BAYOU BEND PETROLEUM LTD.

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2008 AND 2007

MANAGEMENT'S REPORT

The accompanying Consolidated Financial Statements of Bayou Bend Petroleum Ltd and related financial information presented in this annual report are the responsibility of Management and have been approved by the Board of Directors. The Consolidated Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles. The Consolidated Financial Statements and related financial information reflect amounts which must, of necessity, be based upon informed estimates and judgments of Management with appropriate consideration to materiality. All financial information contained in the annual report is consistent, where appropriate, with that contained in the Consolidated Financial Statements.

The Company has developed and maintains systems of internal controls, policies and procedures in order to provide reasonable assurance as to the reliability of the financial records and the safeguard of assets.

KPMG LLP, independent external auditors appointed by the shareholders of the Company, has audited the Consolidated Financial Statements in accordance with the auditing standards generally accepted in Canada on behalf of the shareholders. Their report is included with the Consolidated Financial Statements.

The Board of Directors has established an Audit Committee. The Audit Committee reviews with Management and the external auditors any significant financial reporting issues, the financial statements, and any other matters of relevance to the parties. The Audit Committee meets quarterly to review and approve the interim consolidated financial statements prior to their release, as well as annually to review the Company's annual consolidated financial statements and Management's discussion and analysis, and to recommend their approval to the Board of Directors. The external auditors have unrestricted access to the Company, the Audit Committee and the Board of Directors.

"Keith C. Hill"

Keith C. Hill
President and Chairman

"William D. Hoffman"

William D. Hoffman
Chief Financial Officer

April 16, 2009

KPMG LLP
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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Bayou Bend Petroleum Ltd. as at December 31, 2008 and 2007 and the consolidated statements of operations and deficit, comprehensive loss and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP (signed)

Chartered Accountants

Vancouver, Canada

April 15, 2009, except as to note 15
which is as of April 16, 2009

KPMG LLP, a Canadian limited liability partnership is the Canadian
member firm of KPMG International, a Swiss cooperative.

BAYOU BEND PETROLEUM LTD.
Consolidated Balance Sheets
Expressed in Thousands of United States Dollars

	December 31, 2008	December 31, 2007
ASSETS		
Current assets		
Cash and cash equivalents	$ 45,282	$ 58,575
Investments	79	32,056
Accounts receivable	1,912	3,109
Prepaid expenses	1,546	629
	48,819	94,369
Petroleum and natural gas properties	19,946	75,731
Accumulated depletion, depreciation & amortization	(5,171)	(3,259)
Net properties	14,775	72,472
	$ 63,594	$ 166,841
LIABILITIES		
Current liabilities		
Accounts payable and accrued expenses	$ 5,636	$ 12,868
Advances from joint interest holders	231	394
Asset retirement obligation	1,357	987
	7,224	14,249
Asset retirement obligation	1,904	927
	9,128	15,176
SHAREHOLDERS' EQUITY		
Share capital	250,899	250,835
Contributed surplus	3,024	2,237
Accumulated other comprehensive income	3,282	3,282
Deficit	(202,739)	(104,689)
	54,466	151,665
	$ 63,594	$ 166,841

Commitments (note 14)
Subsequent event (note 15)

See accompanying notes to the consolidated financial statements.

BAYOU BEND PETROLEUM LTD.
Consolidated Statements of Operations and Deficit
Expressed in Thousands of United States Dollars except Per Share Amounts

	For the Year Ended December 31	
	2008	**2007**
Revenues		
Oil and gas sales	$ 6,723	$ 3,661
Royalties	(1,714)	(932)
	5,009	2,729
Costs and Expenses		
Operating	2,202	945
Exploration	10,500	4,816
Dry hole costs	12,716	45,150
Impairment of properties	68,556	23,934
Accretion	55	37
Depletion, depreciation and amortization	1,912	3,259
General and administrative	3,363	3,035
Stock-based compensation	801	2,223
Foreign exchange (gain) loss	5,010	(18,016)
	105,115	65,383
Other income		
Interest income	2,056	4,182
	2,056	4,182
Net loss	(98,050)	(58,472)
Deficit, beginning of year	(104,689)	(46,217)
Deficit, end of year	$ (202,739)	$ (104,689)
Basic loss per share	$ (0.32)	$ (0.21)
Diluted loss per share	$ (0.32)	$ (0.21)
Weighted average number of common shares used in computing earnings per share (in thousands):		
Basic	308,745	278,017
Diluted	308,745	278,017

See accompanying notes to the consolidated financial statements.

