

Kroes Energy Inc.
Consolidated Financial Statements
December 31, 2007

Contents

	<u>Page</u>
Auditors' Report	1
Consolidated Balance Sheets	2
Consolidated Statements of Operations and Deficit	3
Consolidated Statements of Comprehensive Loss and Accumulated Other Comprehensive Loss	4
Consolidated Statements of Cash Flows	5
Notes to the Consolidated Financial Statements	6-25

Auditors' Report

To the Shareholders of
Kroes Energy Inc.

We have audited the consolidated balance sheets of **Kroes Energy Inc.** as at December 31, 2007 and 2006 and the consolidated statements of operations and deficit, comprehensive loss and accumulated other comprehensive loss and cash flows for the years then ended. These consolidated 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, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Grant Thornton LLP

Calgary, Alberta
April 15, 2008

Chartered Accountants

Kroes Energy Inc.

Consolidated Balance Sheets

December 31 2007 2006

Assets

Current

Cash and cash equivalents	\$ 1,152,259	\$ 349,699
Receivables and other	119,844	40,972
Prepays and deposits	9,553	8,053
Assets of discontinued operations (Note 9)	<u>72,730</u>	<u>2,285,997</u>
	1,354,386	2,684,721

Property and equipment (Note 4)	1,907,645	562,404
Assets of discontinued operations (Note 9)	<u>243,931</u>	<u>6,767,542</u>
	\$ 3,505,962	\$ 10,014,667

Liabilities

Current

Payables and accruals	\$ 149,703	\$ 154,196
Liabilities of discontinued operations (Note 9)	<u>22,683</u>	<u>606,696</u>
	172,386	760,892

Asset retirement obligations (Note 5)	32,736	2,862
Liabilities of discontinued operations (Note 9)	<u>22,538</u>	<u>653,904</u>
	227,660	1,417,658

Shareholders' Equity

Capital stock (Note 6b)	6,660,868	6,814,320
Warrants issued (Note 6c)	-	131,984
Contributed surplus (Note 6f)	934,088	679,167
(Deficit) retained earnings	(4,316,654)	1,734,908
Accumulated other comprehensive loss	<u>-</u>	<u>(763,370)</u>
	3,278,302	8,597,009
	\$ 3,505,962	\$ 10,014,667

Nature of operations and going concern (Note 1)
 Commitments and contingency (Note 13)
 Subsequent events (Note 14)

On behalf of the Board

(Signed) "F. Callaway" _____ Director **(Signed) "S. D. Gossen"** _____ Director

See accompanying notes to the consolidated financial statements.

Kroes Energy Inc.

Consolidated Statements of Operations and Deficit

Years Ended December 31

2007

2006

Revenue		
Oil and natural gas sales	\$ 725,460	\$ 8,768
Royalties	<u>(160,364)</u>	<u>(1,556)</u>
	<u>565,096</u>	<u>7,212</u>
Expenses		
Operating	159,404	5,915
Transportation	32,363	395
General and administrative	583,551	762,312
Stock-based compensation	122,937	210,520
Loss on value of investment	139,950	-
Depletion and depreciation	<u>438,027</u>	<u>15,285</u>
	<u>1,476,232</u>	<u>994,427</u>
Loss before other items and income taxes	(911,136)	(987,215)
Other items		
Interest and other income	<u>44,412</u>	<u>16,801</u>
Net loss before income taxes	(866,724)	(970,414)
Income tax provision (recovery)		
Future	<u>(156,406)</u>	<u>-</u>
Net loss from continuing operations	(710,318)	(970,414)
Net (loss) earnings from discontinued operations (Note 9)	<u>(3,381,942)</u>	<u>1,121,159</u>
Net (loss) earnings	\$ <u>(4,092,260)</u>	\$ <u>150,745</u>
Net (loss) per share amounts from continuing operations		
Basic and diluted (Note 8)	\$ <u>(0.020)</u>	\$ <u>(0.028)</u>
Net (loss) earnings per share amounts		
Basic and diluted (Note 8)	\$ <u>(0.113)</u>	\$ <u>0.004</u>
Retained earnings, beginning of year	\$ 1,734,908	\$ 1,584,867
Net (loss) earnings	(4,092,260)	150,745
Distribution of investment (Note 6g)	(1,959,302)	-
Premium on redemption of common shares (Note 6e)	<u>-</u>	<u>(704)</u>
(Deficit) retained earnings, end of year	\$ <u>(4,316,654)</u>	\$ <u>1,734,908</u>

See accompanying notes to the consolidated financial statements.

Kroes Energy Inc.**Consolidated Statements of Comprehensive Loss
and Accumulated Other Comprehensive Loss**

Years Ended December 31

2007**2006**

Net (loss) earnings	\$ (4,092,260)	\$ 150,745
Other comprehensive loss		
Foreign currency translation adjustment	<u>763,370</u>	<u>69,240</u>
Comprehensive loss	\$ <u>(3,328,890)</u>	\$ <u>219,985</u>
<hr/>		
Accumulated other comprehensive (loss)		
Beginning of year	\$ (763,370)	\$ (832,610)
Other comprehensive loss		
Foreign currency translation adjustment	<u>763,370</u>	<u>69,240</u>
Accumulated other comprehensive loss		
End of year	\$ <u>-</u>	\$ <u>(763,370)</u>

See accompanying notes to the consolidated financial statements.

