



north peace energy corp.

Financial Report

09

## Table Of Contents

Letter to Shareholders	01
MD&A	02
Financial Statements	13
Notes to Financial Statements	16

### AGM Details:

North Peace's annual general meeting of shareholders will take place at 10 am on Thursday May 27, 2010 in the Cardium room, Petroleum Club, 319 - 5 Avenue SW, Calgary, Ab.



**Dear fellow shareholders:**

During 2009 we delivered on our business plan. In the first quarter of 2009, we completed construction of our pilot facilities in Red Earth, Alberta. Our two horizontal cyclic steam stimulation (CSS) wells (L1 and L2) have each been through a full cycle and L1's second cycle continues. As a result, we have been producing continuously since May 2009 with cumulative production of approximately 22,000 barrels to date. With Sproule Associates' latest evaluation of our bitumen resources, 105 million barrels of our 2.1 billion barrels of discovered bitumen initially-in-place was upgraded to contingent resources. Financially, we remain debt-free and have adequate working capital to fund operations to the end of the year.

Most importantly for the long term development of North Peace, results from our pilot operations have enabled us to acquire valuable production and operational metrics to more efficiently exploit this resource in the near future.

The pilot operations have been key to advancing our understanding of the resource and are proving instrumental to optimize the advancement of the project. The first cycle steam-to-oil ratios ("SOR") were higher than we had hoped, however other observations and results from the pilot operations are very encouraging. We also confirmed that the high quality bitumen being produced is nearly mobile at reservoir conditions. We have applied the knowledge garnered in the first cycle steaming operations and adapted our steaming strategy to L1's second cycle to a less aggressive, lower pressure approach with solid results. Our SOR for L1's second cycle has now reached the current industry average level of 3.7 (when adjusted for heat content of injected steam in SAGD projects) and is continuing to drop as the cycle nears its end. Now that we are confident in the reservoir's ability to generate sufficient oil for a given energy input, we are focused on increasing heat input rates to the reservoir and increasing production rates per well to minimize future capital costs. Well layout for commercial development remains to be optimized and our pilot is ideally located and suited to transition into a larger scale facility.

In the current market environment, access to sufficient capital through the equity markets for full commercialization would be extremely dilutive for our existing shareholders. As a consequence, in February 2010, our Board of Directors initiated a process to explore strategic alternatives with a view to enhancing shareholder value. Strategic alternatives may include, but are not limited to, a corporate sale, a merger or other business combination such as joint venturing with an interested party, a major financing or any other combination that will result in unlocking additional value for shareholders. At this time, this process continues.

I would like to thank my colleagues at North Peace for their ongoing dedication to the development of the company. They have delivered seamless, reliable operations and demonstrated the ability to quickly interpret, react and adapt to the technical results of our pioneering efforts. I also wish to take this opportunity to thank my fellow directors for their support and leadership.



Louis R Dufresne  
President, CEO and Director  
April 20, 2010

## Management's Discussion and Analysis of Financial Results

*This Management's Discussion and Analysis for North Peace Energy Corp. ("North Peace" or the "Company") provides analysis of the Company's financial results for the year ended December 31, 2009. The following information should be read in conjunction with the financial statements for the year ended December 31, 2009.*

*Additional information about North Peace filed with Canadian securities commissions is available online at [www.sedar.com](http://www.sedar.com).*

Date of Report                      April 20, 2010

### Overview

North Peace has an early stage in-situ oil sands play in northern Alberta with an estimated 2.1 billion barrels of Discovered Bitumen Initially-In-Place. The Company has a 100% working interest in 86,400 acres of Crown oil sands leases in the Peace River area plus interests in other non-core areas. The oil sands leases have the benefit of over 300 legacy wells and are surrounded by accessible oil and natural gas production infrastructure. The target Bluesky zone is a regional sand, deposited in a near shore marine environment at approximately 400 metres in depth. Management estimates the initial area of focus has approximately 22 sections with 10 to 16 metres of oil-bearing thickness, technically sufficient to advance a 10,000 bbl/d commercial project with ultimate potential of 30,000 bbl/d. North Peace is currently advancing the development of its resource using Cyclic Steam Stimulation ("CSS"), a robust and proven in-situ thermal recovery process. The Company is currently operating a two well CSS pilot on its lands.

### Company and Project Overview

During the year ended December 31, 2009 the Company has completed the following significant milestones:

- Completed pilot construction in the first quarter
- Initiated first steam on the L1 well in January
- Achieved first oil production from the pilot in May
  - Produced cumulative oil of 16,041 barrels from the L1 and L2 wells during the year
- Completed the first cycle on the L1 well and started the second cycle
- Steamed the L2 well and commenced oil production
- Completed the winter drilling program at Red Earth which consisted of an additional 10 delineation wells to bring the total well count to 27 delineation wells
- Drilled five conventional exploration wells outside the Red Earth area
  - Three wells (1.6 wells net to North Peace) of the exploration program were successful resulting in 177,800 barrels of Proved plus Probable reserves and NPV10 value before tax of \$3.7 million

Subsequent to December 31, 2009 the Company has completed the following:

- Announced a review of strategic alternatives for the Company
- Entered into an agreement to sell a portion of the drilling royalty credits, which were earned as part of the conventional exploration program for \$450,000

## Financial Results

### Annual Financial Information (Three Year Summary)

	As at and for the years ended December 31		
	2009(\$)	2008(\$)	2007(\$)
Revenues	47,235	397,941	343,621
Net Loss and Comprehensive loss	2,760,247	1,488,297	1,228,325
Basic and diluted Net Loss Per share	0.042	0.032	0.040
Total Assets	78,519,710	74,609,635	43,140,812

Over the last three years the Company has grown in size and assets. The Company's only source of revenue has been interest income (revenue from the pilot project is capitalized). The interest income is generated from the cash invested from the equity financings completed each year since 2007.

The Company's assets have grown since 2006 through capital expenditures. In 2007 the Company drilled five vertical delineation wells and bought out its 30% working interest partner. In 2008 the Company drilled an additional five vertical delineation wells, two horizontal wells and completed the majority of the construction of its pilot project. In 2009, the construction of the pilot project was completed and the Company drilled an additional 10 delineation wells at Red Earth as well as 5 conventional exploration wells outside the Red Earth area.

### Quarterly Financial Information

	2009 Q4(\$)	2009 Q3(\$)	2009 Q2(\$)	2009 Q1(\$)
Revenues	8,193	8,191	4,099	26,752
Net Loss	766,369	640,129	695,369	658,380
Basic and Diluted Loss Per share	0.010	0.008	0.012	0.012

	2008 Q4(\$)	2008 Q3(\$)	2008 Q2(\$)	2008 Q1(\$)
Revenues	150,963	120,028	39,045	87,905
Net Loss	30,100	571,983	486,924	399,290
Basic and Diluted Loss Per share	0.001	0.012	0.013	0.010

### Results of Operations

#### Interest Income

	Year ended December 31,	
	2009(\$)	2008(\$)
Interest Income	47,235	397,941

Interest income was \$47,235 for 2009, with the majority from redeemable term deposits bearing interest between 0.25% and 1.50% and maturing at various times throughout the year. Interest income was \$397,941 in 2008. The decrease in interest income from 2008 is due to lower amounts of cash on deposit throughout the year coupled with significant decreases in interest rates.

