

## 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 opinion on the Company's consolidated financial statements as at and for the year ended December 31, 2019. Their report is presented with the consolidated financial statements.

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 19, 2020

## Independent Auditor's Report

To the Shareholders and the Board of Directors of  
Alvopetro Energy Limited

### Opinion

We have audited the consolidated financial statements of Alvopetro Energy Limited (the "Company"), which comprise the consolidated statements of financial position as at December 31, 2019 and 2018, and the consolidated statements of operations and comprehensive loss, changes in equity and cash flows for the years then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (collectively referred to as the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2019 and 2018, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards ("IFRS").

### Basis for Opinion

We conducted our audits in accordance with Canadian generally accepted auditing standards ("Canadian GAAS"). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Material Uncertainty Related to Going Concern

We draw attention to Note 2 in the financial statements, which describe the events and conditions that indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

### Other Information

Management is responsible for the other information. The other information comprises:

- Management's Discussion and Analysis

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon. In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

We obtained Management's Discussion and Analysis prior to the date of this auditor's report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in this auditor's report. We have nothing to report in this regard.

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements**

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

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian GAAS will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with Canadian GAAS, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to

the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Company to express an opinion on the financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is Sippy Chhina.

*Deloitte LLP*

Chartered Professional Accountants  
Calgary, Alberta  
March 19, 2020

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

(Thousands of United States dollars)

|                                                   | Note | December 31,<br>2019 | December 31,<br>2018 |
|---------------------------------------------------|------|----------------------|----------------------|
| <b>ASSETS</b>                                     |      |                      |                      |
| <b>Current</b>                                    |      |                      |                      |
| Cash and cash equivalents                         |      | 1,215                | 7,070                |
| Restricted cash                                   |      | 270                  | 135                  |
| Trade and other receivables                       |      | 265                  | 284                  |
| Prepaid expenditures                              |      | 370                  | 330                  |
| Assets held for sale                              | 5    | 332                  | 202                  |
| <b>Total current assets</b>                       |      | <b>2,452</b>         | <b>8,021</b>         |
| Exploration and evaluation assets                 | 6    | 35,971               | 35,340               |
| Property, plant and equipment                     | 7    | 30,984               | 22,011               |
| Right-of-use assets                               | 8    | 219                  | -                    |
| Other assets                                      | 9    | 1,790                | -                    |
| <b>Non-current assets</b>                         |      | <b>68,964</b>        | <b>57,351</b>        |
| <b>Total assets</b>                               |      | <b>71,416</b>        | <b>65,372</b>        |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>       |      |                      |                      |
| <b>Current liabilities</b>                        |      |                      |                      |
| Accounts payable and accrued liabilities          |      | 3,244                | 1,221                |
| Lease liabilities                                 | 8    | 101                  | -                    |
| Decommissioning liabilities                       | 10   | 80                   | 71                   |
| Other liabilities                                 | 11   | 5,728                | -                    |
| <b>Total current liabilities</b>                  |      | <b>9,153</b>         | <b>1,292</b>         |
| Lease liabilities                                 | 8    | 62                   | -                    |
| Credit facility                                   | 12   | 5,027                | -                    |
| Other liabilities                                 | 11   | -                    | 2,348                |
| Decommissioning liabilities                       | 10   | 1,300                | 1,160                |
| <b>Total liabilities</b>                          |      | <b>15,542</b>        | <b>4,800</b>         |
| <b>Shareholders' equity</b>                       |      |                      |                      |
| Share capital                                     | 13   | 156,355              | 155,731              |
| Contributed surplus                               |      | 2,790                | 1,813                |
| Deficit                                           |      | (76,878)             | (71,847)             |
| Accumulated other comprehensive loss              |      | (26,393)             | (25,125)             |
| <b>Total shareholders' equity</b>                 |      | <b>55,874</b>        | <b>60,572</b>        |
| <b>Total liabilities and shareholders' equity</b> |      | <b>71,416</b>        | <b>65,372</b>        |

Basis of presentation and going concern (Note 2)

Commitments and contingencies (Note 21)

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)

|                                                           |             | <b>Year ended December 31,</b> |                |
|-----------------------------------------------------------|-------------|--------------------------------|----------------|
|                                                           | <b>Note</b> | <b>2019</b>                    | <b>2018</b>    |
| <b>Revenue</b>                                            |             |                                |                |
| Oil and condensate sales                                  | 18          | 240                            | 519            |
| Royalties and production taxes                            |             | (34)                           | (55)           |
| Net oil and condensate revenue                            |             | 206                            | 464            |
| Other income                                              |             | 194                            | 152            |
| Total revenue and other income                            |             | 400                            | 616            |
| <b>Expenses</b>                                           |             |                                |                |
| Production                                                | 19          | 276                            | 840            |
| Transportation                                            |             | -                              | 13             |
| General and administrative                                | 19          | 2,793                          | 2,762          |
| Depletion and depreciation                                | 7,8         | 234                            | 144            |
| Impairment                                                | 5,6         | 1,645                          | 765            |
| Finance expense                                           | 19          | 259                            | 41             |
| Exploration and evaluation expense                        |             | 95                             | 209            |
| Share-based compensation                                  | 13          | 141                            | 95             |
| Foreign exchange                                          |             | 6                              | 32             |
| (Gain) loss on disposition of assets                      | 5           | (38)                           | 55             |
| Total expenses                                            |             | 5,411                          | 4,956          |
| <b>Loss before taxes</b>                                  |             | <b>(5,011)</b>                 | <b>(4,340)</b> |
| Income tax                                                | 14          | -                              | -              |
| <b>Net loss</b>                                           |             | <b>(5,011)</b>                 | <b>(4,340)</b> |
| <b>Exchange loss on translation of foreign operations</b> |             | <b>(1,269)</b>                 | <b>(5,173)</b> |
| <b>Comprehensive loss</b>                                 |             | <b>(6,280)</b>                 | <b>(9,513)</b> |
| <b>Net loss per share</b>                                 | 13          |                                |                |
| Basic                                                     |             | (0.05)                         | (0.05)         |
| Diluted                                                   |             | (0.05)                         | (0.05)         |

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, |          |
|---------------------------------------------|------|-------------------------|----------|
|                                             | Note | 2019                    | 2018     |
| <b>Common shares</b>                        |      |                         |          |
| Balance, beginning of year                  |      | 155,731                 | 151,937  |
| Issue of common shares – gross proceeds     |      | -                       | 4,019    |
| Issue of common shares – warrants exercised |      | 621                     | -        |
| Issue of common shares – options exercised  |      | 4                       | -        |
| Share issuance costs                        |      | (1)                     | (225)    |
| Balance, end of year                        | 13   | 156,355                 | 155,731  |
| <b>Contributed surplus</b>                  |      |                         |          |
| Balance, beginning of year                  |      | 1,813                   | 1,662    |
| Share issuance costs – warrants issued      | 12   | 818                     | 41       |
| Share-based compensation expense            | 13   | 141                     | 95       |
| Share-based compensation capitalized        | 13   | 23                      | 15       |
| Options exercised                           |      | (5)                     | -        |
| Balance, end of year                        |      | 2,790                   | 1,813    |
| <b>Deficit</b>                              |      |                         |          |
| Balance, beginning of year                  |      | (71,847)                | (67,507) |
| IFRS 16 opening adjustment                  | 4    | (20)                    | -        |
| Net loss                                    |      | (5,011)                 | (4,340)  |
| Balance, end of year                        |      | (76,878)                | (71,847) |
| <b>Accumulated other comprehensive loss</b> |      |                         |          |
| Balance, beginning of year                  |      | (25,125)                | (19,952) |
| IFRS 16 opening adjustment                  | 4    | 1                       | -        |
| Other comprehensive loss                    |      | (1,269)                 | (5,173)  |
| Balance, end of year                        |      | (26,393)                | (25,125) |

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, |                |
|-----------------------------------------------------|------|-------------------------|----------------|
|                                                     |      | 2019                    | 2018           |
| <b>Operating Activities</b>                         |      |                         |                |
| Net loss                                            |      | (5,011)                 | (4,340)        |
| Adjustments for non-cash items:                     |      |                         |                |
| Depletion and depreciation                          | 7,8  | 234                     | 144            |
| Impairment                                          | 5,6  | 1,645                   | 765            |
| Non-cash finance expenses                           | 19   | 225                     | 41             |
| Share-based compensation                            | 13   | 141                     | 95             |
| (Gain) loss on disposition of assets                | 5    | (38)                    | 55             |
| Unrealized foreign exchange loss (gain)             |      | 9                       | (14)           |
| Settlement of decommissioning liabilities           | 10   | (67)                    | (12)           |
| Funds flow from operations                          |      | (2,862)                 | (3,266)        |
| Changes in non-cash working capital                 | 17   | 319                     | 8              |
|                                                     |      | (2,543)                 | (3,258)        |
| <b>Financing Activities</b>                         |      |                         |                |
| Advances under Credit Facility                      | 12   | 5,000                   | -              |
| Credit Facility transaction costs                   | 12   | (1,109)                 | -              |
| Issue of common shares, net of share issuance costs | 13   | 620                     | 3,835          |
| Lease liabilities payments                          | 8    | (234)                   | -              |
| Changes in non-cash working capital                 | 17   | (82)                    | -              |
|                                                     |      | 4,195                   | 3,835          |
| <b>Investing Activities</b>                         |      |                         |                |
| Expenditures on exploration and evaluation assets   | 6    | (3,276)                 | (1,904)        |
| Expenditures on property, plant and equipment       | 7    | (6,151)                 | (719)          |
| Proceeds on dispositions                            | 5    | 179                     | 156            |
| Change in restricted cash                           |      | (143)                   | (44)           |
| Changes in non-cash working capital                 | 17   | 1,834                   | (16)           |
|                                                     |      | (7,557)                 | (2,527)        |
| <b>Change in cash and cash equivalents</b>          |      | <b>(5,905)</b>          | <b>(1,950)</b> |
| <b>Effect of foreign exchange on cash balances</b>  |      | <b>50</b>               | <b>(169)</b>   |
| <b>Cash and cash equivalents, beginning of year</b> |      | <b>7,070</b>            | <b>9,189</b>   |
| <b>Cash and cash equivalents, end of year</b>       |      | <b>1,215</b>            | <b>7,070</b>   |
| Cash and cash equivalents consist of:               |      |                         |                |
| Cash                                                |      | 805                     | 1,210          |
| Cash equivalents                                    |      | 410                     | 5,860          |
| Supplemental information:                           |      |                         |                |
| Cash income taxes paid                              |      | -                       | -              |
| Cash interest income received                       |      | 127                     | 133            |

