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, in accordance with 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 as 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
March 21, 2017

Deloitte.

Deloitte LLP
700, 850 2 Street SW
Calgary, AB T2P 0R8
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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, 2016 and 2015, and the consolidated statements of operations and comprehensive loss, consolidated statements of changes in equity and consolidated statements of cash flows for the years 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 audit 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, 2016 and 2015, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

Deloitte LLP

Chartered Professional Accountants
March 21, 2017
Calgary, Alberta

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Thousands of United States dollars)

	Note	**December 31, 2016**	December 31, 2015
ASSETS			
Current			
Cash and cash equivalents		**17,788**	28,733
Restricted cash	5	**108**	2,288
Trade and other receivables		**431**	247
Prepaid expenditures		**196**	280
Assets held for sale	6	**410**	-
Total current assets		**18,933**	31,548
Other assets		**-**	34
Exploration and evaluation assets	6	**53,259**	48,409
Property, plant and equipment	7	**4,860**	4,293
Non-current assets		**58,119**	52,736
Total assets		**77,052**	84,284
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Accounts payable and accrued liabilities		**1,878**	2,143
Current portion of decommissioning liabilities	8	**78**	13
Total current liabilities		**1,956**	2,156
Deferred tax liability	10	**-**	330
Decommissioning liabilities	8	**1,321**	1,066
Non-current liabilities		**3,277**	3,552
Shareholders' equity			
Share capital	9	**151,937**	151,937
Contributed surplus		**1,558**	1,444
Deficit		**(60,390)**	(47,812)
Accumulated other comprehensive loss		**(19,330)**	(24,837)
Total shareholders' equity		**73,775**	80,732
Total liabilities and shareholders' equity		**77,052**	84,284

Commitments and contingencies (Note 16)

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

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

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

	Note	Year ended December 31, 2016	2015
Revenue			
Oil sales		**561**	535
Royalties and production taxes		**(59)**	(38)
Oil revenue		**502**	497
Other income		**109**	92
Total revenue and other income		**611**	589
Expenses			
Production	14	**1,153**	872
Transportation		**33**	37
General and administrative	14	**3,523**	4,561
Depletion and depreciation	7	**416**	429
Impairment	6,7	**7,823**	13,038
Accretion of decommissioning liabilities	8	**28**	72
Exploration and evaluation expense		**434**	8
Share-based compensation	9	**80**	367
Foreign exchange		**(12)**	124
Loss (gain) on asset disposition	7	**41**	(360)
Total expenses		**13,519**	19,148
Loss before taxes		**(12,908)**	(18,559)
Income tax recovery	10	**(330)**	(6,135)
Net loss		**(12,578)**	(12,424)
Exchange gain (loss) on translation of foreign operations		**5,507**	(15,138)
Comprehensive loss		**(7,071)**	(27,562)
Net loss per share	9		
Basic		**(0.15)**	(0.15)
Diluted		**(0.15)**	(0.15)

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

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
(Thousands of United States dollars)

		Year Ended December 31,	
	Note	**2016**	2015
Common shares			
Balance, beginning of year		**151,937**	151,937
Net change		**-**	-
Balance, end of year	9	**151,937**	151,937
Contributed surplus			
Balance, beginning of year		**1,444**	975
Share-based compensation expense	9	**80**	367
Share-based compensation capitalized	9	**34**	102
Balance, end of year		**1,558**	1,444
Deficit			
Balance, beginning of year		**(47,812)**	(35,388)
Net loss		**(12,578)**	(12,424)
Balance, end of year		**(60,390)**	(47,812)
Accumulated other comprehensive loss			
Balance, beginning of year		**(24,837)**	(9,699)
Other comprehensive income (loss)		**5,507**	(15,138)
Balance, end of year		**(19,330)**	(24,837)

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

ALVOPETRO ENERGY LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Thousands of United States dollars)

		Year ended December 31, 2016	2015
Operating Activities			
Net loss		**(12,578)**	(12,424)
Adjustments for non-cash items:			
Depletion and depreciation	7	**416**	429
Impairment	6,7	**7,823**	13,038
Accretion of decommissioning liability	8	**28**	72
Share-based compensation	9	**80**	367
Loss (gain) on asset disposition	7	**41**	(360)
Deferred tax	10	**(330)**	(6,135)
Unrealized foreign exchange loss		**-**	47
Settlement of decommissioning liability	8	**(175)**	-
		(4,695)	(4,966)
Changes in non-cash working capital	13	**(1,164)**	(1,267)
		(5,859)	(6,233)
Investing Activities			
Expenditures on exploration and evaluation assets	6	**(7,625)**	(11,221)
Expenditures on property, plant and equipment	7	**(769)**	(886)
Expenditures on other assets		**-**	(95)
Proceeds on dispositions	6,7	**311**	-
Change in restricted cash	5	**2,180**	10,814
Changes in non-cash working capital	13	**614**	(3,657)
		(5,289)	(5,045)
Change in cash and cash equivalents		**(11,148)**	(11,278)
Effect of foreign exchange on cash balances		**203**	(909)
Cash and cash equivalents, beginning of year		**28,733**	40,920
Cash and cash equivalents, end of year		**17,788**	28,733
Cash and cash equivalents consist of:			
Cash		**6,568**	8,722
Cash equivalents		**11,220**	20,011
Supplemental information:			
Cash income taxes paid		**-**	16
Cash interest income received		**96**	68

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

NOTE 1 – REPORTING ENTITY

Alvopetro Energy Ltd. ("Alvopetro" or "the Company") is engaged in the exploration for, and the acquisition, development and production of, hydrocarbons in the Recôncavo, Tucano and Camamu-Almada basins onshore 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.

The Company's head office and records are located at 1700, 525 8th Avenue S.W., Calgary, Alberta, Canada, T2P 0B2.

NOTE 2 – BASIS OF PRESENTATION

Basis of Measurement and 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 March 21, 2017.

The consolidated financial statements are presented in U.S dollars ("USD") which is the parent Company's functional currency.

