

International Sovereign Energy Corp.

**Interim Consolidated Financial Statements**

**For the three months ended March 31, 2010**

**(unaudited)**

**Calgary, Alberta**

**May 12, 2010**

# International Sovereign Energy Corp.

## Consolidated Balance Sheets

<i>(unaudited)</i>	March 31, 2010	December 31, 2009
<b>ASSETS</b>		
<i>Current</i>		
Accounts receivable	\$ 1,032,274	\$ 1,322,021
Prepaid expenses and deposits	286,418	263,988
	<b>1,318,692</b>	1,586,009
Restricted cash (Note 6)	2,690,434	2,779,261
Petroleum and natural gas assets (Note 3)	23,970,280	24,874,927
	<b>\$ 27,979,406</b>	<b>\$ 29,240,197</b>
<b>LIABILITIES</b>		
<i>Current</i>		
Accounts payable and accrued liabilities	\$ 3,232,525	\$ 3,354,392
Current portion of asset retirement obligations (Note 4)	173,000	-
Revolving line of credit (Note 5)	3,157,371	3,308,846
	<b>6,562,896</b>	6,663,238
Letter of guarantee (Note 6)	2,376,504	2,457,281
Future income tax liability	484,409	732,387
Asset retirement obligations (Note 4)	2,011,541	2,130,562
	<b>11,435,350</b>	11,983,468
<b>SHAREHOLDERS' EQUITY (Note 7)</b>		
Share capital	21,546,430	21,546,430
Warrants	493,234	493,234
Contributed surplus	1,691,081	1,641,752
Deficit	(7,186,689)	(6,424,687)
	<b>16,544,056</b>	17,256,729
	<b>\$ 27,979,406</b>	<b>\$ 29,240,197</b>

See accompanying notes to the interim consolidated financial statements

Commitments and contingencies (Note 10)

# International Sovereign Energy Corp.

## Consolidated Statements of Operations, Comprehensive Loss and Retained Earnings (Deficit)

<i>(unaudited)</i>	Three months ended	
	2010	2009
<b>REVENUES</b>		
Petroleum and natural gas	\$ 2,487,264	\$ 2,544,921
Royalties	(545,837)	(517,853)
Other	-	13,323
	<b>1,941,427</b>	<b>2,040,391</b>
<b>EXPENSES</b>		
Operating and transportation	595,546	786,713
General and administrative	405,297	747,128
Stock-based compensation (Note 7)	49,329	44,734
Interest	24,273	-
Depletion, depreciation and accretion	1,909,872	1,946,658
International operation costs	23,546	-
Unrealized gain on foreign exchange	(56,456)	(19,646)
	<b>2,951,407</b>	<b>3,505,587</b>
Loss before taxes	<b>(1,009,980)</b>	(1,465,196)
Future income tax recovery	<b>(247,978)</b>	(359,883)
Loss and comprehensive loss	<b>(762,002)</b>	(1,105,313)
Retained earnings (deficit), beginning of period	<b>(6,424,687)</b>	396,007
Deficit, end of period	<b>\$ (7,186,689)</b>	\$ (709,306)
Earnings (loss) per common share		
Basic and diluted	<b>\$ (0.05)</b>	\$ (0.07)
Weighted average number of common shares		
Basic and diluted	<b>16,096,084</b>	16,096,084

