

MANAGEMENT'S REPORT

Management is responsible for the integrity and objectivity of the information contained in this report and for the consistency between the consolidated financial statements and other financial and operating data contained elsewhere in this report. The accompanying consolidated financial statements have been prepared by management in accordance with International Financial Reporting Standards using estimates and careful judgment, particularly in those circumstances where transactions affecting a current period are dependent upon future events. The accompanying consolidated financial statements have been prepared using policies and procedures established by management and fairly reflect the Company's financial position, financial performance and cash flows, within International Financial Reporting Standards. Management has established and maintains a system of internal controls that is designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and the financial information is reliable and accurate.

The Company's external auditors, Deloitte LLP, have audited the consolidated financial statements. Their audit provides an independent view of management's discharge of its responsibilities insofar as they relate to the fairness of reported financial results and the financial performance of the Company.

The Audit Committee of the Board of Directors has reviewed in detail the consolidated financial statements with management and the external auditors. The Audit Committee has reported its findings to the Board of Directors who have approved the consolidated financial statements.



Corey C. Ruttan
President & Chief Executive Officer & Director



Alison Howard
Chief Financial Officer

Calgary, Canada
April 22, 2014

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Alvopetro Energy Ltd.:

We have audited the accompanying consolidated financial statements of Alvopetro Energy Ltd., which comprise the consolidated statements of financial position as at December 31, 2013 and 2012, and the consolidated statements of operations and comprehensive income (loss), consolidated statements of changes in equity and consolidated statements of cash flow for the periods then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

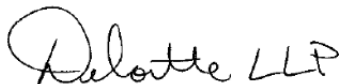
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Alvopetro Energy Ltd. as at December 31, 2013 and 2012, and its financial performance and its cash flows for the periods then ended in accordance with International Financial Reporting Standards.



Chartered Accountants
April 22, 2014
Calgary, Canada

ALVOPETRO ENERGY LTD.**CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**

(Thousands of United States dollars)

	Note	December 31, 2013	December 31, 2012
ASSETS			
Current			
Cash and cash equivalents	17	\$ 100,268	\$ 1,129
Trade and other receivables		342	144
Prepaid expenditures		147	-
Total current assets		100,757	1,273
Non-current assets			
Property, plant and equipment	8	9,697	7,509
Exploration and evaluation assets	5, 7	45,002	35,530
Other assets	6	-	6,000
Total non-current assets		54,699	49,039
Total assets		\$ 155,456	\$ 50,312
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Accounts payable and accrued liabilities		\$ 2,250	\$ 187
		2,250	187
Deferred tax liability	5, 11	3,791	1,691
Decommissioning liabilities	9	2,833	1,014
		8,874	2,892
Shareholders' equity			
Share capital	10	151,937	-
Contributed surplus		74	-
Deficit		(3,679)	-
Accumulated other comprehensive loss		(1,750)	-
Net investment	2	-	37,094
Total shareholders' equity		146,582	37,094
Non-controlling interest	5	-	10,326
Total liabilities and shareholders' equity		\$ 155,456	\$ 50,312

Commitments and contingencies (Note 16)

Subsequent event (Note 17)

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

Approved by:



John D. Wright
Chairman of the Board of Directors



Firoz Talakshi
Chairman of the Audit Committee

ALVOPETRO ENERGY LTD.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

(Thousands of United States dollars, except per share amounts)

	Note	Period ended December 31,	
		2013	2012 ⁽¹⁾
Revenue			
Oil sales		\$ 1,239	\$ 73
Royalties and production taxes		(122)	(5)
Other income		163	-
		1,280	68
Expenses			
Production		1,267	38
Transportation		37	2
General and administrative		4,707	262
Depletion and depreciation	8	403	26
Impairment	8	431	-
Accretion of decommissioning liabilities	9	79	-
Exploration and evaluation expense		111	-
Share-based compensation	10	476	22
Foreign exchange		309	-
Total expenses		7,820	350
Loss before taxes and non-controlling interest		(6,540)	(282)
Income taxes	11	2,131	-
Net loss		(8,671)	(282)
Exchange gain (loss) on translation of foreign operations		(2,780)	314
Comprehensive income (loss)		\$ (11,451)	\$ 32
Net loss attributable to:			
Common shareholders		(7,398)	(246)
Non-controlling interest		(1,273)	(36)
Net loss		\$ (8,671)	\$ (282)
Comprehensive income (loss) attributable to:			
Common shareholders		(9,921)	(10)
Non-controlling interest		(1,530)	42
Comprehensive income (loss)		\$ (11,451)	\$ 32
Net loss per share attributable to common shareholders			
	10		
Basic		0.09	0.00
Diluted		0.09	0.00

(1) Represents the period from December 12, 2012 to December 31, 2012.

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

ALVOPETRO ENERGY LTD.
CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(Thousands of United States dollars)

	Note	Period Ended December 31, 2013			Period Ended December 31, 2012	
		Alvopetro Shareholders' Equity	Net Investment	Non-controlling Interest	Net Investment	Non-controlling Interest
Common Shares						
Balance, beginning of period		\$ -	\$ -	\$ -	\$ -	\$ -
Transfer from net investment	2	151,937	-	-	-	-
Balance, end of period		\$ 151,937	\$ -	\$ -	\$ -	\$ -
Contributed surplus						
Balance, beginning of period		\$ -	\$ -	\$ -	\$ -	\$ -
Share-based compensation expense	10	62	-	-	-	-
Share-based compensation capitalized	10	12	-	-	-	-
Balance, end of period		\$ 74	\$ -	\$ -	\$ -	\$ -
Deficit						
Balance, beginning of period		\$ -	\$ -	\$ -	\$ -	\$ -
Net loss		(3,679)	-	-	-	-
Balance, end of period		\$ (3,679)	\$ -	\$ -	\$ -	\$ -
Accumulated Other Comprehensive Loss						
Balance, beginning of period		-	-	-	-	-
Other comprehensive loss		(1,750)	-	-	-	-
Balance, end of period		\$ (1,750)	\$ -	\$ -	\$ -	\$ -
Net Investment						
Balance, beginning of period		\$ -	\$ 37,094	\$ 10,326	\$ -	\$ -
Acquisition of AOGI	5	-	-	-	36,850	10,284
Net loss		-	(3,719)	(1,273)	(246)	(36)
Other comprehensive gain (loss)		-	(773)	(257)	236	78
Contributions and net change in investment		-	109,402	723	254	-
Share-based compensation expense	10	-	414	-	-	-
Acquisition of non-controlling interest	5	-	9,519	(9,519)	-	-
Transfer to Alvopetro share capital	2	-	(151,937)	-	-	-
Balance, end of period		\$ -	\$ -	\$ -	\$ 37,094	\$ 10,326

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

ALVOPETRO ENERGY LTD.
CONSOLIDATED STATEMENTS OF CASH FLOW
(Thousands of United States dollars)

