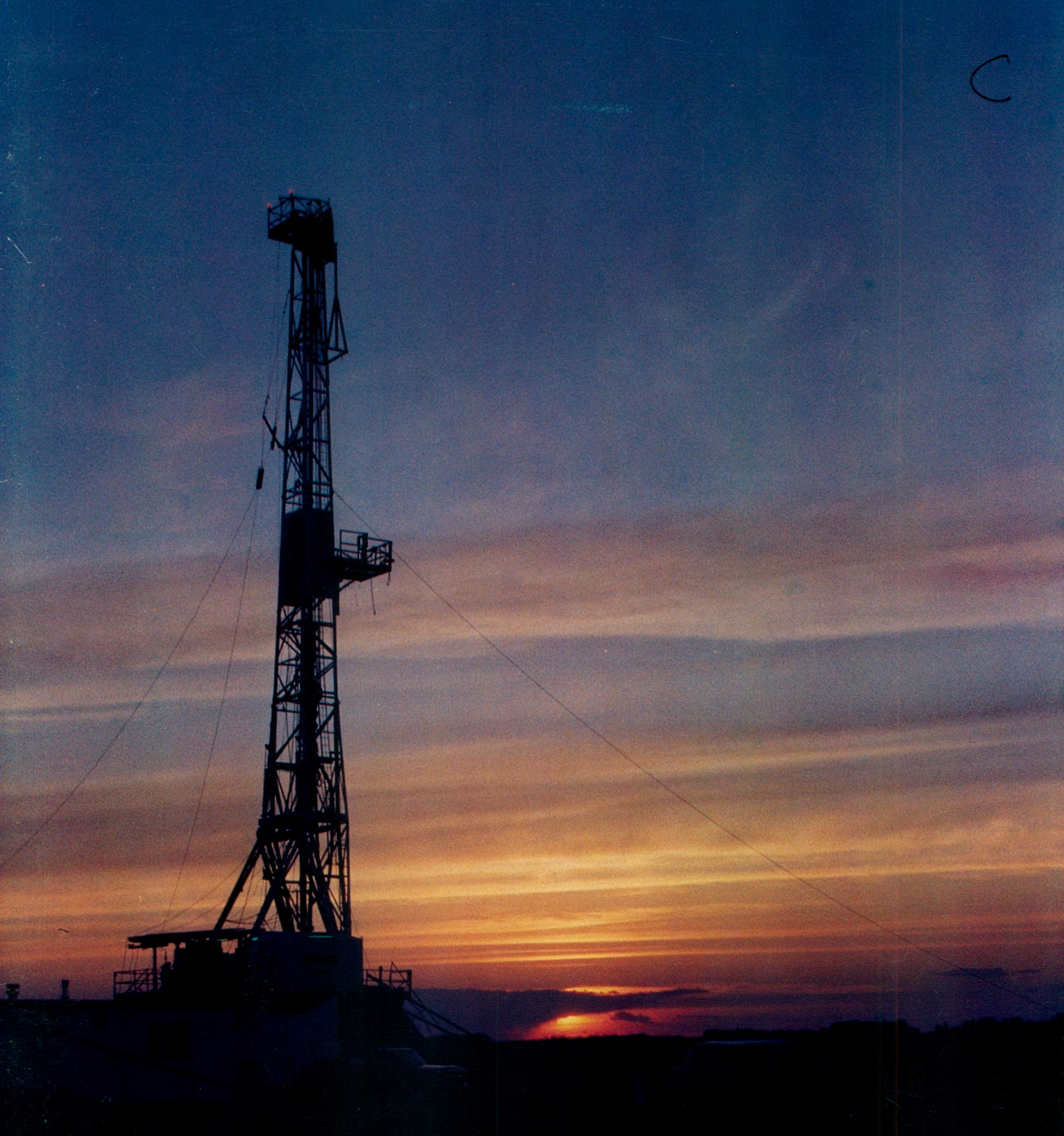

RIO ALTO EXPLORATION LTD.

1987 ANNUAL REPORT

CORPORATE PROFILE

Rio Alto Exploration Ltd. was incorporated under the laws of Alberta on May 13, 1970. The Company engaged in mineral exploration and development in its early years. Since 1984, the emphasis has been changed to oil and gas exploration and development. During this time, Rio Alto has participated in various plays in North America, Europe and Pakistan, and has assembled a significant land position and production base. Rio Alto is a Canadian Controlled Public Corporation listed on the Toronto Stock Exchange.

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CORPORATE INFORMATION

DIRECTORS

John C. Anderson	Calgary, Alberta
Carman W. Byler	Calgary, Alberta
Patrick A. Campbell Fraser	Edinburgh, Scotland
Robert E. Humphreys	Calgary, Alberta
M. Jaffar Khan	Calgary, Alberta
Norman E. Brown	Calgary, Alberta
James R. Smith	Calgary, Alberta
A. Barry Beaven	Calgary, Alberta

OFFICERS AND SENIOR PERSONNEL

John C. Anderson	President
Cuneyt S. Tirmandioglu	Secretary-Treasurer
David A. Robinson	Land and Operations Manager
Stanley M. Prenioslo	Senior Geologist
Beverley A. Berry	Assistant Secretary

HEAD OFFICE
1900, 801 - 6th Avenue S.W.
Calgary, Alberta T2P 3W2

LEGAL COUNSEL
Reed Donahue

SUBSIDIARY
Rio Alto Exploration Inc.

AUDITORS
Collins Barrow

BANK
Royal Bank of Canada

STOCK LISTING
Toronto Stock Exchange
Stock Exchange Symbol: RAX

TRANSFER AGENT AND REGISTRAR
The National Trust Company

The Annual General Meeting of Shareholders will be held at 3:30 p.m. on Thursday, June 23, 1988, in the Boardroom of The 400 Club, Calgary, Alberta.

TO THE SHAREHOLDERS

The company shifted its Canadian exploration focus from Saskatchewan to Alberta during 1987. A total of 26,360 gross acres (7,637 net acres) of land was acquired with 95% of this located in Alberta.

Wells were drilled on two of our new exploration prospects in the last quarter of 1987. These wells along with four drilled at Kerrobert and a small production purchase have reversed the decline in daily oil production and in December our oil production increased from 225 BOPD to 265 BOPD. Subsequent to the year-end, the company participated in two discoveries in Sturgeon Lake 3-25-69-23 and Swan Hills 16-32-67-11 as to 15% and 16.4% working interest respectively. The wells will be completed during the second quarter of 1988. In both areas there are a number of potential development locations. In addition, the Company has an inventory of various good quality prospects located in Central Alberta which will be evaluated during the ensuing year. We expect substantial increases in our daily production and reserves in 1988.

In Pakistan seismic field work and interpretation was completed, identifying eight anomalous structures. The company farmed out part of its interest and now holds a 20% interest in the Karachi permit. Plans have been made to drill the Mol structure in early 1988.

In Italy further seismic was carried out on the Basentello permit, and subsequent to the year-end, Marciano #1 well was drilled and completed as a gas well. The Company has a 13.75% working interest in this well. The production testing is expected to be completed during the second quarter of 1988 with tie-in work to commence immediately thereafter.

The Company raised approximately $2,800,000 through a rights offering in the third quarter of 1987, these funds ensure that our 1988 exploration program will be carried out as planned.

1988 will be a very exciting year for the Company, with excellent Alberta prospects to be drilled along with our first test well in Pakistan.

I would like to thank our shareholders, directors and staff for their continuing support.

J C Anderson

John C. Anderson
President

HIGHLIGHTS OF ACTIVITIES

FINANCIAL	Dec. 31 1987	Dec. 31 1986
Gross revenues	**$ 1,871,710**	$ 2,607,001
Cash flow from operations	**874,530**	1,451,008
Earnings (Loss) for the year	**169,015**	(11,415,992)
Growth expenditures net of incentives	**2,194,514**	1,620,166
Working capital (Deficiency)	**1,604,288**	(41,037)

PRODUCTION		
Average barrels of oil per day	**225**	345
Average thousand cubic feet gas per day	**335**	509