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

## **ALVOPETRO ENERGY LTD.**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

As at and for the years ended December 31, 2019 and 2018

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

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#### **NOTE 1 – NATURE OF OPERATIONS**

Alvopetro Energy Ltd. (“Alvopetro” or “the Company”) is engaged in the exploration for, and the acquisition, development and production of, hydrocarbons in the Recôncavo basin onshore Brazil. Alvopetro is incorporated under the Business Corporations Act (Alberta) and is a publicly traded company listed on the TSX Venture Exchange (TSX: ALV.V) and is also traded on the OTCQX® Best Market in the United States (OTCQX: ALVOF).

The Company’s head office and records are located at 1700, 525 8<sup>th</sup> Avenue S.W., Calgary, Alberta, Canada, T2P 1G1.

#### **NOTE 2 – BASIS OF PRESENTATION AND GOING CONCERN**

##### **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 19, 2020.

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

##### **Going Concern**

These financial statements have been prepared on a going concern basis, which assumes that the Company will continue its operations for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of business. As of December 31, 2019, the Company has not yet achieved commercial operations and had a net loss of \$5.0 million and negative cash flows from operating activities of \$2.5 million for the year ended December 31, 2019, and, at December 31, 2019, had an accumulated deficit of \$76.9 million and a working capital deficit of \$6.7 million. As discussed further in Note 12, the Company has access to \$13 million under the terms of its credit facility agreement entered into in 2019 (and a further \$2 million available upon first natural gas sales from the Caburé project). Alvopetro had drawn a total of \$5.0 million as of December 31, 2019. Management expects the available proceeds from this facility will be sufficient to fund the Caburé and Gomo development as planned and scheduled as well as Alvopetro’s plans and commitments on its exploration blocks and mature fields and ongoing operating, administrative and finance expenses. However, in the event of significant cost overruns or delays in production commencement from the Caburé natural gas field (which may result in ship or pay penalties under the long-term gas sales agreement, charges under the Gas Treatment Agreement, or events of default under the credit facility) or lower than anticipated sales volumes under the long-term gas sales agreement, the Company’s ability to continue as a going concern may depend on management’s ability to secure additional sources of capital. There is no assurance that such financing initiatives will be successful. These conditions indicate the existence of material uncertainties that cast significant doubt regarding the applicability of the going concern assumption. These financial statements do not give effect to adjustments that would be necessary to the carrying values and classification of assets and liabilities should the Company be unable to continue as a going concern. Such adjustments could be material.

##### **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 and assumptions 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. These estimates and associated assumptions are based on historical experience and other factors that are considered relevant. Judgments, estimates and assumptions 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.

## ALVOPETRO ENERGY LTD.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

As at and for the years ended December 31, 2019 and 2018

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

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Judgments, estimates 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 ("E&E") 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 involves significant estimates and assumptions and management's application of the Company's accounting policy for exploration and evaluation assets requires judgment.

The carrying amount of exploration and evaluation assets are reviewed at the end of each reporting period to determine whether there is an indication of impairment or impairment reversal. This requires significant judgment, estimates and assumptions with respect to future prospects, drilling success, well results from other activities including completions and stimulations, existing commitments and expiry of rights to explore, available funds, projected production rates, future market conditions and other significant changes (technological, economic, legal, regulatory).

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

Oil and natural gas assets classified as property, plant and equipment are aggregated into cash-generating units ("CGUs"). The determination of the Company's CGUs is subject to judgment. Factors considered in the classification of CGUs include any integration between assets, shared infrastructures, sales points and sales contracts, geography, geologic structure, exposure to market risks and management's intentions with respect to future development plans. Each CGU is tested for impairment based on estimates of discounted future cash flows. The estimation of future cash flows, including reserves, is an inherently complex process which involves professional judgment and geoscientific interpretation as well as estimates of future production rates, future commodity prices and the timing and amount of future expenditures, all of which are subject to uncertainty.

#### *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, future interest rates and potential changes in the legal, regulatory, environmental and political environments.

#### *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 and condensate is set in USD and the contracted price for natural gas under the Company's long-term natural gas sales agreement is derived from international benchmark prices, due to the business environment as well as policies and regulations in Brazil, management is of the opinion that the primary economic environment influencing the Company's labour, material and other costs as well as actual cash receipts from sales is Brazil.

#### *Joint Arrangement*

The determination of a joint arrangement requires management's judgment and interpretation of IFRS. The classification of a joint arrangement between joint operations and joint venture, which requires further judgment and interpretation, will affect how the financial position and results of the joint arrangement are accounted for.

#### *Going Concern*

The preparation of financial statements requires management to make judgments and estimates regarding the going concern assumption for the Company. The most significant of these judgments, estimate and assumptions relate to the timing and amounts of expected cash flows from the Company's Caburé natural gas field as discussed in detail above.

## **ALVOPETRO ENERGY LTD.**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

As at and for the years ended December 31, 2019 and 2018

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

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#### **NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES**

##### **Consolidation**

These consolidated financial statements include the accounts of Alvopetro and its controlled subsidiaries. Intercompany transactions and balances are eliminated on consolidation. As at December 31, 2019 and 2018, 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 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.

##### **Cash and Cash Equivalents**

Cash and cash equivalents consist of cash on hand and investments and deposits with an initial maturity of three months or less. Cash and cash equivalents are initially recorded at 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 initially recorded at 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 highly probable sale transaction rather than through continued use. 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 subsequent to obtaining the rights to explore, and prior to establishing commercial viability and technical feasibility, are classified as E&E assets. Such costs include land and license acquisition, technical services and studies, exploration drilling and testing, and directly attributable employee compensation. E&E assets include equipment inventory for use on future exploration wells. E&E assets are not depleted and are classified as such until they are considered technically feasible and commercially viable.

When E&E assets are considered technically feasible and commercially viable, they are reclassified to PP&E. Technical feasibility and commercial viability is initially indicated by the assignment of proved and/or probable reserves and then further subject to management judgement considering all relevant factors. Upon determination of technical feasibility and commercial viability, the E&E assets are tested for impairment and the estimated recoverable amount is transferred to PP&E.

When it has been determined that the Company will not be continuing activities in an area classified as an E&E asset or that the accumulated costs are not recoverable, the unrecoverable costs are charged to the consolidated statements of operations and

## ALVOPETRO ENERGY LTD.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

As at and for the years ended December 31, 2019 and 2018

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

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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 consists primarily of oil and natural gas development and production assets and, to a lesser extent, operational equipment for use on future exploration and development projects 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, directly attributable employee compensation and transfers from exploration and evaluation assets where technical feasibility and commercial viability has been established.

Oil and natural gas assets are accumulated on a CGU basis. Costs accumulated within each CGU are depleted using the unit-of-production method based on proved plus probable reserves before royalties as determined by independent petroleum reservoir engineers. Included in the depletion base are capitalized costs and estimated future costs to be incurred in developing proved and probable reserves.

Costs related to replacing parts of assets included in PP&E 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. 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 the consolidated statements of operations and comprehensive loss as incurred.

Corporate assets included within PP&E consist primarily of computer equipment, leasehold improvements and office furniture and equipment. Operational equipment and corporate assets are depreciated over the estimated useful lives of the related assets, ranging from five to ten years, on straight-line basis.

#### **Impairment**

E&E assets are comprised of the accumulated expenditures for each block for which technical feasibility and commercial viability has not yet been determined. E&E assets are reviewed quarterly for indicators of impairment and at the time of transfer to PP&E. Indicators of impairment consist of facts and circumstances suggesting 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.

PP&E assets are grouped for impairment purposes by CGU and reviewed quarterly for indicators of impairment. 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 CGU's recoverable amount is the greater of its fair value less costs of disposal and its value-in-use. Fair value less costs of disposal is determined using discounted future cash flows of proved plus probable reserves using forecasted prices and costs. The value-in-use is determined by estimating the present value of the future net cash flows expected to be derived from the continued use of the asset or CGU. If the carrying amount exceeds the estimated recoverable amount, the CGU is written down with an impairment loss recorded in the consolidated statement of operations and comprehensive loss.

Impairment losses from previous periods 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 but 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.