Kroes Energy Inc.

Consolidated Statements of Cash Flows

Years Ended December 31

2007

2006

Operating

Net loss	\$ (710,318)	\$ (970,414)
Items not affecting cash		
Depletion and depreciation	438,027	15,285
Stock-based compensation	122,937	210,520
Loss on value of investment	139,950	-
Future tax recovery	<u>(156,406)</u>	<u>-</u>
	(165,810)	(744,609)
Change in non-cash operating working capital (Note 12)	<u>(84,865)</u>	<u>(6,117)</u>
	<u>(250,675)</u>	<u>(750,726)</u>

Financing

Net proceeds from share and warrant issues	2,954	1,037,866
Redemption of common shares	<u>-</u>	<u>(1,700)</u>
	<u>2,954</u>	<u>1,036,166</u>

Investing

Additions to property and equipment	(1,323,395)	(554,437)
Partial proceeds from sale of subsidiary (Note 9)	<u>1,000,000</u>	<u>-</u>
	<u>(323,395)</u>	<u>(554,437)</u>

Net change in cash and cash equivalents	(571,116)	(268,997)
Net cash flows of discontinued operations	1,373,676	149,462
Cash and cash equivalents,		
Beginning of year	<u>349,699</u>	<u>469,234</u>
End of year	<u>\$ 1,152,259</u>	<u>\$ 349,699</u>

See accompanying notes to the consolidated financial statements.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

1. Nature of operations and going concern

The Company's continuing operations relate to the exploration for and production of petroleum and natural gas reserves in Canada.

Through its wholly owned subsidiary Zhoda 2001 Corporation ("Zhoda"), the Company held a 45% interest in the joint venture company Kashtan Petroleum Ltd. ("Kashtan"), a limited liability company, registered under the laws of Ukraine. On August 1, 2007, the Company disposed of its 100% interest in Zhoda (see Note 9).

On January 12, 2008, the Company disposed of its 25% interest in the Icacos Block, Cedros Peninsula, Trinidad ("Trinidad") for US\$250,000 (see Note 9).

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles applicable to a going concern which assumes that the Company will realize the carrying value of its assets and satisfy its obligations as they become due in the normal course of operations. For the year ended December 31, 2007, the Company has a net loss of \$710,318 (\$970,414 for the year ended December 31, 2006) and a negative cash flow from operating activities of \$165,810 (\$744,609 for the year ended December 31, 2006).

The ability of the Company to continue as a going concern depends on raising additional financing and achieving profitable operations sufficient to meet all obligations. Although, in the opinion of Management, the use of the going concern assumption is appropriate, there can be no assurance that any steps Management is taking will be successful.

These consolidated financial statements do not reflect adjustments in the carrying values of the assets and liabilities, expenses and the balance sheet classifications that would be used if the going concern assumption were not appropriate. Such adjustments could be material.

2. Summary of significant accounting policies

Basis of presentation

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles within the framework of the accounting policies summarized below.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Zhoda up to the date of disposition. All inter-company transactions and balances are eliminated upon consolidation. For the purpose of these financial statements all operations and accounts of Zhoda and Trinidad, are classified as discontinued operations.

The Company sold its 25% interest in the Icacos Block, Cedros Peninsula, Trinidad on January 12, 2008 and as a result, the operations and assets are classified as discontinued operations.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

2. Summary of significant accounting policies (Continued)

Petroleum and natural gas properties

i) Capitalized costs

The Company follows the full cost method of accounting for its petroleum and natural gas operations as determined by the Canadian Institute of Chartered Accountants Accounting Guideline 16. Under this method all costs related to the exploration for and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses, and costs of drilling both producing and non-producing wells. Proceeds from the sale of properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would significantly alter the rate of depletion and depreciation in the cost centre.

ii) Depletion and depreciation

Depletion of exploration and development costs and depreciation of production equipment and processing facilities is provided using the unit-of-production method based upon estimated proved petroleum and natural gas reserves. The costs of significant undeveloped properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment has occurred. Estimated future costs to be incurred in developing proved reserves are included in costs subject to depletion. For depletion and depreciation purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

Depreciation of office equipment is provided for on a declining balance method at 30% per annum which is designed to depreciate the cost of the assets over their estimated useful lives.

iii) Impairment test

At each reporting period the Company performs an impairment test to determine the recoverability of capitalized costs associated with reserves for each cost centre. An impairment loss is recognized in operations when the carrying amount of a cost centre exceeds its fair value. The carrying amount of the cost centre is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows from proved reserves plus the costs of unproved properties. If the sum of the cash flows is less than the carrying amount, the impairment loss is limited to the amount by which the carrying amount exceeds the sum of the fair value of proved and probable reserves and the costs of unproved properties that have been subject to a separate impairment test and contain no probable reserves.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

2. Summary of significant accounting policies (Continued)

iv) Asset retirement obligations

The Company recognizes the fair value of estimated asset retirement obligations on the consolidated balance sheet when a reasonable estimate of fair value can be made. Asset retirement obligations include those for which a company faces a legal obligation to retire tangible long-lived assets such as well sites, pipelines and facilities. The asset retirement cost, equal to the initially estimated fair value of the asset retirement obligation, is capitalized as part of the cost of the related long lived asset. Changes in the estimated obligation resulting from revisions to estimated timing or amount of undiscounted cash flows are recognized as a change in the asset retirement obligation and the related asset retirement cost.

