

Twoco Petroleums Ltd.
Consolidated Financial Statements
December 31, 2006

Management's Responsibility for Financial Reporting

The Management of Twoco Petroleums Ltd. is responsible for the preparation of the accompanying consolidated financial statements of the Company. 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 consolidated financial statements are presented fairly in all material respects.

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 5, 2007

Auditors' Report

To the Shareholders of
Twoco Petroleums Ltd.

We have audited the consolidated balance sheets of Twoco Petroleums Ltd. as at December 31, 2006 and 2005 and the consolidated statements of income and retained earnings and cash flows for the years 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 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, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "Deloitte & Touche LLP"
Chartered Accountants

Calgary, Alberta
April 5, 2007

Twoco Petroleums Ltd.
Consolidated Balance Sheets
As at December 31, 2006 and 2005

	2006	2005
Assets		
Current assets		
Cash and cash equivalents	\$ 1,867,708	\$ -
Accounts receivable	2,043,174	3,845,762
Prepaid expenses and deposits	<u>386,742</u>	<u>341,677</u>
	4,297,624	4,187,439
Deferred financing charges (note 3)	184,034	-
Property, plant and equipment (note 4)	<u>44,545,637</u>	<u>30,519,164</u>
	<u>\$ 49,027,295</u>	<u>\$ 34,706,603</u>
Liabilities		
Current liabilities		
Bank indebtedness and credit facility (note 5)	\$ -	\$ 2,061,780
Accounts payable and accrued liabilities (note 12)	2,839,618	4,323,698
Due to officers and directors (note 6)	-	370,052
Current portion of capital lease obligation (note 7)	<u>207,756</u>	<u>791,783</u>
	3,047,374	7,547,313
Obligations under capital leases (note 7)	759,854	347,392
Convertible debentures payable (note 3)	11,880,000	-
Asset retirement obligations (note 8)	2,551,724	1,447,956
Future income taxes (note 9)	<u>3,849,800</u>	<u>4,146,155</u>
	<u>22,088,752</u>	<u>13,488,816</u>
Shareholders' Equity		
Share capital (note 10)	21,686,393	17,294,878
Equity portion of convertible debentures payable (note 3)	160,000	-
Contributed surplus (note 10[h])	985,181	588,068
Retained earnings	<u>4,106,969</u>	<u>3,334,841</u>
	<u>26,938,543</u>	<u>21,217,787</u>
	<u>\$ 49,027,295</u>	<u>\$ 34,706,603</u>
Commitments (note 11)		

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 and Retained Earnings
For the Years Ended December 31, 2006 and 2005

	2006	2005
Revenue		
Petroleum and natural gas sales	\$ 12,898,939	\$ 13,221,224
Royalties	<u>(2,379,563)</u>	<u>(2,916,573)</u>
	10,519,376	10,304,651
Alberta Royalty Tax Credit	500,000	500,000
Interest	<u>183,888</u>	<u>67,162</u>
	<u>11,203,264</u>	<u>10,871,813</u>
Expenses		
Operating	1,295,510	643,946
Transportation	466,799	407,176
General and administrative (note 12)	667,145	396,076
Interest on bank debt	44,499	-
Interest on capital leases	100,278	85,615
Interest on debentures payable (notes 3 and 12)	718,082	166,685
Stock-based compensation (notes 10[g] and [h])	397,113	278,871
Amortization of deferred charges	61,345	-
Depletion, amortization and accretion	<u>6,881,173</u>	<u>4,231,723</u>
	<u>10,631,944</u>	<u>6,210,092</u>
Income before income taxes	<u>571,320</u>	<u>4,661,721</u>
Income tax expense (recovery) (note 9)		
Current	35,457	(24,498)
Future	<u>(236,265)</u>	<u>1,661,155</u>
	<u>(200,808)</u>	<u>1,636,657</u>
Net income	772,128	3,025,064
Retained earnings, beginning of year	<u>3,334,841</u>	<u>309,777</u>
Retained earnings, end of year	<u>\$ 4,106,969</u>	<u>\$ 3,334,841</u>
Net income per share (note 10[i])		
Basic	<u>\$ 0.05</u>	<u>\$ 0.23</u>
Diluted	<u>\$ 0.05</u>	<u>\$ 0.20</u>

See accompanying notes to consolidated financial statements.

