

Kroes Energy Inc.
Financial Statements
December 31, 2008

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Auditors' Report

To the Shareholders of
Kroes Energy Inc.

We have audited the balance sheets of Kroes Energy Inc. as at December 31, 2008 and 2007 and the statements of operations and deficit, comprehensive loss and accumulated other 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 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.

Calgary, Alberta
April 21, 2009

The signature of Grant Thornton LLP is written in a cursive, handwritten style.

Chartered Accountants

Kroes Energy Inc.

Balance Sheets

December 31	2008	2007
Assets		
Current		
Cash and cash equivalents	\$ 174,298	\$ 1,152,259
Receivables and other	397,027	119,844
Prepays and deposits	4,031	9,553
Assets of discontinued operations (Note 11)	<u>12,758</u>	<u>72,730</u>
	588,114	1,354,386
Property and equipment (Note 5)	6,173,604	1,907,645
Assets of discontinued operations (Note 11)	<u>-</u>	<u>243,931</u>
	<u>\$ 6,761,718</u>	<u>\$ 3,505,962</u>
Liabilities		
Current		
Payables and accruals	\$ 1,245,009	\$ 149,703
Liabilities of discontinued operations (Note 11)	<u>1,233</u>	<u>22,683</u>
	1,246,242	172,386
Asset retirement obligations (Note 7)	92,570	32,736
Future tax liability (Note 12b)	364,983	-
Liabilities of discontinued operations (Note 11)	<u>-</u>	<u>22,538</u>
	<u>1,703,795</u>	<u>227,660</u>
Shareholders' Equity		
Capital stock (Note 8b)	9,107,951	6,660,868
Warrants issued (Notes 8c and d)	17,402	-
Contributed surplus (Note 8f)	1,062,475	934,088
Deficit	<u>(5,129,905)</u>	<u>(4,316,654)</u>
	5,057,923	3,278,302
	<u>\$ 6,761,718</u>	<u>\$ 3,505,962</u>
Commitments and contingency (Note 16)		
On behalf of the Board		
(Signed) "T. Coffman" _____	Director	(Signed) "S. D. Gossen" _____
		Director

See accompanying notes to the financial statements.

Kroes Energy Inc.**Statements of Operations and Deficit**

Years Ended December 31	2008	2007
Revenue		
Oil and natural gas sales	\$ 1,822,652	\$ 725,460
Royalties	<u>(408,492)</u>	<u>(160,364)</u>
	<u>1,414,160</u>	<u>565,096</u>
Expenses		
Operating	297,820	159,404
Transportation	82,291	32,363
General and administrative	627,973	583,551
Stock based compensation	128,387	122,937
Loss on value of investment	-	139,950
Depletion, depreciation and accretion	<u>1,136,227</u>	<u>438,027</u>
	<u>2,272,698</u>	<u>1,476,232</u>
Loss before other items and income taxes	(858,538)	(911,136)
Other items		
Interest and other income	<u>22,253</u>	<u>44,412</u>
Loss before income taxes	(836,285)	(866,724)
Income taxes (Note 11)	<u>-</u>	<u>(156,406)</u>
Loss from continuing operations	(836,285)	(710,318)
Net earnings (loss) from discontinued operations (Note 11)	<u>23,034</u>	<u>(3,381,942)</u>
Net loss	\$ <u>(813,251)</u>	\$ <u>(4,092,260)</u>
Net loss per share amounts from continuing operations		
Basic and diluted (Note 9)	\$ <u>(0.016)</u>	\$ <u>(0.020)</u>
Net loss earnings per share amounts		
Basic and diluted (Note 9)	\$ <u>(0.016)</u>	\$ <u>(0.113)</u>
Deficit and retained earnings, beginning of year	\$ (4,316,654)	\$ 1,734,908
Net loss	(813,251)	(4,092,260)
Distribution of Shelton shares (Note 8g)	<u>-</u>	<u>(1,959,302)</u>
Deficit, end of year	\$ <u>(5,129,905)</u>	\$ <u>(4,316,654)</u>

See accompanying notes to the financial statements.

