

**Veraz Petroleum Ltd.**  
***CONSOLIDATED FINANCIAL STATEMENTS***  
**December 31, 2009 and 2008**



**KPMG LLP**  
**Chartered Accountants**  
2700-205 5 Avenue SW  
Calgary AB T2P 4B9

Telephone (403) 691-8000  
Fax (403) 691-8008  
Internet [www.kpmg.ca](http://www.kpmg.ca)

## **AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the consolidated balance sheets of Veraz Petroleum Ltd., as at December 31, 2009 and 2008 and the consolidated statements of operations, comprehensive loss and deficit, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Chartered Accountants  
Calgary, Canada  
April 5, 2010

**Veraz Petroleum Ltd.**  
**Consolidated Balance Sheets**  
**As at December 31**

	2009	2008
<b>Assets</b>		
Current assets		
Cash	\$ 3,937,687	\$ 1,136,918
Accounts receivable	4,092,046	176,126
Prepaid expenses and deposits	38,697	37,668
	<u>8,068,430</u>	1,350,712
Property and equipment (note 4)	<u>9,508,329</u>	4,618,877
	<u><u>\$ 17,576,759</u></u>	<u><u>\$ 5,969,589</u></u>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 7,885,425	\$ 797,188
Notes payable (note 5)	28,000	1,733,200
Loan payable (note 4)	8,121,007	-
Deposit received (note 4)	-	121,800
	<u>16,034,432</u>	2,652,188
<b>Shareholders' Equity</b>		
Share capital (note 6)	9,786,106	9,791,539
Contributed surplus (note 7)	2,087,839	1,859,568
Deficit	(9,809,577)	(8,262,264)
Accumulated other comprehensive loss	(522,041)	(71,442)
	<u>(10,331,618)</u>	(8,333,706)
	<u>1,542,327</u>	3,317,401
	<u><u>\$ 17,576,759</u></u>	<u><u>\$ 5,969,589</u></u>

Going concern (note 1)  
 Commitments (note 9)  
 Subsequent events (note 12)

Approved by the Board

\_\_\_\_\_, "Trevor Mitzel", Director

\_\_\_\_\_, "Paul Baay", Director

**The accompanying notes are an integral part of these consolidated financial statements.**

**Veraz Petroleum Ltd.****Consolidated Statement of Operations, Comprehensive Loss and Deficit****For the years ended December 31**

	2009	2008
<b>Interest income</b>	<b>\$ 47</b>	<b>\$ 7,537</b>
<b>Expenses</b>		
General and administrative	1,362,672	1,690,410
Foreign exchange (gain) loss	(418,107)	15,188
Interest on convertible debentures	-	63,375
Interest on notes payable (note 5)	321,346	34,365
Stock-based compensation (note 7)	228,271	152,830
Interest on loan payable (note 11)	42,475	-
Depreciation	10,703	6,767
	<b>1,547,360</b>	<b>1,962,935</b>
<b>Net loss for the year</b>	<b>(1,547,313)</b>	<b>(1,955,398)</b>
Other comprehensive loss		
Cumulative translation adjustment	(450,599)	(71,442)
<b>Comprehensive loss for the year</b>	<b>\$ (1,997,912)</b>	<b>\$ (2,026,840)</b>
<b>Deficit, beginning of year</b>	<b>\$ (8,262,264)</b>	<b>\$ (6,306,866)</b>
Net loss for the year	(1,547,313)	(1,955,398)
<b>Deficit, end of year</b>	<b>\$ (9,809,577)</b>	<b>\$ (8,262,264)</b>
<b>Loss per share, basic and diluted (note 6)</b>	<b>\$ (0.05)</b>	<b>\$ (0.06)</b>

The accompanying notes are an integral part of these consolidated financial statements.

