

Twoco Petroleums Ltd.
Consolidated Financial Statements
December 31, 2004

Management's Responsibility for Financial Reporting

The Management of Twoco Petroleums Ltd. is responsible for the preparation of all information included in this Annual Report. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and include certain estimates that reflect Management's best estimates and judgments. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. The financial information contained elsewhere in this Annual Report has been reviewed to ensure consistency with that in the consolidated financial statements.

Management maintains appropriate systems of internal control that provide reasonable assurance that transactions are appropriately authorized, assets are safeguarded from loss or unauthorized use and financial records provide reliable and accurate information for the preparation of financial statements.

Deloitte & Touche LLP, an independent firm of chartered accountants, was appointed by the shareholders of Twoco Petroleums Ltd. to audit the consolidated financial statements of the Company and provide an independent professional opinion. Their report is presented with the consolidated financial statements.

The Board of Directors, through its Audit Committee, has reviewed the consolidated financial statements including notes thereto with Management and Deloitte & Touche LLP. The members of the Audit Committee are composed of independent directors who are not employees of the Company. The Company's Board of Directors has approved the information contained in the consolidated financial statements based on the recommendation of the Audit Committee.

Wayne A. Malinowski
President and Chief Executive Officer

Timothy A. Bashforth
Secretary and Treasurer

April 8, 2005

Auditors' Report

To the Shareholders of
Twoco Petroleum Ltd.

We have audited the consolidated balance sheets of Twoco Petroleum Ltd. as at December 31, 2004 and December 30, 2003 and the consolidated statements of income (loss) and retained earnings (deficit) and of cash flows for the period from December 31, 2003 to December 31, 2004 and the year ended December 30, 2003. 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 in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2004 and December 30, 2003 and the results of its operations and its cash flows for the period from December 31, 2003 to December 31, 2004 and the year ended December 30, 2003 in accordance with Canadian generally accepted accounting principles.

Calgary, Alberta
April 8, 2005

(signed by) "Deloitte & Touche LLP"

Chartered Accountants

Twoco Petroleum Ltd.
Consolidated Balance Sheets
December 31, 2004 and December 30, 2003

	2004	2003 <i>(restated - see note 2)</i>
Assets		
Current assets		
Cash and cash equivalents	\$ 3,945,069	\$ 1,442,947
Accounts receivable	1,392,058	410,425
Prepaid expenses and deposits	<u>252,930</u>	<u>92,133</u>
	5,590,057	1,945,505
Property, plant and equipment (note 5)	<u>13,797,372</u>	<u>9,208,726</u>
	<u>\$ 19,387,429</u>	<u>\$ 11,154,231</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 13)	\$ 1,298,797	\$ 343,085
Income taxes payable	122,975	-
Due to officers and directors (note 7)	370,052	-
Debentures payable (note 8)	<u>1,500,000</u>	<u>-</u>
	3,291,824	343,085
Due to officers and directors (note 7)	370,051	740,103
Debentures payable (note 8)	-	1,500,000
Asset retirement obligations (note 9)	708,230	220,742
Future income taxes (note 10)	<u>2,485,000</u>	<u>2,059,000</u>
	<u>6,855,105</u>	<u>4,862,930</u>
Shareholders' Equity		
Share capital (note 11)	11,913,350	4,826,332
Special warrants (note 11[e])	-	1,861,632
Contributed surplus (note 11[k])	309,197	135,375
Retained earnings (deficit)	<u>309,777</u>	<u>(532,038)</u>
	<u>12,532,324</u>	<u>6,291,301</u>
	<u>\$ 19,387,429</u>	<u>\$ 11,154,231</u>

See accompanying notes to consolidated financial statements.

Approved by the Board,

(signed) "Wayne A. Malinowski", Director

(signed) "Larry C. Mah", Director

Twoco Petroleum Ltd.

Consolidated Statements of Income (Loss) and Retained Earnings (Deficit)

For the Period From December 31, 2003 to December 31, 2004 and the Year Ended
December 30, 2003