Twoco Petroleums Ltd.
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2006 and 2005

	2006	2005
Cash provided by (used for)		
Operating activities		
Net income	\$ 772,128	\$ 3,025,064
Add items not affecting cash		
Stock-based compensation	397,113	278,871
Future income taxes	(236,265)	1,661,155
Depletion, amortization and accretion	6,881,173	4,231,723
Convertible debentures accretion	40,000	-
Amortization of deferred charges	<u>61,345</u>	<u>-</u>
	7,915,494	9,196,813
Settlement of asset retirement obligations	(59,411)	-
Change in non-cash working capital (note 14[a])	<u>817,327</u>	<u>(1,435,043)</u>
	<u>8,673,410</u>	<u>7,761,770</u>
Financing activities		
Issuance of common shares, net of issue costs	4,331,425	-
Repayment of obligations under capital lease	(171,565)	(152,585)
Repayments to officers and directors	(370,052)	(370,051)
Exercise of agent's options and warrants	-	3,896,528
Redemption of debenture (note 10)	-	(15,000)
Change in non-cash working capital (note 14[a])	-	44,021
Proceeds of convertible debentures, net of financing charges	<u>11,754,621</u>	<u>-</u>
	<u>15,544,429</u>	<u>3,402,913</u>
Investing activities		
Acquisition of property, plant and equipment	(19,744,467)	(18,922,029)
Change in non-cash working capital (note 14[a])	<u>(543,884)</u>	<u>1,750,497</u>
	<u>(20,288,351)</u>	<u>(17,171,532)</u>
Net cash inflow (outflow)	3,929,488	(6,006,849)
Cash and cash equivalents (bank indebtedness), beginning of year	<u>(2,061,780)</u>	<u>3,945,069</u>
Cash and cash equivalents (bank indebtedness), end of year	<u>\$ 1,867,708</u>	<u>\$ (2,061,780)</u>
Cash and cash equivalents (bank indebtedness) is comprised of:		
Indebtedness with bank	\$ -	\$ (2,061,780)
Cash	<u>1,867,708</u>	<u>-</u>
	<u>\$ 1,867,708</u>	<u>\$ (2,061,780)</u>
Supplemental cash flow information:		
Interest paid	<u>\$ 825,747</u>	<u>\$ 301,642</u>
Taxes paid	<u>\$ 35,457</u>	<u>\$ -</u>

The non-cash transactions described in note 14(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, 2006 and 2005

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.

Effective July 1, 2006, Norranco Oil & Gas Ltd. was wound up into the Company.

2. 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 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, petroleum 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.

The amount recorded as the equity portion of the convertible debentures is based upon an estimate of the difference between the debenture proceeds and the estimated present value of debentures without a conversion feature.

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.

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(c) Property, plant and equipment

(i) Petroleum and natural gas properties

The Company follows the full cost method of accounting for its petroleum and natural gas properties and related facilities, whereby all costs related to the acquisition of, exploration for and development of petroleum 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.

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 petroleum and natural gas properties, equipment under capital leases, and amortization of production equipment is provided using the unit-of-production method based upon estimated proved petroleum and natural gas reserves, as determined by independent engineers. For purposes of the calculation, petroleum and natural gas reserves before royalties 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 or an assessment of current fair values.

(iii) Ceiling test

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.

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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. Any recognized impairment is recorded as additional depletion and amortization expense.

(iv) 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.

(d) Asset retirement obligations

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. Any gains or losses on settlement are charged to income in the period of settlement.

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

(e) Stock-based compensation

Compensation costs attributable to all stock options 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, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

The Company has not incorporated an estimated forfeiture rate for stock options that will not vest; rather, the Company accounts for cancellations as they occur.

Twoco Petroleum Ltd.
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(f) Joint venture accounting

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

(g) 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 substantively enacted tax laws and rates that are anticipated to apply in the period of realization.

