

TWOCO PETROLEUMS LTD.

FINANCIAL STATEMENTS

DECEMBER 31, 2009

Auditors' Report

To the Shareholders of
Twoco Petroleum Ltd.:

We have audited the balance sheets of Twoco Petroleum Ltd. as at December 31, 2009 and 2008 and the statements of income (loss), comprehensive income (loss) and retained earnings (deficit) 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, 2009 and 2008 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 27, 2010

(signed) "Deloitte & Touche LLP"
Chartered Accountants

TWOCO PETROLEUMS LTD.

Balance Sheets

As at December 31, 2009 and 2008

	<u>2009</u>	<u>2008</u>
Assets		
Current assets		
Accounts receivable	\$ 909,921	\$ 2,007,891
Prepaid expenses and deposits	<u>624,105</u>	<u>618,960</u>
	1,534,026	2,626,851
Property, plant and equipment (note 6)	<u>49,221,084</u>	<u>61,371,471</u>
	<u>\$ 50,755,110</u>	<u>\$ 63,998,322</u>
Liabilities		
Current liabilities		
Bank indebtedness and credit facility (note 7)	\$ 18,316,692	\$ 16,238,749
Accounts payable and accrued liabilities (note 12)	1,326,693	2,622,449
Current portion of capital lease obligation	-	320,819
Convertible debentures (note 5)	<u>-</u>	<u>11,968,135</u>
	19,643,385	31,150,152
Obligations under capital leases	-	219,505
Unsecured debentures (note 5)	8,158,847	-
Asset retirement obligations (note 8)	3,252,420	3,455,960
Future income taxes (note 9)	<u>1,965,000</u>	<u>4,677,000</u>
	<u>33,019,652</u>	<u>39,502,123</u>
Shareholders' Equity		
Share capital (note 10)	20,181,041	20,216,621
Equity portion of unsecured and convertible debentures (note 5)	20,750	160,000
Contributed surplus (note 10(d))	1,043,960	874,904
Retained earnings (deficit)	<u>(3,510,293)</u>	<u>3,244,674</u>
	<u>17,735,458</u>	<u>24,496,199</u>
	<u>\$ 50,755,110</u>	<u>\$ 63,998,322</u>

Basis of presentation and going concern (note 1)

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 (Deficit)**

For the Years Ended December 31, 2009 and 2008

	2009	2008
Revenue		
Petroleum and natural gas sales	\$ 9,244,996	\$ 20,109,466
Royalties	(639,515)	(3,286,042)
	8,605,481	16,823,424
Interest	-	36
	<u>8,605,481</u>	<u>16,823,460</u>
Expenses		
Operating	3,277,023	2,908,902
Transportation	596,240	703,272
General and administrative (note 12)	979,333	911,349
Interest on bank debt	604,230	294,455
Interest on capital leases	35,977	40,535
Interest on debentures (notes 5 and 12)	1,285,000	953,332
Stock-based compensation (note 10)	9,056	16,725
Amortization of convertible and unsecured debentures (note 5)	21,117	74,128
Depletion, amortization and accretion	11,261,976	10,146,389
	<u>18,069,952</u>	<u>16,049,087</u>
Income (loss) before income taxes	<u>(9,464,471)</u>	<u>774,373</u>
Income tax expense (recovery) (note 9)		
- Current	-	-
- Future	(2,712,000)	40,650
	<u>(2,712,000)</u>	<u>40,650</u>
Net income (loss) and comprehensive income (loss)	<u>(6,752,471)</u>	<u>733,723</u>
Retained earnings, beginning of year	<u>3,244,674</u>	<u>2,923,649</u>
	(3,507,797)	3,657,372
Acquisition of shares in excess of carrying value (note 10)	<u>(2,496)</u>	<u>(412,698)</u>
Retained earnings (deficit), end of year	<u>\$ (3,510,293)</u>	<u>\$ 3,244,674</u>
Net income (loss) and comprehensive income (loss) per share (note 10)		
Basic	<u>\$ (0.45)</u>	<u>\$ 0.05</u>
Diluted	<u>\$ (0.45)</u>	<u>\$ 0.05</u>

See accompanying notes to these financial statements.

