

GALLEON ENERGY INC.

Financial Statements

December 31, 2009

Management's Responsibility for Financial Reporting

The accompanying financial statements and all information in the annual report are the responsibility of management. Management has prepared the financial statements in accordance with Canadian generally accepted accounting principles. In the opinion of management, the financial statements have been prepared within acceptable limits of materiality and, when necessary, management has made informed judgments and estimates in accounting for transactions that were not complete at the balance sheet date. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances as indicated in the notes to the financial statements. Financial information contained elsewhere in the annual report has been prepared and reviewed by management to ensure it is consistent with the financial statements.

Management has established systems of internal controls over financial reporting to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles.

The Audit and Reserves Committee is appointed by the Board of Directors, and comprises directors that are not employees of the Corporation. The Committee meets regularly with management, as well as the external auditors, to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each party is discharging its responsibilities, and to review the financial statements and the external auditors' report. The Board of Directors has approved the financial statements.

Steve Sugianto
President and Chief Executive Officer

Shivon M. Crabtree
Vice President Finance and
Chief Financial Officer

March 10, 2010

AUDITORS' REPORT

To the Shareholders of Galleon Energy Inc.

We have audited the consolidated balance sheets of Galleon Energy Inc. as at December 31, 2009 and 2008 and the consolidated statements of earnings (loss), comprehensive income (loss) and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation'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 consolidated financial statements present fairly, in all material respects, the financial position of the Corporation 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.

Ernst + Young LLP

Chartered Accountants
Calgary, Canada
March 10, 2010

GALLEON ENERGY INC.
Consolidated Balance Sheets

As at December 31 (\$000s)	2009	2008
ASSETS		
CURRENT		
Accounts receivable (note 12)	41,270	54,864
Deposits and prepaid expenses	6,190	6,661
Future income taxes (note 10)	2,884	-
Fair value of financial derivatives (note 12)	4,241	1,237
	54,585	62,762
Goodwill (note 3)	34,891	34,891
Equipment inventory	6,116	12,200
Property and equipment (notes 3, 4, 5, 6, 7 and 8)	1,041,140	1,071,150
	1,136,732	1,181,003
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	55,531	91,305
Capital leases (notes 3 and 8)	1,545	2,110
Bank loan (note 7)	217,243	249,015
Fair value of financial derivatives (note 12)	13,789	-
	288,108	342,430
Asset retirement obligation (note 6)	41,499	39,905
Capital leases (notes 3 and 8)	-	1,541
Future income taxes (note 10)	94,262	107,603
	423,869	491,479
SHAREHOLDERS' EQUITY		
Share capital (note 9)	599,334	547,298
Contributed surplus (note 9)	28,884	23,009
Retained earnings	84,645	119,217
	712,863	689,524
	1,136,732	1,181,003

See accompanying notes

Approved on behalf of the Board of Directors:

“Signed”

William L. Cooke

Director

“Signed”

Daryl Gilbert

Director

GALLEON ENERGY INC.**Consolidated Statements of Earnings (Loss), Comprehensive Income (Loss) and Retained Earnings**

(\$000s, except per share amounts)	Year ended December 31	
	2009	2008
REVENUE		
Petroleum and natural gas revenue	213,144	418,233
Royalties, net of GCA	(32,712)	(71,122)
Realized gain on financial derivative (note 12)	6,651	3,621
Unrealized gain (loss) on financial derivative (note 12)	(10,784)	10,311
Gain on gas contract (note 4)	-	5,340
Other income	752	438
	177,051	366,821
EXPENSES		
Operating	56,714	75,807
Transportation	8,165	8,537
General and administration	15,911	13,326
Interest	9,226	11,138
Stock-based compensation (note 9)	6,114	7,670
Accretion	2,651	2,253
Depletion and depreciation	127,930	137,157
	226,711	255,888
Earnings (loss) before taxes	(49,660)	110,933
Income taxes (note 10)		
Capital and other taxes	426	1,064
Future income taxes (recovery)	(15,514)	30,605
	(15,088)	31,669
NET EARNINGS (LOSS) AND COMPREHENSIVE INCOME (LOSS)	(34,572)	79,264
RETAINED EARNINGS, BEGINNING OF PERIOD	119,217	39,953
RETAINED EARNINGS, END OF PERIOD	84,645	119,217
NET EARNINGS (LOSS) AND COMPREHENSIVE INCOME (LOSS) PER SHARE (note 9)		
Basic	(0.43)	1.11
Diluted	(0.43)	1.10
Weighted average Class A shares – basic	79,656,109	71,105,806
– diluted	79,656,109	72,128,065

See accompanying notes

GALLEON ENERGY INC.
Consolidated Statements of Cash Flows

Year ended December 31

(\$000s)

2009

2008

Cash provided by (used in):

OPERATING ACTIVITIES

Net earnings (loss)	(34,572)	79,264
Items not requiring cash:		
Future income taxes (recovery)	(15,514)	30,605
Depletion and depreciation	127,930	137,157
Accretion	2,651	2,253
Stock-based compensation	6,114	7,670
Unrealized loss (gain) on financial derivative	10,784	(10,311)
Gain on gas contract (note 4)	-	(5,340)
Abandonment costs	(1,281)	(2,385)
Change in non-cash working capital	11,615	(10,837)
	<u>107,727</u>	<u>228,076</u>