Asset retirement costs are depleted using the unit-of-production method and are included in depletion and depreciation in the consolidated statement of operations. Increases in the asset retirement obligations resulting from the passage of time are recorded as accretion to the asset retirement obligations in the consolidated statement of operations. Actual expenditures incurred are charged against the accumulated obligations and is shown as a deduction from operating activities.

Measurement uncertainty

The preparation of the consolidated financial statements in accordance with Canadian generally accepted accounting principles requires management to make certain assumptions and estimates that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from and affect the results reported in these consolidated financial statements as future confirming events occur.

Amounts recorded for depletion and depreciation, asset retirement obligations and amounts used in impairment test calculations are based upon estimates of petroleum and natural gas reserves and future costs to develop those reserves. By their nature, these estimates of reserves, costs and related future cash flows are subject to uncertainty, and the impact on the consolidated financial statements of future periods could be material.

The amounts attributable to the fair value of stock options issued are based on estimates of the future volatility of the Company's share price, expected lives of the options, expected dividends and other relevant assumptions (see Note 8).

Joint operations

The majority of the Company's oil and gas exploration, development and production activities are conducted jointly with others. These consolidated financial statements reflect only the Company's proportionate interest in such activities.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

2. Summary of significant accounting policies (Continued)

Foreign currency translation

i) Self-sustaining foreign operations

All assets and liabilities are translated at the rate of exchange in effect at the balance sheet date. Revenues and expenses are translated at the average exchange rates for the year. Exchange gains and losses arising from the translation are deferred and included in accumulated other comprehensive loss.

ii) Accounts in foreign currencies

Accounts in foreign currencies are translated at the rate of exchange in effect at the balance sheet date. Exchange gains or losses are included in the consolidated statements of operations and deficit.

Income taxes

Income taxes are recorded using the liability method of tax allocation. Future income taxes are calculated based on temporary differences arising from the difference between the tax basis of an asset or liability and its carrying value using substantively enacted tax rates anticipated to apply in the periods when the temporary differences are expected to reverse. Future income tax assets are recognized when it is more likely than not the tax deductions and loss carry-forwards will be utilized. A valuation allowance is recorded against any future income tax assets if it is more likely than not that the asset will not be realized. Changes in income tax rates that are substantively enacted are reflected in the accumulated future income tax balances in the period the change occurs.

Per share amounts

The treasury stock method is used to determine the dilutive effect of stock options and warrants. The treasury stock method assumes that proceeds received from the exercise of in-the-money stock instruments are used to repurchase common shares at the average market price for the year.

Flow-through shares

Resources expenditure deductions for income tax purposes related to Canadian exploration and development activities funded by flow through share arrangements are renounced to investors in accordance with income tax legislation. The liability for future income taxes is increased and capital stock is reduced by the estimated tax benefits transferred to shareholders at the time the resource exploration deductions are renounced.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

2. Summary of significant accounting policies (Continued)

Stock-based compensation

The Company grants stock options to its directors, officers, consultants and employees upon employment and periodically during the period of employment.

The Company records compensation expense in the consolidated statements of operations for stock options granted to directors, officers and employees using the fair value method. Compensation costs are recognized over the vesting period. Fair values are determined using the Black-Scholes option pricing model.

Financial instruments

On January 1, 2007, the Company adopted the CICA Handbook Section 3855, "Financial Instruments – Recognition and Measurement" (See Note 3).

Financial instruments are measured at fair value on initial recognition of the instrument, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as "held-for-trading", "available-for-sale", "held-to-maturity", "loans and receivables", or "other financial liabilities" as defined by the accounting standard.

Financial assets and financial liabilities "held-for-trading" are measured at fair value with changes in those fair values recognized in the consolidated statement of operations. Financial assets "available-for-sale" are measured at fair value, with changes in those fair values recognized in other comprehensive loss ("OCL"). Financial assets "held-to-maturity", "loans and receivables" and "other financial liabilities" are measured at amortized cost using the effective interest method of amortization.

Cash and cash equivalents and investment in marketable securities are designated as "held-for-trading" and are measured at fair value. Receivables and other are designated as "loans and receivables". Payables and accruals are designated as "other-financial-liabilities"

Derivative financial instruments are classified as "held-for-trading" unless designated for hedge accounting. Derivative instruments that do not qualify as hedges, or are not designated as hedges, are recorded using the mark-to-market method of accounting whereby instruments are recorded in the consolidated balance sheet as either an asset or liability with changes in fair value recognized in the consolidated statement of operations.