## Stock-based Compensation

	Year ended December 31,	
	2009(\$)	2008(\$)
Stock-based Compensation	<b>1,132,790</b>	776,133

Stock-based compensation for 2009 was \$1,132,790. The amount in 2009 consists of additional option grants in the year to existing employees and recognition of the expense for existing stock options. \$95,361 related to stock based compensation was capitalized during the year relating to consultants working directly on the capital program and pilot project.

The average fair value of the options granted during 2009 was \$0.33 per option (2008 - \$0.82) assuming an average volatility of 80% (2008 - 80%) on the underlying shares, a weighted average exercise price of \$0.54 (2008 - \$1.46), a risk-free interest rate of 2.11% – 2.23% (2008 - 2.81% - 3.35%), an expected life of 4 years (2008 - 4 years), and an expected dividend rate of nil (2008 - nil).

## Administrative Expenses

	Year ended December 31,	
	2009(\$)	2008(\$)
G&A expense		
Salaries, Benefits and Consulting Fees	<b>1,123,561</b>	937,058
Legal, Accounting and Audit Fees	<b>96,485</b>	123,965
Office rent	<b>258,955</b>	109,471
Other G&A	<b>656,277</b>	526,619
Total G&A expense	<b>2,135,278</b>	1,697,113

### Salaries, Benefits and Consulting Fees

The increase from 2008 is due to increased salaries attributable to additional staff to manage pilot operations and salary increases for existing staff.

### Legal, Accounting and Audit Fees

Legal accounting and audit fees for 2009 are down from 2008 as the company had fewer legal requirements during the year as the focus was on pilot operations.

### Office Rent

The increase in office rent for 2009 is due to a new office lease which was entered into on January 1, 2009. The new office was to accommodate additional staff for operations and various geological, land and thermal consultants.

### Other G&A

The increase in Other G&A for the year is due to increased general office expense for the new office space and tax payments for the look-back provision on the flow through shares.

## Depreciation and Accretion

	Year ended December 31,	
	2009(\$)	2008(\$)
Depreciation and Accretion	<b>71,453</b>	41,662

The Company had depreciation expense during 2009 of \$30,661 compared to \$24,542 for 2008 related to office furniture and computer equipment. The increase from 2008 is due to additional depreciation from new office equipment with the move into the office location in 2009. Accretion related to asset retirement obligations during 2009 was \$40,791 compared to 17,120 in 2008. The increase is due to additional obligations for the pilot facility and the additional delineation and exploration wells.

### Red Earth CSS Pilot

The Red Earth CSS pilot commenced production at the beginning of May 2009. All revenues and expenses from the pilot have been recorded as an adjustment to the capitalized costs of the project. Operating costs were incurred starting January 2009. The majority of these operating costs relate to steam generation, which began in January 2009 and fixed facility costs. Well related operating costs were incurred with first production in May 2009.

	Year ended December 31,	
	2009	2008
Total Production (bbl)	<b>16,041</b>	-
Production (bbls/day)	<b>44</b>	-
Average sales price (CDN\$/bbl)	<b>48.93</b>	-
Revenue	<b>784,922</b>	-
Royalties	<b>(26,569)</b>	-
Operating Costs	<b>(2,714,657)</b>	-
Net operating expenses	<b>(1,956,304)</b>	-

### Liquidity and Capital Resources

As at December 31, 2009 the Company had working capital of \$5.0 million and no debt.

The Company has no significant capital expenditures planned for 2010, therefore current working capital will be sufficient to fund certain capital requirements, pilot operations and general corporate requirements.

As at December 31, 2009, the payments due under the office lease commitment are as follows:

(Cdn \$)	
2010	192,864
2011	192,864
2012	Nil
2013	Nil
2014	Nil
Thereafter	Nil

Capital expenditures were as follows:

(Cdn \$)	Year ended December 31	
	2009(\$)	2008(\$)
Land & Lease rentals	372,215	319,635
Drilling and Completion	7,000,907	8,871,459
Geological costs	196,880	74,411
Pilot facilities		
Construction, equipment and engineering	3,870,984	11,982,697
Capitalized plant overhead and operations	1,956,304	322,495
Other	462,733	477,530
<b>Total</b>	<b>13,860,023</b>	<b>22,048,227</b>

Capitalized stock-based compensation and asset retirement obligation additions are not included in the above table.

#### Additional Disclosure for Venture Issuers without Significant Revenues

The Company has no expensed exploration or research and development costs. Capitalized exploration costs are related to the purchase of oil sands leases, the drilling of 27 delineation wells, the drilling of 5 conventional wells outside our core area and the related geological assessments. Capitalized development costs relate to the construction of the Company's CSS pilot project, the drilling of two horizontal production wells and the completions on three conventional production wells outside of Red Earth.

#### Share Capitalization

The following table shows the common shares, stock options, purchase warrants and performance warrants issued and outstanding at December 31, 2009:

	<b>As at December 31, 2009</b>
Common shares outstanding	76,179,800
Weighted average number of shares outstanding during the year	66,116,879
Stock options outstanding	6,065,000
Performance warrants outstanding	6,300,000
\$0.75 Warrants outstanding	10,554,500
\$2.00 Warrants outstanding	6,666,650

As at April 20, 2009, there were 76,179,800 common shares, 6,065,000 stock options, 6,300,000 performance warrants and 10,554,500 \$0.75 warrants outstanding. The warrants with an exercise price of \$2.00 expired unexercised on February 7, 2010.

#### Off Balance Sheet Arrangements

There were no off balance sheet arrangements, other than the office lease commitment which is accounted for as an operating lease.

#### Transactions with Related Parties

As at December 31, 2009, the Company accrued legal costs of \$125,000 (2008 - \$10,000) payable to a firm in which a director is a partner. As at December 31, 2009, the Company had initiated work with a service company in which the president is an owner. Total capital costs of \$24,764 (2008 - nil) were payable to the service Company upon completion. All related party transactions are in the normal course

of operations. Related party transactions entered into by the Company have been measured at the exchange amount established and agreed to by the related parties.

#### Fourth-Quarter 2009 Activities

During the three months ended December 31, 2009 the Company had interest income of \$8,193 compared to interest income of \$8,191 for the three months ended September 30, 2009. The interest revenue amount was the same as the third quarter as the cash balance and interest rate remained relatively constant.

General and Administrative expenses for the fourth quarter were \$734,619 compared to \$457,539 in the third quarter of 2009. The increase is due to year-end bonuses paid in the fourth quarter.

