

**TWOCO PETROLEUMS LTD.**

**FINANCIAL STATEMENTS**

**DECEMBER 31, 2008**

## Auditors' Report

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To the Shareholders of  
Twoco Petroleum Ltd.:

We have audited the balance sheets of Twoco Petroleum Ltd. as at December 31, 2008 and 2007 and the statements of income (loss), comprehensive income (loss) 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 financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Calgary, Alberta  
April 3, 2009

(signed) "Deloitte & Touche LLP"  
Chartered Accountants

**TWOCO PETROLEUMS LTD.**

**Balance Sheets**

**As at December 31, 2008 and 2007**

	<u>2008</u>	<u>2007</u>
<b>Assets</b>		
Current assets		
Accounts receivable	\$ 2,007,891	\$ 1,829,928
Prepaid expenses and deposits	<u>618,960</u>	<u>553,463</u>
	2,626,851	2,383,391
Property, plant and equipment (note 6)	<u>61,371,471</u>	<u>50,350,663</u>
	<u>\$ 63,998,322</u>	<u>\$ 52,734,054</u>
<b>Liabilities</b>		
Current liabilities		
Bank indebtedness and credit facility (note 7)	\$ 16,238,749	\$ 6,209,859
Accounts payable and accrued liabilities (note 13)	2,622,449	2,062,263
Current portion of capital lease obligation (note 8)	320,819	220,670
Convertible debentures (notes 4 and 5)	<u>11,968,135</u>	<u>-</u>
	31,150,152	8,492,792
Obligations under capital leases (note 8)	219,011	539,505
Convertible debentures (notes 4 and 5)	-	11,840,675
Asset retirement obligations (note 9)	3,455,960	2,762,151
Future income taxes (note 10)	<u>4,677,000</u>	<u>4,636,350</u>
	<u>39,502,123</u>	<u>28,271,473</u>
<b>Shareholders' Equity</b>		
Share capital (note 11)	20,216,621	20,250,003
Equity portion of convertible debentures (note 5)	160,000	160,000
Contributed surplus (note 11[f])	874,904	1,128,929
Retained earnings	<u>3,244,674</u>	<u>2,923,649</u>
	<u>24,496,199</u>	<u>24,462,581</u>
	<u>\$ 63,998,322</u>	<u>\$ 52,734,054</u>

Approved by the Board:

(signed) "Wayne A. Malinowski", Director

(signed) "Larry C. Mah", Director

See accompanying notes to these financial statements

**TWOCO PETROLEUMS LTD.**

**Statements of Income (Loss), Comprehensive Income (Loss) and Retained Earnings**

**For the Years Ended December 31, 2008 and 2007**

	2008	2007
<b>Revenue</b>		
Petroleum and natural gas sales	\$ 20,109,466	\$ 15,595,361
Royalties	(3,286,042)	(2,854,371)
	16,823,424	12,740,990
Interest	36	11,331
	16,823,460	12,752,321
<b>Expenses</b>		
Operating	2,908,902	2,040,992
Transportation	703,272	622,529
General and administrative (note 13[a])	911,349	651,301
Interest on bank debt	294,455	258,247
Interest on capital leases	40,535	53,446
Interest on convertible debentures (notes 5 and 13[b])	953,332	953,332
Stock-based compensation (notes 11[e] and 11[f])	16,725	165,859
Amortization of convertible debentures financing charges (note 5)	74,128	68,377
Depletion, amortization and accretion	10,146,389	9,353,042
	16,049,087	14,167,125
Income (loss) before income taxes	774,373	(1,414,804)
Income tax expense (recovery) (note 10)		
- Current	-	4,890
- Future	40,650	(563,327)
	40,650	(558,437)
Net income (loss) and comprehensive income (loss)	733,723	(856,367)
Retained earnings, beginning of year	2,923,649	4,106,969
	3,657,372	3,250,602
Acquisition of shares in excess of carrying value (note 11[d])	(412,698)	(326,953)
Retained earnings, end of year	\$ 3,244,674	\$ 2,923,649
Net income (loss) and comprehensive income (loss) per share (note 11[g])		
Basic	\$ 0.05	\$ (0.06)
Diluted	\$ 0.05	\$ (0.06)