	2004	2003 <i>(restated - see note 2)</i>
Revenue		
Petroleum and natural gas sales	\$ 5,651,802	\$ 683,208
Royalties	<u>(1,266,159)</u>	<u>(133,893)</u>
	4,385,643	549,315
Alberta Royalty Tax Credit	293,489	30,767
Processing revenue	190,946	15,249
Interest	<u>76,084</u>	<u>4,486</u>
	<u>4,946,162</u>	<u>599,817</u>
Expenses		
Operating costs	570,057	68,819
Transportation costs	223,228	29,635
Interest on debentures payable (note 8)	269,664	64,315
General and administrative (note 13)	416,883	351,581
Stock-based compensation	173,819	135,375
Depletion, amortization and accretion	<u>2,302,696</u>	<u>271,890</u>
	<u>3,956,347</u>	<u>921,615</u>
Income (loss) before income taxes	<u>989,815</u>	<u>(321,798)</u>
Income tax expense (note 10)		
Current	125,000	-
Future	<u>23,000</u>	<u>142,667</u>
	<u>148,000</u>	<u>142,667</u>
Net income (loss)	<u>841,815</u>	<u>(464,465)</u>
Deficit, beginning of period		
As previously stated	(532,038)	(101,767)
Retroactive change in accounting policies (note 2[(f)])	<u>-</u>	<u>34,194</u>
As restated	<u>(532,038)</u>	<u>(67,573)</u>
Retained earnings (deficit), end of period	<u>\$ 309,777</u>	<u>\$ (532,038)</u>
Net income (loss) per share, basic and diluted (note 11[(i)])	<u>\$ 0.08</u>	<u>\$ (0.09)</u>

See accompanying notes to consolidated financial statements.

Twoco Petroleums Ltd.

Consolidated Statements of Cash Flows

For the Period From December 31, 2003 to December 31, 2004 and the Year Ended December 30, 2003

	2004	2003 <i>(restated - see note 2)</i>
Cash provided by (used for)		
Operating activities		
Net income (loss)	\$ 841,815	\$ (464,465)
Add (deduct) items not affecting cash		
Loss on disposal of office equipment and marketable securities	-	3,945
Stock-based compensation	173,819	135,375
Future income taxes	23,000	142,667
Depletion, amortization and accretion	<u>2,302,696</u>	<u>271,890</u>
	3,341,330	89,412
Change in non-cash working capital (note 15[a])	<u>(106,276)</u>	<u>(245,872)</u>
	<u>3,235,054</u>	<u>(156,460)</u>
Financing activities		
Issuance of Special Warrants and shares, net of issue costs	5,628,386	1,791,930
Proceeds on debentures issued	-	1,500,000
Advances to affiliated companies	-	(310,738)
Advances from (repayments to) officers and directors	-	(4,756)
Change in non-cash working capital (note 15[a])	<u>35,038</u>	<u>79,062</u>
	<u>5,663,424</u>	<u>3,055,498</u>
Investing activities		
Acquisition of property, plant and equipment	(6,254,907)	(2,526,361)
Business acquisitions, net of cash acquired (note 3)	(25,918)	6,252
Proceeds on disposal of office equipment and marketable securities	-	1,090
Change in non-cash working capital (note 15[a])	<u>(115,531)</u>	<u>(271,040)</u>
	<u>(6,396,356)</u>	<u>(2,790,059)</u>
Net cash inflow	2,502,122	108,979
Cash and cash equivalents, beginning of period	<u>1,442,947</u>	<u>1,333,968</u>
Cash and cash equivalents, end of period	<u>\$ 3,945,069</u>	<u>\$ 1,442,947</u>
Cash and cash equivalents is comprised of:		
Deposits (indebtedness) with bank	\$ (236,342)	\$ 142,021
Term deposits	<u>4,181,411</u>	<u>1,300,926</u>
	<u>\$ 3,945,069</u>	<u>\$ 1,442,947</u>
Supplemental cash flow information:		
Interest paid	<u>\$ 281,739</u>	<u>\$ 8,219</u>
Taxes paid	<u>\$ 22,119</u>	<u>\$ -</u>

The non-cash transactions described in note 15(b) have been excluded from the statements of cash flows.

See accompanying notes to consolidated financial statements.

Twoco Petroleums Ltd.
Notes to Consolidated Financial Statements
December 31, 2004 and December 30, 2003

1. Nature of operations

The Company was incorporated under the Alberta Business Corporations Act on September 21, 2000 and is engaged in the exploration for, and development of, petroleum and natural gas in western Canada.

These consolidated financial statements include the accounts of Twoco Petroleums Ltd. ("the Company") and its wholly-owned subsidiary, Norranco Oil & Gas Ltd. from June 3, 2004.

On November 27, 2003, the shareholders of the Company approved a 2-for-1 common share split. The conversion price of the debentures payable (note 8), the amounts for stock options granted (note 11[h]), and loss per share have been adjusted on a retroactive basis to reflect this stock split.

The Company has changed the ending date of its financial year from December 30 to December 31, commencing with the twelve month period ending December 31, 2004. There was no impact on the financial results reported for 2004.