Capital expenditures of \$7,309,707 in the fourth quarter of 2009 related to delineation drilling on the Red Earth asset and the Company's 5 well conventional exploration program outside the Red Earth area.

#### Project and Company Outlook

During 2010, the Company will focus on pilot operations, running a third steam cycle on the L1 well and circulating steam into the L2 well.

On February 4, 2010, North Peace's Board of Directors initiated a process to explore strategic alternatives with a view to enhancing shareholder value. The Company engaged CIBC World Markets Inc. ("CIBC") to provide financial advisory services to assist in this strategic review. Strategic alternatives may include, but are not limited to, a corporate sale, merger or other business combination, joint venturing with an interested party, a major financing or any other combination. The Board established a Special Committee of independent directors to work with management and the Company's external advisors and to supervise the strategic review process.

#### Critical Accounting Estimates

The preparation of financial statements requires the Company to make judgements, assumptions and estimates in the application of generally accepted accounting principles that have a significant impact on the financial results of the Company. Actual results could differ from those estimates.

#### *Impairment of Property and Equipment*

Property costs are reviewed at least annually to consider whether there are conditions that may indicate impairment. The carrying values of petroleum and natural gas properties are compared to their net recoverable amount as estimated by quantifiable evidence of the market value of similar assets or geological resources. If the carrying value is found to exceed the estimated net recoverable amount a write down will be recorded.

#### *Asset Retirement Obligations*

The Company is required to provide for future removal and restoration costs. The Company must estimate these costs in accordance with existing laws, contracts or other policies. The fair value of the liability for the Company's asset retirement obligations is recorded in the period in which it is expected to be incurred, discounted to its present value using the Company's credit-adjusted risk free interest rate and expected inflation rate. The offset to the liability is recorded in the carrying amount of property and equipment. The liability amount is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings in the period. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost could also result in an increase or decrease to the

obligation. Actual costs incurred upon settlement of the retirement obligation are charged against the obligation to the extent of the liability recorded.

### *Income Tax Accounting*

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of considerable time.

### *Stock-Based Compensation*

The Company uses the fair value method for valuing stock option grants. The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model. This model requires the Company's management to make estimates and assumptions for the following: dividend yield; expected volatility and risk-free rate. A zero dividend yield is used as the Company does not pay dividends; the volatility is a calculation based on a peer company comparison because of our lack of representative trading history and the risk-free rate is obtained from the Bank of Canada.

### Changes in Accounting Policies (including initial adoption)

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

### Financial Instruments and Other Instruments

The Company's carrying value of cash and cash equivalents, accounts receivable and accounts payable and accruals approximates its fair value due to the immediate or short-term maturity of these instruments.

### Risks and Uncertainties

North Peace is exposed to operational and regulatory risks and uncertainties in the normal course of business that can influence its future financial performance. A summary of certain of these risks is set out below under "Forward-Looking Statements". Readers are cautioned that these descriptions are not exhaustive. Certain additional risks and uncertainties are discussed below.

### *Liquidity Risk*

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

Although in certain cases capital markets have improved since the significant downturn experienced in 2008, capital market conditions may limit the Company's ability to raise the capital necessary to undertake or complete projected capital expenditures after 2010. In addition, if debt or equity financing is available, there is no assurance that it will be on terms acceptable to the Company.

The Company prepares periodic capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. The Company does not have a credit facility.

Based on the current working capital balance, the Company's budget indicates that the Company currently has sufficient capital to fund corporate and operational expenses until the end of 2010. The Company has flexibility in timing future capital expenditures related to further development and will investigate all options to obtain the required funds to grow the Company.

#### *Oil & Gas Prices*

World prices for crude oil and natural gas have been volatile. The Company currently intends to operate its CSS pilot project notwithstanding the prevailing commodity price environment as the purpose of the pilot project is to validate the economic and technical parameters of the commercial project. Crude oil prices, while a significant factor, are only one of many factors in the Company's decision to advance a commercial project. The Company will monitor commodity prices as it is evaluating production performance data from the pilot project. The Company will utilize this data and then current and anticipated crude oil and natural gas prices in evaluating the feasibility of a commercial project.

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

In February 2008, the CICA Accounting Standards Board ("AcSB") confirmed that the changeover to IFRS from Canadian GAAP will be required for publicly accountable enterprises effective for the interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The International Accounting Standards Board ("IASB") issued an amendment to IFRS 1 "Additional Exemptions for First-time Adopters" in July 2009 for oil and gas companies following full cost accounting. This amendment will enable an entity to measure exploration and evaluation assets at the amount determined under the entity's previous accounting principles and it also provides for the measurement of oil and gas assets in the development or production phase, among other things, by allocating the amount determined by the entity's previous accounting principles to the underlying assets on a pro rata basis using reserve volumes or reserve values at the date of transition.

The transition from current Canadian GAAP to IFRS is a significant undertaking that may materially affect the Company's reported financial position and results of operations.

The Company has not completed the development of its IFRS changeover plan, which will include project structure governance, resourcing and training, analysis of key GAAP differences and a phase plan to assess accounting policies under IFRS as well as potential IFRS 1 ("First Time Adoption of IFRS") exemptions. The Company will complete its project scoping, which will include a timetable for assessing the impact on data systems, internal controls over financial reporting and business activities, such as financing and compensation arrangements in the first half of 2010.

### Discovered Petroleum Initially-In-Place

Discovered Petroleum Initially-In-Place (equivalent to Discovered Resources) is that quantity of petroleum that is estimated, as of a given date, to be contained in known accumulations prior to production. The recoverable portion of Discovered Petroleum Initially-In-Place includes production, reserves, and contingent resources. There is no certainty that the Discovered Petroleum Initially-In-Place will ever be produced.

### Forward-Looking Statements

Certain statements contained in this MD&A constitute forward-looking statements that involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements.

In particular, this MD&A contains forward-looking statements pertaining, directly or indirectly, to the following: business and operations strategies including the operations at North Peace's pilot project and potential commencement of a subsequent commercial project.

The forward-looking statements contained in this MD&A are based on a number of expectations and assumptions that may prove to be incorrect. In addition to other assumptions identified in this MD&A, assumptions have been made regarding, among other things: that North Peace will continue to conduct its operations in a manner consistent with past operations; the continuance of existing (and in certain circumstances, proposed) tax and royalty regimes; the general continuance of current industry conditions; the accuracy of the estimates of North Peace's resource volumes; the ability of North Peace to obtain equipment, services and supplies in a timely manner and within budget to carry out its activities; the timely receipt of required regulatory approvals; the ability of North Peace to obtain financing on acceptable terms; future oil and gas prices and future cost assumptions.

