

## AUDITORS' REPORT

To the Shareholders of Ithaca Energy Inc.

We have audited the consolidated balance sheets of Ithaca Energy Inc. (the "Company") as at December 31, 2008 and 2007 and the consolidated statements of net and comprehensive loss and deficit, and cash flows for each of the years ended December 31, 2008 and 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we 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 Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years ended December 31, 2008 and 2007 in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

Chartered Accountant  
Calgary, Alberta  
March 26, 2009

## Ithaca Energy Inc.

### Consolidated Balance Sheets

(all amounts are US\$)

	December 31, 2008	December 31, 2007
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 26,943,802	\$ 96,214,707
Accounts receivable	12,879,389	3,048,284
Restricted cash (note 3)	12,305,014	-
Deposits, prepaid expenses and other	7,329,059	9,915,663
Inventory	1,289,032	-
	<hr/> 60,746,296	<hr/> 109,178,654
Long term receivable	400,617	-
Property, plant and equipment (net) (note 4)	296,523,448	116,963,890
	<hr/>	<hr/>
	\$ 357,670,361	\$ 226,142,544
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<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 41,057,033	\$ 17,949,326
Loan payable (note 6)	61,200,000	-
Long term liability on Beatrice acquisition (note 7)	4,137,413	-
Asset retirement obligation (note 5)	7,407,290	4,716,475
	<hr/>	<hr/>
	\$ 113,801,736	22,665,801
Shareholders' equity		
Share capital (note 8)	\$ 277,029,766	\$ 209,551,869
Contributed surplus (note 9)	5,126,285	1,765,333
Deficit	(38,287,426)	(7,840,459)
	<hr/> 243,868,625	<hr/> 203,476,743
	<hr/>	<hr/>
	\$ 357,670,361	\$ 226,142,544
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Commitments ( Note 12)		

"Approved on behalf of the Board"

"John P. Summers"

Director

"Michael B. A. Nobbs"

Director

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

## Ithaca Energy Inc.

### Consolidated Statement of Net and Comprehensive Loss and Deficit

(all amounts are US\$)

Years ended December 31

	2008	2007
<b>REVENUES</b>		
Oil sales	2,472,106	-
Interest income	809,563	1,337,621
	<u>3,281,669</u>	<u>1,337,621</u>
<b>EXPENSES</b>		
General and administrative	4,822,640	4,650,493
Loan fee amortization (note 6)	3,668,891	-
Operating	4,587,834	-
Depletion, depreciation and accretion (note 4 & 5)	2,811,483	455,825
Loss/(Gain) on foreign exchange	11,938,414	(2,825,380)
Loss on Financial Instrument	1,777,181	-
Stock based compensation (note 8d)	3,529,252	1,109,396
Interest and bank charges	245,483	275,858
	<u>33,381,178</u>	<u>3,666,192</u>
<b>Loss before income taxes</b>	30,099,509	2,328,571
<b>Current Income Taxes</b>	347,458	-
<b>Net and comprehensive loss after income taxes</b>	30,446,967	,2,328,571
<b>Deficit, beginning of year</b>	7,840,459	5,511,888
<b>Deficit, end of year</b>	<u>38,287,426</u>	<u>7,840,459</u>
<b>Net and comprehensive loss per share (basic and diluted) (note 10)</b>	0.23	0.02

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

## Ithaca Energy Inc.

### Consolidated Statements of Cash Flows

Years ended December 31

(all amounts are US\$)

	2008	2007
<b>CASH PROVIDED BY (USED IN):</b>		
<b>OPERATING ACTIVITIES:</b>		
Net loss	(30,446,967)	\$ (2,328,571)
Items not affecting cash		
Depletion, depreciation and accretion	2,811,483	455,825
Loan fee amortisation	3,668,891	-
Loss on financial instrument	1,777,181	-
Stock based compensation (note 8d)	3,360,952	1,109,396
	(18,828,460)	(763,350)
Changes in Non-Cash Working Capital	(21,956,849)	1,461,776
	(40,785,309)	698,426
<b>FINANCING ACTIVITIES:</b>		
Proceeds from issuance of shares	71,050,134	103,620,335
Share issue costs (note 8b)	(3,740,537)	(5,078,594)
Restricted cash (note 3)	(12,305,014)	-
Loan (note 6)	61,200,000	-
Loan issue costs (note 6)	(3,668,891)	-
	112,535,692	98,541,741
<b>INVESTING ACTIVITIES:</b>		
Oil and natural gas properties	(180,595,707)	(72,670,080)
Office furniture and equipment	(693,400)	(221,571)
	(181,289,107)	(72,891,651)
Changes in Non-Cash Working Capital relating to investing activities	25,478,840	20,835,327
	(155,810,267)	(52,056,324)
Loss/(Gain) on foreign exchange	14,788,979	(2,340,743)
<b>INCREASE/ (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	(69,270,905)	\$ 44,843,100
<b>Cash and cash equivalents, beginning of year</b>	\$ 96,214,707	\$ 51,371,607
<b>Cash and cash equivalents, end of year</b>	\$ 26,943,802	\$ 96,214,707