	Note	Period ended December 31,	
		2013	2012 ⁽¹⁾
Operating Activities			
Net loss		\$ (8,671)	\$ (282)
Adjustments for non-cash items:			
Impairment	8	431	-
Depletion and depreciation	8	403	26
Accretion of decommissioning liability	9	79	-
Deferred tax expense	11	2,100	-
Share-based compensation	10	476	22
Unrealized foreign exchange loss		346	-
		(4,836)	(234)
Changes in non-cash working capital	14	303	(37)
		(4,533)	(271)
Investing Activities			
Expenditures on property, plant and equipment	8	(1,217)	-
Expenditures on exploration and evaluation assets	7	(5,606)	(18)
Expenditures on other assets	6	(886)	-
Acquisition of Alvopetro Oil and Gas Investments Inc.	5	-	(35,702)
Changes in non-cash working capital	14	1,415	-
		(6,294)	(35,720)
Financing Activities			
Funds received pursuant to the Arrangement	1	85,554	-
Initial contribution from Petrominerales		-	36,850
Net contributions from Petrominerales	2	23,848	232
Net contributions relating to non-controlling interest		723	-
		110,125	37,082
Change in cash and cash equivalents		99,298	1,091
Effect of foreign exchange on cash balances		(159)	38
Cash and cash equivalents, beginning of period		1,129	-
Cash and cash equivalents, end of period		\$ 100,268	\$ 1,129
Cash and cash equivalents consist of:			
Cash		\$ 100,268	\$ 1,129
Cash equivalents		\$ -	\$ -

(1) Represents the period from December 12, 2012 to December 31, 2012

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

ALVOPETRO ENERGY LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

As at December 31, 2013 and December 31, 2012, and periods ended December 31, 2013 and 2012

All tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted

NOTE 1 – REPORTING ENTITY

Alvopetro Energy Ltd. (“Alvopetro” or “the Company”) is engaged in the exploration, development and production of hydrocarbons in Brazil. Alvopetro is a publicly traded company listed on the TSX Venture Exchange (TSX: ALV.V), was incorporated under the Business Corporations Act (Alberta) on September 25, 2013 as 1774501 Alberta Ltd., and subsequently changed its name to Alvopetro Energy Ltd. on November 19, 2013.

On September 29, 2013, Petrominerales Ltd. (“Petrominerales”), Pacific Rubiales Energy Corp. (“Pacific Rubiales”), and 1774501 Alberta Ltd. (now Alvopetro Energy Ltd. and at that time a wholly-owned subsidiary of Petrominerales) entered into an agreement pursuant to which the parties agreed to complete an arrangement (the “Arrangement”) under section 193 of the Business Corporations Act (Alberta). Under the Arrangement, Pacific Rubiales acquired Petrominerales, with each Petrominerales shareholder receiving cash consideration of CAD\$11.00 and one common share of Alvopetro for each Petrominerales share held. On November 27, 2013, Petrominerales shareholders approved the Arrangement which was completed on November 28, 2013.

In connection with the Arrangement, Petrominerales transferred to Alvopetro its entire interest in the Recôncavo, Tucano, Camamu-Almada and Sergipe-Alagoas basins onshore Brazil consisting of three producing fields and 16 exploration blocks (the “Brazil Properties”) and approximately \$85.6 million (CAD\$91.0 million) in cash. Following completion of the Arrangement, Alvopetro began carrying on the exploration, development and production previously carried on by Petrominerales with respect to the Brazil Properties.

The Company’s head office and records are located at 1175, 332 6th Ave. S.W., Calgary, Alberta, Canada, T2P 0B2.

NOTE 2 – BASIS OF PRESENTATION

Statement of Compliance

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) and were authorized for issuance by the Company’s Board of Directors on April 22, 2014.

Basis of Measurement and Impact of the Arrangement

Transactions occurring prior to the Arrangement on November 28, 2013 were derived from the accounting records of Petrominerales. The Brazil Properties now owned by Alvopetro were acquired by Petrominerales on December 11, 2012 and the financial information from this date to November 28, 2013 is intended to be representative of the Brazil Properties had Alvopetro been operating them as a stand-alone entity, subject to Petrominerales’ control, during this time. The financial information related to this period has been prepared by Alvopetro’s management in accordance with IFRS and requires the use of significant judgments made in allocating reported amounts related to the Brazil Properties. In the opinion of management, these consolidated financial statements reflect all adjustments necessary to present fairly the statements of the financial position and the results of operations in accordance with IFRS, however they may not reflect Alvopetro’s financial position, results of operations and cash flows had the Company been operating in its current structure for the reporting periods presented in these consolidated financial statements, during which time it was a subsidiary of Petrominerales.

Presentation of the Consolidated Statements of Financial Position

As Alvopetro Energy Ltd. was a wholly-owned subsidiary of Petrominerales until the closing of the Arrangement, the transfer of assets and liabilities was recorded by the Company at the carrying amounts recorded in Petrominerales’ consolidated statement of financial position at the time of the transfer, other than certain amounts that were recorded as exploration and evaluation assets by Alvopetro rather than goodwill with respect to the December 11, 2012 acquisition, as explained in Note 5.

ALVOPETRO ENERGY LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

As at December 31, 2013 and December 31, 2012, and periods ended December 31, 2013 and 2012

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Presentation of the Consolidated Statements of Operations and Comprehensive Income (Loss)

All revenue, royalties and production taxes, operating expenses and transportation expenses on the consolidated statements of operations and comprehensive income (loss) are directly attributable to the Brazil Properties now owned by Alvo Petro. General and administrative expenses recorded prior to the Arrangement have been determined based on actual Brazil general and administrative expenses and time charges by Petrominerales employees to the Brazil Properties. Share-based compensation recorded by Petrominerales up to the Arrangement date has been allocated to Alvo Petro based on the percentage of the direct time charged to the Brazil Properties divided by total general and administrative costs for the Petrominerales Calgary office. From the Arrangement date to December 31, 2013 amounts recorded for general and administrative and share-based compensation expenses are based on amounts incurred by Alvo Petro as a stand-alone entity.

Presentation of the Consolidated Statements of Changes in Equity

For reporting periods prior to the Arrangement, Petrominerales' direct ownership of the net assets is shown as a net investment because share capital did not exist. Petrominerales' investment includes the accumulated net loss and net cash investments, including any foreign exchange translation effect of the foreign operations. At the close of the Arrangement, the carrying amount of the net investment of \$151.9 million was ascribed to the common share capital of Alvo Petro.

Use of Judgments, Estimates and Assumptions

The preparation of financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that impact the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the consolidated statements of financial position as well as the reported amounts of revenue, expenses and cash flows during the periods presented. Such estimates relate primarily to unsettled transactions and events as of the date of the financial statements and actual results could differ materially from estimated amounts.