See accompanying notes to these financial statements

**TWOCO PETROLEUMS LTD.**

**Statements of Cash Flows**

**For the Years Ended December 31, 2008 and 2007**

	2008	2007
Cash provided by (used for)		
Operating activities		
Net income (loss) and comprehensive income (loss)	\$ 733,723	\$ (856,367)
Add items not affecting cash		
Stock-based compensation	16,725	165,859
Future income tax expense (recovery)	40,650	(563,327)
Depletion, amortization and accretion	10,146,389	9,353,042
Convertible debentures accretion	53,332	53,332
Amortization of convertible debentures financing charges	74,128	68,377
Settlement of asset retirement obligations	-	(72,567)
	11,064,947	8,148,349
Change in non-cash working capital (note 16[a])	57,532	(1,710,606)
	11,122,479	6,437,743
Financing activities		
Repayment of obligations under capital lease	(220,345)	(207,435)
Share issuance costs	(557)	(500)
Exercise of stock options	762,499	74,750
Repurchase of common shares	(1,478,772)	(509,827)
Financing through bank indebtedness	16,238,749	-
Refund of financing charges on convertible debenture	-	23,000
	15,301,574	(620,012)
Investing activities:		
Acquisition of property, plant and equipment	(20,473,390)	(14,875,074)
Change in non-cash working capital (note 16[a])	259,196	979,776
	(20,214,194)	(13,895,298)
Cash inflow (outflow)	6,209,859	(8,077,567)
Cash and cash equivalents (bank indebtedness), beginning of year	(6,209,859)	1,867,708
Cash and cash equivalents, (bank indebtedness), end of year	\$ 0	\$ (6,209,859)
Cash and cash equivalents (bank indebtedness) is comprised of:		
Indebtedness with bank	\$ (16,238,749)	\$ (6,213,991)
Reclassified to financing activities	16,238,749	-
Term deposits	-	4,132
	\$ -	\$ (6,209,859)
Supplemental cash flow information:		
Interest paid	\$ 1,309,117	\$ 1,213,473
Taxes paid	\$ -	\$ 4,890

The non-cash transactions described in note 16(b) have been excluded from the statements of cash flows.

See accompanying notes to these financial statements

# **TWOCO PETROLEUMS LTD.**

## **Notes to Financial Statements**

**December 31, 2008 and 2007**

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1. Nature of operations

Twoco Petroleum Ltd. ("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.

2. Future accounting pronouncements

In January 2006, the CICA Accounting Standards Board ("AcSB") adopted a strategic plan for the direction of accounting standards in Canada. As part of the plan, accounting standards in Canada for public companies are expected to converge with International Financial Reporting Standards ("IFRS") for reporting periods beginning on or after January 1, 2011. The Company continues to monitor and assess the impact of the convergence of Canadian GAAP and IFRS.

The Company has assessed new and revised accounting pronouncements that have been issued that are not yet effective and determined that the following may have a significant impact on the Company:

Goodwill and intangible assets

As of January 1, 2009, the Company will be required to adopt CICA Section 3064, "Goodwill and Intangible Assets", which will replace CICA Section 3062. This new guidance reinforces a principles-based approach to the recognition of costs as assets in accordance with the definition of an asset and the criteria for asset recognition under CICA Section 1000, "Financial Statement Concepts". Section 3064 clarifies the application of the concept of matching revenues and expenses in Section 1000 to eliminate the current practice of recognizing as assets items that do not meet the definition and recognition criteria. Under this new guidance, fewer items meet the criteria for capitalization. The Company does not expect any impact of this standard.