FINANCING ACTIVITIES

Issue of common shares	53,855	11,825
Repurchase of common shares	(32)	-
Share issue costs	(2,737)	(181)
Capital lease payments	(2,106)	(2,034)
Working capital assumed on acquisition of ExAlta (note 3)	-	(44,966)
Working capital assumed on acquisition of Adamant (note 4)	-	8,308
Bank loan (repayment)	(31,772)	85,637
	<u>17,208</u>	<u>58,589</u>

INVESTING ACTIVITIES

(Additions to) disposal of equipment inventory	6,033	(8,073)
Additions to oil and gas properties	(106,095)	(273,598)
Disposition (acquisition) of oil and gas properties (notes 3 and 4)	8,451	(17,541)
Change in non-cash working capital	(33,324)	12,547
	<u>(124,935)</u>	<u>(286,665)</u>

CHANGE IN CASH

- -

CASH, BEGINNING AND END OF PERIOD

- -

SUPPLEMENTARY INFORMATION

Cash interest paid	9,522	10,890
Cash taxes paid	1,005	811

See accompanying notes

Notes to the Consolidated Financial Statements
For the years ended December 31, 2009 and 2008

Unless otherwise stated, amounts presented in these notes are in Canadian dollars and tabular amounts are in thousands of Canadian dollars, except number of shares and per share amounts.

1. ACCOUNTING POLICIES

Nature of Business and Basis of Presentation

Galleon Energy Inc. (“Galleon” or the “Corporation”) was incorporated under the Business Corporations Act of Alberta on March 27, 2003. The business of the Corporation is the acquisition of, exploration for and development of petroleum and natural gas properties in western Canada. Galleon is listed on the TSX under the symbol “GO”.

The financial statements include the accounts of the Corporation, its wholly owned subsidiary 1175176 Alberta Ltd and its wholly owned partnership Galleon Energy Partnership, on a consolidated basis. On January 1, 2009, the Corporation’s wholly owned subsidiaries, Exalta Energy Inc. and Adamant Energy Inc., were amalgamated with Galleon Energy Inc.

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”), and have, in management’s opinion, been properly prepared within reasonable limits of materiality and within the framework of the accounting policies summarized below.

Measurement uncertainty

The amounts recorded for depletion and depreciation of property and equipment, the provision for asset retirement obligations, the provision for income taxes, the ceiling test calculation and the goodwill impairment test are based on estimates of proven and probable reserves, production rates, oil and natural gas prices, future costs, future prices, and other relevant assumptions. Accruals for royalties and costs are prepared based on estimates when actual amounts are not yet known. Stock based compensation amounts are determined using certain assumptions (see note 9). The fair value of financial derivatives is based on quoted market prices (see note 12). By their nature, these estimates and assumptions are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future years could be significant.

Cash and cash equivalents

Cash and cash equivalents may include highly liquid short-term investments with initial maturities of three months or less. They are recorded at cost which approximates fair market value.

Property and equipment

Petroleum and natural gas properties and equipment

The Corporation follows the full cost method of accounting whereby all costs related to the exploration for and development of petroleum and natural gas reserves, whether productive or unproductive, are capitalized in one Canadian cost centre. Such costs include land acquisition, drilling, equipping, geological and geophysical and overhead expenses related to

exploration and development activities. These costs are depleted on the unit-of-production method using estimated gross proven petroleum and natural gas reserves as determined by independent professional engineers. Petroleum and natural gas reserves are converted to a common unit of measure on an energy equivalent basis of six mcf of gas to one barrel of oil. Costs of acquiring and evaluating unproven properties are excluded from the depletion calculation until it is determined whether or not proven reserves are attributable to the properties or impairment occurs. Proceeds from the sale of petroleum and natural gas properties and related equipment are applied against capitalized costs, with no gain or loss recognized, unless such a sale would result in a change in the rate of depletion of 20% or more.

Drilling credits earned under government incentive programs are recorded as a reduction of petroleum and natural gas properties.

Ceiling test

The Corporation evaluates its petroleum and natural gas assets in each reporting period to determine that the costs are recoverable. If the sum of the anticipated undiscounted cash flows from proved reserves, based on expected future escalating product prices and costs, exceeds the carrying value of the assets, the costs are considered recoverable. If the carrying value is not considered recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from production of the proved and probable reserves.

Office furniture and equipment

Office furniture, equipment and other assets are recorded at cost and depreciated on a straight-line basis over their estimated useful lives of three to five years.

Equipment inventory

The Corporation records equipment inventory as a long-term asset on the balance sheet.

Leases

The Corporation's leases are classified as either capital or operating. Capital leases are those which transfer substantially all the benefits and risks of ownership to the lessee. Assets acquired under capital leases are depleted along with the petroleum and natural gas properties. Obligations recorded under capital leases are reduced by the principal portion of lease payments as incurred and the imputed interest portion of capital lease payments is charged to interest expense. Payments under operating leases are expensed as incurred.

