Consolidated Financial Statements of

International Sovereign Energy Corp.

For the years ended December 31, 2009 and 2008

Management's Report

The information contained in the accompanying financial statements and other financial information as well as the reporting process that produces such statements is the responsibility of Management. Management maintains a system of internal controls designed to reasonably assure that transactions are appropriately authorized, that relevant and reliable financial information is produced in a timely manner and that the assets of the Corporation are adequately safeguarded.

Management is responsible for the integrity and objectivity of the information contained in this report and for the consistency between the consolidated financial statements and other financial and operating data contained elsewhere in these consolidated financial statements and the management discussion and analysis. The accompanying consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada using estimates and careful judgment, particularly in those circumstances where transactions affecting a current period are dependent upon future events. The accompanying consolidated financial statements have been prepared using policies and procedures established by management and fairly reflect the Company's financial position, results of operations and changes in financial position, within Canadian generally accepted accounting principles. Management has established and maintains a system of internal controls that is designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and the financial information is reliable and accurate.

The Company's external auditors, Deloitte & Touche LLP, have audited the consolidated financial statements. The Audit Committee of the Board of Directors that consists of non-management directors has reviewed in detail the consolidated financial statements with management and the external auditors. The Audit Committee has reported its findings to the Board of Directors who have approved the consolidated financial statements.

S Mistry

Sharad Mistry
Chief Financial Officer and
Interim Chief Executive Officer

AUDITORS' REPORT

To the Shareholders of International Sovereign Energy Corp.:

We have audited the consolidated balance sheets of International Sovereign Energy Corp. as at December 31, 2009 and 2008 and the consolidated statements of operations, comprehensive 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 consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 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

March 24, 2010

Deloitte & Touche LLP

Chartered Accountants

International Sovereign Energy Corp.
Consolidated Balance Sheets

As at December 31

	2009	2008
Assets		
Current assets:		
Cash	$ -	$ 1,379,683
Accounts receivable	**1,322,021**	1,581,184
Prepaid expenses and deposits	**263,988**	121,439
	1,586,009	3,082,306
Restricted cash (Note 7)	**2,779,261**	3,819,628
Petroleum and natural gas assets (Note 3)	**24,874,927**	30,215,710
	$ **29,240,197**	$ 37,117,644
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ **3,354,392**	$ 5,733,149
Revolving line of credit (Note 5)	**3,308,846**	-
	6,663,238	5,733,149
Letter of guarantee (Note 7)	**2,457,281**	2,865,564
Future income taxes (Note 9)	**732,387**	2,144,427
Asset retirement obligations (Note 4)	**2,130,562**	2,496,439
	11,983,468	13,239,579
Shareholders' equity (Note 8):		
Share capital	**21,546,430**	21,546,430
Warrants	**493,234**	493,234
Contributed surplus	**1,641,752**	1,442,394
Retained earnings (deficit)	**(6,424,687)**	396,007
	17,256,729	23,878,065
Commitments and contingencies (Note 13)		
	$ **29,240,197**	$ 37,117,644

See accompanying notes to the consolidated financial statements.

Approved by the Board

Signed- “John Lokker”-Director

Signed- “Peter Proszanski” -Director

International Sovereign Energy Corp.

Consolidated Statements of Operations, Comprehensive Loss, and Retained Earnings (Deficit)
For the years ended December 31

		2009		2008
Revenues				
Petroleum and natural gas sales	**$**	**8,867,843**	$	18,470,644
Royalties		**(872,657)**		(3,974,321)
Other income		**26,701**		70,426
		8,021,887		14,566,749
Expenses				
Operating and transportation		**3,513,318**		3,288,070
General and administrative		**2,197,444**		4,215,731
Interest		**82,730**		113,799
Depletion, depreciation and accretion		**8,348,302**		4,912,740
Stock-based compensation		**199,358**		199,898
Provision for international operations (Note 3)		**1,865,227**		-
Impairment of international assets and related obligations (Note 3)		**-**		7,910,646
Loss (gain) on foreign exchange		**39,306**		(31,680)
		16,245,685		20,609,204
Loss before taxes		**(8,223,798)**		(6,042,455)
Current taxes		**8,936**		-
Future income tax recovery (Note 9)		**(1,412,040)**		(2,242,792)
Net loss and comprehensive loss		**(6,820,694)**		(3,799,663)
Retained earnings, beginning of year		**396,007**		4,195,670
Retained earnings (deficit), end of year	**$**	**(6,424,687)**	$	396,007
Loss per common share				
Basic and diluted	**$**	**(0.42)**	$	(0.26)
Weighted average number of common shares				
Basic and diluted		**16,096,084**		14,544,128

See accompanying notes to the consolidated financials statements.

International Sovereign Energy Corp.