**Veraz Petroleum Ltd.**  
**Consolidated Statement of Cash Flows**  
**For the years ended December 31, 2009 and 2008**

	2009	2008
<b>Operating activities</b>		
Net loss for the year	\$ (1,547,313)	\$ (1,955,398)
Items not affecting cash		
Unrealized foreign exchange gains	(322,564)	(167,989)
Interest on convertible debentures	-	63,375
Stock-based compensation (note 7)	228,271	152,830
Interest on loan payable	42,475	-
Depreciation	10,703	6,767
	<u>(1,588,428)</u>	<u>(1,900,415)</u>
Changes in non-cash working capital	7,714,015	(1,863)
	<u>6,125,587</u>	<u>(1,902,278)</u>
<b>Investing activities</b>		
Property and equipment expenditures	(6,281,272)	(1,571,521)
Changes in non-cash working capital	(4,366,223)	385,735
Proceeds from sale of working interest (note 4)	524,252	-
	<u>(10,123,243)</u>	<u>(1,185,786)</u>
<b>Financing activities</b>		
Share issue costs	(5,433)	-
Proceeds from note payable (note 5)	3,204,726	1,705,200
Proceeds from loan payable (note 4)	3,533,030	-
Changes in non-cash working capital	136,484	-
Proceeds on issuance of convertible debentures	-	1,000,000
	<u>6,868,807</u>	<u>2,705,200</u>
<b>Effect of exchange rate changes on cash</b>	<u>(70,382)</u>	<u>167,989</u>
<b>Increase (decrease) in cash</b>	<b>2,800,769</b>	<b>(214,875)</b>
<b>Cash, beginning of year</b>	<u>1,136,918</u>	<u>1,351,793</u>
<b>Cash, end of year</b>	<u><b>\$ 3,937,687</b></u>	<u><b>\$ 1,136,918</b></u>

The accompanying notes are an integral part of these consolidated financial statements.

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**1. Nature of operations**

Veraz Petroleum Ltd. ("Veraz" or the "Company") is a junior resource exploration stage company that focuses its business activities on international oil and gas exploration and development. The Company has entered into a formal agreement (the "Exploration Agreement") to explore Ucayali Block 126 (the "Block"), located in east central Peru, South America.

**Going Concern**

These consolidated financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of operations. The Company has experienced recurring losses, has not generated profitable operations and as at December 31, 2009, has a working capital deficiency of \$7,966,002 and has accumulated losses of \$9,809,577 since inception. Current oil and gas activities are in the exploration stage and have not identified oil and gas reserves. Current cash resources will not be sufficient to continue the exploration and development activities. These matters raise doubt about the ability of the Company to continue to meet its obligations as they become due. Continuing operations are dependent on the ability to obtain adequate funding to finance existing operations, attain commercial production from its oil and gas properties and attain future profitable operations. Management's plans to remediate are described in note 4. These consolidated financial statements do not include any adjustments for the recoverability and classification of recorded asset amounts, nor for the classification of liabilities and revenues and expenses that might be necessary should the Company be unable to continue as a going concern.

**2. Basis of Presentation and Accounting Policies**

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. ("Canadian GAAP")

The consolidated financial statements include the accounts of the Company and its two wholly-owned subsidiaries, Veraz Petroleum Peru S.A.C. (formerly North American Vanadium Peru S.A.C.), incorporated under the laws of Peru on August 17, 2006 and acquired by the Company on November 22, 2006, and Veraz Petroleum (Barbados) Ltd., incorporated under the laws of Barbados on October 24, 2008. All significant inter-company transactions and balances have been eliminated.

**Cash and Cash Equivalents**

Cash includes cash on hand and demand deposits. Cash equivalents include short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. At December 31, 2009 and 2008, the Company did not hold any cash equivalents.

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**Property and Equipment**

Oil & Gas Properties

The Company follows the full cost method of accounting for oil and gas properties and facilities whereby all costs associated with the acquisition, exploration for and development of petroleum and natural gas properties and related reserves are capitalized. Such costs include all direct costs relating to the development of the oil and gas properties, the cost of the acquisition of leases, and exploration and development and administrative costs directly related to development activities. As the Company's oil and gas activities are in the pre-production stage, any incidental revenues are netted against costs until commercial production begins. These costs are evaluated in each reporting period to determine if the costs recorded are recoverable. Any costs that are considered unlikely to be recovered are written off. If commercial production begins, these capitalized costs will be depleted following the unit-of-production method based on proved reserves. Any gain or loss on disposition of unproven properties would be recognized on a relative basis.