Goodwill

Goodwill, at the time of acquisition, represents the excess of the purchase price of a business over the fair value of net assets acquired; thereafter, goodwill is assessed for impairment at least annually. If the fair value of the business is less than the book value, a second test is performed to determine the amount of the impairment. The amount of the impairment is determined by deducting the fair value of the business' other assets and liabilities from the fair value of the business to determine the implied fair value of goodwill and comparing that amount to the book value of goodwill. Any excess of the book value of goodwill over the implied fair value is the impairment amount and will be charged to income in the period of the impairment. For the years ended December 31, 2009 and 2008, no goodwill impairment was required.

Asset retirement obligation

The Corporation follows the recommendations for asset retirement obligations as set out in the CICA Handbook section 3110. This standard requires the recognition and measurement of liabilities related to the legal obligation to abandon and reclaim property, plant and equipment incurred upon acquisition, construction, development and/or normal use of the asset. The initial liability must be measured at fair value and subsequently adjusted for the accretion of discount and changes in the fair value. The asset retirement cost is capitalized as part of property and equipment and depleted into earnings based on units of production. Actual costs incurred upon settlement of the obligations are charged against the liability.

Revenue recognition

Petroleum and natural gas sales are recognized when delivery of the product has been completed and title passes to an external party.

Financial instruments

The financial instruments recognized on the Corporation's balance sheet are deemed to approximate their estimated fair values. All financial assets except derivatives are classified as loans or receivables and are accounted for on an amortized cost basis. All financial liabilities are classified as other liabilities. Derivative instruments are classified as held-for-trading and are recorded on the balance sheet at fair value (see Note 12) with actual amounts received, or paid, on the settlement of the derivative financial instrument recorded in revenue. There were no financial assets on the balance sheet which were designated as available-for-sale.

Joint interests

The Corporation's petroleum and natural gas activities may be conducted jointly with others. These financial statements reflect only the Corporation's proportionate interest in such activities.

Future income taxes

The liability method is used in accounting for income taxes. Under this method, future income tax assets and liabilities are recognized based on differences between the financial reporting and tax bases of assets and liabilities, and measured using the substantively enacted tax rates and laws that will be in effect when the 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 in which the change is substantively enacted.

Flow-through shares

The Corporation has financed a portion of its exploration and development activities through the issuance of flow-through shares. Under the terms of the flow-through share agreements, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregone tax benefits to the Corporation, the carrying value of the shares issued is reduced by the tax effect of the tax benefits renounced to subscribers when the renouncements are filed.

Fair values

The carrying values of accounts receivable and accounts payable approximated their fair values at December 31, 2009 due to their short-term nature. The carrying value of the bank loan approximates its fair value due to the floating interest rate on the facility. The carrying value of the financial derivatives approximates current market prices for comparable contracts at December 31, 2009.

Stock-based compensation

The Corporation follows the accounting standard on stock based compensation as presented in the CICA Handbook section 3870. This standard requires the recognition of stock-based compensation expense for “awards to” or “grants to” employees and non-employees using the fair value method.

The standard requires the fair value of all stock based compensation awards to be expensed over the vesting period of the award with an offsetting credit to contributed surplus. The Black-Scholes option pricing model has been used to calculate the fair value of the stock options granted. Consideration paid by optionees on the exercise of stock options is credited to share capital together with any amount previously included in contributed surplus.

2. CHANGES IN SIGNIFICANT ACCOUNTING POLICIES

As of January 1, 2009, the Corporation has adopted the requirements under CICA 3064 “Goodwill and Intangible Assets”. The new standard replaces the previous goodwill and intangible asset standard and revises the requirement for recognition, measurement, presentation and disclosure of intangible assets. The adoption of this standard has had no impact on the Corporation’s financial statements.

On January 20, 2009 the CICA issued EIC-173 “Credit Risk and the Fair value of Financial Assets and Financial Liabilities”. Under the requirements of EIC-173, an entity’s own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and liabilities, including derivative instruments. The Corporation adopted the requirements of EIC-173 effective January 1, 2009. This has had no material impact on the Corporation’s financial statements or additional disclosure.

Section 3862, "Financial Instruments - Disclosures" was amended for annual financial statements relating to fiscal years ending after September 30, 2009. The amendment requires an entity to classify fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The new disclosure required by section 3862 concerning the nature and extent of the risks associated with the financial instruments, and how those risks are managed, is presented in note 12.

Future accounting policies

The Canadian Accounting Standards Board (AcSB) has confirmed that the use of International Financial Reporting Standards (“IFRS”) will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will replace Canada’s current GAAP for those enterprises that are responsible to large or diverse groups of stakeholders. The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Corporations will be required to provide comparative IFRS information for the fiscal year of 2010.

The Corporation has commenced the conversion project which consists of the following phases: 1) initial diagnostic and planning, 2) impact analysis and evaluation, and 3) implementation and review. The Corporation has completed the initial diagnostic and planning phase which included identifying major differences between current Canadian GAAP and IFRS. The impact analysis and evaluation is in progress.

It has been determined that accounting for property and equipment will be impacted by the conversion to IFRS, including accounting for and assessing depletion and impairment.

In July 2009, the International Accounting Standards Board (IASB) issued an amendment to IFRS 1 “First Time Adoption of International Reporting Standards”. The amendment allows full cost accounting corporations to elect, at the time of adoption, to measure exploration and evaluation assets at the amount determined under the entity’s previous GAAP. The amendment will also permit full cost accounting corporations to measure, at the time of adoption, oil and gas assets in the development or production phases, by using the total value determined under the entity’s previous GAAP and allocating values at the unit of account level based on the Corporation’s reserve volumes or reserve values as of the date of conversion. This exemption will relieve the Corporation from retrospective application of IFRS for its oil and gas assets. The Corporation currently anticipates that this exemption will be used, however, this will not be determined until the impact analysis and evaluation phase of the conversion project is complete.