BAYOU BEND PETROLEUM LTD.
Consolidated Statements of Other Comprehensive Income

Expressed in Thousands of United States Dollars

	For the Year Ended December 31	
	2008	2007
Net loss for the year	$ (98,050)	$ (58,472)
Other comprehensive income:		
Unrealized gains on adoption of U.S. functional currency	-	3,284
Comprehensive loss for the year	$ (98,050)	$ (55,188)

See accompanying notes to the consolidated financial statements.

BAYOU BEND PETROLEUM LTD.
Consolidated Statements of Cash Flows
Expressed in Thousands of United States Dollars

	For the Year Ended December 31	
	2008	2007
Operating activities		
Net loss	$ (98,050)	$ (58,472)
Adjustments for non-cash and non-operating transactions:		
Depletion, depreciation and amortization	1,912	3,259
Impairment of properties	68,556	23,934
Dry hole costs	12,716	45,150
Accretion	55	37
Stock-based compensation	801	2,223
Changes in non-cash operating working capital:		
Accounts receivable	1,197	(3,098)
Prepaid expenses	(917)	(616)
Accounts payable and accrued expenses	(11,916)	2,715
Advances from joint interest holders	(163)	394
Asset retirement obligation	1,292	714
	(24,517)	16,240
Financing activities		
Issuance of share capital	50	166,785
Repayment of related party loans	-	(18)
	50	166,767
Investing activities		
Exploration and development expenditures	(20,803)	(98,195)
Investments, net	31,977	(32,056)
	11,174	(130,251)
Effect of exchange rate changes in cash	-	3,284
Net increase (decrease) in cash and cash equivalents	(13,293)	56,040
Cash and cash equivalents - beginning of year	58,575	2,535
Cash and cash equivalents - end of year	$ 45,282	$ 58,575
Supplemental disclosures of non-cash financing and investing activities:		
Acquisition of Summit Energy Company, L.L.C. and related property interests through the issuance of common stock	$ -	$ 10,593
Acquisition of GOM assets through the issuance of common stock	-	24,764
	$ -	$ 35,357

See accompanying notes to the consolidated financial statements.

1. NATURE OF OPERATIONS

Bayou Bend Petroleum Ltd. (the "Company") is incorporated under the British Columbia Business Corporations Act. The Company is engaged in the business of oil and gas exploration and development in the United States in the Gulf of Mexico.

On February 7, 2007, the Company received regulatory approval to change its name to Bayou Bend Petroleum Ltd. from Kit Resources Ltd. with an effective date of February 9, 2007. The Company's shares trade on the TSX Venture Exchange under the symbol of "BBP".

On February 20, 2007, the Company purchased 100% of the outstanding membership interests in Summit Energy Company, L.L.C. ("Summit").

Notwithstanding that the Company has sufficient financial resources to fund operations through the 2009 fiscal year, continuing operations are dependent on discovery of economic oil and gas reserves and ultimately on the attainment of profitable operations. See Note 15, Subsequent Event.

2. SIGNIFICANT ACCOUNTING POLICIES

a) Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries Bayou Bend Petroleum U.S.A., Ltd., Summit Energy Company, L.L.C. and Bayou Bend Offshore, Ltd.