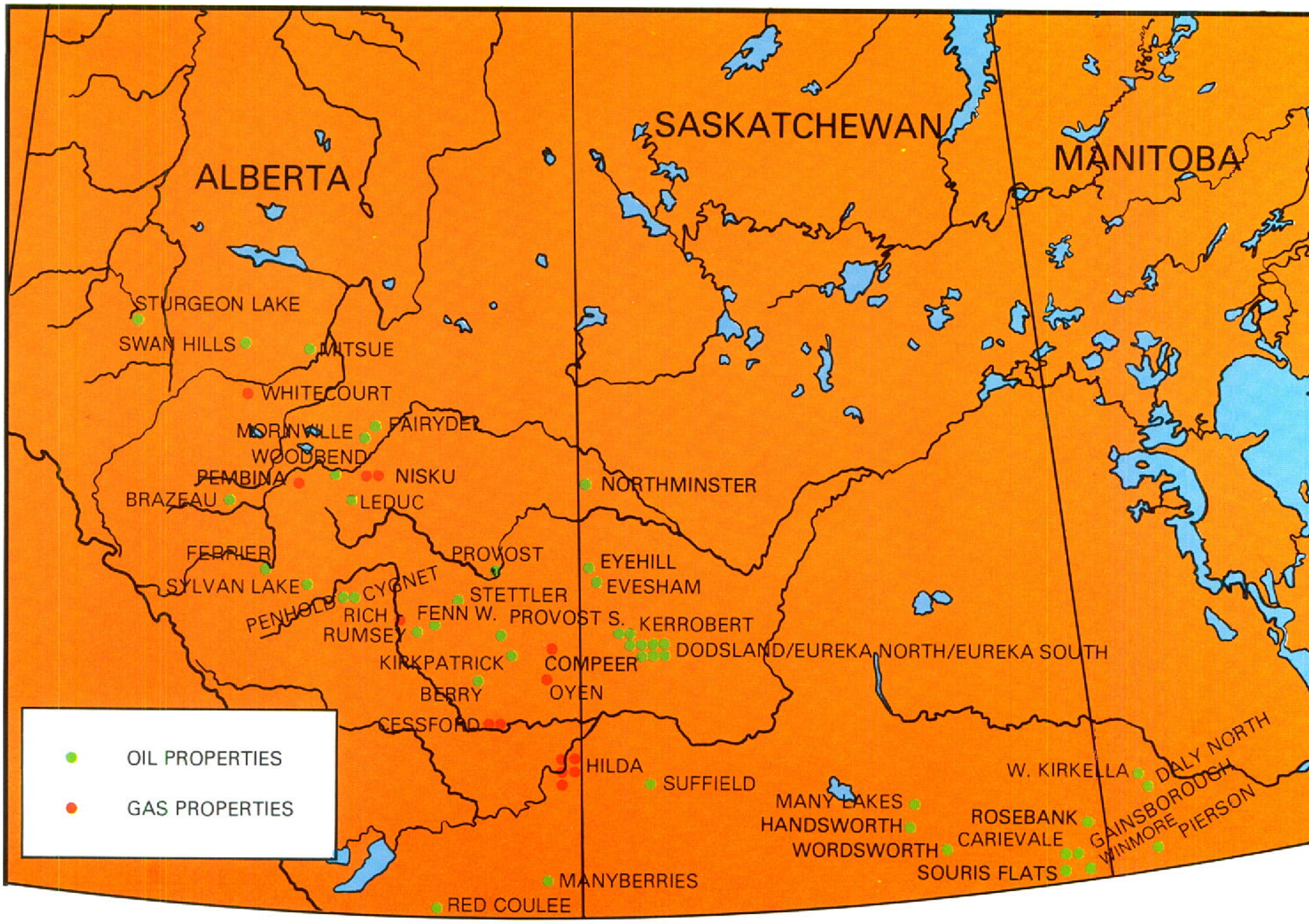
RESERVES		
Proven oil (barrels)	**443,000**	535,000
Proven gas (MCF)	**1,850,000**	1,328,000

WORKING INTEREST WELLS	Gross	Net	Gross	Net
Oilwells – Gross	**286**	**47.0**	257	43.1
Gaswells – Gross	**174**	**11.3**	173	11.1

DRILLING RESULTS		
Oil	**12**	32
Gas	**1**	1
Dry	**5**	8

LAND HOLDINGS (in acres)	1987		1986	
	Gross	Net	Gross	Net
Canada	**116,190**	**15,992**	89,830	8,355
Foreign	**2,265,405**	**262,281**	1,189,693	443,710
	2,381,595	**278,273**	1,279,523	452,065

ACTIVITIES IN WESTERN CANADA



The year 1987 was a transition year for the Company in Western Canada as our exploration efforts were shifted almost entirely from the province of Saskatchewan to the province of Alberta. A total of 26,360 gross acres (7,637 net acres) of lands were acquired on exploration prospects in Western Canada, with over ninety-five percent located in the province of Alberta. Many of these exploration prospects were undergoing drilling operations during the fourth quarter of 1987.

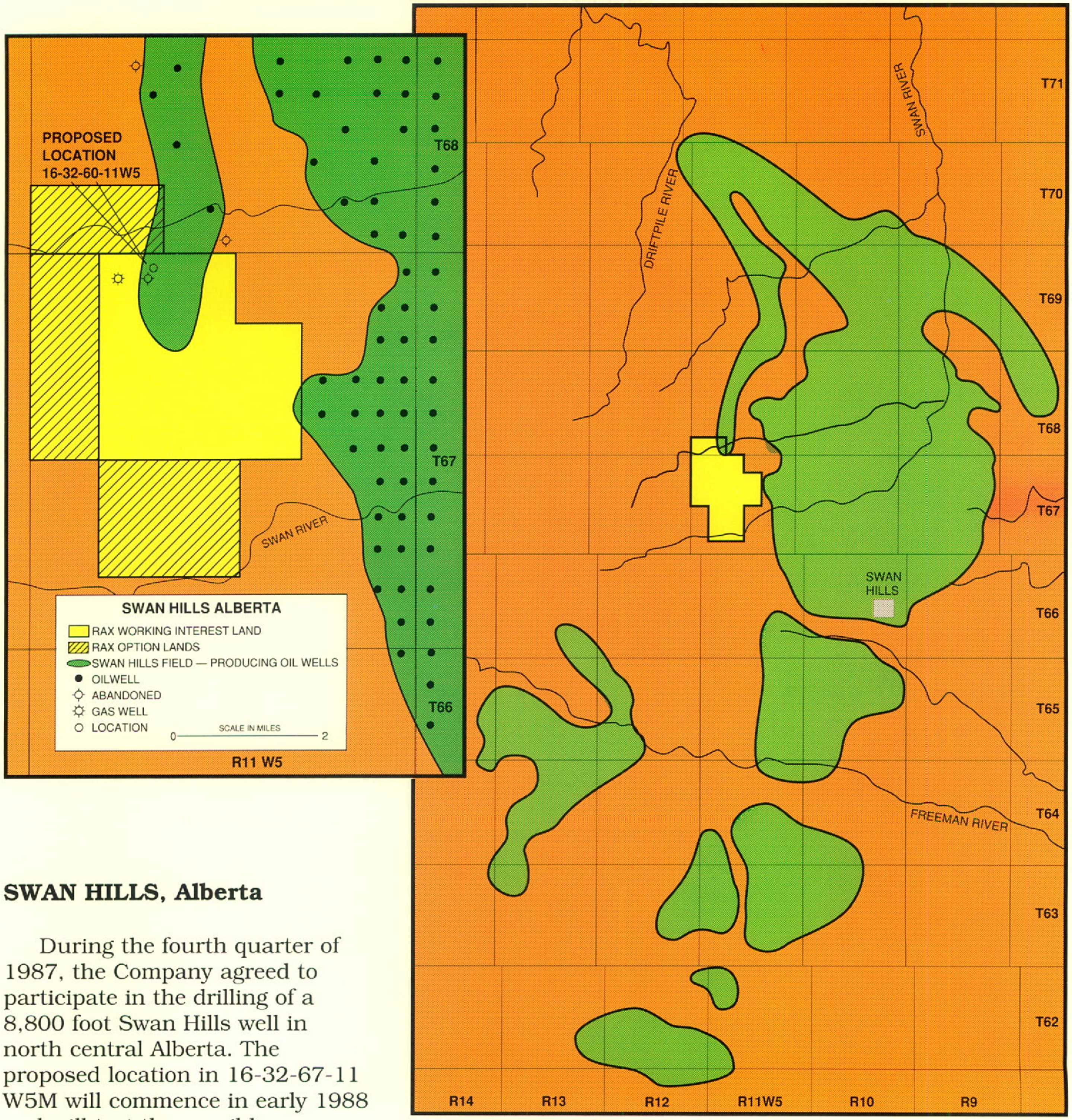
During 1987 the Company participated in the drilling of eighteen wells, resulting in twelve oilwells, one gaswell, two water disposal wells and three dry holes.

As of December 31, 1987 the Company had proven producing reserves of 443,000 barrels of oil. This represents a decline of 17% of the proven producing oil reserves from the end of 1986. This decline is primarily due to the revised reserves of our major producing property at Kerrobert, Saskatchewan.

Gas reserves increased from 1.33 BCF at the end of 1986 to 1.85 BCF at the end of 1987. This represents a 39% increase in gas reserves.

Net production during 1987 averaged 225 BOPD and 335 MCFGPD. However, as of the end of 1987 our production was averaging 265 BOPD and 435 MCFGPD.

With the successful drilling on two of our new exploration prospects in Alberta during the final quarter of 1987, we anticipate increases to our reserves and daily production throughout 1988. Our exploration efforts in Western Canada will be concentrated in Alberta during the next year.