The impact on the Corporation’s financial position and results of operations from the changeover to IFRS is not entirely determinable.

In December 2008, the CICA issued Handbook Section 1582 “Business Combinations,” which will replace CICA Handbook Section 1581 of the same name. Under this guidance, the purchase price used in a business combination is based on the fair value of shares exchanged at their market price at the date of the exchange. Currently, the purchase price used is based on the market price of the shares for a reasonable period before and after the date of the acquisition is agreed upon and announced. This new standard generally requires all acquisition costs to be expensed, which currently are capitalized as part of the purchase price. Contingent liabilities are to be recognized at fair value at the acquisition date and re-measured at fair value through earnings each period until settled. Currently, only contingent liabilities that are resolved and payable are included in the cost to acquire the business. In addition, negative goodwill is required to be recognized immediately in earnings, unlike the current requirement to eliminate it by deducting it from non-current assets in the purchase price allocation. CICA Handbook Section 1582 is effective January 1, 2011.

3. ACQUISITION OF EXALTA ENERGY INC.

On January 16, 2008, the Corporation acquired all of the outstanding common shares of ExAlta Energy Inc. (“ExAlta”). The ExAlta acquisition was accounted for by the purchase method and shares were acquired for an aggregate of \$62.5 million by the issuance of 4,334,856 Class A shares of Galleon at a value of \$14.42 per share plus the assumption of \$48.5 million of net debt including capital leases. The acquisition has been accounted for as a purchase as at the closing date of the transaction, with the purchase price allocated to assets and liabilities as follows:

Allocation of Purchase Price	\$
Property and equipment	95,748
Equipment inventory	1,027
Goodwill	18,869
Future income taxes	582
Bank debt and working capital assumed (including bank debt of \$43.1)	(44,966)
Asset retirement obligation	(3,403)
Capital lease	(3,575)
	64,282
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Calculation of Purchase Price	
Fair value of shares issued	62,509
Transaction costs	1,773
	64,282

4. ACQUISITION OF ADAMANT ENERGY INC

On May 9, 2008, the Corporation acquired all of the outstanding common shares of Adamant Energy Inc. (“Adamant”). The Adamant acquisition was accounted for by the purchase method and shares were acquired for an aggregate of \$65.2 million by the issuance of 4,193,288 Class A shares of Galleon at a value of \$15.55 per share.

The acquisition has been accounted for as a purchase as at the closing date of the transaction, with the purchase price allocated to assets and liabilities as follows:

Allocation of Purchase Price	\$
Property and equipment	76,099
Equipment inventory	271
Working capital assumed (including cash of \$2.4 million)	8,308
Future income taxes	(9,130)
Asset retirement obligation	(4,431)
Gas contract	(5,340)
	65,777
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Calculation of Purchase Price	
Fair value of shares issued	65,206
Transaction costs	571
	65,777

The gas contract was amortized over the term of the contract which expired on December 31, 2008.

5. PROPERTY AND EQUIPMENT

On October 22, 2008 the Corporation purchased oil and gas properties in the Senex area of Alberta for cash, net of adjustments, of \$5.8 million and issuance of 215,000 Class A shares of Galleon for a total purchase price of \$7.1 million.

Allocation of Purchase Price	\$
Property and equipment	5,836
Undeveloped land	1,858
Asset retirement obligations	(551)
	7,143

As at December 31, 2009, \$86.6 million (December 31, 2008 - \$108.4 million) of undeveloped land, seismic and equipment under construction have been excluded from and \$199.7 million (December 31, 2008 - \$173.1 million) in future development costs have been added into the full cost pool for depletion purposes. For the year ended December 31, 2009, \$1.1 million (December 31, 2008 - \$1.2 million) of exploration salaries have been capitalized.

	Cost \$	Accumulated depletion \$	Net book value \$
As at December 31, 2009			
Petroleum and natural gas properties & equipment	1,516,038	(477,553)	1,038,485
Equipment under capital lease	1,719	(443)	1,276
Office furniture and equipment	2,553	(1,174)	1,379
	1,520,310	(479,170)	1,041,140

	Cost \$	Accumulated depletion \$	Net book value \$
As at December 31, 2008			
Petroleum and natural gas properties & equipment	1,413,071	(348,822)	1,064,249
Equipment under capital lease	6,878	(1,278)	5,600
Office furniture and equipment	2,492	(1,191)	1,301
	1,422,441	(351,291)	1,071,150

During the year ended December 31, 2009, certain minor properties were sold for net proceeds of \$8.8 million. A gain or loss was not recognized as the dispositions did not result in a change in the depletion rate of 20% or more.

As at December 31, 2009, the Corporation had recorded drilling credits of \$11.5 million as a reduction of property and equipment.

The Corporation has performed the ceiling test using the following benchmark reference prices at December 31, 2009 for the years 2010 to 2015 and adjusted for commodity differentials specific to the Corporation. Beyond year 2015, the price forecast escalates on average 2.0% per year. A foreign exchange rate of \$0.95 US to \$1.00 CDN was used. No impairment was required.