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

## **Ithaca Energy Inc.**

### **Notes to the Consolidated Financial Statements**

**Year ended December 31, 2008 and December 31, 2007**

#### **1. NATURE OF OPERATIONS**

Ithaca Energy Inc. (the "Corporation" or "Ithaca Energy"), incorporated in Alberta on April 27, 2004 and its wholly-owned subsidiary Ithaca Energy (UK) Limited, incorporated in Scotland are a publicly traded group of companies involved in the exploration and development of oil and gas in the North Sea. The Corporation's shares are listed on the TSX Venture Exchange in Canada and the London Stock Exchange's AIM in the United Kingdom under the symbol "IAE".

Since May 2004, the Corporation has been evaluating the resource potential of certain oil and natural gas exploration properties and is considered to be in its development stage of operations. The recoverability of amounts shown for oil and natural gas properties is dependent upon the determination of economically recoverable reserves.

#### **2. SIGNIFICANT ACCOUNTING POLICIES**

##### **Principles of consolidation**

The consolidated financial statements of the Corporation include the accounts of Ithaca Energy Inc. and its wholly-owned subsidiary Ithaca Energy (UK) Limited. All inter-company transactions and balances have been eliminated.

##### **Use of Estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles 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 date of the financial statements, and the reported amounts of expenses during the reporting period. The amounts recorded for depreciation, asset retirement obligation, future income taxes, and stock based compensation are based upon estimates, as are assumptions used in the ceiling test. Actual results could differ from those estimates.

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

For the purpose of cash flow statements, cash and cash equivalents include investments with an original maturity of three months or less.

##### **Restricted Cash**

Cash that is held for security for bank issued Letters of Credit and bank guarantees are reported in the balance sheet and cash flow statements separately. If the expected duration of the restriction is less than twelve months then it is shown in current assets.

##### **Inventory**

Inventories of materials and supplies are stated at the lower of cost and net realizable value. Cost is determined on the first-in, first out method.

##### **Financial Instruments**

The Corporation's financial instruments consist of cash, accounts receivable and accounts payable and accrued liabilities. It is management's opinion that the Corporation is not exposed to significant interest, currency or credit risk arising from its financial instruments and that their fair values approximate their carrying values.

### **Foreign Currency Translation**

Items included in the financial statements are measured using the currency of the primary economic environment in which the Corporation operates (the 'functional currency'). The consolidated financial statements are presented in United States Dollars, which is the Corporation's and Ithaca Energy (UK) Limited's functional and presentation currency. Foreign currency transactions are translated into the functional currency under the temporal method using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognized in the income statement.

### **Property, Plant and Equipment**

(a) Oil and Natural Gas Operations:

The Corporation follows the full cost method of accounting for exploration and development expenditures whereby all costs relating to the acquisition, exploration and development of oil and natural gas reserves are capitalized. Such costs include lease acquisitions, geological and geophysical data, lease rentals on undeveloped properties, drilling both productive and non-productive wells, production equipment, and overhead charges directly related to acquisition, exploration and development activities. Proceeds received from disposals of properties and equipment are credited against capitalized costs unless the disposal would alter the rate of depletion and depreciation by more than 20 percent, in which case a gain or loss on disposal is recorded. In addition, proceeds received from the sale of future royalties are credited to oil and gas properties.

All costs of acquisition, exploration and development of oil and natural gas reserves, associated tangible plant and equipment costs, and estimated costs of future development of proved developed reserves are depleted and depreciated by the unit of production method based on estimated gross proved reserves before royalties as determined by independent evaluators. Natural gas reserves are converted to equivalent units using their relative energy content of six thousand cubic feet of natural gas to one barrel of oil. The costs of acquiring and evaluating unproved properties are excluded from costs subject to depletion. These properties are assessed periodically to ascertain whether impairment has occurred. 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 costs subject to depletion.

Petroleum and natural gas assets are evaluated annually to determine whether the costs are recoverable. The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves plus the lower of cost and market value of unproved properties exceed the carrying value of the petroleum and natural gas assets. If the carrying value of the petroleum and natural gas assets is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market value of unproved properties. The cash flows are estimated using future product prices and costs and are discounted using the risk-free interest rate.