#### **Leases**

A contractual arrangement where a party has the right to control the use of an identified asset in exchange for consideration is or contains a lease. At commencement, determined to be when the leased asset is available for use, the lease liability is recognized,

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measured at the present value of the lease payments that are not paid at the commencement date and discounted using the implicit lease rate or Alvo Petro's incremental borrowing rate when the implicit rate is not readily determinable. A corresponding right-of-use ("ROU") asset is recognized. The ROU asset is based on the initial measurement of the corresponding lease liability, lease payments made at or before the commencement day, less any lease incentives received and any initial direct costs. ROU assets are subsequently measured at cost less accumulated depreciation and impairment losses.

The ROU asset is depreciated over the shorter of: 1) the asset's useful life; and 2) the lease term on a straight-line basis. Adjustments to the ROU asset are made if the contractual arrangement includes costs to dismantle the asset.

The lease liability is remeasured when there is a change in future lease payments arising from a change in rate, a change to the Company's expected residual value guarantee payable, or changes in the assessment for exercising a purchase, termination or extension option. Lease payments are allocated between repayment of the lease liability and finance expense which is charged to the consolidated statement of operations comprehensive loss.

The carrying balance of the ROU assets and lease liabilities as well as finance expense and depreciation expense amounts are impacted by the judgments and assumptions used to determine the rate. The Company applies the optional practical expedients to not recognize certain short-term leases or leases of low value.

#### **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 obligation using a risk-free rate. As all future abandonment and reclamation activities are expected to be funded in BRL, in determining the risk-free rate the Company uses a Brazil government bond rate for maturities coinciding as closely as possible with the estimated remaining years to abandonment. The change in net present value of the future decommissioning liabilities due to the passage of time is included in finance 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 control of the product has transferred to the buyer, being when the product has been physically transferred to the delivery point agreed to with the buyer. Following delivery, the buyer has full discretion over the product. A receivable is recognized by the Company when the products are delivered to the buyer as this represents the point in time at which the right to consideration becomes unconditional, as only the passage of time is required before payment is due.

#### **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 and certain warrants 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 and warrants, together with corresponding amounts

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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.

#### **Finance Expense**

Finance expense is comprised of lease interest, accretion of decommissioning liabilities, interest charged on the Company's credit facility (including cash interest, interest accrued and due upon repayment of advances, as well as commitment fees), and the amortization of deferred financing costs associated with the Company's credit facility. The portion of the interest charged on the Company's credit facility and the amortization of deferred financing costs that is directly attributable to the development of qualifying PP&E and E&E assets is capitalized directly to those assets.

#### **Income Taxes**

Income tax expense is comprised of current and deferred income taxes. Income tax expense is recognized in the consolidated statements of operations and comprehensive 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 or loss divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share 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, Alvo Petro has chosen to present its consolidated financial statements in USD.

## ALVOPETRO ENERGY LTD.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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Transactions in currencies other than the entity's functional currencies are recognized at the rates of exchange prevailing on 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 loss 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 loss.

#### Financial Instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. All financial assets and liabilities are initially recognized at fair value on the consolidated statements of financial position with subsequent measurement based on the classification of the financial instrument into one of the following categories: subsequently measured at amortized cost, fair value through profit or loss ("FVPL"), or fair value through other comprehensive income ("FVOCI").

Financial instruments classified as FVPL are subsequently carried at fair value, with changes recognized in net income. Financial assets and liabilities classified as amortized cost are subsequently carried at amortized cost using the effective interest rate method. Financial instruments classified as FVOCI are subsequently carried at fair value, with changes recognized in other comprehensive income.

Financial instruments classified as FVPL include cash and cash equivalents and restricted cash. Financial instruments subsequently measured at amortized cost include trade and other receivables, accounts payable and accrued liabilities, lease liabilities, other liabilities and long-term debt outstanding under the Company's credit facility.

At each reporting date, the Company assesses whether there is objective evidence that a financial asset carried at amortized cost is impaired. The Company has adopted the simplified approach in calculating expected credit losses for its trade and other receivables. The Company uses judgment in making these assumptions and selecting the inputs into the expected loss calculation based on past history, including historical loss experience, existing market conditions and forward-looking estimates at the end of each reporting period. Any impairment is recorded in profit or loss and impairment losses can be reversed in subsequent periods.

#### Segmented Operations

All oil and condensate sales revenue is derived from Brazilian operations. All exploration and evaluation assets and all material property, plant and equipment are located in Brazil. Cash and cash equivalents are held in both Canada and Brazil and all of the restricted cash at December 31, 2019 and 2018 is held in Brazil. The Company does not have any significant revenue in Canada other than interest earned on cash.

### NOTE 4 – CHANGES IN ACCOUNTING STANDARDS

#### New and Revised Accounting Standards

On January 1, 2019, the Company adopted IFRS 16 *Leases* under the modified retrospective approach. IFRS 16 replaces IAS 17 *Leases* and IFRIC 4 *Determining Whether an Arrangement Contains a Lease* to provide one framework requiring the recognition of a ROU asset and corresponding lease liability on the statement of financial position for substantially all contracts that contain a lease.

The Company adopted IFRS 16 using the modified retrospective approach which does not require restatement of prior period financial information as the cumulative effect of adoption is recognized as an adjustment to the Company's opening accumulated deficit and the standard is applied prospectively. As such, comparative information in the Company's financial statements are not restated. The ROU assets and lease liabilities are measured at the present value of the remaining lease payments discounted using the Company's incremental borrowing rate. The Company applied the optional practical expedients to not recognize certain short-

**ALVOPETRO ENERGY LTD.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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term leases or leases of low value and has elected to separate non-lease components from lease components for all underlying asset classes at January 1, 2019.

Upon adoption of IFRS 16 on January 1, 2019 the Company recognized ROU assets of \$0.26 million, lease liabilities of \$0.24 million, an increase to its accumulated deficit of \$0.02 million and a nominal effect on accumulated other comprehensive loss. See Note 8 for further details with respect to the ROU assets and lease liabilities.

**Standards Issued but not Yet Effective**

The Company has reviewed the following new and revised accounting pronouncements that have been issued but are not yet effective and may have a potential impact on the consolidated financial statements of the Company:

| <b>Standard and Description</b>                                                                                                                                                                                                                   | <b>Date of Adoption</b> | <b>Expected Impact on Consolidated Financial Statements</b>                                       |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------|---------------------------------------------------------------------------------------------------|
| IFRS 3 <i>Business Combinations</i> – IFRS 3 was amended to revise the definition of a business.                                                                                                                                                  | January 1, 2020         | The Company does not expect the amendments to have a material impact on the financial statements. |
| IAS 1 <i>Presentation of Financial Statements</i> and IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> have been amended to more effectively align the definition of materiality throughout all accounting standards. | January 1, 2020         | The Company does not expect the amendments to have a material impact on the financial statements. |

**NOTE 5 – ASSETS HELD FOR SALE**

|                                      | <b>As at</b>             |                          |
|--------------------------------------|--------------------------|--------------------------|
|                                      | <b>December 31, 2019</b> | <b>December 31, 2018</b> |
| Balance, beginning of year           | 202                      | 236                      |
| Transferred from E&E assets (Note 6) | 351                      | -                        |
| Impairment                           | (37)                     | -                        |
| Disposition                          | (171)                    | -                        |
| Foreign currency translation         | (13)                     | (34)                     |
| Balance, end of year                 | 332                      | 202                      |
| Land                                 | 170                      | 202                      |
| Equipment inventory                  | 162                      | -                        |
| Total                                | 332                      | 202                      |

During 2019, the Company sold equipment inventory classified as held for sale for total proceeds of \$0.2 million and recorded a nominal gain. The impairment loss in 2019 reflects management's revised estimate of the anticipated net proceeds on both the land and equipment inventory held for sale at December 31, 2019.

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|                                       | As at                |                      |
|---------------------------------------|----------------------|----------------------|
|                                       | December 31,<br>2019 | December 31,<br>2018 |
| Balance, beginning of year            | 35,340               | 54,585               |
| Capital expenditures                  | 3,276                | 1,904                |
| Capital expenditures – non-cash       | -                    | 313                  |
| Capitalized share-based compensation  | 8                    | 3                    |
| Change in decommissioning liabilities | 48                   | (31)                 |
| Transfer to PP&E (Note 7)             | (14)                 | (15,527)             |
| Other transfers (Note 5)              | (351)                | (4)                  |
| Asset dispositions                    | -                    | (426)                |
| Impairment                            | (1,608)              | (765)                |
| Foreign currency translation          | (728)                | (4,712)              |
| Balance, end of year                  | 35,971               | 35,340               |

Exploration activities in 2019 were largely focused on the 183(1) well stimulation and drilling the 57(A1) well. Testing of the 183(1) well is fundamental to determining the potential of the Company's Gomo natural gas asset which also includes the 197(1) well. In 2018, considering geographical proximity, shared infrastructure, a common gas sales agreement and management's intentions with respect to development of this area, the 183 and 197 blocks were combined with Block 198 to form a Caburé / Gomo CGU. At this time the Caburé natural gas field was considered technically feasible and commercially viable which warranted the transfer of its \$15.2 million carrying value to PP&E.

Although the proved plus probable reserves assigned to Alvopetro's Gomo gas asset in the December 31, 2019 and the 2018 reserves evaluations indicate technical feasibility and commercial viability, the evaluations are limited to the drainage area around the two existing wells and do not reflect further potential of the asset beyond this area. As such, the Company continues to evaluate the prospectivity and value of this asset with the stimulation of the 183(1) well and initial 72-hour test, which was completed in late 2019 and early 2020. The Company plans to continue its evaluation of this asset by undertaking a longer-term production test of this well. As evaluation of this asset continues, the carrying value of the Gomo portion of the CGU remains in E&E as at December 31, 2019, to be re-evaluated upon results from this additional testing. Given the results to date, the Gomo gas discovered from our 183(1) and 197(1) wells, and the Company's future plans for this project, as well as additional exploration prospects on these blocks, there is no indication of impairment of this E&E asset as at December 31, 2019.