TWOCO PETROLEUMS LTD.

Statements of Cash Flows

For the Years Ended December 31, 2009 and 2008

	<u>2009</u>	<u>2008</u>
Cash provided by (used for)		
Operating activities		
Net income (loss)	\$ (6,752,471)	\$ 733,723
Add items not affecting cash		
Stock-based compensation	9,056	16,725
Future income tax expense (recovery)	(2,712,000)	40,650
Depletion, amortization and accretion	11,261,976	10,146,389
Convertible debentures accretion	91,455	53,332
Amortization of convertible debentures financing charges	<u>21,117</u>	<u>74,128</u>
	1,919,133	11,064,947
Change in non-cash working capital (note 15(a))	<u>491,486</u>	<u>57,532</u>
	2,410,619	11,122,479
Financing activities		
Repayment of obligations under capital lease	(539,823)	(220,345)
Share issuance costs	(1,000)	(557)
Debenture issuance costs	(201,113)	-
Exercise of stock options	-	762,499
Repurchase of common shares	(37,076)	(1,478,772)
Financing through bank indebtedness	2,077,943	16,238,749
Redemption of convertible debentures	(12,000,000)	-
Issuance of unsecured debentures	<u>8,300,000</u>	<u>-</u>
	<u>(2,401,069)</u>	<u>15,301,574</u>
Investing activities:		
Acquisition of property, plant and equipment	(1,214,504)	(20,473,390)
Disposal of property, plant and equipment	1,899,372	-
Change in non-cash working capital (note 15(a))	<u>(694,418)</u>	<u>259,196</u>
	<u>(9,550)</u>	<u>(20,214,194)</u>
Cash inflow (outflow)	-	6,209,859
Bank indebtedness, beginning of year	<u>-</u>	<u>(6,209,859)</u>
Cash and cash equivalents end of year	<u>\$ -</u>	<u>\$ -</u>
Supplemental cash flow information:		
Interest paid	<u>\$ 1,925,207</u>	<u>\$ 1,309,117</u>
Taxes paid	<u>\$ -</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 these financial statements

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

1. Nature of operations and going concern

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.

In late 2008 and continuing through into 2010, 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. Tighter credit and equity markets, especially for small companies where the access to credit and additional equity funding is limited, has and will continue to limit certain of the Company's planned business development activities and it will continue to provide risk for the Company's future.

Subsequent to year end, on April 21, 2010, the Company's lender proposed certain changes to the current credit facilities as described in note 7 and note 16. Management has been working on certain strategic alternatives including, but not limited to, recapitalizing the Company through financing arrangements or merging with other companies. All these alternatives will take time and management believes that it has the continued financial support of the lender and will be able to address and resolve the liquidity issues created by the current economic climate as described above. There is no assurance, however, that any or all of these alternatives will materialize or that additional funding will be available, if and when needed.

As at December 31, 2009, the Company had \$18,300,000 outstanding on its credit facility, a deficit of \$3,510,293 and incurred a loss of \$6,752,471 for the year then ended.

Management believes the going concern assumption is appropriate for these financial statements. Therefore, the financial statements do not reflect the adjustments that may be necessary if the going concern assumption were not applicable. If this assumption were not appropriate, adjustments to the carrying amount of the assets and liabilities, revenue and expenses and the balance sheet classification used may be necessary and could be material.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

2. New and revised accounting pronouncements

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 an impact on the Company:

International Financial Reporting Standards

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 convergence of Canadian GAAP and IFRS.

In July 2009, the International Accounting Standards Board ("IASB") issued amendments to IFRS 1 "First-time adoption of IFRS" allowing additional exemptions for first-time adopters. Under these amendments, oil and gas companies can elect to use historical cost under a previous GAAP as the deemed cost for oil and gas assets on the transition date to IFRS.