Amounts recorded for depletion and depreciation and amounts recognized for property, plant and equipment, exploration and evaluation, and impairment calculations are based on a number of factors including estimates of oil and natural gas reserves, commodity prices and future costs required to develop those reserves. To test impairment, costs are allocated into cash generating units ("CGU's") based on their ability to generate largely independent cash flows. The determination of CGU's is subject to judgment. The transfer of exploration and evaluation assets to property, plant and equipment is based on management's judgment of technical feasibility and commercial viability.

In estimating future decommissioning liabilities various assumptions are required with respect to the amount and timing of abandonment costs, inflation factors, interest rates and potential changes in the legal, regulatory, environmental and political environments. To the extent future revisions to these estimates and assumptions impact the amount of decommissioning liabilities, a corresponding adjustment is made to the property, plant and equipment and/or exploration and evaluation asset balances.

The fair value of share-based compensation is estimated using the Black-Scholes pricing model. These estimates depend on significant assumptions including expected share price volatility, risk free interest rate, annual dividend yield and expected term of the awards.

The measurement of income tax expense, related provisions and deferred tax liabilities and assets is based on judgments in applying income tax law and estimates on the applicable tax rates, timing, likelihood and reversal of temporary differences between the accounting and tax bases of assets and liabilities. These estimates are subject to measurement uncertainty and changes in these estimates could materially impact the financial statements of future periods.

The designation of the Company's functional currencies is a management judgment based on the composition of revenue and costs in the locations in which it operates.

ALVOPETRO ENERGY LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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Contingent liabilities are possible obligations whose existence will only be confirmed by future events not wholly within the control of the Company. Contingent liabilities are disclosed in the financial statements unless the possibility of an outflow of economic resources is considered remote. The evaluation of the likelihood of the contingent events requires management judgment as to the probability of exposure to potential loss.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES

Consolidation

These consolidated financial statements include the accounts of Alvo Petro and its controlled subsidiaries. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Intercompany transactions and balances are eliminated on consolidation. Non-controlling interest in the net assets of consolidated subsidiaries are identified separately from the Company's equity. Non-controlling interest consists of the non-controlling interest at the date of the original business combination plus the non-controlling interest's share of changes in equity since the date of acquisition. As at December 31, 2013, the Company controls 100 percent of its subsidiaries. Prior to November 19, 2013, when the Company acquired the remaining outstanding shares of Alvo Petro Oil and Gas Investments Inc. (Note 5), the Company's consolidated statements of financial position and consolidated statements of operations and comprehensive income (loss) included a non-controlling interest representing the 25 share percent not owned by Alvo Petro.

Business Combinations

Acquisitions of subsidiaries and businesses are accounted for using the acquisition method. The purchase price used in a business combination is based on the fair value at the date of the acquisition. The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 *Business Combinations* are recognized at their fair values at the acquisition date. All acquisition costs are expensed as incurred.

The interest of non-controlling shareholders in the acquiree is initially measured at the non-controlling shareholder's proportion of the net fair value of the assets, liabilities and contingent liabilities recognized or at the fair value of the non-controlling interest. Increases or decreases in the Company's ownership interest while retaining control is a capital transaction.

Joint Operations

Oil and gas exploration and production activities may be conducted jointly with others. These consolidated financial statements reflect the Company's proportionate interests in such activities.

Cash and Cash Equivalents

Cash and cash equivalents consist of investments and deposits with an initial maturity of three months or less. Cash and cash equivalents are stated at cost, which approximates fair value.

Exploration and Evaluation ("E&E") Assets

Pre-exploration and pre-licensing costs associated with the investigating, bidding and acquisition of petroleum properties are expensed as exploration and evaluation expense when the targeted petroleum lease or concession is not obtained.

Costs incurred prior to establishing commercial viability and technical feasibility, such as land and license acquisition, technical services and studies, decommissioning liabilities, exploration drilling and testing, and directly attributable employee compensation are initially classified as E&E assets. E&E assets are not depleted and are carried forward until they are considered technically feasible and commercially viable.

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E&E assets are considered technically feasible and commercially viable when proved and/or probable reserves have been assigned. Upon determination of reserves, the E&E assets attributable to those reserves are first tested for impairment and then reclassified from E&E assets to property, plant and equipment. When E&E assets are determined not to be technically feasible and/or commercially viable or where the Company decides not to continue with the particular activity, the unrecoverable costs are charged to the consolidated statements of operations and comprehensive income (loss) as impairment expense.

Property, Plant and Equipment (“PP&E”)

PP&E costs are classified as crude oil assets and corporate assets.

Crude oil assets include all costs directly associated with the development of crude oil and gas reserves. These expenditures include proved property acquisitions, geological and geophysical costs, development drilling and completions on productive and non-productive wells, infrastructure, decommissioning liabilities and transfers from exploration and evaluation assets where technical feasibility and commercial viability has been determined.

Crude oil assets are accumulated on an area-by-area (component) basis, which, for AlvoPetro, is currently by field. Costs accumulated within each component are depleted using the unit-of-production method based on proved plus probable reserves before royalties using estimated future prices and costs. Included in the depletion base are estimated future costs to be incurred in developing proved and probable reserves and excluded from the depletion base are estimated salvage values.

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property, plant and equipment are capitalized only when they increase the future economic benefits to be derived from the specific asset to which they relate. All other expenditures are recognized as an expense in the consolidated statements of operations and comprehensive income (loss) as incurred. Capitalized costs generally represent amounts incurred in developing proved and/or probable reserves and enhancing production from those reserves including directly attributable employee compensation. The carrying amount of any replaced or sold component is derecognized. The costs of the day-to-day servicing of property, plant and equipment are recognized as an expense in profit and loss as incurred.

Corporate assets included within PP&E consist primarily of computer equipment, vehicles, leasehold improvements, and office furniture and equipment. Depreciation of corporate assets is calculated on a straight-line basis over the useful life of the related assets.

Impairment

Individual assets are grouped for impairment purposes at the lowest level at which there are identifiable cash inflows that are largely independent of the cash inflows of other groups of assets, known as a cash-generating unit (“CGU”). An impairment test is performed whenever events and circumstances indicate that the carrying value of the asset or CGU may exceed the recoverable amount. The recoverable amount is the higher of the fair value less costs to sell and the value in use. If any such indication of impairment exists, an estimate of the CGU’s recoverable amount is made. These assessments require the use of estimates and assumptions including, but not limited to, production volumes, discount rates, future commodity prices and future capital and operating cost estimates.

E&E costs are accumulated by block according to the geographical area specified by the concession contract. When an E&E area is determined to be technically feasible and commercially viable, the accumulated costs are transferred to PP&E. E&E costs are tested for impairment at the time of transfer and at each period end with the unrecoverable costs being charged to the consolidated statements of operations and comprehensive income (loss).

AlvoPetro’s PP&E costs are accumulated on an area-by-area basis and then grouped into CGU’s on the basis of geographical area, having regard to the operational infrastructure of the area as well as other considerations. For impairment testing purposes, corporate assets are allocated to each of the CGU’s on the basis of proportionate future net revenue consistent with the recoverable amount.