The carrying values of oil and gas properties may not reflect their future value. In particular, the future value of the oil and gas properties depends on the start-up of commercial production, the ability of the Company to obtain adequate financing and the future profitability of the oil and gas properties.

A limit is placed on the carrying value of the net capitalized assets in order to test impairment. The Company is required to perform this impairment test at least annually. An impairment loss may be indicated when the carrying value of the assets exceeds the estimated undiscounted future net cash flows associated with the asset's proved reserves. If there is indication of an impairment loss, the costs carried on the balance sheet in excess of the discounted future net cash flows associated with the asset's proved plus probable reserves are charged to depletion, depreciation and accretion on the statement of operations.

Other Assets

Equipment is stated at cost less accumulated depreciation. Depreciation is charged to operations based on the estimated useful life of the asset and is calculated as follows:

Office equipment	20% diminishing balance basis
Computer equipment	30% straight line basis

**Joint Interest Operations**

The Company's exploration and development activities are conducted jointly with others. These financial statements reflect only the Company's interest in such activities.

**Income Taxes**

Income taxes are accounted for using the asset and liability method of income tax allocation. Under the liability method, income tax assets and liabilities are recorded to recognize future income tax inflows and outflows arising from the settlement or recovery of assets and

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

liabilities at their carrying values. Income tax assets are also recognized for the benefits from tax losses and deductions that cannot be identified with particular assets or liabilities, provided those benefits are more likely than not to be realized. Future income tax assets and liabilities are determined based on substantively enacted tax laws and rates that are anticipated to apply in the period of realization.

**Asset Retirement Obligations**

The fair value of obligations associated with the retirement of tangible long-lived assets is recorded in the period the asset is put into use, with a corresponding increase to the carrying amount of the related asset. The obligations recognized are statutory, contractual or legal obligations. The liability is accreted over time for changes in the fair value of the liability through charges to accretion, which is included in depletion, depreciation and accretion expense. The costs capitalized to the related assets are amortized in a manner consistent with the depletion and depreciation of the related asset. At December 31, 2009 and 2008, the asset retirement obligation has been determined to be \$NIL as the Company's exploration activities have been limited to geological and geophysical work.

**Stock-Based Compensation**

The Company uses the fair value method to account for all stock-based payments to employees and non-employees by measuring the compensation cost of the stock-based payments using the Black-Scholes option-pricing model. The fair value of stock-based compensation is recorded as a charge to net earnings based on the vesting period with a credit to contributed surplus. The fair value of each option granted will be estimated using the Black-Scholes option pricing model that takes into account, on the date of grant; the exercise price and expected life of the option; the price of the underlying security; the expected volatility and dividends (if any) on the underlying security; and the risk-free interest rate. Upon exercise of the stock options, consideration paid by the option holder, together with the amount previously recognized in contributed surplus, is recorded as an increase to share capital. The Company has not incorporated an estimated forfeiture rate for stock options that will not vest, rather, the Company accounts for actual forfeitures as they occur.

**Per Share Information**

Per share amounts are calculated by dividing the earnings (loss) attributable to common shareholders by the weighted average number of common shares outstanding during the year. Diluted per share amounts are calculated using the treasury stock method. Under the treasury stock method only instruments with exercise amounts less than market prices impact the diluted calculations. It is also assumed that any proceeds obtained upon the exercise of options and the unrecognized portion of stock-based compensation costs would be used to repurchase shares at the weighted average market price during the period. The weighted average number of shares is then reduced by the number of shares repurchased.

**Revenue Recognition**

Interest income is recognized as earned on a time proportion basis.

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**Financial Instruments**

All financial assets and liabilities are recognized on the balance sheet when the Company becomes a party to the contractual provisions of the instrument and are initially recognized at fair value. Subsequent measurement of the financial instruments is based on their classification. The classification depends on the characteristics and the purpose for which the financial instruments were acquired.

Financial assets are classified into one of four categories which are accounted for as follows:

- Held-to-maturity investments (measured at amortized cost);
- Loans and receivables (measured at amortized cost);
- Held for trading assets (measured at fair value with changes in fair value recognized in earnings immediately);
- Available-for-sale assets are financial assets that do not fit into any other category (measured at fair value with changes in fair value accumulated in Other Comprehensive Income until the asset is sold or impaired).