These consolidated financial statements are prepared in accordance with generally accepted accounting principles in Canada. The significant accounting policies followed by the Company have been applied consistently in the preparation of these consolidated financial statements. These accounting policies are summarized below.

b) Cash and Cash Equivalents

For purposes of reporting cash flows, the Company considers cash and cash equivalents to include amounts held in banks and highly liquid investments with remaining maturities at point of purchase of 90 days or less. The Company places its cash and cash equivalents with institutions of high-credit worthiness.

c) Investments

Investments are accounted for at fair market value and consist of securities backed by the full credit of the United States Government with maturities of less than one year.

d) Petroleum and Natural Gas Properties

The Company uses the successful efforts method to account for its oil and gas exploration and development costs. Exploration well costs are initially capitalized and, if subsequently determined to have not found sufficient reserves to justify commercial production, are charged to dry hole expense. Exploration well costs that have found sufficient reserves to justify commercial production, but those reserves cannot be classified as proved, continue to be capitalized as long as sufficient progress is being made to assess the reserves and economic viability of the well or related project. All other exploration costs, including geological and geophysical costs and annual lease rentals, are charged to exploration expense when incurred.

Producing properties and significant unproved properties are assessed annually, or more frequently as economic events dictate, for potential impairment. Any impairment loss is the difference between the carrying value of the asset and its fair value. Fair value is calculated as the present value of estimated expected future cash flows from proved, probable and, as appropriate, possible reserves.

The Company engages independent engineers in order to determine its share of reserves.

e) Depreciation, Depletion and Amortization (DD&A)

Capitalized costs of proved oil and gas properties are depleted using the unit of production method. For purposes of these calculations, productions and reserves of oil are converted to cubic feet of natural gas on an energy equivalent basis at a ratio of one barrel (bbl) of oil to six thousand cubic feet (mcf) of natural gas.

Successful exploratory wells and development costs are depleted over proved developed reserves. However, to the extent significant development costs are incurred in connection with proved undeveloped reserves, such costs are excluded from depletion until the reserves are developed. Acquired resource properties with proved reserves, including offshore platform costs, are depleted over proved reserves. Acquisition costs of probable reserves are not depleted or amortized while under active evaluation for commercial reserves. Costs are transferred to depletable costs as proved reserves are recognized. Costs

associated with significant development projects are not depleted until commercial production commences.

Corporate assets are depreciated using the straight-line method at annual rates of 20% to 25%.

f) Asset Retirement Obligations

The fair value of the statutory, contractual or legal liability associated with the retirement and reclamation of oil and gas properties is recorded when incurred, with a corresponding increase to the carrying amount of the related oil and gas properties. The increase to capitalized costs is depleted to earnings on a unit of production basis over the life of the proved reserves for each property. Subsequent changes in the estimated fair value of the asset retirement obligation (ARO) are capitalized and depleted over the remaining useful life of the underlying oil and gas properties.

The ARO liabilities are carried at their discounted present value and are accreted over time for the change in their present value. Actual expenditures incurred are charged against the accumulated obligation.

g) Revenue Recognition

Revenues from the sale of petroleum and natural gas are recorded when title passes to an external party and collection is reasonably assured.

h) Income Taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method current income taxes are recognized for the estimated income taxes payable for the current year. Future income taxes are recognized for temporary differences between the tax and accounting basis of assets and liabilities and for the benefit of losses available to be carried forward for tax purposes that are likely to be realized.

Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of future tax assets and liabilities of a change in tax rates is recognized in income in the period that included the date of enactment or substantive enactment.

i) Stock-Based Compensation

All stock-based awards made to employees and non-employees are measured and recognized using a fair value based method. Accordingly, the fair value of the options at the date of the grant is determined and charged to operations, with the offsetting credit to contributed surplus, on a straight-line basis over the vesting period. If and when the stock options are ultimately exercised, the applicable amounts of contributed surplus are transferred to share capital.

j) Loss per Share

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the year. The computation of diluted earnings per share assumes the conversion, exercise or contingent issuance of securities only when such conversion, exercise or issuance would have a dilutive effect on earnings per share. The dilutive effect of outstanding options and warrants and their equivalents is reflected in diluted earnings per share by application of the treasury stock method. The treasury stock method assumes that the proceeds received from the exercise of in-the-money stock options are used to repurchase common shares at the average market price for the reporting period.

