

## Exploring and Servicing Onshore Brazil

# Consolidated Financial Statements

## First Quarter Interim Report, Fiscal 2009

Three Months Ended September 30, 2008

December 1, 2008



## Consolidated Balance Sheets

As at  
(\$000s) (unaudited)

	September 30, 2008	June 30, 2008
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	7,281	9,983
Cash - restricted (note 4)	893	668
Accounts receivable	5,839	7,818
Prepaid expenses and deposits	444	489
Asset held for sale (note 17)	-	975
	<b>14,457</b>	19,933
Deferred acquisition costs (note 3)	2,205	733
Note receivable (note 3)	6,578	-
Cash call receivable	1,092	2,009
Cash reserved for asset retirement (note 8)	286	324
Future income tax asset	2,162	159
Property, plant, and equipment (note 5)	89,276	88,455
	<b>116,056</b>	111,613
<b>Liabilities and Shareholders' Equity</b>		
Current Liabilities:		
Accounts payable and accrued liabilities	7,624	7,540
Liabilities held for sale (note 17)	-	132
Interest payable	829	2,799
Financial derivative liability, net (note 11)	1,027	263
Current portion of capital lease obligations (note 7)	769	974
Current portion of long term debt (note 6a, 6b)	7,844	6,960
Reclassification of long term debt (note 6a)	18,071	18,786
	<b>36,164</b>	37,454
Interest payable (note 9g)	3,710	-
Deferred share subscription (note 9g)	5,966	-
Capital lease obligations (note 7)	263	487
Convertible Debenture (note 6c)	38,298	36,191
Long term debt (note 6b)	2,347	2,080
Asset retirement obligation (note 8)	433	420
Financial derivative liability, net (note 11)	465	724
	<b>87,646</b>	77,356
Going concern (note 1)		
Commitments and guarantees (note 16)		
Subsequent events (note 19)		
Non-controlling interest (note 18)	2,768	2,757
Shareholders' equity:		
Share capital (note 9)	57,701	58,604
Contributed surplus (note 10)	8,360	6,127
Deficit	(40,419)	(33,231)
	<b>25,642</b>	31,500
	<b>116,056</b>	111,613

See accompanying notes to the consolidated financial statements.



Consolidated Statements of Loss and Comprehensive Loss and Deficit  
 Three months ended September 30,  
 (\$000s, except per share amounts) (unaudited)

	2008	2007
<b>Revenues:</b>		
Petroleum and natural gas, net of royalties of \$132 (2007 - \$91)	1,350	862
Drilling services	9,089	1,003
Interest and other	33	122
	<b>10,472</b>	<b>1,987</b>
<b>Expenses:</b>		
Operating - petroleum and natural gas	677	659
Operating - drilling services	7,474	1,758
Depletion, depreciation and accretion	2,022	491
General and administrative	2,458	1,757
Interest and financial expenses (note 6f)	3,075	402
Foreign exchange (gain) loss, net (note 11)	2,421	(983)
Realized loss on financial derivatives (note 11)	228	6
Unrealized loss on financial derivatives, net (note 11)	505	142
Stock compensation expense (note 9e, 9f)	126	477
	<b>18,986</b>	<b>4,709</b>
Loss before income taxes	<b>(8,514)</b>	<b>(2,722)</b>
Current income tax expense	677	165
Future income tax recovery	(2,003)	(165)
	<b>(1,326)</b>	<b>-</b>
Net loss and comprehensive loss	<b>(7,188)</b>	<b>(2,722)</b>
Deficit, beginning of period	<b>(33,231)</b>	<b>(15,650)</b>
Deficit, end of period	<b>(40,419)</b>	<b>(18,372)</b>
Loss per share (note 9h)	<b>(0.08)</b>	<b>(0.03)</b>

See accompanying notes to the consolidated financial statements.