Benchmark Reference Price Forecasts:

	2010	2011	2012	2013	2014	2015
WTI oil USD/Bbl	80.00	82.88	85.83	88.88	92.01	93.85
Alberta spot gas Cdn/Mcf	5.77	6.46	6.55	6.80	7.30	7.69

6. ASSET RETIREMENT OBLIGATION

The Corporation's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. The Corporation estimates the total undiscounted amount of cash flows required to settle its asset retirement obligation is approximately \$86.3 million, which will be incurred over the next 18 years. Credit adjusted risk free rates of 5% and 8% and an inflation rate of 2% were used to calculate the fair value of the asset retirement obligation.

Year ended December 31	2009 \$	2008 \$
Balance, beginning of year	39,905	25,535
Accretion expense	2,651	2,253
Liabilities incurred	1,909	6,668
Liabilities acquired (notes 3 and 4)	-	7,834
Disposition of liabilities	(1,685)	-
Settlement of liabilities	(1,281)	(2,385)
Balance, end of year	41,499	39,905

7. AVAILABLE CREDIT FACILITY

The Corporation has \$310 million in credit facilities available, consisting of a \$270 million extendible 364 day revolving term facility and a \$40 million non-revolving facility. The \$40 million facility is available subject to mutual approval of the banking syndicate and the Corporation, including repayment terms. Collateral for the facilities consists of a demand debenture for \$500 million collateralized by a first floating charge over all of the property and equipment of the Corporation, excluding the capital lease. At December 31, 2009, an amount of \$217.2 million was drawn against the credit facilities (December 31, 2008 - \$249.0 million).

The facilities bear interest at the bank's prime or banker's acceptance rates plus a rate margin. The margins range from 2.0% per annum to 6.0% per annum, based upon the Corporation's debt to cash flow ratio. For the year ended December 31, 2009, the effective interest rate was 3.8% (December 31, 2008 - 4.8%).

An annual review is scheduled to occur on or before May 27, 2010. As at December 31, 2009, the Corporation is in compliance with all covenants, obligations and conditions of its credit agreement.

8. CAPITAL LEASE OBLIGATIONS

The Corporation has an equipment lease financing arrangement with annual minimum lease payments of \$1.6 million in 2010. The lease has an interest rate of 6.3 percent and the equipment purchase price at the end of the lease is \$1.0 million. A general security agreement and a first charge against the equipment have been provided as collateral.

Interest expense of \$0.2 million was incurred on capital leases during the year ended December 31, 2009 (December 31, 2008 - \$0.3 million).

9. SHARE CAPITAL

Authorized

Unlimited number of preferred shares with no par value

Unlimited number of voting Class A shares with no par value

Unlimited number of voting Class B shares with no par value

On December 15, 2008 the Class B shares were converted into Class A shares. The conversion factor was calculated by dividing \$10 by \$5.36264, being the weighted average trading price for the Class A shares for the 30 consecutive trading days commencing October 15, 2008.

Class A Shares	Number of Shares	Amount \$
Balance at December 31, 2007	63,215,552	413,804
Issued for cash on exercise of stock options	1,491,797	11,825
Tax effect of flow through shares (g)	-	(16,200)
Share issue costs, net of tax of \$49	-	(132)
Issued as consideration for shares in ExAlta Energy Inc. (f)	4,334,856	62,509
Issued as consideration for shares in Adamant Energy Inc. (e)	4,193,288	65,206
Issued on acquisition of petroleum and natural gas properties(d)	215,000	1,354
Issued on conversion of Class B shares	1,720,240	5,207
Transfer from contributed surplus	-	3,725
Balance at December 31, 2008	75,170,733	547,298
Issued for cash on exercise of stock options	230,250	695
Common shares purchased (c)	(10,100)	(32)
Issued for cash (b)	7,500,000	36,000
Issued for cash (a)	2,200,000	17,160
Share issue costs, net of tax of \$712	-	(2,025)
Transfer from contributed surplus	-	238
Balance at December 31, 2009	85,090,883	599,334
Class B shares		
Balance at December 31, 2007	922,500	5,207
Conversion of Class B shares to Class A shares	(922,500)	(5,207)
Balance at December 31, 2008 and 2009	-	-
Total share capital at December 31, 2009	85,090,883	599,334

- a) On November 2, 2009, the Corporation issued 2,200,000 flow-through Class A shares at \$7.80 per share by way of a private placement for gross proceeds of \$17,160,000. The Corporation is obligated to incur qualifying exploration expenses of \$17,160,000 prior to December 31, 2010. As at December 31, 2009, \$1.8 million of the required qualifying expenditures have been incurred.
- b) On June 23, 2009, the Corporation issued 7,500,000 Class A shares at \$4.80 per share for cash proceeds of \$36.0 million.