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, if any, 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. Management makes judgments regarding the application of IFRS for each accounting policy. Estimates relate primarily to unsettled transactions and events as of the date of the consolidated financial statements and actual results could differ materially from estimated amounts. Estimates, assumptions and judgments are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and on a prospective basis. Estimates are subject to measurement uncertainty and changes in such estimates in future years could require a material change in the consolidated financial statements.

Estimates, judgments and assumptions made by management that have the most significant effect on the amounts recognized in the consolidated financial statements are discussed in further detail below.

Exploration and Evaluation Assets

Costs incurred after the legal right to explore an area has been obtained and prior to establishing technical feasibility and commercial viability are capitalized as exploration and evaluation assets. Exploration and evaluation assets are transferred to property, plant and equipment upon establishment of technical feasibility and commercial viability. The determination of technical feasibility and commercial viability and the application of the Company's accounting policy for exploration and evaluation assets requires management judgment. Judgments may change as new information becomes available.

The carrying amount of exploration and evaluation assets (by cash generating unit ("CGU")) are reviewed at the end of each reporting period to determine whether there is an indication of impairment. Determining whether there is an indication of impairment requires significant judgment with respect to forecasted commodity prices, future costs, future production rates, the Company's market capitalization, or other significant changes (technological, market, economic, legal, regulatory) that could have an adverse effect on the Company. The determination of CGU's is also subject to judgment. The estimated recoverable amount of a CGU is subject to considerable judgments and estimates by management, including level of drilling success, forecasted commodity prices, future rates of production, future operating and development costs and the timing of those expenditures, capital constraints, discount rates, and development plans. Changes in these judgments, estimates and assumptions could result in a material change in the carrying value of exploration and evaluation assets and future earnings may be impacted.

Property, Plant and Equipment Assets

Oil and natural gas assets classified as property, plant and equipment are accumulated on an area-by-area (component) basis. Costs accumulated within each component are depleted using the unit-of-production method based on proved plus probable reserves. Included in the depletion base are estimated future costs to be incurred in developing proved and probable reserves. The estimation of reserves is an inherently complex process and involves the exercise of professional judgment. Estimates are based on projected future rates of production, estimated commodity prices, engineering data and the timing of future expenditures, all of which are subject to uncertainty. Changes in reserve estimates can have an impact on reported net earnings through revisions to depletion expense, in addition to determining possible impairments and reversal of impairments of property, plant and equipment.

Decommissioning Liabilities

In estimating future decommissioning liabilities various assumptions are required with respect to the amount and timing of abandonment and reclamation costs, inflation factors, interest rates and potential changes in the legal, regulatory, environmental and political environments. Future revisions to these assumptions may result in a material change to the decommissioning liability. 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.

Foreign Exchange

The designation of the Company's functional currencies is a judgment made by management based on the currency of the primary economic environment in which the Company operates. The functional currency of the Brazilian subsidiaries is the Brazilian Real ("BRL"). Despite the fact that the benchmark price for oil is set in USD, due to the business environment, policies and regulations in Brazil, management is of the opinion that the primary economic environment that mainly influences the Company's labour, material and other costs as well as actual cash receipts on oil sales is Brazil.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES

Consolidation

These consolidated financial statements include the accounts of Alvopetro and its controlled subsidiaries. An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Intercompany transactions and balances are eliminated on consolidation. As at December 31, 2016 and 2015, the Company controls 100 percent of its subsidiaries.

Joint Operations

The Company has oil and gas exploration activities that are conducted jointly with others and are considered joint operations. These consolidated financial statements reflect the Company's proportionate share of the assets, liabilities, expenses and cash flows from such activities.

A joint arrangement is either a joint operation, whereby the parties have rights to the assets and obligations for the liabilities, or a joint venture, whereby the parties have rights to the net assets. Classification of such requires management judgment with respect to the structure of the arrangement as well as rights to the assets and obligations of the liabilities.

Cash and Cash Equivalents

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

Restricted Cash

Restricted cash consists of cash, cash equivalents, and short-term cash deposits (deposits with an initial maturity of one year or less) held as collateral to ensure the Company's fulfillment of work commitments and other obligations pursuant to concession contracts and credit agreements. Restricted cash is stated at cost, which approximates fair value. Restricted cash held as collateral for letters of credit expiring in less than one year is classified as current, with the remainder classified as non-current.

Assets Held for Sale

Assets are classified as held for sale if the carrying amount will be recovered principally through a sale transaction rather than through continued use. The sale of these assets must be considered highly probable. In accordance with IFRS, a sale is considered highly probable if the assets are available for immediate sale, and management has stated their intention to sell the properties within one year. Assets classified as held for sale are measured at the lower of the carrying amount and the fair value less costs to sell, and are not depreciated.

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. Additionally, any costs incurred in advance of obtaining the lease or concession are also expensed.

Costs incurred prior to establishing commercial viability and technical feasibility, such as land and license acquisition, technical services and studies, 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. E&E assets include equipment inventory for use on future exploration wells.

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, the unrecoverable costs are charged to the consolidated statements of operations and comprehensive loss as impairment expense. Any related costs incurred subsequent to this determination are directly expensed as exploration and evaluation expense.

Property, Plant and Equipment ("PP&E")

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

Oil and natural gas assets include all costs directly associated with the development of oil and natural 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.

Oil and natural gas assets are accumulated on an area-by-area (component) basis. 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 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, leasehold improvements, office furniture and equipment, and operational equipment for use on future exploration and development projects. 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 by CGU. An impairment test is performed whenever events or changes in circumstances indicate that the carrying value of the asset or CGU may not be recoverable. The recoverable amount is the higher of the fair value less costs of disposal 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 costs.

