from discontinued operations, net of taxes and minority interest	106,019	30,763	36,608	(23,165)	150,225	
Cumulative effect of change in accounting policy	- - -	- - -	- - -	- - -	- - -	
Net income (loss) 87,043	(1,291,139)	(1,227,845)	(2,895,760)	(5,327,701)		
Comprehensive income (loss)	87,043	(1,342,396)	(1,078,650)	(2,989,030)	(5,323,033)	
Net loss per common share - basic and diluted from continuing operations	(0.01)	(0.01)	(0.03)	(0.06)		
Net loss per common share - basic and diluted from discontinued operations	- - -	- - -	- - -	- - -		
Net loss per common share - basic and diluted	(0.01)	(0.01)	(0.03)	(0.06)		

F-37 CANARGO ENERGY CORPORATION Supplemental Financial Information Supplemental Oil and Gas Disclosure - Unaudited ESTIMATED NET QUANTITIES OF OIL AND GAS RESERVES Users of this information should be aware that



the process of estimating quantities of "proved" and "proved developed" natural gas and crude oil reserves is very complex, requiring significant subjective decisions in the evaluation of all available geological, engineering and economic data for each reservoir. The data for a given reservoir may also change substantially over time as a result of numerous factors including, but not limited to, additional development activity, evolving production history and continual reassessment of the viability of production under varying economic conditions. Consequently, material revisions to existing reserve estimates occur from time to time. Although every reasonable effort is made to ensure that reserve estimates reported represent the most accurate assessments possible, the significance of the subjective decisions required and variances in available data for various reservoirs make these estimates generally less precise than other estimates presented in connection with financial statement disclosures. Proved reserves are estimated quantities of natural gas, crude oil and condensate that geological and engineering data demonstrate, with reasonable certainty, to be recoverable in future years from known reservoirs with existing equipment under existing economic and operating conditions. Proved developed reserves are proved reserves that can be expected to be recovered through existing wells with existing equipment and under existing economic and operating conditions. No major discovery or other favorable or adverse event subsequent to December 31, 2003 is believed to have caused a material change in the estimates of proved or proved developed reserves as of that date. The following tables sets forth the Company's net proved oil and gas reserves, including the changes therein, and net proved developed reserves at December 31, 2003, as estimated by the independent petroleum engineering firm, Oilfield Production Consultants Limited: Net Proved Developed and Undeveloped Reserves - Oil (In Thousands of Barrels) - Republic of Georgia 2003 2002 2001 -----

-----	-----	January 1	2,901	3,729	9,665	Purchase of properties	- - -	Revisions of previous estimates	1,951	(630)	(5,689)
-----	-----	December 31	4,395	2,901	3,729	-----	-----	-----	-----	-----	-----
-----	-----	December 31, 2003	2,336	-----	-----	-----	-----	-----	-----	-----	-----

F-38 CANARGO ENERGY CORPORATION Supplemental Financial Information Supplemental Oil and Gas Disclosure - Unaudited Net Proved Developed and Undeveloped Reserves - Gas (In Million Cubic Feet) - Republic of Georgia 2003 2002 2001 -----

-----	-----	January 1	2,414	5,025	13,500	Purchase of properties	- - -	Revisions of previous estimates	(197)	(2,265)	(7,365)
-----	-----	December 31	1,941	2,414	5,025	-----	-----	-----	-----	-----	-----
-----	-----	December 31, 2003	1,133	-----	-----	-----	-----	-----	-----	-----	-----

Net proved oil reserves in the Republic of Georgia consisted of the following at December 31: 2003 2002 -----

-----	-----	PSC	PSC	Oil Reserves Entitlement	Oil Reserves Entitlement	Gross Volumes	Gross Volumes (MSTB)	(MSTB)	(1)	(MSTB)	(MSTB)	(1)
-----	-----	Proved	Developed	Producing	3,593	2,336	4,016	2,811	Proved	Undeveloped	3,169	2,059
-----	-----	Total Proven	6,762	4,395	4,150	2,901	-----	-----	-----	-----	-----	-----

