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
April 22, 2015

Deloitte LLP
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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, 2014 and December 31, 2013, 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, 2014 and December 31, 2013 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

Deloitte LLP

Chartered Accountants
April 22, 2015
Calgary, Alberta

ALVOPETRO ENERGY LTD.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Thousands of United States dollars)

	Note	December 31, 2014	December 31, 2013
ASSETS			
Current			
Cash and cash equivalents		**40,920**	100,268
Restricted cash	6	**3,373**	-
Trade and other receivables		**154**	342
Prepaid expenditures		**428**	147
Total current assets		**44,875**	100,757
Restricted cash	6	**9,749**	-
Other assets	7	**240**	-
Exploration and evaluation assets	8	**62,204**	45,002
Property, plant and equipment	9	**7,489**	9,697
Non-current assets		**79,682**	54,699
Total assets		**124,557**	155,456
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Accounts payable and accrued liabilities		**9,031**	2,250
		9,031	2,250
Deferred tax liability	13	**4,247**	3,791
Decommissioning liabilities	11	**3,454**	2,833
		16,732	8,874
Shareholders' equity			
Share capital	12	**151,937**	151,937
Contributed surplus		**975**	74
Deficit		**(35,388)**	(3,679)
Accumulated other comprehensive loss		**(9,699)**	(1,750)
Total shareholders' equity		**107,825**	146,582
Total liabilities and shareholders' equity		**124,557**	155,456

Commitments and contingencies (Note 18)

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 LOSS

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

		Year ended December 31,	
	Note	**2014**	2013
Revenue			
Oil sales		**1,106**	1,239
Royalties and production taxes		**(107)**	(122)
Oil revenue		**999**	1,117
Other income		**382**	163
Total revenue and other income		**1,381**	1,280
Expenses			
Production		**1,433**	1,267
Transportation		**44**	37
General and administrative		**5,313**	4,707
Depletion and depreciation	9	**441**	403
Impairment	10	**22,591**	431
Accretion of decommissioning liabilities	11	**94**	79
Exploration and evaluation expense		**-**	111
Share-based compensation	12	**637**	476
Foreign exchange		**2,605**	309
Total expenses		**33,158**	7,820
Loss before taxes and non-controlling interest		**(31,777)**	(6,540)
Income taxes	13	**(68)**	2,131
Net loss		**(31,709)**	(8,671)
Exchange loss on translation of foreign operations		**(7,949)**	(2,780)
Comprehensive loss		**(39,658)**	(11,451)
Net loss attributable to:			
Common shareholders		**(31,709)**	(7,398)
Non-controlling interest		**-**	(1,273)
Net loss		**(31,709)**	(8,671)
Comprehensive loss attributable to:			
Common shareholders		**(39,658)**	(9,921)
Non-controlling interest		**-**	(1,530)
Comprehensive loss		**(39,658)**	(11,451)
Net loss per share attributable to common shareholders	12		
Basic		**(0.37)**	**(0.09)**
Diluted		**(0.37)**	**(0.09)**

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)

		Year Ended December 31,			
		2014	2013		
	Note	**Alvopetro Shareholders' Equity**	Alvopetro Shareholders' Equity	Net Investment	Non-controlling Interest
Common Shares					
Balance, beginning of period		**151,937**	-	-	-
Transfer from net investment	2	**-**	151,937	-	-
Balance, end of period		**151,937**	151,937	-	-
Contributed surplus					
Balance, beginning of period		**74**	-	-	-
Share-based compensation expense	12	**637**	62	-	-
Share-based compensation capitalized	12	**264**	12	-	-
Balance, end of period		**975**	74	-	-
Deficit					
Balance, beginning of period		**(3,679)**	-	-	-
Net loss		**(31,709)**	(3,679)	-	-
Balance, end of period		**(35,388)**	(3,679)	-	-
Accumulated Other Comprehensive Loss					
Balance, beginning of period		**(1,750)**	-	-	-
Other comprehensive loss		**(7,949)**	(1,750)	-	-
Balance, end of period		**(9,699)**	(1,750)	-	-
Net Investment					
Balance, beginning of period		-	-	37,094	10,326
Net loss		**-**	**-**	(3,719)	(1,273)
Other comprehensive loss		**-**	**-**	(773)	(257)
Contributions and net change in investment		**-**	**-**	109,402	723
Share-based compensation expense	12	**-**	**-**	414	-
Acquisition of non-controlling interest	5	**-**	**-**	9,519	(9,519)
Transfer to Alvopetro share capital	2	**-**	**-**	(151,937)	-
Balance, end of period		**-**	**-**	-	-