2. Changes in significant accounting policies

(a) Full cost accounting

Effective December 31, 2003, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") Accounting Guideline 16 "Oil and Gas Accounting - Full Cost". The new guideline modifies the ceiling test calculation and outlines additional disclosure requirements. Under the full cost method of accounting, a limit is placed on the carrying amount of petroleum and natural gas properties. A ceiling test is performed to recognize and measure impairment, if any.

Impairment is recognized if the carrying amount of petroleum and natural gas properties, less the cost of unproved properties not subject to depletion (the "adjusted carrying amount") exceeds the estimated undiscounted future cash flows from the Company's proved reserves. The future cash flows are based on forecast prices and costs, as provided by an independent third party. If recognized, the magnitude of the impairment is measured by comparing the adjusted carrying amount to the estimated, discounted future cash flows of the Company's proved and probable reserves. For purposes of the ceiling test, future cash flows are calculated exclusive of indirect costs such as financing charges, general and administrative expenses and income taxes. Any recognized impairment is recorded as additional depletion and amortization expense.

The Company performed a ceiling test under AcG-16 at December 31, 2004 and there was no impact on the financial results reported.

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The future prices used in the ceiling test as of December 31, 2004 are:

Year	Oil <i>(CDN \$/Bbl)</i>	Natural Gas <i>(CDN \$/mcf)</i>
2005	\$ 46.29	\$ 6.84
2006	49.05	6.74
2007	47.50	6.74
2008	45.85	6.33
2009	44.10	6.08
2010	42.25	5.72
2011	43.15	5.88
2012	44.05	6.03

Prior to December 31, 2003, an impairment loss was recognized when the carrying amount of a cost centre exceeded its recoverable amount. The recoverable amount was the sum of the undiscounted cash flows expected from the production of proved reserves plus the lower of cost or market of unproved interests less estimated costs for administration, financing, site restoration and taxes. The cash flows were estimated using period-end prices and costs.

(b) Asset retirement obligations

Effective December 31, 2003, the Company adopted retroactively, with restatement of prior periods, the CICA's new standard on Asset Retirement Obligations. This new section requires liability recognition for retirement obligations associated with long-lived assets, which would include abandonment of petroleum and natural gas wells, related facilities, compressors and natural gas plants, removal of equipment from leased acreage and returning such land to its original condition.

Under the new standard, the estimated fair value of each asset retirement obligation is recorded in the period a well or related asset is drilled, constructed or acquired. Fair value is estimated using the present value of the estimated future cash outflows to abandon the asset at the Company's credit-adjusted risk-free interest rate. The discounted obligation is initially capitalized as part of the carrying amount of the related petroleum and natural gas properties and a corresponding liability is recognized. The increase in petroleum and natural gas properties is depleted and amortized on the same basis as the remainder of the petroleum and natural gas properties. The liability is accreted against income until it is settled or the property is sold and is recorded as accretion expense. Actual restoration expenditures are charged to the accumulated obligation as incurred. The effect of adoption of the new standard on the financial statements is disclosed in note 2(f).

The obligation is reviewed regularly by management based upon current regulations, costs, technologies and industry standards.

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Prior to December 31, 2002, the Company estimated costs of dismantlement, removal and site restoration and recorded them over the remaining life of the proved reserves using the unit-of-production basis. The annual provision was included in depletion and depreciation expense and was accrued as a site restoration liability on the balance sheet. Actual restoration expenditures were charged to the accumulated obligation as incurred.

(c) Stock-based compensation

Effective December 31, 2003, the Company elected to retroactively adopt amendments to CICA Handbook Section 3870 "Stock-based Compensation and Other Stock-based Payments". Under the amended standard, the Company must account for all stock options issued at fair value.

Under the transitional provisions of the standard, the Company has elected to apply the amended standard retroactively, with restatement, to all stock options issued after the effective date of implementation, being January 1, 2002. The effect of adoption of the new standard on the financial statements is disclosed in note 2(f).

Under this method, compensation costs attributable to all share options and warrants granted are measured at fair value at the date of grant and expensed over the vesting period with a corresponding increase to contributed surplus. Upon the exercise of the stock options and warrants, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital. The contributed surplus balance is reduced as the options and warrants are exercised and the amount initially recorded is credited to share capital.

The Company has not incorporated an estimated forfeiture rate for stock options and warrants that will not vest, rather, the Company accounts for actual forfeitures as they occur.

(d) Flow-through shares

Effective for equity issuances after March 19, 2004, the Company records the future income taxes associated with the renunciation of expenditures for income tax purposes on the date the Company renounces the expenditures. This change is in accordance with Abstract 146 from the Emerging Issues Committee of the CICA.

Prior to the adoption of this policy, the Company recorded future income taxes when the associated expenditures were incurred.

