

Kroes Energy Inc.
Consolidated Financial Statements
December 31, 2006

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Auditors' Report

To the Shareholders of
Kroes Energy Inc.

We have audited the consolidated balance sheets of **Kroes Energy Inc.** as at December 31, 2006 and 2005 and the consolidated statements of operations and retained earnings 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, 2006 and 2005 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 25, 2007

Chartered Accountants

Kroes Energy Inc.

Consolidated Balance Sheets

December 31 2006 2005
(Restated
Note 9)

Assets

Current

Cash and cash equivalents	\$ 892,179	\$ 1,558,406
Receivables and other	1,482,052	132,240
Prepays and deposits	96,649	108,210
Inventory	<u>213,842</u>	<u>61,756</u>
	2,684,722	1,860,612

Property and equipment (Note 3)	6,328,516	5,371,620
Restricted funds (Note 4)	<u>1,001,429</u>	<u>955,668</u>
	\$ 10,014,667	\$ 8,187,900

Liabilities

Current

Payables and accruals	\$ 382,800	\$ 277,814
Income taxes payable	<u>378,092</u>	<u>117,779</u>
	760,892	395,593

Asset retirement obligations (Note 5)	115,665	114,203
Future income taxes (Note 9b)	<u>541,101</u>	<u>547,765</u>
	1,417,658	1,057,561

Shareholders' Equity

Capital stock (Note 6)	6,814,320	6,001,721
Warrants issued (Note 6d)	131,984	-
Contributed surplus (Note 6g)	679,167	376,361
Foreign currency translation adjustment	<u>(763,370)</u>	<u>(832,610)</u>
Retained earnings	<u>1,734,908</u>	<u>1,584,867</u>
	8,597,009	7,130,339
	\$ 10,014,667	\$ 8,187,900

Commitment and contingency (Note 13)
Subsequent events (Note 14)

On behalf of the Board

(Signed) "F. Callaway" _____ Director **(Signed) "D.E. Powell"** _____ Director

See accompanying notes to the consolidated financial statements.

Kroes Energy Inc.
Consolidated Statements of Operations
and Retained Earnings

Years Ended December 31 2006 2005

Revenue		
Oil and natural gas sales	\$ 5,204,851	\$ 4,626,915
Royalties	<u>(2,152,942)</u>	<u>(952,232)</u>
	<u>3,051,909</u>	<u>3,674,683</u>
Expenses		
Operating	1,011,988	862,661
General and administrative	984,472	956,588
Stock based compensation	210,520	166,408
Foreign exchange loss	2,284	54,222
Accretion of asset retirement obligations	5,097	7,898
Depletion and depreciation	<u>440,316</u>	<u>276,774</u>
	<u>2,654,677</u>	<u>2,324,551</u>
Earnings before other items and income taxes	397,232	1,350,132
Other items		
Interest and other income	<u>103,431</u>	<u>57,905</u>
Earnings before income taxes	500,663	1,408,037
Income taxes (Note 9)	<u>349,918</u>	<u>601,623</u>
Net earnings	<u>\$ 150,745</u>	<u>\$ 806,414</u>
Net earnings per share amounts:		
Basic (Note 7)	<u>\$ 0.004</u>	<u>\$ 0.025</u>
Diluted (Note 7)	<u>\$ 0.004</u>	<u>\$ 0.024</u>
<hr/>		
Retained earnings, beginning of year	\$ 1,584,867	\$ 817,263
Net earnings	150,745	806,414
Premium on redemption of common shares (Note 6f)	<u>(704)</u>	<u>(38,810)</u>
Retained earnings, end of year	<u>\$ 1,734,908</u>	<u>\$ 1,584,867</u>

See accompanying notes to the consolidated financial statements.

Kroes Energy Inc.

Consolidated Statements of Cash Flows

Years Ended December 31

2006

2005

Operating

Net earnings	\$ 150,745	\$ 806,414
Items not affecting cash		
Depletion and depreciation	440,316	276,774
Accretion of asset retirement obligations	5,097	7,898
Stock based compensation	210,520	166,408
Future income taxes	(7,135)	-
Unrealized foreign exchange loss	(4,154)	32,051
	<u>795,389</u>	<u>1,289,545</u>
Change in non-cash operating working capital (Note 12)	<u>(1,071,060)</u>	<u>(3,464)</u>
	<u>(275,671)</u>	<u>1,286,081</u>

Financing

Proceeds from share issues	1,037,866	75,000
Redemption of common shares	<u>(1,700)</u>	<u>(66,428)</u>
	<u>1,036,166</u>	<u>8,572</u>