Cash and cash equivalents

Cash and cash equivalents are comprised of cash on hand, balances with banks and short-term deposits with a duration of three months or less from the date of acquisition. Bank borrowings are considered to be financing activities.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

2. Summary of significant accounting policies (Continued)

Inventory

Inventory is valued at the lower of cost and estimated net realizable value. Cost is determined on a weighted average basis.

Revenue recognition

Oil and natural gas sales are recognized in earnings when title passes to the customer and delivery has taken place.

Recent accounting pronouncements

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

As of January 1, 2008, the Company will be required to adopt the CICA Section 3031, "Inventories", which will replace the existing inventories standard. The new standard requires inventories to be valued on a first-in, first-out or weighted average basis, which is consistent with the Company's current treatment. The adoption of this standard should not have a material impact on the Company's financial statements.

As of January 1, 2008, the Company will be required to adopt two new CICA Standards, Section 3862, "Financial Instruments – Disclosures" and Section 3863 " Financial Instruments – Presentation" which will replace Section 3861, Financial Instruments – Disclosure and Presentation". The new disclosure standard will increase the Company's disclosure regarding the risks associated with financial instruments and how those risks are managed.

As of January 1, 2008, the Company will be required to adopt CICA, Section 1535, "Capital Disclosures" which will require the Company to disclose its objectives, policies and processes for managing capital.

As of January 1, 2008, the Company will be required to adopt CICA amended Section 1400 "General Standards of Financial statement Presentation" which requires assessing and disclosing the Company's ability to continue as a going concern.

On January 10, 2006, the CICA Accounting Standards Board ("AcSB") ratified a new strategic plan that would see the convergence of Canadian Generally Accepted Accounting Principles ("GAAP") with International Financial reporting Standards ("IFRS") within 5 years. In March 2007, the AsCB released an "Implementation Plan for Incorporating IFRS into Canadian GAAP", which assumed a convergence date of January 1, 2011. The AsCB confirmed this date in February 2008. The Company continues to monitor and assess the consequences of the convergence on the financial statements as they could have a material impact.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

3. Changes in accounting policies

On January 1, 2007, the Company adopted the CICA Handbook Section 1530 "Comprehensive Income", Section 3251 "Equity", Section 3861 "Financial Instruments – Disclosure and Presentation", Section 3855, "Financial Instruments – Recognition and Measurement", and Section 3865, "Hedges". As required by the new standards, prior periods have not been restated, except to reclassify the foreign currency translation adjustment balances as described under other comprehensive income.

The adoption of these standards has had no material impact on the Company's net earnings or cash flows. The other effects of the implementation of the new standards are discussed below:

Comprehensive income (loss)

The new standards introduce comprehensive income, which consists of net earnings and OCL. The Company's financial statements now include a statement of comprehensive loss, which includes the components of other comprehensive loss. OCL is currently comprised of the changes in the foreign currency translation adjustment balance.

The cumulative changes in OCL are included in accumulated other comprehensive loss ("AOCL"), which is presented as a new category within shareholders' equity in the consolidated balance sheet. The accumulated foreign currency translation adjustment, formerly presented as a separate category within shareholders equity, is now included in AOCL. The Company's financial statements now include a consolidated statement of accumulated other comprehensive loss, which provides the continuity of the AOCL balance.

The adoption of comprehensive income has been made in accordance with the applicable transitional provisions. Accordingly, the December 31, 2007 year end accumulated foreign currency translation adjustment balance of \$Nil is now included in AOCL (2006 – \$763,370). In addition, the change in the accumulated foreign currency translation adjustment balance for the year ended December 31, 2007 of \$763,370 is now included in OCL in the consolidated statement of comprehensive loss (2006 - \$69,240).

Financial instruments

The financial instruments standard establishes the recognition and measurement criteria for financial assets, financial liabilities and non-financial derivatives. The Company's accounting policies for financial instruments are described in Note 2.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

3. Changes in accounting policies (Continued)

Hedges

The new standard specifies the criteria under which hedge accounting can be applied and how hedge accounting can be executed. The Company has not designated any hedging relationships.

4. Property and equipment

	<u>2007</u>		
	<u>Cost</u>	<u>Accumulated Depletion and Depreciation</u>	<u>Net Book Value</u>
Exploration and development costs	\$ 2,022,459	\$ 377,944	\$ 1,644,515
Production equipment and processing facilities	281,907	62,323	219,584
Office equipment	37,618	21,542	16,076
Retirement costs of long lived assets	<u>31,210</u>	<u>3,740</u>	<u>27,470</u>
	<u>\$ 2,373,194</u>	<u>\$ 465,549</u>	<u>\$ 1,907,645</u>
	<u>2006</u>		
	<u>Cost</u>	<u>Accumulated Depletion and Depreciation</u>	<u>Net Book Value</u>
Exploration and development costs	\$ 453,245	\$ 8,630	\$ 444,615
Production equipment and processing facilities	97,725	2,332	95,393
Office equipment	37,618	17,949	19,669
Retirement costs of long lived assets	<u>2,862</u>	<u>135</u>	<u>2,727</u>
	<u>\$ 591,450</u>	<u>\$ 29,046</u>	<u>\$ 562,404</u>

Future capital expenditures of \$78,000 (2006 - \$Nil), as estimated by independent engineers, relating to the development of proved reserves have been included in costs subject to depletion. Undeveloped properties with a cost at December 31, 2007 of \$506,446 (2006 - \$Nil) included in exploration and development costs, have not been subject to depletion.