ALVOPETRO ENERGY LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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For impairment losses identified based on a CGU, the loss is allocated on a pro rata basis to the assets within the CGU or group of CGU's. This is completed by reducing the carrying amount of the assets of the CGU on a pro rata basis. The impairment loss is recognized as an expense in the consolidated statements of operations and comprehensive income (loss).

Impairment losses are assessed at each reporting date for indications that the impairment loss no longer exists or has decreased. Impairment losses can be reversed if there is a change in the estimates used to determine the recoverable amount. Reversal of impairment losses cannot exceed the carrying value of the asset prior to impairment less any depreciation and depletion that would have been taken if no impairment had been recognized.

Decommissioning Liabilities

The Company recognizes the estimated fair value of future decommissioning liabilities related to statutory, contractual or other legal obligations associated with the retirement of assets, when a reasonable estimate of the provision can be determined and it is probable that an outflow of resources will be required to settle the obligation. A corresponding increase to the carrying amount of the related asset is recorded.

Decommissioning liabilities are based on the estimated costs to abandon and reclaim the well and well sites that are required to be abandoned under the terms of oil and gas contracts. The estimate is evaluated on a periodic basis and any adjustment to the estimate is applied prospectively. The liability is estimated by discounting expected future cash outflows required to settle the liability using a risk-free rate. The change in net present value of the future decommissioning liabilities due to the passage of time is expensed as accretion expense on the consolidated statements of operations and comprehensive income (loss). The costs capitalized to the related assets are amortized to earnings in a manner consistent with the depletion and depreciation of the underlying assets. Revisions to the estimated timing of cash flows, inflation rates, discount rates or to the original estimated undiscounted costs also result in an increase or decrease to the obligation. Actual costs incurred upon settlement of the retirement obligations are charged against the obligation to the extent of the liability recorded.

Revenue Recognition

Revenue is recognized when the significant risks and rewards of ownership have transferred to the buyer and when collection is reasonably assured.

Share-based Compensation

The Company accounts for share-based compensation using the Black-Scholes option-pricing model to determine the fair value of stock options on grant date using various estimates including expected share price volatility, risk free interest rate and expected term of the options.

Share-based compensation is measured at fair value on the grant date and expensed over the vesting period with a corresponding increase to contributed surplus. Consideration paid upon the exercise of stock options, together with corresponding amounts previously recognized in contributed surplus, is recorded as an increase to share capital. The amount recognized as expense is adjusted for an estimated forfeiture rate for options that will not vest, which is adjusted as actual forfeitures occur, until the shares are fully vested.

Income Taxes

Income tax expense is comprised of current and deferred income taxes. Income tax expense is recognized in profit or loss except to the extent that it relates to items recognized directly in equity.

The Company's subsidiaries in Brazil have the option to compute current income taxes under either the presumed profit regime or the actual profit regime. The actual profit regime is based on estimated taxable income and tax rates which are determined pursuant to tax laws enacted or substantively enacted at the reporting date. Under the presumed profit regime, income is computed monthly based on a specific proportion of the Company's gross revenues depending on the nature of the activities giving rise to those revenues.

ALVOPETRO ENERGY LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

As at December 31, 2013 and December 31, 2012, and periods ended December 31, 2013 and 2012

All tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted

The Company follows the liability method of accounting for deferred taxes. Under this method, deferred income tax assets or liabilities are recorded to reflect the difference between the accounting and tax base of assets and liabilities and unused tax losses. Deferred income taxes are measured using tax rates that are expected to apply to the period when the deferred tax asset is realized or the deferred tax liability is settled, based on tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period. The effect of a change in income tax rate is recognized in income in the period in which the tax rate has been enacted or substantively enacted.

Deferred income tax assets are recognized for deductible temporary differences to the extent it is probable that future taxable profit will be available. The carrying amount of deferred tax assets is reviewed at the end of each reporting period and reduced to the extent it is no longer probable that sufficient taxable profits will be available to allow the assets to be recovered. Deferred income tax assets and liabilities are offset only if there is a legally enforceable right to offset and they relate to income taxes levied by the same tax authority on the same taxable entity or on different tax entities to the extent they could be realized simultaneously.

Per Share Amounts

The Company computes basic earnings per share using net income divided by the weighted average number of common shares outstanding during the period. Diluted per share information is calculated using the treasury stock method which assumes that any proceeds received by the Company upon the exercise of in-the-money stock options, plus unamortized stock compensation costs, would be used to buy back common shares at the average market price for the period.

Foreign and Reporting Currency

The Company's functional currencies are the Brazilian real ("BRL") for all Brazil entities and the U.S. dollar for all Canadian entities. Given that the Company conducts the majority of its business in international markets and its revenues are largely dependent on international commodity prices, Alvo Petro has chosen to present its consolidated financial statements in U.S. dollars.

Transactions in currencies other than the entity's functional currencies are recognized at the rates of exchange prevailing at the date of the transactions. At the end of each reporting period, monetary assets and liabilities denominated in foreign currencies are translated at the exchange rate in effect at the reporting period date. Non-monetary assets, liabilities, revenues and expenses are translated at transaction date exchange rates. Exchange gains or losses are included in the determination of net income as foreign exchange gains or losses.

The assets and liabilities of foreign operations, including fair value adjustments arising on the acquisition, are translated to U.S. dollars at exchange rates at the reporting date. The income and expenses of foreign operations are translated to U.S. dollars at exchange rates at the date of the transactions. Resultant foreign currency differences are recognized in other comprehensive income ("OCI").

Financial Instruments

All financial assets and liabilities are initially recognized at fair value on the consolidated statements of financial position. Subsequent measurement of the financial instruments is based on their classification. Each financial instrument is classified into one of the following categories: financial assets at fair value through profit and loss; held-to-maturity investments, loans and receivables; available for sale financial assets; financial liabilities at fair value through profit or loss; and, financial liabilities measured at amortized cost. The classification depends on the characteristic and the purpose for which the financial instruments were acquired. Except in very limited circumstances, the classification of financial instruments is not subsequently changed.

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Financial instruments carried at fair value through profit and loss on the consolidated statements of financial position include cash and cash equivalents. Realized and unrealized gains and losses on financial assets and liabilities carried at fair value through profit and loss are recognized in net income/loss in the periods such gains and losses arise. Transaction costs related to these financial assets and liabilities are included in net income/loss when incurred. Financial instruments carried at cost or amortized cost include trade and other receivables and accounts payable and accrued liabilities. Transaction costs incurred for these types of financial instruments are included with the initial fair value and the instrument is carried at amortized cost. These costs are amortized into net income/loss over the life of the asset or liability using the effective interest method and are included in finance and other expenses in the consolidated statements of operations and comprehensive income (loss). Gains and losses on financial assets and liabilities carried at cost or amortized cost are recognized in the consolidated statements of operations and comprehensive income (loss) when these assets or liabilities settle.

Segmented Operations

All oil sales revenue is derived from Brazilian operations. The majority of non-current assets are located in Brazil. The Company does not have any significant revenue in Canada other than interest earned on cash balances.