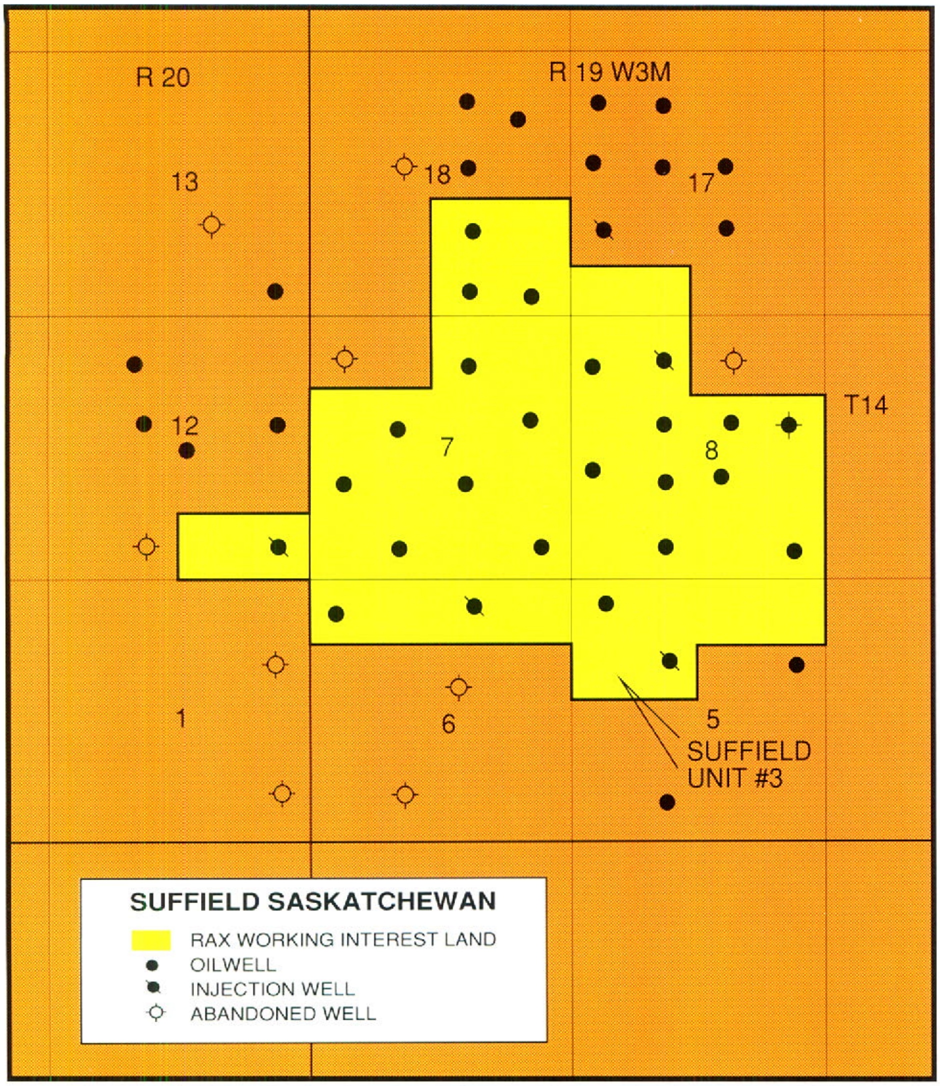


SWAN HILLS, Alberta

During the fourth quarter of 1987, the Company agreed to participate in the drilling of a 8,800 foot Swan Hills well in north central Alberta. The proposed location in 16-32-67-11 W5M will commence in early 1988 and *will* test the possible extension of the Swan Hills Reef.

The Company is participating for 16.4% of the costs in the drilling of the well. By virtue of drilling the well, we will earn 16.4% before payout and 8.2% after payout in the spacing unit for the well and 8.2% in the balance of an eight section block. In addition we have the option of drilling a seven section block and two one section blocks offsetting the eight section block.

Wells to the north and east of our acreage average from 100 - 300 BOPD with ultimate recoverable reserves in the 300,000 barrel range.



SUFFIELD, Saskatchewan

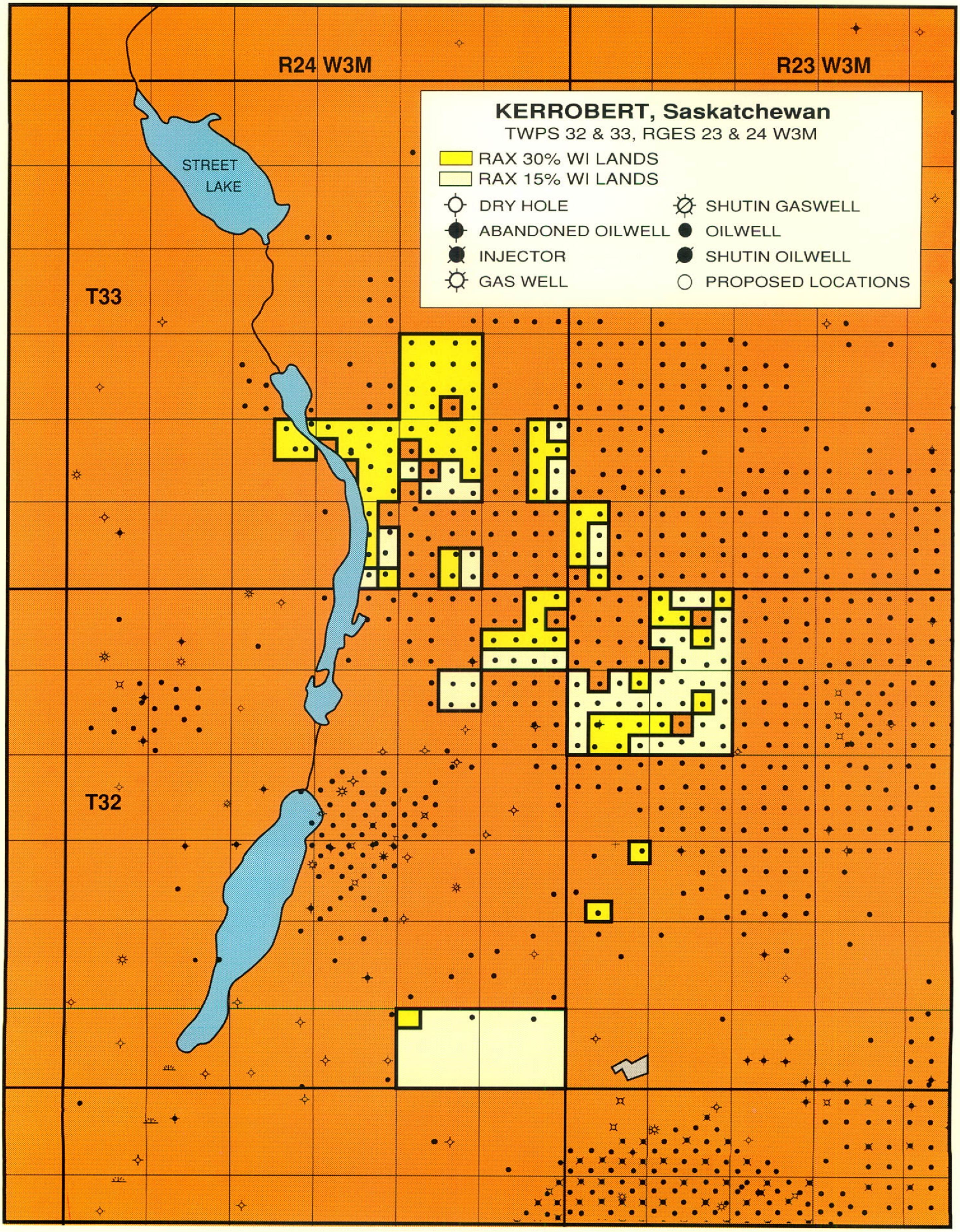
On November 1, 1987 Rio Alto purchased a 3.58433% interest in the Suffield Unit No. Three. The Unit covers the Upper Shaunavon and Roseray formations over 1840 acres. There are 15 producing oilwells and 4 water injectors in the Unit. This Unit interest contributes in excess of 25 BOPD to the Company. Based on a recent appraisal of the Unit, the Company's share of remaining recoverable reserves exceeds 70,000 barrels of oil.