See accompanying notes to the interim consolidated financial statements

# International Sovereign Energy Corp.

## Consolidated Statements of Cash Flows

<i>(unaudited)</i>	Three months ended	
	2010	March 31, 2009
<b>OPERATING</b>		
Net loss	\$ (762,002)	\$ (1,105,313)
Items not involving cash:		
Depletion, depreciation and accretion	1,909,872	1,946,658
Stock-based compensation	49,329	44,734
Future income tax recovery	(247,978)	(359,883)
Unrealized gain on foreign exchange	(56,456)	(19,646)
Abandonment expenditure	-	(214,373)
	892,765	292,177
Change in non-cash working capital (Note 8)	246,274	556,324
Cash flow from operations	1,139,039	848,501
<b>FINANCING</b>		
Revolving line of credit repayment	(151,475)	-
Cash flow used in financing	(151,475)	-
<b>INVESTING</b>		
Petroleum and natural gas expenditures	(951,246)	(2,246,339)
Changes in restricted cash	-	-
Change in non-cash working capital (Note 8)	(92,774)	1,033,729
Cash flow used in investing	(1,044,020)	(1,212,610)
<b>Change in cash</b>	<b>(56,456)</b>	<b>(364,109)</b>
Effects of unrealized foreign exchange on cash	56,456	-
<b>Cash, beginning of period</b>	<b>-</b>	<b>1,379,683</b>
<b>Cash, end of period</b>	<b>\$ -</b>	<b>\$ 1,015,574</b>
<b>Supplementary cash flow information:</b>		
Interest earned	\$ -	\$ 13,323
Interest paid	\$ 24,273	\$ -

See accompanying notes to the interim consolidated financial statements

# International Sovereign Energy Corp.

Notes to Interim Consolidated Financial Statements

For the three months ended March 31, 2010

***(unaudited)***

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## **1. NATURE OF OPERATIONS, GOING CONCERN 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 exploration for and the acquisition, development of petroleum and gas interests. The Company is active in the exploration and development of hydrocarbon reserves in Western Canada. The Company is evaluating its international activities and is looking to reduce its obligation and underlying interests in these international places on a go forward basis. The Company intends to focus on domestic opportunities.

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 March 31, 2010 has a working capital deficit of \$5.2 million and an accumulated deficit of \$7.2 million, and for the quarter ended March 31, 2010 incurred a net loss of \$762,000 and had cash inflow from operating activities of \$1.1 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.

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. The consolidated financial statements are stated in Canadian dollars and have been prepared in accordance with Canadian GAAP.

The preparation of financial statements in conformity with Canadian 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 reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

## **2. SUMMARY OF ACCOUNTING POLICIES**

The interim consolidated financial statements of the Company have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the year ended December 31, 2009. The disclosures provided below are incremental to those included with the annual consolidated financial statements and certain disclosures, which are normally required to be included in the notes to the annual consolidated financial statements, have been condensed or omitted. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Company's annual filings for the year ended December 31, 2009.

# International Sovereign Energy Corp.

Notes to Interim Consolidated Financial Statements

For the three months ended March 31, 2010

**(unaudited)**

## 3. PETROLEUM AND NATURAL GAS ASSETS

	March 31, 2010	December 31, 2009
	\$	\$
Petroleum and natural gas assets		
- Canada	55,391,334	54,464,324
- International	12,366,754	12,366,754
Furniture and equipment	344,832	320,596
	<b>68,102,920</b>	67,151,674
Accumulated depletion and depreciation	31,765,886	29,909,993
Provision for impairment of international assets	12,366,754	12,366,754
Petroleum and natural gas assets, net	<b>23,970,280</b>	24,874,927

The calculation of depletion and depreciation expense included an estimated \$473,700 (March 31, 2009 - nil) for future development costs associated with proved undeveloped reserves and excluded \$2.2 million (March 31, 2009 – \$2.9 million) for the estimated value of unproven properties. Depletion and depreciation expense for the three months ended March 31, 2010 was \$1.9 million (March 31, 2009 - \$1.9 million).

The Company did not capitalize any general and administrative costs for domestic exploration activities for the three months ended March 31, 2010 (March 31, 2009 – nil).

On May 27, 2009 Mari Gas Company Limited ("MGCL"), the operator of the Sukkur and Sujawal Blocks, notified the Company that it considered the Company to be in default of non-payment of cash calls as at June 3, 2009 and subject to forfeiture if arrears of cash calls were not put into good standing. The Company is evaluating its options and commenced legal action against the forfeiture in order to preserve the status quo so it can dispose of its working interests to a third party. In the event of forfeiture, the Company will not be entitled to receive any consideration for such forfeited working interest.