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

Years Ended December 31

2008**2007**

Net loss \$ (813,251) \$ (4,092,260)

Other comprehensive loss

Foreign currency translation adjustment

_____ - 763,370

Comprehensive loss

\$ (813,251) \$ (3,328,890)

Accumulated other comprehensive loss,

Beginning of year

\$ - \$ (763,370)

Other comprehensive loss

Foreign currency translation adjustment

_____ - 763,370

Accumulated other comprehensive loss,

End of year

\$ - \$ -

See accompanying notes to the financial statements.

Kroes Energy Inc.

Statements of Cash Flows

Years Ended December 31

2008

2007

Operating

Net loss	\$ (836,285)	\$ (710,318)
Items not affecting cash		
Depletion, depreciation and accretion	1,136,227	438,027
Stock based compensation	128,387	122,937
Future tax recovery	-	(156,406)
Loss on value of investment	-	139,950
	<u>428,329</u>	<u>(165,810)</u>
Change in non-cash operating working capital (Note 15)	<u>(641,957)</u>	<u>(101,923)</u>
	<u>(213,628)</u>	<u>(267,733)</u>

Financing

Proceeds from share issues	-	2,954
	<u>-</u>	<u>2,954</u>

Investing

Additions to property and equipment	(2,176,916)	(1,323,395)
Cash acquired on acquisition of Vecta (Note 4)	206,658	-
Partial proceeds from sale of subsidiary	-	1,000,000
Change in non-cash working capital (Note 15)	961,498	17,058
	<u>(1,008,760)</u>	<u>(306,337)</u>

Net change in cash and cash equivalents (1,222,388) (571,116)

Net cash flows of discontinued operations 244,427 1,373,676

Cash and cash equivalents,

Beginning of year 1,152,259 349,699

End of year \$ 174,298 \$ 1,152,259

See accompanying notes to the financial statements.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

1. Nature of operations and going concern

The Company's ("Kroes") 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 as outlined in Note 10.

On January 12, 2008, the Company disposed of its 25% interest in the Icacos Block, Cedros Peninsula, Trinidad for US\$250,000 as outlined in Note 10.

On July 30, 2008, the Company acquired 97% of Vecta Energy Corporation's ("Vecta") issued and outstanding common shares and debentures. The balance of the common shares were compulsorily acquired under provisions of the Alberta Business Corporations Act on August 26, 2008 whereby Vecta became a 100% owned subsidiary of Kroes. The Vecta shareholders and the debenture holder received 35,986,521 Kroes shares in aggregate. The acquisition has been accounted for using the purchase method with the results of operations included in the financial statements from the date of acquisition. Both companies were amalgamated on September 30, 2008.

These 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, 2008, the Company has a net loss from continuing operations of \$836,285 (\$710,318 for the year ended December 31, 2007) and cash flow from operating activities of \$428,328 (negative \$165,810 for the year ended December 31, 2007). At December 31, 2008, the Company had a working capital deficiency of \$658,128 (excess \$1,182,000 for the year ended December 31, 2007).

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. Management has assessed its credit facilities and capital requirements in the 1st quarter 2009 and is considering additional equity financings as well as partnership opportunities in order to execute its operating and capital commitments in 2009. Although, in the opinion of management, the use of going concern assumption is appropriate, there can be no assurance that any steps management is taking will be successful.

These 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.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

2. Summary of significant accounting policies

Basis of presentation

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

The Company sold its interest in its Trinidad properties on January 12, 2008 and as a result the operations and assets are treated as discontinued operations for financial purposes.

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 ("CICA") 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 and overhead directly related to exploration and development activities. 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 for using the unit-of-production method based upon estimated proved petroleum and natural gas reserves as estimated by independent petroleum engineers. 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.

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.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

2. Summary of significant accounting policies (Continued)

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.

iv) Asset retirement obligations

The Company recognizes the fair value of estimated asset retirement obligations on the 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 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 are shown as a deduction from operating activities.

Measurement uncertainty

The preparation of the 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 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 financial statements as future confirming events occur.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

2. Summary of significant accounting policies (Continued)

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 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 9).