k) Joint Interests

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

l) New Accounting Standards

Effective January 1, 2008, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") section 3862, *"Financial Instruments – Disclosures"* and CICA section 3863, *"Financial Instruments – Presentation,"* which replaced CICA section 3861, *"Financial Instruments – Disclosure and Presentation."* Section 3862 outlines the disclosure requirements for financial instruments and non-financial derivatives. This guidance prescribes an increased importance on risk disclosures associated with recognized and unrecognized financial instruments and how such risks are managed. Specifically, section 3862 requires disclosure of the significance of financial instruments on the Company's financial position. In addition, the guidance outlines revised requirements for the disclosure of qualitative and quantitative information regarding exposure to risks arising from financial instruments. The presentation requirements under section 3863 are relatively unchanged from the former presentation requirements under section 3861. Please refer to Note 12,

"Financial Instruments and Risk Management" for additional disclosures under section 3862.

Effective January 1, 2008, the Company adopted CICA section 1535, *"Capital Disclosures."* Section 1535 requires disclosure about the Company's objectives, policies and processes for managing capital. These disclosures include a description of what the Company manages as capital, the nature of any externally imposed capital requirements, how the requirements are incorporated into the Company's management of capital, whether the requirements have been complied with or consequences of non-compliance and an explanation of how the Company is meeting its objectives for managing capital. In addition, quantitative disclosures regarding capital are required. Please refer to Note 13, "Capital Disclosures."

Effective January 1, 2008, the Company adopted CICA section 3031, *"Inventories,"* which replaced CICA section 3030 of the same name. The new guidance provides additional measurement and disclosure requirements. While this standard has been adopted, it has no financial statement impact on the Company.

m) Use of Estimates

The preparation of consolidated financial statements in accordance with Canadian GAAP requires that management 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 reporting period. These estimates are subject to measurement uncertainty. Actual results could differ from and affect the results reported in these consolidated financial statements.

In the accounting for oil and gas interests, amounts recorded for depletion and amounts used for impairment test calculations are based on estimates of oil and gas reserves and future cash flows, including development costs. By their nature, the estimates of reserves and the related future cash flows are subject to measurement uncertainty and the impact on the consolidated financial statements of future periods could be material.

n) Foreign Currency Translation

Effective April 1, 2007, the Company's reporting currency was changed from Canadian dollars to U.S. dollars. The Company anticipates that its future sales will be earned in U.S. dollars and significant expenditures of the Company costs will be incurred in U.S. dollars. The comparative financial statements from prior periods have been restated to reflect this change.

For the restatement, the Company followed the method prescribed by the CICA Emerging Issues Committee ("EIC") in release number EIC-130. All prior year financial statements were translated using the current rate method. This method of translation resulted in the financial statements of prior years being translated as if the U.S. dollar reporting currency had been used in those years. The resulting exchange gains and losses were recorded as a cumulative translation adjustment in shareholders' equity.

Prospectively, activities denominated in currencies other than the U.S. dollar are translated using the temporal method. Under this method, monetary assets and liabilities denominated in other currencies are translated into U.S. dollars at the exchange rate in effect at the balance sheet date. Non-monetary assets and liabilities denominated in other currencies are translated at rates in effect on the dates the assets were acquired or liabilities were assumed. Revenues and expenses are translated at rates approximating exchange rates in effect at the time of the transactions. Gains and losses on translation are reflected in the Statement of Operations and Deficit.

3. INTERNATIONAL FINANCIAL REPORTING STANDARDS

In January 2006, the AcSB announced its decision to replace Canadian GAAP with International Financial Reporting Standards ("IFRS") for all Canadian Publicly Accountable Enterprises ("PAE"). On February 13, 2008, the AcSB confirmed January 1, 2011 as the official change-over date for PAE's to commence reporting under IFRS. Although IFRS is principles-based and uses a conceptual framework similar to Canadian GAAP, there are significant differences and choices in accounting policies, as well as increased disclosure requirements under IFRS. The Company continues to monitor and assess the impact of IFRS on its financial statements.

4. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table reconciles the changes in accumulated other comprehensive income (loss) for the years ended December 31, 2008 and 2007.

	For the Year Ended December 31	
	2008	2007
Accumulated other comprehensive income (loss), beginning of year	$ 3,282	$ (2)
Other comprehensive income:		
Unrealized gains on adoption of U.S. functional currency	$ -	$ 3,284
Accumulated other comprehensive income, end of year	$ 3,282	$ 3,282

5. ACQUISITIONS

On February 20, 2007, the Company acquired all of the issued and outstanding membership interests of Summit for cash consideration of $34,043,000. The assets acquired included an 18.1634% interest in a portfolio of assets onshore and offshore Marsh Island in the Gulf of Mexico, together with an 18.1634% interest in a 40 million cubic feet of gas per day (MMcfgpd) production facility tied into the existing regional pipeline infrastructure.

On March 8, 2007, the Company exercised its option under the Summit Purchase Agreement to acquire two additional properties for the issuance of 1,222,604 shares of stock with a value of $1,458,000.

The Company also acquired from certain other participants an additional 17.4175% interest in the Marsh Island project for consideration of $21,263,000. The consideration paid included the issuance of 393,267 shares of stock with a value of $474,000.

In connection with the above transactions and the private placement described in Note 7(a), the Company issued 2.2 million shares of stock as a finders' fee to third parties. An additional 5 million shares of stock were issued under the terms of certain assignment agreements pursuant to which the Company was granted the opportunity to acquire Summit. The value of the 7.2 million shares issued was $8,661,000.

The total consideration, including other related properties and transaction costs, for the above acquisitions was $65,425,000. The allocation of the purchase price is as follows:

Petroleum and natural gas properties	$	63,881
Working capital	$	2,707
Asset retirement obligation	$	(1,163)
	$	65,425

On May 8, 2007, the Company closed on the acquisition of the Gulf of Mexico Assets from Pearl Exploration and Production Ltd., an affiliated company. The Gulf of Mexico Assets were acquired in exchange for 10 million common shares with a value of $24,764,000.

6. PETROLEUM AND NATURAL GAS PROPERTIES

	December 31, 2008					
			Accumulated			
		Cost		Depletion		Net
Petroleum and natural gas	$	19,717	$	(5,108)	$	14,609
Office equipment		229		(63)	$	166
	$	19,946	$	(5,171)	$	14,775

	December 31, 2007					
			Accumulated			
		Cost		Depletion		Net
Petroleum and natural gas	$	75,627	$	(3,239)	$	72,388
Office equipment		104		(20)	$	84
	$	75,731	$	(3,259)	$	72,472

Producing properties include the Eagle's Nest, Mt. Moran North, Greylock, Eugene Island Block 7 and Jefferson Island properties.

As of September 30, 2008, the Company reviewed its portfolio of unproved properties. Based on that review, the Company recorded an impairment expense of $11,584,000 during the quarter ended September 30, 2008. Of that amount, $10,516,000 related to leases in the Marsh Island Area and $1,068,000 related to leases in Federal waters. In 2007, the Company recorded an impairment expense of $23,934,000. These impairments resulted from the evaluation of drilling activities and new seismic data.

In February 2009, the Company made the decision to sell its Gulf of Mexico properties (see Note 15, Subsequent Event). As a result of that decision, the Company reviewed its portfolio of unproved properties at December 31, 2008.

Based on that review, the Company recorded an additional impairment expense of $56,300,000 as of December 31, 2008.