During 2018, the Company recognized a \$0.7 million transfer of equipment classified as E&E assets to the jointly-owned Caburé natural gas unit. Of the total amount, \$0.3 million represented the Company's share and is included in the \$15.5 million transfer to PP&E. Alvopetro's operating partner's share of the equipment transferred (\$0.4 million) was recorded as a disposition. The value assigned to this equipment pursuant to the Unit Operating Agreement ("UOA") was equivalent to Alvopetro's net book value of the equipment and no gain or loss was recorded on the transfer. Non-cash capital expenditures of \$0.3 million in 2018 relate to costs initially funded by our partner under the terms of the UOA (Note 11).

General and administrative costs totaling \$0.3 million (December 31, 2018 - \$0.6 million) that were directly related to exploration and evaluation activities have been capitalized as exploration and evaluation assets.

The Company holds equipment inventory which has historically been primarily used for exploration wells and, accordingly, the carrying value of the equipment inventory is included in E&E assets. In 2019, the Company transferred \$0.4 million of materials inventory to assets held for sale. In 2018, the Company disposed of equipment inventory classified as E&E assets in several separate transactions, all to third parties of Alvopetro. Proceeds, including both cash and non-cash consideration, totaled \$0.1 million and there was no gain or loss recorded on the transactions.

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The Company recorded impairment losses as follows on its E&E assets:

|                         | Year ended December 31, |       |
|-------------------------|-------------------------|-------|
|                         | 2019                    | 2018  |
| Block 57                | (1,572)                 | -     |
| Block 62                | -                       | (129) |
| Block 71                | -                       | (122) |
| Block 106               | -                       | (196) |
| Block 145               | -                       | (105) |
| Block 169               | -                       | (101) |
| Block 255               | -                       | (71)  |
| Equipment inventory     | (36)                    | (41)  |
| Net E&E impairment loss | (1,608)                 | (765) |

During 2019, the Company relinquished Block 57 and recorded an impairment loss of \$1.6 million to bring the carrying value of the block to \$nil at December 31, 2019.

The Company is continually assessing the value of its inventory and provides for impairment on any items which are considered to have a book value in excess of its recoverable amount. At the time of the transfer of \$0.4 million of equipment inventory to assets held for sale (Note 5), a \$0.04 million impairment loss was recognized. As at December 31, 2019, the Company held \$1.5 million (December 31, 2018 - \$1.9 million) of equipment to be utilized for future operations.

Blocks 62, 71 and 145 were relinquished in early 2019 and accordingly, the carrying values at December 31, 2018 were written down to \$nil with an impairment loss of \$0.4 million. The Company relinquished Block 106 in July 2018 and an impairment loss of \$0.2 million was recorded to reduce the carrying value of this block to \$nil at June 30, 2018.

In 2018, impairment losses were recognized on each of Blocks 169 and 255 to bring the carrying value of these blocks to \$nil as of December 31, 2018, following a request filed by Alvopetro with the National Agency of Petroleum, Natural Gas and Biofuels of Brazil ("ANP") to cancel these concession contracts (including the associated work commitments) due to an ongoing injunction prohibiting unconventional activities on these blocks. In 2019, the ANP agreed to terminate the contracts and the related commitments. As the carrying value of these blocks had been fully written off as of December 31, 2018, no further impairment was required in 2019.

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|                                                                       | <b>As at</b>                 |                              |
|-----------------------------------------------------------------------|------------------------------|------------------------------|
|                                                                       | <b>December 31,<br/>2019</b> | <b>December 31,<br/>2018</b> |
| Cost, beginning of year                                               | <b>25,631</b>                | 9,514                        |
| Capital expenditures – cash                                           | <b>6,151</b>                 | 719                          |
| Capital expenditures – non-cash                                       | <b>3,244</b>                 | 2,408                        |
| Capitalized share-based compensation                                  | <b>15</b>                    | 12                           |
| Transfer from E&E assets (Note 6)                                     | <b>14</b>                    | 15,527                       |
| Transfer to ROU assets (Note 8)                                       | <b>(30)</b>                  | -                            |
| Change in decommissioning liabilities                                 | <b>196</b>                   | 189                          |
| Asset dispositions                                                    | -                            | (814)                        |
| Foreign currency translation                                          | <b>(867)</b>                 | (1,924)                      |
| Cost, end of year                                                     | <b>34,354</b>                | 25,631                       |
| Accumulated depletion, depreciation and impairment, beginning of year | <b>(3,620)</b>               | (5,276)                      |
| Depletion and depreciation for the period                             | <b>(67)</b>                  | (144)                        |
| Asset dispositions                                                    | -                            | 441                          |
| Foreign currency translation                                          | <b>317</b>                   | 1,359                        |
| Accumulated depletion, depreciation and impairment, end of year       | <b>(3,370)</b>               | (3,620)                      |
| Net book value, end of year                                           | <b>30,984</b>                | 22,011                       |

Costs of \$15.5 million transferred from E&E in 2018 include the May 31, 2018 carrying value of the Caburé natural gas field of \$15.2 million in which the Company has a 49.1% working interest. Pursuant to the UOA, substantially all the 2018 and 2019 field development is funded by the Company's partner, with Alvopetro's share due in the second quarter of 2020. Alvopetro's share of equipment inventory transferred from E&E assets to the unit represents the remaining \$0.3 million transferred during the period. Non-cash capital expenditures in 2019 and 2018 relate to costs initially funded by our partner under the terms of the UOA. Cash capital expenditures in 2019 primarily related to development of the Company's midstream infrastructure for the Caburé field, including construction of the transfer pipeline and site construction and other costs for the gas treatment facility.

General and administrative costs totaling \$0.6 million (December 31, 2018 - \$0.4 million) that were directly related to property, plant, and equipment activities have been capitalized.

During 2018 the Company executed an agreement to sell its Jiribatuba property for gross proceeds of \$0.1 million and a release of all future liabilities associated with the field, including the future abandonment and reclamation obligations, subject to customary approval by the ANP, resulting in a loss on disposition of \$0.1 million recognized in the period. Dispositions in 2018 also included \$0.05 million for Alvopetro's operating partner's share of equipment held in PP&E transferred to the jointly-owned Caburé natural gas project. As the value assigned to this equipment pursuant to the UOA was equivalent to Alvopetro's net book value of the equipment there was no resultant gain or loss on the transfer.

**Impairment**

At the end of each reporting period the Company assesses impairment and impairment reversal indicators related to all of its CGUs.

The Company's Mãe-da-lua field was not assigned any probable reserves at December 31, 2017 and the carrying value was reduced to \$nil. Although the Company was assigned proved and probable reserves on this field as at December 31, 2019 and 2018, there were no indicators of impairment reversal on this field.

There were no indicators of impairment for the Company's Caburé natural gas field or the Bom Lugar oil field at December 31, 2019 or 2018.

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*Sensitivity Analysis*

In assessing impairment, the estimated recoverable amounts for the Company's assets are determined based on fair value less costs of disposal calculations. The Company incorporates 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 the reporting date, discounted at a rate of 15%. The key assumptions used in determining the recoverable amounts for purposes of the impairment tests are commodity prices, discount rate, reserve volumes, future capital cost estimates, future well locations, timing of future capital investment, and anticipated foreign exchange rates. The Company utilizes forecasted commodity prices from its external reserves evaluator.

Future changes to forecasted commodity prices could result in future impairment losses or impairment reversals. 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 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 exchange rate forecasted by Alvopetro's independent reserves engineer. Fluctuations in the BRL relative to the USD may result in additional impairment charges or impairment reversals.

Based on the assumptions used at December 31, 2019, fluctuations of 5% in forecasted commodity prices and foreign exchange rates and a 2% change to the discount rate would not change the impairment recognized for any of the Company's PP&E properties in 2019.

**NOTE 8 – RIGHT-OF-USE ASSETS AND LEASE LIABILITIES**

The Company's contracts at December 31, 2019 that contain leases or lease components include access to land for midstream development in Brazil as well as office space in both Canada and Brazil.

The net book value of the Company's ROU assets at December 31, 2019 is as follows:

|                                                                      | <b>As at</b>                 |                            |                              |
|----------------------------------------------------------------------|------------------------------|----------------------------|------------------------------|
|                                                                      | <b>December 31,<br/>2019</b> | <b>January 1,<br/>2019</b> | <b>December 31,<br/>2018</b> |
| Net book value, beginning of year                                    | 256                          | -                          | -                            |
| ROU Assets upon adoption of IFRS 16 – formerly operating leases      | -                            | 226                        | -                            |
| ROU Assets upon adoption of IFRS 16 – transferred from PP&E (Note 7) | -                            | 30                         | -                            |
| Additions                                                            | 133                          | -                          | -                            |
| Depreciation of ROU assets                                           | (167)                        | -                          | -                            |
| Foreign currency translation                                         | (3)                          | -                          | -                            |
| Net book value, end of year                                          | 219                          | 256                        | -                            |

|                                      | <b>As at</b>                 |                            |                              |
|--------------------------------------|------------------------------|----------------------------|------------------------------|
|                                      | <b>December 31,<br/>2019</b> | <b>January 1,<br/>2019</b> | <b>December 31,<br/>2018</b> |
| <b>Net Book Value by Asset Class</b> |                              |                            |                              |
| Office space                         | 70                           | 226                        | -                            |
| Surface land access                  | 149                          | 30                         | -                            |
| Total Net Book Value                 | 219                          | 256                        | -                            |

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The Company's lease liabilities at December 31, 2019 are as follows:

|                                            | <b>As at</b>                 |                            |                              |
|--------------------------------------------|------------------------------|----------------------------|------------------------------|
|                                            | <b>December 31,<br/>2019</b> | <b>January 1,<br/>2019</b> | <b>December 31,<br/>2018</b> |
| Lease liabilities, beginning of year       | 244                          | -                          | -                            |
| Lease liabilities upon adoption of IFRS 16 | -                            | 244                        | -                            |
| Additions                                  | 133                          | -                          | -                            |
| Finance expense (Note 19)                  | 14                           | -                          | -                            |
| Lease payments                             | (234)                        | -                          | -                            |
| Foreign currency translation               | 6                            | -                          | -                            |
| Lease liabilities, end of year             | 163                          | 244                        | -                            |
| Current                                    | 101                          | 160                        | -                            |
| Non-current                                | 62                           | 84                         | -                            |
| Total, end of year                         | 163                          | 244                        | -                            |

The Company's weighted average incremental borrowing rate used in measuring lease liabilities was 7.0%.