Net proved gas reserves in the Republic of Georgia consisted of the following at December 31: 2003 2002 -----

-----	-----	PSC	PSC	Gas Reserves Entitlement	Gas Reserves Entitlement	Gross Volumes	Gross Volumes (MMCF)	(MMCF)	(1)	(MMCF)	(MMCF)	(1)
-----	-----	Proved	Developed	Producing	1,742	1,133	7,952	2,385	Proved	Undeveloped	1,243	808
-----	-----	Total Proven	2,985	1,941	8,048	2,414	-----	-----	-----	-----	-----	-----

(1) PSC Entitlement Volumes attributed to CanArgo are calculated using the "economic interest method" applied to the terms of the production sharing contract. PSC Entitlement Volumes are those produced volumes which, through the production sharing contract, accrue to the benefit of Ninotsminda Oil Company after deduction of Georgian Oil's share which includes all Georgian taxes, levies and duties. As a result of CanArgo's interest in Ninotsminda Oil Company, these volumes accrue to the benefit of CanArgo for the recovery of capital, repayment of operating costs and share of profit. F-39 CANARGO ENERGY CORPORATION Supplemental Financial Information Supplemental Oil and Gas Disclosure - Unaudited Results of operations for oil and gas producing activities for 2003, 2002 and 2001 are as follows: Republic of Year Ended December 31, 2003 Georgia -----

-----	Revenues	\$ 7,882,870	Operating expenses	1,051,905	Depreciation, depletion and amortization	2,634,459
-----	Operating Income (Loss)	4,196,506	Income tax provision	-	Results of Operations for Oil and Gas Producing Activities	\$ 4,196,506
-----	Revenues	\$ 4,179,208	Operating expenses	1,537,917	Depreciation, depletion and amortization	3,353,266
-----	Operating Income (Loss)	(711,975)	Income tax provision	-	Results of Operations for Oil and Gas Producing Activities	\$ (711,975)
-----	Revenues	\$	Operating expenses		Depreciation, depletion and amortization	
-----	Operating Income (Loss)		Income tax provision		Results of Operations for Oil and Gas Producing Activities	\$

4,873,623 Operating expenses 1,568,011 Depreciation, depletion and amortization 10,167,368 ----- Operating Income (Loss) (6,861,756) Income tax provision - ----- Results of Operations for Oil and Gas Producing Activities \$ (6,861,756) ===== Costs incurred for oil and gas property acquisition, exploration and development activities for 2003, 2002 and 2001 are as follows: Year Ended December 31, 2003 Eastern Europe ----- Property Acquisition Unproved \* \$ - Proved - Exploration 324,467 Development 5,200,614 ----- Total costs incurred \$ 5,525,081 ===== F-40 CANARGO ENERGY CORPORATION Supplemental Financial Information Supplemental Oil and Gas Disclosure - Unaudited Year Ended December 31, 2002 Eastern Europe ----- Property Acquisition Unproved \* \$ - Proved - Exploration 12,167,238 Development 543,280 ----- Total costs incurred \$ 12,710,518 ===== Year Ended December 31, 2001 Eastern Europe ----- Property Acquisition Unproved \* \$ 5,186,002 Proved - Exploration 5,851,306 Development 2,054,989 ----- Total costs incurred \$ 13,092,297 ===== \* These amounts represent costs incurred by CanArgo and excluded from the amortization base until proved reserves are established or impairment is determined.