Consolidated Statements of Cash Flows  
 Three months ended September 30,  
 (\$000s) (unaudited)

	2008	2007
Cash provided by (used in):		
<b>Operating Activities:</b>		
Net loss and comprehensive loss	(7,188)	(2,722)
Adjustments for non-cash items:		
Non-cash interest expense	817	85
Depletion, depreciation and accretion	2,022	491
Stock compensation expense	126	477
Future income tax recovery	(2,003)	(165)
Unrealized foreign exchange loss (gain), net	2,533	(1,013)
Unrealized financial derivatives loss, net	505	142
	(3,188)	(2,706)
Change in non-cash operating working working capital (note 15)	2,349	1,682
	(839)	(1,024)
<b>Financing Activities:</b>		
Issue of common shares	-	3,562
Share subscription by subsidiary	5,966	-
Draws on long term debt facilities	-	18,965
Repayment of long term debt facilities and capital leases	(1,195)	-
Financing and share issue costs	-	(1,168)
	4,771	21,359
<b>Investing Activities:</b>		
Property, plant, and equipment purchases, net	(2,117)	(23,663)
Cash reserved for asset retirement	(7)	(4)
Cash - restricted	(179)	(153)
Change in non-cash investing working capital (note 15)	(4,409)	2,496
	(6,712)	(21,324)
Foreign exchange gain (loss) on cash and cash equivalents held in foreign currency	78	(31)
Net increase (decrease) in cash and cash equivalents	(2,702)	(1,021)
Cash and cash equivalents, beginning of period	9,983	2,951
Cash and cash equivalents, end of period	7,281	1,930
<b>Supplementary disclosure of cash flow information:</b>		
Interest paid	1,578	71
Withholding taxes paid	1,081	-

See accompanying notes to the consolidated financial statements.

# *Notes to the Consolidated Financial Statements*

*For the three months ended September 30, 2008 and September 30, 2007*

*(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)*

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## **1. BASIS OF PRESENTATION AND GOING CONCERN**

BrazAlta Resources Corp. (“BrazAlta” or the “Corporation”) and its subsidiaries are primarily engaged in oilfield services and petroleum and natural gas exploration and development activities in Brazil, Canada, and other international jurisdictions. The Corporation has a wholly owned subsidiary, BCH Ltd. (“BCH”), which is engaged in providing drilling services in Brazil. The Corporation’s head office is located in Calgary, Alberta, Canada and the Corporation’s shares are traded on the TSX Venture Exchange.

These interim consolidated financial statements do not include all disclosures required for annual financial statements and should be read in conjunction with the most recent audited annual consolidated financial statements and the notes thereto for the year ended June 30, 2008. The significant accounting policies applied are consistent with those in the audited annual consolidated financial statements except for the changes described herein in note 2.

These consolidated financial statements are stated in Canadian dollars and have been prepared by management in accordance with Canadian Generally Accepted Accounting Principles (“GAAP”) on a going concern basis. The going concern basis presumes the realization of assets and settlement of liabilities as they come due in the normal course of operations.

As at September 30, 2008, the Corporation’s wholly owned subsidiary BCH was in violation of covenants relating to its term debt facility (note 6a) pertaining to minimum working capital balances, debt coverage, and interest coverage. The Corporation has and continues to seek cost reductions in order to generate positive cash flow from operations. Also, the Corporation will need to either obtain a new debt facility or negotiate amendments and/or extensions of its existing debt facilities. The Corporation has not yet obtained the waivers from its lenders regarding the covenant violations. While the Corporation is focusing its best efforts on these matters and continues to negotiate with its lender, the outcome cannot be certain at this time. There is, therefore, a risk regarding the Corporation’s ability to continue as a going concern. These financial statements do not include any adjustments to the amounts and classification of assets and liabilities, except for the term debt facility which has been reclassified as a current liability due to the fact that it is callable by the lender at any time, that might be necessary should the Corporation be unable to continue in business and therefore be unable to realize its assets and discharge its liabilities in the normal course of business. Such adjustments could be material.

The Corporation’s ability to continue as a going concern is dependent upon achieving positive cash flow from operations and complying with the covenant terms of its outstanding debt.

## **2. CHANGES IN ACCOUNTING POLICIES**

### *Capital Disclosures*

The Accounting Standards Board (“AcSB”) issued CICA Section 1535, “Capital Disclosures”. The main features of this section are to establish requirements for an entity to disclose qualitative information about its objectives, policies, and processes for managing capital, quantitative data about what it regards as capital, and whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. The new requirements are effective for annual and subsequent interim periods thereafter, beginning on or after October 1, 2007. These disclosures may be found in note 12.