(b) Furniture and Office Equipment:

Computer and office equipment is recorded at cost and depreciated over its estimated useful life on a straight-line basis over three years. Furniture and fixtures are recorded at cost and depreciated over their estimated useful lives on a straight-line basis over five years.

### **Capitalized Interest**

Interest costs associated with major development projects are capitalized until the project is substantially completed. These costs are subsequently depleted together with the related assets.

### **Joint Interest Operations**

Substantially all of the Corporation's oil and natural gas activities are carried out jointly with others. These consolidated Financial Statements reflect only the Corporation's proportionate interest in such activities.

### **Asset Retirement Obligation**

The Corporation records the present value of legal obligations associated with the retirement of long-lived tangible assets, such as producing well sites and processing plants, in the period in which they are incurred with a corresponding increase in the carrying amount of the related long-lived asset. In subsequent periods, the asset estimate obligation is adjusted for the passage of time and any changes in the estimated amount or timing of the settlement of the obligations. The carrying amounts of the long-lived assets are depleted using the unit of production method. Actual costs to retire tangible assets are deducted from the liability as incurred.

### **Revenue Recognition**

Oil revenues associated with the sale of the Corporation's crude oil are recognized when title passes to the customer. The costs associated with the delivery, including operating and maintenance costs and transportation expenses are recognized in the same period in which the related revenue is earned and recorded.

### **Stock based Compensation**

The Corporation has a stock based compensation plan as described in note 8. Stock based compensation expense is recorded in the statement of comprehensive loss and deficit for all options granted in the year, with a corresponding increase recorded as contributed surplus. Compensation expense is based on the estimated fair values at the time of the grant and the expense is recognized over the vesting period of the options. Upon the exercise of the stock options, consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase in share capital. In the event that vested options expire unexercised, previously recognized compensation expense associated with such stock options is not reversed. In the event that options are cancelled, previously recognized compensation expense associated with the unvested portion of such stock options is reversed.

### **Earnings per Share**

Basic earnings per common share are calculated on the net earnings using the weighted average number of shares outstanding during the fiscal period. Diluted earnings per share information is calculated using the treasury stock method which assumes that proceeds obtained upon exercise of options and warrants would be used to purchase common shares at the average market price for the period. No adjustment to diluted earnings per share is made if the result of this calculation is anti-dilutive.

### **Income Taxes**

Income taxes are accounted for using the asset and liability method of tax allocation. Future income taxes are recognized for the future income tax consequences attributable to differences between the carrying values of assets and liabilities and their respective income tax bases. Future income tax assets and liabilities are measured using substantively enacted income tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in rates is included in earnings in the period of the enactment date. Future income tax assets are recorded in the consolidated financial statements if realization is considered more likely than not.

## **Change in Accounting Policies**

### **(a) Financial Instruments Disclosure and Presentation**

In December 2006, the CICA approved Handbook Section 3862 "Financial Instruments – Disclosures", and Handbook Section 3863 "Financial Instruments Presentation". The objective of Section 3863 is to require entities to provide disclosures in their financial statements that enable users to evaluate both the significance of financial instruments for the entity's financial position and performance and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the entity manages those risks. The purpose of Section 3862 is to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows. These sections apply to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007. The Corporation has adopted the new disclosure requirements in 2008. The two sections result in the additional disclosures set out below. There have been no significant changes from the previous year to the Corporation on its exposure to risks and management's objectives, policies and process to manage the market risks outlined below.

The Corporation has identified that it is exposed principally to the following areas of market risk.

#### *i) Commodity Risk*

Commodity price risk related to crude oil prices is one of the Corporation's most significant market risk exposures. Crude oil prices and quality differentials are influenced by worldwide factors such as OPEC actions, political events and supply and demand fundamentals. The Corporation's expenditures are subject to the effects of inflation and prices received for the product sold are not readily adjustable to cover any increase in underlying expenses from inflation. The Corporation may periodically use different types of derivative instruments to manage its exposure to price volatility, thus mitigating fluctuations in commodity-related cash flows. The Corporation currently has no derivative instruments in place.

Fluctuations in oil price may impact the economic recoverability of reserves thereby resulting in impairment. This is one of the factors considered when the impairment test is conducted at year end or following any significant event. If the oil price had been lower by \$5 per barrel in 2008 then the loss for the year would have been higher by \$293,600.

#### *ii) Interest Risk*

The Corporation uses floating rate debt to finance its developments and operations, which is then fixed as required by the debt facility terms.