Joint operations

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

Foreign currency translation

- i) Self-sustaining foreign operations related to Zhoda's interest in Kashtan

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 statements of operations.

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.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

2. Summary of significant accounting policies (Continued)

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 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.

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 statements of operations for stock options granted 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

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 standards.

Financial assets and financial liabilities “held-for-trading” are measured at fair value with changes in those fair values recognized in the 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 are designated as “held-for-trading”. Receivables and other are designated as “loans and receivables”. Payables and accruals are designated as “other-financial-liabilities”.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

2. Summary of significant accounting policies (Continued)

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 balance sheet as either an asset or liability with changes in fair value recognized in the 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.

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, 2009, the Company will be required to adopt the CICA Handbook Section 3064, “Intangible Assets”. The new section establishes standards for the recognition, measurement, and disclosure of goodwill and intangible assets and replaces the existing Handbook Section 3062, “Goodwill and Other Intangible Assets” and Section 3450, “Research and Development costs”. Intangible assets associated with the exploration and development of oil and gas assets are specifically excluded under the new standard. The adoption of this standard should not have a material impact on the Company’s financial statements.

In January 2009, the CICA issued Handbook Sections 1582, Business Combinations, (“Section 1582”), Section 1601, Consolidated Financial Statements, (“Section 1601”) and Section 1602, Non-Controlling Interests (“Section 1602”) which replaced Handbook Sections 1581, Business Combinations, and 1600, Consolidated Financial Statements. Section 1582 establishes standards for the accounting for business combinations that is equivalent to the business combination accounting standard under International Financial Reporting Standards (“IFRS”). Section 1582 is applicable for the Company’s business combinations with acquisition dates on or after January 1, 2011. Early adoption of this Section is permitted. Section 1601 together with Section 1602 establishes standards for the preparation of consolidated financial statements. Sections 1601 and 1602 are effective for fiscal years beginning and or after January 1, 2011. Early adoption of these Sections are permitted. These new standards may be applicable to future corporate transactions.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

2. Summary of significant accounting policies (Continued)

In February 2008, the CICA Accounting Standards Board (“AcSB”) confirmed the transition from Canadian Generally Accepted Accounting Principles (“GAAP”) to International Financial Reporting Standards (“IFRS”) and set the date for convergence at January 1, 2011. The Company is in the process of scoping the magnitude of the conversion project, identifying areas where differences exist between GAAP and IFRS and identifying areas where significant choices exist between alternative accounting treatments. The Company expects the transition to IFRS to have an impact on the financial statements.

3. Changes in accounting policies

Effective January 1, 2008, the Company adopted the CICA standards; Section 3862 Financial Instruments – Disclosures and Section 3863 Financial Instruments – Presentation, which replaced Section 3861 Financial Instruments – Disclosure and Presentation. The new disclosed standard increased the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. The new presentation standard carries forward the former presentation requirements. Refer to Note 12 for additional disclosures.

Effective January 1, 2008, the Company adopted CICA Section 1535, Capital Disclosures, which required disclosure of the Company’s objectives, policies and processes for managing capital. In addition, disclosures will include whether companies have complied with externally imposed capital requirements. Refer to Note 13 for additional disclosures.

On January 1, 2008, the Company adopted the CICA Section 1400, General Standards of Financial Statement Presentation. This new Section requires assessing an entity’s ability to continue as a going concern and disclosing such if any uncertainty exists.

4. Acquisition of Vecta Energy Corporation

On July 30, 2008, the Company acquired 97% of Vecta issued and outstanding common shares. The balance of the common shares were compulsorily acquired under provisions of the Alberta Business Corporations Act on August 26, 2008 whereby Vecta became a 100% owned subsidiary of Kroes. The terms of the acquisition provided that Kroes purchase all the shares of Vecta for 2.456633 Kroes common shares and 0.54220918 Kroes Class 1 Performance Warrants for each Vecta share and the Vecta debenture for 6,612,500 Kroes common shares and 5,312,500 Kroes Class 2 Performance Warrants. The Vecta shareholders and the debenture holder received 35,986,521 Kroes shares in aggregate.