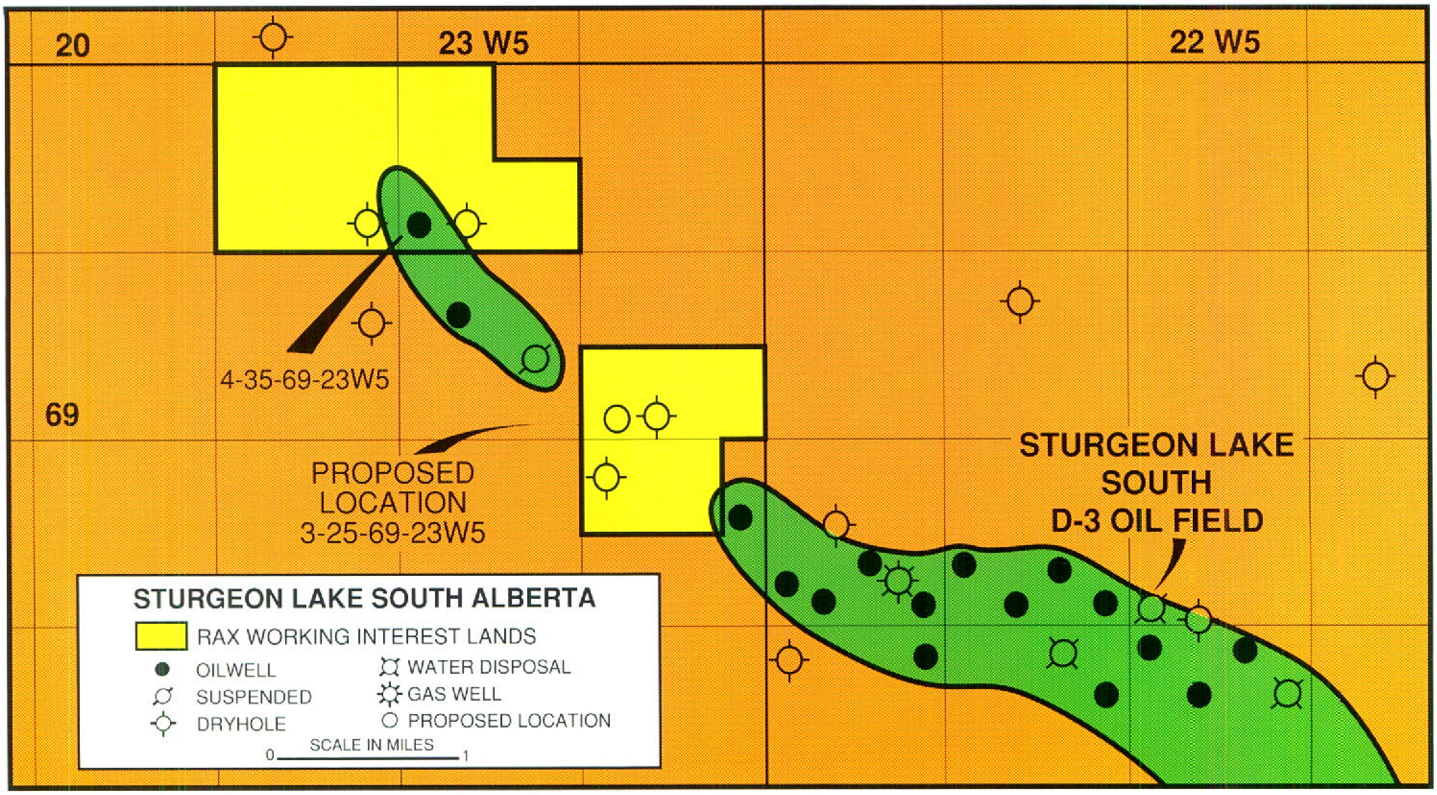
KERROBERT, Saskatchewan

The Company's most significant producing property during 1987 was Kerrobert. Four new oilwells were drilled on the property bringing the total number of Viking oilwells to 132. As of December 31st a total of 70 wells had reached payout. This represents 55% of the total wells drilled on the property.

During 1987, the Company's share of production from the Kerrobert property averaged 162 BOPD and 175 MCFGPD. This represents over 70% of our daily oil production and over 50% of our daily gas production.

We anticipate steady production from the property during 1988. Further development of Kerrobert will be dependent upon future oil prices.


R24 W3M
R23 W3M
KERROBERT, Saskatchewan
TWPS 32 & 33, RGES 23 & 24 W3M
RAX 30% WI LANDS
RAX 15% WI LANDS
DRY HOLE
ABANDONED OILWELL
INJECTOR
GAS WELL
SHUTIN GASWELL
OILWELL
SHUTIN OILWELL
PROPOSED LOCATIONS
STREET
LAKE
T33
T32

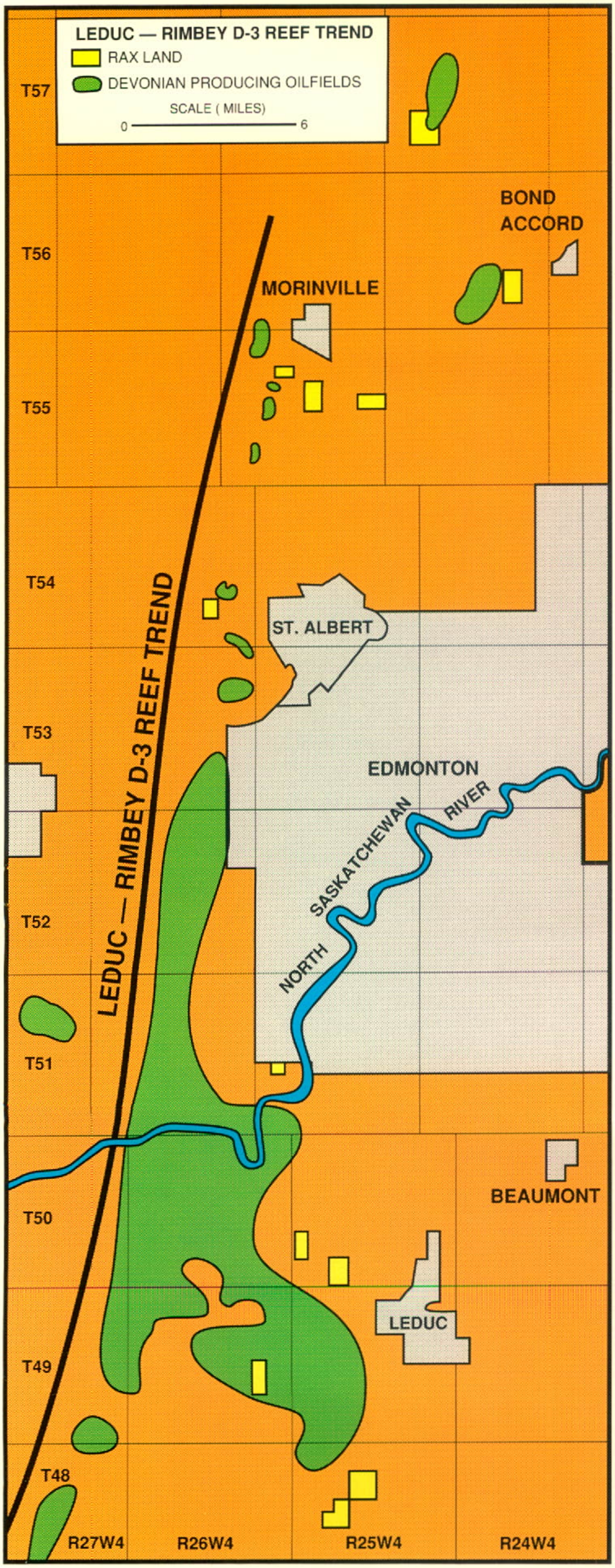


STURGEON LAKE SOUTH, Alberta

In December 1987, the Company participated for 15% of the costs of drilling a 8,000 foot well located in 4-35-69-23 W5M. The well was completed in the Leduc formation, and is currently being put on production. We estimate a production rate in excess of 100 BOPD. A follow up location to this discovery is planned in early 1988. It will be located in 3-25-69-23 W5M and the Company will have 15% interest in the well before payout, reducing to 11.25% interest after payout. The Company owns interests varying from 7.5% to 15% in 1,440 acres along this Leduc Reef trend.