In January 2008, the Company sold its interest in Trinidad for US\$250,000 and retained a 1% overriding royalty to a maximum of US\$1,000,000 on production below 4,000 feet. These assets were written down to the proceeds on the sale and are included on the balance sheet as assets of discontinued operations. No value was attributed to the overriding royalty.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

4. Property and equipment (Continued)

The prices used in the impairment test evaluation of the Company's petroleum properties were as follows:

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	Increase Thereafter
Crude oil per								
BBL (\$Cdn)	\$ 88.35	\$ 85.75	\$ 83.10	\$ 80.50	\$ 77.85	\$ 79.40	\$ 80.99	2.0%
Natural gas per								
Mcf (\$Cdn)	\$ 6.52	\$ 7.34	\$ 7.62	\$ 7.79	\$ 7.97	\$ 8.18	\$ 7.97	2.0%

5. Asset retirement obligations

The following table represents the reconciliation of the beginning and ending aggregate carrying amount of the obligations associated with the retirement of oil and gas assets:

	<u>2007</u>	<u>2006</u>
Asset retirement obligations, beginning of year	\$ 2,862	\$ -
Liabilities incurred	27,423	2,862
Accretion expense	1,526	-
Revision of estimates	<u>925</u>	<u>-</u>
Asset retirement obligations, end of year	\$ <u>32,736</u>	\$ <u>2,862</u>

The total undiscounted amount of estimated cash flows required to settle the obligation is \$43,208 (2006 - \$8,755), which has been discounted using a credit-adjusted risk free rate of 8%. The majority of these obligations are not expected to be settled for years, or decades in the future and will be funded from general Company resources at the time of retirement and removal.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

6. Capital stock

a) Authorized

Unlimited number of common shares

Unlimited number of preferred shares issuable in series

b) Issued and outstanding

	2007		2006	
	Number of Shares	Amount	Number of Shares	Amount
Common shares				
Balance, beginning of year	36,233,488	\$ 6,814,320	32,163,488	\$ 6,001,721
Issued for cash on exercise of options	-	-	500,000	65,000
Issued for cash through a public offering	-	-	3,575,000	1,029,891
Purchased through issuer's bid process	-	-	(5,000)	(997)
Renunciation of flow-through shares	-	(156,406)	-	-
Share issue costs	-	2,954	-	(281,295)
	36,233,488	\$ 6,660,868	36,233,488	\$ 6,814,320
Balance, end of year	36,233,488	\$ 6,660,868	36,233,488	\$ 6,814,320

In 2006, the Company completed a public offering equity financing whereby the Company issued 1,787,500 units which consisted of one common share, one flow-through share and one half of one non-transferable common share purchase warrant exercisable at a price of \$0.45 per warrant. As commission, the Company issued non-transferable options to the agent to purchase 41,667 Agents units a price of \$0.60 per unit. Each unit consists of two common shares and one half of one common share purchase warrant exercisable at a price of \$0.45 per warrant. The agent also received as commission non-transferable options equalling 10% of the units sold (1,787,500 units) which consisted of two common shares and one half of one common share purchase warrant at an exercise price of \$0.45 per warrant. These units were exercisable at \$0.60 for 18 months from the initial closing date and expired unexercised on December 27, 2007. In addition, the Company paid commissions and expenses related to the offering of \$189,009 to the agent.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

6. Capital stock (Continued)

c) Purchase warrants

As part of the 2006 financing (Note 6b), the Company issued to subscribers 893,750 share purchase warrants, exercisable at \$0.45 for 18 months from the initial closing of June 27, 2006. The fair value of these warrants approximated \$131,984 or \$0.1477 per warrant. The fair value of these warrants were estimated using the Black-Scholes option pricing model with an average risk-free interest rate of 4.6%, expected life of 1.5 years, volatility in the price of the Company's common shares of 134% and a dividend yield of 0.00%. These warrants expired unexercised in December 2007.

As part of the agent's commission the Company issued non-transferable options to the agent to purchase 41,667 units, as well as an option to purchase non-transferable options equalling 10% of the units sold (1,787,500 units). These units have non-transferable warrants attached to them that total 110,208. These warrants were exercisable at \$0.45 for 18 months from the initial closing date and expired unexercised on December 27, 2007. The Agent's financing warrants are accounted for as a charge to share issuance costs and a credit to contributed surplus (see Note 6(f)). The fair value of these agent warrants approximated \$16,275 or \$0.1477 per warrant. The fair value of these warrants were estimated using the Black-Scholes option pricing model with an average risk-free interest rate of 4.6%, expected life of 1.5 years, volatility in the price of the Company's common shares of 134% and a dividend yield of 0.00%.