Kroes Energy Inc.
Notes to the Financial Statements

Years ended December 31, 2008 and 2007

4. Acquisition of Vecta Energy Corporation (Continued)

The transaction has been accounted for as an acquisition of net assets using the purchase method with the results of operations included in the financial statements from the date of acquisition.

Common shares issued	\$ 2,085,833
Performance warrants issued	361,250
Capitalized acquisition costs	167,759
Agent warrants	<u>17,402</u>
	\$ 2,632,244
Net assets acquired	
Cash and cash equivalents	\$ 206,658
Accounts receivable and other	50,906
Property and equipment	3,371,251
Payable and accruals	(593,532)
Future income taxes	(364,983)
Asset retirement obligations	<u>(38,056)</u>
	\$ 2,632,244

5. Property and equipment

	2008		
	<u>Cost</u>	<u>Accumulated Depletion and Depreciation</u>	<u>Net Book Value</u>
Exploration and development costs	\$ 7,118,823	\$ 1,339,058	\$ 5,779,765
Production equipment and processing facilities	518,092	210,554	307,538
Office equipment	47,072	25,332	21,740
Asset retirement costs	<u>89,276</u>	<u>24,715</u>	<u>64,561</u>
	\$ 7,773,263	\$ 1,599,659	\$ 6,173,604

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

5. Property and equipment (Continued)

	<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
Asset retirement costs	<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>

Future capital expenditures of \$170,000 (2007 - \$78,000), 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, 2008 of \$3,885,437 (2007 - \$506,446) included in exploration and development costs, have not been subject to depletion.

Included in exploration and development costs is a technical license agreement related to the use of Shear Wave Technology. This license agreement was acquired as a result of the Vecta transaction and was allocated a nominal value. As such, it is presented within exploration and development costs.

In January 2008, the Company sold its interest in Trinidad for US\$250,000 and retained only 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 sale price and are included on the balance sheet as assets of discontinued operations. No value was attributed to the overriding royalty.

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

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>Increase Thereafter</u>
NGL's per								
BBL (\$Cdn)	\$ 70.17	\$ 77.21	\$ 83.92	\$ 90.34	\$ 98.65	\$ 100.62	\$ 102.63	2.0%
Natural gas per								
Mcf (\$Cdn)	\$ 7.23	\$ 7.87	\$ 8.22	\$ 8.52	\$ 9.10	\$ 9.43	\$ 9.03	2.0%

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

6. Credit facilities

As at December 31, 2008, the Company had arranged a \$1,000,000 revolving operating bank loan with the National Bank of Canada. The terms of the loan repayment provide for interest only, but are subject to availability, review and the lender's right of demand. Interest is charged at a rate of prime plus 2% per annum. As of December 31, 2008, there are no amounts outstanding on this credit facility. The credit facility is secured by a floating charge debenture in the amount of \$5,000,000 covering all the assets of the Company.

7. 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>2008</u>	<u>2007</u>
Asset retirement obligations, beginning of year	\$ 32,736	\$ 2,862
Liabilities incurred	16,351	27,433
Accretion expense	1,768	1,526
Revision of estimates (Vecta)	<u>41,715</u>	<u>925</u>
Asset retirement obligations, end of year	\$ <u>92,570</u>	\$ <u>32,736</u>

The total undiscounted amount of estimated cash flows required to settle the obligation is \$183,892 (2007 - \$43,208), 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 several years in the future and will be funded from general Company resources at the time of retirement and removal.