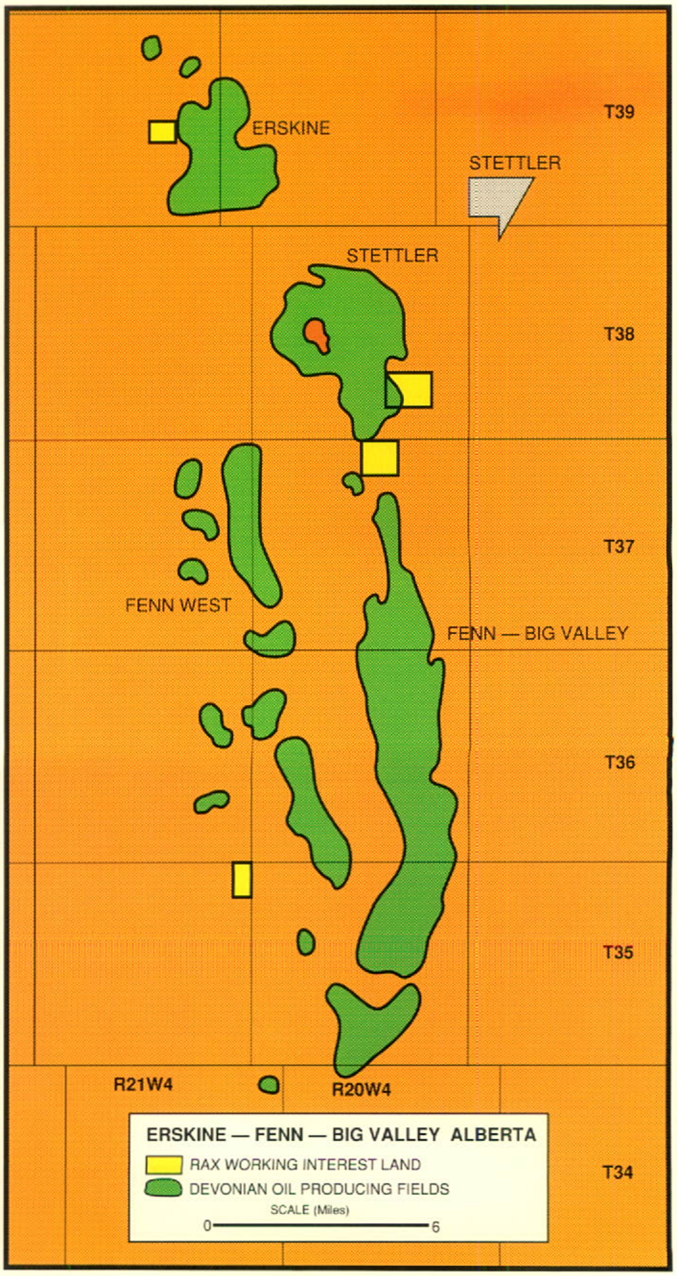
LEDUC-RIMBEY D-3 REEF TREND, Alberta

One area that the Company has concentrated its exploration activities is the Leduc-Rimbey D-3 (Leduc Formation) Reef Trend. We have acquired 3,130 net acres along this trend and have commitments for the drilling of two wells during the first half of 1988. One of these wells will be drilled free of cost to the Company and the other well will be drilled with the Company participating for 25% of costs. In addition to these wells we are evaluating two seismic programs shot over the lands free of cost to the Company.

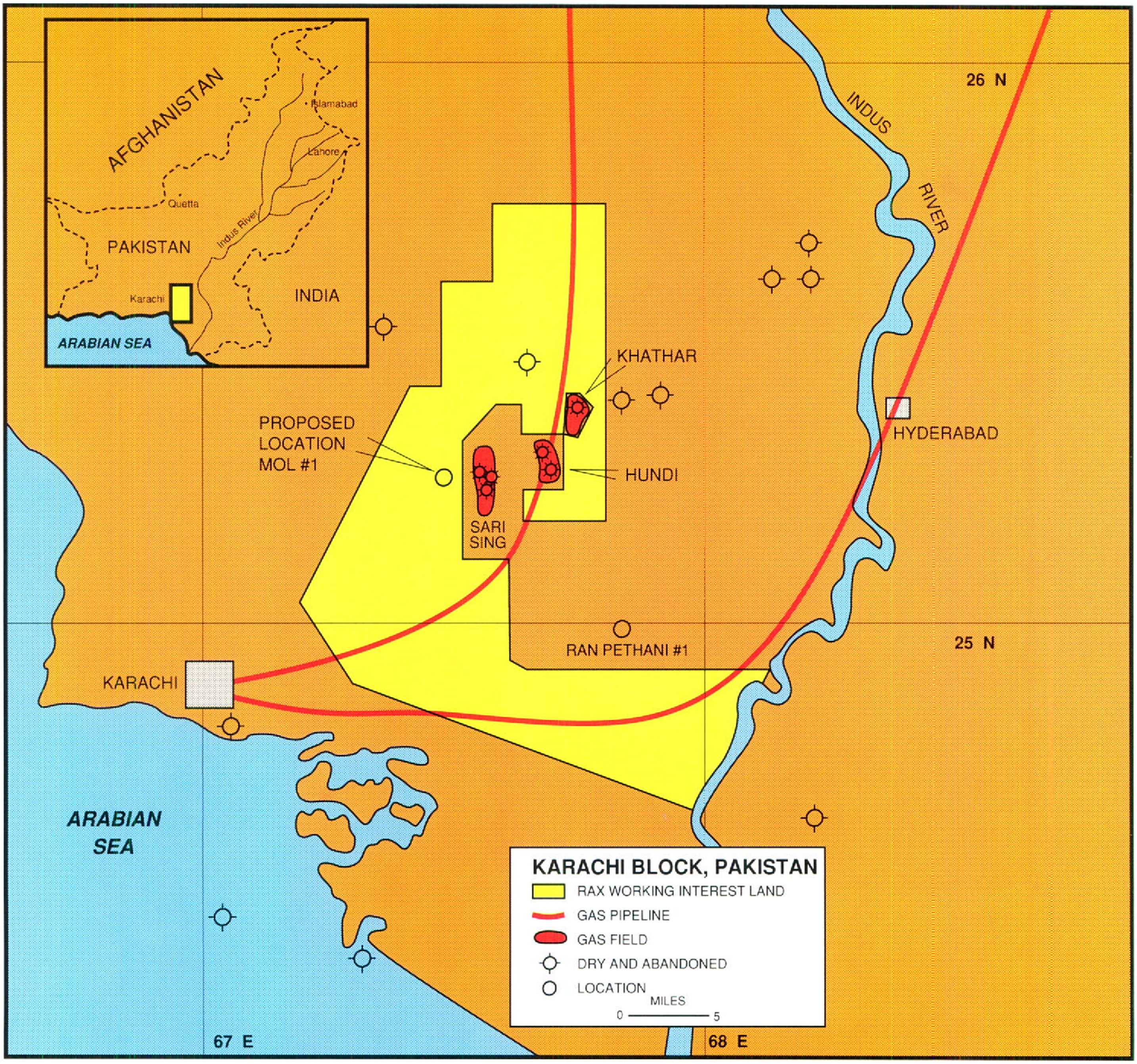


FENN BIG VALLEY, Alberta

Another exploration area for the Company during 1987 was the Fenn Big Valley area of Alberta, noted for its Devonian production. The Company acquired 2,320 net acres along this Devonian Reef trend. We anticipate drilling at least one well on this trend during 1988.