	2007		2006	
	Number of Warrants	Amount	Number of Warrants	Amount
Balance, beginning of year	1,003,958	\$ 131,984	-	\$ -
Issued for cash through a public offering	-	-	893,750	131,984
Agent warrants	-	-	110,208	-
Expired warrants	(1,003,958)	(131,984)	-	-
Balance, end of year	-	\$ -	1,003,958	\$ 131,984

d) Agents options

In 2006, 220,417 agents financing options were issued in connection with the June 27, 2006 public financing referred to in Note 6(b). One option is composed of two common shares and one half one common share purchase warrant. The unit price is \$0.60 per unit and one full warrant entitles the purchaser to purchase a common share for \$0.45 prior to December 28, 2007. These warrants expired unexercised in December 2007.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

6. Capital stock (Continued)

d) Agents options (Continued)

	<u>2007</u>		<u>2006</u>	
	<u>Number of Options</u>	<u>Average Exercise Price</u>	<u>Number of Options</u>	<u>Average Exercise Price</u>
Balance, beginning of year	440,834	\$ 0.45	-	\$ -
Issued under the terms of a public offering	-	-	440,834	0.45
Expired warrants	(440,834)	0.45	-	-
Balance, end of year	-	\$ -	440,834	\$ 0.45

The Agent's financing options are accounted for as a charge to share issuance costs and a credit to contributed surplus (see Note 6(f)). The fair value of these agent financing options approximated \$76,011 or \$0.1724 per warrant. The fair value of these warrants were estimated using the Black-Scholes option pricing model with an average risk-free interest rate of 4.6%, expected life of 1.5 years, volatility in the price of the Company's common shares of 134% and a dividend yield of 0.00%.

e) Normal course issuer bid

In July 13, 2005, the Company received approval from the TSX Venture Exchange for a Normal Course Issuer Bid (the "Bid"). Under the Bid, the Company could purchase for cancellation up to 2,045,000 of its common shares, representing 6% of the common shares outstanding.

In 2006, the Company purchased for cancellation 5,000 common shares at an average price of \$0.34 per share pursuant to the Bid. The excess of the purchase price over book value has been charged to retained earnings.

	<u>2007</u>	<u>2006</u>
Balance, beginning of year	\$ 679,167	\$ 376,361
Value attributed to stock options granted	132,605	210,520
Transfer of carrying value of warrants expired	131,984	-
Fair value of options cancelled	(9,668)	-
Value assigned to brokers financing options	-	92,286
Balance, end of year	\$ 934,088	\$ 679,167

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

6. Capital stock (Continued)

g) Retained earnings (deficit)

With the disposition of Zhoda , the Company received 6,997,507 shares of Shelton Canada Corporation which it distributed to shareholders on August 22, 2007. The fair value of these shares in the amount of \$1,959,302 as determined on August 22, 2007 has been charged to retained earnings (deficit).

7. Per share information

Basic net (loss) earnings per common share is computed by dividing net earnings by the weighted average number of common shares outstanding for the year. Diluted net earnings per common share is computed by dividing net earnings by the diluted weighted average number of common shares outstanding for the year. In the calculation of diluted per share amounts, options under the stock option plan and purchase warrants are assumed to have been converted or exercised on the later of the beginning of the year or the date granted. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares.

	<u>2007</u>	<u>2006</u>
Weighted average shares outstanding:		
Basic	36,233,488	34,067,152
Shares issued pursuant to options and warrants	<u>-</u>	<u>142,611</u>
Diluted	<u>36,233,488</u>	<u>34,209,763</u>

In the 2007 calculation of diluted weighted average shares outstanding, the Company excluded 3,635,000 options and nil warrants (2006 – 1,715,834, options and 1,003,958 warrants) as the exercise price was greater than the average market price of its common shares in these years.

8. Stock-based compensation plan

The Company grants stock options to its directors, officers and consultants. The Company has a policy of reserving up to 10% of the outstanding common shares for issuance to eligible participants. At December 31, 2007, there were 3,623,349 (2006 – 3,623,349) common shares reserved for this purpose. All options issued prior to January 1, 2005 vested immediately upon being granted while the options granted after January 1, 2005 vest equally over three years on the anniversary date of issuance.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

8. Stock-based compensation plan (Continued)

At December 31, 2007, 3,635,000 options (2006 – 2,350,000), with exercise prices ranging from of \$0.085 to \$0.56 were outstanding and 1,956,686 (2006 - 1,599,996) were exercisable at various dates to August 22, 2012. The exercise price of each option granted was equal to or higher than the closing market price of the Company's common shares on the day prior to the issuing of the option.