NOTE 4 – CHANGES IN ACCOUNTING STANDARDS

New Accounting Standards

The Company has reviewed new and revised accounting pronouncements that came into effect and determined the following have or may have an impact on the Company.

Standard and Description	Date of Adoption	Adoption Impact on Consolidated Financial Statements
IFRS 10: "Consolidated Financial Statements" - The standard provides a single model to be applied in control analysis for all investees including special purpose entities.	January 1, 2013	No material impact.
IFRS 11: "Joint Arrangements" - presents a new model for determining whether an entity should account for joint arrangements using proportionate consolidation or the equity method. An entity will have to follow the substance rather than legal form of a joint arrangement and will no longer have a choice of accounting method.	January 1, 2013	No material impact.
IFRS 12: "Disclosure of Interests in Other Entities" - requires a company to provide disclosures about subsidiaries, joint arrangements, associates and unconsolidated structured entities.	January 1, 2013	No material impact.
IFRS 13: "Fair Value Measurement" - provides comprehensive guidance for instances where IFRS requires fair value to be used and on determining fair value and required measurement disclosures.	January 1, 2013	No material impact.
IAS 27: "Separate Financial Statements" - establishes the accounting and disclosure requirements for investments in subsidiaries, joint ventures, and associates when an entity prepares separate financial statements and replaces the current IAS 27 "Consolidated and Separate Financial Statements" as the consolidation guidance is included in IFRS 10 "Consolidated Financial Statements".	January 1, 2013	No material impact.
IAS 28, "Investments in Associates and Joint Ventures" - establishes the accounting for investments in associates and defines how the equity method is applied when accounting for associates and joint ventures.	January 1, 2013	No material impact.
IFRS 7, "Financial Instruments: Disclosures" - relates to the requirements of the offsetting of a financial asset and financial liability when offsetting is permitted under IFRS.	January 1, 2013	No material impact.

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*All tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted***Standards issued but not yet effective**

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

Standard and Description	Date of Adoption	Expected Adoption Impact on Consolidated Financial Statements
IFRS 9: "Financial Instruments" - The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value.	January 1, 2018	The Company is assessing the effect of this future pronouncement on its financial statements.
IAS 32 "Financial Instruments: Presentation" - addresses inconsistencies when applying the offsetting criteria outlined in this standard. These amendments clarify certain of the criteria required to be met in order to permit the offsetting of financial assets and financial liabilities.	January 1, 2014	No material impact expected.
IFRIC 21 "Levies" - clarifies the requirements for recognizing a liability for a levy imposed by a government.	January 1, 2014	The Company is assessing the effect of this future pronouncement on its financial statements.
IAS 36 – "Impairment of assets" – requires additional disclosure on the recoverable amount of an impaired Cash Generating Unit.	January 1, 2014	No material impact expected.

NOTE 5 – ACQUISITION ACTIVITIES*December 11, 2012 Acquisition*

On December 11, 2012, Petrominerales acquired 75 percent of the shares of Alvopetro Oil and Gas Investments Inc., ("AOGI"), a non-publicly traded Canadian company that held certain properties and assets in Brazil, for cash consideration of \$36.9 million.

On the acquisition date, Petrominerales recorded the AOGI assets acquired and the liabilities assumed at their fair values with the surplus of the aggregate consideration relative to the fair value of the identifiable net assets recorded as goodwill. Petrominerales also recorded a non-controlling interest ("NCI") of \$10.3 million relating to the 25 percent interest not controlled at that time. This amount was determined based on the fair value of the shares of AOGI on the acquisition date.

Alvopetro reviewed the assets and liabilities recognized by Petrominerales for this December 11, 2012 acquisition and views the goodwill recorded by Petrominerales as being representative of fair market value associated with AOGI's exploration and evaluation assets, rather than goodwill. Accordingly, as of December 11, 2012, Alvopetro has restated the goodwill amount of \$3.3 million as E&E assets and included the net impact of the resulting deferred tax liability as additional E&E assets, resulting in a total E&E addition of \$35.3 million, compared to the \$30.3 million previously recorded by Petrominerales. Alvopetro believes that the fair market of the exploration and evaluation assets held by AOGI and its Brazil subsidiaries support this value.

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The following summarizes the allocation of the aggregate consideration for the acquisition as recorded by Alvo Petro:

Cash paid	\$ 36,850
Cash acquired	(1,148)
Total consideration net of cash acquired	\$ 35,702
Trade and other receivables	233
Accounts payable and accrued liabilities	(313)
Other assets	6,000
Property, plant and equipment	7,500
Exploration and evaluation assets	35,256
Decommissioning liabilities	(1,000)
Deferred tax liability	(1,691)
Non-controlling interest	(10,283)
Total net assets acquired	\$ 35,702

November 19, 2013 Acquisition

On November 19, 2013, Petrominerales acquired the remaining 25 percent of the outstanding shares of AOGI for CAD\$ 9.0 million which resulted in the elimination of the non-controlling interest. The net investment was increased by \$0.9 million, representing the difference between the cash consideration and the non-controlling interest balance at that time.

NOTE 6 – OTHER ASSETS

	Period ended December 31,	
	2013	2012
Balance, beginning of period	\$ 6,000	\$ -
Deferred acquisition costs of farm-in (Note 5)	-	6,000
Deposit for tubing purchase	886	
Transfer to E&E assets	(6,886)	-
Balance, end of period	\$ -	\$ 6,000

The deferred acquisition costs relate to the estimated fair value of two blocks included in the acquisition of the Brazil properties (Note 5). Under the terms of the agreement, the non-controlling interest shareholder was required to complete the necessary farm-in agreements for the benefit of AOGI. To the extent the non-controlling interest shareholder was unable to complete the farm-in agreements, Petrominerales would have been entitled to up to \$6.0 million in cash or an additional ownership interest in AOGI. With the remaining 25 percent acquisition of AOGI from the non-controlling interest shareholder, these deferred acquisition costs have now been transferred to E&E assets.

NOTE 7 – EXPLORATION AND EVALUATION (E&E) ASSETS

	Period ended December 31,	
	2013	2012
Balance, beginning of period	\$ 35,530	\$ -
Acquisition of AOGI (Note 5)	-	35,256
Capital expenditures	5,606	18
Capitalized share-based compensation	7	-
Transfer from other assets (Note 6)	6,886	-
Change in decommissioning liabilities	59	-
Foreign currency translation	(3,086)	256
Balance, end of period	\$ 45,002	\$ 35,530

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Capital expenditures include \$3.3 million of inventory purchased for use on exploration wells. General and administrative costs totaling \$0.2 million (2012 - \$nil) that were directly related to exploration and evaluation activities have been capitalized as exploration and evaluation assets.