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)

	Note	Year ended December 31, 2014	2013
Operating Activities			
Net loss		**(31,709)**	(8,671)
Adjustments for non-cash items:			
Depletion and depreciation	9	**441**	403
Impairment	10	**22,591**	431
Accretion of decommissioning liability	11	**94**	79
Share-based compensation	12	**637**	476
Deferred tax expense	13	**(112)**	2,100
Unrealized foreign exchange loss		**336**	346
		(7,722)	(4,836)
Changes in non-cash working capital	16	**854**	303
		(6,868)	(4,533)
Investing Activities			
Expenditures on exploration and evaluation assets	8	**(42,160)**	(5,606)
Expenditures on property, plant and equipment	9	**(777)**	(1,217)
Expenditures on other assets	7	**(1,429)**	(886)
Change in restricted cash	6	**(13,122)**	-
Changes in non-cash working capital	16	**5,930**	1,415
		(51,558)	(6,294)
Financing Activities			
Funds received pursuant to the Arrangement	1	**-**	85,554
Net contributions from Petrominerales	2	**-**	23,848
Net contributions relating to non-controlling interest		**-**	723
		-	110,125
Change in cash and cash equivalents		**(58,426)**	99,298
Effect of foreign exchange on cash balances		**(922)**	(159)
Cash and cash equivalents, beginning of year		**100,268**	1,129
Cash and cash equivalents, end of year		**40,920**	100,268
Cash and cash equivalents consist of:			
Cash		**24,370**	100,268
Cash equivalents		**16,550**	-
Supplemental information:			
Cash income taxes paid		19	31
Cash interest income received		349	-

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, 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, 2015.

Basis of Measurement and Impact of the Arrangement

These consolidated financial statements have been prepared on a historical cost basis with respect to all transactions occurring after the Arrangement. Transactions prior to the Arrangement were derived from the account 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

The value of the assets and liabilities transferred to Alvopetro in connection with the Arrangement was determined by the Company based on the carrying amounts recorded in Petrominerales' consolidated statement of financial position at the time of the transfer.

Presentation of the Consolidated Statements of Operations and Comprehensive Loss

All revenue, royalties and production taxes, operating expenses and transportation expenses on the consolidated statements of operations and comprehensive loss are directly attributable to the Brazil Properties now owned by Alvopetro. General and administrative expenses recorded prior to the Arrangement were 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 was allocated to Alvopetro 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. Following completion of the Arrangement, amounts recorded for general and administrative and share-based compensation expenses are based on amounts incurred by Alvopetro as a stand-alone entity.

Presentation of the Consolidated Statements of Changes in Equity

For reporting periods prior to the Arrangement, Petrominerales' direct equity 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 cumulative 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 Alvopetro.

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, future costs required to develop those reserves and anticipated future development activities as well as the expected timing of activities. 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.

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 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. 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, 2014 and 2013, the Company controls 100 percent of its subsidiaries. Prior to November 19, 2013, when the Company acquired the remaining outstanding shares of Alvopetro Oil and Gas Investments Inc. (Note 5), the Company's consolidated statements of financial position and consolidated statements of operations and comprehensive loss included a non-controlling interest representing the 25 share percent not owned by Alvopetro.

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.

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 commitment and other obligations pursuant to concession agreements 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.

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.

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 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 geological 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 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, 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 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 with the unrecoverable costs being charged to the consolidated statements of operations and comprehensive loss.

Crude oil assets are accumulated on an area-by-area (component) basis, which, for Alvopetro, is currently by geological 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. 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.

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 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 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 presumed profit regime may be selected provided revenues are below specified thresholds. 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.

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.

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 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, Alvopetro 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.

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.

Financial instruments carried at fair value through profit and 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 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 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 loss when these assets or liabilities settle.