The Corporation is exposed to interest rate risk to the extent that LIBOR may fluctuate. The Corporation's debt will be denominated in U.S. dollars ("USD") or British Pounds Sterling ("GBP") as appropriate.

The Corporation will evaluate its annual forward cash flow requirements on a rolling monthly basis. Accordingly, individual facility amounts utilized and related interest terms will vary. If the interest rate had been higher by 1% then the interest charged in 2008 would have been \$600,000 higher.

### *iii) Foreign Exchange Rate Risk*

The Corporation is exposed to foreign exchange risks to the extent it transacts in various currencies, while measuring and reporting its results in USD. The exposure to foreign exchange risk is partly mitigated since debt financing is in USD. Since time passes between the recording of a receivable or payable transaction and its collection or payment, the Corporation is exposed to gains or losses on non USD amounts and on balance sheet translation of monetary accounts denominated in non USD amounts upon spot rate fluctuations from quarter to quarter.

The Corporation believes that its foreign exchange risk is mitigated in that future revenues and interest expense and a portion of its operating and exploration costs are largely transacted in USD.

As at December 31, 2008, the Company had no contracts outstanding.

### *iv) Credit Risk*

The Corporation's accounts receivable with customers in the oil and gas industry are subject to normal industry credit risks and are unsecured.

The Corporation routinely has cash on deposit and only places these funds on deposit with financial institutions with a credit rating of A+ or better.

The Corporation assesses partners' and customer's credit worthiness before entering into farm-in or joint venture agreements. In the past, the Corporation has not experienced credit loss in the collection of accounts receivable. As the Corporation's exploration, drilling and development activities expand with existing and new joint venture partners, the Corporation will continue to assess and continuously update its management of associated credit risk and related procedures.

The Corporation regularly monitors all customer receivable balances outstanding in excess of 90 days. At December 31, 2008 there is one debtor that is over 90 days and management has agreed with the debtor that the amount can be paid in 12 equal installments commencing April 2009. Accordingly, there is no allowance for doubtful accounts on accounts receivable. The amount over 90 days is \$1,201,850 and of this amount \$400,617 has been classified as a Long term receivable.

### *v) Liquidity Risk*

Liquidity risk includes the risk that as a result of its operational liquidity requirements the Corporation will not have sufficient funds to settle a transaction on the due date. The Corporation manages liquidity risk by maintaining adequate cash reserves, banking facilities, and by considering medium and future requirements by continuously monitoring forecast and actual cash flows. The Corporation considers the maturity profiles of its financial assets and liabilities. As at December 31, 2008, substantially all accounts payable are current.

## **b) Inventory**

Effective January 1, 2008 the Corporation prospectively adopted Section 3031, "Inventories" which stipulates that major spare parts and standby equipment that are not in use should be included in property plant and equipment, and also provides more guidance on the measurement and disclosure requirements for inventory that is at the lower of cost and net realizable value. There has been no impact on the Corporation's financial statements as a result of adopting this policy.

### c) Capital Disclosures

Effective January 1, 2008 the Corporation has adopted Handbook Section 1535, "Capital Disclosures" which requires entities to disclose their objectives, policies and processes for managing capital, and in addition, whether the entity has complied with any externally imposed capital requirements.

The Corporation's objectives when managing capital are:

- to safeguard the Corporation's ability to continue as a going concern;
- to maintain balance sheet strength and optimal capital structure, while ensuring the Corporation's strategic objectives are met; and
- to provide an appropriate return to shareholders relative to the risk of the Corporation's underlying assets.

In the management of capital, the Corporation includes shareholders' equity, working capital and interest bearing debt. Shareholders' equity includes share capital, contributed surplus, retained earnings or deficit and other comprehensive income.

The Corporation maintains and adjusts its capital structure based on changes in economic conditions and the Corporation's planned requirements. The Board of Directors reviews the Corporation's capital structure and monitors requirements. The Corporation may adjust its capital structure by issuing new equity and/or debt, selling and/or acquiring assets, and controlling capital expenditure programs.

The Board sets guidelines for the management of the Corporation's capital. The Corporation monitors its capital structure using the debt-to-equity ratio and other benchmark measures at the consolidated group level.

(in \$ millions)	December 31, 2008	December 31, 2007
Debt	\$ 61.2	\$ -
Equity	243.9	203.5
Debt as a % of Equity	25%	0%

As at December 31, 2008, there are externally imposed debt covenants with respect to the Corporation's capital structure. These covenants relate to the \$61.2 million loan facility with Dyas (UK) Limited. All covenants have been complied with.

There have been no significant changes from the previous year to management's objectives, policies and processes to manage capital or to the components defined as capital.