(h) Flow-through shares

The Company records the future income taxes associated with the renunciation of expenditures for income tax purposes on the date the Company files the renouncement forms with the Canada Revenue Agency.

(i) Revenue recognition

Revenues associated with the sale of petroleum and natural gas are recorded when title passes to an external party. Revenues from petroleum 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.

(j) Per share information

Net income per share is calculated based on the weighted average number of common shares outstanding during the year. The diluted weighted average number of shares is adjusted for the dilutive effect of options and convertible debentures. Under the treasury stock method, only "in the money" options and convertible debentures are included in the weighted average diluted number of shares. It is also assumed that any proceeds obtained upon the exercise of options and conversion of debentures plus the unamortized portion of stock-based compensation would be used to purchase common shares at the average price during the year. The weighted average number of shares is then reduced by the number of shares acquired.

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(k) Prepaid expenses and deposits

Included in prepaid expenses and deposits are funds held in trust for the Company. The funds bear interest at 4.125% per annum.

(l) Cash and cash equivalents

Cash and cash equivalents consists of cash on deposit with a bank which bears interest at rates varying from 0% to prime less 2% depending on the balance on deposit.

3. Convertible debentures payable

On March 31, 2006, the Company closed a private placement financing through the issuance of \$12 million of redeemable, convertible, unsecured debentures ("Convertible Debentures"). The Convertible Debentures bear interest at a rate of 7.5% per annum, payable commencing September 30, 2006 and quarterly thereafter and will mature three years following the closing date (the "Maturity Date"). Finder's fees and commissions of \$245,379 have been recorded as deferred financing charges and will be amortized over the term of the debentures of three years on a straight-line basis. Amortization expense of \$61,345 has been recognized for the year ended December 31, 2006.

The Convertible Debentures will be convertible into common shares of the Company at the holder's option at any time prior to the Maturity Date at a conversion price equal to \$7.50 per share for a period of two years from the closing date and thereafter at a price of \$8.25 until the Maturity Date. The Company will have the ability to redeem the Convertible Debentures if the closing price of its common shares on the TSX Venture Exchange exceeds \$8.25 for 21 consecutive trading days or in certain circumstances where an offer is made to acquire common shares of the Company.

A market rate of interest for a non-convertible debt offering, representative of the Company's credit standing would be 8%. Therefore, the Company has received an interest benefit of 0.5% for the holder's conversion right, over the three year life of the debentures. The present value of this conversion benefit of \$160,000 was recorded on the consolidated financial statements as the equity portion of convertible debentures. The portion of convertible debentures classified as debt was initially determined to be \$11,840,000. The debt portion of the debentures will accrete up to the face value over the term to maturity. Accretion of \$40,000 has been recognized in interest expense for the year ended December 31, 2006.

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4. Property, plant and equipment

	<u>2006</u>		
	Cost	Accumulated Amortization	Net Book Value
Petroleum and natural gas properties	\$ 56,671,952	\$ 13,023,986	\$ 43,647,966
Other assets	169,767	115,438	54,329
Equipment under capital leases	<u>1,302,961</u>	<u>459,619</u>	<u>843,342</u>
	<u>\$ 58,144,680</u>	<u>\$ 13,599,043</u>	<u>\$ 44,545,637</u>
	<u>2005</u>		
	Cost	Accumulated Amortization	Net Book Value
Petroleum and natural gas properties	\$ 35,861,451	\$ 6,420,074	\$ 29,441,377
Other assets	152,934	95,677	57,257
Equipment under capital leases	<u>1,291,760</u>	<u>271,230</u>	<u>1,020,530</u>
	<u>\$ 37,306,145</u>	<u>\$ 6,786,981</u>	<u>\$ 30,519,164</u>

During the current year, the Company capitalized \$278,462 (2005 - \$256,906) in general and administrative expenses related directly to acquisition, exploration and development activities. As at December 31, 2006, the depletion calculation excluded unproved properties of \$6,190,038 (2005 - \$4,985,864).