Investing

Additions to property and equipment	(1,384,245)	(1,773,450)
Restricted funds	<u>(42,477)</u>	<u>-</u>
	<u>(1,426,722)</u>	<u>(1,773,450)</u>

Net change in cash and cash equivalents (666,227) (478,797)

Cash and cash equivalents,

Beginning of year	<u>1,558,406</u>	<u>2,037,203</u>
End of year	\$ <u>892,179</u>	\$ <u>1,558,406</u>

See accompanying notes to the consolidated financial statements.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

1. Nature of operations

The Company is engaged in the exploration for and production of petroleum and natural gas reserves in Canada, Ukraine and Trinidad.

Operations in Ukraine are conducted by JV Kashtan Petroleum Ltd. ("Kashtan"), a limited liability company, registered under the laws of Ukraine.

Kashtan is licensed to extract oil and gas from Lelyaky field in Pryluky District of Chernihiv Region, Ukraine. The operating license is for an initial term of twenty years, expiring in May 2016 and may be extended for a further twenty years with mutual consent of the Partners.

Ukraine continues to display emerging market characteristics and its legislation and business practices regarding banking operations, foreign currency transactions and taxation is constantly evolving as the government attempts to manage the economy. Risks inherent in conducting business in an emerging market economy include, but are not limited to, volatility in the financial markets and the general economy. Uncertainties over the development of the tax and legal environment, as well as difficulties associated with the consistent application of current laws and regulations have continued. Assets based in Ukraine represent approximately 86% of the consolidated assets. The Company's operations and financial position may be affected by these uncertainties.

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.

Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Zhoda 2001 Corporation ("Zhoda"). Zhoda has a 45% interest in Kashtan. All inter-company transactions and balances are eliminated upon consolidation.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 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.

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 buildings, vehicles and office equipment is provided for on a declining balance method at rates from 5% to 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

December 31, 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 amortized 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.

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 (see Note 1).

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).

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

2. Summary of significant accounting policies (Continued)

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.

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 a separate component of shareholders' equity.

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 retained earnings.

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. 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.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

2. Summary of significant accounting policies (Continued)

Stock-based compensation plan

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

Financial instruments of the Company consist mainly of cash and cash equivalents, restricted funds, receivables and payables and accruals. Unless otherwise disclosed, there are no significant differences between the carrying value of these financial instruments and their estimated fair value.

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.

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.

Functional currency

The functional currency for the consolidated group is as follows:

The operations in Ukraine have a functional currency of Hryvnia; and
the operations in Canada have a functional currency of Canadian dollars.

The Company has chosen the Canadian dollar as its reporting currency for the consolidated group.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

3. Property and equipment

	<u>2006</u>		
	<u>Cost</u>	<u>Accumulated Depletion and Depreciation</u>	<u>Net Book Value</u>
Exploration and development costs	\$ 3,248,036	\$ 429,783	\$ 2,818,253
Production equipment and processing facilities	4,117,206	694,294	3,422,912
Office equipment	65,068	34,452	30,616
Retirement costs of long lived assets	<u>75,931</u>	<u>19,196</u>	<u>56,735</u>
	<u>\$ 7,506,241</u>	<u>\$ 1,177,725</u>	<u>\$ 6,328,516</u>

	<u>2005 (Restated Note 9)</u>		
	<u>Cost</u>	<u>Accumulated Depletion and Depreciation</u>	<u>Net Book Value</u>
Exploration and development costs	\$ 2,968,526	\$ 242,511	\$ 2,726,015
Production equipment and processing facilities	2,984,430	427,754	2,556,676
Office equipment	63,889	37,240	26,649
Retirement costs of long lived assets	<u>79,566</u>	<u>17,286</u>	<u>62,280</u>
	<u>\$ 6,096,411</u>	<u>\$ 724,791</u>	<u>\$ 5,371,620</u>

Future capital expenditures of \$16,084,000 (2005 - \$17,072,000), as estimated by independent engineers, relating to the development of proved reserves in Ukraine have been included in costs subject to depletion. Undeveloped properties in Ukraine with a cost at December 31, 2006 of \$696,000 (2005 - \$1,067,000) included in exploration and development costs, have not been subject to depletion.

Included in the net book value of exploration and development costs is the net book value associated with the Trinidad assets of \$358,166 (2005 - \$352,324). Of this amount, properties with a value of \$348,036 (2005 - \$348,036) are considered unproved properties and not subject to depletion.