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(e) Transportation costs

For the fiscal period beginning December 31, 2003, the Company revised its presentation of transportation costs in accordance with CICA Handbook Section 1100 "Generally Accepted Accounting Principles", which eliminates industry practice as a source of GAAP. As a result, revenue has been presented prior to transportation costs and a separate expense for transportation costs has been presented in the consolidated statements of income and retained earnings. The Company has reclassified previously reported amounts to be consistent with the presentation under this new policy. There was no impact on net income or cash flow in 2004 and 2003.

(f) Effect of change in accounting policies

The cumulative effects of the change in policies for asset retirement obligations and stock-based compensation, where significant, are as follows:

Balance Sheets

	2004	2003
Increase in property, plant and equipment	\$ 702,157	\$ 214,436
Increase in asset retirement obligations	(708,230)	(220,742)
Decrease in future removal and site restoration costs	-	57,500
Increase in future income taxes	-	(17,000)
Increase in share capital	(298,865)	-
Increase in contributed surplus	(309,197)	(135,375)
Increase in stock-based compensation	<u>173,819</u>	<u>135,375</u>
(Decrease in retained earnings) increase in deficit	<u>\$ (440,316)</u>	<u>\$ 34,194</u>

Additional significant accounting policies are outlined in note 4.

3. Business combinations

(a) Norranco Oil & Gas Ltd.

On June 3, 2004, the Company acquired all of the issued and outstanding common shares of Norranco Oil & Gas Ltd. ("Norranco") for a total cash purchase price of \$154,000 plus acquisition costs of \$13,275. The results of operations of Norranco have been included in the accounts of the Company from June 3, 2004. The purchase price has been recorded at the fair value of the assets and liabilities acquired, as follows:

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Working capital, including cash of \$141,357	\$ 18,328
Property, plant and equipment	256,075
Asset retirement obligations	<u>(107,128)</u>
	<u>\$ 167,275</u>

(b) Prelude Oil and Gas Inc. and Predator Resources Ltd.

On July 30, 2003, the Company acquired all of the issued and outstanding common shares of Prelude Oil and Gas Inc. and Predator Resources Ltd. ("Prelude and Predator") for a total purchase price of \$3,036,809 by issuing 1,361,972 common shares. Prelude and Predator were related by virtue of common officers and directors. The acquisitions have been accounted for as business combinations using the purchase method with the results of operations of Prelude and Predator being included in the accounts of the Company from July 30, 2003. The allocation of the purchase price based on the fair values of the assets and liabilities acquired was as follows:

Cash	\$ 6,252
Accounts receivable	4,839
Marketable securities	262
Property, plant and equipment	5,775,000
Accounts payable and accrued liabilities	(360,944)
Due to officers and directors	(778,600)
Future income taxes	(1,560,000)
Future removal and site restoration costs	<u>(50,000)</u>
	<u>\$ 3,036,809</u>

The total purchase price was determined based primarily on reserve report values of Prelude and Predator prepared as of April 1, 2003 by independent engineers, and updated to the transaction date using information prepared by management.

Included in the accounts receivable of the Company was \$360,962 owing from Prelude and Predator that were eliminated as a result of the acquisitions. Prior to the 2003 year-end, Prelude and Predator were wound up into the Company.

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4. Significant accounting policies

(a) Use of estimates

The consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of financial statements for a period involves the use of estimates and approximations, which have been made using careful judgment. The consolidated financial statements have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

(b) Measurement uncertainty

The amounts recorded for depletion and amortization of property, plant and equipment, the asset retirement obligation and the ceiling test calculation are based on estimates of proven reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions.

The amounts disclosed relating to the fair value of stock options issued are based on estimates of the expected lives of the options, expected stock price volatility, expected dividends and other relevant assumptions.

By their nature, these estimates are subject to measurement uncertainty, and the effect of changes in such estimates on the consolidated financial statements of future periods could be significant.

(c) Cash and cash equivalents

Cash and cash equivalents are comprised of deposits with banks and investments in term deposits with initial maturities not exceeding 90 days.

(d) Property, plant and equipment

(i) Oil and natural gas properties

The Company follows the full cost method of accounting for its oil and natural gas properties and related facilities, whereby all costs related to the acquisition of, exploration for and development of oil and natural gas reserves, whether productive or unproductive, are capitalized in a single Canadian cost centre and charged to income as set out below. Such costs include lease acquisition, drilling, geological and geophysical expenditures, lease rentals on undeveloped properties, lease and well equipment costs and overhead expenses directly related to exploration and development activities.

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Proceeds from the disposal of properties are normally applied as a reduction of the cost of the remaining assets, except when such a disposal would alter the depletion and depreciation rate by more than 20%, in which case a gain or loss is recorded.