The following tables summarize the information about the stock options:

	<u>2007</u>		<u>2006</u>	
	<u>Options</u>	<u>Weighted Average Exercise Price</u>	<u>Options</u>	<u>Weighted Average Exercise Price</u>
Outstanding, beginning of year	2,350,000	\$ 0.39	2,920,000	\$ 0.33
Granted	1,760,000	\$ 0.09	100,000	\$ 0.345
Exercised	-	\$ -	(500,000)	\$ 0.13
Cancelled	(475,000)	\$ 0.30	(170,000)	\$ 0.13
Outstanding, end of year	<u>3,635,000</u>	<u>\$ 0.26</u>	<u>2,350,000</u>	<u>\$ 0.39</u>
Options exercisable, end of year	<u>1,541,700</u>	<u>\$ 0.39</u>	<u>1,599,996</u>	<u>\$ 0.32</u>

Exercise Prices	<u>Outstanding Options</u>			<u>Exercisable Options</u>	
	<u>Number of Options Outstanding</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Years to Expiry</u>	<u>Number of Options Exercisable</u>	<u>Weighted Average Exercise Price</u>
\$0.085	1,660,000	\$ 0.085	4.6	-	\$ 0.085
\$0.155	100,000	\$ 0.155	4.3	-	\$ 0.155
\$0.25	675,000	\$ 0.25	0.1	675,000	\$ 0.25
\$0.33	200,000	\$ 0.33	1.0	200,000	\$ 0.33
\$0.345	100,000	\$ 0.345	3.2	66,670	\$ 0.345
\$0.56	900,000	\$ 0.56	2.4	600,030	\$ 0.56
	<u>3,635,000</u>	<u>\$ 0.26</u>	<u>3.0</u>	<u>1,541,700</u>	<u>\$ 0.39</u>

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

8. Stock-based compensation plan (Continued)

The weighted average fair market value of options granted during the year ended December 31, 2007 is \$0.089 (2006 - \$0.31) per option. The fair value of each option granted was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	<u>2007</u>	<u>2006</u>
Risk-free interest rate	3.9% – 4.3%	4.10%
Estimated hold period prior to exercise (years)	5	5
Volatility in the price of the Company's common shares	168% – 170%	143%
Dividend yield	0%	0%

9. Discontinued operations

On August 1, 2007, the Company disposed 100% of its interest in Zhoda to Shelton Canada Corp. ("Shelton") for consideration of \$1,000,000 cash and 6,997,507 common shares of Shelton as well as Shelton's oil and gas properties located in Flat Rock, B.C. and Alexander, Alberta valued at \$429,000. The fair value attributed to the Shelton shares received of \$2,099,252 incorporated a 10% discount factor based on the August 1, 2007 trading of Shelton's common shares. A loss on this sale of \$3,638,656 was recognized.

The discontinued operation of Zhoda are as follows:

	<u>2007</u>	<u>2006</u>
Revenues	\$ 2,967,559	\$ 5,088,699
Less: royalties	(1,473,018)	(2,117,079)
Operating costs	(666,883)	(963,978)
Depreciation and depletion	(294,807)	(427,412)
General and administrative	(85,841)	(214,695)
Other	1,068	86,629
Income taxes	(92,893)	(344,555)
Net earnings— discontinued operations	355,185	1,107,609
Loss on sale	(3,638,656)	-
Net (loss) earnings from discontinued operations	\$ (3,283,471)	\$ 1,107,609

On January 12, 2008, the Company sold its interest in its Trinidad properties for US\$250,000 and as a results, the assets were written down in 2007 to the net proceeds received. For financial purposes, the cost centre operations and assets are treated as discontinued operations. The discontinued operation of the Trinidad are as follows:

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

9. Discontinued operations (Continued)	<u>2007</u>	<u>2006</u>
Revenues	\$ 138,554	\$ 107,384
Less: royalties	(44,819)	(34,307)
Operating costs	(60,413)	(41,699)
Depreciation and depletion	(3,007)	(2,717)
General and administrative	(8,656)	(7,465)
Other	(8,536)	(5,462)
Income taxes	<u>(1,353)</u>	<u>(2,184)</u>
Net earnings— discontinued operations	11,770	13,550
Loss on sale	<u>(110,241)</u>	<u>-</u>
Net (loss) earnings from discontinued operations	\$ <u>(98,471)</u>	\$ <u>13,550</u>

The total net (loss) earnings from discontinued operations for both Zhoda and the Trinidad operations are:

Net (loss) earnings from discontinued operations	\$ <u>(3,381,942)</u>	\$ <u>1,121,159</u>
Net (loss) earnings from discontinued operations per common share:		
Basic and diluted (Note 8)	\$ <u>(0.093)</u>	\$ <u>0.033</u>

The impact of discontinued operations on the Company's consolidated balance sheet is as follows:

	Trinidad	Zhoda	<u>2007</u> Total
Cash and cash equivalents	\$ 5,091	\$ -	\$ 5,091
Receivables and other	<u>67,639</u>	<u>-</u>	<u>67,639</u>
	72,730	-	72,730
Property and equipment	243,931	-	243,931
Payables and accruals	(22,683)	-	(22,683)
Asset retirement obligations	<u>(22,538)</u>	<u>-</u>	<u>(22,538)</u>
Net assets	\$ <u>271,440</u>	\$ <u>-</u>	\$ <u>271,440</u>