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

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>Increase Thereafter</u>
Crude oil per BBL (\$US)	\$ 60.50	\$ 59.70	\$ 58.50	\$ 56.30	\$ 54.60	\$ 55.80	\$ 56.80	2.0%

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

4. Bank indebtedness

The Company has negotiated an operating line of credit to a maximum of \$750,000 U.S. bearing interest at LIBOR plus 1.75% for Kashtan. As security for the operating line, the Company was required to deposit \$787,500 U.S. with the financial institution. At December 31, 2006, there were no draws (2005 – \$Nil) on the operating line. As at December 31, 2006, the Canadian dollar value of the deposit along with earned interest was \$1,001,429 (2005 - \$955,668).

On March 22, 2007 the Company recalled US\$ 787,500 from the Calyon Bank deposit and the remaining US \$ 71,801 representing the interest earned will be returned upon the filing of certain documents required by the Bank.

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>2006</u>	<u>2005</u>
Asset retirement obligations, beginning of year	\$ 114,203	\$ 101,534
Liabilities incurred	3,268	11,589
Accretion expense	5,097	7,898
Revision of estimates	<u>(6,903)</u>	<u>(6,818)</u>
Asset retirement obligations, end of year	\$ <u>115,665</u>	\$ <u>114,203</u>

The total undiscounted amount of estimated cash flows required to settle the obligation is \$690,100 (2005 - \$697,894), 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

December 31, 2006

6. Capital stock

a) Authorized:

Unlimited number of common shares

Unlimited number of preferred shares issuable in series

b) Issued and outstanding:

	<u>2006</u>		<u>2005</u>	
	<u>Number of Shares</u>	<u>Amount</u>	<u>Number of Shares</u>	<u>Amount</u>
Common shares				
Balance, beginning of year	32,163,488	\$ 6,001,721	32,000,988	\$ 5,908,835
Issued for cash on exercise of options	500,000	65,000	300,000	75,000
Transfer of carrying value on exercise of options	-	-	-	45,503
Issued for cash through a public offering	3,575,000	1,029,891	-	-
Purchased through issuer's bid process	(5,000)	(997)	(137,500)	(27,617)
Share issue costs	-	(281,295)	-	-
Balance, end of year	<u>36,233,488</u>	<u>\$ 6,814,320</u>	<u>32,163,488</u>	<u>\$ 6,001,721</u>

In June 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 are exercisable at \$0.60 for 18 months from the initial closing date of June 27, 2006. In addition, the Company paid commissions and expenses related to the offering of \$189,009 to the agent.

c) Escrowed shares:

On closing of the acquisition of Zhoda, the TSX Venture Exchange ("Exchange") required the 8,600,000 common shares issued as consideration to be placed in escrow using its Value Security Escrow Agreement. This agreement provided for the release of 10% of the escrowed shares on January 17, 2003 and 15% on each following six month periods. At December 31, 2005, all shares had been released from escrow.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

6. Capital stock (Continued)

d) Purchase warrants:

As part of the June 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%.

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 are exercisable at \$0.45 for 18 months from the initial closing date of June 27, 2006. The Agent's financing warrants are accounted for as a charge to share issuance costs and a credit to contributed surplus (see note 6(g)). 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%.

	<u>2006</u>		<u>2005</u>	
	<u>Number of Warrants</u>	<u>Amount</u>	<u>Number of Warrants</u>	<u>Amount</u>
Balance, beginning of year	-	\$ -	-	\$ -
Issued for cash through a public offering	893,750	131,984	-	-
Agent warrants	110,208	-	-	-
	<u>1,003,958</u>	<u>\$ 131,984</u>	<u>-</u>	<u>\$ -</u>

e) 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.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

6. Capital stock (Continued)

e) Agents options (Continued)

	<u>2006</u>		<u>2005</u>	
	<u>Number of Shares</u>	<u>Average Exercise Price</u>	<u>Number of Options</u>	<u>Average Exercise Price</u>
Balance, beginning of year	-	\$ -	-	\$ -
Issued under the terms of a public offering	440,834	\$ 0.45	-	\$ -
	<u>440,834</u>	<u>\$ 0.45</u>	<u>-</u>	<u>\$ -</u>
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(g)). 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%.

f) 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.