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 when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount. Where the carrying amount exceeds the estimated recoverable amount, the unrecoverable costs are charged to the consolidated statements of operations and comprehensive 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 all wells and facilities as required under the terms of concession contracts and laws and regulations within Brazil. The estimate is evaluated on a quarterly 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 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, when the amounts of revenue and the costs incurred or to be incurred can be measured reliably, 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, based on management's judgment and assumptions, 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. Forfeitures are estimated at the grant date and adjusted as actual forfeitures occur, until the options are fully vested. 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 Company capitalizes the portion of share-based compensation directly attributable to its exploration and development activities, with a corresponding decrease to share-based compensation expense.

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.

Current tax expense is based on estimated taxable income and tax rates which are determined pursuant to tax law enacted or substantively enacted at the reporting date.

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.

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.

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. 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 and the timing, likelihood and reversal of temporary differences between the accounting and tax bases of assets and liabilities as well the expected recoverability of deferred tax assets. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. If these judgments and estimates prove to be inaccurate, the actual income tax liability may differ significantly from that estimated and recorded by management and future earnings may be impacted.

Per Share Amounts

The Company computes basic earnings or loss per share using net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings 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 BRL for all Brazil entities and the USD 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, Alvopetro has chosen to present its consolidated financial statements in USD.

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 all Brazil entities are translated to USD at exchange rates at the reporting date. The income and expenses of foreign operations are translated to USD at exchange rates at the date of the transactions. Resultant foreign currency differences are recognized in other comprehensive income.

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: fair value through profit or loss; held-to-maturity investments; loans and receivables; available for sale financial assets; and other financial liabilities.

Financial instruments carried at fair value through profit or loss on the consolidated statements of financial position include cash and cash equivalents and restricted cash. Realized and unrealized gains and losses on financial assets and liabilities carried at fair value through profit or loss are recognized in the consolidated statements of operations and comprehensive loss in the periods such gains and losses arise. Transaction costs related to these financial assets and liabilities are included in the consolidated statements of operations and comprehensive loss when incurred.

Financial instruments classified as other loans, receivable and financial liabilities include trade and other receivables and accounts payable and accrued liabilities. These instruments are carried at amortized cost and transaction costs incurred for these types of financial instruments 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 loss. Gains and losses on financial assets and liabilities carried at amortized cost are recognized in the consolidated statements of operations and comprehensive loss when these assets or liabilities settle.

Contingent liabilities

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 consolidated financial statements unless the possibility of an outflow of economic resources is considered remote. Contingent liabilities are recognized in the period when the circumstance becomes probable that a future cash outflow resulting from past operations or events will occur and the amount of the cash outflow can be reasonably estimated. The evaluation of the likelihood of the contingent events requires management judgment as to the probability of exposure to potential loss. The timing of recognition and measurement of the provision requires the application of judgment to existing facts and circumstances, which can be subject to change. The Company is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations, and determine that the loss can be reasonably estimated.

Segmented Operations

All oil sales revenue is derived from Brazilian operations. All exploration and evaluation assets and all material property, plant and equipment are located in Brazil. The majority of the Company's cash and cash equivalents are located in Canada. The Company does not have any significant revenue in Canada other than interest earned on cash and restricted cash balances.

NOTE 4 – CHANGES IN ACCOUNTING STANDARDS

New and Revised Accounting Standards

On January 1, 2016, the Company adopted IFRS 11 Joint Arrangements which was amended regarding the accounting for the acquisition of an interest in a joint operation that constitutes a business. The adoption of this amendment had no impact on the amounts recorded in the consolidated financial statements.

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
IAS 7 *Statement of Cash Flows* - In January 2016, the IASB published amendments to IAS 7 to provide additional disclosures relating to changes in liabilities arising from financing activities, including changes arising from cash flow and non-cash changes.	January 1, 2017	The Company does not expect the amendments to have a material impact on the financial statements.
IFRS 2 *Share-based Payment* – In June 2016, the IASB issued amendments to IFRS 2 to clarify the classification and measurement of share-based payment transactions.	January 1, 2018	The Company is assessing the effect of this future pronouncement on its financial statements.
IFRS 15 *Revenue from Contracts with Customers* – The new standard will replace IAS 18 *Revenue*, IAS 11 *Construction Contracts* and other revenue related interpretations. The new standard clarifies the principles for recognizing revenue from contracts with customers and provides a model for the recognition and measurement of sales of certain non-financial assets.	January 1, 2018	The Company is assessing the effect of this future pronouncement on its financial statements.
IFRS 9 *Financial Instruments* – As of July 2015, the IASB completed the final elements of IFRS 9 which supersedes IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 introduces new models for classification and measurement of financial instruments, hedge accounting and impairment of financial assets.	January 1, 2018	The Company is assessing the effect of this future pronouncement on its financial statements.
IFRS 16 *Leases* – IFRS 16 was issued in January 2016 and replaces IAS 17 *Leases*. The standard introduces a single lessee accounting model for leases with required recognition of assets and liabilities for most leases.	January 1, 2019	The Company is assessing the effect of this future pronouncement on its financial statements.

NOTE 5 – RESTRICTED CASH AND CREDIT FACILITY

	As at	
	December 31, 2016	December 31, 2015
Restricted cash – current	**108**	2,288
Restricted cash – non-current	**-**	-
Restricted cash - total	**108**	2,288

The Company has a credit support facility (the "Facility") with a Canadian bank for up to $45.0 million Canadian dollars ("CAD"). This Facility allows for the issuance of letters of credit ("LC's") and letters of guarantee in support of the financial guarantees required by the National Agency of Petroleum, Natural Gas and Biofuels (the "ANP") for Alvopetro's work commitments under the terms of its concession contracts as discussed further in Note 16. Letters of credit and letters of guarantee issued under the Facility must be supported by either cash collateral posted by Alvopetro or through an Account Performance Security Guarantee from Export Development Canada ("EDC"). EDC supports up to $15.5 million of Alvopetro's LC's issued under the Facility.