During the year ended December 31, 2019 the Company incurred a nominal amount in payments related to leases for which the low-value expedient was applied upon adoption of IFRS 16.

**NOTE 9 – OTHER ASSETS**

Other assets represent the unamortized portion of the Company's deferred financing costs associated with the Company's Credit Facility arrangement entered into in 2019 (Note 12). The deferred financing costs are comprised of cash transactions costs as well as the fair value of the warrants issued to advisors and lenders. These costs are being amortized over the term of the Credit Facility.

|                                          | <b>As at</b>                 |  |                              |
|------------------------------------------|------------------------------|--|------------------------------|
|                                          | <b>December<br/>31, 2019</b> |  | <b>December<br/>31, 2018</b> |
| Balance, beginning of year               | -                            |  | -                            |
| Additions                                | 1,927                        |  | -                            |
| Amortization of deferred financing costs | (137)                        |  | -                            |
| Balance, end of year                     | 1,790                        |  | -                            |

**ALVOPETRO ENERGY LTD.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

As at and for the years ended December 31, 2019 and 2018

*All tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted***NOTE 10 – DECOMMISSIONING LIABILITIES**

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

|                              | As at             |                   |
|------------------------------|-------------------|-------------------|
|                              | December 31, 2019 | December 31, 2018 |
| Balance, beginning of year   | 1,231             | 1,464             |
| Liabilities incurred         | 962               | 155               |
| Revisions to obligations     | (718)             | 3                 |
| Obligations settled          | (67)              | (12)              |
| Disposition of obligations   | -                 | (185)             |
| Accretion                    | 52                | 41                |
| Foreign currency translation | (80)              | (235)             |
| Balance, end of year         | 1,380             | 1,231             |
| Current                      | 80                | 71                |
| Non-current                  | 1,300             | 1,160             |
| Total                        | 1,380             | 1,231             |

Total undiscounted cash flows, escalated at 5.5% (December 31, 2018 - 5.5%) for inflation, required to settle the Company's decommissioning liabilities are estimated to be \$5.8 million (December 31, 2018 - \$2.0 million) and have been discounted using an average risk-free rate of 6.7% (December 31, 2018 - 2.9%). Previously all decommissioning activities were funded with U.S. dollars from Canada; however, going forward, it is expected that cash flows from the Caburé asset will be sufficient to support these activities. This prompted a shift from a U.S. Treasury bill rate to a Brazil government bond rate to align the rate more closely with the source of the funds. This change, along with abandonment timing revisions to maintain consistency with the 2019 independent reserve report, resulted in a reduction in the estimated obligations of \$0.7 million.

In 2018, the Company recorded a revision to decommissioning liabilities associated with the Caburé and Gomo natural gas assets as the timing of abandonment and reclamation was adjusted to coincide with the independent reserve report. Additionally, expected costs to abandon and reclaim all properties were revised to align with actual costs incurred by the Company for similar activities. These revisions resulted in an increase to the estimated provision which was almost entirely offset by a reduction in the inflation rate in 2018.

The 2018 disposition of \$0.2 million represents the estimated decommission liabilities associated with the Company's Jiribatuba field.

**NOTE 11 – OTHER LIABILITIES**

The Company's Other Liabilities represent the accrued payable related to Alvopetro's share, net of cash calls paid and inventory and equipment transfers, of the costs incurred to date with respect to joint development of the Caburé natural gas field in which the Company has a 49.1% working interest. Pursuant to the UOA, the majority of the 2018 and 2019 field development is initially funded by the Company's partner and Alvopetro will reimburse the operating partner for its share of the development costs, including adjustments for inflation in the second quarter of 2020.

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|                                                       | <b>As at</b>                 |                              |
|-------------------------------------------------------|------------------------------|------------------------------|
|                                                       | <b>December 31,<br/>2019</b> | <b>December 31,<br/>2018</b> |
| Balance, beginning of year                            | <b>2,348</b>                 | -                            |
| Alvopetro's share of expenditures incurred            | <b>3,048</b>                 | 2,721                        |
| Partner's share of equipment contributed by Alvopetro | -                            | (405)                        |
| Effective interest                                    | <b>196</b>                   | -                            |
| Foreign currency translation                          | <b>136</b>                   | 32                           |
| <b>Total, end of year</b>                             | <b>5,728</b>                 | <b>2,348</b>                 |
| Current                                               | <b>5,728</b>                 | -                            |
| Non-current                                           | -                            | 2,348                        |
| <b>Total, end of year</b>                             | <b>5,728</b>                 | <b>2,348</b>                 |

The effective interest is calculated based on a Brazil inflation index as specified within the UOA and discounted at 4.4%. As the effective interest is directly attributable to the unit development of the Caburé field, it has been directly capitalized to PP&E as a cost of the Caburé asset.

**NOTE 12 – CREDIT FACILITY**

On September 20, 2019 the Company entered into a \$15 million Credit and Guarantee Agreement (the "Credit Facility") and all funding conditions were met on October 8, 2019 (the "Funding Date"). The Credit Facility is secured by all of Alvopetro's assets and matures on October 8, 2022, with \$13 million available on the Funding Date and the remaining \$2 million available upon first natural gas sales from our Caburé natural gas field. Amounts under the Credit Facility are available to be drawn from the Funding Date to October 8, 2020 ("the Availability Period"). Any undrawn amounts will be cancelled on October 8, 2020. The net proceeds drawn to date on the Credit Facility have been used to fund the development of the Company's Caburé natural gas field, Gomo development costs, payments for the well drilled on Block 57 in the third quarter of 2019, and for ongoing general operational and corporate requirements. The Credit Facility contains certain customary financial and non-financial covenants, standard representations and warranties, and events of default. Financial covenants are effective as of October 8, 2020 (the first anniversary of the Funding Date).

Amounts drawn under the Credit Facility are repayable at maturity. Interest on the Credit Facility includes monthly payments at 9.5% per annum and an additional 3.0% per annum upon repayment of any amounts drawn. The Credit Facility is subject to a 1.0% per annum commitment fee on the unused available balance during the Availability Period. The Credit Facility is a financial instrument and amounts drawn under the Credit Facility subsequent to the Funding Date are treated as a financial liability.

|                                     | <b>As at</b>                 |                              |
|-------------------------------------|------------------------------|------------------------------|
|                                     | <b>December 31,<br/>2019</b> | <b>December<br/>31, 2018</b> |
| Balance at beginning of year        | -                            | -                            |
| Draws on Facility                   | <b>5,000</b>                 | -                            |
| Accrued interest due upon repayment | <b>27</b>                    | -                            |
| <b>Balance at end of year</b>       | <b>5,027</b>                 | -                            |

In addition to cash transaction costs of \$1.1 million incurred to secure this Facility, Alvopetro issued 8,057,868 share purchase warrants to the lenders ("Lender Warrants") and 375,000 share purchase warrants to the Company's financial advisors ("Advisor Warrants"). Each of the Lender Warrants and Advisor Warrants entitles the holder to purchase one common share of Alvopetro, at an exercise price of \$0.60 per common share at any time prior to September 20, 2022 (see Note 13). The Lender Warrants issued in connection with the Credit Facility are considered an equity instrument, valued using the residual value method and reflected as a deferred financing cost incurred for the ability to access the Credit Facility. The cash transaction costs have also been reflected as a deferred financing cost. As the fair value of the services with respect to the Advisor Warrants could not be reliably measured,

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the value was derived from the valuation of the Lender Warrants and recorded as a deferred financing cost. Deferred financing costs are presented as Other Assets on the Consolidated Statement of Financial Position and amortized to finance expense over the term of the Credit Facility.

|                                                               | As at                |                      |
|---------------------------------------------------------------|----------------------|----------------------|
|                                                               | December 31,<br>2019 | December<br>31, 2018 |
| Cash transaction costs                                        | 1,109                | -                    |
| Fair value of Lender Warrants                                 | 782                  | -                    |
| Fair value of Advisor Warrants                                | 36                   | -                    |
| Total transaction costs incurred                              | 1,927                | -                    |
| Amortization                                                  | (137)                | -                    |
| Unamortized Deferred Financing Costs included in Other Assets | 1,790                | -                    |