(ii) Depletion and amortization

Depletion of oil and natural gas properties and amortization of production equipment is provided using the unit-of-production method based upon estimated proved oil and natural gas reserves, as determined by independent engineers. For purposes of the calculation, petroleum and natural gas reserves are converted to a common unit of measure on the basis of their relative energy content where one barrel of oil or liquids equals six thousand cubic feet of natural gas. In determining its depletion base, the Company includes estimated future capital costs to be incurred in developing proved reserves and excludes the cost of significant unproved properties until it is determined whether proved reserves are attributable to the unproved properties or impairment has occurred. Unproved properties are evaluated separately for impairment based on management's assessment of future drilling.

(iii) Other assets

Furniture and office equipment are carried at cost and amortized over the estimated useful lives of the assets at a rate varying from 20% to 30% per annum calculated on a declining balance basis. Amortization is charged at half rates in the year of acquisition.

(e) Joint venture accounting

Substantially all of the Company's exploration and development activities are conducted jointly with others and, accordingly, these consolidated financial statements reflect only the Company's proportionate interest in such activities.

(f) Income taxes

Income taxes are accounted for using the liability method of income tax allocation. Under the liability method, income tax assets and liabilities are recorded to recognize future income tax inflows and outflows arising from the settlement or recovery of assets and liabilities at their carrying values. Income tax assets are also recognized for the benefits from tax losses and deductions that cannot be identified with particular assets or liabilities, provided those benefits are more likely than not to be realized. Future income tax assets and liabilities are determined based on the substantially enacted tax laws and rates that are anticipated to apply in the period of realization.

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(g) Revenue recognition

Revenues associated with the sale of crude oil and natural gas are recorded when title passes to an external party. Revenues from crude oil and natural gas production from properties from which the Company has an interest with other producers are recognized on the basis of the Company's net working interest.

Processing revenue is recognized at contractual rates as the Company processes third party natural gas volumes in its facilities.

(h) Per share information

Net earnings per share is calculated based on the weighted average number of common shares outstanding during the period. The diluted weighted average number of shares is adjusted for the dilutive effect of options and vested warrants. Under the treasury stock method, only "in the money" options are included in the weighted average diluted number of shares. It is also assumed that any proceeds obtained upon the exercise of options would be used to repurchase shares at the weighted average market price during the period. The weighted average number of shares is then reduced by the number of shares acquired.

(i) Comparative figures

Certain of the comparative figures have been reclassified to the current period presentation.

5. Property, plant and equipment

	<u>2004</u>		
	Cost	Accumulated Amortization	Net Book Value
Oil and natural gas properties	\$ 16,259,738	\$ 2,532,305	\$ 13,727,433
Other assets	<u>145,091</u>	<u>75,152</u>	<u>69,939</u>
	<u>\$ 16,404,829</u>	<u>\$ 2,607,457</u>	<u>\$ 13,797,372</u>
	<u>2003</u>		
	<i>(restated - see note 2)</i>		
	Cost	Accumulated Amortization	Net Book Value
Oil and natural gas properties	\$ 9,407,774	\$ 250,000	\$ 9,157,774
Other assets	<u>109,082</u>	<u>58,130</u>	<u>50,952</u>
	<u>\$ 9,516,856</u>	<u>\$ 308,130</u>	<u>\$ 9,208,726</u>

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During the current period, the Company capitalized \$157,456 (2003 - \$54,036) in general and administrative expenses related directly to acquisition, exploration and development activities. As at December 31, 2004, the depletion calculation excluded unproved properties of \$1,914,845 (2003 - \$584,916).

6. Bank debt

As at December 31, 2004, the Company has a revolving demand credit facility with a maximum availability of \$5.0 million and a \$1.5 million general lease line of credit. The interest rate at December 31, 2004 was prime plus 0.50%. The credit facility is secured by a floating charge over all the assets of the Company.

The Company had not drawn on the credit facility at December 31, 2004.

7. Due to officers and directors

The amount due to officers and directors bears interest at 6.5% per annum, and be repaid as to \$370,052 on January 31, 2005, and \$370,051 on January 31, 2006. The amount is unsecured.

8. Debentures payable

Debentures payable consist of \$1,500,000 convertible, redeemable debentures with interest payable six months after the issuance date of September 30, 2003, and quarterly thereafter at 15% per annum. The debentures are unsecured and convertible at the option of the holder at any time prior to maturity, into common shares of the Company at a conversion price of \$1.25 per share. The debentures are redeemable by the Company in cash at any time prior to maturity that there occurs the making of an "Offer", as defined in the debenture agreement. An "Offer" is generally an offer to purchase a controlling interest of the Company. The debentures are due September 30, 2005.