7. SHARE CAPITAL

a) Details are as follows:

	Number of Shares	Share Capital	Contributed Surplus
Authorized:			
Unlimited common shares without par value			
Issued and fully paid:			
Balance - December 31, 2006	83,238,550	$ 47,141	$ 1,566
Issued for cash:			
- private placement	166,666,667	163,114	-
- property acquisition	10,000,000	24,764	
- warrants exercised	38,785,000	4,433	(1,120)
- stock options exercised	750,000	790	(432)
Issued during the year:			
- Summit acquisitions	8,815,871	10,593	
- stock options granted	-	-	2,223
Balance - December 31, 2007	308,256,088	250,835	2,237
Issued for cash:			
- warrants exercised	500,000	50	-
Warrants exercised	-	14	(14)
Issued during the year:			
- stock options granted			801
Balance - December 31, 2008	308,756,088	$ 250,899	$ 3,024

During the first quarter of 2007, the Company closed a private placement of 166,666,667 shares at a price of Cdn$1.20 per share. Gross proceeds of the offering were Cdn$200,000,000 (Cdn$190,796,000 net of filing fees). During the second quarter of 2007 the Company finalized the acquisition of the Gulf of Mexico Assets in exchange for 10 million common shares of the Company.

b) Share Options

The Company has an established share purchase option plan whereby a committee of the Company's board of directors may, from time to time, grant up to a total of 10% of the issued share capital to directors, officers, employees or consultants. The number of shares under option at any specific time to any one optionee shall not exceed 5% of the issued and outstanding common shares of the Company. The term of any options granted under the plan will be fixed

by the Board of Directors and may not exceed five years from the date of grant. All options granted are subject to a four month hold period from the date of granting. Vesting terms are at the discretion of the Board of Directors. All issued stock options have terms of three to five years and vest over periods of up to three years. The exercise price of an option is not less than the closing price on the TSX Venture Exchange ("the Exchange") on the last trading day preceding the grant date, less the applicable discount, provided that the exercise price will not be less than Cdn $0.10 per share.

The continuity of incentive stock options issued and outstanding is as follows:

Stock Option Continuity

	Number of Options	**Weighted Average Exercise Price**
Outstanding at December 31, 2006	1,000,000	Cdn $0.61
Granted	3,165,000	Cdn $1.47
Exercised	(750,000)	Cdn $0.56
Cancelled/Forfeited	(200,000)	Cdn $2.20
Outstanding at December 31, 2007	3,215,000	Cdn $1.37
Granted	3,660,000	Cdn $0.48
Expired	(250,000)	Cdn $0.75
Cancelled/Forfeited	(5,000)	Cdn $2.15
Outstanding at December 31, 2008	6,620,000	Cdn $0.90

At December 31, 2008, 4,179,996 options are exercisable at an average exercise price of Cdn $1.14 per share with a weighted average remaining life of 2.5 years.

Stock Based Compensation

The Company recognizes compensation expense on stock options granted to both employees and non-employees using the fair value method at the date of grant, which the Company records as an expense. The stock option compensation expense is calculated using the Black-Scholes Option Pricing Model. The weighted average fair value of options granted and the assumptions used in their determination are as follows.

	2008	2007
Expected dividend yield	0%	0%
Risk-free interest rate (weighted average)	3.06%	4.07%
Expected stock price volatility (weighted average)	94.24%	68.94%
Expected option life in years (weighted average)	3.00	4.36

Stock option compensation expense for the year ended December 31, 2008 and 2007 were $801,000 and $2,223,000, respectively.

Option pricing models require the input of highly subjective assumptions including the expected price volatility. Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore the existing models do not necessarily provide a reliable single measure of the fair value of the Company's stock options.

c) Warrants

As of December 31, 2006, the Company had share purchase warrants outstanding to purchase 39,285,000 shares at Cdn $0.10 per share, exercisable by January 9, 2008. These warrants were outstanding pursuant to the private placement of 40,000,000 units that closed during 2006. During the first three months ended March 31, 2007, 38,585,000 shares were issued at Cdn $0.10 per share, pursuant to these warrants. During the second three months ended June 30, 2007, 200,000 shares were issued at Cdn $0.10 per share. At September 30, 2007, the Company had share purchase warrants outstanding to purchase 500,000 shares at Cdn $0.10 per share, exercisable by January 9, 2008. These warrants were subsequently exercised on January 8, 2008.