8. Capital stock

a) Authorized:

Unlimited number of common shares

Unlimited number of preferred shares issuable in series

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

8. Capital stock (Continued)

b) Issued and outstanding:

	<u>2008</u>		<u>2007</u>	
	<u>Number of Shares</u>	<u>Amount</u>	<u>Number of Shares</u>	<u>Amount</u>
Common shares				
Balance, beginning of year	36,233,488	\$ 6,660,868	36,233,488	\$ 6,814,320
Renunciation of flow through shares	-	-	-	(156,406)
Shares issued for the acquisition of Vecta Class 2 performance warrants exercised	30,674,021	2,085,833	-	-
Share issue costs	5,312,500	361,250	-	-
	-	-	-	2,954
Balance, end of year	<u>72,220,009</u>	<u>\$ 9,107,951</u>	<u>36,233,488</u>	<u>\$ 6,660,868</u>

c) Share purchase warrants

	<u>2008</u>		<u>2007</u>	
	<u>Number of Warrants</u>	<u>Amount</u>	<u>Number of Warrants</u>	<u>Amount</u>
Balance, beginning of year	-	\$ -	1,003,958	\$ 131,984
Issued on acquisition of Vecta	2,434,538	8,784	-	-
Expired warrants	-	-	(1,003,958)	(131,984)
Balance, end of year	<u>2,434,538</u>	<u>\$ 8,784</u>	<u>-</u>	<u>\$ -</u>

As part of the Vecta acquisition (Note 4), the Company assumed 2,434,538 outstanding Vecta share purchase warrants, exercisable at \$0.61 for a six months period determined from a period after the common shares of Vecta are listed and posted for trading on the TSX Stock Exchange. These warrants were issued through a private placement of \$8.2 million by Vecta Energy in November 2005. The fair value of these warrants approximated \$8,784 or \$0.0036 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 3.3%, expected life of 0.6 years, volatility in the price of the Company's common shares of 165% and a dividend yield of 0.00%. These warrants expired unexercised in March 2009.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

8. Capital stock (Continued)

c) Share purchase warrants (Continued)

As part of a 2006 financing, 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 in 2006 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 Agency's financing warrants are accounted for as a charge to share issuance costs and a credit to contributed surplus. The fair value of these 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%.

d) Agents warrants and options

	<u>2008</u>		<u>2007</u>	
	<u>Number of</u> <u>Warrants</u>	<u>Average</u> <u>Exercise Price</u>	<u>Number of</u> <u>Options</u>	<u>Average</u> <u>Exercise Price</u>
Balance, beginning of year	-	\$ -	440,834	\$ 0.45
Issued on acquisition of Vecta	1,392,911	8,618	-	-
Expired warrants	-	-	<u>(440,834)</u>	<u>0.45</u>
Balance, end of year	<u>1,392,911</u>	<u>\$ 8,618</u>	<u>-</u>	<u>\$ -</u>

As part of the Vecta acquisition the Company assumed Vecta's agent's warrants issued as a result of a private placement by Vecta Energy in November 2005. Vecta issued 1,392,911 agent warrants to the agent, exercisable at \$0.41 per warrant for a six months period determined from a period after the common shares of Vecta are listed and posted for trading on the TSX Stock Exchange. The number of warrants and exercise price have been factored by the rate of Kroes shares issued on the Vecta transaction. The fair value of these agent warrants approximated \$8,618 or \$0.0061 per warrant. The fair value of these warrants was estimated using the Black-Scholes option pricing model with an average risk-free interest rate of 3.3%, expected life of 0.6 years, volatility in the price of the Company's common shares of 165% and a dividend yield of 0.00%. These warrants expired unexercised in March 2009.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

8. Capital stock (Continued)

d) Agents warrants and options (Continued)

In 2006, 220,417 agents financing options were issued in connection with a June 27, 2006 public financing. 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. The Agent's financing options are accounted for as a charge to share issuance costs and a credit to contributed surplus. 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%. These warrants expired unexercised in December 2007.

e) Performance warrants

	<u>2008</u>		<u>2007</u>	
	<u>Number of Warrants</u>	<u>Amount</u>	<u>Number of Warrants</u>	<u>Amount</u>
Balance, beginning of year	-	\$ -	-	\$ -
Class 1 Performance Warrants issued	5,310,675	-	-	-
Class 2 Performance Warrants issued	5,312,500	361,250	-	-
Class 1 Performance Warrants expired	(5,310,675)	-	-	-
Class 2 Performance Warrants exercised	<u>(5,312,500)</u>	<u>(361,250)</u>	-	-
Balance, end of year	<u>-</u>	<u>\$ -</u>	<u>-</u>	<u>\$ -</u>