NOTE 8 – PROPERTY, PLANT AND EQUIPMENT (PP&E)

	Period ended December 31,	
	2013	2012
Cost, beginning of period	\$ 7,535	\$ -
Acquisition of AOGI (Note 5)	-	7,500
Capital expenditures	1,217	-
Capitalized share-based compensation	5	-
Change in decommissioning liabilities	2,004	-
Foreign currency translation	(232)	35
Cost, end of period	\$ 10,529	\$ 7,535
Accumulated depletion and depreciation, beginning of period	(26)	-
Depletion and depreciation for the period	(403)	(26)
Impairment	(431)	-
Foreign currency translation	28	-
Accumulated depletion and depreciation, end of period	(832)	(26)
Net book value, end of period	\$ 9,697	\$ 7,509

General and administrative costs totaling \$0.2 million (2012 - \$nil) that were directly related to investing activities have been capitalized as property, plant and equipment.

During the year ended December 31, 2013, the Company recognized an overall impairment of \$0.4 million (2012 - \$nil) as follows:

	Period ended December 31,	
	2013	2012
Impairment losses		
Bom Lugar	\$ 5,620	\$ -
Jiribatuba	301	-
Aracaju	393	-
Total PP&E impairment loss	\$ 6,314	\$ -
Impairment reversals		
Bom Lugar	\$ (5,582)	-
Jiribatuba	(301)	-
Aracaju	-	-
Total PP&E impairment reversal	\$ (5,883)	\$ -
Net PP&E impairment loss	\$ 431	\$ -

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The impairment loss was a result of a decline in the estimated value of the assets and was calculated based on the difference between the net book value and the value in use. During the nine months ended September 30, 2013, the Company had initially recognized an impairment at each of Bom Lugar (\$5.6 million), Jiribatuba (\$0.3 million), and Aracaju (\$0.3 million) and during the three months ended December 31, 2013, an additional impairment loss of \$0.1 million was recognized at Aracaju. The key assumptions used in determining the value in use were the discount rate, commodity prices, future expected resource volumes, future cost estimates, inventory of undrilled locations, and timing of future capital cost estimates. A discount rate of 15% was used in the assessment of impairment for all CGU's for the periods ended December 31, 2013 and December 31, 2012. In determining the future net cash flows, the Company utilized benchmark pricing forecasts from its reserve evaluator.

During the three months ended December 31, 2013, the impairment booked at each of Bom Lugar and Jiribatuba, less the depletion that would have been recognized had the impairment not been recorded, was reversed. The reversal of the impairment losses resulted from a change from the September 30, 2013 estimates used to determine the value in use at each of these CGU's, specifically a reduction of estimated future operating costs, estimated future capital cost estimates, and an increase in future sales price estimates.

The values assigned to the key assumptions represent management's assessment of the Company's future cash flows given consideration to actual historical data and future trends in the oil and natural gas industry, where applicable, and are based on both internal and external sources.

NOTE 9 – DECOMMISSIONING LIABILITIES

The decommissioning liabilities were estimated based on the net ownership interest of wells and facilities and management's estimates of costs to abandon and reclaim those wells and facilities, and the potential future timing of the costs to be incurred.

	Period ended December 31,	
	2013	2012
Balance, beginning of period	\$ 1,014	\$ -
Acquisition of Brazil assets (Note 5)	-	1,000
Liabilities incurred	59	-
Revisions to obligations	2,004	-
Accretion	79	-
Foreign currency translation	(323)	14
Balance, end of period	\$ 2,833	\$ 1,014

Total undiscounted cash flows, escalated at 6.0% for inflation, required to settle the Company's decommissioning provision are estimated to be \$4.9 million (2012 - \$1.2 million) and have been discounted using an average risk free rate of 3.38% (2012 - 1.78%), which represents an estimated U.S. Treasury bill rate for a period of 15 years, the average remaining years to abandonment.

NOTE 10 – SHARE CAPITAL

a) Authorized

Alvopetro has an unlimited number of common shares authorized for issuance. The Company is also authorized to issue preferred shares in one or more series.

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*All tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted***b) Issued and Outstanding Common Shares**

	Number of Shares	Amount (\$000s)
Balance as at December 31, 2012	-	\$ -
Issued pursuant to the Arrangement	85,166,871	151,937
Balance as at December 31, 2013	85,166,871	\$ 151,937

c) Options to Purchase Common Shares

Alvopetro has established a stock option plan whereby the Company may grant stock options to its directors, officers, employees and consultants. The plan allows for the issuance of up to ten percent of the outstanding common shares of the Company. The exercise price of each option is not less than the volume weighted five-day average price of the Company's common shares on the TSX Venture Exchange prior to the date of grant. Stock option terms are determined by the Company's Board of Directors but typically, options granted vest over a period of three years from the date of grant and expire five years from the date of grant. The initial and only grant thus far under this plan was 2,995,436 stock options on December 16, 2013.

Exercise Price	Options Outstanding	Remaining Contractual Life (years)	Options Exercisable	Remaining Contractual Life (years)
CAD\$1.02	2,995,436	4.96	-	-

d) Share-Based Compensation

Share-based compensation for the periods preceding the Arrangement on November 28, 2013 represent an allocated portion of Petrominerales' share-based compensation expense based on time charged to the Brazil Properties by Petrominerales employees. Of the total share-based compensation expense recognized for the year ended December 31, 2013, approximately \$414,000 (2012 - \$22,000) relates to an allocation of Petrominerales' share-based compensation.

The fair value of the stock options granted under the Alvopetro stock option plan on December 16, 2013 has been estimated on the grant date using the Black-Scholes option pricing model. Weighted average assumptions and resultant fair values for stock options granted are as follows:

	Period ended December 31,	
	2013	2012
Risk free interest rate (%)	1.51	-
Expected term (years)	4.00	-
Expected volatility (%)	50	-
Dividend per share (%)	-	-
Forfeiture rate (%)	5	-
Weighted average fair value (CAD\$)	0.46	-

Total share-based compensation of \$74,000 was computed for the period ended December 31, 2013 relating to the December 16, 2013 Alvopetro stock option grant. Of this amount, approximately \$12,000 was capitalized to exploration and evaluation assets and property, plant and equipment, with the remainder recognized as share-based compensation expense on the consolidated statements of operations and comprehensive income (loss). An additional \$1.2 million will be amortized over the expected term of the options.

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Net loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the applicable period. The following table provides the number of shares used in the basic and diluted per share computations:

	Period ended December 31,	
	2013	2012
Weighted average common shares outstanding, basic and diluted	85,166,871	85,166,871

In determination of the weighted average number of diluted common shares outstanding for the year ended December 31, 2013, all stock options were excluded because the effect would be anti-dilutive. As there were no shares outstanding for AlvoPetro at December 31, 2012, the per share amounts for the period ended December 31, 2012 are based on the number of shares issued pursuant to the Arrangement. In addition, the determination of the weighted average number of basic and diluted common shares outstanding begins on November 28, 2013 with the closing of the Arrangement and the corresponding issuance of the existing share capital of the Company.