The future prices used in the ceiling test as of December 31, 2006 are:

Year	Oil <i>(CDN \$/Bbl)</i>	Natural Gas <i>(CDN \$/mcf)</i>
2007	\$ 63.22	\$ 7.25
2008	68.88	7.86
2009	71.20	7.76
2010	75.00	7.86
2011	72.85	8.11
2012	71.85	8.27
2013	73.30	8.37
2014	74.85	8.62
2015	76.40	8.78
2016	77.95	8.98

Twoco Petroleum Ltd.
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5. Bank indebtedness and credit facility

As at December 31, 2006, the Company has a revolving demand credit facility with a maximum availability of \$20.0 (2005 - \$10.0) million and a \$1.5 (2005 - \$1.5) million general lease line of credit. The interest rate at December 31, 2006 was prime of 6% (2005 - prime of 5%). The effective interest rate for 2006 was 5.36% (2005 - 4.28%). The credit facility is secured by a demand debenture of \$25.0 million plus a floating charge over all the assets of the Company. Under the terms of the credit facility agreement, the Company is required to meet certain financial and other reporting requirements.

The Company had not drawn on the credit facility at December 31, 2006 (2005 - \$2.3 million).

6. Due to officers and directors

The amount due to officers and directors, bearing interest at 6.5% per annum, was repaid on January 31, 2006. The amount was unsecured.

7. Obligations under capital leases

The Company's obligations for equipment under capital leases mature October 2009 to June 2011 and are secured by the specific leased assets with a net book value of \$843,342 (2005 - \$1,020,530).

	2006	2005
Obligations under capital leases	\$ 967,610	\$ 1,139,175
Less: Portion due within one year	<u>207,756</u>	<u>791,783</u>
	<u>\$ 759,854</u>	<u>\$ 347,392</u>

The future minimum lease repayments under the capital leases are as follows:

2007	\$ 260,880
2008	260,880
2009	346,410
2010	161,604
2011	<u>67,336</u>
Total minimum lease payments	1,097,110
Less: Amount representing interest at rates of 5.5% to 6.4%	<u>129,500</u>
	<u>\$ 967,610</u>

Twoco Petroleum Ltd.
Notes to Consolidated Financial Statements
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8. Asset retirement obligations

A reconciliation of the asset retirement obligations is provided below:

	2006	2005
Balance, beginning of year	\$ 1,447,956	\$ 708,230
Accretion expense	69,111	52,198
Liabilities incurred	1,094,068	508,358
Liabilities incurred due to changes in estimate	-	179,170
Liabilities settled	<u>(59,411)</u>	<u>-</u>
Balance, end of year	<u>\$ 2,551,724</u>	<u>\$ 1,447,956</u>

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 \$3,712,076 (2005 - \$2,164,377). These payments are expected to be made over the next 3 to 15 years. The Company used a credit adjusted risk free rate of 6.04% (2005 - 5.92%) and an estimated inflation rate of 1.60% (2005 - 2.20%) to calculate the present value of the asset retirement obligation.

9. 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 34.49% (2005 - 37.62%) to income before income taxes as follows:

	2006	2005
Computed expected tax provision	\$ 197,048	\$ 1,753,739
Increase (decrease) resulting from:		
Non-deductible Crown payments net of		
Alberta Royalty Tax Credits	169,560	541,745
Resource allowance	(245,154)	(647,042)
Stock-based compensation	136,964	104,911
Impact of future tax rate reductions	(513,234)	(87,830)
Other	<u>54,008</u>	<u>(28,866)</u>
	<u>\$ (200,808)</u>	<u>\$ 1,636,657</u>

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

	2006	2005
Carrying value of property, plant and equipment in excess of tax pools	\$ 4,693,900	\$ 4,828,955
Asset retirement obligations	(765,500)	(490,800)
Share issue costs and financing fees	(145,000)	(184,000)
Attributed Canadian Royalty Income carryforward and other	<u>66,400</u>	<u>(8,000)</u>
	<u><u>\$ 3,849,800</u></u>	<u><u>\$ 4,146,155</u></u>