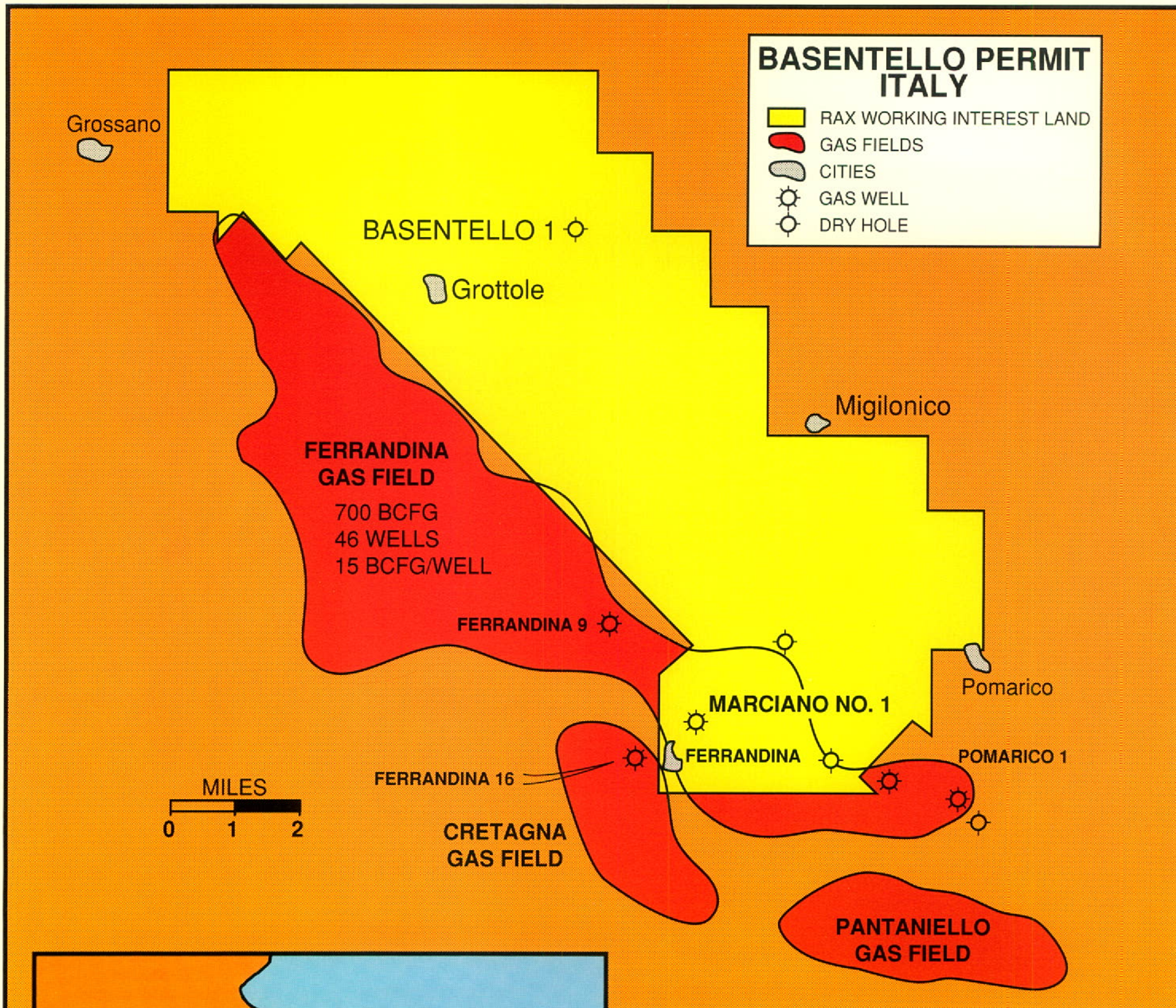
INTERNATIONAL ACTIVITIES



KARACHI BLOCK, Pakistan

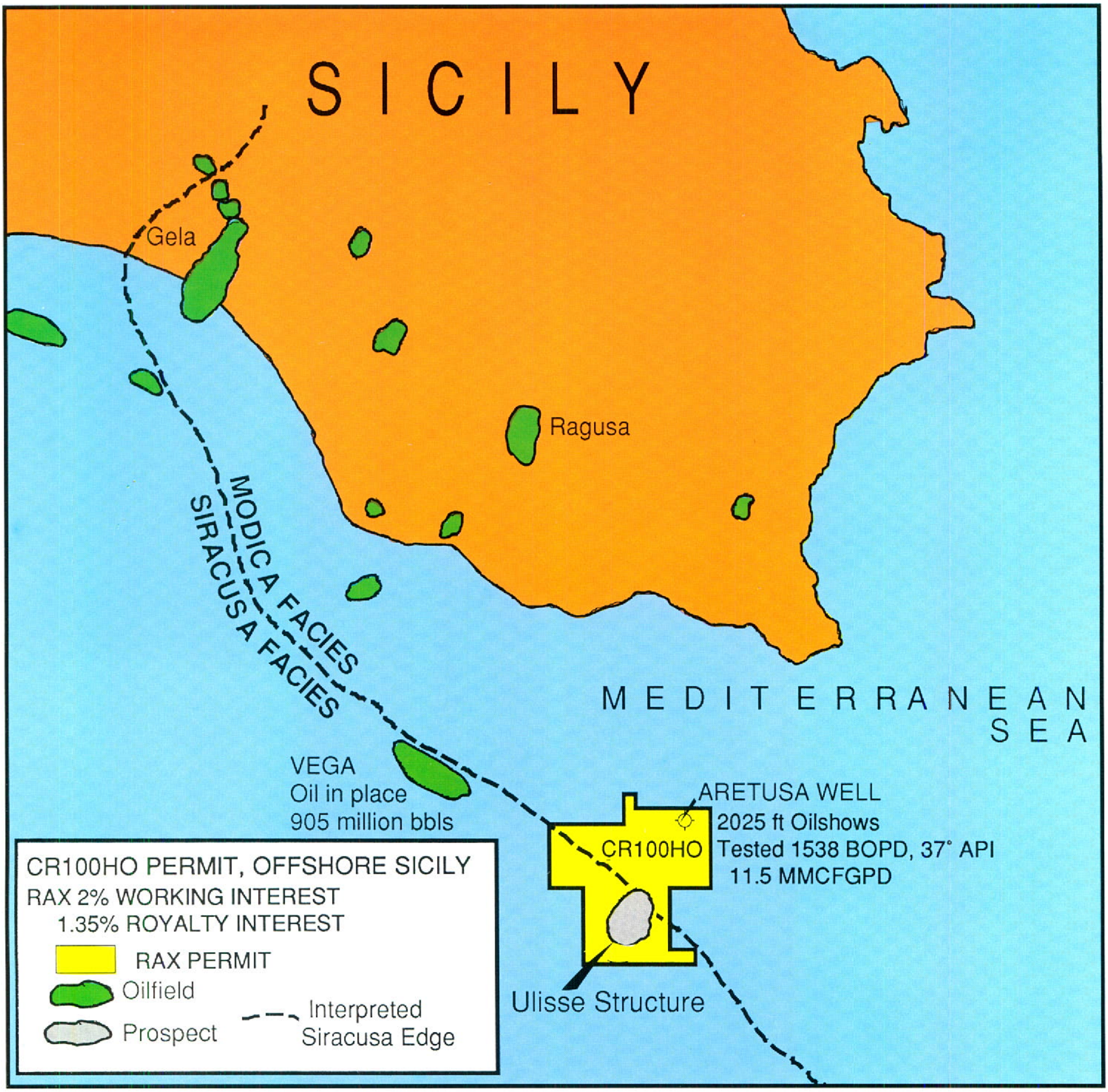
One of the most exciting prospects of the Company is the Karachi Permit in Pakistan. During 1987, we completed a 750 mile seismic survey on the Permit. The seismic survey was shot free of cost to the Company under a farmout arrangement with TCR Pakistan Ltd., a subsidiary of Trans Canada Pipelines Limited. The seismic survey defined eight anomalous structures on the Permit. As a result of the farmout arrangement we own an undivided 20% working interest in the Karachi Permit. The Permit was expanded in 1987 to include a total of 1,193,600 acres.

The Company has agreed to participate for its 20% interest in the drilling of the first well on the Karachi Permit. This well will be located west of the Sari Sing gasfield on the Mol structure. The well will be drilled to 11,000 feet and will evaluate both the Pab and Ranikot formations.



BASENTELLO PERMIT, Italy

The Company reduced its interest in the 43,237 acre Basentello Permit to 13.75% by selling a 5% working interest to a third party. After the evaluation of a seismic survey located on the southern portion of the Permit, a drilling location was selected in the southwest corner of the Permit. The proposed well, Marciano No.1, will be drilled in the first quarter of 1988. The Company has agreed to participate for its 13.75% interest in the well. The well is located to the Southeast and Northwest of the Ferrandina, Cretagna and Pantaniello gasfields.



C.R100.HO PERMIT, Offshore Sicily

During 1987 the reprocessing of existing seismic data identified a potential location on the southern portion of the permit in addition to the centrally located Ulisse location. Discussions have been entered into between the working interest partners to select a drilling location on the Permit. We anticipate that a well will be drilled to evaluate the Jurassic Siracusa Formation during the next eighteen months. The Company owns a 2% working interest and a 1.35% royalty interest in the Permit.

LAND HOLDING
(ACRES)

	WORKING INTEREST GROSS	WORKING INTEREST NET
CANADA		
Saskatchewan	40,264	3,953
Manitoba	3,320	57
Alberta	72,606	11,982
PAKISTAN		
Karachi Permit	1,193,600	238,720
SICILY		
C.R100.HO	66,273	1,325
C.R117.IM	91,286	15,199
C.R124.FI	53,626	0
ITALY		
Basentello	43,327	5,957
FRANCE		
Saint Saens	531,544	0
Altkirch	176,852	0
IRELAND		
Permit 42/7 and 42/12	105,000	578
UNITED STATES	3,897	502
TOTAL	*2,381,595	278,273

* Of this total Rio Alto Exploration holds a royalty interest only in 762,022 acres.

FOUR YEAR FINANCIAL AND OPERATING FUNDAMENTALS

Years ended December 31	**1987**	1986	1985	1984
EARNINGS				
Gross revenues	**$ 1,871,710**	$ 2,607,001	$ 2,870,932	$ 948,900
Net operating income	**1,264,948**	1,815,274	2,273,946	432,048
Earnings (loss) before unusual and extraordinary items	**134,715**	793,208	(2,782,173)	8,720
Per common share	**0.02**	0.11	(0.39)	0.001
Net earnings (loss)	**169,015**	(11,415,992)	(2,782,173)	518,954
Per common share	**0.02**	(1.60)	(0.39)	0.07
CASH FLOWS				
Cash flow from operations	**874,530**	1,451,008	2,074,737	569,111
Per common share	**0.10**	0.20	0.29	0.08
BALANCE SHEET				
Working capital (deficiency)	**1,604,288**	(41,037)	(393,783)	2,777,400
Property and equipment – net	**5,670,224**	4,203,625	15,521,679	15,226,277
Long-term debt	**711,683**	583,335	400,000	—
Deferred revenue	**265,123**	293,442	332,880	345,324
Shareholders' equity	**6,559,561**	3,601,687	15,017,679	17,786,290
Number of common shares outstanding	**10,707,807**	7,127,161	7,127,161	7,118,411
COMMON SHARE PRICE RANGE				
High	**1.25**	1.70	2.60	4.40
Low	**0.65**	0.55	1.20	1.35
Volume of shares traded (000)	**4,710**	1,732	3,786	1,873
OPERATIONS				
Wells drilled (gross)				
Oil	**12**	32	113	22
Gas	**1**	1	3	1
Dry	**5**	8	8	7
Annual production				
Oil – barrels	**82,279**	126,022	77,745	7,191
Gas – mcf	**122,263**	185,883	134,320	73,496
Daily production				
Oil – BOPD	**225**	345	213	20
Gas – MCFPD	**335**	509	368	200
Reserves — proven				
Oil – barrels	**443,000**	535,000	620,000	83,350
Gas – MCF	**1,850,000**	1,328,000	1,073,000	795,000

FINANCIAL AND OPERATING SUMMARY

FINANCING ACTIVITIES

Rights Offering

During the third quarter of 1987, the Company issued 3,563,596 Common Shares pursuant to a Rights Offering Prospectus dated June 15, 1987. Under the terms of the Offering, each holder of Common Shares on the Record Date was issued one Right for each Common Share held. Two Rights and $0.85 were required to subscribe for one Common Share with one Warrant.