Based on management's calculations, the value of the conversion feature was nominal at the date of issue and, as such, no value has been ascribed thereto.

9. Asset retirement obligations

A reconciliation of the asset retirement obligations is provided below:

	2004	2003
Balance, beginning of period	\$ 220,742	\$ -
Accretion expense	9,673	-
Liabilities incurred	<u>477,815</u>	<u>220,742</u>
Balance, end of period	<u>\$ 708,230</u>	<u>\$ 220,742</u>

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The total future asset retirement obligation was estimated by management based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon said wells and facilities and the estimated timing of such abandonment. The Company has estimated the total undiscounted amount required to settle the abandonment obligations to be \$925,651 (2003 - \$355,000). These payments are expected to be made over the next 4 to 9 years. The Company used a credit adjusted risk free rate of 6.10% and an inflation rate of 2.10% to calculate the present value of the asset retirement obligation.

10. Future income taxes

- (a) Current income tax expense differs from that which would be expected from applying the combined effective Canadian federal and provincial income tax rates of 38.62% (2003 - 40.62%) to income before income taxes as follows:

	2004	2003 <i>(restated - see note 2)</i>
Computed expected tax provision	\$ 382,267	\$ (75,725)
Increase (decrease) resulting from:		
Non-deductible crown payments net of Alberta Royalty Tax Credits	221,765	33,255
Resource allowance	(306,662)	(113,192)
Stock-based compensation	67,129	-
Impact of future tax rate reductions	(215,225)	300,709
Other	<u>(1,274)</u>	<u>(2,380)</u>
	<u>\$ 148,000</u>	<u>\$ 142,667</u>

- (b) The significant components of the Company's future income tax liability are as follows:

	2004	2003 <i>(restated - see note 2)</i>
Carrying value of property, plant and equipment in excess of tax pools	\$ 2,738,000	\$ 2,316,700
Non-capital loss carryforwards recognized	-	(156,400)
Share issue costs and financing fees	(245,000)	(89,300)
Attributed Canadian Royalty Income carryforward and other	<u>(8,000)</u>	<u>(12,000)</u>
	<u>\$ 2,485,000</u>	<u>\$ 2,059,000</u>

11. Share capital

- (a) Authorized

Unlimited voting common shares
Unlimited non-voting preferred shares

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(b) Issued

	2004		2003	
	Number	Stated Value	Number	Stated Value
Common Shares				
Balance, beginning of period	6,648,156	\$ 4,826,332	1,888,800	\$ 1,837,657
Pursuant to an initial public offering (note 11[c])	3,530,000	6,001,000	-	-
Warrants exercised (note 11[d])	191,700	335,577	-	-
Special warrants exercised (note 11[e])	1,176,500	1,861,632	-	-
Acquisition of Prelude and Predator (note 3)	-	-	1,361,972	3,036,809
To repay amounts due to officers and directors (note 11[f])	-	-	73,306	250,000
Common share stock split (note 11[g])	-	-	<u>3,324,078</u>	<u>-</u>
	<u>11,546,356</u>	<u>13,024,541</u>	<u>6,648,156</u>	<u>5,124,466</u>
Warrants (note 11[c] and [e])		293,000		5,865
Less: Share issue costs, net of tax benefits (note 11[c])		(749,191)		-
Tax benefits renounced to flow-through shareholders		<u>(655,000)</u>		<u>(303,999)</u>
Balance, end of period		<u>\$ 11,913,350</u>		<u>\$ 4,826,332</u>

- (c) On April 16, 2004, the Company closed its initial public offering ("IPO") of 3,530,000 units at a price of \$1.70 per unit. Each unit is comprised of one common share and one half non-transferable common share purchase warrant. Each whole common share purchase warrant is exercisable until April 16, 2005 into one common share at a price of \$1.95 per share.

The Company paid the agent a 7.5% cash commission on the aggregate proceeds of \$6,001,000 and granted the agent an option to acquire 353,000 agent's units exercisable until April 16, 2005. Each agent's unit consists of one common share exercisable at \$1.70 per share and one-half common share purchase warrant exercisable at \$1.95 per warrant.

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The fair value of the agent's options was estimated to be \$293,000 using the Black-Scholes option pricing model with the following assumptions: expected option life of one year, expected volatility of 85%, risk-free rate of 3%, and a zero dividend yield. This amount has been recorded as a share issuance cost with a corresponding increase in share capital.