- c) On November 24, 2008, the Corporation received regulatory approval for a Normal Course Issuer Bid (“Bid”) to purchase, for cancellation, up to a maximum of 5,610,908 shares of the Corporation. The Bid commenced on November 26, 2008 and terminated on November 25, 2009. In 2009 the Corporation purchased 10,100 shares for total consideration of \$32,627. On November 26, 2009, the Corporation received regulatory approval for a renewal of the Bid, with approval to purchase, for cancellation, up to a maximum of 1,000,000 Class A shares of the Corporation. The renewal commenced on December 1, 2009 and will terminate on November 30, 2010.
- d) On October 22, 2008, the Corporation issued 215,000 Class A shares at a price of \$6.30 per share to a third party as part of the consideration for the acquisition of certain petroleum and natural gas properties.
- e) On May 9, 2008, the Corporation issued 4,193,288 Class A shares at \$15.55 per share as consideration for shares in Adamant Energy Inc. as described in Note 4.
- f) On January 16, 2008, the Corporation issued 4,334,856 Class A shares at \$14.42 per share as consideration for shares in ExAlta Energy Inc. as described in Note 3.
- g) The tax effect of \$16.2 million related to the renouncement in January 2008 of flow-through shares issued in 2007 was recorded in 2008.

The Corporation has a share option plan which was approved on May 19, 2005 and amended on August 25, 2005, June 19, 2007 and May 13, 2008. The exercise price of each option may not be less than the closing price of the Corporation’s Class A shares on the day immediately prior to the date of the grant. Compensation expense is recognized as the options vest. With options granted prior to November 2008, one third of the options vest immediately, and one third vest on each of the first and second anniversaries of the date of the grant. With options granted commencing November, 2008, the vesting period is one third on each of the next three anniversaries of the date of the grant. The options expire five years from the date of grant. The Corporation may grant up to 10% of the aggregate number of Class A shares outstanding and no one optionee is permitted to hold options entitling such optionee to purchase more than 5% of the aggregate number of issued and outstanding Class A shares. Class A shares have been reserved for all options granted.

In July 2009, 5,085,067 share options were surrendered to the Corporation for cancellation, resulting in additional stock-based compensation expense of \$2.0 million.

Year ended December 31	2009 \$	2008 \$
Contributed surplus, beginning of year	23,009	19,064
Stock based compensation expense	6,114	7,670
Transfer to share capital	(238)	(3,725)
Paid on surrender of share options	(1)	-
Contributed surplus, end of year	28,884	23,009

The fair value of options granted was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following assumptions: risk-free interest rates of 1.33 - 4.51%; dividend yield of 0%; volatility factors of the market price of the Corporation’s common shares of 36-59%; and, an average expected life of the options of 3 years. Options granted in 2009 had fair values of between \$1.18 and \$2.61 per option.

	Number of Options	Weighted Average Exercise Price \$
Outstanding, December 31, 2007	6,210,950	12.36
Granted	3,306,000	10.87
Forfeited	(987,502)	(10.40)
Exercised	(1,491,797)	(7.93)
Outstanding, December 31, 2008	7,037,651	11.87
Granted	5,526,000	6.26
Forfeited	(514,500)	(10.98)
Surrendered for cancellation	(5,085,067)	(13.92)
Exercised	(230,250)	(3.02)
Outstanding, December 31, 2009	6,733,834	6.08

The following table summarizes information regarding stock options at December 31, 2009:

Options Outstanding				Options Exercisable	
Exercise Price \$	Number Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price \$	Number Exercisable	Weighted Average Exercise Price \$
3.45-4.74	1,364,000	3.94	4.57	388,000	4.69
5.22-7.74	5,284,000	4.80	6.35	15,000	7.38
13.06-13.17	85,834	1.71	13.13	74,723	13.13
	6,733,834	4.59	6.08	477,723	6.09

Earnings per share

The Corporation utilizes the treasury stock method in the determination of diluted per share amounts. Under this method, the diluted weighted average number of shares is calculated assuming the proceeds that arise from the exercise of outstanding and in the money options are used to purchase common shares of the Corporation at their average market price for the period. For the year ended December 31, 2009, 6,733,834 options have been excluded from the diluted earnings per share calculation as they are anti-dilutive (December 31, 2008 – 5,460,901).

10. INCOME TAXES

The future income tax asset and liability are comprised of the following temporary differences as at:

At December 31	2009 \$	2008 \$
Property and equipment	99,668	101,197
ACRI benefit	(1,260)	(870)
Share issue costs	(1,770)	(2,712)
Asset retirement obligation	(1,193)	(869)
Non-capital losses	(28,932)	(54,628)
Partnership income tax deferral	27,749	66,137
Capital leases	(402)	(986)
Financial derivative	(2,482)	334
Future income tax liability	91,378	107,603
Add current future income tax asset	2,884	-
Long term future income tax liability	94,262	107,603

The provision for income tax differs from the amount that would have been expected if the reported earnings had been subject only to the statutory Canadian income tax rate of 29.1% (December 31, 2008 – 29.7%).

Year ended December 31	2009 \$	2008 \$
Earnings (loss) before income tax	(49,660)	110,933
Corporate tax rate	29.07%	29.73%
Expected tax (recovery)	(14,436)	32,981
Increase (decrease) in taxes resulting from:		
Non-deductible items	47	47
Stock-based compensation	1,777	2,280
Statutory tax rate changes	(2,676)	(4,494)
Deductible capital taxes	(106)	(317)
Other	(120)	108
Future income taxes (recovery)	(15,514)	30,605

At December 31, 2009 the Corporation has approximately \$625.0 million (December 31, 2008 – \$616.0 million) of tax deductions available for Canadian income tax purposes.

