



**TETHYS**  
Petroleum

**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**AND**  
**FINANCIAL STATEMENTS FOR THE YEAR ENDED**  
**DECEMBER 31, 2009**

## **Contents**

### **1. Management Discussion and Analysis**

### **2. Consolidated Financial Statements**

- **Management Report**
- **Auditors Report**
- **Consolidated Statement of Financial Position**
- **Consolidated Statement of Comprehensive Loss**
- **Consolidated Statement of Changes in Equity**
- **Consolidated Statement of Cashflows**
- **Notes to the Consolidated Financial Statements**

**TETHYS PETROLEUM LIMITED**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**for the year ended December 31, 2009**

**Summary of Annual Results**

(All references to \$ are United States dollars unless otherwise noted)  
(Tabular amounts are in thousands, unless otherwise stated.)

<b>Summary of Annual Results</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
(\$000s, except where noted)			
<b>Revenue</b>	8,559	5,360	194
<b>Net Loss</b>	(21,720)	(22,184)	(41,779)
<b>Basic and diluted loss (\$) per share</b>	(0.20)	(0.40)	(1.26)
<b>Capital expenditure</b>	32,221	42,807	23,001
<b>Total Assets</b>	137,082	113,548	71,656
<b>Long Term Liabilities</b>	(17,100)	(6,084)	(1,437)
<b>Cash and working capital surplus/(deficit)</b>	(157)	21,343	25,773
<b>Common shares outstanding</b>			
Basic	134,554,769	66,393,292	45,116,696

*Note. The 2007 comparative figures in the table above have been prepared under US GAAP while the 2008 and 2009 figures comply with IFRS requirements.*

The following Management's Discussion and Analysis ("MD&A") is dated March 31, 2010 and should be read in conjunction with the Company's audited Consolidated Financial Statements and related notes for the year ended December 31, 2009. The accompanying financial statements of the Company have been prepared by management and approved by the Company's Audit Committee and Board of Directors. These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board. Additional information relating to the Company can be found on the SEDAR website at [www.sedar.com](http://www.sedar.com). Readers should also read the "Forward-Looking Statements" legal advisory contained at the end of this MD&A and also the Company's AIF.

**IFRS accounting**

The Accounting Standards Board ("AcSB") confirmed in February 2008 that International Financial Reporting Standards ("IFRS") will be used for Canadian publicly accountable enterprises for financial periods beginning on and after January 1, 2011. As a foreign issuer, Tethys elected early adoption for periods beginning January 1, 2009, with a transition date of January 1, 2008 and consequently prepared its first interim consolidated financial statements in accordance with IFRS for the three month period ended March 31, 2009. The audited consolidated financial statements for the year ended December 31, 2009 are the Company's first set of annual consolidated financial statements prepared under IFRS as issued by the International Accounting Standards Board. For all accounting periods prior to March 31, 2009 the Company prepared its financial statements under accounting principles generally accepted in the United States of America ("US GAAP"). See *Changes to Accounting Policies on page 22*

### Highlights and Significant Transactions

- The Company completed the acquisition of BHCL in Uzbekistan on April 9, 2009 in exchange for 15 million shares. This acquisition resulted in revenue of \$4,731,000 being recorded in 2009.
- On June 19, 2009 the Company completed a public offering raising gross proceeds of \$20,000,000 (net proceeds to the Company were \$17,906,000 after deduction of transaction fees).
- An extension to the Akkulka Exploration Contract to March 2011 was approved by the Kazakhstan authorities on December 9, 2009.
- On December 24, 2009, final governmental approval was received for the Akkulka Gas Production Contract (Phase 2 of the Kyzylloi/Akkulka gas development) giving TAG exclusive rights to produce gas from the Akkulka Block for a period of nine years.
- On October 19, 2009, the Company executed a project financing in the amount of \$4.1 million for drilling a new development well by BHCL at the North Urtabulak Oil Field in Uzbekistan and then in December 2009 executed an agreement with Cornhill Capital and Cornhill Capital Asset Management Limited for the provision of up to \$3 million of debt finance by way of the issuance by the Company of unsecured discounted loan notes. ( All funds had been received by the date of this MD&A.)
- On December 19, 2009, the Company signed a private placement agreement to issue 10 million Ordinary Shares to two investors at \$0.50 per Share for proceeds of \$5 million. The said Ordinary Shares were issued on January 4, 2010. The proceeds of the private placing is to be used to fund the Company's drilling activities and for general corporate purposes for project development and capital expenditures.
- On December 22, 2009 the Company announced that the lower zone of the AKD01 Exploration well in Kazakhstan had flowed at over 2,800 barrels per day ("bpd"), with 1,373 barrels of oil per day ("bopd") after acidisation. Further testing was ongoing. (See "*Outlook*" where well in February 2010 flowed in excess of 6,800 barrels per day.)
- On December 30, 2009, final agreement was reached on the joint venture relating to the Company's Tajik projects, previously announced in December 2007. As a result the Company's interests in Tajikistan have been transferred to Seven Stars Energy Corporation ("SSEC") in which Tethys holds a 51% interest with its Tajik partner holding the remaining 49%. SSEC will be financed through a loan from Tethys and managed by Tethys in accordance with the terms of a shareholders' agreement.
- The gas production in Kazakhstan was significantly lower than anticipated due to closures in the Bukhara Urals pipeline at the beginning and end of the year together with a period of reduced production in the middle of the year as a result of problems further up the pipeline.
- Capital expenditure of \$32,221,000 was incurred in the twelve months to December 31, 2009 compared to \$42,807,000 for the same period in 2008.

### **Nature of Business**

Tethys Petroleum Limited and its subsidiaries (collectively "Tethys" or "the Company") are headquartered in Guernsey, British Isles. The domicile of Tethys Petroleum Limited was moved from Guernsey, British Isles, to the Cayman Islands on July 17, 2008, where it is incorporated. Tethys is an oil and gas company operating within the Republic of Kazakhstan, Republic of Uzbekistan and the Republic of Tajikistan. Tethys' principal activity is exploration for and production of crude oil and natural gas.

## Financial and Operational Review

### Kyzyloi Gas Production

	2009		2008		Change %
	Mcm	Mcf	Mcm	Mcf	
Three months to March 31	15,602	550,907	44,985	1,588,420	(65)
Three months to June 30	36,809	1,299,726	51,002	1,800,881	(28)
Three months to September 30	38,755	1,368,440	48,003	1,694,986	(19)
Three months to December 31	<u>27,766</u>	<u>980,418</u>	<u>28,521</u>	<u>1,007,077</u>	(3)
Annual production	118,932	4,199,491	172,511	6,091,364	(31)

- On January 5, 2006 Tethys' Kazakh subsidiary, TAG, executed a natural gas supply contract with Gaz Impex S.A. ("Gaz Impex") relating to gas sales from TAG's Kyzyloi field in Kazakhstan at an agreed price of \$32 per thousand cubic metres ("Mcm") or \$0.90 per thousand cubic feet ("Mcf") excluding value added tax ("VAT").
- In December 2007 this contract was assigned to Kazakhstani Petrochemical Company Kemikal LLP ("KNK"), who utilise the gas in the domestic Kazakh market.
- On May 1, 2009, this contract was further assigned to Asia Gas NG LLP.
- The Gas Supply Contract, which has a term until the earlier of December 1, 2012, the date on which all contracts and licences pursuant to which the gas to be delivered under the Gas Supply Contract terminate, or when 850 thousand cubic metres (Mcm) (approximately 30 billion cubic feet ("Bcf")) has been delivered, is based on a take-or-pay principle and covers all gas produced from the Kyzyloi Field Licence and Production Contract area up to termination.
- Production was initially from six wells but during the course of 2009 a further two wells were added.
- To the end of Q4 2009 some 297,567 Mcm (approximately 10.5 Bcf) or 35% of the maximum contract volume under the Gas Supply Contract had been delivered.
- In an independent reserve report prepared by McDaniel & Associates as at December 31, 2009 the projected Proved plus Probable reserves to the end of field life for the Kyzyloi field was 1,080,320 Mcm (approximately 38.146 Bcf).
- The Bukhara Urals pipeline, through which the gas output flows, was closed for the period November 28, 2008 to March 5, 2009 and again from November 24, 2009. Additionally from the middle of May 2009 because of restrictions further up in the Bukhara-Urals Gas line the Kyzyloi gas output was temporarily reduced to approximately half of its full production capacity. Full production did not recommence until August 1, 2009. These closures and production restrictions explain the reduced production achieved in 2009.

### Uzbekistan Oil Production (North Urtabulak PEC)

	Total Production		BHCL Share	
	Tonnes	Barrels*	Tonnes	Barrels*
Three months to March 31, 2009	20,909	149,499	10,454	74,746
Three months to June 30, 2009	22,755	162,698	11,377	81,346
Three months to September 30, 2009	24,697	176,584	12,349	88,295
Three months to December 3, 2009	<u>21,710</u>	<u>155,227</u>	<u>10,855</u>	<u>77,613</u>
Annual production	90,071	644,008	45,035	322,000

\* using 7.15 barrels = 1 tonne

- The Company acquired BHCL with effect from April 9, 2009 and so had no rights to the production prior to that date. Production is under a Production Enhancement Contract (“PEC”) for the North Urtabulak oilfield with subsidiaries of the Uzbek State oil and gas company NHC Uzbekneftegas. The Q1 figures are provided to give complete figures for the year.
- Drilling of a new well, NUR116, commenced in November 2009. Production commenced in March 2010.
- Production in Q4 2009 was less than in Q3 2009 mainly because of increased watercut in wells, drop in volumes of fluid produced and workovers like acid jobs and water shutoffs.

## Revenue

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
Gas Sales	907	878	3%	3,828	5,360	-29%
Refined Products sales	1,900	0	100%	4,731	0	100%

- The gas sales are generated from the Kyzylloi contract in Kazakhstan and as referred to in *Kyzylloi Gas Production* above are sold to KNK at an agreed price of \$32 per Mcm (\$0.90 per Mcf) excluding VAT.
- Gas sales in Q4 2009 were much the same as Q4 2008 but 29% down on the year because of the stoppages and production restrictions detailed in *Kyzylloi Gas Production* above.
- The Refined product sales are the result of oil production in Uzbekistan which the Company only acquired in April 2009 and so there is no prior year data.

## Production expenses

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
Production costs	1,416	797	78%	3,405	1,334	155%

- Kazakhstan production costs to December 31, 2009 were \$1,092,000 (\$9.18 per Mcm or \$0.26 per Mcf) compared to \$1,334,000 (\$7.73 per Mcm or \$0.22 per Mcf) in 2008. The unit figures are somewhat distorted due to the periods when the field was shut in as most of the operating costs are fixed.
- Uzbekistan production costs to December 31, 2009 were \$2,313,000 (\$3.59 per barrel).
- Production costs in the three months to December 31, 2009 were \$243,000 for Kazakhstan and \$1,173,000 in Uzbekistan.
- The Q4 2008 Kazakhstan figure included work done on two wells in the Kyzylloi field in anticipation of them commencing production in early 2009 plus \$312,000 of costs directly attributable to the Akkulka contract, encompassing well insurance and property tax.

## Depreciation, depletion and amortization expense

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
DD & A costs	203	725	-72%	3,238	4,333	-25%

- The primary reason that the 2009 DD&A charge is less than that for 2008 is that production in Kazakhstan in 2009 was down by 29% on that for 2008 and DD&A for producing Kazakhstan gas fields is calculated on a unit of production basis.
- The high level of inventory being held in Uzbekistan at December 31, 2009 reduced the DD&A charge for Uzbekistan.

## Exploration and evaluation expenditure

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
Exploration and evaluation	747	1,951	-62%	887	2,292	-61%

- The exploration costs written off in 2009 consist primarily of work done on a number of wells in Tajikistan..
- The exploration costs written off in 2008 consisted of various pre-contract costs plus two wells on the Kul-Bas contract.

## Listing costs

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
Listing costs	1,652	0	100%	1,652	0	100%

- These are legal and costs that relate to the planned possible secondary listing of the Company's ordinary shares on the Hong Kong Stock Exchange.

## Administrative expenses

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
Gen admin & selling costs	4,519	3,874	17%	14,252	13,496	6%
Stock based compensation	240	764	-69%	2,628	4,419	-41%
	<u>4,759</u>	<u>4,638</u>	-3%	<u>16,880</u>	<u>17,915</u>	-6%

- Staff expenses were up on 2009 as a result of new costs in both of the new Uzbekistan subsidiaries BHCL and Tethys Uzbekistan B.V. plus some additional costs in the parent company and Asia Oilfield Equipment BV (AOE) that own and leases the rigs and drilling equipment to other subsidiaries.

- Travel costs were down in 2009 compared to 2008.
- Other costs including office costs and professional fees showed a slight increase on 2008 because of the new operating companies in Uzbekistan.
- Stock based compensation expenses relate to stock options and warrants. The calculation of this non-cash expense is based on the fair value of stock options and warrants granted, amortised over the vesting period of the option or warrant.

### Finance expenses

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
Foreign exchange loss	122	1,669	-93%	2,397	3,060	-22%
Fair value (gain)/loss on derivative financial instruments	258	(271)	-195%	479	(929)	-152%
Loss from jointly controlled entity	1,000	-	100%	1,000	-	100%
Interest	(201)	(391)	-49%	203	371	-45%

- The foreign exchange loss in 2009 was primarily the result of the movement in the Kazakhstan Tenge against the \$ as opposed to 2008 when the loss was caused by the movement of the \$ against the Euro and the Canadian dollar (CD\$). In February 2009, the Kazakhstan central bank took the decision to stop supporting the Tenge against the \$ and the rate moved from approximately KZT123 to KZT150 to the \$. At the end of 2009 the rate was KZT148 to the \$.
- The Fair Value gain or loss on derivative financial instruments reflects the movement in the fair value of warrants issued by the Company that are denominated in a currency other than the Company's functional currency for financial reporting purposes..
- Loss from the jointly controlled joint venture represents the Company's 51% share in the loss incurred by SSEC.
- Interest charges include historical costs interest.

### Taxation

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
Taxation	(214)	0	100%	(214)	0	100%

Tethys is domiciled in the Cayman Islands which has no Company income tax.

The Company's deferred tax liability relates to the Uzbekistan operation. There are sufficient loss carry forwards in Kazakhstan and Tajikistan that no deferred tax liability has been provided in relation to those countries.



## Capital Expenditure

	Three months ended December 31			Year ended December 31		
	2009	2008	Change	2009	2008	Change
Kazakhstan	2,080	10,411	-80%	8,553	21,604	-60%
Tajikistan	4,911	430	1,042%	16,942	2,633	543%
Uzbekistan	2,482	-	100%	3,709	-	100%
Corporate and other	(605)	4,709	-	3,017	18,570	-84%
	<u>8,868</u>	<u>15,550</u>	<u>-43%</u>	<u>32,221</u>	<u>42,807</u>	<u>-25%</u>

Major items of capital expenditure in 2009 were:

### *Kazakhstan*

- Akkulka deep exploration well (AKD01) \$4,650,000
- Phase 2 compressor station \$1,040,000
- Seismic costs and drilling in Kul-Bas \$750,000

### *Tajikistan*

- Seismic exploration in \$6,600,000
- Komsomolsk appraisal well (KOM200) \$6,887,000
- Well rehabilitation and workovers \$2,000,000
- East Olimtoi (EOL09) exploration well \$625,000
- Transportation \$550,000

### *Uzbekistan*

- Well workovers \$1,650,000
- Initial payment for drilling new NUR116 development well \$2,000,000

### *Corporate and other*

- Ancillary rig equipment \$633,000
- Progress payment on ZJ30 rig \$2,384,000

## Summary of Quarterly Results

The 2009 comparative figures in the table below have been prepared under IFRS while the 2008 figures have been restated to comply with IFRS requirements.

	March 31 2008	June 30 2008	Sept 30 2008	Dec 31 2008	March 31 2009	June 30 2009	Sept 30 2009	Dec 31 2009
<b>Financials (\$000's)</b>								
Revenue	1,431	1,566	1,485	878	529	2,797	2,426	2,807
Net loss	(4,611)	(5,023)	(4,964)	(7,645)	(6,016)	(5,594)	(3,946)	(6,166)
Basic and diluted loss (\$) per share	(0.10)	(0.11)	(0.07)	(0.13)	(0.09)	(0.06)	(0.03)	(0.05)
Capital Expenditure	3,541	9,565	14,152	15,085	10,237	4,778	8,337	8,868
Total Assets	82,043	124,968	119,326	113,548	108,201	127,577	124,627	137,082
Total long Term Liabilities	5,960	5,611	5,413	6,084	5,595	5,299	4,997	18,345
Cash and working capital surplus	22,824	56,719	36,598	21,343	7,947	17,351	6,369	(157)

### Significant factors influencing quarterly results

There were stoppages in Kyzylloi gas production in the quarters ending December 31, 2008, March 31, 2009 and December 31, 2009 plus a period of reduced production in the quarters ending June 30, and September 30, 2009.

The BHCL operation in Uzbekistan was acquired by the Company in April 2009.

The Company raised \$50,000,000 (gross) in June 2008 and \$20,000,000 (gross) in June 2009.

In Q4 2009 the long term liabilities include a new loan for \$4,100,000, a deferred gain of \$3,657,000 following the transfer of the Tajikistan subsidiaries and \$3,750,000 received in anticipation of the private placement completed on January 4, 2010.

### Financial position

The significant movements in the balance sheets were as follows:

	<b>Dec 31, 2009</b>	<b>Dec 31, 2008</b>	<b>Movement</b>	<b>Movement Details</b>
Intangible assets	24,378	16,105	8,273	Purchase of the PEC in Uzbekistan plus expenditure on the Kul Bas contract plus the drilling of the Akkulka deep well less transfer of Tajikistan costs to the Joint Venture.
Property, plant and equipment	73,171	65,422	7,749	Phase 2 compressor station in Kazakhstan plus purchase of coiled tubing unit and stage payments on the drilling rigs less depreciation.
Non-current other receivables	5,171	6,357	(1,186)	Primarily because of the movement in VAT balance (including the impact of the exchange movement between the \$/Kazak Tenge) plus part of contractors prepayments balance being transferred to P,P&E on completion of work on the compressor station.
Loan receivable from joint controlled entity	21,727	-	21,727	Loan due from SSEC
Inventories	2,368	213	2,155	Build up in the stock in Uzbekistan that had yet to be delivered to customers.
Cash and cash equivalents	7,297	22,200	(14,903)	See cash flow statement
Share capital	167,203	145,237	21,966	Public offering in June 2009, the acquisition of BHCL for shares and the issue of shares as part purchase of a coiled tubing unit.
Other reserves	27,775	25,147	2,628	Stock based compensation expense in 2009.
Accumulated deficit	(88,374)	(66,654)	(21,720)	Loss incurred in year to December 31, 2009

Deferred gain on of assets to jointly controlled venture	3,659	-	3,659	Gain on sale of assets to SSEC
Non-current financial liabilities - borrowings	9,324	5,096	4,228	Receipt of loan associated with new well in Uzbekistan less capital repayments on ZJ70 drilling rig ("Telesto") loan plus part of ZJ30 drilling rig ("Tykhe") loan moving to current liabilities.
Advanced Equity Subscriptions	3,750	-	3,750	Funds received in advance of January 2010 completion of a \$5 million private placement.
Deferred taxation	598	-	598	Deferred tax liability at December 31, 2009
Non - current Trade and other payables	808	523	285	Historic costs now includes Akkulka in addition to Kyzylloi after issue of the Akkulka Production Contract.
Financial liabilities - borrowings.	1,086	853	233	Impact of part of capital of loan on the Tykhe rig now due in less than twelve months.
Warrants	1,053	146	907	Movement in the liability following issue of CD\$ warrants in connection with short term loan.
Deferred revenue	3,113	-	3,113	BHCL figures including \$3.1 million of cash paid but delivery not completed.
Trade and other payables	6,786	2,735	4,051	Inclusion of BHCL figures but build up of liabilities in line with company growth.

**Contractual obligations and liabilities as at December 31, 2009 (\$,000)**

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 Year	1 - 3 Years	4 - 5 Years	After 5 years
Long term debt	\$10,410,000	\$1,086,000	\$9,324,000	-	-
Operating leases	\$778,000	\$415,000	\$363,000	-	-
Trade and other payables	\$7,594,000	\$6,786,000	\$808,000	-	-
Purchase obligations	\$8,563,000	\$5,790,000	\$173,000	\$2,600,000	-
Joint venture purchase commitments	\$2,137,000	\$2,137,000	-	-	-
Total contractual obligations	\$29,482,000	\$16,214,000	\$10,668,000	\$2,600,000	-

The Company is confident that it will satisfy these commitments in full.

### **Liquidity and Capital Resources**

As at December 31, 2009, the Company had a working capital deficit of \$157,000 while at December 31, 2008 it was a working capital surplus of \$21,343,000. Subsequent to December 31, 2009 the Company took the following actions which resulted in a significant improvement in its liquidity position:

- The private placement of 10 million shares for gross proceeds of \$5,000,000 of which \$3,750,000 had been received before December 31, 2009 was successfully completed in January 2010.
- A second private placement was successfully completed in January 2010 consisting of 12,615,000 shares for gross proceeds of \$10,000,000.
- A further private placement was completed in March 2010 consisting of 30,000,000 shares for gross proceeds CD\$46,500,000.

### **Capital Management**

The Company's capital structure is comprised of shareholders' equity and debt.

The Company's objectives when managing capital is to maintain adequate financial flexibility to preserve its ability to meet financial obligations, both current and long term. The capital structure of the Company is managed and adjusted to reflect changes in economic conditions.

The Company funds its expenditures on commitments from existing cash and cash equivalent balances, primarily received from issuances of shareholders equity and some debt financing. None of the outstanding debt is subject to externally imposed capital requirements.

The Company is engaged in acquiring properties and exploring for crude oil and natural gas but it does not as yet have sufficient revenue generating activities to fund all of the Company's commitments. The Company is therefore required to fund a significant portion of its commitments from existing cash and cash equivalent balances or seek additional financing through debt issuances or equity markets.

Financing decisions are made by management and the Board of Directors based on forecasts of the expected timing and level of capital and operating expenditure required to meet the Company's commitments and development plans. Factors considered when determining whether to issue new debt or to seek equity financing include the amount of financing required, the availability of financial resources, the terms on which financing is available and consideration of the balance between shareholder value creation and prudent financial risk management.

Debt levels are monitored by using the non-GAAP financial metric of Net Debt to Book Capitalisation. Net Debt is calculated as the sum of long term debt balances (including the current portion) less the balance of cash and cash equivalents. The Net Debt at December 31, 2009 was \$3,113,000 and Net Debt to Capitalisation was 2%.

**Set out below is a comparison of the actual use of funds to date and remaining to be expended against what was projected in the prospectus dated June 18, 2007.**

The primary differences were in relation to:

- No suitable property with proven reserves has yet been identified for acquisition although the Company continues to look for suitable opportunities.

	<b>Per June 18, 2007 Prospectus</b>	<b>Incurred To Dec 31, 2009</b>	<b>To be Spent</b>
<i>Kazakhstan</i>			
Shallow drilling plan, compressors for Phase 2, exploration well, acquisition opportunities, Aral Vostochniy and well workovers	28,000	28,010	-
New projects	5,000	-	-
<i>Tajikistan</i>			
Seismic surveys, well rehabilitation and Olimtoi exploration well	7,500	7,225	275
Repayment of Short Term Loan	5,000	5,000	-
Working Capital	500	500	-
	46,000	40,735	275

**Set out below is a comparison of the actual use of funds to date and remaining to be expended against what was projected in the prospectus dated June 19, 2008.**

The primary differences were in relation to:

- The purchase of two drilling rigs and associated equipment.
- Further drilling and related equipment was purchased for use on the shallow drilling and production programme in Kazakhstan and in Tajikistan.
- Unplanned expenditure on a supply and storage base at Bozoi, Kazakhstan, and additional capital spares.
- Although new projects have been considered none has yet been considered suitable.