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

As at December 31, 2016, the total amount of LC's issued under the Facility was $14.1 million (December 31, 2015 - $17.6 million), the full balance of which was satisfied by EDC (December 31, 2015 - $15.3 million). All LC's under the Facility supported by restricted cash as at December 31, 2015 were released during the first quarter of 2016. The current restricted cash as at December 31, 2016 relates to abandonment guarantees posted in Brazil during the three months ended September 30, 2016 for the Bom Lugar and Jiribatuba fields. These guarantees are posted locally in Brazil and are not covered by the Facility or by EDC.

NOTE 6 – EXPLORATION AND EVALUATION ASSETS

	Year ended December 31,	
	2016	2015
Balance, beginning of year	**48,409**	62,204
Capital expenditures	**7,625**	11,221
Capitalized share-based compensation	**27**	95
Transfer from other assets	**-**	272
Change in decommissioning liabilities	**164**	104
Transfer to PP&E (Note 7) and operations	**(185)**	-
Transfer to assets held for sale	**(410)**	-
Farmout	**(300)**	-
Impairment	**(7,531)**	(11,514)
Foreign currency translation	**5,460**	(13,973)
Balance, end of year	**53,259**	48,409

General and administrative costs totaling $1.0 million (2015 - $1.0 million) that were directly related to exploration and evaluation activities have been capitalized as exploration and evaluation assets.

In 2016, the Company entered into a farmout agreement whereby an independent third party ("the Farmee") acquired a 95% participating interest in Block 107 subject to drilling two wells in satisfaction of work commitments on the block. Under the terms of the agreement, Alvopetro received an upfront cash payment of $0.3 million, and, upon completion of the work commitments and approval by the ANP, Alvopetro will be entitled to exchange its 5% participating interest for a 5% gross-overriding royalty ("GORR") on the block. Subject to a drilling success on Block 107, Alvopetro will also be entitled to a 5% GORR on an adjacent exploration block held by the Farmee. In addition to completion of the work commitments, the closing of the farmout is conditional on ANP approval of the transfer and the timely receipt of environmental permits for the commitment wells to be drilled by the Farmee. The latter two of these conditions were satisfied subsequent to December 31, 2016.

Impairment

The Company recorded total impairment charges of $7.5 million to E&E in the year-ended December 31, 2016. Of this amount, $3.0 million related to Block 170, $4.4 million related to Block 256, and $0.1 million related to equipment inventory.

Block 170

With respect to Block 170, the impairment related to costs incurred in the three months ended March 31, 2016 on drilling the 170(B1) well. No commercial quantities of oil or gas were discovered in the well and, on March 29, 2016, the Company notified the ANP of its intention to relinquish this block. All costs incurred up to December 31, 2015 had been impaired in the 2015 financial statements and the 2016 impairment charge of $3.0 million reduced the carrying value of the block to $nil (December 31, 2015 - $nil). Any costs incurred on this block subsequent to March 31, 2016 have been recorded in exploration and evaluation expenditures and included in the consolidated statements of operations and comprehensive loss.

Block 256

During the three months ended September 30, 2016, the 256(A1) well was drilled on Block 256. As no commercial quantities of hydrocarbons were discovered, the well was abandoned. As the company expects to relinquish this block, all costs incurred to date were impaired to bring the carrying value of the block to $nil. Any costs incurred on this block subsequent to September 30, 2016 have been recorded in exploration and evaluation expenditures and included in the consolidated statements of operations and comprehensive loss.

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Equipment inventory

The Company holds equipment inventory for use on future exploration wells and, accordingly, the carrying value of the equipment inventory is included in E&E. As a result of future anticipated sales, $0.5 million of equipment inventory was written down to the estimated recoverable amount of $0.4 million and transferred to assets held for sale in 2016, resulting in an impairment charge of $0.1 million for the year ended December 31, 2016.

2015 Impairments

During the year ended December 31, 2015, the Company recorded E&E impairments totaling $11.5 million. Of this amount, $4.1 million related to costs incurred to December 31, 2015 on Block 170 to bring the carrying value to $nil as at December 31, 2015 as a result of the lack of discovery on the 170(B1) well in early 2016. There was also a $7.2 million impairment recognized in 2015 on Block 182, $6.8 million of which related to costs incurred to date on the 182(B1) well prior to the reclassification to PP&E in 2015 upon the establishment of probable reserves volumes. An additional $0.4 million was recognized on Block 182 relating to costs attributable to a well drilled in 2012. Other impairment charges in 2015 related primarily to inventory write-offs for obsolete and/or damaged materials.

NOTE 7 – PROPERTY, PLANT AND EQUIPMENT

	Year ended December 31,	
	2016	2015
Cost, beginning of year	**8,120**	10,717
Capital expenditures	**769**	886
Transferred from E&E (Note 6)	**114**	-
Transferred from other assets	**-**	6
Asset dispositions	**(68)**	(576)
Capitalized share-based compensation	**7**	7
Change in decommissioning liabilities	**73**	(1,043)
Foreign currency translation	**584**	(1,877)
Cost, end of year	**9,599**	8,120
Accumulated depletion, depreciation and impairment, beginning of year	**(3,827)**	(3,228)
Depletion and depreciation for the year	**(416)**	(429)
Asset dispositions	**16**	576
Impairment	**(292)**	(1,524)
Foreign currency translation	**(220)**	778
Accumulated depletion, depreciation and impairment, end of year	**(4,739)**	(3,827)
Net book value, end of year	**4,860**	4,293

General and administrative costs totaling $0.1 million (2015 - $0.1 million) that were directly related to property, plant and equipment activities have been capitalized. During 2016, the Company disposed of under-utilized office assets and furniture. The total amount received for these items was $0.01 million and the carrying value was $0.05 million for a resultant loss on disposition of $0.04 million.

Impairment

The Company recognized total impairment charges of $0.3 million in the year ending December 31, 2016 (2015 - $1.5 million). At the end of each reporting period the Company assesses impairment or impairment reversal indicators related to all of its CGU's.