Business combinations

In January 2009, the CICA issued new standards for Business Combinations. This standard is effective January 1, 2011 and applies prospectively to business combinations for which the acquisition date is on or after the first annual reporting period beginning on or after January 1, 2011 for the Company. Early adoption is permitted. This standard replaces Handbook Section 1581 Business Combinations, and harmonizes the Canadian standards with IFRS. This standard was amended to require additional use of fair value measurements, recognition of additional assets and liabilities, and increased disclosure. Adopting this standard is expected to have a significant impact on the way the Company accounts for future business combinations.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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#### 3. Changes in accounting policies

##### Financial instruments - disclosures and presentation

Effective January 1, 2008, the Company adopted two new Canadian Institute of Chartered Accountants ("CICA") standards. Handbook Section 3862, "Financial Instruments - Disclosures" and Handbook Section 3863, "Financial Instruments - Presentation". These Handbook Sections replaced existing Handbook Section 3861, "Financial Instruments - Presentation and Disclosure". The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. Specifically, Section 3862 requires disclosure of the significance of financial instruments on the Company's financial position. In addition, the guidance outlines revised requirements for the disclosure of qualitative and quantitative information regarding exposure to risks arising from financial instruments. Refer to note 14, "Financial Instruments and Risk Management" for the additional disclosures under Section 3862. The new presentation standard carries forward the former presentation requirements.

##### Capital disclosures

Effective January 1, 2008, the Company adopted CICA Handbook Section 1535 - "Capital Disclosures", which requires companies to disclose their objectives, policies and processes for managing capital, the nature of externally imposed capital requirements, how the requirements are incorporated into the Company's management of capital, whether the requirements have been complied with, or consequence of non-compliance and an explanation of how the Company is meeting its objectives for managing capital. In addition, quantitative disclosures regarding capital are required. Refer to note 15, "Capital Disclosures".

#### 4. Significant accounting policies

##### (a) Financial instruments

- (i) Convertible debentures are classified as a financial liability and are measured at amortized cost. Amortized cost is the amount at which the financial liability is measured at initial recognition minus principal repayments plus the cumulative amortization of any deferred financing charges and the convertible debenture discount using the effective interest method.

Prior to January 1, 2007, deferred financing charges related to the convertible debentures were presented as a separate asset on the balance sheet and amortized on a straight-line basis. Under the new standards, deferred financing charges are recognized as an offset to the carrying value of convertible debentures and are amortized using the effective interest method.

- (ii) Derivative instruments and hedging

The Company does not have any outstanding derivative or hedging contracts as at December 31, 2008.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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4. Significant accounting policies (continued)

(iii) Comprehensive income

Comprehensive income is the change in equity of the Company from net income and other comprehensive income ("OCI"). OCI consists of the change in the fair value of any financial instruments classified as available for sale. Amounts recognized in OCI must eventually be reclassified to income when the related gains or losses are realized and the related asset or liability is no longer recognized on the Balance Sheet.

The Company has no transactions that are categorized as OCI and, as such, has not presented a statement of accumulated OCI in the financial statements.

(iv) Equity

Section 3251 – "Equity" establishes standards for the presentation of equity and changes in equity during the reporting periods. This section specifies that changes in equity for the period arising from net income, OCI, other changes in deficit, changes in contributed surplus, and changes in share capital must be presented separately.

(b) Use of estimates

The 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. While management believes that its estimates have been reasonable in the circumstances, the global credit market crisis, the volatility in the price of oil and natural gas, the recession in Canada and the slowdown of economic growth in the rest of the world has created a substantially more volatile business environment. These conditions will limit certainty of the Company's previously planned business development activities and it will continue to provide risk for the Company's future operations. To prepare these financial statements, management has recorded adjustments and included disclosures based on their best estimates of future business activity and expected cash flows. The financial statements have, in management's opinion, been properly prepared within the framework of the significant accounting policies summarized below.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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4. Significant accounting policies (continued)

(c) 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, some of these estimates are subject to measurement uncertainty, and the effect of changes in such estimates on the financial statements of future periods could be significant.