**NOTE 13 – 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**

|                                      | Year Ended December 31, |                |                     |                |
|--------------------------------------|-------------------------|----------------|---------------------|----------------|
|                                      | 2019                    |                | 2018                |                |
|                                      | Number of<br>Shares     | Amount (\$000) | Number of<br>Shares | Amount (\$000) |
| Balance, beginning of year           | 96,670,871              | 155,731        | 85,166,871          | 151,937        |
| Shares issued – private placement    | -                       | -              | 11,504,000          | 4,019          |
| Shares issued – exercise of warrants | 1,249,000               | 621            | -                   | -              |
| Shares issued – exercise of options  | 7,296                   | 4              | -                   | -              |
| Cancellation of shares               | (77,379)                | -              | -                   | -              |
| Share issue costs                    | -                       | (1)            | -                   | (225)          |
| Balance, end of year                 | 97,849,788              | 156,355        | 96,670,871          | 155,731        |

**c) Warrants to Purchase Common Shares**

Warrants outstanding at December 31, 2019 are as follows:

|                                                            | Number of Warrants |                  |            |                  |
|------------------------------------------------------------|--------------------|------------------|------------|------------------|
|                                                            | Exercise Price     |                  |            |                  |
|                                                            | USD \$0.50         | USD \$0.60       | CAD \$0.64 | Total            |
| Balance as at December 31, 2017                            | -                  | -                | -          | -                |
| Granted                                                    | 3,300,000          | -                | 376,000    | 3,676,000        |
| Balance as at December 31, 2018                            | 3,300,000          | -                | 376,000    | 3,676,000        |
| Granted                                                    | -                  | 8,432,868        | -          | 8,432,868        |
| Exercised                                                  | (1,009,000)        | -                | (240,000)  | (1,249,000)      |
| Expired                                                    | (1,491,000)        | -                | (136,000)  | (1,627,000)      |
| <b>Balance as at December 31, 2019</b>                     | <b>800,000</b>     | <b>8,432,868</b> | <b>-</b>   | <b>9,232,868</b> |
| <b>Weighted Average Remaining Contractual Life (years)</b> | <b>0.79</b>        | <b>2.72</b>      | <b>-</b>   | <b>2.56</b>      |

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The 2019 warrants granted relate to the Lender Warrants and Advisor Warrants issued in connection with the Credit Facility (Note 12). Each warrant entitles the holder to purchase one common share of Alvopetro, at an exercise price of \$0.60 per common share at any time prior to September 20, 2022.

In connection with the private placement in October 2018, the Company issued 3,676,000 share purchase warrants, each convertible into one common share with an exercise price of \$0.50 (CAD \$0.64). Of these, 800,000 were issued in exchange for advisory fees for which a fair value of the services could not be reliably measured and the Black-Scholes option pricing model was used to determine the fair value. Based on this calculation, using assumptions of a risk-free interest rate of 2.18%, an expected term of 2.0 years and expected volatility of 45%, \$0.04 million (\$0.07 CAD per warrant) of share-based compensation was recognized as share issuance costs. With respect to the remaining 2,876,000 warrants, there was no value assigned on issuance.

**d) 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 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, 2019 are as follows:

|                                                | <b>Number of<br/>Options</b> | <b>Weighted<br/>Average Exercise<br/>Price (CAD\$)</b> |
|------------------------------------------------|------------------------------|--------------------------------------------------------|
| Balance as at December 31, 2017                | 6,538,936                    | 0.52                                                   |
| Granted                                        | 2,542,250                    | 0.38                                                   |
| Expired                                        | (1,900,436)                  | 1.02                                                   |
| Balance as at December 31, 2018                | 7,180,750                    | 0.34                                                   |
| Granted                                        | 970,000                      | 0.75                                                   |
| Expired                                        | (72,000)                     | 1.10                                                   |
| Exercised                                      | (40,000)                     | 0.57                                                   |
| <b>Balance as at December 31, 2019</b>         | <b>8,038,750</b>             | <b>0.38</b>                                            |
| <b>Percentage of common shares outstanding</b> | <b>8.2%</b>                  |                                                        |

| <b>Options Outstanding at December 31, 2019</b> |                      |                                  |                             | <b>Options Exercisable at December 31, 2019</b> |                                  |                             |  |
|-------------------------------------------------|----------------------|----------------------------------|-----------------------------|-------------------------------------------------|----------------------------------|-----------------------------|--|
|                                                 |                      | Weighted<br>Average<br>Remaining |                             |                                                 | Weighted<br>Average<br>Remaining |                             |  |
| Exercise Price                                  | Number of<br>Options | Exercise Price<br>(CAD\$)        | Contractual Life<br>(years) | Number of<br>Options                            | Exercise Price<br>(CAD\$)        | Contractual Life<br>(years) |  |
| CAD\$0.18 - \$0.39                              | 4,328,750            | 0.27                             | 2.05                        | 3,896,001                                       | 0.26                             | 1.90                        |  |
| CAD\$0.40 - \$0.75                              | 3,710,000            | 0.51                             | 2.67                        | 1,873,335                                       | 0.42                             | 0.97                        |  |
| <b>CAD\$0.18 - \$0.75</b>                       | <b>8,038,750</b>     | <b>0.38</b>                      | <b>2.33</b>                 | <b>5,769,336</b>                                | <b>0.31</b>                      | <b>1.60</b>                 |  |

**d) Share-Based Compensation – Stock Options**

The fair value of the stock options granted under the Alvopetro stock option plan for the years ended December 31, 2019 and 2018 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:

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|                                   | <b>Year ended December 31,</b> |             |
|-----------------------------------|--------------------------------|-------------|
|                                   | <b>2019</b>                    | <b>2018</b> |
| Risk free interest rate (%)       | <b>1.46</b>                    | 2.26        |
| Expected term (years)             | <b>4.0</b>                     | 4.0         |
| Expected volatility (%)           | <b>45.0</b>                    | 45.0        |
| Dividend per share (%)            | -                              | -           |
| Forfeiture rate (%)               | <b>5.0</b>                     | 5.0         |
| Weighted average fair value (CAD) | <b>0.28</b>                    | 0.14        |

Total share-based compensation of \$0.2 million was computed for the year ended December 31, 2019 (2018 - \$0.1 million) related to the Alvopetro stock option plan. Of this amount, approximately \$0.02 million (2018 - \$0.02 million) was capitalized to exploration and evaluation assets and property, plant and equipment, with the remainder recognized as share-based compensation expense of \$0.1 million on the consolidated statements of operations and comprehensive loss (2018 - \$0.1 million).

**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:

|                                                   | <b>Year ended December 31,</b> |             |
|---------------------------------------------------|--------------------------------|-------------|
|                                                   | <b>2019</b>                    | <b>2018</b> |
| Weighted average common shares outstanding, basic | <b>96,708,918</b>              | 87,562,224  |

In determination of the weighted average number of diluted common shares outstanding for the years ended December 31, 2019 and 2018, all stock options and warrants were excluded because the effect would be anti-dilutive.

**NOTE 14 – TAXES**

Alvopetro computes Brazil corporate income tax under the actual profit regime. Under this regime, the corporate tax rate 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. The Company expects to be entitled to a tax benefit which reduces the tax rate on eligible activities to 15.25% within Brazil for a period of 10 years, which is the expected future income tax rate assumed.

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:

|                                                               | <b>Year ended December 31,</b> |             |
|---------------------------------------------------------------|--------------------------------|-------------|
|                                                               | <b>2019</b>                    | <b>2018</b> |
| Loss before taxes                                             | <b>(5,011)</b>                 | (4,340)     |
| Statutory income tax rate                                     | <b>15.25%</b>                  | 15.25%      |
| Expected income tax recovery                                  | <b>(764)</b>                   | (662)       |
| Decrease (increase) resulting from:                           |                                |             |
| Change in future tax rate and unrecognized deferred tax asset | <b>312</b>                     | (6,381)     |
| Change in estimated tax pools                                 | <b>51</b>                      | (6)         |
| Permanent difference on impairment and E&E expense            | <b>44</b>                      | 66          |
| Share-based compensation                                      | <b>22</b>                      | 17          |
| Impact of foreign exchange fluctuations                       | <b>245</b>                     | 6,997       |
| Other                                                         | <b>90</b>                      | (31)        |
| Income tax recovery                                           | -                              | -           |

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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.

|                                 | PP&E, E&E<br>and ROU<br>assets | Decommissioning<br>liabilities | Tax loss<br>carryforwards | Other Brazil<br>tax pools | Unrealized<br>taxable foreign<br>exchange gains | Unrecognized<br>deferred tax<br>asset | Total    |
|---------------------------------|--------------------------------|--------------------------------|---------------------------|---------------------------|-------------------------------------------------|---------------------------------------|----------|
| Deferred tax liability (asset)  |                                |                                |                           |                           |                                                 |                                       |          |
| As at December 31, 2017         | 2,842                          | (498)                          | (11,375)                  | (2,773)                   | 155                                             | 11,649                                | -        |
| Deferred tax (recovery) expense | (1,231)                        | 310                            | 5,680                     | 1,711                     | (89)                                            | (6,381)                               | -        |
| As at December 31, 2018         | 1,611                          | (188)                          | (5,695)                   | (1,062)                   | 66                                              | 5,268                                 | -        |
| Deferred tax expense (recovery) | 193                            | (22)                           | (473)                     | 41                        | (51)                                            | 312                                   | -        |
| <b>As at December 31, 2019</b>  | <b>1,804</b>                   | <b>(210)</b>                   | <b>(6,168)</b>            | <b>(1,021)</b>            | <b>15</b>                                       | <b>5,580</b>                          | <b>-</b> |

A deferred tax asset of \$5.6 million exists at December 31, 2019 (December 31, 2018 - \$5.3 million), the full balance of which has not been recognized. Of the full balance of the unrecognized deferred tax asset, \$4.2 million relates to Brazil (December 31, 2018 - \$4.1 million) and \$1.4 million relates to Canada (December 31, 2018 - \$1.2 million). Total tax loss carry-forwards include \$31.3 million attributable to Brazil, which carryforward indefinitely but are limited to annual utilization of up to 30% of taxable income in subsequent periods, and \$5.8 million attributable to Canada which expire between 2032 and 2039.