During the year, the Company purchased for cancellation 5,000 common shares at an average price of \$0.34 per share (2005 -137,500 common shares at an average price of \$0.48 per share) pursuant to the Bid. The excess of the purchase price over book value has been charged to retained earnings.

g) Contributed surplus:

	<u>2006</u>	<u>2005</u>
Balance, beginning of year	\$ 376,361	\$ 255,456
Value attributed to stock options granted	210,520	166,408
Transfer of carrying value of exercised options	-	(45,503)
Value assigned to brokers financing options	92,286	-
	<u>679,167</u>	<u>376,361</u>
Balance, end of year	\$ 679,167	\$ 376,361

Kruse Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

7. Per share information

Basic net 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>2006</u>	<u>2005</u>
Weighted average shares outstanding:		
Basic	34,067,152	32,231,336
Shares issued pursuant to options and warrants	<u>142,611</u>	<u>1,151,733</u>
Diluted	<u>34,209,763</u>	<u>33,383,069</u>
Net earnings per common share:		
Basic	\$ 0.004	\$ 0.025
Diluted	\$ 0.004	\$ 0.024

In the 2006 calculation of diluted weighted average shares outstanding, 1,715,834 shares from options and 1,003,958 warrants (2005 – 975,000 options) were excluded from the calculations, as they were anti-dilutive.

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, 2006, there were 3,623,349 (2005 – 3,216,349) 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.

At December 31, 2006, 2,350,000 options (2005 – 2,920,000), with exercise prices ranging from of \$0.25 to \$0.56 were outstanding and 1,599,996 (2005 - 1,945,000) were exercisable at various dates to March 22, 2011. 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.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

8. Stock-based compensation plan (Continued)

The following tables summarize the information about the stock options:

	<u>2006</u>		<u>2005</u>	
	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding, beginning of year	2,920,000	\$ 0.33	2,245,000	\$ 0.22
Granted	100,000	\$ 0.345	975,000	\$ 0.56
Exercised	(500,000)	\$ 0.13	(300,000)	\$ 0.25
Cancelled	(170,000)	\$ 0.13	-	\$ -
Outstanding, end of year	<u>2,350,000</u>	<u>\$ 0.39</u>	<u>2,920,000</u>	<u>\$ 0.33</u>
Options exercisable, end of year	<u>1,599,996</u>	<u>\$ 0.32</u>	<u>1,945,000</u>	<u>\$ 0.22</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>	
\$0.25	1,075,000	\$ 0.25	1.2	1,075,000	\$ 0.25	
\$0.33	200,000	\$ 0.33	2.0	200,000	\$ 0.33	
\$0.345	100,000	\$ 0.345	4.3	-	\$ 0.345	
\$0.56	<u>975,000</u>	<u>\$ 0.56</u>	<u>3.4</u>	<u>324,996</u>	<u>\$ 0.56</u>	
	<u>2,350,000</u>	<u>\$ 0.39</u>	<u>2.3</u>	<u>1,599,966</u>	<u>\$ 0.32</u>	

The weighted average fair market value of options granted during the year ended December 31, 2006 is \$0.31 (2005 - \$0.48) 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>2006</u>	<u>2005</u>
Risk-free interest rate	4.10%	3.20%
Estimated hold period prior to exercise (years)	5	5
Volatility in the price of the Company's common shares	143%	128%
Dividend yield	0%	0%

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

9. Income taxes

a) Provision for income taxes	<u>2006</u>	<u>2005</u>
Earnings before income taxes	\$ <u>500,663</u>	\$ <u>1,408,037</u>
Expected tax expense at combined federal and provincial rate of 34.49% (2005 – 37.62%)	\$ 172,679	\$ 529,704
Increase (decrease) resulting from:		
Statutory tax rate differences	(149,535)	(280,060)
Tax rate reductions	163,351	94,907
Stock based compensation	72,608	62,603
Other	15,120	50,090
Valuation allowance	<u>75,695</u>	<u>144,379</u>
Provision for income taxes	\$ <u>349,918</u>	\$ <u>601,623</u>
Provision for income taxes:		
Current	\$ 357,053	\$ 601,623
Future	<u>(7,135)</u>	-
	\$ <u>349,918</u>	\$ <u>601,623</u>
b) Future income taxes liability	<u>2006</u>	<u>2005</u>
Future income taxes consist of the following temporary differences:		
Ukraine property and equipment	\$ (541,101)	\$ (547,765)
Canadian property and equipment	119,125	128,004
Non-capital losses	811,070	704,996
Share issue costs	44,207	6,043
Asset retirement obligations	<u>33,543</u>	<u>38,395</u>
	466,844	329,673
Valuation allowance	<u>(1,007,945)</u>	<u>(877,438)</u>
Future income taxes liability	\$ <u>(541,101)</u>	\$ <u>(547,765)</u>