The Company has issued two unconditional, irrevocable bank guarantees for \$313,930 (PKR 25,966,080) and \$457,020 (US\$450,000) in favor of President, Islamic Republic of Pakistan through Director General Petroleum Concessions, Ministry of Petroleum and Natural Resources, Islamabad with respect to Sukkur and Sujawal blocks respectively, in relation to petroleum exploration, development and production in Pakistan, to guarantee the Company's financial obligations. The Company received notice of forfeiture from MGCL and consequently made a provision in the event the guarantees are called upon. The guarantee expired for Sukkur July 20, 2009 and has not been renewed, however the guarantee is still considered to be active. The guarantee for Sujawal expired November 8, 2009. Upon expiry on November 8, 2009, the Company did not renew, however the guarantee is considered to be active. The Company is currently in negotiations for settlement.

# International Sovereign Energy Corp.

Notes to Interim Consolidated Financial Statements

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## 4. ASSET RETIREMENT OBLIGATIONS

The Company's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Company estimates the total undiscounted amount of cash flow required to settle its asset retirement obligations is approximately \$3.8 million (December 31, 2009 – \$3.8 million) which will be incurred from 2010 to 2035. An inflation factor of 2% has been applied to the estimated asset retirement cost. At March 31, 2010 and December 31, 2009 a credit-adjusted risk-free rate of 8% was used to calculate the fair value of the asset retirement obligations. The current portion of these obligations as at March 31, 2010 is approximately \$173,000.

A reconciliation of the asset retirement obligations is provided below:

	March 31, 2010	December 31, 2009
	\$	\$
Balance, beginning of period	2,130,562	2,496,439
Liabilities incurred	-	29,667
Liabilities settled	-	(586,383)
Accretion expense	53,979	190,839
Balance, end of period	2,184,541	2,130,562

## 5. REVOLVING LINE OF CREDIT

The Company has a revolving line of credit to a maximum of \$10.0 million (December 31 2009- \$10.0 million). The Company is required to maintain a working capital ratio of 1:1, defined as current assets, including undrawn availability, to current liabilities, excluding current bank debt. The operating loan bears interest at prime plus 2% 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 and/or assign natural gas contracts together with the guarantee of BII.

As at March 31, 2010, \$3,157,371 (December 31, 2009 - \$3,308,846) was drawn against the facility, and letters of credit in the amount of \$7,500 were held against this facility. As at March 31, 2010, the Company is compliant with its bank covenants based on the revolving line of credit value of \$10.0 million.

As of April 27 2010, the Company's facility was reduced to \$6.5 million.

# International Sovereign Energy Corp.

Notes to Interim Consolidated Financial Statements

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## 6. RESTRICTED CASH AND LETTER OF GUARANTEE

	March 31, 2010	December 31, 2009
	\$	\$
Restricted cash (US\$2.3 million) – Ecuador	2,376,504	2,457,281
Restricted cash (PKR 25.9 million) – Pakistan (Sukkur)	313,930	321,980
<b>Total restricted cash</b>	<b>2,690,434</b>	<b>2,779,261</b>

Included in accounts payable and accrued liabilities are provisions for the Pakistan project. 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 \$770,950 (December 31, 2009 - \$804,470).

	March 31, 2010	December 31, 2009
	\$	\$
Provision for Pakistan – PKR 25.9 million	313,930	321,980
Provision for Pakistan – US\$0.45 million	457,020	482,490
<b>Total provision in accounts payable and accrued liabilities</b>	<b>770,950</b>	<b>804,470</b>

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.

	March 31, 2010	December 31, 2009
	\$	\$
Letter of guarantee to Petroleos del Ecuador	2,376,504	2,457,281
<b>Total letter of guarantee</b>	<b>2,376,504</b>	<b>2,457,281</b>

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## 7. 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 at March 31, 2010 and December 31, 2009	16,096,084	21,546,430

### Warrants

The following table summarizes outstanding warrants at March 31, 2010:

	Number of Warrants	\$
Balance, March 31, 2010 and December 31, 2009	1,414,644	493,234

In addition to the above warrants, the Company issued warrants to agents for various private placements, as summarized below:

	Number of Warrants	Weighted Average Exercise Price \$	Expiry date
Issued with private placement	330,644	3.25	November 30, 2011
Issued with private placement	1,084,000	2.00	September 18, 2010
Agents warrants, private placement	212,000	1.25	September 18, 2010
Total warrants outstanding	1,626,644	1.82	

During the three months ended March 31, 2010 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.