Consolidated Statements of Cash Flows

For the years ended December 31

		2009		2008
Operating				
Net loss	$	**(6,820,694)**	$	(3,799,663)
Items not involving cash:				
Depletion, depreciation and accretion		**8,348,302**		4,912,740
Stock-based compensation		**199,358**		199,898
Impairment of international assets and related obligations		**-**		7,910,646
Loss (gain) on foreign exchange		**39,306**		(31,680)
Future income tax recovery		**(1,412,040)**		(2,242,792)
Abandonment expenditures		**(818,798)**		(224,612)
		(464,566)		6,724,537
Changes in non-cash working capital (Note 10)		**(815,388)**		(33,478)
Cash flow from operations		**(1,279,954)**		6,691,059
Financing				
Revolving line of credit drawdown (repayment)		**3,308,846**		(2,167,000)
Issuance of common shares		-		2,365,063
Cash flow from financing		**3,308,846**		198,063
Investing				
Petroleum and natural gas expenditures		**(4,604,041)**		(7,971,963)
Petroleum and natural gas dispositions		**-**		28,001
Changes in restricted cash		**632,084**		(922,384)
Changes in non-cash working capital (Note 10)		**602,688**		3,109,168
Cash flow used in investing		**(3,369,269)**		(5,757,178)
Change in cash		**(1,340,377)**		1,131,944
Effects of foreign exchange on cash		**(39,306)**		-
Cash, beginning of year		**1,379,683**		247,739
Cash, end of year	**$**	**-**	$	1,379,683
Supplementary cash flow information				
Interest earned	$	**26,701**	$	70,426
Interest paid		**82,730**		113,799

See accompanying notes to the consolidated financial statements.

1. NATURE OF BUSINESS and BASIS OF PRESENTATION

International Sovereign Energy Corp. (“ISR”) and its wholly owned subsidiaries, International Sovereign Energy Corp SA and Bellwether International Inc.(“BII”), (collectively the “Company”), are in the business of exploring for, and the acquisition, development and production of oil and natural gas reserves in the provinces of British Columbia and Alberta. During 2009 and 2008 the subsidiaries remained inactive and the Company is evaluating its international activities, looking to reduce its obligations and underlying interests in these international locations on a go-forward basis.

Basis of Presentation
These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles (“GAAP”).

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

The consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the discharge of liabilities in the normal course of business for the foreseeable future.

The Company as at December 31, 2009 has a working capital deficit of $5.1 million and an accumulated deficit of $6.4 million, and for the year ended December 31, 2009 incurred a net loss of $6.8 million and had cash outflows from operating activities of $1.3 million. 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 certain of the Company’s previously planned business development activities and it will continue to provide risk for the Company’s future.

The ability of the Company to execute on its future business plan may require the Company to raise additional capital (through debt, equity or sale of assets); maintain the continuing support of its lenders, and achieve a profitable level of operations through minimizing general and administrative expenses and optimizing future production.

The outcome of these matters cannot be predicted at this time. These consolidated financial statements do not include any adjustments to the amounts and classifications of assets and liabilities that may be necessary should the Company be unable to continue as a going concern, and these adjustments and reclassifications may be material.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation
The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. During 2009 and 2008 the subsidiaries remained inactive and all inter-company transactions have been eliminated on consolidation.

Joint Operations
Substantially all of the exploration, development and production activities are conducted jointly with others and accordingly, the Company only reflects its proportionate interest in such activities.

2. SIGNIFICANT ACCOUNTING POLICIES (CON'T)

Use of Estimates
Management is required to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Computations of provisions and estimates for income taxes involve management making judgments with respect to interpretations of tax regulations and related legislation which is continually changing. In addition, there are tax matters that have not yet been confirmed by taxation authorities. While management believes the provision for income taxes is adequate, these amounts are subject to measurement uncertainty. The amounts recorded for depletion and depreciation and the provision for asset retirement obligations are based on estimates. The ceiling test calculation is based on estimates of proved and probable reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions. The impairment assessments of unproved properties are based on management's expectations and best estimates of expected recovery. By their nature these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in estimates in future periods could be significant. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which are fully tradable with no vesting restrictions. This option valuation model requires the input of highly subjective assumptions including the expected stock price volatility. Because changes in the subjective input assumptions can materially affect the calculated fair value, such value is subject to measurement uncertainty. Adjustments required, if any, to these provisions will be reflected in the period that it is determined that adjustments are warranted. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be material.

Cash and Cash Equivalents
Cash and cash equivalents include cash and short-term investments with a maturity of three months or less on the date of purchase.

Petroleum and Natural Gas Assets
The Company follows the full cost method of accounting for petroleum and natural gas assets under which all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized. Such costs include lease acquisition costs, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling productive and non-productive wells and overhead charges related directly to acquisition, exploration and development activities.

The Company's international projects are in pre-production stage. The Company defers and capitalizes all costs relating to the investigation and acquisition of international projects on a country by country basis until such time as the costs no longer meet the deferral requirements under GAAP. These projects are assessed at least annually for impairment, as well as when events indicate that impairment may have occurred.

Costs of acquiring and evaluating unproven properties in Canada and costs of exploration in international cost centers are excluded initially from costs subject to depletion, until it is determined whether or not proved reserves are attributable to the properties or, in the case of major development projects, commercial production has commenced, or impairment has occurred. Impairment occurs whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. When proven reserves are determined or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to the costs subject to depletion for that country's cost centre. Proceeds from disposal of properties will normally be applied as a reduction of the cost of the remaining assets unless the disposal would result in a greater than 20% change in the depletion rate, in which case a gain or loss will be recorded.