Under the terms of the Vecta acquisition, Kroes issued 0.54220918 Kroes Class 1 Performance Warrants for each Vecta common share outstanding. These Class 1 Performance Warrants expired unexercised. The holder of the Vecta Debenture was issued 5,312,500 Class 2 Kroes Performance Warrants. The Class 1 Performance Warrants and the Class 2 Performance Warrants were convertible into an aggregate of 5,312,500 Kroes common shares based on the market value of Kroes shares prior to conversion date.

f) Contributed surplus

	<u>2008</u>	<u>2007</u>
Balance, beginning of year	\$ 934,088	\$ 679,167
Value attributed to stock options granted	128,387	132,605
Transfer of carrying value of warrants expired	-	131,984
Fair value of options cancelled	<u>-</u>	<u>(9,668)</u>
Balance, end of year	<u>\$ 1,062,475</u>	<u>\$ 934,088</u>

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

8. Capital stock (Continued)

g) Deficit

With the disposition of Zhoda, the Company received 6,997,507 shares of Shelton 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, was charged to retained earnings (deficit).

9. Per share information

Basic net loss per common share is computed by dividing net loss by the weighted average number of common shares outstanding for the year. Diluted net earnings per common share is computed by dividing net loss 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. In net loss per share situations, the diluted per share amount is the same as basis, as all factors are anti-derivatives.

	<u>2008</u>	<u>2007</u>
Weighted average shares outstanding:		
Basic	50,740,846	36,233,488
Shares issued pursuant to options and warrants	<u>-</u>	<u>-</u>
Diluted	<u>50,740,846</u>	<u>36,233,488</u>

In the calculation of diluted weighted average shares outstanding, the Company excluded 5,760,000 options and 3,827,449 warrants (2007 – 3,635,000 options and Nil warrants) as the exercise price was greater than the average market price of its common shares.

10. 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, 2008, there were 7,222,001 (2007 – 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 Financial Statements

Years ended December 31, 2008 and 2007

10. Stock-based compensation plan (Continued)

At December 31, 2008, 5,760,000 options (2007 – 3,635,000), with exercise prices ranging from of \$0.10 to \$0.56 were outstanding and 1,753,315 (2007 - 1,541,700) were exercisable at various dates to July 30, 2013. 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>2008</u>		<u>2007</u>	
	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding, beginning of year	3,635,000	\$ 0.26	2,350,000	\$ 0.39
Granted	2,800,000	\$ 0.10	1,760,000	\$ 0.09
Cancelled	(675,000)	\$ 0.25	(475,000)	\$ 0.30
Outstanding, end of year	<u>5,760,000</u>	<u>\$ 0.19</u>	<u>3,635,000</u>	<u>\$ 0.26</u>
Options exercisable, end of year	<u>1,753,315</u>	<u>\$ 0.37</u>	<u>1,541,700</u>	<u>\$ 0.39</u>

Range of 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>
\$0.10	4,460,000	\$ 0.10	4.2	553,310	\$ 0.100
\$0.155	100,000	\$ 0.155	3.2	33,334	\$ 0.155
\$0.33	200,000	\$ 0.33	0.02	200,000	\$ 0.33
\$0.345	100,000	\$ 0.345	2.2	66,670	\$ 0.345
\$0.56	900,000	\$ 0.56	1.4	900,000	\$ 0.56
	<u>5,760,000</u>	<u>\$ 0.19</u>	<u>3.59</u>	<u>1,753,314</u>	<u>\$ 0.37</u>

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

10. Stock-based compensation plan (Continued)

The weighted average fair market value of options granted during the year ended December 31, 2008 is \$0.10 (2007 - \$0.089) 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>2008</u>	<u>2007</u>
Risk-free interest rate	3.3%	3.9%-4.3%
Estimated hold period prior to exercise (years)	5	5
Volatility in the price of the Company's common shares	165%	168%-170%
Dividend yield	0%	0%