(d) Property, plant and equipment

(i) Petroleum and nature 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.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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4. Significant accounting policies (continued)

(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 valued 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.

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.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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4. Significant accounting policies (continued)

(e) 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.

(f) Stock-based compensation

Compensation expense 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.

(g) Joint venture accounting

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

(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.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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4. Significant accounting policies (continued)

(i) 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.

(j) 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.

(k) 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.

5. Convertible debentures

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 previously recorded as deferred financing charges have been netted against convertible debentures payable, as disclosed in note 4(a). Amortization expense of \$74,128 has been recognized for the year ended December 31, 2008 (2007 - \$68,377).

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.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

5. Convertible debentures (continued)

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 convertible debentures. The present value of this conversion benefit of \$160,000 was recorded on the 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 convertible debentures will accrete up to the face value over the term to maturity. Accretion of \$53,332 has been recognized in interest expense for the year ended December 31, 2008 (2007 - \$53,332).

The overall effective interest rate on convertible debentures is 8.58% (2007 – 8.58%).

6. Property, plant and equipment

	<b>2008</b>		
	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net Book Value</b>
Petroleum and natural gas properties	\$ 92,676,959	\$ 31,921,856	\$ 60,755,103
Other assets	194,712	150,608	44,104
Equipment under capital leases	<u>1,302,961</u>	<u>730,697</u>	<u>572,264</u>
	<u>\$ 94,174,632</u>	<u>\$ 32,803,161</u>	<u>\$ 61,371,471</u>
	<b>2007</b>		
	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net Book Value</b>
Petroleum and natural gas properties	\$ 71,682,502	\$ 22,070,316	\$ 49,612,186
Other assets	177,806	132,902	44,905
Equipment under capital leases	<u>1,302,961</u>	<u>609,389</u>	<u>693,572</u>
	<u>\$ 73,163,269</u>	<u>\$ 22,812,606</u>	<u>\$ 50,350,663</u>

During the current year, the Company capitalized \$261,079 (2007 - \$247,591) in general and administrative expenses related directly to acquisition, exploration and development activities. As at December 31, 2008, the depletion calculation excluded unproved properties of \$6,806,037 (2007 – \$6,489,197).

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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6. Property, plant and equipment (continued)

The future prices used in the ceiling test as of December 31, 2008 are:

Year	Company Average Oil (CDN \$/Bbl)	Company Average Natural Gas (CDN \$/mcf)
2009	\$ 43.30	\$ 6.89
2010	58.10	7.97
2011	63.40	8.12
2012	69.20	8.94
2013	76.95	9.71
2014	79.15	9.91
2015	81.45	10.11
2016	83.80	10.27
2017	86.15	10.48
2018	88.60	10.70

7. Bank indebtedness and credit facility

As at December 31, 2008, the Company has a revolving demand credit facility with a maximum availability of \$20.0 (2007 - \$20.0) million and a \$1.5 (2007 - \$1.5) million general lease line of credit. The interest rate at December 31, 2008 was prime of 3.5% (2007 - prime of 6%). The effective interest rate for 2008 was 4.73% (2007 - 6.15%). 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 drawn \$16.2 million on the credit facility at December 31, 2008 (2007 - \$6.2 million).

8. 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 \$572,264 (2007 - \$693,572).