	<b>Per June 19, 2008 Prospectus</b>	<b>Incurred to Dec 31, 2009</b>	<b>To be Spent</b>
<i>Kazakhstan</i>			
Shallow Wells and Tie-Ins, deep well, additional seismic and infrastructure	28,100	14,000	14,100
<i>Tajikistan</i>			
Horizontal drilling, seismic, deepening potential gas exploration well plus infrastructure	8,415	7,642	773
Drilling rigs plus ancillary equipment	5,000	17,663	-
New Projects	3,500	500	-
Working Capital and General Corporate Purposes	1,385	1,385	-
	46,400	41,190	14,873

**Set out below are details of the planned use of funds to as detailed in the prospectus dated June 11, 2009.**

The primary differences were in relation to:

- The Komsomolsk well, KOM200, encountered unexpected drilling challenges and is costing more than was anticipated and is not yet completed. As a result the processing plant has not yet been constructed and well KOM201 not drilled.
- The new North Urtabulak well was drilled on a turnkey contract with 50% payment at the beginning of the contract and the other 50% due on completion. A decision on installation of the Gas Lift Compression system is waiting on completion of the current dynamic field model.

	<b>Per June 12, 2009 Prospectus</b>	<b>Incurred to Dec 31, 2009</b>	<b>To be Spent</b>
<i>Tajikistan</i>			
East Komsomolsk - KOM 200 appraisal well Phase 1	3,500	3,500	-
Infrastructure - Komsomolsk gas Processing plant Phase 1	2,000	-	2,000
East Komsomolsk - well KOM 201 Phase 2	3,500	-	3,500
Additional seismic on Bokhtar PSC	3,660	-	3,660
<i>Uzbekistan</i>			
North Urtabulak Gas Lift Compression System	1,190	-	1,190
North Urtabulak new well.	4,000	2,000	2,000
	17,850	5,500	12,350

### **Stockholder Equity**

As at March 31, 2010 the Company had authorized share capital of 700,000,000 Ordinary Shares of which 187,169,769 had been issued and 50,000,000 preference shares of which none had yet been issued. The preference shares have the rights as set out in the Memorandum and Articles of Association approved at the AGM on April 24, 2008.

On December 21, 2009 the Company announced that it would complete a non-brokered private placement of 10,000,000 Ordinary Shares for gross proceeds of US\$5 million subject to regulatory approval. The sum of \$3,750,000 was received in December 2009 with the balance of \$1,250,000 received in January 2010. The Ordinary Shares were placed at a price of US\$0.50 (CAD\$0.53) each. The placement was completed in January 2010.

On January 11, 2010 the Company further announced that it would complete a non-brokered private placement of 12,615,000 Ordinary Shares for gross proceeds of US\$10 million subject to regulatory approval. The Ordinary Shares were placed at a price of CAD\$0.82 each. The placement was completed in January 2010.

On February 12, 2010 the Company announced an additional private placement of 30,000,000 Ordinary Shares for gross proceeds of CAD\$46.5 million subject to regulatory approval. The Ordinary Shares were placed at an average price of CAD\$1.55 each. The placement was completed on March 2, 2010.

As at December 31, 2009 a total of 24,489,455 (December 31, 2008 – 18,311,596) ordinary shares were reserved under the Company's Long Term Stock Incentive Plan and Warrants granted by the Company. Details of the options and warrants are given in note 8 to the Audited consolidated financial statements for the period ended December 31, 2009.

At the AGM held on May 7, 2009 a resolution was passed whereby the number of shares which are reserved for issuance under the Stock Incentive Plan was altered to 12% of the number of Ordinary Shares outstanding at the time of the grant of options rather than the fixed figure of 7,511,760 shares.

## **OUTLOOK**

In previous MD&A's it was stated that Management had reviewed the impact of the recent significant changes in the world economic situation, including the significant decline in energy prices and the decline in the market price for the Company's shares, on its current and planned projects and that it had no plans to curtail any project that had commenced in the course of 2009 or that were included in the commitment capital expenditure listings above, following this assessment. Following the fund raising completed on June 19, 2009 the focus of the short-term capital expenditure programs had remained on both meeting the expenditure plans set out in the short form prospectus issued on June 11, 2009 and on development and production enhancement projects that will enhance short to medium term cash flow.

The Akkulka Production Contract was finally approved by the Kazakhstan authorities in December 2009 and the Company believes that when Phase 2 gas from Akkulka comes on stream then together with the Kyzylloi production and the PEC in Uzbekistan it will be in a position to finance its minimum work programme and operating and G&A costs from these operations. However, in order not only to maintain the Company's current capacity but to meet the Company's planned growth objectives, which include funding planned development activities, the Company would require additional capital. Possible sources of funding include an issue of new shares, including the possibility now being pursued of a possible secondary listing on the Hong Kong Stock Exchange.

The Company is aware, particularly in the current market conditions, that there can be no assurances that the equity or debt financing would be available when required or available on terms that is acceptable to the Company and its shareholders. While the funds raised in the first quarter of 2010 enable the Company to pursue its existing plans, in the longer term the inability of the Company to access sufficient capital for its growth objectives would impact on the Company's preferred planned growth targets.

While the Company acknowledges that current market conditions are undoubtedly more challenging than in previous years it believes that there remain fund raising opportunities that it could pursue to fund growth objectives which the Company believes could add additional cash flow.

The Company is actively seeking partners in certain projects, preferably strategic partners who may bring capital into specific projects, or purchase significant interests in existing projects and assist the Company in building its business in Central Asia. Farm outs and possible asset sales are also being considered as part of an overall strategy to balance risk and optimise the Company's portfolio in order to bring available capital to bear on the most significant projects. No agreements have been entered into as at the date of this MD&A.

Following the announcement on February 8, 2010 that the testing of the Akkulka exploration well AKD01 had flowed oil at a combined rate in excess of 6,800 barrels per day the Company outlook changed, with what might potentially be a significant oil discovery. On February 12, 2010 the Company announced a private placement of 30 million shares raising CD\$46.5 million and then on February 23, 2010 the Company announced that it now planned to drill at least two appraisal wells on the AKD01 (now named "Doris") oil discovery to evaluate and establish the size and potential of the discovery and provide the necessary data to obtain a production contract. These wells will

be extensively evaluated with coring, detailed geophysical logging and testing. A further appraisal well may also be drilled if deemed necessary after evaluating the results of the first two wells. In addition TAG plans to carry out a 3D seismic survey over the Doris discovery and shoot additional targeted 2D seismic lines to firm up further potential in the area. TAG has issued tenders for both the drilling and seismic acquisition and received a number of tender bids. The drilling contractor has now been selected and the first appraisal well (AKD02) is expected to commence drilling in April 2010. The seismic programme is also expected to commence in Q2 2010 and will be targeted to provide additional data for the second appraisal well which should commence drilling in the summer.

The Company has identified several other prospects in the area which appear similar to the Doris oil discovery and now that a hydrocarbon system has been proven at the deeper levels the risk on these prospects is reduced significantly. Tethys demobilised its ZJ70 rig "Telesto" from the AKD01 location and is mobilising the rig to a prospect located in a similar structural position to the southwest which has been named "Dione". This well is expected to commence operations in late April and is planned to target the Cretaceous, Jurassic, Triassic and Permian-Carboniferous intervals. Further exploration drilling on other identified prospects in the area is then planned.

In Tajikistan, the Company has now commenced oil production from the Beshtentak field and is carrying out further work aimed at increasing this production. The Komsomolsk KOM200 gas appraisal well reached the top of the Jurassic sequence. However the drillstring then became stuck, probably due to differential pressures, and to date the Company has not been successful in retrieving the string. Hydrocarbons were indicated both whilst drilling and on electric logs, and an open hole flowback test was carried out which resulted in a stable gas flow, albeit accompanied by water from water bearing zones in the large open hole section. Work is now underway on preparations for a possible sidetrack of this well as well as the possibility of drilling a new well (KOM201) to the north east of KOM200. Work on the East Olimtoi exploration well EOL09 is currently suspended whilst additional equipment is mobilised to Tajikistan to continue drilling to the target zone which is some 1,000 metres (3,280 feet) from the current depth. Recent seismic data has confirmed the exploration potential of this prospect which the Company regards as a possible high impact well if successful. The Company is continuing with its seismic survey programme in Tajikistan with the aim of identifying other targets and is looking at other drilling possibilities. As stated above the Company is actively seeking partners in certain projects, preferably strategic partners, and has begun a farm-out process with respect to certain of its Tajik assets having opened a data room for interested parties.

In Uzbekistan the Company has now drilled a new development well, NUR116, which is currently producing and contributing to an average gross production in March 2010 for the PEC of 1,860 bopd. A dynamic field reservoir model is now close to completion and based on this a more optimised field development will be planned. Further drilling opportunities are being explored together with a programme of acidisation and radial drilling to further enhance existing production. The Company is looking at other opportunities in Uzbekistan, both in additional field redevelopment and in exploration but these are subject to reaching agreement with the Uzbek government on such projects.

Farm outs (such as the possible farm out of certain of the Company's Tajik assets) and possible asset sales are also being considered as part of an overall strategy to balance risk and optimise the Company's portfolio in order to bring available capital to bear on the most significant projects.

### **Sensitivities**

The price of gas sales from gas produced from the Kyzylloi gas field under the Gas Supply Contract is fixed in US dollars until December 1, 2012 and consequently there is no sensitivity to currency movements or market movements in the gas price. The price of Phase 2 gas sales from gas produced from the Akkulka Block has yet to be agreed and therefore could be sensitive to movements in the market price of gas.

The sales revenue in Uzbekistan is sensitive to fluctuations in the price of oil. At gross production levels of 1,860 bopd the movement of \$1 per barrel on the price received by the company would result in plus or minus movement in the sales revenue of \$339,450 per annum.



## **Transactions with Related Parties**

Vazon Energy Limited (“Vazon”) is a corporation organised under the laws of the Bailiwick of Guernsey, of which Dr. David Robson, Chief Executive Officer, is the sole owner and managing director. Tethys has a management services contract with Vazon that came into effect from June 27, 2007 whereby the services of Dr. Robson and other Vazon employees are provided to the Company. The total cost charged to Tethys for services from Vazon in the year ended December 31, 2009 was \$1,677,113 (2008 – \$1,405,028).

Oilfield Production Consultants (OPC) Limited and Oilfield Production Consultants (OPC) USA LLC, both of which have one common director with the company, has charged Tethys a monthly retainer fee for engineering expertise, provided services relating to the optimisation of compression on Kyzyloloi and Akkulka .[and has consulted on certain reservoir modelling work on projects in Tajikistan and Uzbekistan. Total fees for the year ended December 31, 2009 were US\$497,697 (2008 – \$422,770).

Kraken Financial Group (KFG) had a common director with the Company up until 1 September 2009. In 2008, KFG was engaged by the Company to assist in obtaining loan financing in relation to the purchase of both Telesto and Tykhe drilling rigs. As a result of the services provided in connection with the Telesto transaction, KFG received 6% commission of the funds it was responsible for introducing to the Company. This commission was to be taken in the form of 81,477 shares, which were issued in 2009 amounting to \$234,000 (which had been recognised as a liability at the end of 2008). No further services were provided by KFG during 2009 (December 31, 2008 - \$21,000).

During the year ended December 31, 2008, KFG had acted as broker for Tethys in the placement of various insurance policies, including Directors and Officers, for which the combined annual premiums were \$112,615. This service was not provided in 2009.

Transactions with affiliates or other related parties including management of affiliates are to be undertaken on the same basis as third party arms-length transactions.

## **Financial Risk Management**

The Company’s activities expose it to a variety of financial risks: market risk, credit risk and liquidity risk. The Company’s overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the Company’s financial performance.

Risk management is carried out by senior management, in particular, the Executive Board of Directors.

Summarized below are risks which may be material to the Company’s future performance. See also “*Risks and Uncertainties*”.

### **Financial risk factors**

#### *Credit risk*

Credit risk is the risk of financial loss to the Company if a customer or counterparty to financial instruments fails to meet its contractual obligations. Credit risk arises from the Company’s cash and cash equivalents and accounts receivable balances.

With respect to the Company’s financial assets the maximum exposure to credit risk due to default of the counterparty is equal to the carrying value of these instruments. The maximum exposure to credit risk as at the reporting date is:

	<b>December 31</b>	<b>December 31</b>
	<b>2009</b>	<b>2008</b>
	<b>\$</b>	<b>\$</b>
Trade receivables	905	1,124
Cash and cash equivalents	7,297	22,200
Investments	659	587
Loan receivable from jointly controlled entity	21,727	-
	30,588	23,911

Concentration of credit risk associated with the above trade receivable balances in Kazakhstan is as a result of contracted sales to only one customer during the year. The Company does not believe it is dependent upon this customer for sales due to the nature of gas products and the associated market. The Company's sales in Kazakhstan commenced in December 2007 and the Company has not experienced any credit loss to date. At December 31, 2009 the trade receivable amounted to \$905,000, none of which was greater than 60 days overdue. The Company has therefore not recorded a provision against this amount as it does not consider the balance to be impaired.

In Uzbekistan, the Company makes use of five customers. Full payment is required before delivery of the oil and therefore there is limited exposure to credit risk in this country.

Although a significant amount of the deposits at financial institutions are not covered by bank guarantees, the Company does not believe there to be a significant risk of credit loss as the counterparties are banks with high credit ratings (A- or equivalent) assigned by international ratings agencies (Fitch and Standard and Poors).

The Company is exposed to credit risk in relation to its loan receivable from a jointly controlled entity to the extent that the jointly controlled entity fails to meet its contractual obligations. The Company does not believe that the balance is impaired at the reporting date. The carrying amount of the loan receivable represents the maximum exposure to credit risk.

#### *Liquidity risk*

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. This risk relates to the Company's ability to generate or obtain sufficient cash or cash equivalents to satisfy these financial obligations as they become due. Since inception, the Company has incurred significant consolidated losses from operations and negative cash flows from operating activities, and has an accumulated deficit at December 31, 2009.

The Company's processes for managing liquidity risk includes preparing and monitoring capital and operating budgets, co-ordinating and authorizing project expenditures and ensuring appropriate authorization of contractual agreements. The budget and expenditure levels are reviewed on a regular basis and updated when circumstances indicate change is appropriate. The Company seeks additional financing based on the results of these processes.

The timing of cash outflows relating to financial liabilities and commitments at the reporting date are summarized on page 10 above in *Contractual obligations and liabilities as at December 31, 2009*.

There can be no assurance that debt or equity financing will be available or sufficient to meet the Company's requirements or if debt or equity financing is available, that it will be on terms acceptable to the Company. The inability of the Company to access sufficient capital for its operations could have a material adverse impact on the Company's financial condition, results of operations and prospects.

### *Market risk*

Market risk is the risk of loss that may arise from changes in market factors such as commodity prices, interest rate and foreign exchange rates.

### *Commodity price risk*

Commodity price risk arises from the effect that fluctuations of future commodity process may have on the price received for sales of gas and refined oil products. The marketability and price of natural gas and oil that is produced and may be discovered by the Company will be affected by numerous factors that are beyond the control of the Company.

Natural gas prices are subject to wide fluctuations, the Company has entered into a fixed price contract for sales of gas from the Kyzylloi field. However, any material decline in natural gas prices could result in a reduction of Tethys' future net production revenues and impact on the commercial viability of the Company's existing and future oil and gas discoveries. It may become uneconomic to produce from some wells as a result of lower prices, which could result in a reduction in volumes and the value of Tethys' gas reserves, if the Company elected not to produce from certain wells at lower prices.

Any material decline in refined oil product prices could result in a reduction of the Company's Uzbekistan net production revenue.

All of these factors could result in a material decrease in the Company's net production revenue causing a reduction in its acquisition and development activities.

### *Interest rate risk*

Interest rate risk is the risk that the value of a financial instrument will be affected by changes in market interest rates. Existing long term debt is agreed at fixed interest rates and consequently has limited exposure to changes in market interest rates.

The Company is exposed to interest rate risk on short term deposits to the extent that the significant reductions in market interest rates would result in a decrease in the interest earned by the Company. A change of 1% in the interest rate would have had an immaterial change in the interest earned both in the current or prior year.

As at the reporting date the Company's interest rate profile was:

	Fixed rate financial instruments	Floating rate financial instruments	<b>Total</b>
At December 31, 2009	\$	\$	\$
Cash and cash equivalents	-	7,297	7,297
Financial liabilities - borrowings	10,410	-	10,410
Interest rate swap	95	-	95
	<u>10,505</u>	<u>7,297</u>	<u>17,802</u>

	Fixed rate financial instruments	Floating rate financial instruments	Total
At December 31, 2008	\$	\$	\$
Cash and cash equivalents	1,832	20,368	22,200
Financial liabilities - borrowings	5,949	-	5,949
	<u>7,781</u>	<u>20,368</u>	<u>28,149</u>

#### *Foreign exchange risk*

The Company is exposed to risks resulting from fluctuations in foreign currency exchange rates. A material change in the value of any such foreign currency could result in a material adverse effect on the Company's cash flow and future profits. The Company is exposed to exchange rate risk to the extent that balances and transactions denominated in a currency other than the US dollar. In addition, a significant portion of expenditures in Kazakhstan and Tajikistan are denominated in local currency, the Tenge and Somoni, respectively. The Company is not currently using exchange rate derivatives to manage exchange rate risks but is attempting to negotiate exchange rate stabilization conditions in new local Tenge denominated service and supply contracts in Kazakhstan.

The Company holds the majority of its cash and cash equivalents in US dollars. However, the Company does maintain deposits in other currencies, as disclosed in the following table, in order to fund ongoing general and administrative activity and other expenditure incurred in these currencies.

The carrying amounts of the Company's significant foreign currency denominated monetary assets and liabilities at the reporting dates are as follows:

<b>In US\$ equivalent 2009</b>	<b>CAD</b>	<b>GBP</b>	<b>EUR</b>	<b>SOMONI</b>	<b>KZT</b>
Cash and cash equivalents	52	132	83	11	187
Trade and other receivables	-	34	2	-	5,393
Trade and other payables	(35)	(318)	-	-	(561)
Financial liabilities borrowings	-	(383)	-	-	-
<b>Net exposure</b>	<u><b>17</b></u>	<u><b>(535)</b></u>	<u><b>85</b></u>	<u><b>11</b></u>	<u><b>5,019</b></u>
<b>In US\$ equivalent 2008</b>	<b>CAD</b>	<b>GBP</b>	<b>EUR</b>	<b>SOMONI</b>	<b>KZT</b>
Cash and cash equivalents	3,514	2,859	162	19	193
Trade and other receivables	-	-	-	-	5,967
Trade and other payables	(40)	(240)	(5)	-	(344)
Financial liabilities borrowings	-	(365)	-	-	-
<b>Net exposure</b>	<u><b>3,474</b></u>	<u><b>2,254</b></u>	<u><b>157</b></u>	<u><b>19</b></u>	<u><b>5,816</b></u>

The following table details the Company's sensitivity to a 10% weakening in US dollars against the respective foreign currencies, which represents management's assessment of a reasonable change in foreign exchange rates.

	<b>CAD</b>	<b>GBP</b>	<b>EUR</b>	<b>SOMONI</b>	<b>KZT</b>
<b>2009 Effect in US\$'000</b>					
Profit or (loss) before tax	-	(20)	10	-	500
<b>2008 Effect in US\$'000</b>					
Profit or (loss) before tax	340	260	20	-	580

A 10% weakening of the US dollar against the currencies above at December 31, 2009 would have had an equal but opposite effect on the amounts shown above, assuming all other variables remained constant.

### **Capital risk management**

The Company's capital structure is comprised of shareholders' equity and debt.

The Company's objectives when managing capital is to maintain adequate financial flexibility to preserve its ability to meet financial obligations, both current and long term. The capital structure of the Company is managed and adjusted to reflect changes in economic conditions.

The Company funds its expenditures on commitments from existing cash and cash equivalent balances, primarily received from issuances of shareholders equity and some debt financing. None of the outstanding debt is subject to externally imposed capital requirements.

Financing decisions are made by management and the Board of Directors based on forecasts of the expected timing and level of capital and operating expenditure required to meet the Company's commitments and development plans. Factors considered when determining whether to issue new debt or to seek equity financing include the amount of financing required, the availability of financial resources, the terms on which financing is available and consideration of the balance between shareholder value creation and prudent financial risk management.

Net debt is calculated as total borrowings (including 'current and non-current borrowings' as shown in the consolidated statement of financial position) less cash and cash equivalents. Total capital is calculated as 'equity' as shown in the consolidated statement of financial position plus net debt.

At December 31	<b>2009</b>	2008
	\$	\$
Total financial liabilities - borrowings (Note 17)	10,410	5,949
Less: cash and cash equivalents	(7,297)	(22,200)
Net debt / (funds)	<u>3,113</u>	<u>(16,251)</u>
Total equity	167,203	145,237
<b>Total capital</b>	<u>170,316</u>	<u>128,986</u>

The Company is not currently subject to any externally imposed capital restrictions.

## **Fair value estimation**

Effective January 1, 2009, the Company adopted the amendment to IFRS 7 for financial instruments that are measured in the reporting date at fair value, this requires disclosure of fair value measurements by level of the following fair value measurement hierarchy:

Level 1: Quoted prices (unadjusted) in active markets for identical assets and liabilities. The Company does not have any assets or liabilities that require Level 1 inputs.

Level 2: Inputs other than quoted prices included within Level 1 that are observable, either directly or indirectly. For the Company, Level 2 inputs include prices that can be corroborated with other observable inputs for substantially the complete term of the contract.

Level 3: Unobservable inputs. The Company does not use Level 3 inputs for any of its recurring fair-value measurements.

As at December 31, 2009 the Company's only financial liabilities measured at fair value on a recurring basis were the warrant liability and interest rate swap described in Note 17, the measurement inputs of which is designated as Level 2 and Level 3 respectively.

At December 31, 2009, the interest rate swap described in Note 17 is classified as Level 3 in the fair value hierarchy. The inputs required to measure the fair value of the interest rate swap include production and price assumptions that are reliant on adjustments or interpolation made by management to an otherwise standard valuation model. A reconciliation from the beginning balance to the ending balance of the interest rate swap has been included at Note 17 of the audited consolidated financial statements.

## **RISKS AND UNCERTAINTIES AND OTHER INFORMATION**

Readers are encouraged to read and consider the risk factors and additional information regarding the Company, included in its 2009 Annual Information Form filed with the Canadian securities regulators, a copy of which is posted on the SEDAR website at [www.sedar.com](http://www.sedar.com)

### **Environmental**

The Company's operations are subject to environmental regulations in the jurisdictions in which it operates and the Company carries out its activities and operations in material compliance with all relevant and applicable environmental regulations and pursuant to best industry practices. In Kazakhstan, quarterly reports are required to be submitted by the Company to the Shalkar (Bozoi) Tax Committee. Payments made by the Company to date have been very small. The Company is also required to prepare reports on any pollution of air, toxic waste and current expenses on environmental protection which have been made by the Company and which are submitted to the appropriate Kazakh authorities. Reports are submitted on semi-annual basis for information purposes and no payments are applicable.

Under the Bokhtar PSC in Tajikistan, any Development Plan shall also include an abandonment and site restoration programme together with a funding procedure for such programme. All funds collected pursuant to the funding procedure shall be allocated to site restoration and abandonment and will be placed in a special interest bearing account by KPL which shall be held in the joint names of the State and KPL or their respective nominees, or its designee. KPL's responsibilities for environmental degradation, site restoration and well abandonment obligations, and any other actual contingent and potential activity associated with the environmental status of the Development Area shall be limited to the obligation to place the necessary funds in the approved account. In addition any relinquished areas must be brought into the same condition as they were prior to their transfer to KPL (soil fertility condition, quality of the ground and environment). All expenditures incurred in abandonment and site restoration are cost recoverable. An independent environmental base line study has been carried out on the Beshtentak oilfield.