Segmented Operations

All oil sales revenue is derived from Brazilian operations. All material exploration and evaluation assets and property, plant and equipment are located in Brazil. The majority of the Company's cash as well as all current and non-current restricted cash 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

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
IAS 32 *Financial Instruments: Presentation* - addresses inconsistencies when applying the offsetting criteria outlined in this standard. These amendments clarify criteria required to be met in order to permit the offsetting of financial assets and financial liabilities as well as disclosure requirements.	January 1, 2014	Adoption of these amendments did not impact these consolidated financial statements.
IFRIC 21 *Levies* - clarifies the requirements for recognizing a liability for a levy imposed by a government.	January 1, 2014	Adoption of this interpretation did not impact these consolidated financial statements.
IAS 36 *Impairment of assets* – requires additional disclosure on the recoverable amount of an impaired Cash Generating Unit.	January 1, 2014	The impact of adopting these amendments can be found in Note 10.

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* – As of July 2014, 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 11 *Joint Arrangements* – was amended regarding the accounting for the acquisition of an interest in a joint operation that constitutes a business.	January 1, 2016	The Company is assessing the effect these amendments 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, 2017	The Company is assessing the effect of this future pronouncement on its financial statements.

NOTE 5 – ACQUISITION ACTIVITIES

In December 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. 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 recorded on the 75 percent acquisition. 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 – RESTRICTED CASH AND CREDIT FACILITY

	As at	
	December 31, 2014	December 31, 2013
Restricted cash – current	**3,373**	-
Restricted cash – non-current	**9,749**	-
Balance, end of period	**13,122**	-

During 2014, the Company entered into a credit support facility (the “Facility”) with a Canadian bank for up to CAD$45.0 million. This Facility allows for the issuance of letters of credit (“LC”) and letters of guarantee in support of the financial guarantees required by the National Agency of Petroleum, Natural Gas and Biofuels (the “ANP”), an agency of the Brazil government, for Alvopetro’s work commitments under the terms of its concession contracts as discussed further in Note 18. These types of financial guarantees for work commitments are required by the ANP for all operators in Brazil. 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.

Under the initial terms of the Facility, the issuance of letters of credit and letters of guarantee had to be fully cash collateralized by Alvopetro. Cash collateral requirements are in excess of actual committed amounts due to additional amounts required to be deposited for foreign currency risk margins, in accordance with the terms of our Facility.

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In December 2014, the Company obtained an Account Performance Security Guarantee ("PSG") from Export Development Canada ("EDC") in support of certain LC's previously supported by cash collateral of the Company. As a result, a total of $15.1 million was transitioned from the Facility to EDC's Account PSG and the cash collateral was released on December 31, 2014. Total fees of $0.5 million were paid to EDC as part of the transaction.

As at December 31, 2014 the total amount of irrevocable letters of credit issued through the Facility was $27.9 million, with $15.1 million satisfied through EDC's Account PSG and $12.8 million satisfied through restricted cash deposits of Alvopetro. Of the $12.8 million restricted cash amount, $3.1 million was classified as current because it related to LC's expiring within one year and $9.7 million was classified as non-current.

During the year-ended December 31, 2014, the Company earned floating-rate interest income on the restricted cash deposits under the Facility which was approximately 0.35 percent per annum.

At December 31, 2014 there is an additional $0.3 million of cash collateral posted with respect to corporate credit cards, classified as current.

NOTE 7 – OTHER ASSETS

	Year ended December 31,	
	2014	2013
Balance, beginning of period	**-**	6,000
Deposits with suppliers for long lead items	**1,429**	886
Transfer to E&E assets	**(1,090)**	(6,886)
Foreign currency translation	**(99)**	-
Balance, end of period	**240**	-

The 2013 opening balance related to deferred acquisition costs based on the estimated fair value of two blocks included in the acquisition of the Brazil properties. 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 as discussed in Note 5, these deferred acquisition costs were transferred to E&E assets in 2013.

The balance outstanding at December 31, 2014 relates to deposits with suppliers for long-lead items required for the Company's future exploration activities.

NOTE 8 – EXPLORATION AND EVALUATION (E&E) ASSETS

	Year ended December 31,	
	2014	2013
Balance, beginning of period	**45,002**	35,530
Capital expenditures	**42,160**	5,606
Capitalized share-based compensation	**215**	7
Transfer from other assets (Note 7)	**1,090**	6,886
Change in decommissioning liabilities	**491**	59
Transfer to PP&E	**(13)**	-
Impairment (Note 10)	**(20,330)**	-
Foreign currency translation	**(6,411)**	(3,086)
Balance, end of period	**62,204**	$ 45,002

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

Capital expenditures include $5.6 million (2013- $3.3 million) of inventory purchased for use on exploration wells. Additional expenditures on long lead items for exploration projects are included in other asset expenditures (Note 7). General and administrative costs totaling $1.8 million (2013 - $0.2 million) that were directly related to exploration and evaluation activities have been capitalized as exploration and evaluation assets.