No assurance can be given that these expectations will prove to be correct and such forward-looking statements included in this MD&A should not be unduly relied upon. Actual results could differ materially as a result of changes in North Peace's plans, changes in commodity prices, regulatory changes, general economic, market and business conditions as well as production, development and operating performance and other risks associated with oil and gas operations including anticipated success of resource prospects and the expected characteristics of resource prospects; anticipated capital requirements, project rates of return and estimated project life; estimates of original discovered resource; estimates of recovery factors; lack of diversification; and overall technical and economic feasibility of the Company's project. These statements speak only as of the date of this MD&A or as of the date specified in the documents accompanying this MD&A, as the case may be.

The Company undertakes no obligation to publicly update or revise any forward-looking statements except as expressly required by applicable securities laws.

## MANAGEMENT'S REPORT

The accompanying Financial Statements of North Peace Energy Corp. and related financial information presented in this annual report are the responsibility of Management and have been approved by the Board of Directors. The Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles. The Financial Statements and related financial information reflect amounts which must, of necessity, be based upon informed estimates and judgments of Management with appropriate consideration to materiality. All financial information contained in the annual report is consistent, where appropriate, with that contained in the Financial Statements.

KPMG, LLP, independent external auditors appointed by the shareholders of the Company have examined the Financial Statements and they have expressed an opinion on the statements. Their report is included in the Financial Statements.

The Board of Directors has established an Audit Committee. The Audit Committee reviews with Management and the external auditors any significant financial reporting issues, the financial statements, and any other matters of relevance to the parties. The Audit Committee meets quarterly to review and approve the interim financial statements prior to their release, as well as annually to review the Company's annual financial statements and Management's discussion and analysis, and to recommend their approval to the Board of Directors. The external auditors have unrestricted access to the Company, the Audit Committee and the Board of Directors.



Louis Dufresne  
President and Chief Executive Officer



James Glessing  
Chief Financial Officer

April 20, 2010



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## AUDITORS' REPORT TO THE SHAREHOLDERS

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

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

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

Chartered Accountants

Calgary, Canada  
April 20, 2010

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

Balance Sheets, as at

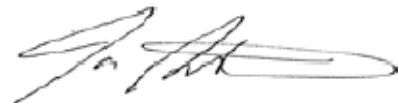
(Cdn \$)	December 31, 2009	December 31, 2008
<b>Assets</b>		
Current assets		
Cash and cash equivalents (note 5)	\$ 8,716,278	\$ 18,119,752
Accounts receivable	678,815	922,537
Prepaid expenses	102,914	86,290
	<b>9,498,007</b>	19,128,579
Oil and gas properties (note 6)	68,987,750	54,875,482
Other assets	33,953	48,097
Future income tax asset (note 8)	-	557,477
	<b>\$ 78,519,710</b>	<b>\$ 74,609,635</b>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities		
Accounts payable and accruals	\$ 4,344,217	\$ 8,788,438
Current Portion of asset retirement obligations (note 7)	161,940	112,389
	<b>4,506,157</b>	8,900,827
Asset retirement obligations (note 7)	449,269	329,914
Future income tax liability (note 8)	231,296	-
	<b>5,186,722</b>	9,230,741
Shareholders' equity		
Equity Instruments (note 9)	76,644,605	67,158,445
Contributed surplus (note 10)	4,042,103	2,813,922
Deficit	(7,353,720)	(4,593,473)
	<b>73,332,988</b>	65,378,894
	<b>\$ 78,519,710</b>	<b>\$ 74,609,635</b>

Future Operations (note 1)

Commitments (note 12)

Subsequent Events (note 9 & 16)

Signed on behalf of the Board:



Ian Robertson, Director



Don Garner, Director

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

## Statements of Loss, Comprehensive Loss and Deficit

(Cdn \$)	Year ended December 31,	
	2009	2008
<b>Revenue</b>		
Interest income	\$ 47,235	\$ 397,941
	<b>47,235</b>	<b>397,941</b>
<b>Operating expenses</b>		
General and administrative	2,135,278	1,697,113
Stock-based compensation (note 9)	1,132,790	776,133
Depletion, depreciation and accretion	71,453	41,662
	<b>3,339,521</b>	<b>2,514,908</b>
Net Loss before taxes	3,292,286	2,116,967
Future Income Tax Reduction	532,039	628,670
Net Loss and Comprehensive Loss	\$ 2,760,247	\$ 1,488,297
Deficit at beginning of year	4,593,473	3,105,176
Deficit at end of year	\$ 7,353,720	\$ 4,593,473
Net Loss per share (note 15)		
Basic and Diluted	\$ 0.042	\$ 0.032

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

## Statements of Cash Flows

(Cdn \$)	Year ended December 31,	
	2009	2008
<b>Cash provided by (used in):</b>		
<b>Operating Activities</b>		
Net Loss	\$ (2,760,247)	\$ (1,488,297)
Non-cash charges to earnings		
Depletion, depreciation and accretion	71,453	41,662
Stock-based compensation	1,132,790	776,133
Future income tax recovery	(532,039)	(628,670)
	<b>(2,088,043)</b>	<b>(1,299,172)</b>
Net change in non cash working capital		
Accounts receivable	581,093	(363,437)
Prepaid expenses	(16,624)	(39,930)
Accounts payable and accruals	135,354	(25,109)
	<b>(1,388,220)</b>	<b>(1,727,648)</b>
<b>Investing Activities</b>		
Additions to oil and gas properties	(13,860,020)	(22,048,227)
Other assets	(16,518)	(17,936)
Net change in non cash working capital		
Accounts receivable	(337,371)	(195,500)
Accounts payable and accruals	(4,579,575)	7,788,893
	<b>(18,793,484)</b>	<b>(14,472,770)</b>
<b>Financing Activities</b>		
Net Proceeds on issue of common shares	10,778,230	24,275,777
Net change in non cash working capital		
Accounts payable and accruals	-	80,000
	<b>10,778,230</b>	<b>24,355,777</b>
<b>Increase in cash and cash equivalents</b>	<b>(9,403,474)</b>	<b>8,155,359</b>
<b>Cash and cash equivalents, beginning of year</b>	<b>18,119,752</b>	<b>9,964,393</b>
<b>Cash and cash equivalents, end of year</b>	<b>\$ 8,716,278</b>	<b>\$ 18,119,752</b>
Supplemental disclosure:		
Interest received	\$ 199,466	\$ 380,329

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## **1. Nature of operations and future operations**

North Peace Energy Corp. (the “Company” or “North Peace”) resulted from the amalgamation of Juno Capital Corp. and North Peace Energy Inc. pursuant to the provisions of the *Business Corporations Act* (Alberta) on February 6, 2007. The Company’s principal business activity is the exploration, exploitation and development and production of petroleum and natural gas resources in the Province of Alberta.

North Peace is a development stage enterprise whose principle focus is the creation of shareholder value through the production of heavy oil from its oil sands leases at its Red Earth project. Production from its pilot project has commenced in the first half of 2009, however production of commercial quantities is not expected for two to three years.