Within the PEC in Uzbekistan in the event that the Company advises the Operating Committee that it no longer intends to perform any Operating Services on a well then it is required to plug and abandon such well at its own expense or the State gas company shall immediately assume responsibility for such well. In the latter such event the

Company shall have no responsibility with regard to plugging and abandoning the well. While operating the well the Company is required to observe all environmental laws of the Republic of Uzbekistan.

At present, the Company believes that it meets all applicable environmental standards and regulations, in all material respects, and has included appropriate amounts in its capital expenditure budget to continue to meet its environmental obligations.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The consolidated financial statements for the year ended December 31, 2009 have been prepared in accordance with International Financial Reporting Standards (“IFRS”) and International Financial Reporting Interpretations Committee (IFRIC) are in accordance with IFRS 1 - First-time Adoption of IFRS. The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of financial assets and financial liabilities (including derivative instruments) at fair value through profit and loss.

Please refer to the audited consolidated financial statements for the year ended December 31, 2009 Note 2 *Summary of Significant Accounting Policies* for details of the Company’s accounting policies and to Note 26 Transition to IFRS for the reconciliations of the changes resulting from this transition. See also *Changes to Accounting Policies* below.

The following is a discussion of those accounting policies and estimates that are considered critical in the determination of the Company’s financial results.

### **Financial instruments**

Financial assets and financial liabilities are recognised on the Company’s statement of financial position when the Company becomes party to the contractual provisions of the instrument. Financial assets are de-recognised when the contractual rights to the cashflows from the financial asset expire or when the contractual rights to those assets are transferred. Financial liabilities are de-recognised when the obligation specified in the contract is discharged, cancelled or expired.

#### *Investments*

Investments comprise restricted current balances that are held on deposit with banks in the Republic of Kazakhstan in respect of the Company’s asset retirement obligations (ARO) in this country and are classified as non-current. They are carried at fair value with gains or losses taken to the statement of comprehensive loss.

#### *Trade receivables, loans and other receivables*

Trade receivables, loans and other receivables, which are non-derivative financial assets that have fixed or determinable payments that are not quoted in an active market, are classified as loans and receivables. They are included in current assets, except for maturities greater than 12 months after the reporting date, which are classified as non-current assets. The Company’s loans and receivables comprise trade and other receivables in the statement of financial position.

Loans and receivables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest rate method, net of any impairment.

A provision for impairment of trade receivables is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments (more than 60 days overdue) are considered indicators that the trade receivable is impaired.

The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognised in the statement of comprehensive loss. When a trade receivable is uncollectible, it is written off against the allowance account for trade receivables.

#### *Cash and cash equivalents*

Cash and cash equivalents comprise cash in hand, deposits held at call with banks and other short-term highly liquid investments with original maturities of three months or less. These are carried at fair value with gains or losses recognized through statement of comprehensive loss.

#### *Financial liabilities - borrowings*

Borrowings are initially recognised at the fair value of the consideration received less directly attributable transaction costs. After initial recognition, interest bearing loans and borrowings are subsequently measured at amortised cost using the effective interest method. Gains and losses are recognised in the statement of comprehensive loss when the liabilities are derecognised as well as through the amortisation process.

#### *Trade payables*

Trade payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Accounts payable are classified as current liabilities if payment is due within one year or less. If not, they are presented as non-current liabilities. Trade payables are measured at amortised cost using the effective interest method.

#### *Equity instruments*

Equity instruments issued by the Company are recorded at the proceeds received net of direct issue costs.

#### *Derivative financial instruments*

Derivative financial instruments are initially recognized at fair value on the date a derivative contract was entered into and are subsequently remeasured at their fair value with changes in the fair value immediately recognised in the statement of comprehensive loss.

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of the host contract. Contracts are assessed for embedded derivatives when the Company becomes a party to them, including at the date of a business combination.

#### *Derivative contracts qualifying for the 'own-use' treatment*

An 'own-use' contract is one that was entered into and continues to be held for the purpose of the receipt or delivery of the non financial item in accordance with the entity's expected purchase, sale or usage requirements. Contracts that are for the Company's own use are exempt from the requirements of IAS39.

### **Inventories**

Inventories consist of refined oil products, spare parts and consumable materials and are shown at the lower of cost and net realisable value. Cost is determined on a weighted average cost method for refined oil products and the first-in-first-out method for spare parts and consumable materials inventories.

### **Taxation including deferred taxation**

The tax expense represents the sum of current tax expense and deferred tax.

Current tax expense is based on the taxable profits for the year. The Company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the bases of assets and liabilities and their carrying amounts in the financial statements. However, deferred income tax is



not accounted for if it arises from initial recognition of an asset or liability in a transaction, other than a business combination, that at the time of the transaction affects neither the accounting nor taxable profit or loss. Deferred income tax assets are recognised to the extent that it is probable that the future taxable profit will be available against which the temporary differences can be utilised, otherwise a valuation allowance is provided for deferred tax assets if management consider it is more likely than not that these items will either expire before the Company is able to realise the benefit, or that future deductibility is uncertain.

Deferred income tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the reporting date and are expected to apply when the related deferred tax asset is realised or the deferred income tax liability settled.

### **Share-based payments**

The Company operates a number of equity-settled, share-based compensation plans, under which the entity receives services from employees as consideration for equity instruments (options and warrants) of the Company. The fair value of the employee options and warrants granted in exchange for the employee services, is recognised as an expense. The total amount to be expensed is determined by reference to the fair value of the options granted, excluding the impact of any non-market service and performance vesting conditions. Non-market vesting conditions are included in assumptions about the number of options that are expected to vest. When options vest in instalments over the vesting period, each instalment is accounted for as a separate arrangement. At each reporting date, the entity revises its estimates of the number of options that are expected to vest. It recognises the impact of the revision of original estimates, if any, in the statement of comprehensive loss, with a corresponding adjustment to equity.

The proceeds received net of any directly attributable transaction costs are credited to share capital when the options are exercised.

### **Provisions**

Provisions are recognised when the Company has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the Company expects some or all of a provision to be reimbursed, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the income statement net of any reimbursement. The increase in the provision due to passage of time is recognised as interest expense.

### **Revenue recognition**

Revenue comprises the fair value of the consideration received or receivable for the sale of natural gas and oil products in the ordinary course of the Company's activities and is recognized when the amount can be reliably measured, it is probable that future economic benefits will flow to the entity, and when specific criteria have been met for each of the Company's activities as described below. Revenue is shown after eliminating sales within the Company.

Revenue from natural gas sales is recognized when the gas has been lifted and the risk of loss transferred to a third-party purchaser and is shown net of royalties, Mineral Extraction Tax (MET) and value-added tax. Revenue from refined product sales is recognized upon delivery and is shown net of value-added tax. All payments received before delivery are recorded as deferred revenue until delivery has occurred.

The Company recognises finance income earned on the Company's cash and cash equivalents and short term investments on an accrual basis.

### **Barter transactions**

Where goods or services are exchanged for goods or services of a dissimilar nature, the revenue is measured at the fair value of the goods or services received, adjusted by the amount of cash or cash equivalents received or paid. If the fair value of the goods or services received cannot be reliably measured, the revenue is measured at the fair value of the goods or services given up, again adjusted by the amount of cash or cash equivalents received.

### **Borrowing costs**

Borrowing costs directly attributable to the acquisition, construction or production of a qualifying capital asset or project under construction are capitalised and added to the asset or project cost during construction until such time

as the asset or project is substantially ready for its intended use. Where funds are specifically borrowed to finance an asset or project, the amount capitalised represents the actual amount of borrowing cost incurred. Where funds used to finance an asset or project form part of general borrowings, the amount capitalised is calculated by using a weighted average of rates applicable to relevant general borrowings of the Company during the period. All other borrowing costs are recognised in the income statement in the period in which they are incurred.

### **Leases**

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases are charged to the income statement on a straight-line basis over the period of the lease.

### **Business combinations**

Business combinations are accounted for using the purchase method of accounting. The cost of an acquisition is measured as the cash paid and the fair value of other assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the net fair value of the identifiable assets, liabilities and contingent liabilities acquired is recognised as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Goodwill represents the excess of the cost of an acquisition over the fair value of the Company's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in 'intangible assets'. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units for the purpose of impairment testing. The allocation is made to those cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose identified according to operation segment.

### **Fair value**

The fair value of investments, accounts receivable, accounts payable and accrued liabilities approximate their carrying amounts due to the short term maturity of the instruments. Long term debt and other non-current liabilities have been recorded at amortised cost using the effective interest rate method.

### **Segment reporting**

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker has been identified as the Executive directors that make strategic decisions.

### **Foreign currency translation**

The consolidated financial statements are presented in US Dollars, which is the Company's functional and reporting currency.

All monetary assets and liabilities denominated in foreign currencies are translated into US dollars at the rate of exchange in effect at the balance sheet date. Non-monetary assets are translated at historical exchange rates.

Revenue and expense items (excluding depreciation and amortisation which are translated at the same rates as the related assets) are translated at the average rate of exchange.

Exchange gains and losses arising on translation are taken to the statement of comprehensive loss.

### **Oil and gas exploration and evaluation expenditure**

Oil and natural gas exploration and evaluation expenditures are accounted for using a modified ‘successful efforts’ method of accounting. Costs are accumulated on a field-by-field basis. Exploration and evaluation expenditures, including license acquisition costs, are capitalised as exploration and evaluation assets when incurred. Expenditure directly associated with an exploration well is capitalised until the determination of reserves is evaluated. If reserves are not identified, these costs are charged to expense. All other associated exploration and evaluation expenditures are carried forward as an asset in the balance sheet where the rights of tenure of the property are current and it is considered probable that the costs will be recouped through successful development of the property, or alternatively by its sale. Capitalised exploration and evaluation expenditure is written down to its recoverable amount where the above conditions are no longer satisfied.

If it is determined that a commercial discovery has not been achieved in relation to the property, all other associated costs are written down to their recoverable amount. If commercial reserves are found, exploration and evaluation assets are tested for impairment and transferred to development tangible and intangible assets. No depreciation and/or amortisation is charged during the exploration and evaluation phase.

### **Oil and gas properties**

Oil and gas properties are stated at cost, less accumulated depreciation and accumulated impairment losses.

Expenditure on the construction, installation or completion of infrastructure facilities such as platforms, pipelines and the drilling of development wells, including unsuccessful development or delineation wells, is capitalised within oil and gas properties, as long as the facts and circumstances indicate that the field has commercially viable reserves.

The initial cost of an asset comprises its purchase price or construction cost, any costs directly attributable to bringing the asset into operation, the initial estimate of the asset retirement obligation, and for qualifying assets, borrowing costs. The purchase price or construction cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset. The capitalised value of a finance lease is also included within property, plant and equipment.

Where commercial production in an area of interest has commenced, oil and gas properties are depreciated on a unit-of-production basis over the proved and probable reserves of the field concerned, except in the case of assets whose useful life is shorter than the lifetime of the field, in which case the straight-line method is applied. Rights and concessions are depleted on the unit-of-production basis over the total proved and probable reserves of the relevant area. The unit-of-production rate for the amortisation of field development costs takes into account expenditures incurred to date, together with future development expenditure to develop the proved and probable reserves. Changes in factors such as estimates of proved and probable reserves that affect unit-of-production calculations do not give rise to prior year financial period adjustments and are dealt with on a prospective basis.

### **Other property, plant and equipment**

Property, plant and equipment are carried at cost less accumulated depreciation. Depreciation is charged so as to write off the cost of these assets less residual value over their estimated useful economic lives, for the following classes of assets:

Drilling rigs and related oil and gas equipment	Unit of production 3,650 days operating days
Smaller rig related equipment	Straight line 6 – 8 years
Motor vehicles	Straight line 4 years
Computer equipment	Straight line 3 years
Office equipment	Straight line 5 years

### **Reserve Estimates**

The Company engaged McDaniel to evaluate the Company’s oil and natural gas reserves in Kazakhstan. For Tajikistan, the Company engaged TRACS to evaluate its oil and natural gas reserves attributable to Beshtentak and Komsomolsk fields, located within the Tajikistan Contract Area. In connection therewith, McDaniel and TRACS

prepared independent evaluations of the Company's natural gas reserves in respect of Kazakhstan and Tajikistan. For Kazakhstan, the Statement of Reserves Data and Other Oil and Gas Information was prepared on and is dated March 17, 2010 (the "Kazakh Statement"). The effective date of the Kazakh Statement is December 31, 2009. For Tajikistan, the Statement of Reserves Data and Other Oil and Gas Information was prepared on and is dated March 24, 2010 (the "Tajik Statement"). The effective date of the Tajik Statement is December 31, 2009. The Kazakh Statement and Tajik Statement have been prepared in accordance with NI 51-101.

The process of estimating reserves requires significant judgment based on available geological, geophysical, engineering, and economic data, projected rates of production, estimated commodity price forecasts and the timing of future expenditures, all of which are subject to interpretation and uncertainty. Reserve estimates can impact net Revenue through depletion expense and the application of impairment tests. Revisions or changes in reserve estimates can have either a positive or a negative impact on net Revenue and can impact the carrying amount of capital assets.

### **Business Combinations**

Business combinations are accounted for using the purchase method of accounting. The cost of an acquisition is measured as the cash paid and the fair value of other assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the net fair value of the identifiable assets, liabilities and contingent liabilities acquired is recognised as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Goodwill represents the excess of the cost of an acquisition over the fair value of the group's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in 'intangible assets'. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units for the purpose of impairment testing. The allocation is made to those cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose identified according to operating segment.

### **Intangible assets**

#### **Production enhancement contracts**

Production enhancement contracts are stated at cost less accumulated amortisation and have a finite useful life. Amortization is calculated using a unit-of-production basis over the estimated incremental production entitlement expected to be received over the life of the contract.

#### **Impairment of non-financial assets**

Exploration and evaluation costs are tested for impairment when reclassified to oil and gas properties or whenever facts and circumstances indicate potential impairment. An impairment loss is recognised for the amount by which the exploration and evaluation expenditure's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of the exploration and evaluation expenditure's fair value less costs to sell and their value in use.

Values of oil and gas properties and other property, plant and equipment are reviewed for impairment when indicators of such impairment exist. If any indication of impairment exists an estimate of the asset's recoverable amount is calculated. Individual assets are grouped for impairment assessment purposes at the lowest level at which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. An asset group's recoverable amount is the higher of its fair value less costs to sell and its value in use. Where the carrying amount of an asset group exceeds its recoverable amount, the asset group is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are adjusted for the risks

specific to the asset group and are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money.

If the carrying amount of the asset exceeds its recoverable amount, the asset is impaired and an impairment loss is charged to the income statement so as to reduce the carrying amount to its recoverable amount (i.e. the higher of fair value less cost to sell and value in use).

For assets excluding goodwill, an assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the Company makes an estimate of the recoverable amount. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years.

### **Asset retirement obligation (ARO)**

Provision is made for the present value of the future cost of abandonment of oil and gas wells and related facilities. This provision is recognised when a legal or constructive obligation arises.

The estimated costs, based on engineering cost levels prevailing at the reporting date, are computed on the basis of the latest assumptions as to the scope and method of abandonment. Provisions are measured at the fair value of the expenditures expected to be required to settle the obligation using a pre-tax rate, updated at each reporting date that reflects current market assessments of the time value of money and the risks specific to the obligation. The corresponding amount is capitalised as part of exploration and evaluation expenditure or oil and gas properties and is amortised on a unit-of-production basis as part of the depreciation, depletion and amortisation charge. Any adjustment arising from the reassessment of estimated cost of ARO is capitalised, whilst the charge arising from the accretion of the discount applied to the ARO is treated as a component of finance costs.

### **Changes in accounting policy and disclosures**

#### *(a) Recent and amended standards adopted by the Company*

The following new and amended accounting standards are mandatory and relevant for the Company for the first time for the financial year beginning January 1, 2009:

- IFRS 7 'Financial instruments – Disclosures' (amendment). This amendment requires enhanced disclosures about fair value measurement and liquidity risk. In particular, the amendment requires disclosure of fair value measurements by level of a fair value measurement hierarchy.
- IFRS 8, 'Operating segments'. IFRS 8 replaces IAS 14, 'Segment reporting'. It requires a 'management approach' under which segment information is presented on the same basis as that used for internal reporting purposes.
- IAS 23 (amendment), 'Borrowing costs' requires an entity to capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) as part of the cost of that asset. The option of immediately expensing those borrowing costs has been removed. This has no impact on the Company as its policy has always been to capitalise borrowing cost on qualifying assets.
- IFRS 2 (amendment), 'Share-based payment'. The amended standard deals with vesting conditions and cancellations. It clarifies that vesting conditions are service conditions and performance conditions only. Other features of a share-based payment are not vesting conditions. These features would need to be included in the grant date fair value for transactions with employees and others

providing similar services; they would not impact the number of awards expected to vest or valuation thereof subsequent to grant date. All cancellations, whether by the entity or by other parties, should receive the same accounting treatment. The amended standard does not have a material impact on the Company's financial statements.

*(b) Standards, amendments and interpretations to existing standards that are not yet effective and have not been early adopted by the Company*

The following standards and amendments to existing standards have been published and are mandatory for the Company's accounting periods beginning on or after January 1, 2010 or later periods:

- IFRS 2, 'Share-based payments' – provides further guidance on determining the classification of share based payment awards in consolidated and separate financial statements and is linked to the application of IFRS 3 (revised). The amendments are effective for annual periods beginning on or after July 1, 2009. The amendment will not result in a material impact on the Company's financial statements.
- IFRS 3 (revised) 'Business combinations' is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after July 1, 2009.

The revised standard continues to apply the acquisition method to business combinations, with some significant changes. For example, all payments to purchase a business are to be recorded at fair value at the acquisition date, with contingent payments classified as debt subsequently re-measured through the statement of comprehensive loss. There is a choice on an acquisition-by-acquisition basis to measure the minority interest in the acquiree either at fair value or at the minority interest's proportionate share of the acquiree's net assets. All acquisition-related costs should be expensed. The Company will apply IFRS 3 (revised) to all business combinations from January 1, 2010.

- IFRS 8, 'Operating Segments' which provides further requirements for disclosure of information about segment assets and is effective for periods beginning on or after January 1, 2010 has no impact on disclosure of segment assets currently reported by the Company.
- IFRS 9, 'Financial Instruments' was issued in November 2009 as the first step in its project to replace IAS 39 'Financial Instruments: Recognition and Measurement'. IFRS 9 introduces new requirements for classifying and measuring financial assets that must be applied starting January 1, 2013, with early adoption permitted. The IASB intends to expand IFRS 9 during the intervening period to add new requirements for classifying and measuring financial liabilities, de-recognition of financial instruments, impairment and hedge accounting. The Company is currently assessing the impact of this standard.
- IAS 27 (revised) 'Consolidated and Separate Financial Statements'; requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control and these transactions will no longer result in goodwill or gains and losses. The standard also specifies when control is lost. Any remaining interest in the entity is remeasured to fair value, and a gain or loss is recognised in profit or loss. The Company will apply this standard prospectively to transactions with non-controlling interests from January 1, 2010. The amendment will not result in a material impact on the Company's financial statements.
- IAS 38 (amendment), 'Measurement of non-current assets (or disposal groups) classified as held-for-sale'. The amendment is part of the IASB's annual improvements project published in April 2009 and the Company will apply IAS 38 (amendment) from the date IFRS 3 (revised) is adopted. The amendment clarifies guidance in measuring fair value of an intangible asset acquired in a business combination and it permits the grouping of intangible assets as a single asset if each asset has similar

useful economic lives. The amendment will not result in a material impact on the Company's financial statements.

- IFRIC 17, 'Distributions of non-cash assets to owners', clarifies how an entity should measure distributions of assets, other than cash, when it pays dividends to its owners and is effective for annual periods beginning on or after July 1, 2009. The amendment will not result in a material impact on the Company's financial statements.

### **Explanation of transition to IFRS**

The consolidated financial statements for the year ended December 31, 2009 are the Company's first financial statements prepared under IFRS. For all accounting periods prior to this, the Company prepared its financial statements under generally accepted accounting principles in the United States of America ('US GAAP'). In accordance with IFRS 1 'First time adoption of IFRS', certain disclosures relating to the transition to IFRS are given in this note. These disclosures are prepared under IFRS as set out in the basis of preparation in note 2 of the audited consolidated financial statements.

IFRS 1 allows first time adopters to IFRS to take advantage of a number of voluntary exemptions from the general principal of retrospective restatement. The Company has taken the following exemptions:

### **IFRS 3 Business combinations**

This standard has not been applied to acquisitions of subsidiaries that occurred before January 1, 2008 the Company's transition date.

### **IFRIC 1 Changes in existing decommissioning, restoration and similar liabilities**

The Company has elected to apply exemption from full retrospective application of Asset retirement obligations as allowed under IFRS 1. As such the Company has re-measured the provisions as at January 1, 2008 [2009?] under IAS 37, estimated the amount to be included in the cost of the related asset by discounting the liability to the date at which the liability first arose using best estimates of the pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation, and recalculated the accumulated depreciation, depletion and amortisation under IFRS.

Please refer to Note 26 in the audited consolidated financial statements for the year ended December 31, 2009 for US GAAP to IFRS reconciliations.

### **Accounting systems**

The Company makes use of Sun Systems accounting software package to meet its accounting requirements. This is a well established package which will enable the Company to meet all of the accounting requirements under IFRS.

### **INTERNAL CONTROLS OVER FINANCIAL REPORTING**

The Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of Tethys are responsible for establishing and maintaining internal control over financial reporting (ICFR) as that term is defined in National Instrument 52-109 – Certification of Disclosure in Annual and Interim Filings. The CEO and the CFO of Tethys are responsible for designing a system of internal controls over financial reporting, or causing them to be designed under their supervision, in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with IFRS.

Management of Tethys has designed and implemented, under the supervision of its CEO and CFO, a system of internal controls over financial reporting as of December 31, 2009 which it believes is effective for a company of its size. There were no changes in Tethys' internal control over financial reporting that occurred during the year ended December 31, 2009 that has materially affected or that is reasonably likely to affect, Tethys' control over financial reporting. The Company's control system and procedures are reviewed periodically and adjusted or updated as necessary. In addition where any new or additional risks have been identified by Company personnel then the management of Tethys has put in place appropriate procedures to mitigate these risks.

Under the supervision of the CEO and the CFO, an evaluation was conducted of the effectiveness of internal control over financial reporting based on "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organisations of the Treadway Commission. Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as at December 31, 2009. No material weakness relating to the design of the Company's system of ICFR or relating to the Company's operations as at December 31, 2009 have been identified.

## **DISCLOSURE CONTROLS AND PROCEDURES**

The CEO and the CFO are responsible for establishing and maintaining disclosure controls and procedures (DC+P) as that term is defined in NI 52-109. Disclosure controls and procedures have been designed by the Tethys Management, under the supervision of the CEO and CFO, to ensure that information required to be disclosed by the Company is accumulated, recorded, processed and reported to the Company's management as appropriate to allow timely decisions regarding disclosure. The Company's CEO and CFO have concluded, based on their evaluation as of the end of the period covered by this MD&A, that the Company's disclosure controls and procedures as of the end of such period are effective to provide reasonable assurance that material information related to the company, including its consolidated subsidiaries, is communicated to them as appropriate to allow timely decisions regarding required disclosure.

An evaluation was performed under the supervision of the CEO and CFO, of the effectiveness of the Company's disclosure controls as defined in Multilateral Instrument 52-109. Based on that evaluation the CEO and CFO concluded that the design and operation of the Company's disclosure controls and procedures were effective as at December 31, 2009.