**STANDARDIZED MEASURE OF DISCOUNTED FUTURE NET CASH FLOWS RELATING TO PROVED OIL AND GAS RESERVES** The following information has been developed utilizing procedures prescribed by SFAS No. 69 Disclosure about Oil and Gas Producing Activities ("SFAS 69") and based on crude oil reserve and production volumes estimated by the Company's engineering staff. It may be useful for certain comparative purposes, but should not be solely relied upon in evaluating the Company or its performance. Further, information contained in the following table should not be considered as representative of realistic assessments of future cash flows, nor should the Standardized Measure of Discounted Future Net Cash Flows be viewed as representative of the current value of the Company. CanArgo believes that the following factors should be taken into account in reviewing the following information: (1) future costs and selling prices will probably differ from those required to be used in these calculations; (2) actual rates of production achieved in future years may vary significantly from the rate of production assumed in the calculations; (3) selection of a 10% discount rate is arbitrary and may not be reasonable as a measure of the relative risk inherent in realizing future net oil and gas revenues; and (4) future net revenues may be subject to different rates of income taxation. Under the Standardized Measure, future cash inflows were estimated by applying period-end oil prices adjusted for fixed and determinable escalations to the estimated future production of period-end proven reserves. Future cash inflows were reduced by estimated future development, abandonment and production costs based on period-end costs in order to arrive at net cash flow before tax. Future income tax expenses has been computed by applying period-end statutory tax rates to aggregate future pre-tax net cash flows, reduced by the tax basis of the properties involved and tax carryforwards. Use of a 10% discount rate is required by SFAS No. 69. F-41 CANARGO ENERGY CORPORATION Supplemental Financial Information Supplemental Oil and Gas Disclosure - Unaudited Management does not rely solely upon the following information in making investment and operating decisions. Such decisions are based upon a wide range of factors, including estimates of probable as well as proven reserves and varying price and cost assumptions considered more representative of a range of possible economic conditions that may be anticipated. The standardized measure of discounted future net cash flows relating to proved oil and gas reserves is as follows: Republic of DECEMBER 31, 2003 (IN THOUSANDS) Georgia ----- Future cash inflows \$ 90,674 Less related future: Production cots 24,621 Development and abandonment costs 6,407 ----- Future net cash flows before income taxes 59,646 Future income taxes (1) (1,596) ----- Future net cash flows 58,050 10% annual discount for estimating timing of cash flows 20,520 ----- Standardized measure of discounted future net cash flows \$ 37,530 ===== Republic of DECEMBER 31, 2002 (IN THOUSANDS) Georgia ----- Future cash inflows \$ 54,761 Less related future: Production cots 17,959 Development and abandonment costs 7,500 ----- Future net cash flows before income taxes 29,302 Future income taxes (1) (600) ----- Future net cash flows 28,702 10% annual discount for estimating timing of cash flows 14,595 ----- Standardized measure of discounted future net cash flows \$ 14,107 ===== (1) Future cash flows are based on PSC Entitlement Volumes attributed to CanArgo using the "economic interest method" applied to the terms of the production sharing contract. PSC Entitlement Volumes are those produced volumes which, through the production sharing contract, accrue to the benefit of Ninotsminda Oil Company after deduction of Georgian Oil's share which includes all Georgian taxes, levies and duties. As a result of CanArgo's interest in Ninotsminda Oil Company, these volumes accrue to the benefit of CanArgo for the recovery of capital, repayment of operating costs and share of profit. F-42 CANARGO ENERGY CORPORATION Supplemental Financial Information Supplemental Oil and Gas Disclosure - Unaudited A summary of the changes in the standardized measure of discounted future net cash flows applicable to proved oil and gas

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reserves is as follows: December 31, 2003 ----- In Thousands 2003 2002 2001 -----  
 ----- Beginning of year \$ 14,107 \$ 16,695 \$ 62,966 Purchase (sale) of reserves in place - - - Revisions of previous  
 estimates 24,576 (6,978) (36,196) Development costs incurred during the period 324 543 2,055 Additions to proved  
 reserves resulting from extensions, discoveries and improved recovery - - - Accretion of discount - - - Sales of oil and  
 gas, net of production costs (6,829) (2,625) (2,327) Net change in sales prices, net of production costs 8,317 4,990  
 (12,865) Changes in production rates (timing) and other (2,965) 1,482 3,062 ----- ----- Net increase  
 (decrease) 23,423 (2,588) (46,271) ----- ----- End of year \$ 37,530 \$ 14,107 \$ 16,695 =====  
 ===== F-43