	2008	2007
Obligations under capital leases	\$ 539,830	\$ 760,175
Less: Portion due within one year	<u>320,819</u>	<u>220,670</u>
	<u>\$ 219,011</u>	<u>\$ 539,505</u>

**TWOCO PETROLEUMS LTD.**

**Notes to Financial Statements**

**December 31, 2008 and 2007**

8. Obligations under capital leases (continued)

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

2009	\$ 346,410
2010	161,604
2011	<u>67,336</u>
 Total minimum lease payments	 575,350
 Less: Amount representing interest at rates of 5.5% to 6.4%	 <u>35,520</u>
	 <u>\$ 539,830</u>

9. Asset retirement obligations

	<b>2008</b>	<b>2007</b>
Balance, beginning of year	\$ 2,762,151	\$ 2,551,724
Accretion expense	155,834	139,480
Liabilities incurred	381,137	340,566
Changes in estimate	156,838	(197,052)
Liabilities settled	<u>-</u>	<u>(72,567)</u>
 Balance, end of year	 <u>\$ 3,455,960</u>	 <u>\$ 2,762,151</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 \$5,313,793 (2007 - \$3,927,093). These payments are expected to be made over the next 2 to 15 years. The Company used a credit adjusted risk free rate of 6.78% (2007 - 6.01%) and an estimated inflation rate of 2.1% (2007 - 1.95%) 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 29.50% (2007 - 31.12%) to income before income taxes as follows:

	<b>2008</b>	<b>2007</b>
Computed expected tax provision	\$ 228,440	\$ (454,435)
Increase (decrease) resulting from:		
Stock-based compensation	4,934	53,274
Impact of future tax rate deductions	(208,414)	(167,689)
Other	<u>15,690</u>	<u>10,413</u>
	 <u>\$ 40,650</u>	 <u>\$ (558,437)</u>

**TWOCO PETROLEUMS LTD.**

**Notes to Financial Statements**

**December 31, 2008 and 2007**

10. Future income taxes (continued)

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

	<b>2008</b>	<b>2007</b>
Carrying value of property, plant and equipment in excess of tax pools	\$ 5,969,096	\$ 5,536,909
Asset retirement obligations	(1,230,291)	(795,499)
Share issue costs and financing fees	(40,871)	(84,578)
Attributed Canadian Royalty Income carryforward and other	<u>(20,934)</u>	<u>(20,482)</u>
	<u>\$ 4,677,000</u>	<u>\$ 4,636,350</u>

11. Share capital

(a) Authorized

Unlimited voting common shares  
Unlimited non-voting preferred shares

(b) Issued

	<b>2008</b>		<b>2007</b>	
	<b>Number</b>	<b>Stated Value</b>	<b>Number</b>	<b>Stated Value</b>
<b>Common shares</b>				
Balance, beginning of year	15,147,606	\$20,250,003	15,259,806	\$21,686,393
Pursuant to a normal course issuer bid	(790,600)	(1,066,074)	(137,200)	(182,874)
Exercise of stock options (note 11[c])	<u>610,000</u>	<u>1,033,249</u>	<u>25,000</u>	<u>96,861</u>
Balance, end of year	<u>14,967,006</u>	\$20,217,178	<u>15,147,606</u>	\$21,600,380
Less: Share issue cost, net of tax benefits		(557)		(500)
Tax benefits renounced to flow-through shareholders		<u>-</u>		<u>(1,349,877)</u>
Balance, end of year		<u>\$20,216,621</u>		<u>\$20,250,003</u>

(c) During the year 610,000 stock options were exercised for gross cash proceeds of \$762,500. \$270,750 was allocated from contributed surplus relating to these options.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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#### 11. Share capital (continued)

- (d) On October 16, 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 obliged to make any purchases pursuant to the 2006 issuer bid. For the year ended December 31, 2008, the Company acquired NIL (2007 – 114,000) common shares at an average price of \$3.60 per share pursuant to the normal course issuer bid dated October 16, 2006. The excess cost of re-acquisition over stated value in the amount of \$NIL (2007 - \$258,216) has been charged to retained earnings.

On October 16, 2007, the Company commenced a normal course issuer bid under which it can repurchase up to 750,000 of its common shares until October 16, 2008. 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 obliged to make any purchases pursuant to this 2007 issuer bid. For the year ended December 31, 2008, the Company acquired 490,600 (2007 – 23,200) common shares at an average price of \$2.40 (2007 - \$4.30) per share pursuant to the normal course issuer bid dated October 16, 2007. The excess cost of re-acquisition over stated value in the amount of \$515,449 (2007 - \$68,738) has been charged to retained earnings.