The Rights Offering was fully subscribed for and generated $2,776,269 for the Company net of issue expenses of $252,788.

The Warrants will entitle holders to purchase one Common Share of the Company at a subscription price of $1.40 per share up to the close of business on August 3, 1988 which may potentially generate $5.0MM in net proceeds to the Company.

Long-Term Debt

During the month of July, 1987, the Company arranged a $500,000 operating loan with the Royal Bank of Canada of which $295,000 was drawn down at December 31, 1987.

During the year, the Company made nine monthly installments of $27,777 on its three year term loan which stood at $750,007 at year end.

Cash Flow

The cash flow from operations decreased to $874,530 ($0.10 per share) in 1987 from $1,451,008 ($0.20 per share) in 1986 as a consequence of lower oil and gas revenues. However, the Company closed the year with a strong working capital position of $1.6MM which will culminate in higher revenues and cash flows in 1988.

OPERATIONS

Oil and Gas Revenue

Oil and gas revenue net of royalties has dropped approximately 30% in 1987 compared to 1986. The major reason for this decline was payout being reached by 70 of the 132 wells drilled at Kerrobert, Saskatchewan, the Company's major producing property. Upon recovery of its investment in Kerrobert, the Company's working interest in the wells is reduced to 15% from 30%. The Company's average oil production was 225 BOPD in 1987 compared to 345 BOPD in 1986. The product prices on the other hand recovered only mildly compared to 1986. The average oil and gas price in energy equivalents was $20.66 in 1987 compared to $19.71 a year earlier. The average net back also increased moderately to $12.32 in 1987 from $11.56 in 1986.

The decline in oil and gas production however, was halted during the latter part of the fourth quarter. The four wells drilled in Section 26-32-24 W3M in Kerrobert in which the Company participated as to 15% working interest were put on production in November, 1987 at initial rates of 30-40 BOPD from each well.

Sturgeon Lake 4-35-69-23 discovery was placed on production mid-December at a rate of approximately 100 BOPD. The Company has a 15% working interest before pay-out reverting to a 7.5% working interest after pay-out in this well.

The Company also has acquired a 3.58433% interest in the Suffield Unit #3 with net oil production in excess of 25 BOPD to Rio Alto in November and a 100% working interest in two Mississippian oilwells in Carievale, Saskatchewan with an average production of approximately 22 BOPD net to the Company in December.

As a result of the above developments, daily oil production has increased to 265 BOPD in December, 1987.

The gas production averaged 335 MCFGPD in 1987 compared to 509 MCFGPD a year earlier. Approximately 50% of this drop is attributable to Kerrobert production being reduced as a result of pay-out wells. The balance is due to reduced nominations at the Hilda Unit and the Cessford 6-30 well.

Expenses

Production expenses decreased to $512,078 from $717,786 a year earlier as a result of operating efficiencies and reduced working interest in the Kerrobert area.

General and administrative expenses moderately increased to $794,245 from $682,410 in 1986 of this amount, $393,000 (1986 - $332,500) has been capitalized and $401,245 (1986 - $349,910) has been expensed. The increase in general and administrative expenses was due to the overhead related to the Company's activities in Pakistan, increase in staff and a general increase in the level of business activity.

CAPITAL PROGRAM

During the year the Company incurred $1.8MM in capital expenditures net of capitalized general and administrative expenses. The Company has shifted its focus from low productivity plays in Saskatchewan to high quality prospects in Alberta and consequently acquired interests in 26,360 acres (7,637 net acres) at a cost to it of $520,000. During the year the Company participated in the drilling of eighteen wells at a cost of approximately $800,000.

Foreign property additions were limited to seismic work in the Karachi Permit, Pakistan. The Company has farmed-out a net 27.5% working interest out of its 47.5% working interest in the Karachi Permit to TCR Pakistan Ltd., a wholly owned subsidiary of Trans Canada Pipelines Limited of Calgary in consideration for the latter reimbursing the Company for substantially all of the expenditures incurred in the permit since inception. Total foreign property additions amounted to $174,000 in 1987.

FINANCIAL OUTLOOK IN 1988

Rio Alto starts 1988 with a healthy working capital position, a low level of long-term debt and an inventory of excellent prospects both internationally and in Western Canada.

The management is confident that the Company will be able to improve its operating and financial fundamentals significantly in the ensuing year.

CONSOLIDATED BALANCE SHEET
DECEMBER 31, 1987

ASSETS

	1987	1986
CURRENT ASSETS		
Cash	$ 1,046,028	$ 80,838
Accounts receivable	1,581,627	769,414
Due from an officer — current portion	7,000	7,000
	2,634,655	857,252
DUE FROM AN OFFICER (note 2)	49,700	56,700
FUNDS IN ESCROW (note 3)	212,155	259,176
PROPERTY AND EQUIPMENT (note 4)	5,670,224	4,203,625
	$ 8,566,734	$ 5,376,753

LIABILITIES

	1987	1986
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 697,043	$ 898,289
Current maturities of long-term debt	333,324	—
	1,030,367	898,289
LONG-TERM DEBT (note 5)	711,683	583,335
DEFERRED REVENUE (note 6)	265,123	293,442

SHAREHOLDERS' EQUITY

	1987	1986
SHARE CAPITAL (note 7)	20,230,657	17,441,798
DEFICIT	(13,671,096)	(13,840,111)
	6,559,561	3,601,687
	$ 8,566,734	$ 5,376,753

Approved on behalf of the Board,

J C Anderson, Director

, Director

CONSOLIDATED STATEMENT OF EARNINGS AND DEFICIT
YEAR ENDED DECEMBER 31, 1987

	1987	1986
REVENUE		
Oil and gas sales, net of royalties	$ 1,777,026	$ 2,533,060
Interest and other	94,684	73,941
	1,871,710	2,607,001
EXPENSES		
Production	512,078	717,786
General and administrative (note 4)	401,245	349,910
Interest on long-term debt	83,857	88,297
Depletion and depreciation	705,515	657,800
	1,702,695	1,813,793
EARNINGS BEFORE INCOME TAXES, UNUSUAL AND EXTRAORDINARY ITEM	169,015	793,208
DEFERRED INCOME TAXES	34,300	—
EARNINGS BEFORE UNUSUAL AND EXTRAORDINARY ITEM	134,715	793,208
UNUSUAL ITEM		
Write-down of property and equipment	—	(12,209,200)
EARNINGS (LOSS) BEFORE EXTRAORDINARY ITEM	134,715	(11,415,992)
Deferred tax reduction on application of prior years' losses	34,300	—
NET EARNINGS (LOSS) FOR THE YEAR	169,015	(11,415,992)
DEFICIT, BEGINNING OF YEAR	(13,840,111)	(2,424,119)
DEFICIT, END OF YEAR	$ (13,671,096)	$ (13,840,111)
EARNINGS (LOSS) PER SHARE	$ 0.02	$ (1.60)

CONSOLIDATED STATEMENT OF CASH FLOW
YEAR ENDED DECEMBER 31, 1987

	1987	1986
CASH PROVIDED BY (USED FOR)		
OPERATING ACTIVITIES		
Cash flow from operations	$ 874,530	$ 1,451,008
FINANCING ACTIVITIES		
Increase in long-term debt	461,672	183,335
Issue of common shares on exercise of rights net of issue expenses of $252,788	2,776,269	—
Issue of common shares on exercise of stock options	12,590	—
Increase in non-cash working capital	(1,013,459)	(121,688)
Decrease in funds in escrow and deferred revenue	18,702	253,349
Repayments from an officer	7,000	7,000
	2,262,774	321,996
INVESTING ACTIVITIES		
Property and equipment additions, net of petroleum incentive payments	(2,194,514)	(1,620,166)
Proceeds on disposal of oil and gas properties	22,400	71,220
	(2,172,114)	(1,548,946)
INCREASE IN CASH	965,190	224,058
CASH (BANK INDEBTEDNESS), BEGINNING OF YEAR	80,838	(143,220)
CASH, END OF YEAR	$ 1,046,028	$ 80,838

AUDITORS' REPORT

To the Shareholders
Rio Alto Exploration Ltd.