NOTE 11 – TAXES

Income tax expense is comprised of the following amounts relating to current tax expense and deferred tax expense:

	Period ended December 31,	
	2013	2012
Current income tax expense	\$ 31	\$ -
Deferred income tax expense	2,100	-
Income tax expense	\$ 2,131	\$ -

For the 2012 and 2013 taxation year, AlvoPetro elected to compute Brazil corporate income tax under the presumed profit regime and the current income tax expense reflected above is the estimated current income tax for the year ended December 31, 2013 under this system. Although the Company is in an overall loss position, the presumed profit regime is anticipated to provide lower indirect and other tax costs to the Company compared to the actual profit system and therefore higher overall tax savings within Brazil. Under the presumed profit system, profit is computed by applying certain predetermined percentages to gross revenues, resulting in an inherent tax rate of approximately two percent on Brazilian gross revenues. The election to compute taxes under the presumed profit regime is made annually and is available where total revenues from the immediately preceding year were less than BRL 48.0 million (increasing to BRL 72.0 million in 2014). Losses realized for tax purposes within Brazil while under the presumed profit regime do not carry-forward.

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Income tax expense differs from the amount that would have been expected by applying the statutory income tax rate to loss before taxes. The principal reasons for this difference are as follows:

	Period ended December 31,	
	2013	2012
Loss before taxes	\$ (6,540)	\$ (282)
Statutory income tax rate	34%	34%
Expected income tax recovery	(2,224)	(96)
Increase (decrease) resulting from:		
Presumed profit income tax	31	-
Accounting transfers to E&E for which no additional tax basis has been recognized	2,040	-
Unrecognized deferred tax asset	561	108
Tax losses in Brazil not available for carry-forward under the presumed regime	238	-
Foreign currency effects	385	-
Share-based compensation	162	7
Other	938	(19)
Income tax expense	\$ 2,131	\$ -
Consisting of:		
Current income tax expense	31	-
Deferred tax expense	2,100	-
Total tax expense	\$ 2,131	\$ -

On the acquisition of AOGI (Note 5), a deferred tax liability of \$1.7 million was recognized as the accounting bases of the assets exceeded the tax bases. In addition, the deferred tax liability increased in 2013 as a result of the transfer of \$6.0 million in deferred acquisition costs to exploration and evaluation assets for which there were no additional tax pools recognized.

The components of the Company's deferred tax assets and liabilities arising from temporary differences and loss carry-forwards as well as the associated amount of deferred tax recovery or expense recognized in the Company's consolidated statements of operations and comprehensive income (loss) are outlined below. Under the presumed profit regime in Brazil, as income tax is computed based on gross revenues, there is no benefit to tax pool deductions during the period in which the Company has elected to compute tax under the presumed profit regime. However, these amounts are accumulated for Brazil tax purposes in the same manner they would be under the actual profit regime (including theoretical depletion, depreciation, and other such claims) and when a company later transitions to the actual profit regime, these tax pools may be utilized on a go-forward basis (other than any losses realized during the period in which the entity was under the presumed profit regime which will not be deductible in the future).

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	Opening Deferred Tax Liability	Recognized in profit or loss	Closing Deferred Tax Liability
For the period ended December 31, 2012			
Exploration and evaluation assets	\$ 8,061	\$ 41	\$ 8,102
Property, plant and equipment	(1,220)	(46)	(1,266)
Decommissioning liabilities	(340)	(5)	(345)
Other Brazil tax pools	(4,810)	(64)	(4,874)
Tax loss carry-forwards	-	(34)	(34)
Unrecognized deferred tax asset	-	108	108
Net deferred tax liability	\$ 1,691	\$ -	\$ 1,691
For the period ended December 31, 2013			
Exploration and evaluation assets	8,102	(1,984)	6,118
Property, plant and equipment	(1,266)	3,935	2,669
Decommissioning liabilities	(345)	(618)	(963)
Other Brazil tax pools	(4,874)	958	(3,916)
Tax loss carry-forwards	(34)	(752)	(786)
Unrecognized deferred tax asset	108	561	669
Net deferred tax liability	\$ 1,691	\$ 2,100	\$ 3,791

As at December 31, 2013, the Company has tax losses in Canada of approximately \$3.1 million for which no deferred tax asset has been recognized.

NOTE 12 – CAPITAL MANAGEMENT

The Company's capital consists of the following:

	As at December 31,	
	2013	2012
Working capital	\$ 98,507	\$ 1,086
Share capital	151,937	-

Alvopetro's primary objective for managing its capital structure is to maintain financial capacity for the purpose of sustaining future exploration and development activities and maintaining investor and market confidence.

The Company considers its capital structure to include share capital and working capital. The Company currently has sufficient cash on hand to carry out its planned activities; however, management is continually monitoring changes in economic conditions and the risk characteristics of the underlying petroleum and natural gas industry. In the event that adjustments to the capital structure are necessary, the Company may consider issuing additional equity, raising debt or revising its capital investment programs.

The Company has not paid or declared any dividends since the date of incorporation.

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NOTE 13 – FINANCIAL INSTRUMENTS

Overview

The Company's financial instruments consist of cash and cash equivalents, trade and other receivables and accounts payable and accrued liabilities on the consolidated statement of financial position. The nature of Alvo Petro's operations exposes the Company to credit risk, foreign currency risk, liquidity risk, and market risk. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and to monitor market conditions and the Company's activities. The Board of Directors has overall responsibility for establishment and oversight of the Company's risk management.

Credit Risk

Credit risk is the risk of financial loss to the Company if counterparties do not fulfill their contractual obligations. The Company has credit risk on cash and cash equivalents and trade and other receivables.

Crude oil production is sold to two counterparties, one of which represents greater than 90 percent of the Company's total oil sales revenue for the period. Typically, the Company's maximum credit exposure to this and other oil sales customers is one month's sales revenue. Alvo Petro does not anticipate non-performance from this counterparty and has assessed the risk of non-collection of oil sales as minimal.

The carrying amount of accounts receivable and cash and cash equivalents represents the maximum credit exposure. The Company did not write-off any receivables during the periods ended December 31, 2013 or 2012 and as at December 31, 2013 there were no significant amounts past due or impaired.

Cash and cash equivalents consist of cash balances.

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. All of the Company's oil sales are denominated in Brazilian reais based on a U.S. dollar oil price and all operational and capital activities related to the Brazil properties are transacted primarily in Brazilian reais. In Canada, cash balances are held in both U.S. and Canadian dollars and expenditures are transacted in both currencies.

The Company attempts to mitigate its exposure to exchange fluctuations by monitoring exchange rates and planning capital activities and transfers of funds to Brazil such that the amount of Reais held in Brazil is moderately in excess of estimated capital and operational requirements.