Financial liabilities, which include long-term debt and other similar instruments, must be measured at their amortized cost, except for those items classified as held for trading, which must be measured at fair value.

**Principles of Consolidation and Translation of Foreign Currencies**

The consolidated financial statements include the amounts of the Company and its subsidiaries, all of which are wholly-owned and are accounted for as self-sustaining operations. The Company has adopted the current rate method of foreign currency translation. Under this method, revenues and expenses are translated using the average exchange rates for the applicable period, assets and liabilities are translated using the exchange rates in effect on the balance sheet dates, and shareholder's equity is translated using historical rates in effect at the date of each transaction. Resulting exchange differences are reported as a separate component of other comprehensive income.

**Use of Estimates**

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions 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 management's best estimate as additional information becomes available.

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**Measurement Uncertainty**

The recoverability of unproved properties is dependent on the discovery of economical reserves, the ability of the Company to obtain financing to complete development of the properties and on future production. The recoverability was reviewed for impairment based on management's assessment of potential indicators of impairment and best estimates of likely courses of action by the Company. The carrying value is not intended to reflect present or future values of the properties. The recorded costs are subject to measurement uncertainty and it is reasonably possible, based on existing knowledge, that changes in future conditions could require a material change in the recognized amounts.

The amounts recorded relating to fair values of stock options issued are based on estimates of future volatility of the Company's share price, expected lives of the options, expected dividends to be paid by the Company and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effects of changes in such estimates on the financial statements of future periods could be material.

**3. Changes in significant accounting policies**

**Goodwill and Intangible Assets**

As of January 1, 2009, the Company adopted new standards for Goodwill and Intangible Assets. New standards have been established for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. The adoption of these new standards did not have any impact on the consolidated financial statements.

**Business Combinations**

In January 2009, "Business Combinations", Section 1582, replaced the previous business combinations standard. The standard requires assets and liabilities acquired in a business combination, contingent consideration and certain acquired contingencies to be measured at their fair values as of the date of acquisition. In addition, acquisition-related and restructuring costs are to be recognized separately from the business combination and included in the statement of earnings. The adoption of this standard will impact the accounting treatment of future business combinations.

**Consolidated Financial Statements**

"Consolidated Financial Statements", Section 1601, which together with Section 1602 below, replace the former consolidated financial statements standard. Section 1601 establishes the requirements for the preparation of consolidated financial statements. The adoption of this standard should not have a material impact on the Company's consolidated financial statements.

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**Non-controlling Interests**

"Non-controlling Interests", Section 1602. The standard establishes the accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. This standard requires a non-controlling interest in a subsidiary to be classified as a separate component of equity. In addition, net earnings and components of other comprehensive income are attributed to both the parent and non-controlling interest. The adoption of this standard should not have a material impact on the Company's consolidated financial statements.

**International Financial Reporting Standards ("IFRS")**

The AcSB has confirmed the convergence of Canadian GAAP with International Financial Reporting Standards ("IFRS") which will be effective for years beginning on or after January 1, 2011. The transition from current Canadian GAAP to IFRS may materially affect the Company's reported financial position and results of operations. Specific changes resulting from implementation of IFRS have not been determined at this time. Key information will be disclosed as it becomes available during the transition period.

**Financial Instruments**

In May 2009, the CICA amended Section 3862, "Financial Instruments – Disclosures," to include additional disclosure requirements about fair value measurement for financial instruments and liquidity risk disclosures. These amendments require a three level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement. These amendments are effective for the Company on December 31, 2009.

**4. Property and equipment**

	<b>2009</b>		
	<b>Cost</b>	<b>Accumulated Depreciation</b>	<b>Net Book Value</b>
Oil and natural gas properties	\$ 9,393,738	\$ -	\$ 9,393,738
Equipment	132,061	17,470	114,591
	<b>\$ 9,525,799</b>	<b>\$ 17,470</b>	<b>\$ 9,508,329</b>

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

	2008		
	Cost	Accumulated Depreciation	Net Book Value
Oil and natural gas properties	\$ 4,480,727	\$ -	\$ 4,480,727
Equipment	144,917	6,767	138,150
	<u>\$ 4,625,644</u>	<u>\$ 6,767</u>	<u>\$ 4,618,877</u>

- (a) During the period ended December 31, 2009, the Company capitalized general and administrative expenses in the amount of \$389,073 (\$324,670 - December 31, 2008).