(d) Purchase warrants and agent's options

A summary of the Company's purchase warrants and agent's options as at December 31, 2004 and changes during the period then ended is as follows:

	<u>Number</u>	<u>Weighted Average Exercise Price</u>
Outstanding, December 31, 2003	117,650	\$ 1.70
Granted and issued (note 11[c])	2,294,500	1.91
Exercised	<u>(191,700)</u>	1.75
Outstanding and exercisable, December 31, 2004	<u>2,220,450</u>	<u>\$ 1.91</u>

The purchase warrants and agent's options have a weighted average remaining life of 0.29 years.

- (e) On December 22, 2003, the Company issued 1,176,500 flow-through Special Warrants at \$1.70 per Special Warrant pursuant to a financing agreement dated December 22, 2003. Each Special Warrant is exchangeable for no additional consideration into one flow-through common share. The Company agreed to file a prospectus to qualify the distribution of the common shares on exercise of the Special Warrants. The Special Warrants would be automatically exercised on the earlier of: a) the fifth day after receipt from relevant securities authorities for a final prospectus and b) one year after the Company becomes a reporting issuer on an applicable Exchange.

The 1,176,500 Special Warrants outstanding as at December 30, 2003 were automatically exchanged into 1,176,500 common shares for no additional consideration upon acceptance by the relevant securities exchange for the Company's final prospectus related to its IPO on April 17, 2004.

Income tax exploration deductions of \$2,000,050 were renounced to subscribers effective December 31, 2003. Expenditures of \$2,000,050 were incurred in 2004 and the resultant tax effect of \$655,000 has been recorded as a reduction in share capital.

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The agent was paid a placement fee of \$150,000 and was granted warrants entitling the agent to acquire at no additional consideration, 117,650 Agent's options. Each Agent's option entitled the agent to acquire one common share at \$1.70 per option until December 22, 2004. All such options were exercised prior to December 2004. The fair value of the Agent's options was estimated to be \$5,865 using the Black-Scholes model with the following assumptions: expected option life of 1 year, risk-free rate of 3%, expected volatility of 0% and a zero dividend yield. This amount has been recorded as a share issuance cost with a corresponding increase in share capital.

- (f) On July 30, 2003, the Company issued 73,306 common shares to repay amounts due to officers and directors at \$3.41 per share (before stock split as disclosed in note 11[g]). This transaction was measured at the exchange amount, being the amount agreed to by the related parties.
- (g) On November 27, 2003, the shareholders of the Company approved a 2 for 1 common share split.

The conversion price of the debentures payable (note 8), the amounts for stock options granted (note 11[h]), and the calculation of income (loss) per share (note 11[i]) have been adjusted to reflect this stock split on a retroactive basis.

- (h) Stock option plan

The Company has one fixed stock option plan whereby the Company may grant options to its directors, officers, employees and consultants for up to 10% of the issued and outstanding common shares of the Company, of which 930,000 have been granted to date. The maximum number of common shares optioned to any one optionee in a twelve month period shall not exceed 5% of the outstanding common shares of the Company at the time of granting. Options granted under the plan generally have a five-year term and vest as determined by the Board of Directors. The exercise price of each option equals the market value of the Company's common shares at the date of grant.

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A summary of the status of the Company's stock option plan as at December 31, 2004, and changes during the period then ended is as follows:

	2004		2003	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of period	610,000	\$ 1.25	-	\$ -
Granted	<u>320,000</u>	2.20	<u>610,000</u>	1.25
Outstanding, end of period	<u><u>930,000</u></u>	\$ 1.58	<u><u>610,000</u></u>	\$ 1.25

- (i) The following table summarizes information about stock options outstanding and exercisable at December 31, 2004:

Outstanding			Exercisable		
Range of Exercise Prices	Number of Options	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
\$ 1.25	610,000	3.66	\$ 1.25	305,000	\$ 1.25
1.75	20,000	4.36	1.75		
2.20	280,000	4.61	2.20		
2.80	<u>20,000</u>	4.98	2.80	<u> </u>	
	<u><u>930,000</u></u>	3.99	\$ 1.58	<u><u>305,000</u></u>	\$ 1.25

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subject assumptions including the expected stock price volatility.

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The fair value of options granted under the Company's stock-based compensation plan was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2004	2003
Risk-free interest rate (%)	3.51	3.94
Option life (years)	2.00	5.00
Expected volatility (%)	48	-
Weighted average fair value of each option granted (\$)	0.64	1.25
Dividend yield per share	-	-

- (j) The following is a continuity of flow-through Common shares issued and outstanding:

	Number of Shares	Amount
September 2002	1,376,000	\$ 1,651,200
December 2003	<u>1,176,500</u>	<u>2,000,050</u>
Balance issued	<u>2,552,500</u>	<u>\$ 3,651,250</u>

As of December 31, 2004, the Company has incurred expenditures of \$2,000,050 to satisfy the full flow-through obligation.