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As a result of the continued decline in current and forecasted commodity prices, an indication of impairment existed as at December 31, 2016. As a result of capital expenditures on the 182(B1) well in 2016 as well as a decline in the forecasted commodity prices, the carrying value of the 182(B1) well as at December 31, 2016 exceeded the estimated recoverable amount of $0.5 million and an impairment of $0.3 million was recognized to reduce the carrying value to the estimated recoverable amount.

The 2015 impairment of $1.5 million relates to the Bom Lugar field. An estimated recoverable amount of $4.6 million was determined for the Bom Lugar field as at December 31, 2015. The estimated recoverable amount increased to $5.1 million as at December 31, 2016. Despite the increase in the estimated recoverable amount, a reversal of prior impairments was not recognized in the year ending December 31, 2016 as the reversal was not attributable to an increase in undiscounted cash flows, but rather the discounted impact of changes in timing assumptions with respect to future cash flows.

The estimated recoverable amounts for both the 182(B1) well and the Bom Lugar field were determined based on fair value less costs of disposal calculations, which are classified as Level 3 fair value measurements as certain key assumptions are not based on observable market data but rather management's best estimates. Refer to Note 12 for information on fair value hierarchy classifications. In determining the estimated recoverable amount, the Company incorporated the net present value of the future cash flows from proved plus probable oil reserves estimated by the Company's external reserve evaluator as at December 31, 2016, discounted at a rate of 15%. The key assumptions used in determining the recoverable amounts for purposes of the impairment tests were commodity prices, discount rate, reserve volumes, future capital cost estimates, future well locations, timing of future capital investment, and anticipated foreign exchange rates for any costs denominated in BRL. The Company utilized forecasted oil prices from its external reserves evaluator as follows:

	Brent ($/bbl)[1] As at December 31,	
Year	**2016**	2015
2016	**actuals**	45.00
2017	**55.00**	60.00
2018	**65.00**	70.00
2019	**70.00**	80.00
2020	**71.40**	81.20
2021	**72.83**	82.42
Thereafter – escalated at	**2.0%**	1.5%

(1) Actual prices used in the computation of discounted future cash flows were adjusted for quality differentials and negotiated discounts under the 182(B1) oil sales contract.

Future changes to forecasted commodity prices for crude oil could result in additional impairment charges or impairment reversals. The Company determined its estimated recoverable amount using a discount rate of 15%. Increases or decreases to the assumed discount rate could result in additional impairment charges or impairment reversals. The majority of the Company's production expenses and, to a lesser extent, a portion of the Company's future development costs, are denominated in BRL. For purposes of estimating these future costs, any costs denominated in BRL were translated to USD assuming the December 31, 2016 exchange rate. Fluctuations in the BRL relative to the USD may result in additional impairment charges or impairment reversals. The following table depicts the effects of changes in forecasted commodity prices, discount rates, and foreign exchange rates on the estimated recoverable amount of 182(B1) and the Bom Lugar field as at December 31, 2016:

	Increase (Decrease) in Estimated Recoverable Amount					
	Increase in commodity prices of 5%	**Decrease in commodity prices of 5%**	**Increase in discount rate of 2%**	**Decrease in discount rate of 2%**	**Increase in BRL relative to USD of 5%**	**Decrease in BRL relative to USD of 5%**
182(B1)	**76**	**(79)**	**(10)**	**10**	**(55)**	**50**
Bom Lugar	**802**	**(817)**	**(607)**	**703**	**(264)**	**239**

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The estimated recoverable amount of the Jiribatuba CGU was in excess of the carrying amount and no impairment was recorded on the Jiribatuba field in 2015 or 2016. The above fluctuations in discount rates, forecasted commodity prices and foreign exchange rates would not have not have resulted in an impairment on this property as at December 31, 2016.

NOTE 8 – 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.

	Year ended December 31,	
	2016	2015
Balance, beginning of year	**1,079**	3,454
Liabilities incurred	**320**	113
Revisions to obligations	**(83)**	(1,052)
Obligations settled	**(175)**	-
Disposition (Note 7)	**-**	(363)
Accretion	**28**	72
Foreign currency translation	**230**	(1,145)
Balance, end of year	**1,399**	1,079

Total undiscounted cash flows, escalated at 6.5% (2015 - 6.5%) for inflation, required to settle the Company's decommissioning provision are estimated to be $2.1 million (2015 - $1.9 million) and have been discounted using an average risk free rate of 2.5% (2015 – 2.5%), which represents an estimated U.S. Treasury bill rate for a period of 15 years (2015 – 20 years), the approximate weighted-average remaining years to abandonment.

The Company recorded a revision to the decommissioning liability during the year ended December 31, 2016 to, in management's opinion, more accurately reflect the estimated timing of abandonment of a key block. The revision for the year ended December 31, 2015 represented a reduction in the future estimated costs associated with abandonment and reclamation of the Company's existing wells and facilities.

Of the total $1.4 million in decommissioning liabilities as at December 31, 2016, $0.08 million relates to costs expected to be incurred within one year and accordingly, is classified as current at December 31, 2016.

NOTE 9 – 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.

b) Issued and Outstanding Common Shares

	Number of Shares	Amount
Balance as at December 31, 2016 and 2015	**85,166,871**	**$ 151,937**

c) Options to Purchase Common Shares

Alvopetro has 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 five-day volume weighted 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

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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 options outstanding at December 31, 2016 are as follows:

	Number of Options	Weighted Average Exercise Price (CAD$)
Balance as at December 31, 2014	4,567,436	0.82
Granted	2,303,500	0.34
Expired	(10,000)	1.02
Forfeited	(17,500)	0.75
Balance as at December 31, 2015	6,843,436	0.66
Granted	2,461,500	0.24
Expired	(1,141,330)	0.84
Forfeited	(1,289,504)	0.42
Balance as at December 31, 2016	**6,874,102**	**0.53**