NOTE 9 – PROPERTY, PLANT AND EQUIPMENT (PP&E)

	Year ended December 31,	
	2014	2013
Cost, beginning of period	**10,529**	7,535
Capital expenditures	**777**	1,217
Transferred from E&E	**13**	-
Capitalized share-based compensation	**49**	5
Change in decommissioning liabilities	**459**	2,004
Foreign currency translation	**(1,110)**	(232)
Cost, end of period	**10,717**	10,529
Accumulated depletion and depreciation, beginning of period	**(832)**	(26)
Depletion and depreciation for the period	**(441)**	(403)
Impairment (Note 10)	**(2,261)**	(431)
Foreign currency translation	**306**	28
Accumulated depletion and depreciation, end of period	**(3,228)**	(832)
Net book value, end of period	**7,489**	9,697

General and administrative costs totaling $0.2 million (2013 - $0.2 million) that were directly related to investing activities have been capitalized as property, plant and equipment.

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NOTE 10 – IMPAIRMENT

For the year-end December 31, 2014, the Company recognized an overall impairment of $22.6 million (2013 - $0.4 million) as follows:

	Year ended December 31,	
	2014	2013
Impairment losses – PP&E		
Bom Lugar	**2,261**	5,620
Jiribatuba	**-**	301
Aracaju	**-**	393
Total PP&E impairment loss	**2,261**	6,314
Impairment reversals		
Bom Lugar	**-**	(5,582)
Jiribatuba	**-**	(301)
Aracaju	**-**	-
Total PP&E impairment reversal	**-**	(5,883)
Net PP&E impairment loss	**2,261**	431
Impairment losses – E&E		
Block 131	**4,938**	-
Block 132	**1,387**	-
Block 144	**5,789**	-
Block 157	**4,912**	-
Block 196	**3,304**	-
Total E&E impairment loss	**20,330**	-
Total Impairment	**22,591**	431

PP&E Impairments

The $2.3 million impairment loss on PP&E in 2014 was a result of a decline in the estimated value of the Bom Lugar field largely due to declining commodity prices in the fourth quarter of 2014 and to a lesser extent, increased projected capital costs. The impairment loss was calculated based on the difference between the net book value and the estimated recoverable amount. The estimated recoverable amount was determined for each mature field based on the net present value of the after-tax cash flows from the Company's proved plus probable reserves using a discount rate of 15% (2013 – 15%). The key assumptions used in determining the recoverable amounts for purposes of the impairment test were the discount rate, commodity prices, resource volumes, future capital cost estimates, future well locations, and timing of future capital investment. 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. All assumptions used are based on the Company's 2014 reserve report from its independent reserves evaluator.

In 2013, the Company initially booked impairments at each of its fields during the nine months ended September 30, 2013 but reversed the majority of these impairments during the three months ended December 31, 2013 (less the depletion that would have been recognized had the impairment not been recorded). 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 net impairment loss of $0.4 million is attributable to the Company's Aracaju property which was written down to $nil.

E&E Impairments

In 2014, the Company recorded E&E impairment of $17.0 million related to Blocks 131, 132, 144, and 157. The impairments have been recorded as a result of the Company's decision to relinquish these blocks to the ANP. Under the terms of the concession contracts, a total payment of BRL 12.2 million ($4.6 million) is owed to the ANP for the associated performance guarantees for these blocks. This amount is included in accounts payable and accrued liabilities in the consolidated statement of financial position. The impairment expense recorded reduces the book value of these blocks to $nil as at December 31, 2014, which is the estimated recoverable amount, and includes the $4.6 million of performance guarantees owing to the ANP.

In 2014, the Company recorded an E&E impairment of $3.3 million related to Block 196. While this block has not yet reached the end of the phase expiry, the Company has not identified any prospects on this block. Under the terms of the concession contract for this block, BRL 3.0 million ($1.1 million) is owed to the ANP to the extent the Company relinquishes the block. This amount is included in accounts payable and accrued liabilities in the consolidated statement of financial position. The impairment expense recorded reduces the book value of this block to $nil as at December 31, 2014, which is the estimated recoverable amount, and includes the $1.1 million work commitment.