On October 16, 2008, the Company commenced a normal course issuer bid under which it can repurchase up to 750,000 of its common shares until October 16, 2009. 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 obliged to make any purchases pursuant to this 2008 issuer bid. For the year ended December 31, 2008, the Company acquired 300,000 (2007 – NIL) common shares at an average price of \$1.01 (2007 - \$NIL) per share pursuant to the normal course issuer bid dated October 16, 2008. The excess of stated value over the re-acquisition costs \$102,751 (2007 - \$NIL) has been charged to retained earnings.

#### (e) Stock option plan

The Company has a 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 1,467,000 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.

**TWOCO PETROLEUMS LTD.**

**Notes to Financial Statements**

**December 31, 2008 and 2007**

11. Share capital (continued)

A summary of the status of the Company's stock option plan as at December 31, 2008 and 2007 and changes during those years then ended is as follows:

	<b>2008</b>		<b>2007</b>	
	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>
Outstanding, beginning of year	1,432,000	\$ 2.53	1,442,000	\$ 2.51
Issued	10,000	3.50	15,000	4.46
Exercised	<u>(610,000)</u>	1.25	<u>(25,000)</u>	2.99
Outstanding, end of year	<u>832,000</u>	\$ 3.47	<u>1,432,000</u>	\$ 2.53

The following table summarizes information about stock options outstanding and exercisable:

<b>2008</b>			<b>2007</b>		
<b>Range of Exercise Prices</b>	<b>Number of Options</b>	<b>Average Remaining Life (Years)</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>
\$ -	-	-	\$ -	610,000	\$ 1.25
1.75	20,000	0.36	1.75	20,000	1.75
2.20	280,000	0.61	2.20	280,000	2.20
3.00	218,000	1.02	3.00	218,000	3.00
3.75	170,000	1.32	3.75	170,000	3.75
4.46	15,000	3.31	4.46	15,000	4.46
7.10	119,000	1.93	7.10	119,000	7.10
3.50	<u>10,000</u>	4.31	3.50	<u>-</u>	-
	<u>832,000</u>	1.10	\$ 3.47	<u>1,432,000</u>	\$ 2.53

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:

Weighted average risk-free interest rate (%) of each option granted	4.07
Option life (years)	2.00
Weighted average expected volatility (%) of each option granted	62
Weighted average fair value of each Option granted (\$)	1.63
Dividend yield per share	-

**TWOCO PETROLEUMS LTD.**

**Notes to Financial Statements**

**December 31, 2008 and 2007**

11. Share capital (continued)

(f) Contributed surplus

	<b>2008</b>	<b>2007</b>
Balance, beginning of year	\$ 1,128,929	\$ 985,181
Exercise of stock options	(270,750)	(22,111)
Stock-based compensation expense	<u>16,725</u>	<u>165,859</u>
Balance, end of year	<u>\$ 874,904</u>	<u>\$ 1,128,929</u>

(g) Per share amounts

The weighted average number of shares outstanding for the year ended December 31, 2008 was 15,353,605 (2007 – 15,220,739).

In computing diluted net income per share amounts, 73,018 (2007 – NIL) shares were added to the weighted average number of common shares outstanding during the year ended December 31, 2008 for the dilutive effect of stock options and convertible debentures. For 2007 and 2008, stock options and convertible debentures were determined to be anti-dilutive and have been excluded from the calculation of diluted net income per share.