	Options Outstanding at December 31, 2016			**Options Exercisable at December 31, 2016**		
Exercise Price	Number of Options	Weighted Average Exercise Price (CAD$)	Weighted Average Remaining Contractual Life (years)	Number of Options	Weighted Average Exercise Price (CAD$)	Weighted Average Remaining Contractual Life (years)
CAD$0.21 - $0.39	3,123,667	0.25	4.5	355,837	0.28	3.9
CAD$0.40 - $0.75	1,632,166	0.42	3.1	1,257,496	0.43	3.1
CAD$1.01 - $1.10	2,118,269	1.02	2.0	2,106,245	1.02	2.0
CAD$0.21 - $1.10	**6,874,102**	**0.53**	**3.4**	**3,719,578**	**0.75**	**2.5**

d) Share-Based Compensation

The fair value of the stock options granted under the Alvopetro stock option plan for the year-ended December 31, 2016 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:

	Year ended December 31,	
	2016	2015
Risk free interest rate (%)	**0.70**	0.68
Expected term (years)	**2.9**	3.4
Expected volatility (%)	**46.7**	50.0
Dividend per share (%)	**-**	-
Forfeiture rate (%)	**5.0**	5.0
Weighted average fair value (CAD)	**0.09**	0.10

Total share-based compensation of $0.1 million was computed for the year ended December 31, 2016 (2015 - $0.5 million) related to the Alvopetro stock option plan. Of this amount, approximately $0.03 million (2015 - $0.1 million) 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 loss.

e) Net Loss Per Share

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:

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

	Year ended December 31,	
	2016	2015
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 years ended December 31, 2016 and 2015, all stock options were excluded because the effect would be anti-dilutive.

NOTE 10 – TAXES

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

	Year ended December 31,	
	2016	2015
Current income tax expense	**-**	-
Deferred income tax expense (recovery):		
Origination of temporary differences in the current year	**(300)**	(1,825)
Change in estimated tax pools	**(30)**	(4,310)
Deferred income tax recovery	**(330)**	(6,135)
Income tax recovery	**(330)**	(6,135)

Alvopetro computes Brazil corporate income tax under the actual profit regime. Under this regime corporate tax on taxable income is 34% and tax losses may be carried forward indefinitely; however, any utilization of losses in a subsequent taxation year is limited to 30% of the taxable income in that period.

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:

	Year ended December 31,	
	2016	2015
Loss before taxes	**(12,908)**	(18,559)
Statutory income tax rate	**34%**	34%
Expected income tax recovery	**(4,389)**	(6,310)
Increase (decrease) resulting from:		
Change in unrecognized deferred tax asset	**5,784**	3,674
Change in estimated tax pools	**(30)**	(4,310)
Permanent difference on impairment and E&E expense	**394**	-
Share-based compensation	**39**	160
Permanent difference on gain on asset disposition	**-**	31
Impact of foreign exchange gains and losses	**(1,332)**	1,254
Other	**(796)**	(634)
Income tax recovery	**(330)**	(6,135)

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 loss are outlined below.

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

Deferred tax liability (asset)	PP&E and E&E assets	Decommissioning liabilities	Tax loss carryforwards	Other Brazil tax pools	Unrealized taxable foreign exchange gains	Unrecognized deferred tax asset	Total
At December 31, 2014	10,037	(1,175)	(2,968)	(3,454)	-	1,807	4,247
Deferred tax (recovery) expense	(7,938)	515	(3,330)	-	944	3,674	(6,135)
Foreign currency translation	798	290	1,215	1,104	-	(1,189)	2,218
As at December 31, 2015	2,897	(370)	(5,083)	(2,350)	944	4,292	330
Deferred tax expense (recovery)	(591)	(107)	(4,440)	(465)	(511)	5,784	(330)
As at December 31, 2016	**2,306**	**(477)**	**(9,523)**	**(2,815)**	**433**	**10,076**	**-**

A deferred tax asset of $10.1 million exists at December 31, 2016 (December 31, 2015 - $4.3 million), the full balance of which has not been recognized. Of the full balance of the unrecognized deferred tax asset, $9.6 million relates to Brazil (December 31, 2015 - $4.3 million) and $0.5 million relates to Canada (December 31, 2015 - $nil). Total tax loss carryforwards include $25.1 million attributable to Brazil, which carryforward indefinitely but are limited to annual utilization of up to 30% of taxable income in subsequent periods, and $3.6 million attributable to Canada which expire between 2032 and 2036.

NOTE 11 – CAPITAL MANAGEMENT

The Company's capital consists of the following:

	As at December 31,	
	2016	2015
Working capital	**17,055**	29,405
Shareholders' equity	**73,775**	80,732

Alvopetro manages its capital to support the Company's strategic growth objectives and maintain financial capacity and flexibility for the purpose of funding the Company's exploration and development activities.

The Company considers its capital structure to include working capital (including current restricted cash and assets held for sale) and shareholders' equity. At December 31, 2016, the Company's net working capital surplus was $17.1 million (December 31, 2015 - $29.4 million), which includes $17.8 million (December 31, 2015 - $28.7 million) of cash, $0.1 million (December 31, 2015 - $2.3 million) of current restricted cash, and assets held for sale of $0.4 million (December 31, 2015 - $nil).

During the three months ended September 30, 2016, the Company posted $0.1 million of restricted cash for abandonment guarantees related to the Bom Lugar and Jiribatuba fields. The Company does not have any other restricted cash balances at December 31, 2016 as the $2.3 million restricted cash at December 31, 2015 was released on March 31, 2016.

The Company has performance security guarantees with EDC which support up to $15.5 million of LC's provided in respect of work commitments in Brazil. As at December 31, 2016, a total of $14.1 million of LC's were satisfied by EDC (December 31, 2015 - $15.3 million) and the Company had $1.4 million in available capacity for new LC's (December 31, 2015 - $0.2 million). Additional capacity may become available as work commitments are met and the related LC's are released. LC's supported by EDC at December 31, 2016 include $0.4 million with respect to Block 256, $3.1 million with respect to Block 107, and $1.5 million with respect to Block 198. The work commitment for Block 256 was satisfied with the 256(A1) well, which was drilled in the three months ended September 30, 2016, subject to ANP approval. The work commitments associated with Block 107 were farmed out to a third party in three months ended September 30, 2016 and, the work commitment with respect to Block 198 was satisfied with the 198(A1) well which was drilled subsequent to December 31, 2016.