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As at December 31, 2013 and 2012, the following financial instruments were denominated in currencies other than the U.S. dollar:

	Period Ended December 31			
	2013		2012	
	CAD (000's)	BRL (000's)	CAD (000's)	BRL (000's)
Cash and cash equivalents	90,727	2,075	-	265
Trade and other receivables	7	785	-	295
Accounts payable and accrued liabilities	(31)	(3,264)	-	(384)
Net exposure in foreign currency	90,703	(404)	-	176
Net exposure in USD (\$000s)	85,280	(173)	-	86

In 2014, the Company converted approximately CAD\$71.3 million of the Canadian dollars held at December 31, 2013 to U.S. dollars of \$65.0 million.

The Company had no forward exchange rate contracts in place as at or during the periods ended December 31, 2013 and 2012.

Commodity Price Risk

Changes in commodity prices have an impact on the results of the Company's operations and cash generated from operating activities and can affect the Company's ability to raise capital. Crude oil prices are impacted by world economic and political events that dictate the levels of supply and demand. The Company did not have any forward contracts in place as at or during the periods ended December 31, 2013 and 2012.

Interest Rate Risk

The Company is exposed to interest rate cash flow risk on cash and cash equivalents due to fluctuations in market interest rates applied to cash balances. Cash received by the Company pursuant to the Arrangement earned interest income at an average rate of 1.25 percent per annum for the period ended December 31, 2013.

NOTE 14 – CHANGES IN NON-CASH WORKING CAPITAL

Change in:	Period ended December 31,	
	2013	2012
Trade and other receivables	\$ (198)	\$ 90
Prepaid expenditures	(147)	-
Accounts payable and accrued liabilities	2,063	(127)
	\$ 1,718	\$ (37)
Changes relating to:		
Operating activities	303	(37)
Investing activities	1,415	-
	\$ 1,718	\$ (37)

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*All tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted***NOTE 15 – RELATED PARTY TRANSACTIONS**

Alvopetro is party to non-material office-related administrative transactions with Petrobank Energy and Resources Ltd., a related party of the Company during 2013 due to common directors. These transactions include administrative consulting fees and office sub-lease expenses charged to Alvopetro, summarized as follows:

	Period Ended December 31,	
	2013	2012
Office rent and related costs	\$ 39	\$ -
Administrative consulting fees	\$ 2	\$ -

As at December 31, 2013, the Company owed Petrobank \$2,000 (2012 - \$nil).

Key management personnel are comprised of Alvopetro's directors and officers, compensation for these individuals is set forth as follows:

	Period ended December 31,	
	2013	2012
Short-term benefits ⁽¹⁾⁽²⁾	\$ 77	\$ -
Share-based compensation ⁽²⁾	48	-
Total	\$ 125	\$ -

Notes:

- (1) Represents short-term benefits (salaries and related benefits) for Alvopetro directors and officers appointed as a result of the Arrangement. No amounts have been included for compensation for directors and officers of Alvopetro prior to November 28, 2013, as Alvopetro had not yet been formed.
- (2) Before any capitalization of any directly attributable compensation to E&E or PP&E.

NOTE 16 – COMMITMENTS AND CONTINGENCIES

The following is a summary of contractual commitments as at December 31, 2013:

Commitments	< 1 Year	1-3 Years	Thereafter	Total
Minimum work commitments ⁽¹⁾	\$ 9,094	\$ 9,376	\$ 6,025	\$ 24,495
Office leases ⁽²⁾	234	215	-	449
Total commitments	\$ 9,328	\$ 9,591	\$ 6,025	\$ 24,944

Notes:

- (1) Under the terms of the ANP concession contracts for each of our exploration blocks, the Company has work commitments which must be completed prior to the applicable phase expiry date. The work commitments are normal course commitments for companies operating in Brazil and typically include, among other things, acquisition and processing of seismic data and drilling wells. Work commitments noted above include amounts for all of Alvopetro's blocks, including the four blocks awarded in Brazil's 12th Bid Round for which concession contracts are expected to be signed in May, 2014, and two blocks acquired in 2013 pursuant to farm-in agreements. Alvopetro has applied to the ANP for an extension to the phase expiry deadline for seven of its blocks that are expiring in 2014. While we expect such extension to be granted, the Company cannot guarantee that the ANP will grant the requested extension. To the extent the extension is not granted on one or more of the requested blocks, the associated concession contract(s) may be revoked and Alvopetro may be required to pay to the ANP an amount representing the value pursuant to the contract of the unfulfilled portion of the related work commitments (up to a maximum of \$9.1 million for the Company's 9th Brazil Bid Round blocks for which the extension has been requested).
- (2) The Company is committed to future minimum payments for office space in Canada and Brazil.

ALVOPETRO ENERGY LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

As at December 31, 2013 and December 31, 2012, and periods ended December 31, 2013 and 2012

All tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted

The National Agency of Petroleum, Natural Gas and Biofuels, an agency of the Brazil government (the “ANP”) requires all operators in Brazil to provide financial guarantees for all work commitments. The Company is required to provide a financial guarantee to the ANP with respect to our above-noted work commitments, as the applicable concession contracts are executed. As at December 31, 2013, the financial guarantees were satisfied by guarantee insurance provided to the Company’s Brazilian subsidiary through certain insurance companies in Brazil. After December 31, 2013, the guarantee insurance was replaced (see Note 17).

Alvopetro’s activities in Brazil are subject to minimum local content requirements with respect to materials and supplies utilized. The specific local content requirements for the exploration phase were determined during the bidding process for each particular block and are assessed at the phase expiry date. Management undertakes considerable effort to adhere to these requirements; however, there may be circumstances when it is not advantageous or reasonably possible for the Company to do so. If the Company does not meet the local content requirements for a particular phase as specified according to the respective concession contract, a fine, which varies by concession depending on exploration phase and type of cost, will be incurred. The Company is continually monitoring its local content compliance and actual or potential fines and, as of December 31, 2013, the potential estimated fine is not material.

NOTE 17 – SUBSEQUENT EVENT

Subsequent to December 31, 2013, the Company entered into a credit support facility (the “Facility”) with a Canadian bank, for up to CAD\$30.0 million. This Facility allows for the issuance of letters of credit and letters of guarantee in support of the financial guarantees required by the ANP for Alvopetro’s work commitments. These types of financial guarantees for work commitments are required by the ANP for all operators in Brazil. Pursuant to its terms, the issuance of letters of credit and letters of guarantee through our Facility must be cash collateralized by Alvopetro. Cash collateral amounts posted by Alvopetro may at times be in excess of actual committed amounts due to additional amounts required to be deposited for foreign exchange currency risk margins, in accordance with the terms of our Facility.

In 2014, through the Facility, the Company issued irrevocable letters of credit for a total of BRL 51.3 million and, accordingly, posted cash collateral of approximately \$26.7 million. The Company earns interest income on these cash deposits at a rate of approximately 0.21 percent per annum based on current terms. The Company’s working capital of approximately \$98.5 million at December 31, 2013 exceeded the required cash collateral amounts of \$26.7 million by \$71.8 million.

Additional letters of credit and letters of guarantee, and any required accompanying cash collateralization, will be issued and posted, as applicable and as required, for any future Blocks acquired by Alvopetro in Brazil.