As the Company is in the development stage, all costs capitalized to oil and natural gas properties have been classified as unproved properties and accordingly, no depletion and depreciation expense has been recorded. If commercial production begins, these capitalized costs will be depleted following the unit-of-production method based on proved reserves.

- (b) On November 19, 2008, the Company entered into an agreement with Petrominerales Peru S.A.. ("Petrominerales Peru") whereby it agreed to sell half of its 90% interest in Block 126 (a 45% participating interest) to Petrominerales Peru for consideration of US \$500,000 and the condition that Petrominerales Peru provide the Company a non-interest bearing, non-revolving term loan in the amount of US \$9,000,000 (the "**Loan**") for the purpose of funding the Company's portion of the exploration program on Block 126. As described in Note 4(c) below, the Loan includes a term that if Petrominerales Peru requires the Loan to be repaid, the Company could repurchase the 45% participating interest (together with a 10% participating interest Petrominerales Peru acquired from a third-party) for \$1. During the year ended December 31, 2008, the Company received a US \$100,000 (CDN \$121,800) deposit as an advance on the purchase.

On December 4, 2009 the Peruvian Government approved the transfer of the 45% interest to Petrominerales Peru. The remaining US \$400,000 of the purchase price was paid to the Company and the Loan was provided thereby completing the sale of the 45% working interest in the Block.

- (c) In conjunction with the agreement described above, Petrominerales Peru. agreed to fund a portion of the Company's exploration program through a non-interest bearing, non-revolving term loan facility of US \$9,000,000. Until the approval of the transaction by the Peruvian Government on December 4, 2009, funds advanced to the Company were done so as an interest bearing promissory note as described in note 5(b). Subsequent to the approval of the transaction, the outstanding promissory note was converted to a non-interest bearing loan as described above. As at December 31, 2009, the Company had received US \$7,726,933 (CDN \$8,121,007) under the loan facility. Subsequent to year end, Petrominerales Peru acknowledged in writing receipt of the final processed seismic from the Company, On or before April 4, 2010, Petrominerales Peru will have the option to either: (a) forgive the loan in its entirety, or (b) demand repayment of the loan. If Petrominerales Peru chooses to demand the

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

loan, the Company has the option to either repay the loan in its entirety or convert the loan into common shares of the Company if the conversion will not result in Petrominerales Peru holding more than 49% of the outstanding common shares of the Company. If the Company either repays or converts the loan to common shares of the Company, Petrominerales Ltd. will transfer and convey all of its shares and interests in Petrominerales Peru, which holds a 55% interest in Block 126, to the Company in exchange for \$1.

Under the terms of the Loan, Petrominerales Peru has the option to either require the Company to repay the Loan or to forgive the Loan. If Petrominerales Peru requires the Company to repay the Loan, upon such repayment Petrominerales Ltd., the parent of Petrominerales Peru, is required to sell all of the outstanding shares of Petrominerales Peru to the Company for \$1, which would result in the Company holding a 100% participating interest in Block 126. Subsequent to December 31, 2009, as described in note 12(a), Petrominerales Peru forgave all amounts owing under the Loan. The Company will recognize the Loan forgiveness as contingent sale proceeds under the sale of the working interest in Block 126 described in Note 4(b).

**5. Notes payable**

- (a) Notes payable includes an amount of \$28,000 which is non-interest bearing and due on demand.
- (b) As described in Note 4(c), up until December 4, 2009, funds advanced to the Company by Petrominerales Peru for the purpose of assisting the Company in satisfying its obligations under the exploration program on Block 126 were done so in accordance with an interest bearing promissory note. The note initially had an interest rate of 18% through April 30, 2009, which was reduced to 12% for the period from May 1, 2009 to December 4, 2009. All amounts owing under the promissory note were converted on December 4, 2009 into the Loan described in Note 4(c).