### Other Pronouncements

In February 2008, the AcSB issued Section 3064, "Goodwill and Intangible Assets" and amended Section 1000, "Financial Statement Concepts" clarifying the criteria for the recognition of assets, intangible assets and internally developed intangible assets. Items that no longer meet the definition of an asset are no longer recognized as assets. The standard is effective for fiscal years beginning on or after October 1, 2008 and early adoption is permitted. The Corporation is currently evaluating the impact these sections will have, if any, on the consolidated financial statements.

In January 2006, the AcSB adopted a strategic plan for the direction of accounting standards in Canada. Accounting standards for public companies in Canada are required to converge with the International Financial Reporting Standards ("IFRS") by 2011. The Corporation is in initial stages of assessing IFRS and its impact on the consolidated financial statements.

### 3 RESTRICTED CASH

Restricted cash of \$10,419,840 is held by the Bank of Scotland as cash security for a Letter of Credit that Ithaca Energy (UK) Limited provided to the UK Department of Energy and Climate Control when it was granted Field Development Plan approval for the Jacky Field. The cash will be restricted until July 2009 when the requirement for the Letter of Credit will be reviewed.

Restricted cash of \$1,855,174 is held by the Bank of Scotland as cash security for a Bank Guarantee that Ithaca Energy (UK) Limited provided to the Crown Estate when it was granted Field Development Plan approval for the Jacky Field. The cash will be restricted until November 2009 when the requirement for the bank guarantee will be reviewed.

### 4 PROPERTY, PLANT AND EQUIPMENT

	December 31, 2008	December 31, 2007
Oil and natural gas properties	\$ 297,918,747	\$ 116,675,835
Less accumulated depletion	(2,178,728)	-
	<u>295,740,019</u>	<u>116,675,835</u>
Office furniture and equipment	1,171,222	477,822
Less accumulated depreciation and amortization	(387,793)	(189,767)
	<u>783,429</u>	<u>288,055</u>
	<u>\$ 296,523,448</u>	<u>\$ 116,963,890</u>

During November 2008 the Corporation acquired a producing asset (Beatrice Field) and consequently began recognising depletion expense amounting to \$2,178,728 by December 31, 2008 (2007 – NIL). At December 31, 2008, oil and natural gas properties included \$272.1 million (2007 - \$68.7 million) relating to proved properties and \$24.6 million (2007 \$48.0 million) relating to unproved properties. During 2008, the Corporation capitalized \$7.6 million (2007 - \$4.1 million) of overhead directly related to exploration, appraisal and development activities. Future development costs for the proved oil and gas properties are forecast to be approximately \$334.7million.

At December 31, 2008 included in the above balance is an amount of \$1.7 million (2007: NIL) relating to capitalized interest.

A ceiling test was performed for both years and there was no impairment of proved oil and gas properties. There was an impairment of \$24.1 million (2007: NIL) relating to unproved oil and gas properties and this has been added to the proved oil and gas properties cost pool which is depleted over unit of production based on proved reserves .

The forecasted future prices used in the ceiling test were as follows:

	<b>Oil Reference Price (\$/bbl)</b>
2009	51.73
2010	61.37
2011	64.66
2012	72.11
2013	83.05

### **Acquisitions**

In August 2008 Ithaca completed the acquisition of a 66.67% working interest in the Stella and Harrier Shallow discoveries which lie in United Kingdom Continental Shelf Block 30/6 Rest of Block (Chalk Layers and Younger) ("Stella"), for an initial consideration of \$15 million from joint owners Shell U.K. Limited ("Shell") and Esso Exploration and Production UK Limited ("Esso"). A further payment of \$15 million will become payable to Shell and Esso at the time of Field Development Plan approval and proceeds from Ithaca's share of production will be subject to a 5% overriding royalty.

In November 2008 the Corporation completed its transaction to lease the Beatrice assets resulting in immediate access to production averaging up to 2,000 bopd and providing the export route for the Jacky crude. The lease premium was \$10 million plus \$0.8 million in acquired stock.

### **Disposal**

On 31 October, 2008 Ithaca entered into a Sale and Purchase Agreement (the "Dyas Transaction") with Dyas UK Limited ("Dyas") for the sale of a portion of its interests in all of its oil and gas licences and the provision of a convertible loan facility. The Dyas Agreement provided that Dyas would purchase 25.25% of Ithaca's interests in all assets owned by the Company as the date of the transaction for the consideration of £40 million (approximately US\$65.6 million) cash effective November 1, 2008. Dyas advanced this sum to Ithaca as a loan until closing of the transaction at which time the consideration would be repaid and the loan would become immediately repayable.