Business combinations

In January 2009, the CICA issued new standards for business combinations. These standards are effective January 1, 2011 and apply 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. 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.

3. Changes in accounting policies

Goodwill and intangible assets

Effective of January 1, 2009, the Company has adopted CICA Section 3064, "Goodwill and Intangible Assets", which has replaced 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 adoption of this new standard has not had an impact on the Company's financial statements.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

3. Changes in accounting policies (continued)

Credit risk and the fair value of financial assets and financial liabilities

On January 20, 2009, the Company adopted the CICA's EIC-173, "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities." The EIC provides guidance on how to take into account credit risk of an entity and its counterparty when determining the fair value of the financial assets and liabilities, including derivative instruments. The adoption of this EIC did not have a material impact on the amounts reported in the Company's financial statements.

Financial Instruments Disclosure

In June 2009, the CICA issued amendments to CICA Handbook Section 3862, "Financial Instruments – Disclosures." The amendments include enhanced disclosures related to the fair value of financial instruments and the liquidity risk associated with financial instruments. The amendments are effective for annual financial statements for fiscal years ending after September 30, 2009. The additional disclosures required by this standard are provided in Note 13.

4. Significant accounting policies

(a) Financial instruments

- (i) Financial instruments are classified into one of five categories: held-for-trading, held-to-maturity investments, loans and receivables, available-for-sale financial assets or other financial liabilities. All financial instruments are measured in the balance sheet at fair value except for loans and receivables, held-to-maturity investments and other financial liabilities which are measured at amortized cost. Subsequent measurement and accounting for changes in fair value will depend on their initial classification, as follows: held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net earnings. Available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the instrument is derecognized or impaired.

The Company has classified its bank indebtedness and credit facility as held-for-trading. Accounts receivable and deposits are classified as loans and receivables. Accounts payable and accrued liabilities and debentures are classified as other financial liabilities.

- (ii) Derivative instruments and hedging

The Company does not have any outstanding derivative or hedging contracts as at December 31, 2009.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

4. Significant accounting policies (continued)

(b) 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.

(c) 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 the 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, 2009 and 2008

4. Significant accounting policies (continued)

(d) 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.

(e) 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, 2009 and 2008

4. Significant accounting policies (continued)

(e) Property, plant and equipment (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) 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.

(iv) 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 using market adjusted discount rates. Any recognized impairment is recorded as additional depletion and amortization expense.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

4. Significant accounting policies (continued)

(f) 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 over time until it is settled or the property is sold. 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.

(g) Stock-based compensation

Compensation expense attributable to all stock options granted is 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 forfeitures as they occur.

(h) 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.

(i) 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, 2009 and 2008

4. Significant accounting policies (continued)

(j) 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.

(k) 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.

(l) Per share information

Net income (loss) 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.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

5. Debentures

(a) Unsecured debentures

On March 31, 2009, the Company closed a private placement financing through the issuance of \$8.3 million of unsecured debentures ("Debentures") and warrants ("Warrants") to purchase common shares. The Debentures bear interest at a rate of 17% per annum, payable commencing June 30, 2009 and quarterly thereafter and will mature two years following the closing date. Finder's fees and commissions of \$189,172 have been netted against debentures payable. Accretion of \$7,781 has been recognized in interest expense for the year ended December 31, 2009 (2008 - NIL). Amortization expense of \$72,928 has been recognized for the year ended December 31, 2009, (2008 - NIL) relating to financing fees and commissions.

Subscribers 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 4:00 pm (Calgary time) on March 31, 2011. A total of 4,150,000 warrants were issued. At December 31, 2009 there were 4,150,000 warrants outstanding.

The value of the warrants was determined to be \$20,750. The portion of the Debentures classified as debt was determined to be \$8,279,250. The debt portion of the Debentures will accrete up to the face value over the term to maturity.