## **FORWARD-LOOKING STATEMENTS**

In the interest of providing Tethys' shareholders and potential investors with information regarding the Company and its subsidiaries, including management's assessment of Tethys' and its subsidiaries' future plans and operations, certain statements contained in this MD&A constitute forward-looking statements or information (collectively referred to herein as "forward-looking statements") within the meaning of the "safe harbour" provisions of applicable securities legislation. Forward-looking statements are typically identified by words such as "anticipate", "believe", "expect", "plan", "intend", "forecast", "target", "project" or similar words suggesting future outcomes or statements regarding an outlook. Forward looking statements in this MD&A include, but are not limited to, statements with respect to: the projected 2010 capital investments projections, and the potential source of funding therefor. Readers are cautioned not to place undue reliance on forward-looking statements, as there can be no assurance that the plans, intentions or expectations upon which they are based will occur. By their nature, forward-looking statements involve numerous assumptions, known and unknown risks and uncertainties, both general and specific, that contribute to the possibility that the predictions, forecasts, projections and other forward-looking statements will not occur, which may cause the Company's actual performance and financial results in future periods to differ materially from any estimates or projections of future performance or results expressed or implied by such forward-looking statements. These risks, uncertainties and assumptions include, among other things: volatility of and assumptions regarding oil and gas prices; fluctuations in currency and interest rates; ability to successfully complete proposed equity financings; product supply and demand; market competition; ability to realise current market gas prices; risks inherent in the Company's and its subsidiaries' marketing operations, including credit risks; imprecision of reserve estimates and estimates of recoverable quantities of oil and natural gas and other



sources not currently classified as proved; the Company's and its subsidiaries' ability to replace and expand oil and gas reserves; unexpected cost increases or technical difficulties in constructing pipeline or other facilities; unexpected delays in its drilling operations; delays in the delivery of its drilling rigs; unexpected difficulties in, transporting oil or natural gas; risks associated with technology; the Company's ability to generate sufficient cash flow from operations to meet its current and future obligations; the Company's ability to access external sources of debt and equity capital; the timing and the costs of well and pipeline construction; the Company's and its subsidiaries' ability to secure adequate product transportation; changes in royalty, tax, environmental and other laws or regulations or the interpretations of such laws or regulations; political and economic conditions in the countries in which the Company and its subsidiaries operate; the risk of international war, hostilities, civil insurrection and instability affecting countries in which the Company and its subsidiaries operate and terrorist threats; risks associated with existing and potential future lawsuits and regulatory actions made against the Company and its subsidiaries; and other risks and uncertainties described from time to time in the reports and filings made with securities regulatory authorities by Tethys.

With regard to forward looking information contained in this MD&A, the Company has made assumptions regarding, amongst other things, the continued existence and operation of existing pipelines; future prices for natural gas; future currency and exchange rates; the Company's ability to generate sufficient cash flow from operations and access to capital markets to meet its future obligations; the regulatory framework representing mineral extraction taxes, royalties, taxes and environmental matters in the countries in which the Company conducts its business: gas production levels; and the Company's ability to obtain qualified staff and equipment in a timely and cost effective manner to meet the Company's demands. Statements relating to "reserves" or "resources" or "resource potential" are deemed to be forward-looking statements, as they involve the implied assessment, based on certain estimates and assumptions that the resources and reserves described exist in the quantities predicted or estimated, and can be profitably produced in the future. Although Tethys believes that the expectations represented by such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. Readers are cautioned that the foregoing list of important factors is not exhaustive. Furthermore, the forward-looking statements contained in this MD&A are made as of the date of this MD&A, and except as required by law Tethys does not undertake any obligation to update publicly or to revise any of the included forward looking statements, whether as a result of new information, future events or otherwise. The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement.

## **Management Report**

The accompanying consolidated financial statements and all the information in the annual report are the responsibility of management. The consolidated financial statements have been prepared by management in accordance with the accounting policies described in the notes to the financial statements. In the opinion of management, the consolidated financial statements have been prepared within acceptable limits of materiality and are in accordance with International Financial Reporting Standards, appropriate in the circumstances, as issued by the International Accounting Standards Board. The consolidated financial information contained elsewhere in the annual report has been reviewed to ensure consistency with that in the consolidated financial statements.

Management has developed and maintains systems of internal accounting controls, policies and procedures in order to provide reasonable assurance as to the reliability of the financial records and the safeguarding of assets.

External auditors, appointed by the shareholders of the Company, have examined the consolidated financial statements and have expressed an opinion on the consolidated statements. Their report is included with the consolidated financial statements.

The Board of Directors of the Company has established an Audit Committee, consisting of independent non-management directors, to review consolidated financial statements with management and the auditors. The Board of Directors has approved the consolidated financial statements on the recommendation of the Audit Committee.

Dr. D. Robson  
Chief Executive

B. Murphy  
Chief Financial Officer

March 31, 2010

March 31, 2010

## AUDITORS' REPORT

### To the Shareholders of Tethys Petroleum Limited

We have audited the consolidated statements of financial position of Tethys Petroleum Limited as at December 31, 2009, December 31, 2008 and January 1, 2008 and the consolidated statements of comprehensive loss, changes in equity and cash flows for each of the years ended December 31, 2009 and 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2009, December 31, 2008 and January 1, 2008 and the results of its operations and its cash flows for each of the years ended December 31, 2009 and 2008 in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

*PricewaterhouseCoopers LLP*

Chartered Accountants  
Calgary, Alberta

# **Tethys Petroleum Limited**

Consolidated Financial Statements

**December 31, 2009**

(in thousands of US dollars)

# Tethys Petroleum Limited

## Consolidated Statement of Financial Position

(in thousands of US dollars)

		As at December 31		As at January 1
	Note	2009	2008	2008
		\$	\$	(note 26) \$
<b>Non-current assets</b>				
Property, plant and equipment	12	73,171	65,422	38,327
Intangible assets	11	24,378	16,105	7,335
Investments	13	659	587	318
Trade and other receivables	14	5,171	6,357	5,814
Loan receivable from jointly controlled entity	15	21,727	0	0
		<u>125,106</u>	<u>88,471</u>	<u>51,794</u>
<b>Current assets</b>				
Inventories		2,368	213	-
Trade and other receivables	14	2,311	2,664	1,360
Cash and cash equivalents	16	7,297	22,200	26,692
		<u>11,976</u>	<u>25,077</u>	<u>28,052</u>
<b>Total assets</b>		<u>137,082</u>	<u>113,548</u>	<u>79,846</u>
<b>Equity attributable to shareholders</b>				
Share capital	20	13,455	6,639	4,511
Share premium	20	153,748	138,598	94,972
Other reserves		27,775	25,147	20,728
Accumulated deficit		(88,374)	(66,654)	(44,470)
<b>Total equity</b>		<u>106,604</u>	<u>103,730</u>	<u>75,741</u>
<b>Non-current liabilities</b>				
Deferred gain on sale of assets to jointly controlled entity	15	3,659	-	-
Financial liabilities - borrowings	17	9,324	5,096	-
Shares to be issued		3,750	-	-
Deferred taxation	9	598	-	-
Trade and other payables	18	808	523	776
Asset retirement obligations	19	206	465	1,050
		<u>18,345</u>	<u>6,084</u>	<u>1,826</u>
<b>Current liabilities</b>				
Financial liabilities - borrowings	17	1,086	853	-
Derivative financial instruments - warrants	17	1,053	146	-
Derivative financial instruments – interest rate swap	17	95	-	-
Deferred revenue		3,113	-	-
Trade and other payables	18	6,786	2,735	2,279
		<u>12,133</u>	<u>3,734</u>	<u>2,279</u>
<b>Total liabilities</b>		<u>30,478</u>	<u>9,818</u>	<u>4,105</u>
<b>Total shareholders' equity and liabilities</b>		<u>137,082</u>	<u>113,548</u>	<u>79,846</u>
Commitments and contingencies	25			

The notes on pages 1 to 58 form part of these consolidated financial statements. The financial statements on pages 1 to 63 were approved by the Board on 31 March 2010 and were signed on its behalf.

“Dr. D. Robson”  
Chief Executive

“B. Murphy”  
Chief Financial Officer

# Tethys Petroleum Limited

## Consolidated Statement of Comprehensive Loss

(in thousands of US dollars, except for per share amounts)

	Note	Year ended December 31,	
		2009	2008
		\$	\$
Sales and other operating revenues	6	8,559	5,360
Finance income		76	832
Total revenue and other income		<u>8,635</u>	<u>6,192</u>
Production expenditures		(3,405)	(1,334)
Depreciation, depletion and amortization		(3,238)	(4,333)
Exploration and evaluation expenditure written off		(887)	(2,292)
Listing expenses		(1,652)	-
Administrative expenses	7	(16,880)	(17,915)
Foreign exchange gains (loss) net		(2,397)	(3,060)
Fair value gain / (loss) on derivative financial instrument		(479)	929
Loss from jointly controlled entity	15	(1,000)	-
Finance costs		<u>(203)</u>	<u>(371)</u>
<b>Loss before taxation</b>		<b>(21,506)</b>	<b>(22,184)</b>
Taxation	9	<u>(214)</u>	<u>-</u>
<b>Net loss and comprehensive loss for the year attributable to shareholders</b>		<b><u>(21,720)</u></b>	<b><u>(22,184)</u></b>
<b>Loss per share attributable to shareholders</b>			
Basic and diluted	10	<u>(0.20)</u>	<u>(0.40)</u>

No dividends were paid or are declared for the year (2008 – \$Nil).

The notes on pages 1 to 58 form part of these consolidated financial statements.

# Tethys Petroleum Limited

Consolidated Statement of Changes in Equity  
(in thousands of US dollars)

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	Note	Attributable to shareholders					Total equity \$
		Share capital \$	Share premium \$	Accumulated deficit \$	Option reserves \$	Warrant reserves \$	
<b>Balance at January 1, 2008</b>	20	4,511	94,972	(44,470)	4,173	16,555	75,741
Comprehensive loss for the year		-	-	(22,184)	-	-	(22,184)
<b>Transactions with shareholders</b>							
Issue of share capital	20	2,128	47,872	-	-	-	50,000
Cost of share issue		-	(4,246)	-	-	-	(4,246)
Share-based payments		-	-	-	4,419	-	4,419
<b>Total transactions with shareholders</b>		<u>2,128</u>	<u>43,626</u>	<u>-</u>	<u>4,419</u>	<u>-</u>	<u>50,173</u>
<b>Balance at January 1, 2009</b>		6,639	138,598	(66,654)	8,592	16,555	103,730
Comprehensive loss for the year		-	-	(21,720)	-	-	(21,720)
<b>Transactions with shareholders</b>							
Issue of share capital	20	6,816	17,245	-	-	-	24,061
Cost of share issue		-	(2,095)	-	-	-	(2,095)
Share-based payments		-	-	-	2,628	-	2,628
<b>Total transactions with shareholders</b>		<u>6,816</u>	<u>15,150</u>	<u>-</u>	<u>2,628</u>	<u>-</u>	<u>24,594</u>
<b>At December 31, 2009</b>		<u>13,455</u>	<u>153,748</u>	<u>(88,374)</u>	<u>11,220</u>	<u>16,555</u>	<u>106,604</u>

The option reserve and warrant reserve are denoted together as “other reserves” on the consolidated statement of financial position. These reserves are non distributable.

The notes on pages 1 to 58 form part of these consolidated financial statements.

# Tethys Petroleum Limited

## Consolidated Statement of Cash Flows

(in thousands of US dollars)

	Note	Year ended December 31,	
		2009	2008
		\$	\$
<b>Cash flow from operating activities</b>			
Loss before taxation		(21,506)	(22,184)
Adjustments for			
Share based payments	8	2,628	4,419
Net finance cost (income)		127	(461)
Unsuccessful exploration and evaluation expenditures	11	887	2,292
Depreciation, depletion and amortization	12	3,238	4,333
Fair value gain (loss) on derivative financial instrument		479	(929)
Net unrealised foreign exchange loss		1,120	1,277
Loss from jointly controlled entity		1,000	-
Deferred revenue		3,113	-
Net change in non-cash working capital	24	(1,160)	(844)
<b>Net cash used in operating activities</b>		<u>(10,074)</u>	<u>(12,097)</u>
<b>Cash flow from investing activities</b>			
Interest received		76	832
Expenditure on exploration and evaluation assets		(22,648)	(6,519)
Expenditures on property, plant and equipment		(9,573)	(36,288)
Investment in restricted cash		(72)	(269)
Acquisition of subsidiary, net of cash received		532	-
Sale of subsidiaries, net of cash disposed		(112)	-
Movement in advances to construction contractors		829	1,548
Value added tax receivable		(670)	(2,091)
Net change in non-cash working capital	24	1,273	(217)
<b>Net cash used in investing activities</b>		<u>(30,365)</u>	<u>(43,004)</u>
<b>Cash flow from financing activities</b>			
Proceeds from issuance of short-term borrowings	17	2,500	-
Repayment of short-term borrowings		(2,500)	-
Proceeds from issuance of long-term borrowings	17	5,020	7,430
Repayment of long-term borrowings	17	(856)	(579)
Interest paid on long-term borrowings and other non-current payables		(152)	(380)
Other non-current liabilities	18	(109)	(253)
Proceeds related to shares to be issued		3,750	-
Proceeds from issuance of equity, net of issue costs	20	17,906	45,754
<b>Net cash generated from financing activities</b>		<u>25,559</u>	<u>51,972</u>
Effects of exchange rate changes on cash and cash equivalents		(23)	(1,363)
<b>Net decrease in cash and cash equivalents</b>		(14,903)	(4,492)
Cash and cash equivalents at beginning of the year		22,200	26,692
<b>Cash and cash equivalents at end of the year</b>		<u>7,297</u>	<u>22,200</u>

The notes on pages 1 to 58 form part of these consolidated financial statements.



# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### **1 General information**

Tethys Petroleum Limited and its subsidiaries (collectively “Tethys” or “the Company”) are headquartered in Guernsey, British Isles. The domicile of Tethys Petroleum Limited was moved from Guernsey, British Isles to the Cayman Islands on July 17, 2008, where it is incorporated. The address of the Company’s registered office is 89 Nexus Way, Camana Bay, Grand Cayman, Cayman Islands. Tethys is an oil and gas Company operating within the Republic of Kazakhstan, Republic of Uzbekistan and the Republic of Tajikistan. Tethys’ principal activity is the acquisition of and development of crude oil and natural gas fields.

The Company has its primary listing on the Toronto Stock Exchange (TSX).

#### **Statement of compliance**

These consolidated financial statements have been prepared on a going concern basis under the historical cost convention except as modified by the revaluation of available for sale financial assets, and financial assets and financial liabilities at fair value through the statement of comprehensive loss and are in accordance with International Financial Reporting Standards (IFRSs) and International Financial Reporting Interpretations Committee (IFRIC) interpretations issued by the International Accounting Standards Boards (“IASB”) and effective or issued and early adopted as at the time of preparing these financial statements.

The March 31, 2009 interim consolidated financial statements were the Company’s first interim financial statements prepared under IFRS, with a transition date to IFRS of January 1, 2008. Consequently the comparative figures for 2008 and the Company’s statement of financial position as at January 1, 2008 have been restated from accounting principles generally accepted in the United States of America (‘US GAAP’) to comply with IFRS. The reconciliations to IFRS from the previously published US GAAP financial statements are explained in note 26 of these financial statements by the IASB.

The preparation of financial statements in conformity with IFRS requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management’s best knowledge of the amount, event or actions, actual results ultimately may differ from those estimates. Areas where estimates are significant to the consolidated financial statements are disclosed in note 4.

### **2 Summary of significant accounting policies**

#### **Basis of preparation**

The consolidated financial statements for the year ended December 31, 2009 have been prepared in accordance with International Financial Reporting Standards (“IFRS”) and IFRIC Interpretations and are in accordance with IFRS 1 - First-time Adoption of IFRS. The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of financial assets and financial liabilities (including derivative instruments) at fair value through profit and loss.

# **Tethys Petroleum Limited**

## **Notes to Consolidated Financial Statements**

(tabular amounts in thousands of US dollars)

The consolidated financial statements are presented in United States Dollars and all amounts are rounded to the nearest thousand (US\$'000) except where otherwise indicated. Foreign operations are included in accordance with the policies set out in this note.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Company's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in note 4.

Since inception, the Company has incurred significant losses from operations and negative cash flows from operating activities, and has an accumulated deficit at December 31, 2009. The Company has significant short-term and longer term contractual commitments that will necessitate cash outflows. In the first three months of 2010 the Company raised in \$58.35 million. In the longer term, the ability of the Company to successfully carry out its business plan will be dependent upon its ability not only to maintain the current level of gas and oil production but also to achieve further production of commercial oil and gas and to control the costs of operating and capital expenditures. The Company completed an Initial Public Offering (IPO) of equity securities on the Toronto Stock Exchange (TSX) on June 27, 2007. The Company subsequently issued additional capital for gross proceeds of \$50 million on June 27, 2008 and \$20 million on June 19, 2009 that generated sufficient funds to secure its future at least in the short term. If in the future, the Company is unable to generate significant revenues and cash flows from operations it may need to seek further funding from its shareholders or alternative sources. There can be no assurances that management will be successful with these initiatives. While these factors create doubt about the Company's ability to continue as a going concern, management is confident of achieving the Company's short term plans.

The financial statements have been prepared on the basis that the Company will continue to operate as a going concern, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. These financial statements do not reflect adjustments in the carrying values of assets and liabilities reported, revenue or expenses and the classification used on the statement of financial position, that would be necessary if the going concern assumption was not appropriate. Such adjustments could be material.

### **Foreign Operations**

Tethys' future operations and earnings will depend upon the results of Tethys' operations in the Republic of Kazakhstan, Uzbekistan and Tajikistan. There can be no assurance that Tethys' will be able to successfully conduct such operations, and a failure to do so would have a material adverse effect on Tethys' financial position, results of operations and cash flows. Also, the success of Tethys' operations will be subject to numerous contingencies, some of which are beyond management control. These contingencies include general and regional economic conditions, prices for crude oil and natural gas, competitions and changes in regulation. Since Tethys' is dependent on international operations, Tethys' will be subject to various additional political, economic and other uncertainties. Among other risks, Tethys' operations may be subject to the risks and restrictions on transfer of funds, import and export duties, quotas and embargoes, domestic and international customs and tariffs, and changing taxation policies, foreign exchange restrictions, political conditions and regulations.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### Changes in accounting policy and disclosures

#### *(a) New and amended standards adopted by the Company*

The following new and amended accounting standards are mandatory and relevant for the Company for the first time for these financial statements:

- IFRS 7 'Financial instruments – Disclosures' (amendment). This amendment requires enhanced disclosures about fair value measurement and liquidity risk. In particular, the amendment requires disclosure of fair value measurements by level of a fair value measurement hierarchy.
- IFRS 8, 'Operating segments'. IFRS 8 replaces IAS 14, 'Segment reporting'. It requires a 'management approach' under which segment information is presented on the same basis as that used for internal reporting purposes.
- IAS 23 (amendment), 'Borrowing costs' requires an entity to capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) as part of the cost of that asset. The option of immediately expensing those borrowing costs has been removed. This has no impact on the Company as its policy has always been to capitalise borrowing cost on qualifying assets.
- IFRS 2 (amendment), 'Share-based payment'. The amended standard deals with vesting conditions and cancellations. It clarifies that vesting conditions are service conditions and performance conditions only. Other features of a share-based payment are not vesting conditions. These features would need to be included in the grant date fair value for transactions with employees and others providing similar services; they would not impact the number of awards expected to vest or valuation thereof subsequent to grant date. All cancellations, whether by the entity or by other parties, should receive the same accounting treatment. The amended standard does not have a material impact on the Company's financial statements.

#### *(b) Standards, amendments and interpretations to existing standards that are not yet effective and have not been early adopted by the Company*

The following standards and amendments to existing standards have been published and are mandatory for the Company's accounting periods beginning on or after January 1, 2010 or later periods, but the Company has not early adopted them:

- IFRS 2, 'Share-based payments' – provides further guidance on determining the classification of share based payment awards in consolidated and separate financial statements and is linked to the application of IFRS 3 (revised). The amendments are effective for annual periods beginning on or after July 1, 2009. The amendment will not result in a material impact on the Company's financial statements.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

- IFRS 3 (revised) 'Business combinations' is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after July 1, 2009.

The revised standard continues to apply the acquisition method to business combinations, with some significant changes. For example, all payments to purchase a business are to be recorded at fair value at the acquisition date, with contingent payments classified as debt subsequently re-measured through the statement of comprehensive loss. There is a choice on an acquisition-by-acquisition basis to measure the minority interest in the acquiree either at fair value or at the minority interest's proportionate share of the acquiree's net assets. All acquisition-related costs should be expensed. The Company will apply IFRS 3 (revised) to all business combinations from January 1, 2010.

- IFRS 8, 'Operating Segments' which provides further requirements for disclosure of information about segment assets and is effective for periods beginning on or after January 1, 2010 has no impact on disclosure of segment assets currently reported by the Company.
- IFRS 9, 'Financial Instruments' was issued in November 2009 as the first step in its project to replace IAS 39 'Financial Instruments: Recognition and Measurement'. IFRS 9 introduces new requirements for classifying and measuring financial assets that must be applied starting January 1, 2013, with early adoption permitted. The IASB intends to expand IFRS 9 during the intervening period to add new requirements for classifying and measuring financial liabilities, de-recognition of financial instruments, impairment and hedge accounting. The Company is currently assessing the impact of this standard.
- IAS 27 (revised) 'Consolidated and Separate Financial Statements'; requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control and these transactions will no longer result in goodwill or gains and losses. The standard also specifies when control is lost. Any remaining interest in the entity is remeasured to fair value, and a gain or loss is recognised in profit or loss. The Company will apply this standard prospectively to transactions with non-controlling interests from January 1, 2010. The amendment will not result in a material impact on the Company's financial statements.
- IAS 38 (amendment), 'Measurement of non-current assets (or disposal groups) classified as held-for-sale'. The amendment is part of the IASB's annual improvements project published in April 2009 and the Company will apply IAS 38 (amendment) from the date IFRS 3 (revised) is adopted. The amendment clarifies guidance in measuring fair value of an intangible asset acquired in a business combination and it permits the grouping of intangible assets as a single asset if each asset has similar useful economic lives. The amendment will not result in a material impact on the Company's financial statements.
- IFRIC 17, 'Distributions of non-cash assets to owners', clarifies how an entity should measure distributions of assets, other than cash, when it pays dividends to its owners and is effective for annual periods beginning on or after July 1, 2009. The amendment will not result in a material impact on the Company's financial statements.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### **Basis of consolidation**

#### *Subsidiaries*

Subsidiaries are all entities over which the Company has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. Subsidiaries are fully consolidated from the date on which control is transferred to the Company.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Company. The cost of acquisition is measured at the fair value of assets given, equity instruments issued and debt incurred or assumed at the date of acquisition, being the date on which the Company gains control. The excess of the cost over the fair value of the Company's share of identifiable net assets acquired is recorded as goodwill. If the cost is less than the fair value of net assets acquired, the difference is recognised directly in the statement of comprehensive loss. All subsidiaries, as listed in note 23, have been consolidated into the Company's consolidated financial statements.

Inter-Company transactions, balances and unrealised gains or losses between subsidiaries are eliminated. The financial statements of the subsidiaries are prepared using consistent accounting policies and reporting date as of the Company.

#### *Joint ventures*

The Company's interests in jointly controlled entities are accounted for using the equity method of accounting. Under the equity method, the investment in a jointly controlled entity is carried in the statement of financial position at cost plus post-acquisition charges in the Company's share of net assets of the jointly controlled entity, less distributions received and less any impairment in value of the investment. The Company's statement of comprehensive loss reflects the Company's share of the results after tax of the jointly controlled entity.

When the Company's share of losses in the jointly controlled entity equals or exceeds its interest in the entity, including any other unsecured receivables, the Company does not recognise further losses, unless it has incurred obligations or made payments on behalf of the jointly controlled entity. Financial statements of jointly controlled entities are prepared for the same reporting year as the Company.

The Company recognises the portion of gains or losses on the sale of assets by the Group to the joint venture that is attributable to the other parties in the joint venture. The Company does not recognise its share of profits or losses that results from the purchase of assets by the Group from the joint venture until when the asset is resold or, where relevant, as the asset is depreciated by the jointly controlled entity.