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

9. Discontinued operations (Continued)

	Trinidad	Zhoda	<u>2006</u> Total
Cash and cash equivalents	\$ 37,827	\$ 504,653	\$ 542,480
Receivables and other	18,855	1,422,225	1,441,080
Prepays and deposits	15,092	73,503	88,595
Inventory	<u>482</u>	<u>213,360</u>	<u>213,842</u>
	72,256	2,213,741	2,285,997
Property and equipment	358,168	5,407,947	5,766,113
Restricted funds	-	1,001,429	1,001,429
Payables and accruals	(12,587)	(594,109)	(606,696)
Asset retirement obligations	(21,498)	(91,305)	(112,803)
Future income taxes	<u>-</u>	<u>(541,101)</u>	<u>(541,101)</u>
Net assets	<u>\$ 396,339</u>	<u>\$ 7,396,602</u>	<u>\$ 7,792,939</u>

10. Income taxes

2007

2006

a) Provision for income taxes

Loss before income taxes before discontinued operations	\$ <u>(866,724)</u>	\$ <u>(970,414)</u>
Expected tax expense (recovery) at combined federal and provincial rate of 32.12% (2006 – 34.49%)	\$ <u>(278,392)</u>	\$ (334,696)
Increase (decrease) resulting from:		
Stock based compensation	39,487	72,608
Non-taxable portion of capital gains	283,172	-
Effect of tax pools not previously recognized	(164,095)	-
Rate change and other	79,878	118,632
Valuation allowance	<u>(116,456)</u>	<u>143,456</u>
Provision for income taxes	\$ <u>(156,406)</u>	\$ <u>-</u>

b) Future income tax assets

Due to the uncertainty of realizing the future income tax assets it was determined that more likely than not did not exist. Therefore, no future income tax asset has been recognized on the consolidated balance sheet. Future income tax assets consist of the following temporary differences:

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

10. Income taxes (Continued)	<u>2007</u>	<u>2006</u>
Canadian property and equipment	\$ (59,490)	\$ (71,865)
Non-capital losses	518,590	749,719
Share issue costs	37,481	44,207
Asset retirement obligations	<u>8,184</u>	<u>830</u>
	504,765	722,891
Valuation allowance	<u>(504,765)</u>	<u>(722,891)</u>
Future income tax liability	\$ <u>-</u>	\$ <u>-</u>

c) **Tax losses available**

The Company has incurred losses for Canadian income tax purposes of approximately \$2,074,358 (2006 - \$2,582,005), the related benefit of these losses has not been recognized in the consolidated financial statements. Unless sufficient taxable income is earned these losses will expire as follows:

2014	\$ 435,765
2015	795,600
2026	<u>842,993</u>
	\$ <u>2,074,358</u>

11. **Financial instruments**

Fair values

The Company's financial instruments consist of cash and cash equivalents, receivables and other, and payables and accruals. The fair value of the financial instruments approximate their book values due to the relatively short-term maturities.

Credit risk management

Receivables and other include amounts receivable for oil and natural gas sales which are generally made to large credit worthy purchasers and accounts receivable from joint venture partners which are generally recoverable from future production. Accordingly, the Company views credit risks on these amounts as low.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

11. Financial instruments (Continued)

Foreign currency risk

The Company has cash and cash equivalents, receivables, and payables and accruals denominated in foreign currencies related to discontinued operations, and thus are exposed to the financial risk of earnings fluctuations arising from changes in foreign exchange rates and the degree of volatility of these rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

12. Supplemental cash flow information	<u>2007</u>	<u>2006</u>
Change in non-cash working capital:		
Receivables and other	\$ (78,872)	\$ (20,136)
Prepays and deposits	(1,500)	1,750
Payables and accruals	<u>(4,493)</u>	<u>12,269</u>
	<u>\$ (84,865)</u>	<u>\$ (6,117)</u>
Income taxes paid	\$ -	\$ -
Income taxes paid by discontinued operations	<u>\$ 1,353</u>	<u>\$ 395,472</u>

13. Commitments and contingency

- a) The Company has committed to annual rental payments for office premises until February 2010 as follows:

2008	\$ 72,721
2009	\$ 75,024
2010	\$ 12,761

- b) The Company is a defendant in legal claims associated with normal operations. These claims, although unresolved at the current time, in management's opinion are not expected to have a material impact on the financial position or results of operations of the Company and accordingly, no amount has been accrued in the consolidated financial statements for potential settlements.
- c) The Company was committed to spend \$625,625 on qualifying exploration and development expenditures prior to December 31, 2007 as part of the flow through share financing in July 2006. As at December 31, 2007, all of its qualifying expenditures were incurred.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

Years Ended December 31, 2007 and 2006

14. Subsequent events

- a) On January 12, 2008, the Company disposed of its 25% interest in the Icacos Block, Cedros Peninsula, Trinidad for US\$250,000. The Trinidad cost centre has been treated as discontinued operations.

 - b) On January 28, 2008, the Company and Vecta Energy Corporation (“Vecta”), a private Alberta corporation, entered into an agreement dated January 28, 2008, whereby the Company and Vecta will merge, as equals, all of their businesses and operations. The merger will be accomplished by the Company making a take-over bid for all of the issued and outstanding shares of Vecta. It is expected that the transaction will be a “Fundamental Acquisition” pursuant to TSX Venture Policy 5.3. The take-over bid by the Company and the completion of the merger are subject to the conclusion of a definitive agreement between the parties, finalization of due diligence and regulatory approval.
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15. Comparative amounts

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year.