Alvopetro has the ability to adjust its capital structure by issuing new equity or debt and making adjustments to its capital expenditure program, other than with respect to work commitments. The Company considers its capital structure at this time to include shareholders' equity which, at December 31, 2016 was $73.8 million (December 31, 2015 - $80.7 million). 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.

NOTE 12 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

Overview

The Company's financial instruments consist of cash and cash equivalents, restricted cash, trade and other receivables and accounts payable and accrued liabilities. The nature of Alvopetro's operations exposes the Company to credit 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, restricted cash, and trade and other receivables.

At December 31, 2016, accounts receivable consisted of $0.2 million from crude oil customers with the remainder related to other trade and Brazil tax credit receivables. Crude oil production is sold to two counterparties, one of which represented 65 percent of the Company's oil sales revenues in 2016 compared to 33 percent in 2015. Alvopetro routinely assesses the recoverability of the accounts receivable from its crude oil customers and the risk of non-collection from these counterparties is not expected to have a significant impact on the financial statements.

The Company closely monitors other trade receivables, specifically those outstanding for greater than 60 days. When collection does not seem reasonably attainable, an allowance is recorded. The accounts receivable balance at December 31, 2016 includes an allowance of $0.1 million (2015 - $0.1 million), the majority of which relates to GST credits and has been provided for based on correspondence with the Canada Revenue Agency. The carrying amount of accounts receivable represents the maximum credit exposure.

Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations when due, under both normal and unusual conditions without incurring unacceptable losses or jeopardizing the Company's business objectives. The Company manages this risk by preparing annual capital expenditure budgets, operating expense budgets and general and administrative expense budgets, which are monitored and updated as considered necessary. Alvopetro does not currently derive positive cash flow from its operations. Existing capital expenditures and ongoing production and G&A expenses have been funded from the Company's cash balances. Future capital expenditures may require additional funding in excess of current cash and cash equivalent balances and future cash flows from operations. In addition, $14.1 million of the LC's for work commitments are currently supported by EDC. This coverage is reviewed annually. To the extent some or all of the EDC coverage were limited in the future, the Company may be required to support the required amount from its existing cash balance which would limit its ability to fund future capital projects and further increase the need for additional financing. Future spending may be funded from a combination of asset sales, joint ventures, farmouts, debt financing or equity issuances. This may create a liquidity risk in the future to the extent current economic conditions persist and the Company is not able to secure the necessary funding to proceed with its capital and growth plans.

Market Risk

Market risk is the risk that changes in the foreign exchange rates, commodity prices and interest rates will affect the Company's cash flows, net income or loss or comprehensive income or loss. The objective of managing market risk is to maintain and control these risks within acceptable limits while maximizing returns.

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 BRL based on a USD oil price and all operational, administrative and capital activities related to the Brazil properties are transacted primarily in BRL. In Canada the Company has expenditures in both CAD and USD. To minimize foreign currency risk, the Company's cash balances are held primarily in USD within Canada. Management transfers funds to Brazil only as needed to fund immediate capital and operational requirements and typically maintains minimal cash balances in BRL. In Canada, USD funds are converted to CAD periodically on an as-needed basis.

As at December 31, 2016 and 2015, the following financial instruments were denominated in currencies other than the USD:

	Year Ended December 31			
	2016		2015	
	CAD (000's)	**BRL (000's)**	CAD (000's)	BRL (000's)
Cash and cash equivalents	**208**	**1,064**	197	1,482
Restricted cash – current	**-**	**351**	-	-
Trade and other receivables	**-**	**1,403**	10	933
Accounts payable and accrued liabilities	**(248)**	**(4,434)**	(54)	(7,315)
Net exposure in foreign currency	**(40)**	**(1,616)**	153	(4,900)
Net exposure in USD ($000s)	**(30)**	**(496)**	111	(1,255)

The Company had no forward exchange rate contracts in place as at or during the years ended December 31, 2016 and 2015.

Based on financial instruments held at December 31, 2016 and 2015, fluctuations in the exchange rates as indicated below would have the following estimated effect on net loss and other comprehensive income:

	Year Ended December 31,	
	2016	2015
Effect of 5% increase in CAD and BRL to USD		
(Increase) decrease to net loss	**(1)**	6
(Increase) to accumulated other comprehensive loss	**(28)**	(52)
Effect of 5% decrease in CAD and BRL to USD		
Decrease (increase) to net loss	**1**	(6)
Decrease (increase) to accumulated other comprehensive loss	**25**	46

Commodity Price Risk

Although the Company is not dependent on cash flows derived from its oil sales, changes in commodity prices may have a significant impact on the assessment of the carrying value of the Company's properties and any impairment losses recorded as a result of a decline in those values would increase the Company's net loss. Fluctuations in commodity prices can also affect the Company's ability to obtain future financings and the capacity of those future financings. Given its level of oil sales, the Company did not have any forward contracts in place as at or during the years ended December 31, 2016 and 2015. To the extent oil sales increase in the future, the Company may consider a hedging program to protect cash flows and manage commodity price risk.

Interest Rate Risk

The Company is exposed to interest rate cash flow risk on cash and cash equivalents and restricted cash due to fluctuations in market interest rates applied to cash balances. The effect of this risk on the Company is assessed as minimal.

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Fair Value of Financial Instruments

The Company classifies the fair value of financial instruments according to the following hierarchy based on the amount of observable inputs used to value the instrument:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2 valuations are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.
Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

Assessment of the significance of a particular input to the fair value measurement requires judgment that may affect the placement within the fair value hierarchy level. Due to the short-term nature of accounts receivable and accounts payable and accrued liabilities, their carrying value approximates their fair value. The carrying values and respective fair values of Alvopetro's financial instruments at December 31, 2016 and 2015 is set forth in the table below. The Company does not currently have any financial instruments classified as Level 2 or Level 3.