(b) 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 bore interest at a rate of 7.5% per annum payable quarterly and matured on March 31, 2009 at which time they were redeemed in full. Amortization expense of \$18,532 has been recognized for the year ended December 31, 2009 (2008 - \$74,128).

The Convertible Debentures were convertible into common shares of the Company at the holder's option at any time prior to March 31, 2009 (the "Maturity Date") at a conversion price equal to \$7.50 per share for a period up to two years from the closing date and thereafter at a price of \$8.25 until the Maturity Date. The Company had the ability to redeem the Convertible Debentures if the closing price of its common shares on the TSX Venture Exchange exceeded \$8.25 for 21 consecutive trading days or in certain circumstances where an offer was made to acquire common shares of the Company. The present value of this conversion benefit of \$160,000 was recorded on the financial statements as the equity portion of convertible debentures. The Convertible Debentures matured on March 31, 2009 and were fully redeemed. The equity portion of the debentures was included in contributed surplus as the conditions for conversion were never met (note 10(d)). The overall effective interest rate on convertible debentures was 8.58% (2008-8.58%).

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

6. Property, plant and equipment

	2009		
	Cost	Accumulated Amortization	Net Book Value
Petroleum and natural gas properties	\$ 92,886,690	\$ 43,704,843	\$ 49,181,847
Other assets	<u>207,295</u>	<u>168,058</u>	<u>39,237</u>
	<u>\$ 93,093,985</u>	<u>\$ 43,872,901</u>	<u>\$ 49,221,084</u>
	2008		
	Cost	Accumulated Amortization	Net Book Value
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>

During the current year, the Company capitalized \$245,024 (2008 - \$261,079) in general and administrative expenses related directly to acquisition, exploration and development activities. As at December 31, 2009, the depletion calculation excluded unproved properties of \$6,127,494 (2008 – \$6,806,037).

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

6. Property, plant and equipment (continued)

The future prices used in the ceiling test as of December 31, 2009 are:

Year	Company Average Oil (CDN \$/Bbl)	Company Average Natural Gas (CDN \$/mcf)
2010	53.45	5.68
2011	59.35	6.62
2012	62.80	6.99
2013	66.35	7.40
2014	71.91	7.49
2015	79.75	7.71
2016	87.85	7.85
2017	90.20	8.22
2018	92.60	8.82
2019	95.00	8.81

7. Bank indebtedness and credit facility

As at December 31, 2009, the Company has the following credit facilities:

Facility #1 – Operating Demand Loan Facility. Revolving loan used for general operations and to assist with repayment of the Company's previously existing credit facility. The facility has a maximum principal amount of \$18 million. The interest rate varies from prime plus 0.5% to prime plus 1.50% based on the Company's net debt to trailing cash flow ratio. At December 31, 2009, the Company had a balance of \$17,400,000 drawn on this facility.

Facility #2 – Non-Revolving reducing demand loan facility. Non-revolving loan by way of one draw of \$500,000, repayable in 48 monthly payments of \$10,417 plus interest. Interest is charged at rate of prime plus 2.00% per annum. At December 31, 2009, this facility had a balance owing of \$416,667. The future minimum principal payments are as follows:

2010	\$	125,000
2011		125,000
2012		125,000
2013		41,667
Total	\$	<u>416,667</u>

The financing facilities are secured by a general security agreement granting a mortgage, pledge, charge and security interest in all of the Company's property, assets and undertakings. The facility agreement requires that the Company not allow its working capital ratio excluding bank indebtedness to fall below 1.00:1. Bank indebtedness also includes \$500,025 in bank overdrafts.

On April 21, 2010, the Company's lender proposed certain changes to the current credit facilities as described in note 16.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

8. Asset retirement obligations

	2009	2008
Balance, beginning of year	\$ 3,455,960	\$ 2,762,151
Accretion expense	192,237	155,834
Liabilities incurred	5,069	381,137
Reduction in liabilities on sales of assets	(234,244)	-
Changes in estimate	<u>(166,602)</u>	<u>156,838</u>
Balance, end of year	<u>\$ 3,252,420</u>	<u>\$ 3,455,960</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 \$5,004,765 (2008 - \$5,313,793). These payments are expected to be made over the next 2 to 15 years. The Company used a credit adjusted risk free interest rate of 8.00% (2008 – 6.78%) and an estimated inflation rate of 1.5% (2008 – 2.10%) to calculate the present value of the asset retirement obligation.