### *Other pronouncements*

On July 1, 2008, the Corporation adopted three additional CICA Handbook requirements, section 3862 “Financial Instruments – Disclosures”, section 3863 “Financial Instruments – Presentations”, section 3031 “Inventories”. The effect of these standards are incremental disclosures regarding the significance of financial instruments for the entity’s financial position and performance, the nature, the extent, and management of risks to which the entity is exposed to arising from financial instruments as detailed in note 11.

## *Notes to the Consolidated Financial Statements*

*For the three months ended September 30, 2008 and September 30, 2007*

*(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)*

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### *Goodwill and intangible assets*

In February 2008, the CICA issued Section 3064, “Goodwill and Intangible Assets”, replacing Section 3062, “Goodwill and Other Intangible Assets” and Section 3450, “Research and Development Costs”. Various changes have been made to other sections of the CICA Handbook for consistency purposes. The new Section will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company will adopt the new standards for its fiscal year beginning July 1, 2009. It establishes standards for the recognition, measurement, presentation, and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The Company does not expect that the adoption of these new Sections will have a material impact on its consolidated financial statements.

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

On February 13, 2008, the AcSB confirmed that effective for interim and annual financial statements related to fiscal years beginning on or after January 1, 2011, International Financial Reporting Standards (IFRS) will replace Canada’s current Generally Accepted Accounting Principles for all publicly accountable profit oriented enterprises. The Corporation is currently assessing the effect on its financial reporting practices and requirements and is preparing for this transition.

### **3. DEFERRED ACQUISITIONS CHARGES AND NOTE RECEIVABLE**

As of September 30, 2008, the Corporation had incurred \$2,205 (June 30, 2008 - \$733) of deferred acquisition costs pursuant to its acquisition of Canacol Energy Inc. Included in the balance at September 30, 2008 is \$1,215 relating to the value of the warrants issued to Standard Bank (note 9c). In addition, the Corporation had advanced Canacol Energy Inc. (“Canacol”) \$6,578 (June 30, 2008 - \$Nil) in short-term loans due November 2008. As security for this amount, BrazAlta had taken a lien on the securities of Canacol Sucursal Colombia and has a general security agreement from Canacol which is subordinated to Standard Bank Plc. Also, refer to note 19 for additional details regarding the completion of the acquisition on October 30, 2008.

### **4. CASH - RESTRICTED**

As at September 30, 2008, a total of \$893 (June 30, 2008 - \$668) in cash assets were restricted. Of this balance, \$665 (June 30, 2008 - \$638) was restricted in conjunction with a reserve for interest instalments due within the next three months on the Corporation’s term debt facility described in note 6a. The remaining \$228 (June 30, 2008 - \$30), relates to a security deposit for the Corporation’s financial derivative contracts as described in note 11.

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

### 5. PROPERTY, PLANT, AND EQUIPMENT

	Three Months Ended September 30, 2008			Year Ended June 30, 2008		
	Cost	Accumulated Depreciation	Net Book Value	Cost	Accumulated Depreciation	Net Book Value
Petroleum and natural gas properties	31,322	(6,458)	24,864	29,549	(5,484)	24,065
Drilling rig equipment	62,955	(2,734)	60,221	62,046	(1,819)	60,227
Service rig equipment	1,579	(107)	1,472	1,579	(83)	1,496
Vehicles	2,025	(445)	1,580	2,025	(344)	1,681
Office Equipment & Other	996	(183)	813	841	(191)	650
Building & Leasehold	88	(10)	78	88	-	88
Land	248	-	248	248	-	248
	<b>99,213</b>	<b>(9,937)</b>	<b>89,276</b>	<b>96,376</b>	<b>(7,921)</b>	<b>88,455</b>

The costs excluded from the depletion calculation include undeveloped land costs, completion equipment inventory, and drilling in progress. As at September 30, 2008, the total costs of unproven properties excluded from the depletion calculation and ceiling test were \$2,763 (June 30, 2008 - \$2,507). No indirect overhead costs were capitalized during the three months ended years ended September 30, 2008 or 2007. Asset under capital leases at September 30, 2008 totalled \$2,025 (June 30, 2008 - \$2,025). Accumulated depreciation of these assets at September 30, 2008 totalled \$445 (June 30, 2008 - \$344). Amortization expense related to leased capital assets for the three months September 30, 2008 totalled \$101 (2007 - \$Nil).