10. Share capital

(a) Authorized

Unlimited voting common shares
 Unlimited non-voting preferred shares

(b) Issued

	2006		2005	
	Number	Stated Value	Number	Stated Value
Common Shares				
Balance, beginning of year	14,773,306	\$ 17,294,878	11,546,356	\$ 11,913,350
Warrants exercised (note 10[e])	-	-	1,721,250	3,356,438
Conversion of debentures (note 10[f])	-	-	1,188,000	1,485,000
Exercise of agent's options (note 10[e])	-	-	317,700	540,090
Pursuant to flow through share offering (note 10[c])	<u>486,500</u>	<u>4,500,125</u>	<u>-</u>	<u>-</u>
	<u><u>15,259,806</u></u>	<u>21,795,003</u>	<u><u>14,773,306</u></u>	<u>17,294,878</u>
Less: Share issue costs, net of tax benefits (note 10[c])		<u>(108,610)</u>		<u>-</u>
Balance, end of year		<u><u>\$ 21,686,393</u></u>		<u><u>\$ 17,294,878</u></u>

(c) On May 9, 2006, the Company closed a private placement financing of 486,500 common shares issued on a flow-through basis at \$9.25 per share for gross proceeds of \$4,500,125. The Company paid finder's fees and related financing charges of \$168,698.

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(d) On October 18, 2006, the Company commenced a normal course issuer bid under which it can repurchase up to 750,000 of its common shares until October 16, 2007. All common shares purchased by the Company will be returned to treasury and cancelled. Although the Company has the intention to acquire common shares, it is not obligated to make any purchases pursuant to this 2006 issuer bid. For the year ended December 31, 2006 no purchases had been made.

(e) Purchase warrants and agent's options

A summary of the Company's purchase warrants and agent's options as at December 31, 2006 and 2005 and changes during the years ended is as follows:

	<u>Number</u>	<u>Weighted Average Exercise Price</u>
Outstanding, December 31, 2004	2,220,450	\$ 1.91
Exercised	(2,038,950)	\$ 1.91
Expired	<u>(181,500)</u>	\$ 1.95
Outstanding and exercisable, December 31, 2005 and 2006	<u>\$ -</u>	<u>\$ -</u>

(f) Debentures payable consisted 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 were unsecured and convertible, at the option of the holder at any time prior to maturity on September 30, 2005, into common shares of the Company at a conversion price of \$1.25 per share. The debentures were redeemable by the Company in cash at any time prior to maturity in the event of 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.

On September 30, 2005, debentures payable of \$1,485,000 were converted into 1,188,000 common shares of the Company (note 10[b]). The remaining debentures payable of \$15,000 were repaid by the Company.

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(g) 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 1,442,000 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 or 2% in the case of consultants and employees conducting investor relations activities on behalf of the Company. 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 is determined by the Board of Directors in accordance with applicable stock exchange policies.

A summary of the status of the Company's stock option plan as at December 31, 2005 and 2006, and changes during those years then ended is as follows:

	2006		2005	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of year	1,442,000	\$ 2.51	930,000	\$ 1.58
Issued	-	-	512,000	4.21
Outstanding, end of year	1,442,000	\$ 2.51	1,442,000	\$ 2.51

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The following table summarizes information about stock options outstanding and exercisable at December 31, 2006:

Outstanding			Exercisable		
Range of Exercise Prices	Number of Options	Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
\$ 1.25	610,000	1.66	\$ 1.25	610,000	\$ 1.25
1.75	20,000	2.36	1.75	20,000	1.75
2.20	280,000	2.62	2.20	280,000	2.20
2.80	20,000	2.94	2.80	20,000	2.80
3.00	218,000	3.02	3.00	109,000	3.00
3.75	175,000	3.33	3.75	87,500	3.75
7.10	<u>119,000</u>	3.94	7.10	<u>59,500</u>	7.10
	<u>1,442,000</u>	2.47	\$ 2.51	<u>1,186,000</u>	\$ 2.16

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:

	2006	2005
Weighted average risk-free interest rate (%) of each option granted	-	3.17
Option life (years)	-	2.00
Weighted average expected volatility (%) of each option granted	-	52
Weighted average fair value of each option granted (\$)	-	1.31
Dividend yield per share	-	-

No new stock options were issued in 2006.