9. Future income taxes

(a) Income tax expense differs from that which would be expected from applying the combined effective Canadian federal and provincial income tax rates of 29.00% (2008 – 29.50%) to income before income taxes as follows:

	2009	2008
Computed expected tax provision	\$ (2,744,696)	\$ 228,440
Increase (decrease) resulting from:		
Stock-based compensation	2,626	4,934
Impact of future tax rate deductions	22,630	(208,414)
Other	<u>7,440</u>	<u>15,690</u>
	<u>\$ (2,712,000)</u>	<u>\$ 40,650</u>

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

	2009	2008
Carrying value of property, plant and equipment in excess of tax pools	\$ 2,868,674	\$ 5,969,096
Asset retirement obligations	(851,483)	(1,230,291)
Share issue costs and financing fees	(31,566)	(40,871)
Attributed Canadian Royalty Income carry forward and other	<u>(20,625)</u>	<u>(20,934)</u>
	<u>\$ 1,965,000</u>	<u>\$ 4,677,000</u>

TWOCO PETROLEUMS LTD.

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December 31, 2009 and 2008

10. Share capital

(a) Authorized

Unlimited voting common shares

Unlimited non-voting preferred shares

(b) Issued

	2009		2008	
	Number	Stated Value	Number	Stated Value
Common shares				
Balance, beginning of year	14,967,006	\$20,216,621	15,147,606	\$20,250,003
Pursuant to a normal course issuer bid	(25,600)	(34,580)	(730,600)	(1,066,074)
Exercise of stock options (note 10(c))	-	-	610,000	1,033,249
Balance, end of year	<u>14,941,406</u>	\$20,182,041	<u>14,967,006</u>	\$20,217,178
Less: Share issue cost, net of tax benefits		<u>(1,000)</u>		<u>(557)</u>
Balance, end of year		<u>\$20,181,041</u>		<u>\$20,216,621</u>

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

10. Share capital (continued)

(c) Stock option plan

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, 2009, the Company acquired NIL (2008 – 490,600) common shares at an average price of NIL (2008 - \$2.40) 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 NIL (2008 - \$515,449) 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 25,600 (2008 – 300,000) common shares at an average price of \$1.35 (2008 - \$1.01) per share pursuant to the normal course issuer bid dated October 16, 2008. The excess of stated value over the re-acquisition costs \$2,496 (2008 - \$102,751) has been charged to retained earnings.

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 537,000 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, 2009 and 2008

10. Share capital (continued)

A summary of the status of the Company's stock option plan as at December 31, 2009 and 2008 and changes during those years then ended is as follows:

	2009		2008	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of year	832,000	\$ 3.47	1,432,000	\$ 2.53
Issued	-		10,000	3.50
Exercised	-		(610,000)	1.25
Expired	<u>(305,000)</u>	2.20	<u>-</u>	
Outstanding, end of year	<u>527,000</u>	\$ 4.21	<u>832,000</u>	\$ 3.47

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

	2009			2008		
Range of Exercise Prices	Number of Options	Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	
\$			\$ 1.75	20,000	1.75	
			2.20	280,000	2.20	
3.00	218,000	0.02	3.00	218,000	3.00	
3.75	165,000	0.32	3.75	170,000	3.75	
4.46	15,000	2.31	4.46	15,000	4.46	
7.10	119,000	0.93	7.10	119,000	7.10	
3.50	<u>10,000</u>	3.31	3.50	<u>10,000</u>	3.50	
\$	<u>527,000</u>	0.45	\$ 4.21	<u>832,000</u>	3.47	

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, 2009 and 2008

10. Share capital (continued)

(d) Contributed surplus

	2009	2008
Balance, beginning of year	\$ 874,904	\$ 1,128,929
Exercise of stock options	-	(270,750)
Addition due to maturity of convertible debentures	160,000	
Stock-based compensation expense	<u>9,056</u>	<u>16,725</u>
Balance, end of year	<u>\$ 1,043,960</u>	<u>\$ 874,904</u>

(e) Per share amounts

The weighted average number of shares outstanding for the year ended December 31, 2009 was 14,964,735 (2008 – 15,353,605).