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

9. Income taxes (Continued)

c) Tax losses available

The Company and its subsidiaries have incurred losses for Canadian income tax purposes of approximately \$2,796,793 (2005 - \$2,096,953), 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:

2007	\$	28,344
2008		144,899
2009		-
2010		50,532
2014		824,621
2015		871,518
2026		876,879

d) Restatement of prior periods

During 2006, it was determined that the future income tax liability related to a taxable temporary difference of Zhoda's 45% joint interest in Kashtan were not correctly determined. The effect of the restatement on prior periods earnings is immaterial to the consolidated financial statements. The 2005 consolidated financial statements have been restated to reflect the following adjustments:

		Change Increase (decrease) <u>2005</u>
Assets		
Property and equipment	\$	289,539
Liabilities		
Future income taxes	\$	289,539
Shareholders' equity		
Foreign currency translation adjustment	\$	-
Net earnings and retained earnings	\$	-

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

10. Geographic segments

The Company is organized into divisions by geographic area consisting of Canada, Trinidad and Ukraine. All divisions derive revenue from oil and gas properties.

	<u>2006</u>			
	<u>Canada</u>	<u>Trinidad</u>	<u>Ukraine</u>	<u>Total</u>
Oil and gas revenue, net	\$ 7,212	\$ 73,077	\$ 2,971,620	\$ 3,051,909
Net earnings (loss)	(970,414)	14,420	1,106,739	150,745
Property and equipment	562,403	358,166	5,407,947	6,328,516
Identifiable assets	961,127	430,422	8,623,118*	10,014,667
				<u>2005</u>
	<u>Canada</u>	<u>Trinidad</u>	<u>Ukraine</u>	<u>Total</u>
Oil and gas revenue, net	\$ -	\$ 75,047	\$ 3,599,636	\$ 3,674,683
Net earnings (loss)	(879,281)	28,908	1,656,787	806,414
Property and equipment	20,389	361,333	4,989,898	5,371,620
Identifiable assets	520,261	523,461	7,144,178*	8,187,900

* Includes the restricted funds related to Ukraine (see Note 4).

11. Financial instruments

Credit risk

The Company, in the normal course of business, monitors the financial condition of its customers and reviews credit history of each new customer. The Company establishes an allowance for doubtful accounts that corresponds to the specific credit risk of its customers, historical trends and economic circumstances. An allowance as at December 31, 2006 of \$123,541 (2005 - \$61,770) has been provided for and \$61,771 (2005 - \$61,770) is included in the consolidated statements of operations in the general and administrative expenses.

Foreign currency risk

The Company has cash and cash equivalents, receivables, and payables and accruals denominated in foreign currencies, 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.

Sales within Ukraine by Kashtan are by law denominated in local currency (Hryvnia). Funds for repatriation back to Canada are then converted to, and transmitted in, U.S. dollars. Regulations imposed by the Ukrainian authorities are subject to ongoing change.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

12. Supplemental cash flow information

Change in non-cash working capital:

	<u>2006</u>	<u>2005</u>
Receivables and other	\$ (1,349,812)	\$ 47,902
Prepays and deposits	11,561	(71,436)
Inventory	(152,086)	(30,230)
Payables and accruals	104,986	87,833
Income taxes payable	<u>260,313</u>	<u>8,835</u>
	(1,125,038)	42,904
Adjustment for unrealized foreign exchange in above items	<u>53,978</u>	<u>(46,368)</u>
	<u>\$ (1,071,060)</u>	<u>\$ (3,464)</u>

Cash and cash equivalents consist of:

Cash on hand and balances with banks	\$ <u>892,179</u>	\$ <u>1,558,406</u>
Income taxes paid	\$ <u>395,472</u>	\$ <u>602,785</u>

13. Commitment and contingency

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

2007	\$ 64,940
2008	\$ 64,940
2009	\$ 66,041
2010	\$ 11,264

- 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 is 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, 2006, \$ 365,745 has been incurred and renounced to subscribers.

Kroes Energy Inc.

Notes to the Consolidated Financial Statements

December 31, 2006

14. Subsequent events

- a) On March 2, 2007, the Company granted 100,000 options pursuant to the Company's stock option plan to directors and officers. The options are exercisable at a price of \$0.155 per common share, vest equally over three years on the anniversary date of issuance and expire after 5 years from the date of grant.
 - b) On March 22, 2007, the Company recalled US\$ 787,500 from the Calyon Bank deposit it had established as security for the Kashtan operating line of credit. The remainder of the US\$ 71,801 representing the interest earned will be returned to the Company upon the filing of certain documents required by the Bank.
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15. Comparative amounts

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