2. SIGNIFICANT ACCOUNTING POLICIES (CON'T)

The net carrying value of the Company's petroleum and natural gas properties for each country is limited to an ultimate recoverable amount. This is determined by estimating the present value of future escalated cash flows based on management's best estimate of the future operating environment using proved reserves. Future net revenues are estimated using future price forecasts. Net capitalized costs of the Company's petroleum and natural gas properties in each cost centre are evaluated in each reporting period to determine whether the costs are impaired and exceed the fair value of the properties. The costs are not impaired if the sum of the undiscounted cash flows expected from the production of proved reserves and the cost, net of impairment allowances, of unproved properties exceed the carrying value of the cost centre. If the carrying value of the cost centre is impaired, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the cost, net of impairment allowances, of unproved properties. The cash flows are estimated using future product prices and costs and are discounted using a market based interest rate. Any reduction in value, as a result of the ceiling test will be charged to operations.

Depletion and Depreciation

For each cost center with proved reserves, the capitalized costs associated with proven reserves, including the costs of production equipment, are depleted and depreciated on the unit-of-production method based on the estimated proven reserves before royalties, determined by independent petroleum engineers. Oil and gas reserves and production are converted into equivalent units based upon estimated relative pricing content at a ratio of six thousand cubic feet of gas to one barrel of oil.

Other assets, comprised of office equipment and furniture and fixtures, are recorded at cost and depreciated over their useful life on a declining balance basis of approximately 20 percent.

Asset Retirement Obligation

The Company records a liability for the fair value of future asset retirement obligations in the period in which they are incurred, normally when the asset is purchased or developed. On recognition of the liability there is a corresponding increase in the carrying amount of the related asset within the petroleum and natural gas assets, which is depleted on a unit-of-production basis over the life of the reserves. Estimates used are evaluated on a periodic basis and any adjustments are applied prospectively. The liability is adjusted each reporting period to reflect the passage of time, with the accretion charged to earnings. Actual costs incurred upon settlement of the obligations are charged against the liability.

Financial Instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument to another entity. Upon initial recognition all financial instruments, including derivatives, are recognized on the balance sheet at fair value. Subsequent measurement is then based on the financial instruments being classified into one of five categories: held for trading, held to maturity, loans and receivables, available for sale and other liabilities. The Company has designated its financial instruments into the following categories applying the indicated measurement methods:

Financial Instrument	Category	Measurement Method
Cash	Held for trading	Fair value
Accounts receivable and deposits	Loans and receivables	Amortized cost
Restricted cash	Held for trading	Fair value
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Revolving line of credit	Other liabilities	Amortized cost
Letter of guarantee	Held for trading	Fair value

The Company will assess at each reporting period whether a financial asset, other than those classified as held for trading, is impaired. An impairment loss, if any, is included in net earnings.

2. SIGNIFICANT ACCOUNTING POLICIES (CON'T)

The Company may periodically enter into certain financial derivative and physical delivery sales contracts in order to reduce its exposure to market risks from fluctuations in commodity prices. These instruments are not used for trading or speculative purposes. The Company did not enter into any such contracts in 2009 or 2008.

The Company measures and recognizes embedded derivatives separately from the host contracts when the economic characteristics and risks of the embedded derivatives are not closely related to those of the host contract, when it meets the definition of a derivative and when the entire contract is not measured at fair value. Embedded derivatives are recorded at fair value.

Revenue Recognition
Petroleum and natural gas revenues are recognized when the commodities are sold and title passes to an external party. All of the Company's revenues are earned in Canada.

Interest income is recognized when earned.

Foreign Currency
The Company follows the temporal method when translating foreign currency transactions and the financial statements of its integrated subsidiaries. Under this method, foreign currency denominated assets and liabilities are translated at the exchange rate prevailing at the balance sheet date for monetary items and at the transaction date for non-monetary items. Revenues and expenses, except depletion and depreciation, are translated at average exchange rates for the period. Depletion and depreciation are translated at the same rate as the related assets. Exchange gains or losses arising from the translation of monetary items are included in the determination of net loss.

Stock-based Compensation
The Company uses the fair value based method of valuing stock-based compensation based on a Black-Scholes model. Under this method, the compensation cost attributed to stock options are measured at the fair value at the grant date and expensed over the vesting period with a corresponding increase to contributed surplus. Upon settlement of the stock options, the previously recognized value in contributed surplus and proceeds are recorded as an increase to shareholders' capital.

The Company had not incorporated an estimated forfeiture rate for grants under the Plan that will not vest, rather, the Company accounts for forfeitures as they occur.

Income Taxes
The Company follows the liability method of accounting for income taxes. Temporary differences arising from the differences between the tax basis of an asset or liability and its carrying amount on the balance sheet are used to calculate future income tax assets or liabilities. Future income tax assets or liabilities are calculated using tax rates substantively enacted and anticipated to apply in the periods that the temporary differences are expected to reverse. The benefit of any uncertain tax benefits, if any, are only recognized if it is more likely than not that they would be realized.