NOTE 11 – 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,	
	2014	2013
Balance, beginning of period	**2,833**	1,014
Liabilities incurred	**450**	59
Revisions to obligations	**500**	2,004
Accretion	**94**	79
Foreign currency translation	**(423)**	(323)
Balance, end of period	**3,454**	2,833

Total undiscounted cash flows, escalated at 6.5% (2013- 6.0%) for inflation, required to settle the Company's decommissioning provision are estimated to be $5.3 million (2013 - $4.9 million) and have been discounted using an average risk free rate of 3.0% (2013 – 3.4%), which represents an estimated U.S. Treasury bill rate for a period of 20 years (2013 – 15 years), the weighted-average remaining years to abandonment.

NOTE 12 – 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 ($000s)
Balance as at December 31, 2013 and 2014	**85,166,871**	**$ 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 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 options outstanding at December 31, 2014 are as follows:

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

	Number of Options	Weighted Average Exercise Price (CAD $)
Balance as at December 31, 2013	2,995,436	1.02
Granted	1,572,000	0.45
Outstanding at December 31, 2014	4,567,436	0.82

	Options Outstanding at December 31, 2014			Options Exercisable at December 31, 2014		
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$0.40 - $0.50	1,430,000	0.40	4.98	-	-	-
CAD$0.51 - $1.00	40,000	0.57	4.81	-	-	-
CAD$1.01 - $1.24	3,097,436	1.02	3.98	1,497,719	1.02	3.96
CAD$0.40 - $1.24	4,567,436	0.82	4.30	1,497,719	1.02	3.96

d) Share-Based Compensation

The fair value of the stock options granted under the Alvopetro stock option plan for the year-ended December 31, 2014 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,	
	2014	2013
Risk free interest rate (%)	1.32	1.51
Expected term (years)	4.00	4.00
Expected volatility (%)	50.00	50.00
Dividend per share (%)	-	-
Forfeiture rate (%)	5.00	5.00
Weighted average fair value (CAD$)	0.16	0.46

Total share-based compensation of $0.9 million was computed for the period ended December 31, 2014 (2013- $74,000) related to the Alvopetro stock option plan. Of this amount, approximately $0.3 million (2013- $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 loss. An additional $0.5 million will be amortized over the expected term of the options.

Of the total share-based compensation expense recognized for the year ended December 31, 2013, $0.4 million relates to an allocation of Petrominerales' share-based compensation.

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

e) Net Loss Per Share Attributable to Common Shareholders

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:

	Year ended December 31,	
	2014	2013
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, 2014 and 2013, all stock options were excluded because the effect would be anti-dilutive.

NOTE 13 – TAXES

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

	Year ended December 31,	
	2014	2013
Current income tax expense	**44**	31
Deferred income tax (recovery) expense	**(112)**	2,100
Income tax (recovery) expense	**(68)**	2,131

For the 2013 and 2014 taxation years, 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 under this system. Under the presumed profit system, profit is computed by applying certain predetermined percentages to gross revenues, resulting in an inherent tax rate of approximately three 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 72.0 million (BRL 48.0 million in 2013). Losses realized for tax purposes within Brazil while under the presumed profit regime do not carry-forward.

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,	
	2014	2013
Loss before taxes	**(31,777)**	(6,540)
Statutory income tax rate	**34%**	34%
Expected income tax recovery	**(10,804)**	(2,224)
Increase (decrease) resulting from:		
Impairment	**7,681**	147
Presumed profit income tax	**44**	31
Accounting transfers to E&E for which no additional tax basis has been recognized	**-**	2,040
Unrecognized deferred tax asset	**1,138**	561
Tax losses in Brazil not available for carry-forward under the presumed profit regime	**932**	238
Foreign currency effects	**263**	385
Share-based compensation	**306**	162
Other	**372**	791
Income tax (recovery) expense	**(68)**	2,131

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

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. 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). For the 2015 taxation year, the Company has elected to transition to the actual profit regime.