# International Sovereign Energy Corp.

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**(unaudited)**

## 7. SHARE CAPITAL (CON'T)

The following table summarizes the stock option activity for three months ended March 31, 2010:

	Number of Options	Weighted Average Exercise Price
Balance, December 31, 2009	885,000	\$ 1.22
Granted	100,000	\$ 0.60
Balance, March 31, 2010	985,000	\$ 1.16
<b>Exercisable, March 31, 2010</b>	<b>243,334</b>	<b>\$ 1.40</b>

The following table summarizes stock options outstanding and exercisable as at March 31, 2010:

Range of Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercised	Weighted Average Exercise Price
\$0.50-\$0.99	150,000	4.7 years	\$ 0.63	-	-
\$1.00-\$1.49	785,000	3.9 years	\$ 1.20	193,334	\$ 1.25
\$1.50-\$2.00	50,000	1.9 years	\$ 2.00	50,000	\$ 2.00
	985,000	3.7 years	\$ 1.16	243,334	\$ 1.40

Options to purchase 985,000 common shares for three months ended March 31, 2010 were not included in the calculation of the weighted average – diluted common shares outstanding, as they were anti-dilutive.

The Company accounts for its stock-based compensation plan using the fair value method. Under this method, a compensation cost is charged over the vesting period for stock options granted to officers, directors and employees with a corresponding increase to contributed surplus.

The fair value of the options granted during the three months ended March 31, 2010 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:

	March 31, 2010	December 31, 2009
Fair value of options granted	<b>\$0.36</b>	\$0.26
Risk-free interest	<b>2.36%</b>	2.36%
Expected volatility	<b>86.4%</b>	87.6%
Expected life	<b>5 years</b>	5 years
Dividend per share	<b>nil</b>	Nil

# International Sovereign Energy Corp.

Notes to Interim Consolidated Financial Statements

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*(unaudited)*

## 7. SHARE CAPITAL (CON'T)

The following table reconciles the Company's contributed surplus:

	March 31, 2010
Balance, beginning of period	\$ 1,641,752
Stock-based compensation expense	49,329
Balance, end of period	\$ 1,691,081

## 8. SUPPLEMENTAL CASH FLOW INFORMATION

### Changes in non-cash working capital

	Three Months ended March 31	
	2010	2009
<i>Changes in non-cash working capital – operating:</i>		
Accounts receivable	\$ 230,133	\$ 186,803
Prepaid and deposits	(22,430)	53,249
Unrealized foreign exchange on restricted cash and international provisions	8,050	-
Accounts payable and accrued liabilities	30,521	316,272
	<b>246,274</b>	<b>\$ 556,324</b>
<i>Changes in non-cash working capital – investing:</i>		
Accounts receivable	\$ 59,615	\$ 53,831
Accounts payable and accrued liabilities	(152,389)	979,898
	<b>\$ (92,774)</b>	<b>\$ 1,033,729</b>

# International Sovereign Energy Corp.

Notes to Interim Consolidated Financial Statements

For the three months ended March 31, 2010

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## **9. FINANCIAL INSTRUMENTS**

### **Fair Value of Financial Instruments**

The Company's financial instruments recognized on the balance sheet include cash, accounts receivable, deposits, restricted cash, accounts payable and accrued liabilities, a revolving credit line and 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 two percent and accordingly fair value approximates the carrying value. The restricted cash balances are equal to their fair values.

In light of the current economic conditions, the Company continues to monitor its accounts receivable and its allowance for doubtful accounts. As at March 31, 2010, there have been no allowances taken or amounts written off.

The Company has exposure to market risk including commodity, interest and foreign exchange risk, in addition to credit risk and liquidity risk from its use of financial instruments. There have not been any changes to the Company's exposure to risks, or the objectives, policies and processes to manage these risks from December 31, 2009.

There has been no change in the Company's policies or objectives for managing capital since December 31, 2009.

## **10. 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 part of its ongoing operations, the Company may be involved in potential litigation or claims associated with its international operations. 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.