Per Share Information
Per share information is calculated on the basis of the weighted average number of Company shares outstanding during the fiscal year. Diluted per share information includes the impact of the potential dilution that could occur if securities or other contracts to issue shares were exercised or converted to shares. Diluted per share information is calculated using the treasury stock method that assumes any proceeds received by the Company upon the exercise of in-the-money share options plus the unamortized share compensation cost would be used to buy back Company shares at the average market price for the period.

2. SIGNIFICANT ACCOUNTING POLICIES (CON'T)

Flow-through Shares
The Company issues flow-through shares from time to time to finance a portion of its exploration and development activities. Pursuant to the terms of these issues, the tax benefits associated with the resource expenditures will be renounced to the shareholders in accordance with income tax legislation. To recognize the renunciation of the tax benefits, the future tax liability is increased and share capital is reduced by the estimated amount of the tax benefits renounced to the shareholders at the time the related expenditures are renounced with the Canada Revenue Agency.

Current Year Accounting Standards
Effective January 1, 2009, ISR adopted Section 3064, Goodwill and Intangible Assets, which establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets subsequent to its initial recognition. The new standard has no current impact on the Company's consolidated financial statements. This standard was adopted prospectively.

During 2009, amendments were made to Section 3862, Financial Instruments – Disclosures. The amendments include enhanced disclosures relating to the fair value of financial instruments and the liquidity risk associated with financial instruments. Section 3862 now requires that all financial instruments measured at fair value be categorized into one of three hierarchy levels. See Note 11 for the enhanced disclosures and liquidity risk disclosures. The amendments are consistent with recent amendments to financial instruments disclosure under International Financial Reporting Standards.

Future Accounting Changes

Business Combinations
In 2009 a new standard 1582, Business Combinations replaced the previous business combinations standard. The new standard applies prospectively to business combinations on or after January 1, 2011 with earlier adoption permitted. Under this standard, the purchase price used in a business combination is based on the fair value of shares exchanged at the market price at the acquisition or closing date. Under the current standard, the purchase price used is based on the market price of the shares for a reasonable period before and after the date the acquisition is announced. In addition, the new standard requires all acquisition costs to be expensed while the current standard allows for the capitalization of these costs as part of the purchase price. The new standard also addresses contingent liabilities which will be required to be recognized at fair value on acquisition and subsequently re-measured at each reporting period until settled. The current standard requires only contingent liabilities that are payable to be recognized. The new standard requires negative goodwill to be recognized in earnings rather than the current standard of deducting from non-current assets in the purchase price allocation. The adoption of section 1582 will also require the adoption of sections 1601, Consolidated Financial Statements and 1602, Non-controlling Interests. ISR is currently assessing the impact of the standard.

Consolidated Financial Statements and Non-controlling Interests
In 2009 two new standards, 1601, Consolidated Financial Statements and 1602, Non-controlling Interests, were issued which replace the existing guidance under section 1600, Consolidated Financial Statements. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. These standards are effective for business combinations occurring on or after January 1, 2011, with early application permitted. ISR is currently assessing the impact of the standard.

Future Financial Reporting Standards
The CICA Accounting Standards Board ("AcSB") adopted a strategic plan for the direction of accounting standards in Canada. In February 2008, the Accounting Standards Board confirmed that International Financial Reporting Standards ("IFRS") will replace Canadian GAAP in 2011 for publicly accountable entities. The Company is currently evaluating the impact to the financial statements.

3. PETROLEUM and NATURAL GAS ASSETS

	2009	2008
	$	$
Petroleum and natural gas assets		
-Canada	**54,464,324**	49,604,785
-International	**12,366,754**	12,366,754
Other assets	**320,596**	314,014
	67,151,674	62,285,553
Accumulated depletion and depreciation	**29,909,993**	21,752,533
Provision for impairment of international assets	**12,366,754**	10,317,310
Net book value	**24,874,927**	30,215,710

The calculation of 2009 Canadian depletion and depreciation expense included an estimated $473,700 (2008 - nil) for future development costs associated with proved undeveloped reserves and excluded $2,121,615 (2008 - $2,783,906) for the carrying value of unproven properties.

The Company capitalized $356,298 of geological and geophysical costs associated with exploration and development of Canadian capital assets during the year ended December 31, 2009 (2008 – nil).

The Company performed a ceiling test calculation at December 31, 2009 resulting in the undiscounted cash flows from proved reserves plus the cost (less any impairment) of unproved properties exceeding the carrying the value of oil and gas assets. The following table summarizes the future benchmark prices the Company used in the ceiling test:

	AECO C	Edmonton Par Price	Alberta Heavy
	$CDN/MMBTU	$CDN/BBL	$CDN/BBL
2010	5.82	82.43	62.43
2011	6.29	85.02	65.02
2012	6.77	87.62	64.62
2013	7.28	92.84	67.84
2014	7.80	98.07	72.73
2015-2019 (1)	8.53	104.11	77.70
thereafter (2)	2%	2%	2%

(1) Prices are shown as the average over the period.
(2) Percentage change of 2.0% represents the change in future prices each year after 2019 to the end of the reserve life.