11. Discontinued operations

On August 1, 2007, the Company disposed 100% of its interest in Zhoda to 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 results of the discontinued operations of Zhoda were as follows:

	<u>2008</u>	<u>2007</u>
Revenues	\$ -	\$ 2,967,559
Less: royalties	-	(1,473,018)
Operating costs	-	(666,883)
Depreciation, depletion and accretion	-	(294,807)
General and administrative	-	(85,841)
Other	-	1,068
Income taxes	-	(92,893)
Net earnings— discontinued operations	-	355,185
Loss on sale	-	(3,638,656)
Net (loss) earnings from discontinued operations	\$ -	\$ (3,283,471)

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

11. Discontinued operations (Continued)

On January 12, 2008, the Company sold its interest in its Trinidad properties for US \$250,000 and as a result, 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 results of the discontinued operations of the Trinidad assets were as follows:

	<u>2008</u>	<u>2007</u>
Revenues	\$ -	\$ 138,554
Less: royalties	-	(44,819)
Operating costs	-	(60,413)
Depreciation, depletion and amortization	-	(3,007)
General and administrative	(14,536)	(8,656)
Other	37,925	(8,536)
Income taxes	(355)	(1,353)
Net earnings– discontinued operations	23,034	11,770
Loss on sale	-	(110,241)
Net earnings (loss) from discontinued operations	\$ 23,034	\$ (98,471)

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

Net earnings (loss) from discontinued operations	\$ 23,034	\$ (3,381,942)
Net earnings (loss) from discontinued operations per common share:		
Basic and diluted (Note 8)	\$ 0.000	\$ (0.093)

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

	<u>2008</u>	<u>2007</u>
Cash and cash equivalents	\$ 12,628	\$ 5,091
Receivables and other	130	67,639
	12,758	72,730
Property and equipment	-	243,931
Payables and accruals	(1,233)	(22,683)
Asset retirement obligations	-	(22,538)
Net assets	\$ 11,525	\$ 271,440

Kroes Energy Inc.
Notes to the Financial Statements

Years ended December 31, 2008 and 2007

12. Income taxes

a) Provision for income taxes	<u>2008</u>	<u>2007</u>
Loss before income taxes before discontinued operations	\$ <u>(836,285)</u>	\$ <u>(866,724)</u>
Expected tax recovery at combined federal and provincial rate of 29.50% (2007 – 32.12%)	\$ <u>(246,704)</u>	\$ (278,392)
Increase (decrease) resulting from:		
Stock based compensation	37,874	39,487
Non-taxable portion of capital gains	-	283,172
Effect of tax pools not previously recognized	-	(164,095)
Rate change and other	31,765	79,878
Valuation allowance	<u>177,065</u>	<u>(116,456)</u>
Provision for income taxes	\$ <u>-</u>	\$ <u>(156,406)</u>

b) Future income tax liability

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 balance sheet. Future income tax assets consist of the following temporary differences:

	<u>2008</u>	<u>2007</u>
Canadian property and equipment	\$ <u>(111,624)</u>	\$ (59,490)
Non-capital losses	1,233,629	518,590
Share issue costs	52,460	37,481
Asset retirement obligations	<u>23,143</u>	<u>8,184</u>
	1,197,608	504,765
Valuation allowance	<u>(1,562,591)</u>	<u>(504,765)</u>
Future income tax liability	\$ <u>(364,983)</u>	\$ <u>-</u>

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

12. Income taxes (Continued)

c) Tax losses available

The Company has incurred losses for Canadian income tax purposes of \$4,934,514 (2007 - \$2,074,358), the related benefit of these losses has not been recognized in the financial statements. Unless sufficient taxable income is earned these losses will expire as follows:

2014	\$	199,588
2015		1,008,850
2026		1,803,777
2027		857,050
2028		<u>1,065,249</u>
	\$	<u>4,934,514</u>

13. Financial instruments and risks associated with assets and liabilities

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.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. At December 31, 2008, the Company was holding cash and equivalents of \$174,298 and had one million dollars available from its revolving credit facility. The credit currently available to the Company is in part determined by the Company's borrowing base which is largely dependent on the Company's petroleum and natural gas reserves. If, at any time during the term of the credit facility, the lender has reason to believe that the borrowing base has materially declined, the lender can recalculate the Company's borrowing base and could as a result, decrease the credit currently available to the Company.