	December 31, 2016		December 31, 2015	
	Carrying Value	**Fair Value**	Carrying Value	Fair Value
Carried at fair value through profit or loss				
Cash and cash equivalents[1]	**17,788**	**17,788**	28,733	28,733
Restricted cash – current [1][2]	**108**	**108**	2,288	2,288
	17,896	**17,896**	31,021	31,021
Carried at amortized cost				
Trade and other receivables	**431**	**431**	247	247
Accounts payable and accrued liabilities	**(1,878)**	**(1,878)**	(2,143)	(2,143)
	(1,447)	**(1,447)**	(1,896)	(1,896)

(1) Level 1
(2) Restricted cash balances include amounts pledged as collateral for work commitments (Note 5).

NOTE 13 – CHANGES IN NON-CASH WORKING CAPITAL

	Year ended December 31,	
Change in:	**2016**	2015
Trade and other receivables	**(125)**	(144)
Prepaid expenditures	**149**	46
Accounts payable and accrued liabilities	**(574)**	(4,826)
	(550)	(4,924)
Changes relating to:		
Operating activities	**(1,164)**	(1,267)
Investing activities	**614**	(3,657)
	(550)	(4,924)

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

NOTE 14 – NATURE OF EXPENSES

Production expenses by nature were as follows:

	Year Ended December 31,	
Production expenses:	**2016**	2015
Personnel	**347**	488
Production facilities rental	**277**	22
Other fixed	**238**	141
Variable	**165**	218
Workover	**126**	3
Production expenses	**1,153**	872

The majority of the Company's production expenses in 2016 relate to personnel costs and production facilities rental costs for the 182(B1) well. This rental contract was cancelled during the three months ended June 30, 2016.

General and administrative expenses ("G&A") by nature were as follows:

	Year Ended December 31,	
G&A expenses:	**2016**	2015
Personnel	**2,937**	3,345
Travel	**169**	396
Office and IT costs	**457**	602
Professional fees	**633**	741
General corporate	**451**	607
Gross G&A expenses	**4,647**	5,691
Capitalized to E&E and PP&E	**(1,124)**	(1,130)
Net G&A expenses	**3,523**	4,561

The majority of the Company's G&A relates to personnel costs. General corporate expenses include public company costs, corporate insurance, directors' fees, rental vehicle costs, cell phones and other miscellaneous expenses. G&A expenses that are directly attributable to exploration and development projects are capitalized. The majority of capitalized costs relate to personnel.

NOTE 15 – RELATED PARTY TRANSACTIONS

Alvopetro has been party to non-material office-related administrative transactions with Touchstone Exploration Inc. ("Touchstone"), a related party of the Company due to the common directors, summarized as follows:

	Year Ended December 31,	
	2016	**2015**
Office rent and related costs	**60**	190

This contract was terminated during the three months ended September 30, 2016. As at December 31, 2016 and December 31, 2015, the Company owed Touchstone $nil.

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

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

	Year ended December 31,	
	2016	**2015**
Short-term benefits(1)	**490**	732
Share-based compensation(1)	**100**	286
Total	**590**	1,018

Notes:
(1) Before 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, 2016:

Commitments	**< 1 Year**	**1-3 Years**	**Thereafter**	**Total**
Minimum work commitments(1)				
Block 183	1,023	-	-	1,023
Block 106	350	-	-	350
Block 107(2)	2,332	-	-	2,332
Block 177	2,206	-	-	2,206
Block 169	1,166	-	-	1,166
Block 198(3)	1,166	-	-	1,166
Block 255	1,396	-	-	1,396
Block 256(4)	310	-	-	310
Block 57(5)	-	272	-	272
Block 62(5)	-	272	-	272
Block 71(5)	-	186	-	186
Block 145(5)	-	272	-	272
Bom Lugar	-	-	107	107
Jiribatuba	-	-	107	107
Total minimum work commitments	**9,949**	**1,002**	**214**	**11,165**
Office leases(6)	**185**	**183**	-	**368**
Total commitments	**10,134**	**1,185**	**214**	**11,533**

Notes:
(1) Under the terms of the ANP concession contracts for each of our exploration blocks, the Company has commitments which must be completed prior to the applicable phase expiry date. The Company is required to post a performance guarantee with the ANP for all commitments in the table above.
(2) During the three months ended September 30, 2016, the Company entered into a farmout agreement with respect to Block 107. Under the terms of the agreement, the Farmee is responsible to drill two wells in satisfaction of the work commitments included in the table above. In addition to completion of the work commitments by the Farmee, the farmout is also subject to ANP approval of the transfer and the receipt of environmental permits for the two wells to be drilled by the Farmee. Both of these conditions were satisfied subsequent to December 31, 2016.
(3) Subsequent to December 31, 2016, the Company completed drilling the 198(A1) well in satisfaction of the work commitment in the table above, subject to ANP approval.
(4) During the three months ended September 30, 2016, the Company completed drilling the 256(A1) well in satisfaction of the work commitment in the table above, subject to ANP approval.
(5) Alvopetro holds a 65% interest in each of these blocks and the amounts provided in the table above represent Alvopetro's share of the related commitments.
(6) The Company is committed to future minimum payments for office space in Canada and Brazil.

As is customary in the oil and gas industry, we may at times have work plans in place to reserve or earn certain acreage positions or wells. If we do not complete such work plans in a timely manner, the acreage positions or wells may be lost, or penalties may be applied.

The Company currently has no contingent liabilities recorded; however, in the normal course of operations, we may have disputes with industry participants for which we currently cannot determine the ultimate results. The Company has a policy to record contingent liabilities as they become determinable and the probability of loss is more likely than not.

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, cost-effective 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 penalty, 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 penalties and, as of December 31, 2016, the potential estimated penalty was $0.2 million (December 31, 2015 - $0.1 million), which is included in accounts payable and accrued liabilities in the respective consolidated statements of financial position.