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

	Net Earnings (Loss) <i>(numerator)</i>	Weighted Average Shares <i>(denominator)</i>	Per Share Amount
<b><u>2008</u></b>			
Basic net income (loss) per share	\$ 733,723	15,353,605	\$ 0.05
Dilutive securities:			
Options	-	73,018	
Convertible debentures	<u>-</u>	<u>-</u>	
Diluted net income (loss) per share	<u>\$ 733,723</u>	<u>15,426,623</u>	<u>\$ 0.05</u>
<b><u>2007</u></b>			
Basic net income (loss) per share	\$ (856,367)	15,220,739	\$ (0.06)
Dilutive securities:			
Options	-	-	
Convertible debentures	<u>-</u>	<u>-</u>	
Diluted net income (loss) per share	<u>\$ (856,367)</u>	<u>15,220,739</u>	<u>\$ (0.06)</u>

**TWOCO PETROLEUMS LTD.**

**Notes to Financial Statements**

**December 31, 2008 and 2007**

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12. Commitments

The Company is committed under a lease on its office premises, with future minimum payments (excluding expected occupancy costs) as at December 31, 2008 as follows:

2009	\$	89,100
2010		89,100
2011		<u>51,975</u>
	\$	<u>230,175</u>

13. Related party transactions

(a) Legal services in the amount of \$60,033 (2007 - \$53,357) were provided by a law firm of which a director of the Company was also an associate. Consulting fees of \$39,572 (2007 - \$NIL) were incurred to a corporation of which a director of the Company is the president and shareholder. During the year ended December 31, 2007, such director was a partner with an accounting firm to which the Company incurred accounting fees of \$77,674. Included in accounts payable and accrued liabilities at December 31, 2008 is \$NIL (2007 - \$551) owing to these related parties.

(b) Included in interest on convertible debentures payable (note 5) is \$114,750 (2007 - \$114,750) paid to directors, to debenture holders related to directors and to companies controlled by directors. Included in convertible debentures payable at December 31, 2008 are debentures payable to these related parties with a carrying value of \$1,509,686 (2007 - \$1,509,686).

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 and risk management

(a) Fair values

The Company's financial instruments consist of accounts receivable, accounts payable and accrued liabilities, convertible debentures, and bank indebtedness and credit facility. The fair value of these instruments approximate their carrying amounts due to their short terms to maturity or because they bear interest at market rates for similar instruments. The fair value of the convertible debentures approximates carrying amount as the debentures mature in the short term and interest rates are not expected to fluctuate materially during that time.

(b) Credit risk

Virtually all of the Company's accounts receivable are due from joint venture partners in the oil and gas industry and from purchasers of the Company's petroleum and natural gas production and are subject to normal industry credit risks. The Company generally extends unsecured credit to these parties 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's maximum exposure to credit risk on the sale of petroleum and natural gas production is approximately two months of production.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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#### 14. Financial instruments and risk management (continued)

Receivables from petroleum and natural gas marketers are normally collected on the twenty-fifth day of the month following production. Receivables related to the sale of the Company's petroleum and natural gas production are from major marketing companies with investment grade credit ratings. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to expenditure and issuing cash calls on large capital projects from its partners on capital projects before they commence. The Company reviews the financial status of joint venture partners before partner approval is obtained.

##### (c) Liquidity risk

Liquidity risk relates to the risk the Company will encounter difficulty in meeting obligations associated with financial liabilities. The financial liabilities on its balance sheet consist of accounts payable and accrued liabilities, obligations under capital lease, convertible debentures payable and bank indebtedness. Management closely monitors cash flow requirements to ensure that it has sufficient cash on demand or borrowing capacity to meet operational and financial obligations.

##### (d) Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices, and interest rates will affect the Company's net earnings or the value of financial instruments. These risks are generally outside the control of the Company. The objective of the Company is to mitigate market risk exposures within acceptable limits, while maximizing returns.

##### (e) Interest rate risk

The Company is exposed to interest rate cash flow risk on its outstanding bank indebtedness which has a floating interest rate and would impact the Company's future cash flows. The Company had no interest rate swaps or hedges at December 31, 2008.

In regards to interest rate cash flow risk, an increase or decrease of one percent to the effective interest rate for the Company would have impacted net earnings by \$73,826 for the period.