	PP&E and E&E assets	Decommissioning liabilities	Tax loss carryforwards	Other Brazil tax pools	Unrecognized deferred tax asset	Total
At December 31, 2012	6,836	(345)	(34)	(4,874)	108	1,691
Deferred tax expense (recovery)	1,951	(618)	(752)	958	561	2,100
As at December 31, 2013	8,787	(963)	(786)	(3,916)	669	3,791
Deferred tax expense (recovery)	1,299	(367)	(2,182)	-	1,138	(112)
Foreign currency translation	(49)	155	-	462	-	568
As at December 31, 2014	**10,037**	**(1,175)**	**(2,968)**	**(3,454)**	**1,807**	**4,247**

As at December 31, 2014, the full balance of the Company's net deferred tax asset was not recognized. Included in the unrecognized deferred tax asset were tax losses in Canada of approximately $12 million (2013 - $3.1 million) which will expire between 2032 and 2034.

NOTE 14 – CAPITAL MANAGEMENT

The Company's capital consists of the following:

	As at December 31, 2014	2013
Working capital, including current restricted cash	**35,844**	98,507
Non-current restricted cash	**9,749**	-
Shareholders' equity	**107,825**	146,582

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), non-current restricted cash, and shareholders' equity. At December 31, 2014, the Company's net working capital surplus was $35.8 million (December 31, 2013 - $98.5 million), which includes $40.9 million (December 31, 2013 - $100.3 million) of cash and $3.4 million (December 31, 2013 - $nil) of current restricted cash, but excludes non-current restricted cash of $9.7 million (December 31, 2013 – $nil).

The Company's current portion of restricted cash of $3.4 million includes $3.1 of cash collateral pledged for letters of credit expiring within the next twelve months associated with work commitments in Brazil. The cash posted as collateral may be available earlier pending completion of the related work commitments. Additional current restricted cash relates to cash pledged for corporate credit cards ($0.3 million).

Alvopetro has $9.7 million of non-current restricted cash related to collateral posted for work commitments in Brazil for letters of credit with expiry dates subsequent to December 31, 2015. Funds may be made available to Alvopetro earlier pending completion of the related work commitments.

In 2014 Alvopetro recorded $5.7 million in anticipated performance guarantees on five exploration blocks (Note 10). Of this amount, $4.6 million relates to four exploration blocks that were relinquished subsequent to year-end. The related performance guarantees are anticipated to be paid in the second quarter of 2015. A total of $6.2 million of associated LC's for these performance guarantees are supported by the Account PSG from EDC and will be released following this payment. The associated LC's are in excess of the actual anticipated payment due to foreign currency risk margins required under the Facility as well as a decline in the BRL relative to the U.S. dollar from the date the original LC's were issued. Following the release of the $6.2 million in LC's relating to the relinquished blocks, LC's on blocks currently supported by Alvopetro's restricted cash balances can be transitioned to the PSG from EDC.

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 share capital which, at December 31, 2014 was $107.8 million (December 31, 2013 - $146.6 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 15 – 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.

Crude oil production is sold to two counterparties, one of which represents greater than 90 percent (2013 - 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. Alvopetro 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 represents the maximum credit exposure. During the current year Alvopetro wrote-off $73,000 (2013 - $nil) to reduce its GST receivable to $nil at December 31, 2014. This amount represented the GST paid by the Company from November 28, 2013 to December 31, 2014 and the decision was made to write it off based on recent correspondence with Canada Revenue Agency. As at December 31, 2014 there were no significant amounts past due or impaired.

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. The Company believes that it has access to sufficient capital through its cash and cash equivalents and restricted cash balances to meet current spending forecasts.

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, 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 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 U.S. dollar oil price and all operational and capital activities related to the Brazil properties are transacted primarily in BRL. 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 BRL held in Brazil is moderately in excess of estimated capital and operational requirements.

As at December 31, 2014 and 2013, the following financial instruments were denominated in currencies other than the U.S. dollar:

	Period Ended December 31			
	2014		2013	
	CAD (000's)	**BRL (000's)**	CAD (000's)	BRL (000's)
Cash and cash equivalents	**1,540**	**708**	90,727	2,075
Restricted cash – current	**354**	**-**	-	-
Trade and other receivables	**5**	**366**	7	785
Accounts payable and accrued liabilities	**(104)**	**(22,875)**	(31)	(3,264)
Net exposure in foreign currency	**1,795**	**(21,801)**	90,703	(404)
Net exposure in USD ($000s)	**1,547**	**(8,209)**	85,280	(173)

In 2014, the Company converted approximately CAD$84.8 million of the Canadian dollars held at December 31, 2013 to U.S. dollars of $77.5 million and realized a foreign exchange loss on the conversion as a result in the decline in the Canadian dollar relative to the U.S. dollar from December 31, 2013 to the date of conversion in 2014.