In circumstances where the significant risks and rewards of ownership of non-monetary assets transferred have not been transferred to the jointly controlled entity, the associated gain or loss is unrealised and, thus, not recognised in profit or loss but recognised as a deferred gain on the statement of financial position. The deferred gain is recognised in the statement of comprehensive loss when the asset is resold or, where relevant, as the asset is depreciated by the jointly controlled entity.

Accounting policies of the joint venture are consistent with accounting policies adopted by the Company.

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### **Segment reporting**

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker has been identified as the Executive directors that make strategic decisions.

### **Foreign currency translation**

The consolidated financial statements are presented in US Dollars, which is the Company's functional and reporting currency.

All monetary assets and liabilities denominated in foreign currencies are translated into US dollars at the rate of exchange in effect at the reporting date. Non-monetary assets are translated at historical exchange rates.

Revenue and expense items (excluding depreciation and amortization which are translated at the same rates as the related assets) are translated at the average rate of exchange.

Exchange gains and losses arising on translation are taken to the statement of comprehensive loss.

### **Oil and gas exploration and evaluation expenditure**

Oil and natural gas exploration and evaluation expenditures are accounted for using a modified 'successful efforts' method of accounting. Costs are accumulated on a field-by-field basis. Exploration and evaluation expenditures, including license acquisition costs, are capitalised as exploration and evaluation assets when incurred. Expenditure directly associated with an exploration well is capitalised until the determination of reserves is evaluated. If reserves are not identified, these costs are charged to expense. All other associated exploration and evaluation expenditure are carried forward as an asset in the statement of financial position where the rights of tenure of the property are current and it is considered probable that the costs will be recouped through successful development of the property, or alternatively by its sale. Capitalised exploration and evaluation expenditure is written down to its recoverable amount where the above conditions are no longer satisfied.

If it is determined that a commercial discovery has not been achieved in relation to the property, all other associated costs are written down to their recoverable amount. If commercial reserves are found, exploration and evaluation assets are tested for impairment and transferred to development tangible and intangible assets. No depreciation and/or amortisation is charged during the exploration and evaluation phase.

### **Oil and gas properties**

Oil and gas properties are stated at cost, less accumulated depreciation and accumulated impairment losses.

Expenditure on the construction, installation or completion of infrastructure facilities such as platforms, pipelines and the drilling of development wells, including unsuccessful development or delineation wells, is capitalised within oil and gas properties, as long as the facts and circumstances indicate that the field has commercially viable reserves.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The initial cost of an asset comprises its purchase price or construction cost, any costs directly attributable to bringing the asset into operation, the initial estimate of the asset retirement obligation, and for qualifying assets, borrowing costs. The purchase price or construction cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset. The capitalised value of a finance lease is also included within property, plant and equipment.

Where commercial production in an area of interest has commenced, oil and gas properties are depreciated on a unit-of-production basis over the proved and probable reserves of the field concerned, except in the case of assets whose useful life is shorter than the lifetime of the field, in which case the straight-line method is applied. Rights and concessions are depleted on the unit-of-production basis over the total proved and probable reserves of the relevant area. The unit-of-production rate for the amortisation of field development costs takes into account expenditures incurred to date, together with future development expenditure to develop the proved and probable reserves. Changes in factors such as estimates of proved and probable reserves that affect unit-of-production calculations do not give rise to prior year financial period adjustments and are dealt with on a prospective basis.

### Other property, plant and equipment

Property, plant and equipment are carried at cost less accumulated depreciation. Depreciation is charged so as to write off the cost of these assets less residual value over their estimated useful economic lives, for the following classes of assets:

Drilling rigs and related oil and gas equipment	Unit of production	3,650 operating days
Smaller rig related equipment	Straight line	6 – 8 years
Vehicles	Straight line	4 years
Computer equipment	Straight line	3 years
Office equipment	Straight line	5 years

### Intangible assets

#### *Production enhancement contracts*

Production enhancement contracts are stated at cost less accumulated amortisation and have a finite useful life. Amortization is calculated using a unit-of-production basis over the estimated incremental production entitlement expected to be received over the life of the contract.

### Impairment of non-financial assets

Exploration and evaluation costs are tested for impairment when reclassified to oil and gas properties or whenever facts and circumstances indicate potential impairment. An impairment loss is recognised for the amount by which the exploration and evaluation expenditure's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of the exploration and evaluation expenditure's fair value less costs to sell and their value in use.

Values of oil and gas properties and other property, plant and equipment are reviewed for impairment when indicators of such impairment exist. If any indication of impairment exists an estimate of the asset's recoverable

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

amount is calculated. Individual assets are grouped for impairment assessment purposes at the lowest level at which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. An asset group's recoverable amount is the higher of its fair value less costs to sell and its value in use. Where the carrying amount of an asset group exceeds its recoverable amount, the asset group is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are adjusted for the risks specific to the asset group and are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money.

If the carrying amount of the asset exceeds its recoverable amount, the asset is impaired and an impairment loss is charged to the statement of comprehensive loss so as to reduce the carrying amount to its recoverable amount (i.e. the higher of fair value less cost to sell and value in use).

For assets excluding goodwill, an assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the Company makes an estimate of the recoverable amount. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years.

### ***Asset retirement obligation (ARO)***

Provision is made for the present value of the future cost of abandonment of oil and gas wells and related facilities. This provision is recognised when a legal or constructive obligation arises.

The estimated costs, based on engineering cost levels prevailing at the reporting date, are computed on the basis of the latest assumptions as to the scope and method of abandonment. Provisions are measured at the fair value of the expenditures expected to be required to settle the obligation using a pre-tax rate, updated at each reporting date that reflects current market assessments of the time value of money and the risks specific to the obligation. The corresponding amount is capitalised as part of exploration and evaluation expenditure or oil and gas properties and is amortised on a unit-of-production basis as part of the depreciation, depletion and amortisation charge. Any adjustment arising from the reassessment of estimated cost of ARO is capitalised, whilst the charge arising from the accretion of the discount applied to the ARO is treated as a component of finance costs.

### **Financial instruments**

Financial assets and financial liabilities are recognised on the Company's statement of financial position when the Company becomes party to the contractual provisions of the instrument. Financial assets are de-recognised when the contractual rights to the cashflows from the financial asset expire or when the contractual rights to those assets are transferred. Financial liabilities are de-recognised when the obligation specified in the contract is discharged, cancelled or expired.



# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### *Investments*

Investments comprise restricted current balances that are held on deposit with banks in the Republic of Kazakhstan in respect of the Company's asset retirement obligations (ARO) in this country and are classified as non-current. They are carried at fair value with gains or losses taken to the statement of comprehensive loss.

### *Trade receivables, loans and other receivables*

Trade receivables, loans and other receivables, which are non-derivative financial assets that have fixed or determinable payments that are not quoted in an active market, are classified as loans and receivables. They are included in current assets, except for maturities greater than 12 months after the reporting date, which are classified as non-current assets. The Company's loans and receivables comprise trade and other receivables in the statement of financial position.

Loans and receivables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest rate method, net of any impairment.

A provision for impairment of trade receivables is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments (more than 60 days overdue) are considered indicators that the trade receivable is impaired. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognised in the statement of comprehensive loss. When a trade receivable is uncollectible, it is written off against the allowance account for trade receivables.

### *Cash and cash equivalents*

Cash and cash equivalents comprise cash in hand, deposits held at call with banks and other short-term highly liquid investments with original maturities of three months or less. These are carried at fair value with gains or losses recognized through statement of comprehensive loss.

### *Financial liabilities - borrowings*

Borrowings are initially recognised at the fair value of the consideration received less directly attributable transaction costs. After initial recognition, interest bearing loans and borrowings are subsequently measured at amortised cost using the effective interest method. Gains and losses are recognised in the statement of comprehensive loss when the liabilities are derecognised as well as through the amortisation process.

### *Trade payables*

Trade payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Accounts payable are classified as current liabilities if payment is due within one year or less. If not, they are presented as non-current liabilities. Trade payables are measured at amortised cost using the effective interest method.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### *Equity instruments*

Equity instruments issued by the Company are recorded at the proceeds received net of direct issue costs.

### *Derivative financial instruments*

Derivative financial instruments are initially recognized at fair value on the date a derivative contract was entered into and are subsequently remeasured at their fair value with changes in the fair value immediately recognised in the statement of comprehensive loss.

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of the host contract. Contracts are assessed for embedded derivatives when the Company becomes a party to them, including at the date of a business combination.

### *Derivative contracts qualifying for the 'own-use' treatment*

An 'own-use' contract is one that was entered into and continues to be held for the purpose of the receipt or delivery of the non financial item in accordance with the entity's expected purchase, sale or usage requirements. Contracts that are for the Company's own use are exempt from the requirements of IAS39.

### **Inventories**

Inventories consist of refined oil products, spare parts and consumable materials and are shown at the lower of cost and net realisable value. Cost is determined on a weighted average cost method for refined oil products and the first-in-first-out method for spare parts and consumable materials inventories.

### **Taxation including deferred taxation**

The tax expense represents current tax and deferred tax.

Current tax is based on the taxable profits for the year. The Company's current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

Deferred income tax is recognised, using the liability method, on temporary differences arising between the bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction, other than a business combination, that at the time of the transaction affects neither the accounting nor taxable profit or loss. Deferred income tax assets are recognised to the extent that it is probable that the future taxable profit will be available against which the temporary differences can be utilised and the carry forward of unused tax credits and unused tax losses can be utilised.

Deferred income tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the reporting date and are expected to apply when the related deferred tax asset is realised or the deferred income tax liability settled.

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### **Share-based payments**

The Company operates a number of equity-settled, share-based compensation plans, under which the entity receives services from employees as consideration for equity instruments (options and warrants) of the Company. The fair value of the employee options and warrants granted in exchange for the employee services, is recognised as an expense. The total amount to be expensed is determined by reference to the fair value of the options granted, excluding the impact of any non-market service and performance vesting conditions. Non-market vesting conditions are included in assumptions about the number of options that are expected to vest. When options vest in instalments over the vesting period, each instalment is accounted for as a separate arrangement. At each reporting date, the entity revises its estimates of the number of options that are expected to vest. It recognises the impact of the revision of original estimates, if any, in the statement of comprehensive loss, with a corresponding adjustment to equity.

The proceeds received net of any directly attributable transaction costs are credited to share capital and share premium when the options are exercised.

### **Provisions**

Provisions are recognised when the Company has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the Company expects some or all of a provision to be reimbursed, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the statement of comprehensive loss, net of any reimbursement. The increase in the provision due to passage of time is recognized as interest expense.

### **Revenue recognition**

Revenue comprises the fair value of the consideration received or receivable for the sale of natural gas and oil products in the ordinary course of the Company's activities and is recognized when the amount can be reliably measured, it is probable that future economic benefits will flow to the entity, and when specific criteria have been met for each of the Company's activities as described below. Revenue is shown after eliminating sales within the Company

Revenue from natural gas sales is recognized when the gas has been lifted and the risk of loss transferred to a third-party purchaser and is shown net of royalties, Mineral Extraction Tax (MET) and value-added tax. Revenue from refined product sales is recognized upon delivery and is shown net of value-added tax. All payments received before delivery are recorded as deferred revenue until delivery has occurred.

The Company recognises finance income earned on the Company's cash and cash equivalents and short term investments on an accrual basis.

### **Barter transactions**

Where goods or services are exchanged for goods or services of a dissimilar nature, the revenue is measured at the fair value of the goods or services received, adjusted by the amount of cash or cash equivalents received or

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

paid. If the fair value of the goods or services received cannot be reliably measured, the revenue is measured at the fair value of the goods or services given up, again adjusted by the amount of cash or cash equivalents received.

### **Borrowing costs**

Borrowing costs directly attributable to the acquisition, construction or production of a qualifying capital asset or project under construction are capitalised and added to the asset or project cost during construction until such time as the asset or project is substantially ready for its intended use. Where funds are specifically borrowed to finance an asset or project, the amount capitalised represents the actual amount of borrowing cost incurred. Where funds used to finance an asset or project form part of general borrowings, the amount capitalised is calculated by using a weighted average of rates applicable to relevant general borrowings of the Company during the period. All other borrowing costs are recognised in the statement of comprehensive loss in the period in which they are incurred.

### **Leases**

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases are charged to the statement of comprehensive loss on a straight-line basis over the period of the lease.

### **Business combinations**

Business combinations are accounted for using the purchase method of accounting. The cost of an acquisition is measured as the cash paid and the fair value of other assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the net fair value of the identifiable assets, liabilities and contingent liabilities acquired is recognized as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognized directly in the statement of comprehensive loss.

Goodwill represents the excess of the cost of an acquisition over the fair value of the Company's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in 'intangible assets'. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units for the purpose of impairment testing. The allocation is made to those cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose identified according to operation segment.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### Fair value

The fair value of investments, trade and other receivables, trade and other payables approximate their carrying amounts due to the short term maturity of the instruments. Loan receivables, long term debt and other non-current liabilities have been recorded at amortized cost using the effective interest rate method.

### 3 Financial risk management

The Company's activities expose it to a variety of financial risks: market risk, credit risk and liquidity risk. The Company's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the Company's financial performance.

Risk management is carried out by senior management, in particular, the Executive Board of Directors.

#### a) Financial risk factors

##### *Credit risk*

Credit risk is the risk of financial loss to the Company if a customer or counterparty to financial instruments fails to meet its contractual obligations. Credit risk arises from the Company's cash and cash equivalents and accounts receivable balances.

With respect to the Company's financial assets the maximum exposure to credit risk due to default of the counter party is equal to the carrying value of these instruments. The maximum exposure to credit risk as at the reporting date is:

	<b>December 31 2009</b>	<b>December 31 2008</b>
	\$	\$
Trade receivables	905	1,124
Cash and cash equivalents	7,297	22,200
Investments	659	587
Loan receivable from jointly controlled entity	21,727	-
	<u>30,588</u>	<u>23,911</u>

Concentration of credit risk associated with the above trade receivable balances in Kazakhstan is as a result of contracted sales to only one customer during the year. The Company does not believe it is dependent upon this customer for sales due to the nature of gas products and the associated market. The Company's sales in Kazakhstan commenced in December 2007 and the Company has not experienced any credit loss to date. At December 31, 2009 the trade receivable amounted to \$905,000, none of which was greater than 60 days overdue. The Company has therefore not recorded a provision against this amount as it does not consider the balance to be impaired.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

In Uzbekistan, the Company makes use of five customers. Full payment is required before delivery of the oil and therefore there is limited exposure to credit risk in this country.

Although a significant amount of the deposits at financial institutions are not covered by bank guarantees, the Company does not believe there to be a significant risk of credit loss as the counterparties are banks with high credit ratings (A- or equivalent) assigned by international ratings agencies (Fitch and Standard and Poors).

The Company is exposed to credit risk in relation to its loan receivable from a jointly controlled entity to the extent that the jointly controlled entity fails to meet its contractual obligations. The Company does not believe that the balance is impaired at the reporting date. The carrying amount of the loan receivable represents the maximum exposure to credit risk.

### *Liquidity risk*

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. This risk relates to the Company's ability to generate or obtain sufficient cash or cash equivalents to satisfy these financial obligations as they become due. Since inception, the Company has incurred significant consolidated losses from operations and negative cash flows from operating activities, and has an accumulated deficit at December 31, 2009.

The Company's processes for managing liquidity risk includes preparing and monitoring capital and operating budgets, co-ordinating and authorizing project expenditures and ensuring appropriate authorization of contractual agreements. The budget and expenditure levels are reviewed on a regular basis and updated when circumstances indicate change is appropriate. The Company seeks additional financing based on the results of these processes.

	Less than 1 year	1-3 years	4-5 years	Thereafter	Total
	\$	\$	\$	\$	\$
Trade and other payables	6,786	808	-	-	7,594
Financial liabilities - borrowings (note 17)	1,086	9,324	-	-	10,410
Commitments (note 25)	5,790	173	2,600	-	8,563
Share of purchase commitments related to joint venture (note 15)	2,137	-	-	-	2,137
Operating lease commitments (note 25)	415	363	-	-	778
Total expected cash outflow	16,214	10,668	2,600	-	29,482

The timing of cash outflows relating to financial liabilities and commitments at the reporting date are summarized below:

There can be no assurance that debt or equity financing will be available or sufficient to meet the Company's requirements or if debt or equity financing is available, that it will be on terms acceptable to the Company. The

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

inability of the Company to access sufficient capital for its operations could have a material adverse impact on the Company's financial condition, results of operations and prospects.

### *Market risk*

Market risk is the risk of loss that may arise from changes in market factors such as commodity prices, interest rate and foreign exchange rates.

### *Commodity price risk*

Commodity price risk arises from the effect that fluctuations of future commodity prices may have on the price received for sales of gas and refined oil products. The marketability and price of natural gas and oil that is produced and may be discovered by the Company will be affected by numerous factors that are beyond the control of the Company.

Natural gas prices are subject to wide fluctuations, the Company has entered into a fixed price contract for sales of gas from the Kyzylol field in Kazakhstan. However, any material decline in natural gas prices could result in a reduction of Tethys' future net production revenues and impact on the commercial viability of the Company's existing and future oil and gas discoveries. It may become uneconomic to produce from some wells as a result of lower prices, which could result in a reduction in volumes and the value of Tethys' gas reserves, if the Company elected not to produce from certain wells at lower prices.

Any material decline in refined oil product prices could result in a reduction of the Company's Uzbekistan net production revenue.

All of these factors could result in a material decrease in the Company's net production revenue causing a reduction in its acquisition and development activities.

The impact of changes in commodity price is assessed in note 4.

### *Interest rate risk*

Interest rate risk is the risk that the value of a financial instrument will be affected by changes in market interest rates. Existing long term debt is agreed at fixed interest rates and consequently has limited exposure to changes in market interest rates.

The Company is exposed to interest rate risk on short term deposits to the extent that the significant reductions in market interest rates would result in a decrease in the interest earned by the Company. A change of 1% in the interest rate would have had an immaterial change in the interest earned both in the current or prior year.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

As at the reporting date the Company's interest rate profile was:

	Fixed rate financial instruments	Floating rate financial instruments	Total
At December 31, 2009	\$	\$	\$
Cash and cash equivalents	-	7,297	7,297
Financial liabilities - borrowings	10,410	-	10,410
Interest rate swap	95	-	95
	<u>10,505</u>	<u>7,297</u>	<u>17,802</u>
	Fixed rate financial instruments	Floating rate financial instruments	Total
At December 31, 2008	\$	\$	\$
Cash and cash equivalents	1,832	20,368	22,200
Financial liabilities - borrowings	5,949	-	5,949
	<u>7,781</u>	<u>20,368</u>	<u>28,149</u>

### Foreign exchange risk

The Company is exposed to risks resulting from fluctuations in foreign currency exchange rates. A material change in the value of any such foreign currency could result in a material adverse effect on the Company's cash flow and future profits. The Company is exposed to exchange rate risk to the extent that balances and transactions denominated in a currency other than the US dollar. In addition, a significant portion of expenditures in Kazakhstan and Tajikistan are denominated in local currency, the Tenge and Somoni, respectively. The Company is not currently using exchange rate derivatives to manage exchange rate risks but is attempting to negotiate exchange rate stabilization conditions in new local Tenge denominated service and supply contracts in Kazakhstan.

The Company holds the majority of its cash and cash equivalents in US dollars. However, the Company does maintain deposits in other currencies, as disclosed in the following table, in order to fund ongoing general and administrative activity and other expenditure incurred in these currencies.

The carrying amounts of the Company's significant foreign currency denominated monetary assets and liabilities at the reporting dates are as follows:

In US\$ equivalent 2009	CAD	GBP	EUR	SOMONI	KZT
Cash and cash equivalents	52	132	83	11	187
Trade and other receivables	-	34	2	-	5,393
Trade and other payables	(35)	(318)	-	-	(561)
Financial liabilities - borrowings	-	(383)	-	-	-
<b>Net exposure</b>	<u>17</u>	<u>(535)</u>	<u>85</u>	<u>11</u>	<u>5,019</u>



# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

<b>In US\$ equivalent 2008</b>	<b>CAD</b>	<b>GBP</b>	<b>EUR</b>	<b>SOMONI</b>	<b>KZT</b>
Cash and cash equivalents	3,514	2,859	162	19	193
Trade and other receivables	-	-	-	-	5,967
Trade and other payables	(40)	(240)	(5)	-	(344)
Financial liabilities - borrowings	-	(365)	-	-	-
<b>Net exposure</b>	<b>3,474</b>	<b>2,254</b>	<b>157</b>	<b>19</b>	<b>5,816</b>

The following table details the Company's sensitivity to a 10% weakening in US dollars against the respective foreign currencies, which represents management's assessment of a reasonable change in foreign exchange rates.

	<b>CAD</b>	<b>GBP</b>	<b>EUR</b>	<b>SOMONI</b>	<b>KZT</b>
<b>2009 Effect in US\$'000</b>					
Profit or (loss) before tax	-	(20)	10	-	500
<b>2008 Effect in US\$'000</b>					
Profit or (loss) before tax	340	260	20	-	580

A 10% strengthening of the US dollar against the currencies above at December 31, 2009 would have had an equal but opposite effect on the amounts shown above, assuming all other variables remained constant.

### b) Capital risk management

The Company's capital structure is comprised of shareholders' equity and debt.

The Company's objectives when managing capital is to maintain adequate financial flexibility to preserve its ability to meet financial obligations, both current and long term. The capital structure of the Company is managed and adjusted to reflect changes in economic conditions.

The Company funds its expenditures on commitments from existing cash and cash equivalent balances, primarily received from issuances of shareholders equity and some debt financing. None of the outstanding debt is subject to externally imposed capital requirements.

Financing decisions are made by management and the Board of Directors based on forecasts of the expected timing and level of capital and operating expenditure required to meet the Company's commitments and development plans. Factors considered when determining whether to issue new debt or to seek equity financing include the amount of financing required, the availability of financial resources, the terms on which financing is available and consideration of the balance between shareholder value creation and prudent financial risk management.

Net debt is calculated as total borrowings (including 'current and non-current borrowings' as shown in the consolidated statement of financial position) less cash and cash equivalents. Total capital is calculated as 'equity' as shown in the consolidated statement of financial position plus net debt.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

At December 31	2009	2008
	\$	\$
Total financial liabilities - borrowings (Note 17)	10,410	5,949
Less: cash and cash equivalents	<u>(7,297)</u>	<u>(22,200)</u>
Net debt / (funds)	3,113	(16,251)
Total equity	<u>167,203</u>	<u>145,237</u>
<b>Total capital</b>	<u>170,316</u>	<u>128,986</u>

If the Company is in a net debt position, the Company will assess whether the projected cash flow is sufficient to service this debt and support ongoing operations. Consideration will be given to reducing the total debt or raising funds through an alternative route such as the issuing of equity.

The Company is not currently subject to any externally imposed capital restrictions.

### c) Fair value estimation

Effective January 1, 2009, the Company adopted the amendment to IFRS 7 for financial instruments that are measured in the reporting date at fair value, this requires disclosure of fair value measurements by level of the following fair value measurement hierarchy:

Level 1: Quoted prices (unadjusted) in active markets for identical assets and liabilities. The Company does not have any assets or liabilities that require Level 1 inputs.

Level 2: Inputs other than quoted prices included within Level 1 that are observable, either directly or indirectly. For the Company, Level 2 inputs include prices that can be corroborated with other observable inputs for substantially the complete term of the contract.

Level 3: Unobservable inputs. For the Company, Level 3 inputs include production and price assumptions that are not based on observable market data (unobservable inputs) or are reliant on adjustments or interpolations are made by management to an otherwise standard valuation model.

As at December 31, 2009 the Company's only financial liabilities measured at fair value on a recurring basis were the warrant liability and interest rate swap described in Note 17, the measurement inputs of which is designated as Level 2 and Level 3 respectively.