**NOTE 15 – CAPITAL MANAGEMENT**

The Company's capital consists of the following:

|                                   | <b>As at December 31,<br/>2019</b> | 2018   |
|-----------------------------------|------------------------------------|--------|
| Working capital (deficit) surplus | <b>(6,701)</b>                     | 6,729  |
| Credit facility                   | <b>5,027</b>                       | -      |
| Shareholders' equity              | <b>55,874</b>                      | 60,572 |

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, the credit facility, and shareholders' equity. At December 31, 2019, the Company's net working capital deficit was \$6.7 million (December 31, 2018 – \$6.7 million surplus), which includes \$1.2 million (December 31, 2018 - \$7.1 million) of cash and cash equivalents.

In 2019, the Company entered into the Credit Facility (Note 12), providing access to up to \$13 million, with the final \$2 million available upon first production from the Caburé natural gas development. As of December 31, 2019, a total of \$5 million had been drawn under the Credit Facility. Alvopetro may adjust its capital structure by issuing new equity or debt and adjusting its capital expenditure program, as allowed pursuant to contracted work commitments.

The Company has a credit support facility with a Canadian bank which allows for the issuance of letters of credit ("LCs") and letters of guarantee in support of financial guarantees required by the National Agency of Petroleum, Natural Gas and Biofuels of Brazil ("ANP") for Alvopetro's work commitments under the terms of its concession contracts as discussed further in Note 21. LCs 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"). As at December 31, 2019, the total amount of LCs issued under the Facility was \$4.9 million (December 31, 2018 - \$6.1 million), the full balance of which was supported by EDC on behalf of Alvopetro. LCs supported by EDC at December 31, 2019 include \$3.7 million (December 31, 2018 - \$1.2 million) of LCs related to commitments that have been satisfied or cancelled but were not released by all banks until 2020.

Current restricted cash of \$0.3 million (December 31, 2018 - \$0.1 million) includes \$0.2 million of cash posted in respect of abandonment guarantees and \$0.1 million in respect of a portion of the Company's exploration work commitment on Block 57. The portion relating to Block 57 was released in January 2020.

## **ALVOPETRO ENERGY LTD.**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

#### **NOTE 16 – FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT**

##### **Overview**

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, 2019, accounts receivable consisted of \$0.02 million (December 31, 2018 - \$0.01 million) from crude oil customers with most of the remainder related to other trade and tax credit receivables. Crude oil and condensate production is sold to two counterparties, one of which represented 64 percent of the Company's sales revenues in 2019 (2018 – 40 percent). 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. There were no expected credit losses recognized in 2019 or 2018.

##### **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 forecasting cash flows for a minimum period of twelve months. This involves preparing annual capital expenditure budgets (for discretionary and non-discretionary activities), 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. Capital expenditures and ongoing production and G&A expenses to date have been funded from the Company's cash balances and in 2019, from draws under the Company's Credit Facility (Note 12). Although positive cash flows are expected upon commencement of production from the Caburé field, there is uncertainty surrounding the timing of commencement of these cash flows. Moreover, the Company's Credit Facility contains event of default provisions which may be triggered should gas sales under the Company's long-term gas sales agreement not commence by May 31, 2020. These factors elevate the Company's liquidity risk as discussed in Note 2.

In addition, LCs for work commitments are currently supported by EDC. This coverage is reviewed annually and to the extent some or all of the EDC coverage were limited in the future, the Company may be required to provide the required amount from its existing cash balance which would reduce the Company's available funds, limiting its ability to fund future capital projects and further increase the need for additional financing. As of December 31, 2019, the Company had \$4.9 million in LCs supported by EDC, which included \$3.7 million for LCs on work commitments that had been either met or cancelled by the ANP as of December 31, 2019 and were returned by all involved banks in 2020.

##### **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 mitigate the effects of these risks within acceptable limits while maximizing returns.

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*All tabular amounts are expressed in thousands of United States dollars, except per share amounts or as otherwise noted**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 and condensate sales are denominated in BRL based on a USD benchmark 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 typically held primarily in USD within Canada and transferred to Brazil as needed to fund capital and operational requirements. Management closely monitors foreign exchange rates and transfers cash to Brazil in an effort to both meet immediate needs and optimize on foreign currency and interest rates within Brazil. At December 31, 2019, the Company held BRL 1.7 million of cash and cash equivalents in Brazil (December 31, 2018 – BRL 13.7 million). At the end of 2018, additional funds were held within Brazil for anticipated payments in early 2019 in connection with construction of the Company's pipeline for the Caburé project. In Canada, USD funds are converted to CAD on an as-needed basis.

As at December 31, 2019 and 2018, the following financial instruments were denominated in currencies other than the USD:

|                                          | Year Ended December 31 |             |             |             |
|------------------------------------------|------------------------|-------------|-------------|-------------|
|                                          | 2019                   |             | 2018        |             |
|                                          | CAD (000's)            | BRL (000's) | CAD (000's) | BRL (000's) |
| Cash and cash equivalents                | 91                     | 1,656       | 434         | 13,653      |
| Restricted cash – current                | -                      | 1,089       | -           | 525         |
| Trade and other receivables              | 28                     | 891         | 31          | 991         |
| Accounts payable and accrued liabilities | (315)                  | (11,001)    | (312)       | (3,362)     |
| Lease liabilities                        | (89)                   | (384)       | -           | -           |
| Other liabilities                        | -                      | (23,088)    | -           | (9,098)     |
| Net exposure in foreign currency         | (285)                  | (30,837)    | 153         | 2,709       |
| Net exposure in USD (\$000s)             | (219)                  | (7,650)     | 112         | 699         |

The Company had no forward exchange rate contracts in place as at or during the years ended December 31, 2019 and 2018.

Based on financial instruments held at December 31, 2019 and 2018, fluctuations in the exchange rates as indicated below would have the following estimated effect on net loss and other comprehensive loss:

|                                                             | Year Ended December 31, |      |
|-------------------------------------------------------------|-------------------------|------|
|                                                             | 2019                    | 2018 |
| Effect of 5% appreciation in CAD and BRL to USD             |                         |      |
| (Increase) decrease to net loss                             | (11)                    | 4    |
| (Increase) decrease to accumulated other comprehensive loss | (414)                   | 41   |
| Effect of 5% depreciation in CAD and BRL to USD             |                         |      |
| Decrease (increase) to net loss                             | 11                      | (4)  |
| Decrease (increase) to accumulated other comprehensive loss | 375                     | (38) |

*Commodity Price Risk*

Although the Company has not been dependent on cash flows derived from its oil and condensate sales to date, 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 crude oil and natural gas prices may reduce future net income and cash flows of the Company and may impact the ability of the Company to execute planned expenditures, meet ongoing obligations and repay interest and amounts drawn under the Credit Facility. 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 sales, the Company did not have any forward contracts in place as at or during the years ended

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December 31, 2019 and 2018. The Company may consider a hedging program in the future 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. As the interest rate on the Company's Credit Facility is fixed, it is not exposed to interest rate risk on amounts drawn under the Credit Facility.

*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, 2019 and 2018 is set forth in the table below. The Company does not currently have any financial instruments classified as Level 2 or Level 3. During the year ended December 31, 2019, there were no transfers of financial instruments between any of the above levels.

|                                                     | December 31, 2019 |                 | December 31, 2018 |                |
|-----------------------------------------------------|-------------------|-----------------|-------------------|----------------|
|                                                     | Carrying Value    | Fair Value      | Carrying Value    | Fair Value     |
| <b>Carried at fair value through profit or loss</b> |                   |                 |                   |                |
| Cash and cash equivalents <sup>(1)</sup>            | 1,215             | 1,215           | 7,070             | 7,070          |
| Restricted cash – current <sup>(1)</sup>            | 270               | 270             | 135               | 135            |
|                                                     | <b>1,485</b>      | <b>1,485</b>    | <b>7,205</b>      | <b>7,205</b>   |
| <b>Carried at amortized cost</b>                    |                   |                 |                   |                |
| Trade and other receivables                         | 265               | 265             | 284               | 284            |
| Accounts payable and accrued liabilities            | (3,244)           | (3,244)         | (1,221)           | (1,221)        |
| Lease liabilities                                   | (163)             | (163)           | -                 | -              |
| Other liabilities <sup>(2)</sup>                    | (5,728)           | (5,728)         | (2,348)           | (2,271)        |
| Credit facility                                     | (5,027)           | (5,027)         | -                 | -              |
|                                                     | <b>(13,897)</b>   | <b>(13,897)</b> | <b>(3,285)</b>    | <b>(3,208)</b> |

(1) Level 1

(2) The carrying value of Other Liabilities includes adjustments for inflation, according to the contract, to be calculated from when the liability was incurred.