We have examined the consolidated balance sheet of Rio Alto Exploration Ltd. as at December 31, 1987 and the consolidated statements of earnings and deficit and cash flow for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1987 and the results of its operations and cash flow for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Alberta
February 24, 1988

Collins Barrow

CHARTERED ACCOUNTANTS

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEAR ENDED DECEMBER 31, 1987

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in Canada which, in the case of the Company, conform in all material respects with International Accounting Standards. The significant accounting policies are summarized below:

(a) Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Rio Alto Exploration Inc., and its proportionate share of assets, liabilities, revenues and expenses of Rio Alto Drilling Fund (1976) (a limited partnership).

(b) Exploration and development costs

The Company follows the full cost method of accounting in accordance with the guideline issued by the Canadian Institute of Chartered Accountants, whereby all costs associated with the exploration for and development of oil and gas reserves are capitalized in cost centres on a country by country basis. Such costs include land acquisitions, drilling, geological and geophysical, interest and overhead expenses related to exploration and development activities. Gains or losses are not recognized upon disposition of oil and gas properties unless crediting the proceeds against accumulated costs would result in a material change in the rate of depletion.

Costs capitalized in the cost centres are depleted using the unit-of-production method, based on estimated proven oil and gas reserves as determined by Company and independent engineers. For purposes of the depletion calculation, oil and gas reserves are converted to a common unit of measure on the basis of their relative energy content which is 6 MCF of gas to 1 BBL of oil.

In applying the full cost method, the Company performs a ceiling test which restricts the capitalized costs less accumulated depletion and depreciation for each cost centre from exceeding an amount equal to the estimated undiscounted value of future net revenues from proven oil and gas reserves, based on current prices and costs, and after deducting estimated future general and administrative expenses, financing costs and income taxes for each cost centre. For the purposes of ceiling test the oil and gas prices which were effective at the balance sheet date were used.

The Company annually reviews the costs associated with undeveloped properties to determine whether the costs will be recoverable. An impairment allowance is made if the results of the review indicate an impairment has been incurred.

(c) Depreciation

Sundry equipment is depreciated on the declining balance method at rates varying between 20% and 30%.

(d) Joint venture accounting

A substantial portion of the Company's exploration and production activities related to oil and gas are conducted jointly with others and accordingly, the accounts reflect only the company's proportionate interest in such activities.

(e) Foreign currency translation

The accounts of the foreign subsidiary and other foreign operations have been translated to Canadian dollars using the temporal method on the following basis: monetary items at the rate of exchange at the year-end; other assets and liabilities at the historical rate of exchange. The items in the statement of earnings are translated at the average rate of exchange prevailing during the year except for depletion and depreciation, which are translated at the same rates as used for the related assets. Material translation gains and losses on monetary items are included in the statement of earnings.

(f) Earnings per share

Basic earnings (loss) per share is calculated using the weighted average number of common shares outstanding during the year. Fully diluted earnings per share is not shown where there are no material dilutive factors.

2. DUE FROM AN OFFICER

Due from an officer consists of the following:

	1987	1986
Non-interest bearing loan, repayable in equal annual installments of $7,000	**$ 56,700**	$ 63,700
Less: Current portion	**7,000**	7,000
	$ 49,700	$ 56,700

3. FUNDS IN ESCROW

Funds in escrow represent the amounts received and held in trust in advance of delivery of gas under a take-or-pay agreement (see note 6). The trustee invests the trust funds in term deposits and distributes interest quarterly. Portions of these monies are distributed to the Company after the value of gas delivered is determined at the expiry of each contract year.

4. PROPERTY AND EQUIPMENT

	1987			1986
	Cost	**Accumulated Depreciation and Depletion**	**Net**	Net
Petroleum and natural gas leases, including exploration, development and equipment thereon				
Canada	**$ 7,432,697**	**$ 2,410,113**	**$ 5,022,584**	$ 3,760,210
Italy	**257,191**	**—**	**257,191**	279,591
Pakistan	**284,222**	**—**	**284,222**	65,544
Sundry equipment	**243,888**	**137,661**	**106,227**	98,280
	$ 8,217,998	**$ 2,547,774**	**$ 5,670,224**	$ 4,203,625

During the year, the Company capitalized general and administrative expenses in the amount of $393,000 (1986 - $332,500) of total general and administrative expenses incurred of $794,245 (1986 - $682,410). Interest of $57,754 (1986 - $Nil) has been capitalized during the year.

5. LONG-TERM DEBT

	1987	1986
Term loan	**$ 750,007**	$ 583,335
Operating loan	**295,000**	—
	1,045,007	583,335
Current portion	**(333,324)**	—
	$ 711,683	$ 583,335

Term Loan

Term loan bears an interest rate of prime plus ¾% and is repayable in equal installments of $27,777 per month. The principal repayment requirements for term loan for the next three years are: 1988 - $333,324, 1989 - $333,324, 1990 - $83,359.

Operating Loan

During 1987, the Company arranged for a $500,000 credit facility of which $295,000 was drawn down at December 31, 1987. The loan bears an interest rate of prime plus ¾% and is repayable on demand. Based upon the indebtedness outstanding at December 31, 1987, and representations from the bank, no principal repayments are expected to be made in 1988.

The term and operating loans are secured by a floating charge debenture of $1,500,000 on the Canadian assets of the Company, a general assignment under Section 177 of the Bank Act covering the major producing properties of the Company and a general assignment of book debts together with certain negative pledges.

6. DEFERRED REVENUE

Pursuant to natural gas sales agreements, the Company is entitled to receive $265,123 (1986 - $293,442) for natural gas that will not be delivered until future years. The revenue has been deferred and will not be recognized in the statement of earnings until such time as the natural gas is delivered.

7. SHARE CAPITAL

A) Authorized
1,000,000 Preferred shares of no par value
20,000,000 Common shares of no par value

B) Issued

Common Shares	Number of Shares	Consideration
Balance as at December 31, 1985 and 1986	7,127,161	$17,441,798
Issued on exercise of rights net of share issue expenses of $252,788	3,563,596	2,776,269
Issued on exercise of stock options	17,050	12,590
Balance as at December 31, 1987	10,707,807	$20,230,657

C) Warrants

The Company has reserved 3,563,531 common shares for issue pursuant to a Warrant Indenture dated June 15, 1987 between the Company and the Canada Trust Company. The warrants entitle holders thereof to purchase one common share at a subscription price of $1.40 per share up to the close of business on August 3, 1988.

D) Stock Options

At December 31, 1987, 414,875 common shares were reserved for options issuable to officers and employees as follows:

Number of Share	Price	Date Granted	Expiry Date
226,875	0.82	27 Mar 86	27 Mar 91
25,500	0.78	21 Apr 86	21 Apr 91
37,500	0.72	11 Dec 86	11 Dec 91
125,000	0.78	27 Nov 87	27 Nov 92
414,875			

8. INCOME TAXES

The provision made for income taxes in 1987 and 1986 is different from the amount which would have been expected if it were assumed that the reported pre-tax earnings were subject to the Canadian Federal and Provincial statutory income tax rates for the year. The principal reasons for the differences between such "expected" income tax provisions and the amounts actually provided were as follows:

	1987	1986
Effective Canadian tax rate	**49%**	47%
Computed "expected" tax (recovery)	**$ 82,817**	$ (5,365,516)
Increase (decrease) in taxes resulting from:		
Non-deductible crown royalties	**69,992**	53,291
Resource allowance	**(121,699)**	(195,565)
Depletion non-deductible for tax purposes	**18,800**	28,576
Difference between the Canadian corporate tax rate and that applicable to foreign operations	**(8,444)**	(16,023)
Alberta royalty tax credit	**(4,720)**	(19,026)
Tax benefit not recognized due to lack of virtual certainty of realization	—	5,515,177
Other	**(2,446)**	(914)
	$ 34,300	$ —

9. REMUNERATION OF SENIOR OFFICERS AND DIRECTORS

The total remuneration paid to directors and officers of the Company (including the five highest paid employees) amounted to $251,879 (1986 – $240,323).

10. RELATED PARTY TRANSACTIONS

a) The President of the Company has the right to participate up to 5% of the Company's interest in wells drilled or participated by the Company and borrow funds from the Company on an interest free basis for such participation. Included in accounts receivable at December 31, 1987 was $67,362 owing from the President in connection with his participation in the Company's prospects.

b) The Company has entered into net production revenue interest agreements with certain senior officers and employees whereby they receive net production revenue from wells drilled or participated by the Company at rates ranging from 0.5% to 1.5%. The total amount earned by these senior officers and employees in 1987 amounted to $31,443 (1986 – $40,642).

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