The Company had no forward exchange rate contracts in place as at or during the years ended December 31, 2014 and 2013.

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 ability and capacity of future financings. The Company did not have any forward contracts in place as at or during the periods ended December 31, 2014 and 2013.

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 Company earned interest income on its cash and restricted cash balances at an average rate of 0.35 percent per annum for the year ended December 31, 2014 (2013- 1.25 percent).

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.

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

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, 2014 is set forth in the table below. The Company does not currently have any fair value measurements classified as Level 2 or Level 3.

	December 31, 2014		December 31, 2013	
	Carrying Value	**Fair Value**	Carrying Value	Fair Value
Carried at fair value through profit or loss				
Cash and cash equivalents(1)	**40,920**	**40,920**	100,268	100,268
Restricted cash – current and non-current(1)(2)	**13,122**	**13,122**	-	-
	54,042	**54,042**	100,268	100,268
Carried at cost or amortized cost				
Trade and other receivables	**154**	**154**	342	342
Accounts payable and accrued liabilities	**(9,031)**	**(9,031)**	(2,250)	(2,250)
	(8,877)	**(8,877)**	(1,908)	(1,908)

(1) Level 1
(2) Restricted cash balances include amounts pledged as collateral for work commitments (Note 6).

NOTE 16 – CHANGES IN NON-CASH WORKING CAPITAL

	Year ended December 31,		
Change in:	**2014**		2013
Trade and other receivables	**144**	$	(198)
Prepaid expenditures	**(303)**		(147)
Accounts payable and accrued liabilities	**6,943**		2,063
	6,784	$	1,718
Changes relating to:			
Operating activities	**854**		303
Investing activities	**5,930**		1,415
	6,784	$	1,718

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

NOTE 17 – RELATED PARTY TRANSACTIONS

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

	Year Ended December 31,	
	2014	**2013**
Office rent and related costs	**225**	**39**
Administrative consulting fees	**6**	**2**

As at December 31, 2014, the Company owed Touchstone $nil (2013 - $2,000).

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

	Year ended December 31,	
	2014	**2013**
Short-term benefits(1)(2)	**918**	77
Share-based compensation(2)	**576**	48
Total	**1,494**	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.

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

NOTE 18 – COMMITMENTS AND CONTINGENCIES

The following is a summary of contractual commitments as at December 31, 2014:

Commitments	< 1 Year	1-3 Years	Thereafter	Total
Minimum work commitments(1)				
Block 182	1,146	-	-	1,146
Block 183	1,141	-	-	1,141
Block 170	-	1,130	-	1,130
Block 106	-	429	-	429
Block 107	-	2,862	-	2,862
Block 177	-	2,707	-	2,707
Block 169	-	1,431	-	1,431
Block 198	-	1,431	-	1,431
Block 255	-	1,713	-	1,713
Block 256	-	381	-	381
Bom Lugar	-	-	132	132
Jiribatuba	-	-	132	132
Aracaju	-	-	94	94
Total minimum work commitments	**2,287**	**12,084**	**358**	**14,729**
Office leases(2)	**341**	**35**	-	**376**
Total commitments	2,628	12,119	358	15,105

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. As the Company drilled its commitment well on Block 197 during the year ended December 31, 2014 and the associated LC was released by the ANP, this amount is no longer reflected in the table above. In addition, we completed drilling our first well on Block 183, which, subject to ANP approval, fulfils the majority of the well commitment amount for Block 183. An estimated shortfall of BRL$60,000 related to the Block 183 work commitment is included in accounts payable and accrued liabilities in the December 31, 2014 consolidated statement of financial position. Performance guarantees associated with Blocks 131, 132, 144, 157 and 196 have been included in accounts payable and accrued liabilities as at December 31, 2014 (Note 10), and are therefore excluded in the table above.

(2) The Company is committed to future minimum payments for office space in Canada and Brazil. In Brazil, the Company is required to provide a guarantee for certain office rental payments. The total amount of the guarantee provided as at December 31, 2014 was approximately $0.1 million.

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, 2014, the potential estimated fine was $74,000, which is included in accounts payable and accrued liabilities in the December 31, 2014 consolidated statement of financial position.