At December 31, 2009, the interest rate swap described in Note 17 is classified as Level 3 in the fair value hierarchy. The inputs required to measure the fair value of the interest rate swap include production and price assumptions that are reliant on adjustments or interpolation made by management to an otherwise standard valuation model. A reconciliation from the beginning balance to the ending balance of the interest rate swap has been included at Note 17.

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### **4 Critical judgements and accounting estimates**

The preparation of financial statements requires management to make certain judgements, accounting estimates and assumptions that affect the amounts reported for assets and liabilities as at the reporting date and the amounts reported for revenues and expenses during the year. The nature of estimation means that actual outcomes could differ from those estimates. Accordingly, the impact of these estimates, assumptions and judgments on the consolidated financial statements in future periods could be material. The key sources of estimation uncertainty that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities are discussed below.

#### **Going Concern**

The assessment of the Company's ability to execute its strategy by funding future working capital requirements involves judgement. The Directors monitor future cash requirements to assess the Company's ability to meet these future funding requirements. Further information regarding going concern is outlined in note 2.

#### **Recoverability of asset carrying values**

The Company assesses its property plant and equipment, including intangible exploration and evaluation assets, for possible impairment if there are events or changes in circumstances that indicate that carrying values of the assets may not be recoverable, or at least at every reporting date. Such indicators include changes in the Company's business plans, changes in commodity prices, evidence of physical damage and, for oil and gas properties, significant downward revisions of estimated recoverable volumes or increases in estimated future development expenditure.

If there are low oil prices or natural gas prices during an extended period the Company may need to recognize significant impairment charges. The assessment for impairment entails comparing the carrying value of the cash-generating unit with its recoverable amount, that is, value in use. Value in use is usually determined on the basis of discounted estimated future net cash flows. Determination as to whether and how much an asset is impaired involves management estimates on highly uncertain matters such as future commodity prices, the effects of inflation on operating expenses, discount rates, production profiles and the outlook for regional market supply-and-demand conditions for crude oil, natural gas and refined products.

At the reporting date, an impairment test was carried out on the Akkulka and Kyzylloi, gas fields in accordance with the accounting policy stated in note 2. The recoverable amounts of the fields have been determined based on value in use calculations. These calculations require the use of estimates. The present value of future cash flows was computed on an pre-tax basis by applying forecast prices of gas reserves to estimated future production of proved and probable gas reserves, less estimated future expenditures to be incurred in developing and producing the proved and probable reserves. The present value of estimated future net revenues is computed using a discount factor of 10%. The discount rate used is pre-tax and reflects the specific risks relating to the underlying cash generating unit.

The value in use calculation assumes natural gas sales prices in US\$/Mcf as follows:

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
	\$	\$	\$	\$	\$	\$	\$	\$	\$	\$	\$	\$	\$	\$
Natural gas														
US\$/Mcf														
Kyzyloi	0.90	0.90	0.90	4.41	4.91	5.37	5.62	5.84	6.04	6.25	6.45	6.63	6.81	7.0
Akkulka	0.90	3.38	3.90	4.41	4.91	5.37	5.62	5.84	6.04	6.25	6.45	6.63	-	-

The above price estimates are lower than those previously expected by the Company, which is a reflection of the current gas market uncertainty in Central Asia. As at the reporting date and at the date of approval of these consolidated financial statements, the gas price remains the subject of negotiations which have not been finalised. This is a source of measurement uncertainty in the Company's impairment test since there can be no assurance as to what price will be achieved.

The current price estimates for the Kyzyloi field results in an excess of recoverable amount over the carrying value of the Kyzyloi cash generating unit of \$13.3 million. The current price estimates for the Akkulka field results in excess of recoverable amount over the carrying value of the Akkulka cash generating unit of \$17.6 million.

If the forecast prices applied to the Kyzyloi impairment test were to reduce by US\$0.10 per Mcf below the assumed price of US\$4.41 (from 2013) per Mcf, the excess of recoverable amount over the carrying value of the Kyzyloi field would be reduced by approximately \$639,000 for each \$US 0.10 diminution of actual price realised.

If the forecast prices applied to the Akkulka impairment test were to reduce by US\$0.10 per Mcf below the assumed price of US\$3.38 per Mcf, the excess of recoverable amount over the carrying value of the Akkulka field would be reduced by approximately \$883,000 for each \$US 0.10 diminution of actual price realised.

### Oil and gas reserves

Proved and probable oil and gas reserves are used in the units of production calculation for depletion as well as the determination of the timing of well closure costs and impairment analysis. There are numerous uncertainties inherent in estimating oil and gas reserves. Assumptions that are valid at the time of estimation may change significantly when new information becomes available. Changes in the forecast prices of commodities, exchange rates, production costs or recovery rates may change the economic status of reserves and may ultimately result in the reserves being restated.

The Company makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. Such estimates and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

### Asset retirement obligation

Provisions for environmental clean-up and remediation costs associated with the Company's drilling operations are based on current legal and constructive requirements, technology, price levels and expected plans for

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

remediation. Actual costs and cash outflows can differ from estimates because of changes in laws and regulations, public expectations, prices, discovery and analysis of site conditions and changes in clean-up technology.

### **Income taxes**

The Company is subject to income taxes in numerous jurisdictions. Significant judgement is required in determining the worldwide provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain. The Company recognises liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the current and deferred income tax assets and liabilities in the period in which such determination is made.

### **Fair value of derivative and other financial instruments**

The fair value of financial instruments that are not traded in an active market is determined by using valuation techniques. The Company uses its judgement to select a variety of methods and make assumptions that are mainly based on market conditions existing at the end of each reporting period.

### **Other significant areas of judgement**

The estimates, assumption and judgments made in relation to the fair value of stock based compensation and warrants and the associated expense recognition is subject to measurement uncertainty. The estimated fair value of financial assets and liabilities, by their very nature, are subject to measurement uncertainty.

## **5 Segmental Reporting**

### **Geographical segments**

Management has determined the operating segments based on the reports reviewed by the executive directors that are used to make strategic decisions. Reports provided to the executive directors with respect to segment information are measured in a manner consistent with that of the financial statements. The assets and liabilities are allocated based on the operations of the segment and for assets, the physical location of the asset.

The executive directors consider the business from predominantly a geographic perspective and the Company currently operates in three geographical markets: Kazakhstan, Tajikistan and Uzbekistan.

In Kazakhstan, the Company is producing gas from the Kyzylloi field and is undertaking exploration and evaluation activity in the Akkulka and Kulbas fields. In Tajikistan, the Company is currently undertaking exploration and evaluation activity and in Uzbekistan, the Company operates under the North Urtabulak Production Enhancement Contract, which gives incremental production rights to increase the production volume of oil from wells on the North Urtabulak Oil Field.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The Company also operates a corporate segment which acquired a number of drilling rigs and related oil and gas equipment which will be utilised in Kazakhstan, Tajikistan, and Uzbekistan and possibly throughout the rest of Central Asia.

The segment results for the year ended December 31, 2009 are as follows:

	<b>Kazakhstan</b>	<b>Tajikistan</b>	<b>Uzbekistan</b>	<b>Other and Corporate</b>	<b>Consolidated</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Gas sales	3,828	-	-	-	3,828
Refined product sales	-	-	4,731	-	4,731
Other income	3,230	-	-	1,824	5,054
<b>Segment revenue</b>	<b>7,058</b>	<b>-</b>	<b>4,731</b>	<b>1,824</b>	<b>13,613</b>
Inter-segment revenue	(3,230)	-	-	(1,824)	(5,054)
<b>Revenue from external customers</b>	<b>3,828</b>	<b>-</b>	<b>4,731</b>	<b>-</b>	<b>8,559</b>
Loss from jointly controlled entity	-	(1,000)	-	-	(1,000)
<b>(Loss)/ profit before taxation</b>	<b>(5,165)</b>	<b>(3,040)</b>	<b>478</b>	<b>(13,779)</b>	<b>(21,506)</b>
Taxation	(64)	-	(145)	(5)	(214)
<b>Net (loss)/profit attributable to shareholders</b>	<b>(5,229)</b>	<b>(3,040)</b>	<b>333</b>	<b>(13,784)</b>	<b>(21,720)</b>

Sales in the Kazakhstan segment were made to a single customer. Sales in the Uzbekistan segment were to five customers. Sales to three of those customers representing greater than 10% of total segment revenue were \$2,600,000, \$763,000 and \$712,000.

Borrowing costs of \$2,100,503 were incurred during the year. These borrowing costs were capitalised in the Tajikistan segment (\$1,387,702), Kazakhstan segment(\$356,173) and Uzbekistan segment (\$154,270). The remaining \$202,358 was expensed through the statement of comprehensive loss.

Amortisation of \$1,106,830 of assets held in the Corporate segment were capitalised in Kazakhstan: \$460,451 and Tajikistan: \$646,379.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

Segment results for the year ended December 31, 2008 are as follows:

	<b>Kazakhstan</b>	<b>Tajikistan</b>	<b>Uzbekistan</b>	<b>Other and Corporate</b>	<b>Consolidated</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Gas sales	5,360	-	-	-	5,360
Refined product sales	-	-	-	-	-
Other income	4,210	-	-	2,115	6,325
<b>Segment revenue</b>	<b>9,570</b>	<b>-</b>	<b>-</b>	<b>2,115</b>	<b>11,685</b>
Inter-segment revenue	(4,210)	-	-	(2,115)	(6,325)
<b>Revenue from external customers</b>	<b>5,360</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>5,360</b>
<b>Loss before taxation</b>	<b>(9,450)</b>	<b>(629)</b>		<b>(12,105)</b>	<b>(22,184)</b>
Taxation	-	-	-	-	-
<b>Net loss attributable to shareholders</b>	<b>(9,450)</b>	<b>(629)</b>	<b>-</b>	<b>(12,105)</b>	<b>(22,184)</b>

Sales in the Kazakhstan segment were made to a single customer.

No borrowing costs incurred on loans within the Corporate segment were capitalised between segments.

No amortisation of assets held in the Corporate segment were capitalised between segments.

The segment assets and liabilities as at December 31, 2009 and capital expenditures for the year then ended are as follows:

	<b>Kazakhstan</b>	<b>Tajikistan</b>	<b>Uzbekistan</b>	<b>Other and Corporate</b>	<b>Consolidated</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Total assets	72,152	21,984	11,015	31,931	137,082
Total liabilities	1,914	3,759	6,992	17,813	30,478
Cash expenditure on exploration & evaluation assets, property, plant and equipment	8,553	16,942	3,709	3,017	32,221
Depreciation, depletion & amortization	2,497	138	603	-	3,238

Total assets for Tajikistan include the Company's investment in the joint venture (note 15).

Included in Kazakhstan liabilities are payables in relation to exploration and evaluation assets of \$411,202.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The segment assets and liabilities at December 31, 2008 and capital expenditures for the year ended December 31, 2008 are as follows:

	<b>Kazakhstan</b>	<b>Tajikistan</b>	<b>Uzbekistan</b>	<b>Other and Corporate</b>	<b>Consolidated</b>
	\$	\$	\$	\$	\$
Total assets	68,240	2,801	-	42,507	113,548
Total liabilities	1,844	154	-	7,820	9,818
Cash expenditure on exploration & evaluation assets, property, plant and equipment	21,604	2,633	-	18,570	42,807
Depreciation, depletion & amortization	4,182	51	-	100	4,333

Included in Kazakhstan liabilities are payables in relation to exploration and evaluation assets of \$33,618.

The segment assets and liabilities at January 1, 2008 are as follows:

	<b>Kazakhstan</b>	<b>Tajikistan</b>	<b>Uzbekistan</b>	<b>Other and Corporate</b>	<b>Consolidated</b>
	\$	\$	\$	\$	\$
Total assets	50,737	207	-	28,902	79,846
Total liabilities	2,321	-	-	1,784	4,105

The segment assets attributable to the Kazakhstan segment consist mainly of capital additions related to the Kyzylai and Akkulka fields, including the installation of pipelines linking these fields to the Bhukara-Urals trunk line, as well as the costs of exploration pending determination of the Kul-Bas field.

The segment assets attributable to the Tajikistan segment consist of the costs of exploration pending determination of the Tajikistan production sharing contract.

The segment assets attributable to the Uzbekistan segment consist mainly of well costs related to the North Urtabulak field. These other intangible assets have been recognized at provisional fair value as described in note 21.

The other and corporate segment assets consist mainly of oil and gas equipment such as drilling rigs and related equipment and cash and cash equivalents. The other and corporate segment liabilities consist mainly of the loans obtained to finance the purchase of two drilling rigs, more fully disclosed in note 17.



# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 6 Revenue

	Year ended	
	December 31, 2009	December 31, 2008
	\$	\$
Gas sales	3,828	5,360
Refined product sales	4,731	-
	<u>8,559</u>	<u>5,360</u>

Revenue has been grossed up for non-monetary transactions, namely marketing commission of \$141,426 (2008: nil) and utility services of \$752,807 provided with respect to Uzbekistan (2008: nil). The corresponding expenses are shown within administrative and production expenses respectively.

### 7 Administrative expenses

Administrative expenses by nature	Year ended	
	December 31, 2009	December 31, 2008
	\$	\$
Staff expenses	5,469	4,517
Share-based payments	2,628	4,419
Travel expenses	2,590	3,099
Professional fees	1,909	1,695
Office costs	1,835	2,311
Other administrative expenses	2,449	1,874
	<u>16,880</u>	<u>17,915</u>

Key management personnel have been identified as the board of directors and eight senior managers. Details of key management remuneration are shown in note 23.

### 8 Share-based payments

The Company has adopted a stock incentive plan referred to as the “2007 Long Term Stock Incentive Plan” pursuant to which the Company may grant stock options to any director, employee or consultant of the Company, or any subsidiary or Vazon Energy Limited (collectively, “Service Providers”).

The maximum number of Ordinary Shares reserved for issuance under the plan equals 12% (2008 – a specific number of shares: 7,511,670) of the outstanding Ordinary Shares. The plan is administered by the Compensation and Nomination Committee of the Board of Directors. Options may be granted pursuant to recommendations of the Compensation and Nomination Committee. The Compensation and Nomination Committee may determine the vesting schedule and term, provided that options may not have a term exceeding ten years. Subject to any resolution passed by the Compensation and Nomination Committee, options will terminate three months after an option holder ceases to be a Service Provider.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The exercise price of options granted under the plan may not be less than the closing price of Ordinary Shares on the principal stock exchange where the Ordinary Shares are listed as of the date of the option grant. The plan contains amendment provisions which allow amendments to the plan by the Board of Directors, without shareholder approval, for amendments of a “housekeeping” nature, changes to vesting or termination provisions, and discontinuance of the plan. The plan also provides that outstanding options will vest immediately on the occurrence of a “change of control” (as defined in the plan). Options granted under the plan are only assignable to certain related entities of an option holder or otherwise with the consent of the Company.

Under the plan, the options vest in three tranches with one third vesting immediately, one third after one year and one third after two years. These options are equity settled share based payment transactions.

### *Stock options*

The following table summarizes the stock option activity under the 2007 Long Term Stock Incentive Plan.

	<b>Number of options</b>	<b>Weighted average exercise price \$</b>
Outstanding at January 1, 2008	4,497,000	2.76
Granted	2,274,000	2.51
Forfeited	(96,000)	2.75
Exercised	-	n/a
Expired	-	n/a
	<hr/>	
Outstanding at December 31, 2008	6,675,000	2.67
	<hr/>	
Exercisable at December 31, 2008	3,692,000	2.71
	<hr/>	
Outstanding at January 1, 2009	6,675,000	2.67
Granted	5,808,000	0.71
Forfeited	(281,000)	0.94
Exercised	-	n/a
Expired	(496,000)	2.43
	<hr/>	
Outstanding at December 31, 2009	11,706,000	1.75
	<hr/>	
Exercisable at December 31, 2009	7,325,666	2.20
	<hr/>	

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The following table lists the options outstanding at December 31, 2009 by exercise price.

Exercise price \$	Options outstanding	Weighted average remaining term (in years)	Options exercisable	Weighted average remaining term (in years)
0.60	5,056,000	4.72	1,685,333	4.68
0.88	120,000	4.84	40,000	4.84
2.50	2,330,000	5.58	1,443,333	5.53
2.75	4,182,000	4.53	4,139,000	4.52
3.18	18,000	4.93	18,000	4.93
Total	11,706,000	4.81	7,325,666	4.76

The fair value of the liability is estimated using the Black-Scholes pricing model using the following average assumptions:

	December 31, 2009	December 31, 2008
Weighted average fair value	\$0.2841	\$1.5493
Risk free rate	1.74%	3.32%
Expected term	3 years	4 years
Volatility	97.9%	73.5%
Dividend	Nil	Nil
Weighted average share price	\$0.51	\$2.66

In estimating expected volatility, the Company considers the historical volatility of the share price of similar entities over the most recent period that is commensurate with the expected option term.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### Warrants

The following table summarizes the warrant activity for the year ended December 31, 2009.

	<b>Number of warrants</b>	<b>Weighted average exercise price \$</b>
Outstanding at January 1, 2008	10,203,658	4.73
Granted	1,433,298	2.33
Forfeited	-	n/a
Exercised	-	n/a
Expired	-	n/a
	<hr/>	
Outstanding at December 31, 2008	11,636,956	4.43
	<hr/>	
Exercisable at December 31, 2008	11,636,956	4.43
	<hr/> <hr/>	
Outstanding at January 1, 2009	11,636,956	4.44
Granted	2,500,000	0.60
Forfeited	-	n/a
Exercised	-	n/a
Expired	(1,353,501)	4.13
	<hr/>	
Outstanding at December 31, 2009	12,783,455	3.73
	<hr/>	
Exercisable at December 31, 2009	12,783,455	3.73
	<hr/> <hr/>	

During the year ended December 31, 2009, there were 2,500,000 (2008 – 1,433,298) warrants issued in connection with loan financing (note 17.2).

Of the warrants outstanding at the beginning of the year, 8,857,504 relate to warrants granted to the Company's executive officers. 7,504,003 of these warrants remain outstanding and exercisable at December 31, 2009.

There are no performance conditions attached to the warrants and all the granted warrants were immediately vested. Warrants are equity settled share based payment transactions.

In estimating expected volatility, the Company considers the historical volatility of the share price of similar entities over the most recent period that is commensurate with the expected warrant term.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The following table lists the warrants outstanding at December 31, 2009 by exercise price.

Exercise price \$	Warrants outstanding	Weighted average remaining term (in years)	Warrants exercisable	Weighted average remaining term (in years)
1.25	638,298	1.94	638,298	1.94
2.50	3,436,154	8.82	3,436,154	8.82
3.25	795,000	1.20	795,000	1.20
5.50	2,255,835	1.49	2,255,835	1.49
6.88	3,158,168	2.99	3,158,168	2.99
0.60	2,500,000	0.96	2,500,000	0.96
Total	<u>12,783,455</u>	<u>3.73</u>	<u>12,783,455</u>	<u>3.73</u>

As at December 31, 2009, there was no unrecognized compensation expense related to unvested warrants.

## 9 Taxation

Tethys is domiciled in the Cayman Islands which has no Company income tax.

At December 31, 2009, in Kazakhstan the Company had \$10.3 million (2008 \$4.1 million) and in Uzbekistan \$2.0 million (2008 \$2.2 million) of tax carry – forward losses, that would be available to offset against any future taxable profit. No deferred tax asset has been recognised in respect of \$10.3 million of losses in Kazakhstan (2008 - \$4.1 million). In 2009 the Company has not been able to utilise any of the losses in Kazakhstan, previously unrecognised, through the statement of comprehensive loss. Of the \$10.3 million losses in Kazakhstan with no deferred tax asset, substantially all expire in various amounts from 2012 to 2016. Uzbekistan tax carry - forward losses of \$2.0 million have no fixed expiry date.

The temporary differences comprising the net deferred income tax liability as at December 31, 2009 are as follows:

	<b>December 31, 2009</b>
Capital assets	\$ (1,078)
Tax losses	325
Other	155
Net deferred tax liability	<u>(598)</u>

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The provision for income taxes is different from the expected provision for income taxes for the following reasons:

	\$
Loss before income taxes	(21,506)
Income tax rate	20%
Expected income tax expense (recovery)	<u>(4,301)</u>
<i>Increase (decrease) resulting from:</i>	
Non-deductible expenses	535
Impact of effective tax rates in other foreign jurisdictions	2,616
Rate reduction on future income taxes	139
Losses and tax assets not utilised/recognised	1,155
Other	70
	<u>214</u>
Current income tax expense (recovery)	-
Deferred tax expense (recovery)	<u>214</u>
	<u>214</u>

## 10 Loss per share

### Basic and diluted loss per share

	Loss for the year \$	Weighted average number of shares (thousands)	Per share amount \$
<b>Year ended December 31, 2009</b>			
Loss attributable to ordinary shareholders – Basic and diluted	<u>(21,720)</u>	106,450	<u>(0.20)</u>
<b>Year ended December 31, 2008</b>			
Loss attributable to ordinary shareholders – Basic and diluted	<u>(22,184)</u>	55,988	<u>(0.40)</u>

Basic loss per share is calculated by dividing the loss attributable to shareholders of the Company by the weighted average number of ordinary shares in issue during the year. Diluted per share information is calculated by adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares. Potential ordinary shares including share options and warrants, are considered to be anti-dilutive and have therefore been excluded from the diluted per share calculation.

Subsequent to the year end, the Company issued further shares as disclosed in note 22.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 11 Intangible assets

	Other intangible asset \$	Exploration and evaluation assets \$	Total \$
<b>At January 1, 2008</b>			
Cost	-	7,335	7,335
Accumulated amortisation and impairment	-	-	-
<b>Net book amount</b>	<b>-</b>	<b>7,335</b>	<b>7,335</b>
<b>Year ended December 31, 2008</b>			
Opening net book amount	-	7,335	7,335
Additions	-	10,622	10,622
Amounts written off to exploration and evaluation costs	-	(1,852)	(1,852)
Amortisation charge	-	-	-
<b>Closing net book amount</b>	<b>-</b>	<b>16,105</b>	<b>16,105</b>
<b>At December 31, 2008</b>			
Cost	-	16,105	16,105
Accumulated amortisation and impairment	-	-	-
<b>Net book amount</b>	<b>-</b>	<b>16,105</b>	<b>16,105</b>
<b>Year ended December 31, 2009</b>			
Opening net book amount	-	16,105	16,105
Additions through acquisition of subsidiary	5,553	-	5,553
Additions	-	23,289	23,289
Disposal of subsidiaries at book amount	-	(19,176)	(19,176)
Amounts written off to exploration and evaluation costs	-	(887)	(887)
Amortisation charge	(506)	-	(506)
<b>Closing net book amount</b>	<b>5,047</b>	<b>19,331</b>	<b>24,378</b>
<b>At December 31, 2009</b>			
Cost	5,553	19,331	24,884
Accumulated amortisation and impairment	(506)	-	(506)
<b>Net book amount</b>	<b>5,047</b>	<b>19,331</b>	<b>24,378</b>
Asset retirement obligation asset at net book amount included in above			
At December 31, 2009	-	47	47
At December 31, 2008	-	126	126
At January 1, 2008	-	-	-

Borrowing costs of \$1,387,000 (2008 – nil) have been capitalised within exploration and evaluation assets during the year. The effective weighted average interest rate of the relevant borrowings was 22% (2008 – nil). The

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

effective interest rate is higher than the nominal rate due to the cost of associated warrants (Note 17.2) and royalties (Note 17.3). For the year ended December 31, 2009 \$779,389 (2008 - \$371,716) was capitalised from administrative expenses.