3. PETROLEUM and NATURAL GAS ASSETS (CON'T)

During 2009 there were no deferred international expenditures (2008 - $2,049,444 in Pakistan) that were excluded from the depletion calculation. The Company performed an impairment assessment at December 31, 2009 and 2008 of its international property and equipment, which were all in the preproduction stage. As a result of this assessment, the Company recorded impairments against its petroleum and natural gas capitalized costs in Pakistan in 2009 of $1,865,227 (2008 - $7,910,646). The following table reconciles the international provision for the year ended December 31, 2009:

	$
Impairment of international assets and other related obligations, December 31, 2008	2,049,444
Reversal of cash call related to Pakistan	(2,049,444)
Accrual for bank guarantees	804,470
Accrual for other potential liabilities	1,060,757
Impairment of international assets and other related obligations, December 31, 2009	1,865,227

4. ASSET RETIREMENT OBLIGATIONS

Asset retirement obligations were estimated based on the Company's net ownership interest in all wells and facilities, the estimated costs to abandon and reclaim the wells and facilities and the estimated timing of the costs to be incurred in future periods. The total undiscounted amount of the estimated cash flows required to settle the asset retirement obligations is approximately $3.8 million (2008 - $3.2 million) which will be incurred over the next 26 years with the majority of costs incurred between 2015 to 2035. A credit adjusted risk-free rate of eight percent and inflation rate of two percent were used to calculate the fair value of the asset retirement obligations.

The following reconciles the Company's asset retirement obligations:

	2009	2008
	$	$
Balance, beginning of year	2,496,439	1,108,664
Liabilities incurred	29,667	77,041
Liabilities settled	(818,798)	(224,612)
Accretion expense	190,839	82,999
Change in estimate	232,415	1,452,347
Balance, end of year	2,130,562	2,496,439

5. REVOLVING LINE OF CREDIT

ISR has a revolving line of credit available up to $10.0 million with a Canadian chartered bank. The Company is required to maintain a working capital ratio of 1:1, defined as current assets, including any undrawn balance on the credit line, to current liabilities. The revolving line of credit bears interest at prime plus one percent and is secured by a demand debenture for a maximum of $25.0 million providing a floating charge over all assets of the Company and a letter of undertaking not to encumber or dispose of assets, other than in the normal course of business without consent of the financial institution and to provide security under section 426 of the Bank Act and/or assign natural gas contracts. The $10.0 million borrowing base is subject to an annual review by the bank and there can be no assurance that the credit facility available upon the next scheduled review will not be reduced. The next scheduled review is for April 1, 2010.

At December 31, 2009, $3,308,846 (2008 – nil) was drawn against the revolving line of credit, and a letter of credit of $7,500 was held against this credit line. The Company is in compliance with its bank covenants as at December 31, 2009.

6. ACQUISITION of BELLWETHER INTERNATIONAL INC.

On March 31, 2008, the Company completed the acquisition of Bellwether International Inc. ("BII"), the holder and operator of the Charapa Hydrocarbon Concession Contract, Ecuador (the "Charapa Contract"), pursuant to the Memorandum of Agreement between the Company and South American investment Inc. ("SAI"). The Company acquired all the issued and outstanding shares of BII for $1.00. The Company also obtained all right, title and interest to US$2,340,000, which funds provide a performance guarantee under the terms and conditions of the Charapa Contract. The guaranteed funds will be progressively release to the Company upon completion of certain qualified expenditures under the Charapa Contract terms and conditions. The Company also acquired the amount receivable by SAI from BII.

The allocation of the purchase price for the assets, based on fair values, was as follows:

	$
Assets acquired	
Restricted cash (US$2,340,000)	2,457,281
Liabilities assumed	
Letter of guarantee to Petroleos del Ecuador, Petroecuador (US$2,340,000)	(2,457,281)
Net assets acquired for $1.00	-

No value has been attributed to the oil and gas interests acquired in Ecuador as these are in the exploration stage. The Company did not record any goodwill on acquisition.

The Company has agreed to develop a work program that is to be completed in 2010.

7. RESTRICTED CASH and LETTER OF GUARANTEE

	2009	2008
	$	$
Asset		
Restricted cash (US $2.3 million) - Ecuador	**2,457,281**	2,865,564
Restricted cash (US $450k) - Pakistan (Sujawal)	**-**	551,070
Restricted cash (25.9 Rupees) - Pakistan (Sukkur)	**321,980**	402,994
Total restricted cash	**2,779,261**	3,819,628
Accounts Payable and Accrued Liabilities		
Provision for Pakistan - 25.9 rupees	**321,980**	**-**
Provision for Pakistan - US $450k	**482,490**	**-**
	804,470	**-**
Letter of Guarantee to Petroleos del Ecuador, PetroEcuador	**2,457,281**	2,865,564
Total provisions and guarantees	**3,261,751**	2,865,564

During 2008, the Company completed the acquisition of Bellwether International Inc., the holder and operator of the Charapa Hydrocarbon Concession Contract, Ecuador. With this transaction, the Company obtained all right, title and interest to funds that provide a performance letter of guarantee under the terms and conditions of the Charapa Contract. The guaranteed funds will be progressively released to the Company upon completion of certain qualified expenditures under the Contract terms and conditions.