The contractual maturities of financial liabilities as of December 31, 2008 are as follows:

	Total	2009	2010	Thereafter
Accounts payable and accrued liabilities	\$ 1,246,242	\$ 1,246,242	\$ -	\$ -
Operating leases	87,785	75,024	12,761	-
Asset retirement obligations	<u>92,570</u>	-	-	<u>92,570</u>
	<u>\$ 1,426,597</u>	<u>\$ 1,321,266</u>	<u>\$ 12,761</u>	<u>\$ 92,570</u>

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

13. Financial instruments and risks associated with assets and liabilities (Continued)

Given the Company's available liquid resources and the Company's 2009 budget, management expects to have sufficient available funds to meet the current and financial contractual obligations.

Commodity price risk

The Company is exposed to risks from fluctuations in the natural gas sales prices. During the year, the Company did not have any derivative financial instruments in place to manage this risk. When appropriate, Kroes will enter into forward sale commitments, in limited quantities and at fixed prices, with the Board of Director's approval. The Company does not use derivative financial instruments for speculative purposes.

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 production. Accordingly, the Company views credit risks on these amounts as low. The maximum credit risk exposure associated with the Company's financial assets is the carrying value.

The cash equivalents consist mainly of amounts held with reputable financial institutions. None of the cash equivalents are in asset backed commercial paper products. Management believes the risk of loss is minimal.

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. The Company believes their exposure is minimal given the minimal amount of foreign currency held at year end.

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

14. Capital management

Management's objective when managing capital is to provide an adequate return to its shareholders and to safeguard the Company's ability to obtain financing and have access to capital. In the management of capital, the Company includes shareholders' equity, bank loan as well as cash and cash equivalents.

To facilitate the management of its capital structure, the Company prepares annual expenditure and operating budgets that are updated as necessary depending on success factors, industry conditions and operating cash flow. These annual and updated budgets are approved by the Board of Directors. Kroes has the ability to adjust its capital structure by making modifications to its capital expenditure program or by issuing new equity.

15. Supplemental cash flow information

	<u>2008</u>	<u>2007</u>
Change in non-cash working capital:		
Receivables and other	\$ (166,305)	\$ (78,872)
Prepays and deposits	5,522	(1,500)
Payables and accruals	<u>480,324</u>	<u>(4,493)</u>
	<u>\$ 319,541</u>	<u>\$ (84,865)</u>
Changes in non-cash working capital related to:		
Operating activities	\$ (641,957)	\$ (101,923)
Investing activities	<u>961,498</u>	<u>17,058</u>
	<u>\$ 319,541</u>	<u>\$ (84,865)</u>
Income taxes paid	\$ -	\$ -
Income taxes paid by discontinued operations	<u>\$ 355</u>	<u>\$ 1,353</u>

16. Commitments and contingency

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

2009	\$	75,024
2010	\$	12,761

Kroes Energy Inc.

Notes to the Financial Statements

Years ended December 31, 2008 and 2007

16. Commitments and contingency (Continued)

- 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 financial statements for potential settlements.
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17. Related parties

The Company has undertaken joint ventures with Vecta Resources, LLC ("Vecta Resources"), a related party to the Company. Vecta Resources owns approximately 16.51% of the issued and outstanding shares of the Company. In 2008, Vecta Resources participated in three projects, the Company's share being \$611,529 and Vecta Resources share being \$203,843. In each case, Vecta Resources pays its full share of project costs in the normal course of operations on a comparable basis to similar transactions conducted between arm's length parties on standard commercial terms for the oil and gas industry. As at December 31, 2008, the amounts owing from Vecta Resources of \$46,231 are included in receivables and other.

18. Comparative amounts

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