These financial statements are prepared on the assumption that the Company will continue as a going concern and realize its assets and discharge its liabilities in the normal course of business. If the going concern assumption was not appropriate for these financial statements, adjustments might be necessary to the carrying value of assets and liabilities, the reported revenues and expenses and the balance sheet classifications used.

The recoverability of the amounts shown for petroleum and natural gas assets is dependent upon the discovery of economically recoverable oil and gas resources and the ability of the Company to obtain financing necessary to complete the exploration and development and the success of future operations. Recent market events, including disruption of credit markets and other financial systems and the deterioration of global economic conditions have resulted in reducing ability to complete equity and debt financings. These matters cast doubt on the ability of the Company to continue to meet its obligations. As at December 31, 2009 the Company had working capital of \$5.0 million and no debt which will be sufficient to fund pilot operations, general and administration expenses and retain all oil and gas assets for 2010.

## **2. Adoption of new accounting policies**

Effective January 1, 2009 the Company adopted Section 3064 “Goodwill and Other Intangible Assets” issued by the CICA. Under the new accounting standard, criteria for the recognition, measurement and disclosure of goodwill and intangible assets were revised. The new standard had no current impact on the Company’s financial statements.

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## **2. Adoption of new accounting policies (continued)**

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

On January 1, 2011 the Company will be required to adopt International Financial Reporting Standards (“IFRS”) and prepare its financial statements under this new set of standards, including comparative figures for 2010. Although IFRS is principles-based and uses a conceptual framework similar to Canadian GAAP, there are significant differences and choices in accounting policies as well as increased disclosure requirements under IFRS. The Company is currently assessing the impact of the conversion from Canadian GAAP to IFRS on its financial statements.

## **3. Significant accounting policies**

These financial statements are prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). The significant policies are detailed as follows:

### **(a) Use of estimates**

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenues and expenses during the year. The calculation of asset retirement obligations includes estimates of the future costs to settle the asset retirement obligation, the timing of the cash flows to settle the obligation, and the future inflation rates. The calculation of future income taxes requires judgement in applying tax laws and regulations, estimating the timing of temporary difference reversals, and estimating the realizability of future tax assets. Actual results could differ from those estimates. The fair values of stock options are based on estimates using the Black-Scholes option pricing model and the total value of such stock options is recorded as stock based compensation expense on the financial statements. The impairment calculation includes estimates of market values of similar assets or geological resources. The ceiling test calculation is based on estimates of proved and, if applicable, probable reserves, production rates, petroleum and natural gas process, future costs and other assumptions.

### **(b) Cash and cash equivalents**

Cash includes cash balances with banks and those short-term money market instruments which are redeemable in three months or less.

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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### **3. Significant accounting policies (continued)**

#### **(c) Petroleum and natural gas properties**

##### Capitalized costs

The Company follows the full cost method of accounting for exploration and development expenditures, wherein all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized in a Canadian cost centre. Such costs include lease acquisition costs, geological and geophysical expenditures, lease rentals on non-productive properties, cost of drilling both productive and non-productive wells and related production equipment costs, and that portion of general and administrative expenses directly attributable to exploration and development activities.

Proceeds from the disposition of petroleum and natural gas properties are applied to reduce the capitalized costs and no gain or loss is recognized on the disposal of petroleum and natural gas properties unless such disposition would alter the depletion and amortization rate by 20 percent or more.

Revenue, royalties, operating costs and related depletion from the pilot project are capitalized until planned principle operations have commenced.

##### Depletion/Depreciation

Capitalized costs, together with estimated future capital costs associated with proved undeveloped reserves and amounts related to asset retirement obligations will be depleted and depreciated using the unit-of-production method based on total estimated proved petroleum and natural gas reserves, before royalties, as determined by independent engineers. The relative volumes of petroleum and natural gas reserves and production are converted to equivalent units of oil based on relative energy content of six thousand cubic feet of natural gas to one barrel of oil. Costs of undeveloped and unproved properties are initially excluded from depletion calculations. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to the capitalized costs subject to depletion.

Steaming facilities, such as the steam generator at the pilot project, will be depreciated on a straight line basis using their useful life of 15 years.

Office equipment is recorded at cost and depreciation is provided on a declining balance basis at 30%.

##### Impairment

Oil and gas properties excluded from depletion are reviewed at least annually to consider whether there are conditions that may indicate impairment. The carrying values of these oil and gas properties are compared to their net recoverable amount as estimated by quantifiable evidence of the market value of similar assets or geological resources. If the carrying value is found to exceed the estimated net recoverable amount a write down will be recorded.

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## **3. Significant accounting policies (continued)**

### **(c) Petroleum and natural gas properties (continued)**

Impairment (continued)

The carrying value of oil and gas properties subject to depletion is assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves, the lower of cost and market of unproved properties and the cost of major development projects exceed the carrying value. When the carrying value is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value of the assets exceeds the discounted cash flows expected from the production of proved and probable reserves, the lower of cost and market of unproved properties and the cost on major development projects. The cash flows are estimated using future product prices and costs and are discounted using a risk-free interest rate.

### **(d) Joint interests**

The Company's exploration, development and production activities may be conducted jointly with others and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

### **(e) Asset retirement obligations**

Asset retirement obligations reflect the liability associated with retirement and reclamation of long-lived assets such as petroleum and gas wells and related equipment. An asset retirement obligation is recognized in the period it is incurred and a reasonable estimate of the fair value can be made. Fair value is estimated based on the present value of the estimated future cash outflows to abandon the asset, discounted at the Company's credit-adjusted risk-free interest rate. The asset retirement cost, equal to the fair value of the retirement obligation at the time the obligation is incurred, is capitalized as part of the cost of the related long-lived asset and depleted using the unit-of-production method. Subsequent to the initial measurement of the asset retirement obligation, the obligation is adjusted at the end of each period to reflect the passage of time as accretion and changes in estimated future cash flows underlying the obligation. Actual costs incurred to abandon the asset reduce the asset retirement obligation.

### **(f) Income taxes**

Income taxes are calculated using the asset and liability method of tax allocation accounting. Temporary differences arising from the difference between the tax basis of an asset or liability and its carrying value on the balance sheet are used to calculate future income tax liabilities or assets. Future income tax liabilities or assets are calculated using tax rates anticipated to apply in the periods that the temporary differences are expected to reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that substantive enactment occurs. To the extent that the Company does not consider it to be more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## **3. Significant accounting policies (continued)**

### **(g) Stock-based compensation**

Stock options and performance warrants issued by the Company are accounted for in accordance with the fair-value based method of accounting. The fair value of options and performance warrants issued to directors, officers, employees, consultants and service providers to the Company is charged to income with an offsetting amount recorded to contributed surplus. Fair value is measured using the Black-Scholes options pricing model. Consideration paid upon the exercise of stock options or performance warrants, together with corresponding amounts previously recognized in contributed surplus, is recorded as an increase to share capital. Unvested stock options issued to consultants and service providers are revalued each reporting period. Forfeitures of stock options are accounted for as they occur.