Also in 2008, the Company issued unconditional, irrevocable bank guarantees in favor of Mari Gas Company Limited with respect to the Sujawal and Sukkur blocks in Pakistan, in relation to petroleum exploration, development and production in Pakistan, to guarantee the Company’s financial obligations.

Both Pakistan guarantees expired in 2009; however, the Company considers both to be active and have allowed for provisions within accounts payable and accrued liabilities for $804,470.

8. SHARE CAPITAL

Authorized
Unlimited number of Class A common voting shares
Unlimited number of Class B common non-voting shares
Unlimited number of Class A preferred voting, 7%
Non-cumulative, redeemable shares

Common shares, voting

	Number	$
Balance, December 31, 2007	13,928,084	19,671,569
Issuance of common shares (i)	2,168,000	2,264,150
Fair value of warrants (i)	-	(460,523)
Future income tax effect	-	71,234
Balance, December 31, 2008 and 2009	16,096,084	21,546,430

(i) On September 19, 2008, the Company issued 2,168,000 units for gross proceeds of $2,650,000 by way of private placement. Each unit consisted of one Class A common share and one half of one transferable Class A common share purchase warrant. Each whole warrant entitles the holder to purchase one Class A common share for a period of 12 months following the closing date at a price of $1.50 and at $2.00 per share in the subsequent 12 months. If over a period of 20 consecutive trading days, the Company's stock price before the warrant expiry date exceeds the warrant exercise price by 30% on a daily closing volume weighted average basis, the Company may, within 30 days give notice to the holders that the warrants will expire on the 30th day following the date of the notice unless exercised by the holders. The fair value of each warrant granted by the Company was estimated using the Black-Scholes option pricing model assuming no dividends will be paid on common shares, a risk-free interest rate of 2.8% on an average life of two years and a volatility of 85.0% to be $460,523 in aggregate, or $0.42 per warrant.

Issuance costs of $385,850 have been netted against the proceeds. Included in the share issuance costs are the warrants valuation cost representing the value of 212,000 warrants granted to the agent, each warrant being exercisable into one Class A common share at $1.25 within 24 months of closing. The fair value of each warrant granted by the Company was estimated using the Black-Scholes option pricing model assuming no dividends will be paid on common shares, a risk-free interest rate of 2.8% on an average life of two years and a volatility of 85.0% to be $100,914 in aggregate, or $0.48 per warrant.

8. SHARE CAPITAL (CON'T)

Warrants
The following table summarizes outstanding warrants at December 31, 2009:

	Number of Warrants	**$**
Balance, December 31, 2007	-	-
Issued with private placement (i)	1,084,000	460,523
Extension of expiry of warrants	330,644	32,711
Balance, December 31, 2008 and 2009	1,414,644	493,234

In addition to the above warrants, the Company issued 212,000 warrants to the agent for a fair value of $100,914, which are recorded in contributed surplus.

	Number of Warrants	Weighted Average Exercise Price $	Expiry date
Balance, December 31, 2007	-	-	
Issued with private placement	330,644	3.25	30-Nov-11
Issued with private placement	1,084,000	2.00	18-Sep-10
Agent's warrants	212,000	1.25	18-Sep-10
Balance, December 31, 2009 and 2008	1,626,644	1.82	

The Company had extended the expiry date of the 330,644 warrants issued on December 29, 2007 in connection with a non-brokered private placement of units from November 30, 2008 to November 30, 2011. The fair value of each warrant extended by the Company was estimated using the Black-Scholes option pricing model assuming no dividends will be paid on common shares, a risk free interest rate of 3.0% on an average life of 3 years and a volatility of 70% resulting in a fair value of $32,711 in aggregate, or $0.10. As at December 31, 2009, no warrants were exercised.

Stock Options
The Company has a stock option plan whereby up to 10% of the issued and outstanding common shares may be granted under option to employees, directors and other persons who provide ongoing management or consulting services to the Company. Stock option exercise price is a fixed price not less than the fair value of the stock on the day preceding the grant date. Options vest over a three year period, with one third of the number granted vesting on each of the first, second and third anniversary dates from the date of grant. Options have a five year term to maturity.