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**6. Share capital**

**(a) Common Shares**

Authorized:

Unlimited number of common shares without par value

Issued and outstanding:

	2009		2008	
	Shares	Amount	Shares	Amount
Balance, beginning of year	32,523,580	\$ 9,791,539	30,196,831	\$ 8,538,164
Share issue costs	-	(5,433)	-	-
Issued for finder's fees on oil and gas properties	-	-	200,000	190,000
Issued on conversion of debentures	-	-	2,126,749	1,063,375
Balance, end of year	32,523,580	\$ 9,786,106	32,523,580	\$ 9,791,539

**(b) Per share amounts**

The weighted average number of common shares issued and outstanding for the period are as follows:

	2009	2008
Basic	32,523,580	30,396,622
Diluted	32,523,580	30,396,622

All stock options for all periods have been excluded from the diluted loss per share calculation as the effect would be anti-dilutive.

**(c) Convertible debentures**

During the year ended December 31, 2008, the Company completed a private placement unsecured convertible debenture financing for \$1,000,000. Directors and officers of the Company purchased \$250,000 of the debentures.

The conversion price of the debentures was contingent upon the satisfaction of certain conditions on or before December 31, 2008. In the event that these conditions were not met by December 31, 2008, the debentures were automatically convertible at \$0.50 per common share. The convertible debentures bore interest at 10% per annum with interest payable on the earlier of the date of conversion, or December 31, 2008. In the event the principal amount of the debentures was converted into common shares, all interest under the debentures would be payable through the issuance of common

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

shares. For purposes of determining the number of common shares to be issued to satisfy the obligation to pay interest, each common share shall be deemed to have a value equal to the conversion price of the debenture.

On December 31, 2008, the convertible debentures and accrued interest were converted to common shares at \$0.50 per common share. The number of common shares issued for conversion were 2,126,749 with a stated value of \$1,063,375.

**7. Option plans**

**(a) Stock options**

The Company has a stock option plan whereby up to 10% of the issued and outstanding common shares may be granted to employees, directors and other persons who provide ongoing management or consulting services to the Company. Stock options are granted for a term of five years and vest over three years from the date granted. The exercise price of each option equals the market price of the Company's common shares on the date of the grant.

As at December 31, 2009, the following options have been issued and remain outstanding:

	2009		2008	
	Options Outstanding	Weighted average exercise price per share	Options Outstanding	Weighted average exercise price per share
Balance, beginning of year	2,570,000	\$0.35	1,100,000	\$1.25
Granted	635,000	0.61	1,870,000	0.35
Forfeited	(20,000)	0.35	-	-
Cancelled/expired	-	-	(400,000)	\$1.25
Balance, end of year	3,185,000	\$0.40	2,570,000	\$0.35
Options exercisable, end of year	850,000	\$0.35	-	-

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

The following table summarizes information about the stock options outstanding at December 31, 2009:

<b>Options outstanding</b>				<b>Options exercisable</b>	
<b>Range of Exercise price</b>	<b>Number outstanding</b>	<b>Weighted average exercise price</b>	<b>Weighted average Remaining contractual life (years)</b>	<b>Number exercisable</b>	<b>Weighted average exercise price</b>
\$0.15-0.65	635,000	\$0.61	4.8	NIL	N/A
\$0.35	2,550,000	\$0.35	3.9	850,000	\$0.35
	3,185,000	\$0.40	4.1	850,000	\$0.35

**(b) Stock-based compensation**

The Company accounts for its stock-based compensation plan using the fair value method. Under this method stock-based compensation is charged to contributed surplus over the vesting period of the options granted.

The fair values of options granted during the period have been estimated based on the following assumptions:

	<b>2009</b>	<b>2008</b>
Fair value	<b>\$0.56</b>	\$0.25
Average risk-free interest rate	<b>2.0%</b>	2.1%
Expected life	<b>3 years</b>	3 years
Expected volatility	<b>119%</b>	139%
Expected dividend	<b>\$NIL</b>	\$NIL

**(c) Contributed surplus**

	<b>2009</b>	<b>2008</b>
Balance, beginning of period	<b>\$ 1,859,568</b>	\$ 1,706,738
Stock-based compensation expense	<b>228,271</b>	152,830
Balance, end of period	<b>\$ 2,087,839</b>	\$ 1,859,568

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**8. Income taxes**

A reconciliation of income taxes at statutory rates with the reported taxes is as follows:

	<u>2009</u>	<u>2008</u>
Statutory rate	<b>29.0%</b>	29.5%
Expected current income tax recovery	<b>\$ (448,721)</b>	\$ (576,842)
Stock-based compensation	<b>66,199</b>	45,085
Effect of reduction in statutory rate and other	<b>(369,662)</b>	128,489
Change in valuation allowance	<b>752,184</b>	403,268
Income tax provision	<b>\$ -</b>	\$ -

The significant components of the Company's future tax assets as of December 31, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
Property and equipment	<b>\$ (1,371,994)</b>	\$ (123,418)
Operating losses – Canadian	<b>1,067,535</b>	611,489
Operating losses – Peru	<b>2,107,814</b>	516,138
Other	<b>(38,573)</b>	-
Less: Valuation allowance	<b>(1,764,782)</b>	(1,004,209)
	<b>\$ -</b>	\$ -

The Company has accumulated losses of approximately \$4,270,000, which may be used to reduce future years' Canadian taxable income. These losses expire at various times from 2010 to 2029.

The Company has accumulated losses of approximately \$7,026,000, which may be used to reduce future years' Peruvian taxable income. These losses are available indefinitely.

**9. Commitments**

**(a) Work commitments**

- (i) During the period ended December 31, 2007, the Company entered into a License Contract to explore Ucayali Block 126, located in east central Peru, South America (the "Exploration Agreement"). The license is comprised of a four stage, seven-year work commitment where the Company has the right to withdraw from the license at the end of each period associated with the term of the license. The Company has purchased a performance bond in the amount of US \$180,000 to secure the capital expenditure requirements associated with the Company's interest in the exploration license.

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

<b>Stage</b>	<b>Duration</b>	<b>Activity</b>	<b>Letter of Guarantee Required, gross (net to Company)</b>
First Stage - <i>completed</i>	12 months from December 22, 2007	Reprocessing of 1,000 km of seismic lines and comprehensive geological study of the area	US\$ 200,000
Second Stage	24 months from completion of the first stage	Drilling of two (2) exploratory or confirmation wells	US \$ 2,500,000 (\$1,125,000)
Third Stage	24 months from completion of the second stage	Drilling of one (1) exploratory well	US \$ 1,250,000 (\$562,500)
Fourth Stage	24 months from completion of the third stage	Drilling of one (1) exploratory well	US \$ 1,250,000 (\$562,500)

During December 2008, the Company issued a letter of guarantee of US \$1,125,000 for their share of the second stage work commitment and replaced the letter of guarantee previously issued for the first stage work commitment.

- (ii) Under the Exploration Agreement, the Company is responsible to make an annual education and technology contribution, which contribution is based on commercial daily production and is described as follows:

		<b>Gross</b>	<b>Net</b>
From commencement until commercial production	US	\$50,000	\$22,500
From commercial production of 0-30,000 barrels per day	US	\$80,000	\$36,000
From commercial production of 30,001-50,000 barrels per day	US	\$120,000	\$54,000
Over 50,000 barrels per day	US	\$180,000	\$81,000

**(b) Lease commitments**

The Company has entered into several lease agreements for office space. The Company's financial commitment under the agreements are as follows:

2010	\$ 108,759
2011	\$ 62,101

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**10. Capital disclosures**

The Company's objective is to maintain a strong capital position in order to be able to fund its proportionate share of the work commitments under the Exploration Agreement.

Given that the Company's activities are in the exploration stage, the Company's capital structure includes common share capital, and working capital (current assets minus current liabilities) or net debt. From time to time, in order to maintain or adjust the capital structure, the Company may issue common shares or other securities, sell assets or adjust its capital spending to manage current and projected debt levels and required work commitments.

The Board of Directors has established that the Company maintains sufficient capital such that working capital is positive and that sufficient capital is available to meet budgeted general and administrative expenses plus the Company's proportionate share of required work commitments for the next 12 months. As at December 31, 2009, the Company had negative working capital of \$7,966,002 (December 31, 2008 - \$1,301,476) thereby not meeting the required positive working capital criteria established by the Board. As described in Note 4, in November 2008, the Company entered into an agreement to sell a 45% working interest in the Block, which sale closed on December 4, 2009. The proceeds from the sale and the Loan (which was subsequently forgiven, as described in Note 12(a)) will be sufficient to fund the Company's budgeted general and administrative expenses and its proportionate share of required work commitments for 2010..