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|                                          | <b>Year ended December 31,</b> |             |
|------------------------------------------|--------------------------------|-------------|
| Change in:                               | <b>2019</b>                    | <b>2018</b> |
| Trade and other receivables              | (2)                            | (161)       |
| Prepaid expenditures                     | (30)                           | (170)       |
| Accounts payable and accrued liabilities | 2,103                          | 323         |
|                                          | <b>2,071</b>                   | <b>(8)</b>  |
| Changes relating to:                     |                                |             |
| Operating activities                     | 319                            | 8           |
| Financing activities                     | (82)                           | -           |
| Investing activities                     | 1,834                          | (16)        |
|                                          | <b>2,071</b>                   | <b>(8)</b>  |

**NOTE 18 – REVENUE**

The Company's oil and condensate sales revenues are derived from two customers, under contracts based on floating prices, specifically the Brent benchmark adjusted for contracted discounts based on both a fixed cost per barrel and a fixed percentage of Brent. In the year ended December 31, 2019, discounts averaged 10% of the Brent price (year ended December 31, 2018 - 6%).

As at December 31, 2019, accounts receivable included \$0.02 million of accrued sales revenue which related to December 2019 production. There were no collection issues requiring adjustment to revenue recorded in the year ended December 31, 2019 or December 31, 2018.

Revenue is measured at the consideration specified in the contracts and represents amounts receivable net of discounts. Performance obligations associated with the sale of crude oil are satisfied when control of the product is transferred to the customer. This occurs when the oil is physically transferred to the delivery point agreed with the customer and the customer obtains legal title. Payment terms are on or before the 25<sup>th</sup> day of the month following satisfaction of the performance obligation.

**NOTE 19 – NATURE OF EXPENSES**

Production expenses by nature were as follows:

|                      | <b>Year Ended December 31,</b> |             |
|----------------------|--------------------------------|-------------|
| Production expenses: | <b>2019</b>                    | <b>2018</b> |
| Personnel            | 102                            | 325         |
| Other fixed          | 150                            | 292         |
| Variable             | 24                             | 116         |
| Workover             | -                              | 107         |
| Production expenses  | <b>276</b>                     | <b>840</b>  |

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

|                             | <b>Year Ended December 31,</b> |             |
|-----------------------------|--------------------------------|-------------|
|                             | <b>2019</b>                    | <b>2018</b> |
| G&A expenses:               |                                |             |
| Personnel                   | 2,524                          | 2,410       |
| Travel                      | 117                            | 93          |
| Office and IT costs         | 145                            | 312         |
| Professional fees           | 371                            | 657         |
| General corporate           | 621                            | 348         |
| Gross G&A expenses          | 3,778                          | 3,820       |
| Capitalized to E&E and PP&E | (985)                          | (1,058)     |
| Net G&A expenses            | 2,793                          | 2,762       |

General corporate expenses include public company costs, corporate insurance, directors' fees and other miscellaneous expenses. G&A expenses directly attributable to exploration and development projects, primarily being personnel costs, are capitalized. Office and IT expenses are comparatively lower than 2018 with the adoption of IFRS 16 and the classification of the Company's office space contracts as leases.

Finance expenses by nature are as follows:

|                                                    | <b>Year Ended December 31,</b> |             |
|----------------------------------------------------|--------------------------------|-------------|
|                                                    | <b>2019</b>                    | <b>2018</b> |
| Finance expenses:                                  |                                |             |
| Lease interest (Note 8)                            | 14                             | -           |
| Accretion of decommissioning liabilities (Note 10) | 52                             | 41          |
| Amortization of deferred financing costs (Note 9)  | 137                            | -           |
| Interest on Credit Facility (Note 12)              | 132                            | -           |
| Gross finance expenses                             | 335                            | 41          |
| Capitalized to E&E and PP&E                        | (76)                           | -           |
| Finance expenses                                   | 259                            | 41          |

Interest calculated on the Credit Facility includes cash interest and commitment fees paid monthly as well as accrued interest due and payable upon repayment of amounts drawn. The portion of each of the interest on the Credit Facility and the amortization of deferred financing costs that is directly attributable to eligible PP&E and E&E activities is capitalized to those assets, with the remainder, as shown above, included in the consolidated statements of operations and comprehensive loss. Of the \$0.3 million of finance expense in 2019, \$0.2 million is a non-cash expense (2018 – \$0.04 million).

**NOTE 20 – RELATED PARTY TRANSACTIONS**

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

|                          | <b>Year ended December 31,</b> |             |
|--------------------------|--------------------------------|-------------|
|                          | <b>2019</b>                    | <b>2018</b> |
| Short-term benefits      | 477                            | 423         |
| Share-based compensation | 110                            | 77          |
| Total                    | 587                            | 500         |

Alvo Petro directors and officers participated in the October 2018 private placement. Of the total common shares issued under the private placement, 860,000 common shares were subscribed for by three insiders of Alvo Petro for total proceeds of CAD\$0.4 million. Of the total 3,676,000 warrants issued, 215,000 were issued to these insiders with an exercise price of CAD\$0.64 per share, all of which were exercised by these insiders in advance of the December 15, 2019 expiry date for total proceeds to

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Alvopetro of CAD\$0.1 million. The terms of these subscriptions by directors and officers were equivalent to the subscription terms by other investors.

The following table lists the Company's subsidiaries and their respective places of incorporation, each owned 100% directly and indirectly at December 31, 2019:

| <b>Subsidiary Name</b>                            | <b>Country of Incorporation</b> |
|---------------------------------------------------|---------------------------------|
| Alvopetro Oil and Gas Investments Inc.            | Canada                          |
| Alvopetro S.A. Extração de Petróleo e Gás Natural | Brazil                          |
| Alvopetro Investimentos e Participações Ltda.     | Brazil                          |
| Alvopetro Participações em Petróleo E Gás Ltda.   | Brazil                          |

**NOTE 21 – COMMITMENTS AND CONTINGENCIES**

The following is a summary of contractual commitments as at December 31, 2019:

| <b>Commitments</b>                      | <b>&lt; 1 Year</b> | <b>1-3 Years</b> | <b>Thereafter</b> | <b>Total</b>  |
|-----------------------------------------|--------------------|------------------|-------------------|---------------|
| Minimum work commitments <sup>(1)</sup> |                    |                  |                   |               |
| Block 183 <sup>(2)</sup>                | -                  | 827              | -                 | 827           |
| Bom Lugar                               | -                  | -                | 87                | 87            |
| Mãe-da-lua                              | -                  | -                | 87                | 87            |
| <b>Minimum work commitments</b>         | <b>-</b>           | <b>827</b>       | <b>174</b>        | <b>1,001</b>  |
| <b>Gas Treatment Agreement</b>          | <b>2,298</b>       | <b>5,719</b>     | <b>20,968</b>     | <b>28,985</b> |
| <b>Total commitments</b>                | <b>2,298</b>       | <b>6,546</b>     | <b>21,142</b>     | <b>29,986</b> |

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) In February 2018, the ANP approved a suspension to the portion of Block 183 currently in the second exploration phase to which the above commitment is applicable. The Company will have 517 days from receipt of the environmental permit for the well to be drilled to meet the required work commitment.

The Company's long-term gas sales agreement ("GSA") with Bahiagás provides for the sale of 5.3 mmcfpd (150,000 m3/d) on a firm basis and 12.4 million mmcfpd (350,000 m3/d) on an interruptible basis and includes ship or pay penalties for supply failure in respect of the firm volumes and also take or pay penalties applicable to Bahiagás should it be unable to accept the firm volumes specified in the contract. The Company believes it can meet the firm sales commitments under the GSA solely with our production from the Caburé natural gas field, however supply failure penalties may arise where construction is delayed, where there are unplanned production interruptions, or to the extent reservoir performance is below expected production rates. Supply failure penalties are a function of the shortfall of firm volumes and the prevailing natural gas price under the GSA at the time, which is determined based on a trailing weighted average basket of benchmark reference prices including Henry Hub and National Balancing Point natural gas prices and Brent crude oil prices. Alvopetro can mitigate these risks by adjusting firm volumes annually, meeting sales commitments under the GSA with third-party gas supplies, through development of existing gas resources, or through new gas discoveries from existing prospect inventory. Firm gas deliveries under the GSA will commence on June 27, 2020 (the "Firm Start Date"), with interruptible deliveries commencing earlier with mutual consent. The Company expects to commence gas deliveries on an interruptible basis in the second quarter of 2020; however firm sales volumes (and the applicable potential penalties to both parties) will not commence until the Firm Start Date, or such earlier date as the parties may agree.

Alvopetro has a 10-year contract (the "Gas Treatment Agreement") with Enerflex Ltd. ("Enerflex"), pursuant to which, Enerflex constructed and will own, operate and maintain a natural gas treatment facility (the "Facility"). Alvopetro is committed to integrated service fees totaling \$2.9 million per year once the Facility is operational. Alvopetro anticipates that the Facility will be operational in the second quarter of 2020 and has reflected the associated commitment in the table above based on this start date. A portion of the payments are in BRL and therefore exposed to foreign exchange fluctuations. Management has assessed

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that this agreement contains a lease component under IFRS 16 which will affect the classification of these fees in future consolidated financial statements. The Gas Treatment Agreement includes customary penalties and standby charges to the extent Alvopetro is unable to receive the services on the start date. In addition, the Gas Treatment Agreement includes early termination penalty provisions which vary depending on timing of the termination. While the Gas Treatment Agreement also includes strict availability requirements and downtime credits, such credits may not fully offset costs incurred by Alvopetro due to ship or pay obligations under the GSA as discussed above to the extent processing in the Facility is limited due to unplanned or longer than scheduled maintenance or repair.

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 such work plans are not completed 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 the outcomes are not determinable. The Company has a policy to record contingent liabilities as they become determinable and the probability of loss is more likely than not.