The following table reconciles the Company's contributed surplus:

	2009 $	**2008** $
Balance, beginning of year	1,442,394	1,174,293
Stock-based compensation	199,358	199,898
Agent warrant expense	-	100,914
Extension of expiry date of warrants	-	(32,711)
Balance, end of year	1,641,752	1,442,394

8. SHARE CAPITAL (CON'T)

The fair value of the options granted during the years ended December 31, 2009 and 2008 were estimated on the date of grant using the Black-Scholes option pricing model with weighted average assumptions and resulting values for grants as follows:

	2009	2008
Fair value of options granted	$0.26	$0.83
Risk-free interest	2.36%	2.80%
Expected life	5 years	5 years
Expected volatility	87.6%	84.6%
Dividend per share	nil	nil

The following table sets forth a reconciliation of the plan activity through December 31, 2009:

	Number of Options	Weighted Average Exercise Price
Balance, December 31, 2007	537,667	$ 1.93
Options granted	580,000	$ 1.25
Options cancelled	(487,667)	$ 2.00
Balance, December 31, 2008	630,000	$ 1.31
Options granted	255,000	$ 1.00
Balance, December 31, 2009	885,000	$ 1.22

The following table summarizes stock options outstanding and exercisable under the plan at December 31, 2009:

Range of exercise price	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
$0.50 - $0.99	50,000	4.9 years	$0.70	-	-
$1.00 - $1.49	785,000	4.1 years	$1.20	193,334	$1.25
$1.50 - $2.00	50,000	2.2 years	$2.00	33,333	$2.00
	885,000	**3.8 years**	**$1.22**	**226,667**	**$1.36**

Options to purchase 885,000 common shares for the year ended December 31, 2009 (2008 – 630,000) were not included in the calculation of the weighted average – diluted common shares outstanding, as they were anti-dilutive.

9. INCOME TAXES

The provision for taxes varies from the amounts that would be computed by applying the effective Canadian federal and provincial income tax rates to earnings before income taxes as shown below:

	2009	2008
	$	$
Loss before income taxes	(8,223,798)	(6,042,455)
Corporate income tax rate	29.00%	29.50%
overy	(2,384,903)	(1,782,524)
Increase (decrease) resulting from:		
Non-deductible expenses	70,303	50,700
Change of tax pool	586,860	(79,195)
Effect of change in tax rates	319,255	(416,106)
Other reconciling items	(3,555)	(15,667)
Future income tax recovery	(1,412,040)	(2,242,792)

The future tax liability at December 31 is comprised of the tax effect of temporary differences as follows:

	2009 $	2008 $
Carrying values in excess of tax basis, net of asset retirement obligation	775,129	2,281,442
Share issue costs	(42,742)	(137,015)
Attributed Canadian royalty income carry forward	48,952	48,952
	781,339	2,193,379
Valuation allowance	(48,952)	(48,952)
Balance. December 31	732,387	2,144,427

10. SUPPLEMENTAL CASH FLOW INFORMATION

	2009 **$**	2008 **$**
Changes in non-cash working capital		
Changes in non-cash working capital – operating:		
Accounts receivable	199,548	(75,614)
Prepaid expenses and deposits	(142,549)	4,734
Accounts payable and accrued liabilities	(872,387)	37,402
	(815,388)	(33,478)
Changes in non-cash working capital – investing:		
Accounts receivable	59,615	81,865
Accounts payable and accrued liabilities	543,073	3,027,303
	602,688	3,109,168

11. FINANCIAL RISK MANAGEMENT

The Company is subject to the following risks related to its financial instruments.

(i) Commodity price risk
The Company is exposed to fluctuations in commodity prices for natural gas, crude oil and natural gas liquids. Commodity prices are affected by many factors including supply, demand and the Canadian to US dollar exchange rate.

The Company has no financial or fixed price commodity contracts in place at December 31, 2009 and 2008.

(ii) Interest rate and cash flow risk
The Company's revolving line of credit (Note 5) is exposed to fluctuations in Canadian interest rates and as such the required cash flow to service the debt will fluctuate as a result of changes in interest rates. The Company currently does not use interest rate hedges or fixed interest rate contracts to manage the Company's exposure to interest rates. A change in interest rates of 1% would impact loss before taxes by approximately $20,000.

(iii) Foreign currency exchange rate risk
At December 31, 2009, the Company had $321,980 (PKR25, 960,880) of cash on deposit denominated in Pakistan rupees, and $2,457,281 (US$2.3 million), on deposit denominated in United States dollars. These amounts are in restricted cash accounts to support bank guarantees and performance bonds (Note 6). The Company has no net exposure risk relating to these amounts as there is an equal accrued liability. The Company had no outstanding forward foreign exchange contracts in place at December 31, 2009.

(iv) Credit risk
Credit risk is the risk of financial loss to the Company if a customer or counter-party to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from purchasers of the Company's petroleum and natural gas, joint venture partners and the counterparties to risk management contracts.

Receivables from purchasers of the Company's petroleum and natural gas are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large, credit worthy petroleum marketers. The Company historically has not experienced any collection issues with its marketers of petroleum and natural gas and intentionally uses several marketers in order to diversify this risk. Joint venture receivables are typically collected within one to four 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 commencement of the joint venture project and smaller partners are cash called to pay for their share of costs in advance of a project commencing. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition, further risk exists with joint venture partners as disagreements occasionally arise that increase the potential for non-collection. To offset this risk, the Company often has the ability to withhold production from joint venture partners in the event of non-payment. At December 31, 2009, the carrying amount of accounts receivable represents the maximum credit exposure. The Company does not have an allowance for doubtful accounts as at December 31, 2009, and did not provide for any doubtful accounts nor was it required to write-off any receivables during the year ended December 31, 2009.