8. ASSET RETIREMENT OBLIGATION

The total future asset retirement obligation was 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 $3,600,000, which will be incurred over the next 20 years with 40% of the costs incurred between 2009 and 2012. An accretion factor of 2% was used to calculate the fair value of the asset retirement obligation.

Changes to the asset retirement obligation were as follows:

	2008	2007
Balance, beginning of year	$ 1,914	-
Liabilities acquired through acquisitions	-	1,163
Liabilities incurred during the year	753	825
Revisions of estimated cash flows	673	-
Liabilities settled during the year	(134)	(111)
Accretion	55	37
Balance, end of year	$ 3,261	1,914

9. INCOME TAXES

a. Future income tax expense:

The provision for income taxes reflects an effective tax rate which differs from Federal and Provincial statutory tax rates. The main differences are as follows:

		Years Ended December 31,	
		2008	2007
Loss before income taxes	$	(98,050)	(58,472)
Corporate income tax rate		31.0%	34.1%
Computed income tax recovery		(30,396)	(19,939)
Increase (decrease) resulting from:			
Non-taxable foreign exchange gain		1,553	(6,143)
Share issuance costs charged to share capital		-	(2,819)
Non-deductible compensation expense		248	758
Foreign tax rate difference		(3,910)	(524)
Effect of change in tax rates		188	216
Change in valuation allowance		31,570	28,813
Effect of change in Foreign exchange rates		483	
Other		264	(362)
Income tax expense	$	-	-

b. The components of the future income tax assets are as follows:

		December 31,	
		2008	2007
Future income tax assets:	$		
Non-capital losses		24,045	18,887
Share issue costs carried forward		1,311	2,257
Properties - tax basis over carrying value		35,544	7,996
Exploration expenses		685	875
Future income tax assets		61,585	30,015
Valuation allowance		(61,585)	(30,015)
Future income tax asset	$	-	-

c. The Company has available to carry-forward the following:

		December 31,	
		2008	2007
Canadian losses from operations	$	1,527	796
Canadian exploration expenses		2,636	3,240
Canadian unamortized share issue costs		4,545	7,460
U.S. Federal losses from operations		67,565	53,349
U.S. Federal - tax basis over carrying values of properties		101,556	22,846

The Canadian losses from operations may be used to offset future Canadian taxable income and will expire over the period from 2014 to 2028. The Canadian exploration expenses may be carried forward indefinitely to offset future taxable Canadian income. Canadian unamortized share issue costs may offset future taxable Canadian income of years 2009 to 2011. The U.S. Federal losses are available to offset future taxable income in the United States through 2028.

10. SIGNIFICANT CUSTOMERS

The Company has oil and natural gas sales to customers accounting for 52%, 23% and 22%, respectively, of total oil and natural gas revenues for the year ended December 31, 2008. Comparable amounts for 2007 were 0%, 69% and 27%, respectively.

11. RELATED PARTY TRANSACTIONS

Namdo Management Services Ltd. (Namdo) provides administrative support to the Company under an agreement which commenced April 1, 2007. The amounts paid

to Namdo during the years ended December 31, 2008 and 2007 were $264,000 and $187,000, respectively. Namdo is a private corporation owned by a shareholder of the Company.

During the year ended December 31, 2008, the Company incurred legal fees of $18,000 with a law firm in which an officer of the Company is a partner. In 2007, the comparable amount was $251,000.

During the years ended December 31, 2008 and 2007, the Company incurred geological and geophysical (G&G) costs of $469,000 and $134,000, respectively, with a G&G firm in which an officer of the Company is a managing partner.

12. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company's financial instruments consist of cash, cash equivalents, investments, accounts receivable, accounts payable, accrued expenses and advances from joint interest holders.

Cash, cash equivalents and investments are designated as held for trading and therefore carried at fair value, with unrealized gain or loss recorded in interest income.