### 12 Property, plant and equipment

	Oil and gas properties \$	Oil and gas equipment \$	Vehicles \$	Office and computer equipment \$	Total \$
<b>At January 1, 2008</b>					
Cost	35,499	2,057	579	386	38,521
Accumulated depreciation	(143)	-	(19)	(32)	(194)
<b>Net book amount</b>	<b>35,356</b>	<b>2,057</b>	<b>560</b>	<b>354</b>	<b>38,327</b>
<b>Year ended December 31, 2008</b>					
Opening net book amount	35,356	2,057	560	354	38,327
Additions	12,495	17,983	809	581	31,868
Deletions	(440)	-	-	-	(440)
Depreciation charge	(3,969)	(72)	(168)	(124)	(4,333)
<b>Closing net book amount</b>	<b>43,442</b>	<b>19,968</b>	<b>1,201</b>	<b>811</b>	<b>65,422</b>
<b>At December 31, 2008</b>					
Cost	47,554	20,040	1,388	967	69,949
Accumulated depreciation	(4,112)	(72)	(187)	(156)	(4,527)
<b>Net book amount</b>	<b>43,442</b>	<b>19,968</b>	<b>1,201</b>	<b>811</b>	<b>65,422</b>
<b>Year ended December 31, 2009</b>					
Opening net book amount	43,442	19,968	1,201	811	65,422
Additions	6,908	4,853	98	155	12,014
Additions through acquisition of subsidiary	-	-	-	117	117
Disposal of subsidiaries at book amount	-	-	(162)	(140)	(302)
Depreciation charge	(2,823)	(1,033)	(117)	(107)	(4,080)
<b>Closing net book amount</b>	<b>47,527</b>	<b>23,788</b>	<b>1,020</b>	<b>836</b>	<b>73,171</b>
<b>At December 31, 2009</b>					
Cost	54,462	24,893	1,324	1,099	81,778
Accumulated depreciation	(6,935)	(1,105)	(304)	(263)	(8,607)
<b>Net book amount</b>	<b>47,527</b>	<b>23,788</b>	<b>1,020</b>	<b>836</b>	<b>73,171</b>



# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

	<b>Oil and gas properties</b> \$	<b>Oil and gas equipment</b> \$	<b>Vehicles</b> \$	<b>Office and computer equipment</b> \$	<b>Total</b> \$
Asset retirement obligation at net book amount included in above:					
At December 31, 2009	18	-	-	-	18
At December 31, 2008	175	-	-	-	175
At January 1, 2008	918	-	-	-	918

	<b>Oil and gas properties</b> \$	<b>Oil and gas equipment</b> \$	<b>Vehicles</b> \$	<b>Office and computer equipment</b> \$	<b>Total</b> \$
Asset under construction at net book amount included in above					
<b>At December 31, 2009</b>	25,858	-	-	-	25,858
At December 31, 2008	23,251	3,210	-	-	26,461
At January 1, 2008	17,105	1,879	-	-	18,984

Assets under construction as at December 31, 2009 and December 31, 2008 includes the cost of developing the Akkulka concession and tie-in pipeline and are not being depreciated until commencement of production.

Borrowing costs of \$513,000 have been capitalised to oil and gas properties in the current year (2008 - \$712,000). The effective weighted average interest rate of the relevant borrowing was 19.58%, (2008 22.7 %). The effective interest rate is higher than the nominal rate due to the cost of associated warrants (note 17.2). For the year ended December 31, 2009 \$438,584 (2008 - \$41,239) was capitalised from administrative expenses.

### 13 Investments

	<b>December 31, 2009</b> \$	<b>December 31, 2008</b> \$	<b>January 1, 2008</b> \$
Restricted cash	659	587	318

Restricted cash at December 31, 2009, December 31, 2008, and January 1, 2008 consisted of interest bearing bank deposits held in Kazakhstan. These deposits have been placed to satisfy local Kazakhstan requirements in respect of asset retirement obligations.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 14 Trade and other receivables

	December 31, 2009 \$	December 31, 2008 \$	January 1, 2008 \$
<b>Current</b>			
Trade receivables	905	1,124	219
Prepayments	502	900	351
Other receivables	904	640	790
	2,311	2,664	1,360
<b>Non-current</b>			
Advances to construction contractors	333	1,514	3,062
Hong Kong Stock Exchange (HKSE) deferred offering costs	352	-	-
Value added tax receivable	4,486	4,843	2,752
	5,171	6,357	5,814
	7,482	9,021	7,174

Current trade and other receivables are unsecured and non-interest bearing. Normal payment terms for the Company are 30 days. Prepayments primarily relate to prepaid insurance and other corporate operating expense items.

Trade receivables of \$905,000 (December 31, 2008 – \$1,124,000) are more than thirty days past due but are not considered impaired. The other classes within trade and other receivables do not contain impaired assets.

Non-current advances to construction contractors relate to suppliers who were paid in advance for materials and services relating to both the Akkulka and the Kul-Bas contracts. For the Akkulka contract, the prepayments relate to the drilling of a new well and payments on compressors, pipes and associated construction work that will constitute phase two of the Company's gas production plan. For Kul-Bas the prepayment related primarily to the drilling of a new well.

### 15 Investment in Joint Venture

The Company has a 51% interest in a jointly controlled entity, Seven Stars Energy Corporation Limited (SSEC). On December 30, 2009 the Company transferred ownership of its three Tajik subsidiaries to SSEC. At December 31, 2009 the Company's investment in the joint venture was \$nil.

The consideration received by Tethys' from SSEC was a note receivable in the amount of \$21,727,000, which represents Tethys' book value of assets transferred plus an amount for certain costs previously expensed by Tethys' which are recoverable from SSEC.

This transaction resulted in a gain of \$4,699,000, which has been deferred on the statement of financial position. This amount has been recorded as a reduction of the investment account in the amount of \$1,040,000 (which has reduced the investment account to \$nil as at December 31, 2009), with the remaining balance of

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

\$3,659,000 being recorded as a deferred gain. The deferred gain will be recognised in the income when realised.

The following amounts represent the movements in the investment account during the year:

	<b>December 31, 2009</b>
	\$
Balance, beginning of year	-
Contributions	2,040
Share of losses from jointly controlled entity	(1,000)
Deferred gain on assets sold to jointly controlled entity	(1,040)
Balance, end of year	<u>-</u>

The following tables represent the assets and liabilities of the jointly controlled entity at the year end and its results for the year to December 31, 2009.

	<b>December 31, 2009</b>
	\$
<b>Assets</b>	
Non-current assets	24,173
Current assets	<u>113</u>
Total assets	<u>24,286</u>
<b>Liabilities</b>	
Non-current liabilities	(21,727)
Accruals	<u>(519)</u>
Total liabilities	<u>(22,246)</u>
<b>Net assets</b>	<u>2,040</u>

	<b>December 31, 2009</b>
	\$
Revenue	-
Expenses	(1,960)
Loss before tax	<u>(1,960)</u>
51% share of joint venture loss before tax	<u>(1,000)</u>

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### Commitments

On June 13, 2008, the Company's wholly owned subsidiary, Kulob Petroleum Limited ("KPL"), signed a Production Sharing Contract ("PSC") with the Government of the Republic of Tajikistan. Under the PSC, KPL will recover 100% of its costs from up to 70% of total production (the maximum allowed under the newly approved production sharing legislation of Tajikistan) and the remaining production (termed "Profit Oil and Gas") will be shared 70% to KPL and 30% to the Government whose share includes all taxes, levies and duties. The terms are fixed over the life of the PSC which is a minimum of 25 years.

Pursuant to the PSC, Tethys has committed to funding a work program designed to provide data for a focused exploration of the Contract Area and which will be carried out in two stages (the "Work Program"). The first phase of the Work Program will include geological studies, reprocessing of existing seismic and other geophysical data, acquisition of seismic and other geophysical data and the commencement of initial rehabilitation activities on the Beshtentak and Khoja Sartezi fields. The minimum spend commitment under Phase 1 of the contract is US\$3,000,000. This expenditure was required to be met within 18 months of the effective date of the contract, which is December 13, 2009. This commitment was satisfied through the payment on January 2, 2009 of \$4,925,000 for a contract agreed on November 14, 2008 relating to a seismic survey work program.

The total cost of the seismic work program agreement is \$9,850,600, which can be unilaterally terminated at any point by the Company with immediate repayment of amounts remitted in advance of the fulfilled scope of works at the moment of termination, provided the Contractor has reached Stage One Completion. By December 31, 2009, a total of \$5,659,652 had been advanced (including the \$4,925,000 above). Phase 2 of the seismic survey commenced in October 2009.

The Company's share of Phase 2 commitment is \$2,137,383.

### 16 Cash and cash equivalents

	December 31, 2009 \$	December 31, 2008 \$	January 1, 2008 \$
Cash at bank and in hand	6,788	19,868	983
Short-term deposits	509	2,332	25,709
	<u>7,297</u>	<u>22,200</u>	<u>26,692</u>

Cash at banks earn interest at floating rates based on daily bank deposit rates. Short term deposits are made for varying periods of between one day and three months, depending on the cash requirements of the Company, and earn interest at the respective short term deposit rates.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 17 Financial liabilities

#### 17.1 Borrowings

	Effective interest rate %	Maturity date	December 31, 2009 \$	December 31, 2008 \$	January 1, 2008 \$
<b>Current</b>					
Short-term portion of long-term loans	19 – 23 p.a.	2010	1,086	853	-
<b>Non-current</b>					
Long-term loans	19 – 23 p.a.	2011 2012	8,199 1,125	5,096 -	- -
			<u>10,410</u>	<u>5,949</u>	<u>-</u>

Financial borrowings relate to financing arrangements that were put in place to fund the acquisition of the Telesto deep drilling rig (Telesto) and the Tykhe drilling rig (Tykhe) in 2008 and the drilling of a new well in Uzbekistan in 2009.

Principal repayments for the loans are as follows:

		Drilling rig loans \$	Uzbekistan loans \$	Total \$
To December 31,	2010	1,464	-	1,464
	2011	4,577	4,100	8,677
	2012	-	1,136	1,136
Remaining principal payments		<u>6,041</u>	<u>5,236</u>	<u>11,277</u>
Less: unamortised debt discount		<u>(503)</u>	<u>(364)</u>	<u>(867)</u>
Balance, end of year		<u>5,538</u>	<u>4,872</u>	<u>10,410</u>
	Current	1,086	-	1,086
	Non-current	<u>4,452</u>	<u>4,872</u>	<u>9,324</u>

The loan to fund Telesto bears interest at a nominal rate of 12%. In addition 795,000 warrants to purchase Tethys shares at CAD\$3.25 with a term of three years were issued to lenders. The fair value associated with the warrants issued has been recognised as a debt discount and presented as a direct reduction to the face value of the long-term debt, with the effective interest rate method being used to amortise the discount over the life of the loan. Lenders have security over the shares of Tethys Petroleum Inc. which has no other assets except the drilling rig. No corporate guarantees or security are being provided by Tethys.

The loan to fund Tykhe bears interest at a nominal rate of 15%. In addition 638,298 warrants to purchase Tethys shares at CAD\$1.25 with a term of three years were issued to lenders. The fair value associated with

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

the warrants issued has been recognised as a debt discount and presented as a direct reduction to the face value of the long-term debt, with the effective interest rate method being used to amortise the discount over the life of the loan. Lenders have security over the shares of AOE Tykhe BV which has no other assets except the drilling rig and in addition a corporate guarantee is being provided by Tethys.

During the year the Company obtained a short term loan of \$2,500,000 which was fully repaid by June 30, 2009. In connection with the loan financing, 2,500,000 warrants to purchase Tethys shares at CAD\$0.60 with a term of 18 months were issued to lenders. The loan was initially measured at fair value and subsequently measured at amortized cost using the effective interest rate method. The fair value of \$421,370 associated with the warrants issued has been fully amortised with the effective interest rate method during the year (note 17.2).

Based on the borrowing rates currently available to the Company for long term borrowings with similar terms and average maturities (22%), the fair value of the non-current financial borrowings in relation to the drilling rigs and new well in Uzbekistan approximates its carrying value.

On October 19, 2009 Tethys closed a loan financing for \$4.1 million with a group of investors in connection with the drilling of a new well in Uzbekistan. A coupon of 10% per annum is due for the first two months, which is the expected drilling time of the well. Thereupon the lenders will receive 6% per annum coupon and 6.25% of the revenue received by BHCL from sales of the net production from the new well for every \$1.0 million invested, calculated monthly and payable quarterly in arrears over a period of up to 24 months. If the well does not produce the investor will receive only the 6% per annum coupon on the funds invested.

On December 14, 2009 in connection with the drilling of the above new well in Uzbekistan the Company further approved the issue of loan notes to a maximum value of \$3,000,000 at an issue rate of \$0.88 per note and redemption value of \$1, resulting in an effective rate of 6.5%. By December 31, 2009, \$1,000,000 loan notes had been placed. A royalty of 11.25% is payable to the loan note holders calculated on sales of net production from the new well. The royalty entitlement was identified as an embedded derivative and required to be separated from the loan note. The royalty entitlement has been accounted for as a derivative financial instrument – interest rate swap. Refer to note 17.

Issue of the loan notes was completed via a broker to whom a royalty commission is payable at 4.5% for every \$1.0 million placed. The fair value of the commission payable at December 31, 2009 was \$42,333. The Company measured the fair value of the commission payables by applying a valuation technique based on the discounted estimated future net cash flows expected to be derived from the royalty entitlement. A discounted cash flow (DCF) method requires management to estimate future cash flows associated with the instrument and then discount those amounts to present value at a rate of return that considers the relative risk of the cash flows (5%). The fair value associated with the royalty entitlement has been recognised as a transaction cost and presented as a direct reduction to the face value of the borrowing with the effective interest rate method being used to amortise the cost over the life of the loan. The commission liability has been included in current trade and other payables.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 17.2 Derivative financial instrument - warrants

	December 31, 2009	December 31, 2008	January 1, 2008
	\$	\$	\$
Balance, beginning of year	146	-	-
Issued during the year	422	1,163	-
Fair value loss / (gain)	485	(929)	-
Adjustment	-	(88)	-
Balance, end of year	<u>1,053</u>	<u>146</u>	<u>-</u>

The warrant liability represents the financial liability relating to share warrants that are denominated in a currency that is not the Company's functional currency. These warrants were issued in connection with the two rig loans described in note 17.1.

The liability was initially recognised at fair value. As the warrants are denominated in foreign currency, there is a written option for the holder to exchange the foreign currency denominated warrant for a fixed number of functional currency denominated shares. This option is a derivative financial instrument and was initially recognised at fair value and subsequently measured at fair value through income.

The fair value of the liability is estimated using the Black-Scholes pricing model using the following average assumptions:

	December 31, 2009	December 31, 2008
Weighted average fair value	\$0.29	\$0.15
Exercise price	\$1.24	\$3.25
Risk free rate	1.46%	2.41%
Expected term	1.18 years	2.56 years
Volatility	87%	85%
Dividend	Nil	Nil

### 17.3 Derivative financial instruments - interest rate swap

The interest rate swap represents the derivative financial instrument entered into in connection with the Uzbekistan loan financing disclosed in note 17.1 completed in the year. This instrument is a derivative financial instrument and was initially recognised at fair value and subsequently measured at fair value through income. The Company measured the fair value of the liability by applying a valuation technique based on the discounted estimated future net cash flows expected to be derived from the instrument. A discounted cash flow (DCF) method requires management to estimate future cash flows associated with the instrument and then discount those amounts to present value at a rate of return that considers the relative risk of the cash flows (5%).

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

	December 31, 2009	December 31, 2008
	\$	\$
Balance, beginning of year	-	-
Derivative financial instrument	101	-
Gain recognised in the statement of comprehensive loss	(6)	-
Balance, end of year	95	-

### 18 Trade and other payables

	December 31, 2009	December 31, 2008	January 1, 2008
	\$	\$	\$
<b>Current</b>			
Trade payables	4,236	1,117	1,183
Accruals	1,997	414	643
Payables to related parties	35	489	453
Other creditors	518	715	-
	<u>6,786</u>	<u>2,735</u>	<u>2,279</u>
<b>Non-current</b>			
Other non-current payables	<u>808</u>	<u>523</u>	<u>776</u>

Trade payables are non-interest bearing and are normally settled on 30 day terms. Accruals represent mainly fees outstanding to the drilling contractor in Uzbekistan, drilling related fees in Tajikistan and professional fees. Other current creditors consist mainly of local taxes in the Republic of Kazakhstan and the current portion of the Kyzylloi historical costs. All current trade and other payables are interest free and payable within 12 months.

Included within other non-current payables are accruals for historical costs due to the Government of Kazakhstan on the Kyzylloi and Akkulka contracts in Kazakhstan.

#### Kyzylloi

The principal amount outstanding at December 31, 2009 was \$735,053 (2008 – \$908,098) and this is to be repaid in quarterly instalments by March 2014. The liability is non-interest bearing. The liability is measured at amortised cost using the effective interest rate method. The net present value of liability using an assumed rate of interest of 10% (2008 – 10%) is \$510,455 (2008 – \$680,000) of which \$101,955 (2008 – \$157,000) is current, leaving a non-current balance of \$408,500 (2008 – \$523,000). The fair value of the liability approximates its carrying value, (2008 - \$508,441).

#### Akkulka

Upon signature of the Akkulka gas production contract on December 23, 2009, the historical cost liability in relation to this field became due. The principal amount outstanding at December 31, 2009 was \$933,997 and this is to be repaid in quarterly instalments by June 2018. The liability is non-interest bearing. The liability is measured at amortised cost using the effective interest rate method. The net present value of liability using an



# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

assumed rate of interest of 22% is \$414,437 of which \$19,581 is current, leaving a non-current balance of \$394,856.

Based on the borrowing rates currently available to the Company for loans with similar terms and average maturities, the fair value of the non-current liability relating to historic costs approximates its carrying value.

Principal repayments for both contracts are as follows:

		\$
To December 31,	2010	283
	2011	283
	2012	283
	2013	283
	2014	283
	2015 and thereafter	260
Remaining principal payments		1,675
Less: unamortised debt discount		(745)
Balance, end of year		930
	Current	122
	Non-current	808
		930

### 19 Asset retirement obligations

	<b>Year ended</b>
	<b>December 31, 2009</b>
	\$
At January 1, 2009	465
Additional obligations incurred	77
Change in estimated cash flow	(358)
Unwinding of discount due to passage of time	22
<b>At December 31, 2009</b>	<b>206</b>

The Company makes provision for the future cost of decommissioning oil and gas production facilities and pipelines on a discounted basis. These costs are expected to be incurred between 2012 and 2022. The provision has been estimated using existing technology at current prices, escalated at 10% (2008 – 10%) and discounted at 11% (2008 – 11%). The economic life and the timing of the asset retirement obligation are dependent on Government legislation, commodity price and the future production profiles of the project. In addition, the estimated cash outflows are subject to inflationary and/or deflationary pressures in the cost of third party service provision.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 20 Share capital

	<b>December 31, 2009 Number</b>	<b>December 31, 2008 Number</b>	<b>January 1, 2008 Number</b>
<b>Authorized</b>			
Ordinary shares with a par value of \$0.10 each	700,000,000	700,000,000	500,000,000
Preference shares with a par value of \$0.10 each	50,000,000	50,000,000	-
<b>Ordinary equity share capital</b>			
<b>Allotted and fully paid</b>	<b>Number</b>	<b>Share capital \$</b>	<b>Share premium \$</b>
At January 1, 2008	45,116,696	4,511	94,972
Issued during the year for cash	21,276,596	2,128	43,626
<b>At December 31, 2008</b>	<b>66,393,292</b>	<b>6,639</b>	<b>138,598</b>
<b>At January 1, 2009</b>	<b>66,393,292</b>	<b>6,639</b>	<b>138,598</b>
Issued during the year for purchase of oil and gas equipment	1,400,000	140	701
Issued during the year in connection with finance charges	81,477	8	226
Issued during the year for purchase of a subsidiary	15,000,000	1,500	1,487
Issued during the year for cash	51,680,000	5,168	12,736
<b>At December 31, 2009</b>	<b>134,554,769</b>	<b>13,455</b>	<b>153,748</b>

The preference shares have the rights as set out in the Memorandum and Articles of Association approved at the AGM on April 24, 2008. Significant terms related to preference shares are summarised below:

- May be issued in one or more series;
- Are entitled to any dividends in priority to the ordinary shares;
- Confer upon the holders thereof rights in a winding-up priority to the ordinary shares;
- And may have such other rights, privileges and conditions (including voting rights) as the Board may determine prior to the first allotment of any series of preference shares, provided that if a series of preference shares has no or limited voting rights it shall be designated as such by the Board.

On January 13, 2009, 1,400,000 ordinary shares were issued to a supplier as partial consideration for the purchase of a coil tubing unit. The fair value of the shares issued was determined by reference to the fair value of the goods received at the measurement date.

On April 9, 2009, the Company issued 15,000,000 ordinary shares to Rosehill Energy Limited as consideration for the acquisition of its wholly owned subsidiary. Details of this transaction are disclosed in note 21.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

On April 27, 2009, the Company issued 81,477 ordinary shares to Kraken Financial Group Limited, a related party, as consideration for services rendered in connection with the placement of shares of the Company in 2008. The fair value of the shares issued was determined by reference to the fair value of the services received at the measurement date.

On June 19, 2009, the Company issued 51,680,000 ordinary shares for consideration of \$17,906,000, net of transaction costs.

As at December 31, 2009 a total of 24,489,455 (December 31, 2008 – 18,311,596) ordinary shares are reserved under the Company's Long Term Stock Incentive Plan and Warrants granted by the Company. Details of the options and warrants are given in note 8.

There are currently no preference shares outstanding (2008 – None).

### **21 Business combination**

On April 9, 2009 the Company acquired 100% of the issued share capital in Baker Hughes (Cyprus) Limited (BHCL), a Company incorporated in Cyprus, which operates under a production enhancement contract relating to the North Urtaubulak field in Uzbekistan. Tethys issued 15,000,000 ordinary shares as purchase consideration in the acquisition. The acquisition agreement places a trading restriction on the shares as follows: 7,500,000 cannot be resold until 6 months from the date of issue and the remaining 7,500,000 cannot be resold until 12 months from the date of issue.

The acquired business contributed revenues of \$4,731,000 and a net profit before taxation of \$477,000 to the Company for the period from April 9, 2009 to December 2009 (note 5). If the acquisition had occurred on January 1, 2009 the revenue of the Company would have been \$1,017,371 higher (unaudited) and the net profit before taxation would have been \$112,000 higher (unaudited). These amounts have been calculated using the Company's accounting policies and by adjusting the results of the subsidiary to reflect the additional depreciation and amortization that would have been charged assuming the fair value adjustments to property, plant and equipment and intangible assets had applied from January 1, 2009.

The fair value of the shares issued was based on the published price of the shares on the date of acquisition. As the shares were issued with a trading restriction, this resulted in a marketability discount being applied to the published price to arrive at fair value. The marketability discount was valued using the Black Scholes Option Pricing Model using the following assumptions: dividend yield of 0%; expected term of 0.75 years; a risk free interest rate of 0.60% and expected volatility of 121%. This resulted in an adjustment of \$2,344,484 to the purchase consideration.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The provisional fair values of identifiable assets and liabilities of BHCL as at the date of acquisition were:

	(Unaudited) Acquiree carrying value \$	Preliminary provisional fair value \$	As at December 31, 2009, provisional fair value \$
<b>Consideration at April 9, 2009</b>			
Equity instruments (15,000,000 ordinary shares)		2,987	2,987
Direct costs related to the acquisition		57	57
<b>Total consideration transferred</b>		<u>3,044</u>	<u>3,044</u>
<b>Recognised amounts of identifiable assets acquired and liabilities assumed</b>			
Cash and cash equivalents	532	532	532
Trade and other receivables	502	502	-
Intangible asset	-	3,820	5,553
Property, plant and equipment	9,373	118	117
Inventory	-	-	753
Deferred revenue	-	-	(1,594)
Current trade and other payables	(1,928)	(1,928)	(1,933)
Deferred income tax liability	-	-	(384)
<b>Total identifiable net assets</b>	<u>8,479</u>	<u>3,044</u>	<u>3,044</u>

Assets and liabilities acquired in a business combination are required to be recognised at fair value. In the absence of an active market for the North Urtabulak Field Production Enhancement Contract, the Company measured the fair value of the asset by applying a valuation technique based on the discounted estimated future net cash flows expected to be derived from the asset. A discounted cash flow (DCF) method requires management to estimate future cash flows associated with the asset and then discount those amounts to present value at a rate of return that considers the relative risk of the cash flows.