### **(h) Per share information**

Per share information is calculated using the weighted average number of shares outstanding during the period. The treasury stock method is used to calculate diluted per share amounts, whereby proceeds from the exercise of in-the-money stock options and share purchase warrants are used to purchase the Company's common shares at the average market price during the period. Diluted per share amounts reflect the potential dilution that could occur if stock options or share purchase warrants were exercised and converted to common shares.

### **(i) Flow-through shares**

The resource expenditure deductions for income tax purposes related to exploration and development activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. The carrying value of the shares issued is reduced by the income tax effect of the renunciation when the corresponding exploration and development expenditures are renounced.

### **(j) 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 to another entity. Upon initial recognition, all financial instruments, including all derivatives, are recognized on the balance sheet at fair value. Subsequent measurement is then based on the financial instruments being classified into one of five categories: held for trading, held to maturity, loans and receivables, available for sale and other liabilities. The Company has designated its cash as held for trading, which are measured at fair value. Accounts receivable are classified as loans and receivables, which are measured at amortized cost. Accounts payable and accrued liabilities are classified as other liabilities, which are measured at amortized cost that is determined using the effective interest method.

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## **3. Significant accounting policies (continued)**

### **(j) Financial Instruments (continued)**

The Company is exposed to market risks resulting from fluctuations in commodity prices, foreign exchange rates and interest rates in the normal course of operations. A variety of derivative instruments may be used by the Company to reduce its exposure to fluctuations in commodity prices, foreign exchange rates and interest rates. All derivative contracts would be classified as held for trading and will be recorded on the balance sheet at fair value, with changes in the fair value recognized in net income unless the derivative contracts are designated in a cash flow hedging relationship. The fair values of these derivative instruments are based on an estimate of the amounts that would have been received or paid to settle these instruments prior to maturity given future market prices and other relevant factors. Proceeds and costs realized from holding the derivative is recognized in net income at the time each transaction under a contract is settled.

The Company measures and recognizes embedded derivatives separately from the host contracts when the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract, when it meets the definition of a derivative and when the entire contract is not measured at fair value. Embedded derivatives are recorded at fair value.

The Company immediately expenses all transaction costs incurred in relation to the acquisition of a financial asset or liability. The Company applies trade-date accounting for the recognition of a purchase or sale of cash equivalents.

Comprehensive income requires certain gains and losses from changes in fair value to be temporarily presented outside net income. It includes unrealized gains and losses, such as changes in currency translation adjustment relating to self-sustaining foreign operations, unrealized gains or losses on available-for-sale investments and the effective portion of gains or losses on derivatives designated as cash flow hedges. The application of this standard did not result in comprehensive income being different from the net income for the periods presented.

## **4. Basis of presentation**

Certain prior year figures have been reclassified to conform to the presentation adopted in 2009.

## **5. Cash and cash equivalents**

Included in cash and cash equivalents is a redeemable term variable rate deposit totaling \$8,043,918 which currently bears interest at 0.25 % and matures on June 23, 2010. The term deposits are fully redeemable, without penalty, 30 days after the date of investment and therefore classified as cash and cash equivalents.

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

## 6. Oil and gas properties

(Cdn \$)	December 31, 2009	December 31, 2008
Oil and gas interests	\$ 50,590,278	\$ 42,442,785
Pilot facilities		
Equipment and construction	16,255,708	12,432,697
Startup costs	185,459	-
Capitalized operations	2,228,811	-
Accumulated depletion and depreciation	(272,506)	-
	\$ 68,987,750	\$ 54,875,482

The Company is advancing a Cyclic Steam Stimulation (“CSS”) project on its Red Earth land holdings. A pilot project consisting initially of two horizontal CSS wells has been built and is currently operating. At December 31, 2009, the Company has no proved or probable reserves on its Red Earth lands. Accordingly, no provision for depletion expense has been made.

In 2009, the company drilled five conventional wells outside of the Red Earth area as part of its exploration program. These wells resulted in booked reserves as at December 31, 2009 and depletion will commence on these wells starting January 1, 2010.

Stock-based compensation costs of \$95,391 was capitalized during the year ended December 31, 2009 (2008 – \$93,864).

Deposits with the Energy Resources and Conservation Board of \$497,494 (2008 – \$126,782) were included in oil and gas properties as at December 31, 2009.

## 7. Asset retirement obligations

The following table represents the reconciliation of the carrying amount of the obligation associated with the retirement of the Company’s petroleum and gas interests.

(Cdn \$)	December 31, 2009	December 31, 2008
Asset retirement obligations, beginning of year	\$ 442,303	\$ 215,820
Increase in liabilities	141,160	212,296
Accretion	40,791	17,120
Change in estimates	(13,045)	(2,933)
Asset retirement obligations, end of year	\$ 611,209	\$ 442,303
Current portion	\$ 161,940	\$ 112,389

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

## 7. Asset retirement obligations (continued)

The total undiscounted amount of cash flows required to settle the obligations as measured at December 31, 2009 is estimated to be \$1,470,248 (2008 - \$1,121,365). These obligations will be settled based on the useful lives of the underlying assets, which ranges from one to ten years. The credit-adjusted risk free rate at which the estimated cash flows were discounted was 10% (2008 - 8%) and the estimated inflation rate used to project future costs was 2% (2008 - 2%).

## 8. Income Taxes

Future income tax components are as follows:

(Cdn \$)	December 31, 2009	December 31, 2008
Future income tax asset		
Share issuance costs	\$ 597,146	\$ 590,471
Non-capital losses carried forward	2,192,535	918,645
Asset retirement obligations	155,523	110,576
	<b>2,945,204</b>	1,619,692
Future income tax liability		
Carrying value of oil and gas properties in excess of tax basis	\$ (3,176,500)	\$ (1,062,215)
	<b>\$ (231,296)</b>	<b>\$ 557,477</b>

The provision for income taxes recorded in the financial statements differs from the amount which would be obtained by applying the statutory income tax rate of 29.00% (2008 - 29.50%), as follows:

(Cdn \$)	December 31, 2009	December 31, 2008
Loss for the year before income tax	\$ (3,292,286)	\$ (2,116,967)
Anticipated income tax recovery	\$ (954,763)	\$ (624,506)
Non deductible expenses		
Stock based compensation	328,509	201,393
Other	9,826	-
Change in income tax rate	84,389	91,972
		(331,141)
Change in valuation allowance	-	(297,529)
Total future tax reduction	<b>\$ (532,039)</b>	<b>\$ (628,670)</b>

The company has non capital losses of \$8.8 million as at December 31, 2009.

The non-capital losses carried-forward expire in years up to 2028.