The fair values of cash, cash equivalents, accounts receivable, accounts payable, accrued expenses and advances from joint interest holders approximate carrying values because of the short-term nature of these instruments. The fair values of investments are determined directly by reference to quoted market prices.

The Company is exposed in varying degrees to a variety of financial instrument related risks.

Credit Risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. The Company manages its credit risk through its counterparty ratings and credit limits. The Company is mainly exposed to credit risk on its bank accounts and accounts receivable. Bank accounts are with banks that have a minimum credit rating of R-1 (mid) or better (as measured by Dominion Bond Rate Services) or the equivalent thereof according to a recognized bond rating service.

Accounts receivable are primarily with natural gas marketers and joint venture partners in the oil and gas industry and are subject to normal industry credit risks. As of December 31, 2008, the Company's receivables consist of $996,000 from

joint venture partners and other trade receivables and $916,000 of revenue accruals and other receivables from natural gas marketers.

Joint venture receivables are typically collected within one to two months of the joint venture bill being issued to the partner. The Company mitigates the risk from joint venture receivables by obtaining partner approval of capital expenditures prior to starting a project

Receivables from natural gas marketers are typically collected on the end of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with established marketers. The Company has not experienced any collection issues with its natural gas marketers.

Liquidity Risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as they are 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, without incurring unacceptable losses or risk harm to the Company's reputation.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company uses authorizations for expenditures on both operating and non-operating projects to further manage capital expenditures.

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. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns.

The significant market risk exposures to which the Company is exposed are foreign currency, commodity price and interest rate risks.

Foreign currency risk – The Company maintains a portion of its cash in Canadian dollars. The Company's operations are conducted in U.S. dollars. The Company's operating results and cash flows are affected to varying degrees by the changes in the Canadian dollar vis-à-vis the U.S. dollar. Company expenditures are incurred predominately in U.S. dollars. The Company has not entered into any agreements or purchased any instruments to hedge possible currency risks.

At December 31, 2008, the Company had $36,287,000 denominated in Canadian dollars. As of December 31, 2008, with other variables unchanged, a 1% strengthening of the U.S. dollar against the Canadian dollar would decrease the net loss by $363,000 due to this financial asset.

Commodity price risk – The prices that the Company receives for its crude oil and natural gas production may have a significant impact on its revenue and cash provided by operating activities. Any significant price decline in commodity prices would adversely affect the amount of funds available for capital reinvestment purposes. At this time the Company does not use derivative financial instruments to manage its exposure to this risk.

Interest rate risk – The Company's bank accounts earn interest income at variable rates. The Company's future interest income is exposed to changes in short-term rates.

13. CAPITAL DISCLOSURE

The Company's objective when managing capital is to safeguard the Company's ability to continue as a going concern such that it can provide returns for shareholders and benefits for other stakeholders.

The Company considers its capital structure to include shareholders' equity and working capital. The Company manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust its capital structure, the Company may issue new shares or sell assets to settle liabilities. The Company is not subject to externally imposed capital requirements.

14. COMMITMENTS

The Company enters into commitments and contractual obligations in the normal course of business, including the purchase of services, farm-in agreements, seismic data acquisition agreements and lease agreements.

The Company has operating leases for office space which expire on various dates through 2011. Future minimum commitments as of December 31, 2008 under these operating leases are as follows:

2009	$	117,000
2010		92,000
2011		8,000
	$	217,000

Expenses related to operating leases for office space were $39,000 and $7,000 in 2008 and 2007, respectively.

15. SUBSEQUENT EVENT

In February 2009, the Company decided to sell its Gulf of Mexico properties and entered into a Letter of Intent with a third party. On April 16, 2009, the Company entered into a definitive purchase and sale agreement with a third party to sell substantially all of its oil and gas properties, including related asset retirement obligations, for $12,500,000 in cash and a deferred, contingent payment of up to $8,000,000 based on proved reserves, as defined, at December 31, 2010. The transaction is expected to close prior to the end of May 2009.

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