In addition, Dyas provided Ithaca with a senior secured loan (the "Dyas Facility") with which to redeem in full the fully drawn Royal Bank of Scotland US\$60 million Predevelopment Facility. The Dyas Facility has a margin over US Dollar Libor of 4.5% and an initial term of two years. The loan is extendable by Dyas in two one-year tranches should the oil price average less than US\$60 per barrel in the previous year, giving Ithaca an extended credit facility.

Dyas UK Limited has the option at any time during the subsequent two years to acquire an additional 15.15% of the Corporation's portfolio held as at 1 November, 2008, for a consideration of \$61.2 million, as adjusted for working capital movements in the intervening period. In the event that the option is exercised, then the \$61.2 million outstanding loan facility would become immediately due and payable, and the consideration would then be applied to meet this obligation in full. On December 17, 2008 the Dyas Transaction partially completed with all the interests other than that relating to the Stella field having been transferred. As a consequence the consideration paid on the partial completion was adjusted to £35 million with the balance of £5 million payable upon the transfer of the Stella interest. The transfer of the interest in the Stella property is expected to complete in late March or early April 2009.

The 20% (6.7% expected unitization) interest in the Barbara gas field was disposed of on November 14, 2008 as non core to Ithaca. The sale proceeds were \$8.25 million.

## 5 ASSET RETIREMENT OBLIGATIONS

The total future asset retirement obligation was estimated by management based on its net ownership interest in all wells and facilities, estimated costs to reclaim and abandon wells and facilities and the estimated timing of the costs to be incurred in future periods. The Corporation estimates its total undiscounted asset retirement obligations to be \$8,029,898 as at December 31, 2008. The Corporation uses a credit adjusted risk free rate of 8.0 percent based upon the Corporation's current cost of borrowing and an inflation rate of 2.5 percent over the varying lives (1 to 3 years) of the assets to calculate the present value of the asset retirement obligation. Upon the acquisition of the Beatrice Field in November 2008 the Corporation did not assume the decommissioning liabilities

The following table provides a reconciliation of the Company's total discounted asset retirement obligations:

	2008	2007
<b>Balance, beginning of year</b>	\$ 4,716,475	\$ 1,513,000
Liabilities incurred	4,493,350	2,645,184
Accretion	434,730	362,948
Liabilities disposed of	(2,237,265)	-
Revision of estimates	-	195,343
<b>Balance, end of year</b>	<b>\$ 7,407,290</b>	<b>\$ 4,716,475</b>

## 6 LOAN PAYABLE

The Corporation had the following loan facility in place with Dyas (UK) Limited

	Balance Available	Outstanding as at December 31, 2008	Interest Rate per annum	Maturity Date
Loan Facility	\$61,200,000	\$61,200,000	LIBOR+4.5%	October 31, 2010

Arrangement and redemption fees for the previous RBS Loan Facility were \$3,668,891 and have been fully amortized in 2008.

The Loan Facility is collateralized by a bond and floating charge over the assets of Ithaca Energy (UK) Limited ("the Borrower") and a share pledge by Ithaca Energy Inc over its share in the Borrower.

The Financial covenants relating to the Pre-development Facility are

1. The ratio of the Net Present Value of the Jacky and Athena fields to the amount outstanding is not less than 1.2 : 1
2. The Net Assets of Ithaca Energy Inc are not less than \$100,000,000 at any time,

There were no violations of the covenants in the period.

## 7 LONG TERM LIABILITY ON BEATRICE ACQUISITION

On completion of the acquisition of the Beatrice Facilities on November 10, 2008 there were 75,000 barrels of oil in an oil storage tank at the Nigg Terminal. This volume of oil is required to be in the storage tank when the Beatrice Facilities are re-transferred. This volume of oil was valued at the price on the forward oil price curve at the expected date of re-transfer and will be subject to revaluation at each financial quarter. The expected date of re-transfer is likely to be more than three years.

## 8. SHARE CAPITAL

### (a) Authorized

The Corporation has authorized share capital of an unlimited number of common shares of no par value.