11. FINANCIAL RISK MANAGEMENT (CON'T)

As at December 31, 2009, accounts receivable are aged as follows:

	$
Not past due (less than 120 days)	1,265,279
Past due (over 120 days)	56,742
Total	1,322,021

There are no material financial assets that the Company considers past due and at risk of collection. As at December 31, 2009, the Company's accounts receivable balance consisted of $1.1 million owing by natural gas marketers, or approximately 91% of accounts receivable.

(v) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation. The contractual maturities of accounts payable and accrued liabilities totaling approximately $3.4 million as at December 31, 2009 are due within one year.

Liquidity risks may necessitate the need for the Company to pursue equity issuances, obtain project or debt financing, or enter into joint arrangements. There is no assurance that the necessary financing will be available in a timely manner.

As at December 31, 2009, the Company had a working capital deficit of $5.1 million and access to a credit facility of $10.0 million (Note 5) of which $3.3 million was drawn at December 31, 2009.

(vi) Fair value of financial instruments

The Company's financial instruments as at December 31, 2009 and 2008 include cash, accounts receivable, deposits, restricted cash, accounts payable and accrued liabilities, a revolving credit line and a letter of guarantee. The fair values of accounts receivable, deposits and accounts payable and accrued liabilities approximate their carrying amounts due to their short terms to maturity.

The revolving line of credit bears interest at prime plus one percent and accordingly fair value approximates the carrying value. The restricted cash balances are equal to their fair values.

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

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2 valuations are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.

Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

The Company's cash and cash equivalents, restricted cash and letter of guarantee are classified as Level 1.

11. FINANCIAL RISK MANAGEMENT (CON'T)

(vii) Capital management

The Company's objective is to maintain a flexible capital structure which will allow it to execute its capital expenditure program, which includes expenditures in oil and gas activities which may or may not be successful. Therefore, the Company monitors the level of risk incurred in its capital expenditures to balance the proportion of debt and equity in its capital structure.

The Company manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying petroleum and natural gas assets. The Company considers its capital structure to include shareholders' equity and working capital as follows:

	2009	2008
	$	$
Shareholders' equity	**17,256,729**	23,878,065
Working capital:		
Cash	**-**	1,379,683
Accounts receivable	**1,322,021**	1,581,184
Prepaid expenses and deposits	**263,988**	121,439
Accounts payable and accrued liabilities	**(3,354,392)**	(5,733,149)
Revolving line of credit	**(3,308,846)**	-
Working capital (deficiency)	**(5,077,229)**	(2,650,843)
Total Capital	**12,179,500**	21,227,222

The Company's general policy is to maintain a sufficient capital base in order to manage its business in the most effective manner with the goal of increasing the value of its assets and thus its underlying share value. The Company's objectives when managing capital are to maintain financial flexibility in order to preserve its ability to meet financial obligations, including potential obligations arising from additional acquisitions; to maintain a capital structure that allows the Company to favor the financing of its growth strategy using internally-generated cash flow and its debt capacity; and to optimize the use of its capital to provide an appropriate investment return to its shareholders. The Company strives to properly exploit its current asset base and to acquire top quality assets. To that end, the Company is not averse to maintaining a high ratio of debt to total capital if management determines the assets it is acquiring or the projects it is drilling are of high quality.

The Company manages its capital structure and makes adjustments by continually monitoring its business conditions including the current economic conditions, the risk characteristics of the Company's petroleum and natural gas assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other factors that influence commodity prices and funds from operations such as quality and basis differentials, royalties, operating costs and transportation costs.

In order to maintain or adjust the capital structure, the Company considers its forecasted funds from operations while attempting to finance an acceptable capital expenditure program including acquisition opportunities, the current level of operating facility credit available from the Company's financial institution as a result of petroleum and natural gas reserve growth, the availability of other sources of debt with different characteristics than operating facility, the sale of assets, limiting the size of the capital expenditure program and the issue of new equity if available on favorable terms.

The Company is in compliance with bank covenants. The Company's operating facility is determined by the lender and based on the lender's borrowing base model which is determined based on the Company's petroleum and natural gas reserves.

12. SEGMENTED INFORMATION

The Company's core area of operation is in Canada.

	Canada		International	
	2009	2008	**2009**	2008
	$	$	**$**	$
Revenue, net of royalties	**7,995,186**	14,496,323	**-**	-
Property Plant and Equipment (Note 3)	**24,874,927**	28,166,266	**-**	2,049,444

13. COMMITMENTS AND CONTINGENCIES

The Company has an operating lease for office premises expiring August 31, 2011 which requires minimum monthly payments of $11,871 or $142,452 per year.

As a part of its ongoing operations, the Company is involved in potential litigation and claims. Management is of the opinion that there will be no material impact on the financial position, results of operations or liquidity of the Company, as a result of such claims.

14. RELATED PARTY TRANSACTIONS

In 2008, general and administrative expenses included approximately $1.2 million unilaterally withdrawn from the Company's bank account prior to the Annual General Meeting on June 23, 2008 by the previous executives of the Company. These executives considered themselves to be entitled to a change of control payment under their respective employment contracts. The Company is attempting to recover these payments through the courts.

In 2009, the Company did not have any related party transactions.