- (k) Contributed surplus

The following table reconciles the Company's contributed surplus:

	2004	2003 <i>(restated - see note 2)</i>
Balance, beginning of period	\$ 135,375	\$ -
Stock-based compensation expense	<u>173,822</u>	<u>135,375</u>
Balance, end of period	<u>\$ 309,197</u>	<u>\$ 135,375</u>

- (l) Per share amounts

Per share amounts have been calculated on the weighted average number of shares outstanding during the period. The weighted average number of shares outstanding for the period ended December 31, 2004 was 10,018,710 (2003 - 5,006,600).

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In computing diluted net income per share amounts, 695,010 shares were added to the weighted average number of common shares outstanding during the period ended December 31, 2004 for the dilutive effect of employee stock options and warrants. The conversion of debentures payable was anti-dilutive.

The exercise of Agent's options, stock options, and the conversion of debentures payable would be anti-dilutive for the year ended December 31, 2003 as the Company was in a loss position; therefore, the diluted weighted average number of common shares equals the basic weighted average number of common shares.

The following reconciles the denominators for the 2004 basic and diluted net income per share calculations:

	Net Earnings <i>(numerator)</i>	Weighted Average Shares <i>(denominator)</i>	Per Share Amount
Basic net income per share	\$ 841,815	10,018,710	\$ 0.08
Dilutive securities:			
Options	-	313,421	
Warrants	<u>-</u>	<u>381,589</u>	
Diluted net income per share	<u>\$ 841,815</u>	<u>10,713,720</u>	\$ 0.08

12. Commitments

The Company is committed under equipment leases and a lease on its office premises (including expected occupancy costs) for future minimum rental payments as follows:

2005	\$ 81,788
2006	78,848
2007	80,268
2008	<u>73,579</u>
	<u>\$ 314,483</u>

At December 31, 2004, the Company had no forward commodity contracts in place.

13. Related party transactions

Accounting fees of \$81,437 (2003 - \$18,459) were incurred to a partnership of which a director of the Company is a partner. Legal fees in the amount of \$8,000 (2003 - \$NIL) were incurred to a law firm of which a director of the Company is also an associate. Included in accounts payable and accrued liabilities at December 31, 2004 is \$16,466 (2003 - \$10,000) owing to these related parties.

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These transactions are measured at the exchange amount which is the amount agreed to by the related parties based on standard commercial terms.

14. Financial instruments

(a) Fair values

The fair values of cash and cash equivalents, accounts receivable, deposits, accounts payable, and income taxes payable approximate their carrying values due to the relatively short-term maturity of these instruments. The fair values of the debentures payable and amount due to officers and directors approximate their carrying values as they bear interest at market rates for similar instruments.

(b) Credit risk

Virtually all of the Company's accounts receivable are with companies in the petroleum and natural gas industry in Canada and are subject to normal industry credit risks. The Company generally extends unsecured credit to these companies and therefore the collection of accounts receivable may be affected by changes in economic or other conditions. Management believes the risk is mitigated by the size and reputation of the companies to which they extend credit. The Company has not experienced any credit loss in the collection of accounts receivable to date.

The Company's maximum credit risk exposure is limited to the carrying fair value of its accounts receivable.

(c) Commodity price risk

The nature of the Company's operations results in exposure to fluctuations in commodity prices. Management continuously monitors commodity prices and initiates instruments to manage exposure to these risks when it deems necessary.

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15. Supplemental cash flow information

(a) Changes in non-cash working capital

	2004	2003
Accounts receivable	\$ (974,310)	\$ (346,364)
Prepaid expenses and deposits	(160,794)	(74,497)
Accounts payable and accrued liabilities	825,360	(16,989)
Current taxes payable	<u>122,975</u>	<u>-</u>
	<u>\$ (186,769)</u>	<u>\$ (437,850)</u>
Change in non-cash working capital relating to:		
Financing activities	\$ 35,038	\$ 79,062
Investing activities	(115,531)	(271,040)
Operating activities	<u>(106,276)</u>	<u>(245,872)</u>
	<u>\$ (186,769)</u>	<u>\$ (437,850)</u>

(b) Excluded from the statements of cash flows are the following non-cash items:

	2004	2003
Share issuance costs (note 11[c])	\$ <u>293,000</u>	\$ <u>-</u>
Tax benefits renounced to flow-through equity holders (note 11[b])	\$ <u>(655,000)</u>	\$ <u>(303,999)</u>
Tax benefits on cash share issuance costs	\$ <u>252,000</u>	\$ <u>-</u>
Acquisition of Prelude and Predator	\$ <u>-</u>	\$ <u>3,030,557</u>