<b>Authorized</b>
Unlimited number of Voting Common Shares without nominal or par value
Unlimited number of Preferred Shares issuable in series

### (b) Issued

The issued share capital is as follows:

<b>Issued</b>	<b>Number</b>	<b>Amount</b>
<b>Balance December 31, 2006</b>	82,904,475	\$ 110,782,103
Issued for cash – November issue	27,400,000	101,837,132
Issued for cash – options exercised	1,627,500	1,783,203
Transfer from Contributed Surplus on options exercised		228,025
Share issue costs	-	(5,078,594)
<b>Balance December 31, 2007</b>	111,931,975	\$ 209,551,869
Issued for cash – options exercised	330,000	759,599
Issued for cash	50,000,000	70,290,535
Share issue costs		(3,740,537)
Transfer from Contributed Surplus on options exercised		168,300
<b>Balance December 31, 2008</b>	162,261,975	\$ 277,029,766

On August 11, 2008 the Corporation successfully closed an equity offering via a fully marketed deal. Gross proceeds were C\$75 million through the issue of 50 million common shares at a price of C\$1.50 per common share.

### (c) Stock Options

The Corporation has a stock option plan, approved by shareholders on April 12, 2006, for directors, officers, employees and consultants which provides for the granting of options to acquire common shares. At December 31, 2008, there were 16,226,197 (2007 8,290,447) common shares authorized for issuance under the plan.

At December 31, 2008 10,694,500 stock options to purchase common shares were outstanding, having an exercise price range of \$0.20 (C\$0.25) and \$1.69 to \$2.99 (C\$1.80 to C\$3.65) per share with an average remaining contractual life of 1.89 years. The Corporation's share price at December 31, 2008 was C\$ 0.31 and therefore only 3,444,500 options out of 10,694,500 options outstanding were in the money.

Changes to the Corporation's stock options are summarized as follows:

	2008		2007	
	Number of Options	Wt. Avg. Exercise Price *	Number of Options	Wt. Avg. Exercise Price *
Balance, Beginning of Year	4,330,000	\$ 2.01	4,052,500	\$ 1.64
Granted	7,224,500	1.82	2,365,000	2.26
Cancelled	(530,000)	1.97	(460,000)	2.28
Exercised	(330,000)	2.07	(1,627,500)	1.06
Balance, End of Year	10,694,500	\$ 1.89	4,330,000	\$ 2.01
Exercisable, End of Year	2,613,333	\$ 1.91	2,852,500	\$ 1.84

\*The weighted average exercise price has been converted into U.S. dollars based on the foreign exchange rate in effect at the date of issuance.

The following is a summary of stock options outstanding as at 31 December, 2008.

Range of Exercise Price	Options Outstanding		
	Number of Options	Wt. Avg. Life (Years)	Wt. Avg. Exercise Price *
\$0.20 (C\$0.25)	3,444,500	4.92	\$ 0.20
\$0.90	450,000	0.17	0.90
\$1.69 (C\$1.80)	600,000	4.67	1.69
\$2.07 - \$2.99 (C\$2.-2 - C\$3.65)*	6,200,000	2.51	2.85
	10,694,500	3.31	\$ 1.89

\*The exercise price and the weighted average exercise price has been converted into U.S. dollars based on the foreign exchange rate in effect at the date of issuance.

The following is a summary of stock options exercisable at 31 December, 2008.

Options Exercisable			
Range of Exercise Price	Number of Options	Wt. Avg. Life (Years)	Wt. Avg. Exercise Price *
\$0.90	450,000	0.17	0.90
\$2.07 - \$2.99 (C\$2.-2 – C\$3.65)*	2,163,333	0.73	3.09
	2,613,333	0.64	\$ 1.91

\*The exercise price and the weighted average exercise price has been converted into U.S. dollars based on the foreign exchange rate in effect at the date of issuance

On January 30, 2008 the Corporation's Board granted 1,125,000 options at an exercise price of C\$3.65 to employees. On February 15, 2008 the Corporation's Board granted 2,590,000 options at an exercise price of C\$3.65 to directors and employees. On September 2, 2008 the Corporation's Board granted 600,000 options at an exercise price of C\$1.80 to employees. On December 8, 2008 the Corporation's Board granted 3,444,500 options at an exercise price of C\$0.25 to directors and employees

At December 31, 2008 10,694,500 stock options to purchase common shares were outstanding, having an exercise price range of \$0.90 (C\$1.06) and \$1.68 to \$3.70 (C\$1.80 to C\$3.65) per share.