##### (f) Foreign currency risk

The Company is exposed to foreign currency fluctuations as crude oil and natural gas prices are referenced to U.S. dollar denominated prices. As at December 31, 2008, the Company had no forward foreign exchange contracts in place, nor any significant working capital items denominated in foreign currencies.

## TWOCO PETROLEUMS LTD.

### Notes to Financial Statements

December 31, 2008 and 2007

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14. Financial instruments and risk management (continued)

(g) Commodity price risk

The nature of the Company's operations results in exposure to fluctuations in commodity prices. As at December 31, 2008, the Company had no derivative contracts in place.

15. Capital disclosure

The Company's objectives when managing capital are: (i) to maintain a flexible capital structure, which optimizes the cost of capital at acceptable risk; and (ii) to maintain investor, creditor and market confidence to sustain the future development of the business.

The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of our underlying assets. The Company considers its capital structure to include shareholders' equity, debt and working capital. To maintain or adjust the capital structure, the Company may from time to time, issue shares, raise debt and/or adjust its capital spending to manage its current and projected debt levels.

The Company monitors capital based on the current and projected ratios of debt to cash flow and debt to capital employed. The Company's objective is to maintain a debt to cash flow from operations ratio of less than two times. The ratio may increase at certain times as a result of acquisitions. To facilitate the management of this ratio, the Company prepares annual budgets, which are updated depending on varying factors such as general market conditions and successful capital deployment. The annual budget is approved by the Board of Directors.

The Company's share capital is not subject to external restrictions.

There were no changes in the Company's approach to capital management from the previous year.

16. Supplemental cash flow information

a) Changes in non-cash working capital

	<b>2008</b>	<b>2007</b>
Accounts receivable	\$ (177,963)	\$ 213,246
Prepaid expenses and deposits	(65,497)	(166,721)
Accounts payable and accrued liabilities	<u>560,188</u>	<u>(777,355)</u>
	<u>\$ 316,728</u>	<u>\$ (730,830)</u>
Change in non-cash working capital relating to:		
Operating activities	\$ 57,532	\$ 979,776
Investing activities	<u>259,196</u>	<u>(1,710,606)</u>
	<u>\$ 316,728</u>	<u>\$ (730,830)</u>

**TWOCO PETROLEUMS LTD.**

**Notes to Financial Statements**

**December 31, 2008 and 2007**

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16. Supplemental cash flow information (continued)

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

	<b>2008</b>	<b>2007</b>
Asset retirement liabilities incurred	<u>\$ 537,975</u>	<u>\$ 143,514</u>

17. Subsequent events

Subsequent to year end, and pursuant to the Normal Course Issuer Bid dated October 16, 2008, the Company repurchased 24,300 common shares at prices ranging from \$1.04 to \$1.95 per share for consideration of \$35,279.

Subsequent to year end, the Company closed a private placement of \$8.3 million of unsecured debentures ("Debentures") and warrants to purchase common shares. Subscribers for Debentures received one-half of one share purchase warrant for each \$1.00 of principal amount of Debentures. Each whole share purchase warrant entitles the holder thereof to purchase a common share of the Company at a price of \$1.20 per share at any time prior to March 31, 2011. An aggregate of 4,150,000 common shares may be issued if all of the share purchase warrants are exercised prior to their expiry. The Debentures bear interest at the rate of 17% per annum, payable commencing June 30, 2009 and quarterly thereafter and will mature March 31, 2011. The Debentures are not redeemable by the Company. The proceeds of the offering will be used, in part, to repay the 7.5% redeemable, convertible unsecured debentures of the Company which matured March 31, 2009 and for general corporate purposes. The Company paid a total of \$128,600 in finder's fees in connection with the sale of Debentures. The Debentures, share purchase warrants and any common shares issuable upon the exercise of the share purchase warrants have a hold period which expires August 1, 2009.