### 6. LONG TERM DEBT

#### a. Term debt facility

The Corporation, through its wholly owned service company BCH, has a term debt facility. The term debt facility is secured by a first charge on all of the assets and contracts of BCH and its wholly owned subsidiary BCH Energy do Brasil Servicos de Petroleo Ltda. ("BCH Ltda."). In addition, the loan is secured through the pledge of the shares of BCH Ltda. by BCH and a pledge of the shares of BCH owned by BrazAlta. Furthermore, the loan is guaranteed by BCH's parent company BrazAlta. As of September 30, 2008, there was US\$25,000 (June 30, 2008 - US\$25,000) drawn on the facility.

The facility is repayable in quarterly instalments comprising interest only in the first anniversary year of the facility and then the remaining balance in equal quarterly instalments of principal plus interest commencing in September 2008 (first repayment occurred in October 2008) with final payment due in August 2012. The facility bears interest at LIBOR plus 3.25%.

As at September 30, 2008, BCH was in violation of covenants relating to its term debt facility pertaining to minimum working capital balances, debt coverage, and interest coverage. BCH has not yet obtained the necessary waivers from its lenders regarding the covenant violations. The Corporation continues to work with its lender, however, there can be no assurance that it will be able to successfully obtain the necessary waiver. The entire term debt facility balance is classified as a current liability.

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

	September 30, 2008	June 30, 2008
	\$	\$
BCH - Long-term debt - opening balance	24,778	-
Term debt facility	-	28,935
Transaction costs	-	(986)
Repayment of long-term debt facility	-	(3,231)
Total long-term debt	24,778	24,718
Accretion of transaction costs	82	276
Unrealized foreign exchange (gain) loss	1,005	(216)
	25,865	24,778
Current portion, term debt facility <sup>1,2</sup>	(7,794)	(5,992)
Callable portion, term debt facility <sup>2</sup>	(18,071)	(18,786)
BCH -Long-term debt - ending balance	-	-

<sup>1</sup> Current portion due in next twelve months based on repayment schedule

<sup>2</sup> As a result of covenant violation, entire loan balance is callable at any time

### b. Reserves based revolving line credit facility

BrazAlta and its Brazil Joint Venture partner, W. Washington Petroleo S.A. (“W. Washington”) have entered into a reserves based revolving line of credit facility of up to US\$50,000. The facility limit is based on the lender’s evaluation of reserves estimates, and currently has a maximum draw of gross US\$7,100 (net US\$3,373). As of September 30, 2008, there was a gross draw of US\$7,100 (net US\$3,373) (June 30, 2008 - gross US\$9,000 (net US\$4,275)) drawn on the facility.

The reserves based revolving line of credit facility is secured by a first charge on all of W. Washington’s assets, as well as W. Washington’s and BrazAlta’s interests in oil and gas concession contracts in Brazil and the receivables from any corresponding oil sales. In addition, the shares of BrazAlta Brasil Norte Comercializacao de Petroleo Ltda. (“BrazAlta Norte”) owned by BrazAlta have been pledged as security. Furthermore, the loan has been guaranteed by BrazAlta and BrazAlta Norte.

The revolving facility is interest payments only for three years with repayment of the outstanding principal due in full in August 2010. The facility bears interest at LIBOR plus 3.50%. The facility is cross guaranteed by BrazAlta as a 47.5% joint-interest partner.

	September 30, 2008	June 30, 2008
	\$	\$
Reserves based revolving line credit facility - opening balance	3,048	-
Reserves based revolving line credit facility issued	-	4,554
Transaction costs	-	(1,740)
Repayment of long-term debt facility	(935)	-
Total long-term debt	2,113	2,814
Accretion of transaction costs	131	433
Unrealized foreign exchange (gain) loss	153	(199)
	2,397	3,048
Current portion, term debt facility	(50)	(968)
Long-term reserves based revolving line credit facility - ending balance	2,347	2,080

### c. Convertible debenture

The Corporation, through its wholly owned service company BCH, has issued a US\$40,000 Convertible Subordinated Secured Debenture (the “Convertible Debenture”).