Changes recognised in the provisional fair value balances during the year were due to new information obtained about facts and circumstances that existed as of the acquisition date which, if known, would have affected the measurement of the amounts at that date.

The fair value of the acquired assets relating to the Production Enhancement Contract (PEC) for the North Urtabulak field of \$5,553,000 is provisional pending completion of the final valuation report for those assets.

There were no business combinations in the year ended December 31, 2008.

## 22 Events occurring after the reporting period

On November 9, 2009, Tethys announced its submission of a Form A1 listing application to the Hong Kong Stock Exchange (HKSE) with respect to a possible secondary listing of its ordinary shares on the main board of the HKSE estimated to be completed in the first half of 2010. No definite timetable nor the amount of any placement has yet been finalised and there is no guarantee that the Company's application will be successful.

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

On December 19, 2009 the Company entered into agreements for a non-brokered private placement of 10,000,000 Ordinary Shares for gross proceeds of US\$5 million subject to regulatory approval. The sum of \$3,750,000 was received on December 22, 2009 with the balance of \$1,250,000 received on January 7, 2010. The Ordinary Shares were placed at a price of US\$0.50 (CAD\$0.53) each. The placements were completed on January 4, 2010.

On January 11, 2010 the Company further announced that it would complete a non-brokered private placement of 12,615,000 Ordinary Shares for gross proceeds of US\$10 million subject to regulatory approval. The Ordinary Shares were placed at a price of CAD\$0.82 (US\$0.79) each. The placement was completed on January 25, 2010.

On February 4, 2010 the Company placed an additional \$2 million in loan notes approved by the Company on December 10, 2009 (Note 17.1). These loan notes were in connection with the drilling of the new well in Uzbekistan.

On February 12, 2010 the Company announced an additional private placement of 30,000,000 Ordinary Shares for gross proceeds of CAD\$46.5 (US\$45.1) million. The Ordinary Shares were placed at an average price of CAD\$1.55 (US\$0.79) (US\$1.50) each. The placement was completed on March 1, 2010.

On February 15, 2010 the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan confirmed its approval of the transfer of 100% of the participatory interest of TethysAralgas LLP in the charter capital of Kul-Bas LLP in favour of its parent Company, Tethys Kazakhstan Limited.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 23 Related party transactions

All subsidiaries, as listed below, have been consolidated into the consolidated accounts. A list of the investments in subsidiary undertakings (all of whose operations comprise one class of business, being Oil and Gas Exploration, Development and Production), including the name, proportion of ownership interest, country of operation and country of registration, is given below.

	Percentage	Country of operation	Country of registration
Tethys Uzbekistan BV	100%	Netherlands	Netherlands
Tethys Petroleum Inc.	100%	USA	USA
Tethys Afghanistan Inc.	100%	Dormant	USA
Tethys Kazakhstan Limited	100%	Guernsey	Guernsey
Tethys Aral Gas LLP	100%	Kazakhstan	Kazakhstan
Kul-Bas LLP	100%	Kazakhstan	Kazakhstan
Tethys Munai Gaz LLP	100%	Dormant	Kazakhstan
Tethys Services Kazakhstan LLP	100%	Kazakhstan	Kazakhstan
		Kazakhstan/ Tajikistan	Netherlands
Asia Oilfield Equipment BV	100%	Tajikistan	Netherlands
Tethys Europa BV	100%	Dormant	Netherlands
AOE Telesto BV	100%	Dormant	Netherlands
AOE Tyke BV	100%	Dormant	Netherlands
AOE Tyke SA	100%	Dormant	Luxemburg
		United Kingdom	United Kingdom
Tethys Services Limited	100%	Kingdom	Kingdom
Tethys Caspian Limited	100%	Dormant	Cyprus
Tethys Tajikistan Limited	100%	Tajikistan	Jersey
Imperial Drilling Services Limited	100%	Cayman Islands	Cayman Islands
Seven Stars Energy Corporation	51%	Tajikistan	BVI
Tethyda Limited	100%	Dormant	Cyprus
Baker Hughes (Cyprus) Limited	100%	Uzbekistan	Cyprus
Rosehill Energy Limited	100%	Uzbekistan	Cayman Islands

The Company has an indirect shareholding of the following companies through its share of Seven Stars Energy Corporation:

Tethys Services Tajikistan Ltd.	51%	Tajikistan	Tajikistan
Kulob Petroleum Ltd.	51%	Tajikistan	Jersey
Sogdiana Petroleum Ltd.	51%	Tajikistan	Cayman Islands

#### Other

Vazon Energy Limited (“Vazon”) is a corporation organized under the laws of the Bailiwick of Guernsey, of which Dr. David Robson, Chief Executive Officer, is the sole owner and managing director. Tethys has a management services contract with Vazon that came into effect from June 27, 2007 whereby the services of Dr.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

Robson and other Vazon employees are provided to the Company. The total cost charged to Tethys for services from Vazon in the year ended December 31, 2009 was \$1,677,113 (2008 – \$1,405,028).

Oilfield Production Consultants (OPC) Limited and Oilfield Production Consultants (OPC) USA LLC, both of which have one common director with the Company, has charged Tethys a monthly retainer fee for engineering expertise, provided services relating to the optimization of the existing compressors and those to be installed as part of Phase 2 gas production from Akkulka, and has consulted on certain reservoir modelling work on projects in Tajikistan and Uzbekistan. Total fees for the year ended December 31, 2009 were \$497,697 (2008 – \$422,770).

Kraken Financial Group (KFG) had a common director with the Company up until 1 September 2009. In 2008, KFG was engaged by the Company to assist in obtaining loan financing in relation to the purchase of both Telesto and Tykhe drilling rigs. As a result of the services provided in connection with the Telesto transaction, KFG received 6% commission of the funds it was responsible for introducing to the Company. This commission was to be taken in the form of 81,477 shares, which were issued in 2009 amounting to \$234,000 (which had been recognized as a liability at the end of 2008). No further services were provided by KFG during 2009 (December 31, 2008 - \$21,000).

During the year ended December 31, 2008, KFG had acted as broker for Tethys in the placement of various insurance policies, including Directors and Officers, for which the combined annual premiums were \$112,615. This service was not provided in 2009.

The remuneration of the key management personnel of the Company, which includes both directors and other officers, is set out below in aggregate.

	<b>Year ended</b>	
	<b>December 31, 2009</b>	<b>December 31, 2008</b>
Salaries and short-term employee benefits	3,026	2,926
Share-based payments	2,071	3,062
	<u>5,097</u>	<u>5,988</u>

Transactions with affiliates or other related parties including management of affiliates are recorded at their exchange amount.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 24 Changes in working capital

	Year ended	
	December 31, 2009	December 31, 2008
Trade and other receivables	353	(1,304)
Inventories	(2,155)	(213)
Trade and other payables	4,051	456
Change in non-cash working capital	2,249	(1,061)
Non-cash transactions	(2,136)	-
Net changes in non-cash working capital	113	(1,061)

The principal non-cash transaction is related to the issue of shares as consideration for the acquisition discussed in note 21.

Net changes in non-cash working capital are categorized as follows:

	Year ended	
	December 31, 2009	December 31, 2008
Operating activities	(1,160)	(844)
Investing activities	1,273	(217)
Balance	113	(1,061)

### 25 Commitments and contingencies

#### Kazakhstan

##### *Kyzyloi Field and the Kyzyloi Field Licence and Production Contract*

The Kyzyloi Field Licence and Production Contract for production of gas on the Kyzyloi Field was initially issued by the Kazakh government to the state holding Company Kazakhgas on June 12, 1997 and was transferred to Tethys Aral Gas (TAG) on May 15, 2001. The contract was entered into between the MEMR and TAG on May 5, 2005, initially until June 12, 2007. However, in January 2005, the Ministry of Energy and Mineral Resources (MEMR) agreed to extend the contract until June 2014. Gas production commenced under the contract in December 2007.

The Kyzyloi Field Licence and Production Contract grants TAG exploration and production rights over an area of approximately 70,967 acres (287.2 km<sup>2</sup>) and extends down to the base of the Paleogene sequence. Pursuant to the contract, TAG must reimburse the Kazakh government for approximately \$1,211,000 in historical costs,



# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

to be paid in equal quarterly instalments from the commencement of production until full reimbursement. Under the latest extension of the Kyzylloi Field Licence and Production Contract, TAG has committed to spending approximately \$2.7 million for a workover program over the seven year period until 2014. In November 2009, the Company finalised and agreed the 2010 work program with a commitment of \$100,000.

### *Akkulka Exploration Licence and Contract*

The Akkulka Exploration Licence and Contract was entered into between the Kazakh State Committee of Investments and TAG on September 17, 1998. The Akkulka Exploration Licence initially granted TAG exploration rights for a period of five years and both the Akkulka Exploration Licence and Contract were valid until September 17, 2003. On December 9, 2009, TAG entered into an amendment agreement with the MEMR to extend the period of the Akkulka Exploration Licence and Contract from September 17, 2009 until March 10, 2011. Under the amendment agreement, TAG has committed to spending an additional \$850,000 over the 18 month period and the 2010 work program for Akkulka was agreed with a capital commitment of \$676,700.

### *Akkulka Production Contract*

On December 23, 2009, TAG and MEMR signed the Akkulka Production Contract giving TAG exclusive rights to produce gas from the Akkulka Block for a period of nine years. Contingent upon commencement of commercial production on the Akkulka contractual territory, a total amount of US\$3,500,000 will be due to the Kazakhstan Government as a reimbursement of historical costs previously incurred by the Government in relation to the contractual territory. For that part of the contractual territory from which production will commence in 2010 staged payments over a period of nine years totalling approximately \$933,997 will also be due to the Kazakh government for the reimbursement of historical costs (note 18). The 2010 minimum work program was agreed with a capital commitment of \$141,400.

### *Kul-Bas Exploration and Production Contract*

The Kul-Bas Exploration and Production Contract was signed between Kul-Bas and the MEMR on November 11, 2005. This contract, which is for a period of 25 years (unless extended by mutual agreement of the parties), with an initial six-year exploration period and a 19-year production period, grants Kul-Bas with exploration and production rights over an original 2,688,695 acres (10,881 km<sup>2</sup>) surrounding the Akkulka Block. Pursuant to the original contract, 20% of the area was to be relinquished at the end of the second year of the contract, with 20% to be relinquished annually thereafter up to the end of the six year exploration period. However, in response to an application on behalf of the Company, on April 27, 2009, Amendment 1 to the Kul-Bas Exploration and Production Contract was signed, according to which 20% is relinquished by the end of contract year 2 (completed), 0% in contract year 3 (2008), 10% by the end of contract year 4 (2009), 20% by the end of year 5 (2010) and all remaining contract area, outside commercial discovery areas, by the end of year 6 (2011).

The work program on this area amounted to a total of approximately \$7,773,500 over the initial six-year exploration period. The remaining commitment of \$2,894,000 relating to the contractual territory is required to be satisfied by November 11, 2011 and is included within the 2010 work program of \$3 million which is outlined for one new 4,000 meters exploration well. In addition to the minimum work program commitments, the Kazakhstan Government is to be compensated for the historical costs related to the contractual territory in the amount of US\$3,275,780. The Company has previously paid an amount of US\$49,137 in relation to this balance. If and when commercial production commences, US\$88,666 is due in quarterly instalments until the remaining historical costs of US\$3,226,643 has been paid in full.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### Tajikistan

Per *Note 15 Investment in Joint Venture* above the Company's share of seismic contract commitment is \$2,137,383.

### Uzbekistan

In connection with the drilling of a new well (NU116), the Company entered into a Turnkey contract with a fixed commitment of \$3,943,976, of which \$2,071,988 had been paid prior to the year end. The outstanding balance of \$1,871,988 would be paid upon completion of the well which was anticipated to be February 2010.

### Operating leases

Operating leases consist primarily of leases for offices. Lease commitments are as follows:

	<b>Total</b>	<b>Less than 1 year</b>	<b>1 – 3 years</b>
	\$	\$	\$
Operating leases	779	415	364

2009 expenditure on lease commitments included in the statement of comprehensive loss amounted to \$480,552, (2008 - \$801,213).

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### **26 Explanation of transition to IFRS**

The consolidated financial statements for the year ended December 31, 2009 are the Company's first financial statements prepared under IFRS. For all accounting periods prior to this, the Company prepared its financial statements under generally accepted accounting principles in the United States of America ('US GAAP'). In accordance with IFRS 1 'First time adoption of IFRS', certain disclosures relating to the transition to IFRS are given in this note. These disclosures are prepared under IFRS as set out in the basis of preparation in note 2.

IFRS 1 allows first time adopters to IFRS to take advantage of a number of voluntary exemptions from the general principal of retrospective restatement. The Company has taken the following exemptions:

#### **IFRS 3 Business combinations**

This standard has not been applied to acquisitions of subsidiaries that occurred before January 1, 2008, the Company's transition date.

#### **IFRIC 1 Changes in existing decommissioning, restoration and similar liabilities**

The Company has elected to apply exemption from full retrospective application of Asset retirement obligations as allowed under IFRS 1. As such the Company has re-measured the provisions as at January 1, 2008 under IAS 37, estimated the amount to be included in the cost of the related asset by discounting the liability to the date at which the liability first arose using best estimates of the pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation, and recalculated the accumulated depreciation, depletion and amortisation under IFRS.

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 26.1

#### Reconciliation of equity as at January 1, 2008

	Notes	US GAAP \$	Effect of transition to IFRS \$	IFRS \$
<b>Assets</b>				
<b>Non-current assets</b>				
Intangible assets	a	-	7,335	7,335
Property, plant and equipment	b	37,472	855	38,327
Investments		318	-	318
Trade and other receivables		5,814	-	5,814
		<u>43,604</u>	<u>8,190</u>	<u>51,794</u>
<b>Current assets</b>				
Trade and other receivables		1,360	-	1,360
Cash and cash equivalents		26,692	-	26,692
		<u>28,052</u>	<u>-</u>	<u>28,052</u>
<b>Total assets</b>		<u>71,656</u>	<u>8,190</u>	<u>79,846</u>
<b>Equity and Liabilities</b>				
<b>Equity attributable to shareholders</b>				
Share capital		4,511	-	4,511
Share premium		94,972	-	94,972
Other reserves	c	20,082	646	20,728
Accumulated deficit	e	(51,625)	7,155	(44,470)
		<u>67,940</u>	<u>7,801</u>	<u>75,741</u>
<b>Non-current liabilities</b>				
Trade and other payables		776	-	776
Asset retirement obligations	d	661	389	1,050
		<u>1,437</u>	<u>389</u>	<u>1,826</u>
<b>Current liabilities</b>				
Trade and other payables		2,279	-	2,279
		<u>2,279</u>	<u>-</u>	<u>2,279</u>
Total liabilities		<u>3,716</u>	<u>389</u>	<u>4,105</u>
<b>Total shareholders' equity and liabilities</b>		<u>71,656</u>	<u>8,190</u>	<u>79,846</u>

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### Explanation of the effect of the transition to IFRS

The following explains the material adjustments to the statement of financial position as at January 1, 2008:

	\$
(a) Reclassification of cost from property, plant and equipment to intangible assets. In accordance with IAS 16, IAS 38 and IFRS 6 the Company reallocated certain costs relating to unproved properties from property, plant and equipment to intangible assets.	7,661
Expense pre licence expenditure. On discontinuance of the policy of full cost accounting, expenditure incurred prior to the date on which the Company obtaining legal title to the relevant licences or concessions to explore and develop areas of interest, previously capitalised within the full cost pool, is written off.	<u>(326)</u>
Net effect –increase in intangible assets	<u>7,335</u>
(b) Reclassification of cost from property plant and equipment to intangible assets.	(7,661)
Reverse impairment loss. On transition to IFRS, a previous impairment loss recognised for Kazakhstan oil and gas properties in the year ended December 31, 2007 was reversed. US GAAP establishes a 'cost ceiling' for each cost center which limits the amount of costs that can be capitalized in each cost center. If a cost center's unamortized capitalized costs exceed the ceiling, the net capitalized costs must be written down to the ceiling. In calculating the ceiling limit under US GAAP, the present value of estimated future net revenues is computed by applying current prices of oil and gas reserves to estimated future production of proved oil and gas reserves, less estimated future expenditures to be incurred in developing and producing the proved reserves. The present value of estimated future net revenues is computed using a discount factor of 10% and assuming continuation of existing economic conditions. At the date of transition to IFRS, all CGUs were assessed for impairment by comparing the carrying value of the CGU to the recoverable amount. Recoverable amount was determined as value in use and was calculated as the present value of future cash flows expected to be derived from the CGU. The present value of future cash flows was computed on a pre-tax basis by applying forecast prices of oil and gas reserves to estimated future production of proved and probable oil and gas reserves, less estimated future expenditures to be incurred in developing and producing the proved and probable reserves. The present value of estimated future net revenues is computed using a discount factor of 8%.	12,800
Expense unsuccessful exploration and evaluation cost. On the discontinuance of full cost accounting, drilling expenditures associated with unsuccessful exploration wells drilled prior to December 31, 2007 were expensed. These costs were previously included in the carrying value of the full cost pool.	(3,799)

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

	\$
Expense pre licence expenditure. On discontinuance of the policy of full cost accounting, expenditure incurred prior to the date on which the Company obtaining legal title to the relevant licences or concessions to explore and develop areas of interest, which were previously capitalised within the full cost pool, is written off.	(907)
Increase the carrying value of oil and gas assets due to restatement of the asset retirement obligation. The discounted value of the future cash flows related to funding the Company's asset retirement obligation in relation to oil and gas properties is increased due to a change in the discount rate applied from a risk adjusted rate as required by US GAAP to a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. This results in an addition to the carrying value of oil and gas properties. This increase in carrying value is depreciated over the remaining life of the relevant field in accordance with the Company's depreciation policy.	389
Reduction in depreciation of oil and gas properties. Each producing field or concession is depreciated separately using the unit of production method based on proved and probable reserves. Under US GAAP depreciation was based on the countrywide full cost pool of all proved properties, both producing and non-producing, and calculated on the unit of production method over only the proved reserves.	33
Net effect – increase in property, plant and equipment	855
(c) Adoption of IFRS 2. The expense relating to employee options is recognised individually for each vesting tranche over the applicable vesting period, as opposed to on a straight line method over the total requisite service period as permitted by US GAAP.	646
Effect - increase option reserve	646
(d) Increase in asset retirement provision. The provision relating to the cost of future restoration cost of oil and gas properties increases in line with the increase noted in (b) above.	389
Effect – increase in provisions for asset retirement obligations.	389
(e) <b>The cumulative effect of these transition adjustments on the accumulated deficit as at January 1, 2008 is a decrease of:</b>	<b>7,155</b>

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

### 26.2

### Reconciliation of equity as at December 31, 2008

	Notes	US GAAP \$	Effect of transition to IFRS \$	IFRS \$
<b>Assets</b>				
<b>Non-current assets</b>				
Intangible assets	a	-	16,105	16,105
Property, plant and equipment	b	73,793	(8,371)	65,422
Investments		587	-	587
Trade and other receivables		6,357	-	6,357
		<hr/>		
		80,737	7,734	88,471
<b>Current assets</b>				
Inventories		213	-	213
Trade and other receivables		2,664	-	2,664
Cash and cash equivalents		22,200	-	22,200
		<hr/>		
		25,077	-	25,077
<b>Total assets</b>				
		<hr/>		
		105,814	7,734	113,548
<b>Equity and Liabilities</b>				
<b>Equity attributable to shareholders</b>				
Share capital		6,639	-	6,639
Share premium		138,598	-	138,598
Other reserves	c	25,189	(42)	25,147
Accumulated deficit	f	(74,252)	7,598	(66,654)
		<hr/>		
		96,174	7,556	103,730
<b>Non-current liabilities</b>				
Financial liabilities - borrowings		5,096	-	5,096
Trade and other payables		523	-	523
Asset retirement obligations	d	433	32	465
		<hr/>		
		6,052	32	6,084
<b>Current liabilities</b>				
Financial liabilities – borrowings		853	-	853
Derivative financial instruments – warrants	e	-	146	146
Trade and other payables		2,735	-	2,735
		<hr/>		
		3,588	146	3,734
<b>Total liabilities</b>				
		<hr/>		
		9,640	178	9,818
<b>Total shareholders' equity and liabilities</b>				
		<hr/>		
		105,814	7,734	113,548

# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

The nature of adjustments from US GAAP to IFRS at December 31, 2008 is similar to those at January 1, 2008.

	\$
(a) Reclassification of cost from property, plant and equipment to intangible assets	18,272
Expense pre licence expenditure	(715)
Expense unsuccessful exploration cost. On the discontinuance of full cost accounting, drilling expenditures associated with unsuccessful exploration wells drilled during the prior from January 1, 2008 to December 31, 2008 were expensed. These costs were previously included in the carrying value of the full cost pool.	(1,464)
Increase the carrying value of oil and gas assets due to restatement of the asset retirement obligation on exploration well drilled during the prior from January 1, 2008 to December 31, 2008 due to reduction in the discount rate as described in note 26.1b.	<u>12</u>
Net effect – increase in intangible assets	<u>16,105</u>
(b) Reclassification of cost from property plant and equipment to intangible assets	(18,272)
Reverse impairment loss	12,800
Expense unsuccessful exploration cost	(3,799)
Expense pre licence expenditure	(1,347)
Increase the carrying value of oil and gas assets due to restatement of the asset retirement obligation.	98
Reduction of depreciation, depletion and amortisation of oil and gas properties	<u>2,149</u>
Net effect –decrease in Property, plant and equipment	<u>(8,371)</u>
(c) Adoption of IFRS 2	1,121
Adoption of IAS 32.	<u>(1,163)</u>
Net effect –decrease in other reserves	<u>( 42)</u>
(d) Increase in asset retirement obligation. Effect – increase in provision for asset retirement obligation.	32
(e) Adoption of IAS 32. Effect – increase in Derivative financial instruments – warrants.	146
(f) <b>The cumulative effect of these transition adjustments on the accumulated deficit as at December 31, 2008 is a decrease of:</b>	<b>7,598</b>



# Tethys Petroleum Limited

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

26.3	<b>Consolidation reconciliation of comprehensive loss for the year ended December 31, 2008</b>			
	Notes	US GAAP \$	Effect of transition to IFRS \$	IFRS \$
		5,360	-	5,360
		832	-	832
		<u>6,192</u>		<u>6,192</u>
		(1,334)	-	(1,334)
	a	(6,449)	2,116	(4,333)
	b	-	(2,292)	(2,292)
	d	(17,527)	(388)	(17,915)
		(3,060)		(3,060)
	c	-	929	929
	e	(449)	78	(371)
		<u>(22,627)</u>	<u>443</u>	<u>(22,184)</u>
		-	-	-
		<u>(22,627)</u>	<u>(443)</u>	<u>(22,184)</u>
		(0.40)		(0.40)

The nature of the adjustments are explained as follows:

	\$
(a) Reduction in the depletion expense for the year	2,116
(b) Expense unsuccessful exploration wells drilled during the year (note 26.2a)	(1,464)
Expense pre licence expenditure incurred during the year (note 26.1a)	(388)
Expense pre licence expenditure incurred during the year (note 26.1b)	(440)
Net effect – increase in exploration and evaluation expenditure written off	<u>(2,292)</u>
(c) Fair value gains on derivative financial instrument	929
(d) Increase in the cost of employee share options for the year	(388)

# **Tethys Petroleum Limited**

## Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars)

- |   |    |
|---|----|
| (e) Decrease in the accretion charge on the Company's asset retirement obligation due to the transition adjustment (note 26.1d) | 78 |
|---|----|

### **Restatement of cash flow statement from US GAAP to IFRS**

The restatement from US GAAP to IFRS had no significant effect on the reported cash flows generated by the Company. The reconciling items between US GAAP presentation and IFRS presentation have no net effect on the cash flows generated