The Company is not subject to any externally imposed capital requirements.

**11. Financial instruments and risk management**

The Company is exposed to various risks that arise from its business environment and the financial instruments it holds. The Audit Committee and the Board of Directors of the Company review the adequacy of the risk management framework in relation to these risks. The following outlines the Company's risk exposures, quantifies these risks, and explains how these risks are managed.

**(a) Credit risk**

The Company is exposed to credit risk in relation to its cash and accounts receivable. The Company maintains cash with highly rated international banks and therefore considers these assets to have negligible credit risk.

The Company's accounts receivable is comprised of \$27,001 from the Government of Canada related to refundable goods and services tax and accordingly have negligible credit risk.

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

The remaining \$4,065,045 relates to amounts owing to the Company from its joint venture partner in the oil and gas industry. Management does not believe that this concentration of credit risk will result in any loss to the Company based on past payment experience. The Company's policy to mitigate credit risk associated with these balances is to establish relationships with large and reputable joint venture partners. However, the receivables are from participants in the oil and gas sector and collection of the outstanding balances is dependent on industry factors and therefore subject to credit risk. The Company collected 95% of the outstanding receivable subsequent to year end.

The Company does not have an allowance for doubtful accounts as at December 31, 2009 and 2008, and did not provide for any doubtful accounts nor was it required to write-off any accounts receivable during the years ended December 31, 2009 and 2008.

**(b) Liquidity risk**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking harm to the Company's reputation. The Company continuously monitors forecast and actual cash flows to ensure that it has sufficient funds available to meet current and foreseeable financial requirements at a reasonable cost.

Management believes that future cash flows from proposed financings and borrowings will be adequate to support these financial liabilities. See note 10 for further details.

**(c) Market risks**

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices and interest rates will affect the Company's net earnings or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. Given that the current oil and gas activities are in the exploration stage and that no oil and gas reserves have been identified, the Company does not use financial derivatives or physical delivery sales contracts and accordingly, commodity price risk is negligible.

**(i) Foreign currency risk**

Foreign currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate as a result of changes in foreign currency exchange rates. The Company is exposed to foreign currency fluctuations as the Company transacts business in both Canada and Peru and purchases goods and services denominated in Canadian Dollars, Peruvian Neuvos Soles and US Dollars. As a result, the Company has both foreign exchange transaction and translation exposure.

**Veraz Petroleum Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2009 and 2008**

---

**(ii) Interest rate risk**

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is currently not exposed to interest rate risk as the loan payable described in note 4(c) is non-interest bearing.

**(d) Fair values of financial instruments**

The Company's financial instruments as at December 31, 2009 include cash and accounts receivable, accounts payable and accrued liabilities, notes payable and loans payable.

<b>Financial instrument</b>	<b>Category</b>	<b>Measurement method</b>
Cash	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Accounts payable and accrued liabilities	Financial liabilities	Amortized cost
Notes payable	Financial liabilities	Amortized cost
Loan payable	Financial liabilities	Amortized cost

The fair value of cash, accounts receivable, accounts payable and accrued liabilities and notes payable approximate their carrying amounts due to their short terms to maturity.

The fair value of the loan payable is based on Level 3 inputs – items not observable in the market or from quoted prices. The fair value of the loan on December 4, 2009 was estimated based on the difference between the face value of the loan being \$8,360,490 and the unamortized discounted value of the loan using a 12% discount rate and term to maturity as described in note 4(c). The implied discount, which is the difference between the amounts received and the fair value of the loan has been treated as a reduction of the Company's property and equipment assets. The fair value of the loan at December 31, 2009 approximates its carrying value given the short period of time since issue.

**12. Subsequent events**

**Sale of interest**

On March 24, 2010, Petrominerales provided notice to the Company of their continued participation to explore Block 126 and forgave the outstanding Loan owed by the Company described in note 4(c). The Company will treat the loan forgiveness as contingent sale proceeds and will reduce the value of its property and equipment by the outstanding loan amount.