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

## 9. Share Capital

### (a) Authorized

Unlimited number of common shares

Unlimited number of first preferred shares issuable in series

Unlimited number of second preferred shares issuable in series

### (b) Issued

	Number of Shares	Amount
<b>Common Shares</b>		
Balance December 31, 2007	38,050,640	42,037,961
Tax effect on previously incurred share issue costs	-	364,971
Stock Options exercised	50,500	50,500
Equity financing (i)	16,969,660	22,999,951
Share issue costs (ii)	-	(1,774,667)
Tax effect of share issue costs	-	479,736
Balance December 31, 2008	55,070,800	\$ 64,158,452
<b>Equity financing (iii)</b>	<b>21,109,000</b>	<b>9,921,230</b>
<b>Share issue costs (iv)</b>	<b>-</b>	<b>(831,720)</b>
<b>Tax effect of share issue costs</b>	<b>-</b>	<b>207,930</b>
<b>Tax effect of flow through shares</b>	<b>-</b>	<b>(1,500,000)</b>
<b>Balance December 31, 2009</b>	<b>76,179,800</b>	<b>\$ 71,955,892</b>

	Number of Warrants	Amount
<b>\$0.75 Share Purchase Warrants</b>		
Balance December 31, 2008	-	\$ -
<b>Equity financing (iii)</b>	<b>10,554,500</b>	<b>1,688,720</b>
<b>Balance December 31, 2009</b>	<b>10,554,500</b>	<b>1,688,720</b>

### **\$2.00 Share Purchase Warrants**

Balance December 31, 2007	-	\$ -
Equity financing (i)	6,666,650	2,999,993
Balance December 31, 2008 and December 31, 2009	<b>6,666,650</b>	<b>\$ 2,999,993</b>

<b>Total Equity Instruments</b>		<b>\$ 76,644,605</b>
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# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

## 9. Share Capital (continued)

### (b) Issued (continued)

- i. On August 7, 2008 the Company completed a private placement equity offering, issuing a total of 13,333,300 units ("Units"), at a price of \$1.50 per Unit and 3,636,360 flow-through common shares ("Flow-Through Shares"), at a price of \$1.65 per Flow-Through Share for gross proceeds of approximately \$26 million. Each Unit consists of one common share and half of one common share purchase warrant. Each full warrant entitles the holder to acquire one common share at an exercise price of \$2.00 per share until February 7, 2010. The fair value of the warrants is \$0.45 per warrant assuming a volatility of 80% on the underlying shares, a risk-free interest rate of 2.75%, an expected life of 1.5 years and an expected dividend rate of 0%. Subsequent to year end, the warrants expired unexercised.
- ii. Share issue costs relate to the costs incurred for the equity issuance on August 7, 2008.
- iii. On June 23, 2009 the Company completed a private placement equity offering, issuing a total of 21,109,000 units ("Units"), at a price of \$0.55 per Unit for gross proceeds of approximately \$11.6 million. Each Unit consists of one common share and half of one common share purchase warrant. Each full warrant entitles the holder to acquire one common share at an exercise price of \$0.75 per share until December 23, 2010. The fair value of the warrants is \$0.16 per warrant assuming a volatility of 80% on the underlying shares, a risk-free interest rate of 1.30%, an expected life of 1.5 years and an expected dividend rate of nil.
- iv. Share issue costs relate to the costs incurred for the equity issuance on June 23, 2009

### (c) Stock options

Changes in the number of shares issuable under outstanding options were as follows:

	Number of options	Range of Exercise Prices	Weighted Average Exercise Price
Balance, December 31, 2007	2,280,500	\$ 1.00 – 2.62	\$ 1.43
Options exercised	(50,500)	1.00	1.00
Option Granted	1,830,000	1.18 – 1.50	1.46
Balance, December 31, 2008	4,060,000	\$ 1.00 – 2.62	\$ 1.45
<b>Options granted</b>	<b>2,455,000</b>	<b>0.28 – 0.55</b>	<b>0.54</b>
<b>Options forfeited</b>	<b>(450,000)</b>	<b>1.00 – 1.50</b>	<b>1.17</b>
<b>Balance, December 31, 2009</b>	<b>6,065,000</b>	<b>\$ 0.28 – 2.62</b>	<b>\$ 1.11</b>

The average fair value of the options granted during 2009 was \$0.33 per option (2008 - \$0.82) assuming an average volatility of 80% (2008 - 80%) on the underlying shares, a weighted average exercise price of \$0.54 (2008 - \$1.46), a risk-free interest rate of 2.11% – 2.23% (2007 - 2.81% - 3.35%), an expected life of 4 years (2008 - 4 years), and an expected dividend rate of nil (2008 - nil).

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

## 9. Share Capital (continued)

### (c) Stock Options (continued)

The majority of the options vest 1/3 per year on the first, second and third anniversary of the date of the grant. Options issued to consultants vest at equal amounts at 6 months, 18 months and 30 months after the date of grant. All options expire 5 years after the initial grant date.

In 2008, the Company granted 1,830,000 stock options at a weighted average exercise price of \$1.46 per share to management, employees, consultants and directors. 475,000 of the stock options granted to management will be exercisable only when the vesting terms have been satisfied and the Company's previously announced cyclic steam pilot project demonstrates first oil production. These options have the same vesting terms as existing options and vest 1/3 per year on the first, second and third anniversary of the date of the grant. First oil production from the pilot was achieved in May 2010.

The following table sets forth information about stock options outstanding as at December 31, 2009.

Range of Exercise Price	Number of Options	Options Outstanding		Options Exercisable	
		Weighted Average Price Per Share	Remaining Contractual Life (yrs)	Options Exercisable	Weighted Average Price Per Share
\$0.28 – \$0.50	50,000	\$0.28	4.14	16,667	\$0.28
\$0.51 – \$1.00	3,520,000	\$0.69	3.55	1,086,666	\$0.99
\$1.01 – \$2.00	2,095,000	\$1.53	3.41	836,666	\$1.58
\$2.00 – \$3.00	400,000	\$2.62	2.42	283,333	\$2.62
	6,065,000	\$1.11	3.43	2,223,332	\$1.43

### (d) Performance Warrants

	Number of Warrants	Exercise Price
Balance, December 31, 2007	6,300,000	\$ 0.50
<b>Balance, December 31, 2008 and December 31, 2009</b>	<b>6,300,000</b>	<b>\$ 0.50</b>
Exercisable, December 31, 2009	-	\$ -

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

## 9. Share Capital (continued)

### (d) Performance Warrants (continued)

The performance warrants may be exercised the earlier of: (a) immediately following a liquidity event whereby the Board of the Company determines to liquidate all or substantially all of the assets of the Company, (b) immediately following an offer to purchase at least 66 2/3% of the outstanding common shares for cash or similar consideration that is received and taken up and paid for by the offeror, or (c) December 31, 2010, otherwise they expire.