#### (d) Stock-Based Compensation

Options granted are accounted for using the fair value method. The compensation cost charged against earnings for stock options granted in 2008 was \$3,529,252 (2007 - \$1,109,396) The fair value of each stock option grant was estimated at the date of grant, using the Black-Scholes option pricing model with the following assumptions:

	2008	2007
Risk free interest rate	3.12	4.25
Expected dividend yield	0%	0%
Expected stock volatility	154%	77%
Expected life	5 years	3 years
Weighted Average Fair Value	\$ 0.92	\$ 1.13

#### 9. CONTRIBUTED SURPLUS

	2008	2007
Balance, beginning of year	\$ 1,765,333	\$ 883,962
Issue of Stock Options	3,529,252	1,109,396
Transfer to Share Capital on exercise of options	(168,300)	(228,025)
Balance, end of year	\$ 5,126,285	\$ 1,765,333

## 10. PER SHARE AMOUNTS

The weighted average number of shares outstanding during 2008 was basic 131,633,833 (2007 87,742,543) and diluted 138,513,009 (2007 92,459,071). The difference between basic and diluted shares relates to outstanding stock options. For the purpose of calculating the diluted net loss per share for the year ended December 31, 2007 and the year ended December 31, 2008, incremental shares from assumed exercise of stock options are not included due to the anti-dilutive effect.

## 11. FUTURE INCOME TAXES

The provision for future income taxes differs from the amount computed by applying the combined statutory Canadian Federal and Provincial tax rates to earnings before taxes. The reasons for these differences are as follows:

	2008	2007
Loss before taxes	\$30,099,509	\$ 2,328,571
Enacted tax rate	29.50%	32.12%
Computed income taxes at the enacted rate	8,879,355	747,937
Expenses not deductible for tax purposes	30,136,136	(356,338)
Recognition of previously unrecognised assets	965,193	556,706
Difference in foreign tax rates	24,810,622	(75,809)
Change in tax rates	(928,858)	(114,767)
Change in tax rates on opening	(58,962)	-
Change in valuation allowance	(63,803,486)	(757,728)
Total	\$ -	\$ -

At December 31, 2008, the Corporation had estimated future tax assets as follows:

	2008	2007
Future Tax Assets		
Non-capital losses	\$ 144,955,846	\$ 2,539,362
Share issue costs	2,906,756	2,975,917
Fixed assets	(134,013,428)	-
General Provision	2,594,348	-
Valuation Allowance	(16,443,522)	(5,515,299)
Total	\$ -	\$ -

## 12. COMMITMENTS

The Corporation has the following financial commitments:

	2009	2010	2011	2012	2013
General & Administrative	\$ 320,000	\$ 320,000	\$ 320,000	\$ 320,000	\$ 320,000
Exploration activities	\$ 245,400	\$ 245,400			
Inner Moray Firth	\$ 27,078,000				
Rig Commitment	\$ 4,049,955				
Exploration well		\$ 14,000,000			

## 13. RELATED PARTY TRANSACTIONS

A Director of the Corporation is a partner in Burstall Winger LLP who acts as legal counsel for the Corporation. The amount of fees, measured at the exchange amount, paid to Burstall Winger LLP in the period to December 31, 2008 was \$384,925 (2007 - \$387,000). The balance outstanding at December 31, 2008 was \$:NIL (2007 - \$176,037).

## 14 FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES

Financial instruments of the Company consist mainly of cash and cash equivalents, receivables, payables, loans and financial derivative contracts, all of which are included in these financial statements. At December 31, 2008, the classification of financial instruments and the carrying amounts reported on the balance sheet and their estimated fair values are as follows:

Classification	Carrying Amount	Fair Value
Cash and cash equivalents	26,943,802	26,943,802
Accounts receivable - current	12,879,389	12,879,389
Accounts receivable – long term	400,617	400,617
Accounts payable	41,057,033	41,057,033
Loans	61,200,000	61,200,000
Long Term Liability	4,137,413	4,137,413
<b>Total</b>	<b>146,618,254</b>	<b>146,618,254</b>

The carrying value of the long term receivable is approximately equal to the fair value.

## 15. SUPPLEMENTAL INFORMATION

	2008	2007
Interest paid during the year	\$ 3,311,177	\$ 189
Income taxes paid during the year	\$ 116,464	\$ -

## **16. SUBSEQUENT EVENTS**

### **Exchange Rate Contract**

On March 11, 2009, the Corporation entered in to a "Window Forward Plus" contract with the Bank of Scotland to hedge circa 90% of the Corporation's known future US Dollar to British Pound Sterling exchange rate exposure. The contract ensures that the Corporation, which incurs a substantial amount of its expenditure in British Pounds Sterling, is able to lock in a US\$/£ rate of no worse than 1.40:1.0 for a series of foreign exchange transactions throughout the year and yet continues to benefit from any additional strengthening of the US Dollar down to 1.29:1 (the "Trigger" rate). Any strengthening of the US\$/£ rate beyond the Trigger rate during any of the periods or "windows" between the transaction dates will lead to a rate of 1.40:1.00 being applied to that individual transaction. The contract covers \$49 million equivalent of British Pounds Sterling expenditure.