11. COMMITMENTS

Office Lease Payments:

At December 31, 2009 the Corporation is committed to \$1.8 million in future minimum payments under operating leases for office space in 2010.

Litigation:

The Corporation is involved in various claims and legal actions arising in the normal course of business. The Corporation does not expect that the outcome of these proceedings will have a material adverse effect on the Corporation as a whole.

12. FINANCIAL INSTRUMENTS AND FINANCIAL RISK FACTORS

Fair value of financial assets:

The Corporation's financial instruments recognized in the balance sheet consist of accounts receivable, accounts payable, bank loan and financial derivative ("financial instruments"). The carrying value of accounts receivable and accounts payable approximated their fair values at December 31, 2009 due to their short-term nature. The carrying value of the bank loan approximates fair value due to the floating interest rate on the facility. The fair value of the financial derivative is recognized on the balance sheet as described below.

Credit risk:

Credit risk is the risk that a customer or counterparty will fail to perform an obligation or fail to pay amounts due causing a financial loss. The Corporation's accounts receivable are with customers and joint venture partners in the oil and gas industry and are subject to normal credit risks. A portion of the Corporation's production is currently sold through joint venture partners under normal industry sale and payment terms. As at December 31, 2009, approximately 62% of the accounts receivable balance is due from three customers, compared to 39% due from three customers at December 31, 2008. These customers are considered to have high credit worthiness. The Corporation generally grants unsecured credit but routinely assesses the financial strength of its customers and joint venture partners. No provision has been made for past due receivables as of December 31, 2009 as the Corporation has assessed there are no impaired receivables.

At December 31	2009 \$
Current	34,802
30 - 60 days	1,605
60 - 90 days	1,493
Greater than 90 days	3,370
Total	41,270

Liquidity risk:

Liquidity risk arises through excess financial obligations over available financial assets due at any point in time. The Corporation's objective in managing liquidity risk is to maintain sufficient available reserves in order to meet its liquidity requirements at any point in time. The Corporation believes that it has access to sufficient capital through internally generated cash flows and external equity sources, and to undrawn committed credit facilities to meet current spending forecasts. The Corporation's current liabilities mature within a one year period.

Interest rate risk:

The Corporation is exposed to interest rate risk as changes in interest rates may affect future cash flows and the fair value of its financial instruments. The Corporation's primary debt facility has a floating interest rate that will fluctuate based on prevailing market conditions. Cash flows are sensitive to changes in interest rates on this instrument. Given the amount of debt employed, the Corporation's strategy is to manage interest rate risk. If interest rates on the floating instrument were to change by 1% it is estimated that annual cash flow would change by approximately \$2.2 million.

Market risk:

Market risk is the risk of uncertainty arising from possible market price movements and their impact on the future performance of the business. The market price movements that could adversely affect the value of the Corporation's financial assets, liabilities and expected future cash flows include commodity price risk and interest rate risk. It is estimated that annual cash flow would change approximately by \$1.6 million and by \$4.0 million, respectively, due to a \$1 USD WTI and a \$0.25/Mcf CDN change in oil and natural gas prices.

The Corporation has the following financial contracts in place as at December 31, 2009:

Natural Gas:

March 1, 2009 – March 31, 2010	5,000 GJ/d	CDN \$5.96/GJ
March 1, 2009 – March 31, 2010	5,000 GJ/d	CDN \$6.01/GJ
January 1, 2010 to December 31, 2011	5,000 GJ/d	CDN \$5.85/GJ
January 1, 2010 to December 31, 2011	5,000 GJ/d	CDN \$5.75/GJ
January 1, 2010 to December 31, 2011	5,000 GJ/d	CDN \$5.75/GJ

Crude Oil:

Fixed Price:

January 1, 2010 – December 31, 2010	500 Bbl/d	WTI CDN \$74.30/Bbl
January 1, 2010 – December 31, 2010	500 Bbl/d	WTI CDN \$76.50/Bbl
January 1, 2010 – December 31, 2010	500 Bbl/d	WTI CDN \$77.00/Bbl
January 1, 2010 – December 31, 2010	500 Bbl/d	WTI CDN \$74.50/Bbl
January 1, 2010 – December 31, 2010	500 Bbl/d	WTI CDN \$76.25/Bbl
January 1, 2010 – December 31, 2010	500 Bbl/d	WTI CDN \$77.00/Bbl
January 1, 2011 – December 31, 2011	500 Bbl/d	WTI CDN \$92.00/Bbl
January 1, 2011 – December 31, 2011	1,000 Bbl/d	WTI CDN \$92.20/Bbl
January 1, 2011 – December 31, 2011	500 Bbl/d	WTI CDN \$92.00/Bbl

Costless Collars:

January 1, 2010 – December 31, 2010	500 Bbl/d	WTI CDN \$75.00-\$94.00/Bbl
January 1, 2010 – December 31, 2010	500 Bbl/d	WTI CDN \$75.00-\$95.00/Bbl

Interest Rate Swap:

Notional Amount CAD \$100 million	Term: January 20, 2009 – January 20, 2011
Fixed rate 1.1% - Floating rate is reset against CAD--CDOR on each 3 month anniversary	

The Corporation has entered into the above contracts for the purpose of protecting funds generated from operations from the volatility of commodity prices and interest rates. The Corporation recognizes the fair value of its financial derivatives on the balance sheet each reporting period with the change in fair value recognized as an unrealized gain or loss on the statement of earnings. At December 31, 2009 the fair value is estimated to be a net liability of \$9.6 million, composed of a \$4.2 million short term asset and a \$13.8 million current liability.

The fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. The Corporation characterizes inputs used in determining fair value using a hierarchy that prioritizes inputs depending on the degree to which they are observable. The three levels of the fair value hierarchy are as follows:

- Level 1 - inputs represent quoted prices in active markets for identical assets or liabilities. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 - inputs other than quoted prices included in Level 1 that are observable, either directly or indirectly as of the reporting date. Level 2 valuations are based on inputs which can be observed or corroborated in the market place from sources such as the New York Mercantile Exchange and the Natural Gas Exchange.
- Level 3 - inputs that are less observable, unavailable or where the observable data does not support the majority of the instrument's fair value.

The fair value determinations for the Corporation's financial derivatives are based upon Level 3 inputs, having been provided by the counterparties with whom the transactions were completed and tested by the Corporation for reasonableness.

The Corporation has the following costless collar physical derivative contracts in place for natural gas at December 31, 2009:

August 1, 2009 – March 31, 2010	5,000 GJ/d	CDN \$3.00 - \$6.60 /GJ
August 1, 2009 – March 31, 2010	5,000 GJ/d	CDN \$3.00 - \$6.53 /GJ

The Corporation has entered into the above physical derivative contracts for the purpose of protecting funds generated from operations and the volatility of natural gas prices.

13. CAPITAL STRUCTURE FINANCIAL POLICIES

The Corporation defines capital as total debt and shareholders' equity comprised of retained earnings and share capital. The Corporation's primary capital management objective is to maintain a strong balance sheet affording the Corporation financial flexibility to achieve goals of continued growth and access to capital. The basis for the Corporation's capital structure is dependent on the Corporation's expected business growth and changes in the business environment. The Corporation manages its capital structure and makes adjustments according to market conditions to maintain flexibility while achieving the objectives stated above. To manage the capital structure, the Corporation may adjust capital spending, issue new shares, issue new debt or repay existing debt.

The Corporation monitors its progress through the following two measures utilizing book values: net debt to funds from operations and total debt to total debt and shareholders' equity. Net debt to funds from operations is calculated as current liabilities and long term debt less current assets divided by the most recent four quarters annualized funds from operations. Total debt to total debt plus shareholders' equity is calculated as short term debt plus long term debt divided by short term debt plus long term debt plus shareholders' equity. The Corporation's strategy is to maintain net debt to funds from operations at or below a level of 1.5 to 1. While the Corporation may exceed this rate from time to time, variations are viewed as short term, and efforts are made after a period of variation to bring the measure back in line.

The Corporation's strategy concerning capitalization is to utilize more equity than debt. This is measured by targeting total debt to total debt plus shareholders' equity at a ratio of less than 0.4 to 1. The Corporation has no externally imposed capital requirements.

At December 31 (\$000's except ratio amounts)	Target Measure	2009	2008
Components of ratios			
Current assets (excluding fair value of financial derivative and future income taxes)		47,460	61,525
Current liabilities (including short term debt and excluding fair value of financial derivative)		274,319	342,430
Short term debt (bank loan and current portion of capital lease)		218,788	251,125
Net debt (working capital and capital lease)		226,859	282,446
Total debt (bank loan and capital lease)		218,788	252,666
Shareholders' equity (share capital plus retained earnings)		683,979	666,515
Total capitalization (total debt plus shareholders' equity)		902,767	919,181
Funds from operations ¹		97,393	241,298
Net debt/funds from operations	< 1.5 times	2.3	1.2
Total debt/total debt plus shareholders' equity	< 0.4 times	0.2	0.3

¹ Funds from operations is a non-GAAP measure and is based on cash flow from operating activities before changes in non-cash working capital and abandonment expenditures.

The increase in the net debt to funds from operations ratio from 2008 to 2009 resulted primarily from the 60% decrease in funds from operations, offset by the 20% decrease in net debt.

14. SUBSEQUENT EVENTS

- a) Subsequent to December 31, 2009, a fiscal 2011 crude oil financial commodity contract for 1,000 Bbls/d at CDN \$92.20 per Bbl was unwound for net proceeds of \$1.4 million.
- b) The Corporation entered into a natural gas financial commodity contract subsequent to December 31, 2009 for 5,000 GJ/d for the period April 1, 2010 to March 31, 2011 at \$5.76 CAD/GJ.
- c) Subsequent to December 31, 2009, the Corporation completed a property acquisition for approximately \$17.5 million.
- d) On March 10, 2010, the Board of Directors of the Corporation decided that, after a review of the extensive depth of its 1,000 well prospect inventory, the spending required to advance these projects and its cost of capital, among other matters, to initiate a process to identify and consider strategic alternatives with a view to enhancing shareholder value. Strategic alternatives may include, but are not limited to, sale of the corporation, merger or other business combination, a sale of a material portion of Galleon's assets, farm-in or farm-out or acquisition, among other alternatives. There are no guarantees that the process will result in a transaction or, if a transaction is entered into, as to its terms or timing.

15. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the current period's consolidated financial statement presentation.