The performance warrants vest immediately if (a) or (b) above occurs, or after the shares are listed on a recognized stock exchange and all of the following performance criteria are satisfied; (i) the Company has a market capitalization of at least \$30,000,000; (ii) at least 32,000,000 equity shares are outstanding; and (iii) the Company meets or exceeds the minimum listing requirements of a Tier 1 Issuer as defined in the policies of the TSX Venture Exchange (collectively the "Performance Criteria"). If the Performance Criteria are met, the warrants vest as follows: 2,700,000 performance warrants upon achieving a share price of \$1.00 per share, 1,800,000 performance warrants upon achieving a share price of \$1.50 per share and 1,800,000 performance warrants upon achieving a share price of \$2.00 per share. Share prices are calculated based on the ten day weighted average trading price per share of the Company.

As at December 31, 2009 all performance criteria related to the Company have been satisfied except the minimum listing requirements for a Tier 1 Issuer on the TSX Venture Exchange.

The fair value of the performance warrants was estimated at \$1,466,550 using the Black-Scholes option pricing model assuming expected volatility of 90% and an expected life of between one and three years with corresponding risk-free rates of 4.07% to 4.16%. During 2006, all the substantive criteria were considered probable and the \$1,466,550 was expensed.

The remaining contractual life of the outstanding and exercisable performance warrants is 1 year.

## 10. Contributed surplus

(Cdn \$)	December 31, 2009	December 31, 2008
Balance, beginning of year	\$ 2,813,922	\$ 2,131,653
Stock-based compensation		
Expensed	1,144,826	794,233
Capitalized	165,039	183,983
Decrease/Increase in fair value of non-employee options		
Expensed	(12,036)	(18,100)
Capitalized	(69,648)	(277,847)
Balance, end of year	\$ 4,042,103	\$ 2,813,922

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## **11. Related party transactions**

As at December 31, 2009, the Company accrued legal costs of \$125,000 (2008 - \$10,000) payable to a firm in which a director is a partner. As at December 31, 2009, the Company had initiated work with a service company in which the president is an owner, total capital costs of \$24,764 (2008 - nil) were payable to the service Company upon completion. All related party transactions are in the normal course of operations. Related party transactions entered into by the Company have been measured at the exchange amount established and agreed to by the related parties.

## **12. Commitments**

As at December 31, 2009, the Company was committed under a lease for office premises, requiring future minimum rental payments of \$192,864 per annum (2008 - \$192,864), expiring December 31, 2011.

## **13. Financial instruments**

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework.

### **Credit risk**

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. At December 31, 2009, the Company's accounts receivable relates to interest income and GST refunds. The amount outstanding is the Company's maximum credit exposure. All outstanding accounts receivable are less than 30 days old.

The term deposits are fully redeemable, without penalty, 30 days after the date of investment and therefore classified as cash and cash equivalents. When applicable, the Company manages the credit exposure related to short-term investments by selecting counter parties based on credit ratings and monitors all investments to ensure, as far as possible, a stable return. The carrying amount of accounts receivable and cash and cash equivalents represents the maximum credit exposure.

### **Liquidity risk**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

Based on the current working capital balance the Company currently has sufficient capital to fund corporate and operational expenses until the end of 2010. However, the recent downturn in the capital markets may limit the Company's ability to raise the capital necessary to undertake or complete projects capital expenditures during 2010 or undertake expanded operations in 2010 if the capital market conditions do not improve. If debt or equity financing is available, there is no assurance that it will be on terms acceptable to the Company.

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## **13. Financial instruments (continued)**

The Company prepares periodic capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. The Company does not have a credit facility.

### Market risk

Market risk is the risk that changes in foreign exchange rates, commodity prices, and interest rates will affect the Company's net earnings or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns.

### Foreign currency exchange rate risk

Foreign currency exchange rate risk is the risk that the future cash flows will fluctuate as a result of changes in foreign exchange rates. The Company does not sell or transact in any foreign currency, however, the United States dollar influences the price of all oil sold in Canada. The Company had no forward exchange rate contracts in place as at or during the year ended December 31, 2009.

### Commodity price risk

Commodity price risk is the risk that the future cash flows will fluctuate as a result of changes in commodity prices. From time to time, the Company may use both financial derivatives and physical delivery sales contracts to manage market risks. Any such transactions would be approved by the Board of Directors. The Company has not entered into any financial or physical delivery sales contracts on future production at December 31, 2009.

### Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company's exposure is limited to interest rate fluctuations on its cash in its bank account which bears a floating rate of interest, historically between 0.25% and 4.50%. The Company had no interest rate swap or financial contracts in place as at or during the year ended December 31, 2009.

### Fair value

The Company's carrying value of cash and cash equivalents, accounts receivable and accounts payable and accruals approximates its fair value due to the immediate or short-term maturity of these instruments.

# NORTH PEACE ENERGY CORP.

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## 14. Capital Management

The Company's objectives when managing capital is to safeguard its ability to continue as a going concern, so that it can continue to provide returns to shareholders and benefits for other stakeholders. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets.

As the Company does not have any externally imposed capital requirements, other than disclosed elsewhere in the financial statements, the Company has defined its capital to mean its long-term debt (nil) and shareholders' equity, as determined each reporting date.

In order to maintain or adjust its capital structure, the Company may from time-to-time issue additional common shares. As a result of the economic global downturn, access to its capital markets may be limited. The Company will adjust its capital spending if access to external capital sources is unavailable. In the future the Company may consider adding debt to its capital structure, the form and amount of potential debt will be dependent on future capital requirements and the resulting debt to equity ratios.

There have been no changes to capital management in the year ended December 31, 2009.

## 15. Loss per Share

The following is a reconciliation of basic and diluted loss per share.

	Year ended December 31,	
	2009	2008
Net Loss (Cdn \$)	<b>2,760,247</b>	1,488,297
Weighted average number of shares outstanding	<b>66,116,879</b>	47,219,898
Basic loss per share	<b>0.042</b>	0.032
Diluted loss per share	<b>0.042</b>	0.032

The Company is in a loss position for the period and all options are out of the money, therefore all dilutive instruments are anti-dilutive in nature.

## 16. Subsequent events

On January 15, 2010 the Company entered into an agreement to sell a portion of the drilling royalty credits, which were earned as part of the conventional exploration program conducted outside of its Red Earth lands. Total proceeds from the disposition were \$450,000 and as at March 31, 2010 all proceeds had been received by the Company.

# **NORTH PEACE ENERGY CORP.**

(A Development Stage Company)

Notes to Financial Statements

As at December 31, 2009, as at December 31, 2008

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## **16. Subsequent events (continued)**

On February 4, 2010, North Peace's Board of Directors initiated a process to explore strategic alternatives with a view to enhancing shareholder value. The Company engaged CIBC World Markets Inc. ("CIBC") to provide financial advisory services to assist in this strategic review. Strategic alternatives may include, but are not limited to, a corporate sale, merger or other business combination, joint venturing with an interested party, a major financing or any other combination. The Board established a Special Committee of independent directors to work with management and the Company's external advisors and to supervise the strategic review process.

TSX-V: NPE

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