(h) **Contributed surplus**

The following table reconciles the Company's contributed surplus:

	2006	2005
Balance, beginning of year	\$ 588,068	\$ 309,197
Stock-based compensation expense	<u>397,113</u>	<u>278,871</u>
Balance, end of year	<u>\$ 985,181</u>	<u>\$ 588,068</u>

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(i) Per share amounts

The weighted average number of shares outstanding for the year ended December 31, 2006 was 15,087,865 (2005 - 13,381,704).

In computing diluted net income per share amounts, 851,551 (2005 - 1,573,736) shares were added to the weighted average number of common shares outstanding during the year ended December 31, 2006 for the dilutive effect of stock options, warrants and convertible debentures. For 2006, certain stock options representing 119,000 underlying shares and the convertible debentures were determined to be anti-dilutive and have been excluded from the calculation of diluted net income per share in 2006.

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

	Net Earnings (numerator)	Weighted Average Shares (denominator)	Per Share Amount
<u>2006</u>			
Basic net income per share	\$ 772,128	15,087,865	\$ 0.05
Dilutive securities:			
Options	-	851,551	
Convertible debentures	-	-	
Diluted net income per share	<u>\$ 772,128</u>	<u>15,939,416</u>	<u>\$ 0.05</u>
	Net Earnings (numerator)	Weighted Average Shares (denominator)	Per Share Amount
<u>2005</u>			
Basic net income per share	\$ 3,025,064	13,381,704	\$ 0.23
Dilutive securities:			
Options	-	677,122	
Warrants	-	312,041	
Convertible debentures	-	584,573	
Diluted net income per share	<u>\$ 3,025,064</u>	<u>14,955,440</u>	<u>\$ 0.20</u>

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11. Commitments

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

2007	\$ 40,188
2008	<u>36,839</u>
	<u>\$ 77,027</u>

At December 31, 2006 and 2005, the Company had no forward commodity contracts in place.

12. Related party transactions

- (a) Accounting services in the amount of \$73,102 (2005 - \$73,833) were provided by a partnership of which a director of the Company is a partner. Legal services in the amount of \$130,083 (2005 - \$47,673) were provided by a law firm of which a director of the Company is also an associate. Included in accounts payable and accrued liabilities at December 31, 2006 is \$22,348 (2005 - \$17,260) owing to these related parties.
- (b) Included in interest on convertible debentures payable (note 3) is \$72,066 (2005 - \$68,942) paid to directors, to debenture holders related to directors and to companies controlled by directors. Included in convertible debentures payable at December 31, 2006 are debentures payable to these related parties with a carrying value of \$1,267,200 (2005 - \$NIL).

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

13. Financial instruments

- (a) Fair values

The fair values of cash and cash equivalents, bank indebtedness, 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, obligations under capital leases and amount due to officers and directors approximate their carrying values as they bear interest at market rates for similar instruments.

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(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 value of its accounts receivable.

(c) Interest rate risk

The Company is exposed to interest rate cash flow risk to the extent that bank indebtedness bears interest at floating interest rates.

The Company is exposed to interest rate price risk to the extent that the debentures payable are at a fixed interest rate.

(d) 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.

14. Supplemental cash flow information

(a) Changes in non-cash working capital

	2006	2005
Accounts receivable	\$ 1,802,588	\$ (2,453,704)
Prepaid expenses and deposits	(45,065)	(88,747)
Accounts payable and accrued liabilities	(1,484,080)	3,024,901
Current income taxes payable	<u>-</u>	<u>(122,975)</u>
	<u>\$ 273,443</u>	<u>\$ 359,475</u>
Change in non-cash working capital relating to:		
Financing activities	\$ -	\$ 44,021
Investing activities	(543,884)	1,750,497
Operating activities	<u>817,327</u>	<u>(1,435,043)</u>
	<u>\$ 273,443</u>	<u>\$ 359,475</u>

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

	2006	2005
Conversion of debentures (note 10[f])	\$ <u> -</u>	\$ <u>1,485,000</u>
Asset retirement liabilities incurred	\$ <u>1,094,068</u>	\$ <u>687,528</u>
Acquisition of equipment under capital leases (notes 4 and 7)	\$ <u> -</u>	\$ <u>1,291,760</u>