In computing diluted net income (loss) per share amounts, NIL (2008 – 73,018) shares were added to the weighted average number of common shares outstanding during the year ended December 31, 2009 for the dilutive effect of stock options and convertible debentures. For 2009 and 2008, stock options, unsecured debentures 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
<u>2009</u>			
Basic net income (loss) per share	\$ (6,752,471)	14,964,735	\$ (0.45)
Dilutive securities:			
Options	-	-	
Secured debentures	-	-	
Convertible debentures	<u>-</u>	<u>-</u>	
Diluted net income (loss) per share	<u>\$ (6,752,471)</u>	<u>14,964,735</u>	<u>\$ (0.45)</u>

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

10. Share capital (continued)
(e) Per share amounts (continued)

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

11. Commitments

The Company is committed under a lease on its office premises, with future minimum payments (excluding expected occupancy costs) as at December 31, 2009 as follows:

2010	89,100
2011	<u>51,975</u>
	<u>\$ 141,075</u>

12. Related party transactions

(a) Legal services in the amount of \$27,462 (2008 - \$60,033) were provided by a law firm of which a director of the Company was also an associate. Consulting fees of \$51,800 (2008 - \$39,572) were incurred to a corporation of which a director of the Company is the president and shareholder. Included in accounts payable and accrued liabilities at December 31, 2009 is \$12,191 (2008 - \$NIL) owing to these related parties.

(b) Included in interest on debentures payable (note 5) is \$263,220 (2008 - \$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 (2008 - \$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.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

13. Financial instruments and risk management

(a) Fair values of financial assets and liabilities

The Company's financial instruments consist of accounts receivable, deposits, accounts payable and accrued liabilities, 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 the carrying amount as the debentures mature in the short term and interest rates are not expected to fluctuate materially during that time.

The Company classifies the fair value of the financial assets and liabilities according to the following hierarchy based on the amount of observable inputs used to value the instrument.

Level 1 – Inputs to the valuation methodology are quoted prices for identical assets or liabilities in active markets

Level 2 – Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for asset or liabilities, either directly or indirectly for substantially the full term of the financial instruments. Level 2 valuations are based on inputs including quoted forward priced for commodities, time value and volatility factors which can be substantially observed or corroborated in the market place.

Level 3 – Inputs to the valuation methodology are not based on observable market data.

Bank indebtedness and credit facilities have been included in level 1.

The Company has classified its financial instruments as follows:

Category	Financial Instrument
Loans or receivables	Accounts receivable and deposits
Held for trading	Bank indebtedness and credit facility
Financial liabilities	Accounts payable and accrued liabilities and debentures

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

13. Financial instruments and risk management (continued)

(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 the carrying value of accounts receivable.

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.

At December 31, 2009, accounts receivable aging was as follows:

Current	87%
31 – 60 days	2%
61 – 90 days	4%
90 plus days	7%

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

13. Financial instruments and risk management (continued)

(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.

As at December 31, 2009, the financial liabilities on the Company's balance sheet mature as follows

	0 – 3 months	4 – 12 months	12 months or more
Bank indebtedness and credit facilities	\$ 531,275	\$ 93,750	\$ 17,691,667
Accounts payable and accrued liabilities	1,326,693	-	-
Unsecured debentures	<u>-</u>	<u>-</u>	<u>8,158,847</u>
	<u>\$ 1,857,968</u>	<u>\$ 93,750</u>	<u>\$ 25,850,514</u>

Subsequent to year end, the Company's lender proposed certain changes to the current credit facilities which could potentially change the maturity dates of the Company's bank indebtedness and credit facilities (notes 1, 7 and 16).

(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) Commodity price risk

The nature of the Company's operations results in exposure to fluctuations in commodity prices. As at December 31, 2009, the Company had no commodity risk management contracts in place.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

13. Financial instruments and risk management (continued)

(f) 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, 2009.

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 \$249,391 for the period.

(g) 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, 2009, the Company had no forward foreign exchange contracts in place, nor any significant working capital items denominated in foreign currencies.

14. 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.

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

14. Capital disclosure (continued)

Due to the major acquisition of certain properties in late 2008 with debt financing, coupled with the subsequent decline in the natural gas market and pricing for the ensuing year as well as the collapse of the credit and equity markets in late 2008 and continuing into 2009 and 2010, the Company has not been able to maintain its objective and ratios as described above. For the year ended December 31, 2009 the debt to cash flow ratio was 14:1. Management is actively looking for strategic alternatives to address the issues as described in note 1.

The Company's share capital is not subject to external restrictions. See note 7 for a description of external bank covenants.

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

15. Supplemental cash flow information

a) Changes in non-cash working capital

	2009	2008
Accounts receivable	\$ 1,097,970	\$ (177,963)
Prepaid expenses and deposits	(5,145)	(65,497)
Accounts payable and accrued liabilities	<u>(1,295,757)</u>	<u>560,188</u>
	<u>\$ (202,932)</u>	<u>\$ 316,728</u>
Change in non-cash working capital relating to:		
Operating activities	\$ 491,486	\$ 57,532
Investing activities	<u>(694,418)</u>	<u>259,196</u>
	<u>\$ (202,932)</u>	<u>\$ 316,728</u>

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

	2009	2008
Reduction in asset retirement obligations on sale of assets	\$ (234,244)	\$ -
Change in estimate on asset retirement obligations	(166,602)	
Asset retirement liabilities incurred	5,069	537,975
	<u>\$ (395,377)</u>	<u>\$ 537,975</u>

TWOCO PETROLEUMS LTD.

Notes to Financial Statements

December 31, 2009 and 2008

16. Subsequent events

Subsequent to year end, the Company's lender proposed to make certain changes to the current credit facilities which could potentially change the maturity dates of the Company's bank indebtedness and credit facilities as discussed in notes 1 and 7.

Effective March 5, 2010, the Company entered into an amending agreement with its lender on its credit facility agreement whereby effective April 15, 2010, the borrowing base will be re-calculated by the lender upon receipt of each independent reserve evaluation report required to be determined under the agreement. The next review is set for April 15, 2010 and can be set at an earlier date at the discretion of the lender. Under this amending agreement, the Company is also required to deliver a General Security Amending Agreement by providing a fixed charge on certain specific land and oil and gas interest of the Company.

On April 21, 2010, the Company's lender proposed to increase the interest rate of facility #1 to a rate of prime plus 3.75% effective as of April 15, 2010. The repayments of facility #1 are to be made from net proceeds of any additional borrowing, proceeds on sale of property and proceeds from equity issuance. Facility #1 remains as a demand facility with interest payable monthly.

The above changes to facility #1 were made based on the lender's current assessment and interpretation of the Company's reserves and future commodity prices. These kinds of interpretations can vary from lender to lender and are subject to the lender's lending policies from time to time and the fluctuating and uncertain gas markets.

There are no changes proposed to the terms of the Company's non-revolving reducing facility #2.

The next review date for the Company's current credit facilities is expected to occur on June 30, 2010. As the available credit limits of lending on the credit facilities are based on the bank's interpretations of reserves and future commodity prices, there can be no assurance that the amount of credit facilities will not change at the next scheduled review. Readers are referred to notes 1 and 7 with respect to management's strategies in response to and their assessment of the effects of the changes to the credit facilities.