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

The Convertible Debenture bears interest at a rate of 15%, payable annually, and matures January 31, 2010. It is convertible any time prior to maturity, at Allis-Chalmers' option, into Common Shares of BCH at a conversion price of US\$4.163 per BCH Common Share, equating to 9,608,456 shares of BCH representing approximately 49% of the post-conversion outstanding common shares of BCH at September 30, 2008. As at September 30, 2008, there have been no conversions exercised on the Convertible Debenture.

The Convertible Debenture is secured by a second charge on all of the assets and contracts of BCH and its wholly owned subsidiary BCH Ltda. The Convertible Debenture is subordinate to the long-term debt facility described in note 6a. The Convertible Debenture does not provide Allis-Chalmers recourse to BCH's parent BrazAlta for the loan.

Interest on the Convertible Debenture for the three month period ended September 30, 2008 of \$2,180 (2007 - \$Nil) is comprised of \$1,575 (2007 - \$Nil) in accrued coupon interest payments, \$277 (2008 - \$Nil) of accretion of the Convertible Debenture, and \$ 328 (2007 - \$Nil) of accretion of the deferred financing costs.

	September 30, 2008	June 30, 2008
	\$	\$
BCH - Convertible Debenture - opening balance	36,191	-
Convertible Debenture issued	-	40,088
Transaction costs	-	(2,935)
Valuation of conversion feature allocated to non-controlling interest (note 18)	-	(2,480)
Debt component of convertible debentures	36,191	34,673
Accretion of Convertible Debenture and deferred financing charges	605	935
Unrealized foreign exchange loss	1,503	583
BCH - Convertible Debentures - ending balance	38,299	36,191

### d. Rancho Hermoso debt facility

On August 29, 2008, Canacol closed the acquisition of a private Colombian exploration and production company, Rancho Hermoso S.A. for US\$28,600. A debt facility was jointly put in place in order to finance the acquisition of Rancho Hermoso S.A. BrazAlta (through a subsidiary) and Canacol jointly borrowed from Standard Bank Plc. the sum of US\$25,600 as co-borrowers. The loan comprises two credit facilities:

- a) a US\$50,000 three year senior secured borrowing base revolving credit facility with current availability of US\$14,000; and
- b) a US\$11,600 mezzanine facility.

The security package and terms for the Standard Bank Loan comprises a lien on the shares of Rancho Hermoso S.A.; a guarantee from each of BrazAlta and Canacol; and a hedge of a percentage of Rancho Hermoso S.A. production. The revolving credit facility is payable in full on August 27, 2011 and the mezzanine facility is payable in six equal semi-annual payments beginning on February 27, 2009.

In addition, BrazAlta has issued to Standard Bank, warrants to acquire 10,000,000 BrazAlta Common Shares at a price of C\$0.80 per BrazAlta Common Share for a period of five years and has cancelled the 3,500,000 warrants previously issued to Standard Bank Plc. last year at US\$2.00 as part of the issuance of the reserves based revolving credit facility. Refer to note 9c for additional details regarding the warrants.

As of September 30, 2008, the Corporation had been in violation of the terms and conditions of this credit facility as a result of the failure to complete the acquisition of Canacol Energy Inc. by September 29, 2008. This has since been rectified with the completion of the acquisition on October 30, 2008 as disclosed in note 19. On October 30, 2008, the acquisition of Canacol was completed by BrazAlta. As of September 30, 2008, the Corporation has not

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

recorded any of the debt balance on its balance sheet relating to this reserves based lending line.

### e. Revolving operating line of credit

The Corporation, through its wholly owned subsidiary BCH Ltda., has a revolving operating line of credit of with an outstanding balance at September 30, 2008 of BRL \$3,000 (\$1,650). The line of credit bears interest at the Sistema Especial de Liquidação de Custódia (“SELIC”) interest rate, a Brazilian variable interest rate, plus 6% per annum on the balance outstanding. At September 30, 2008, \$1,356 had been drawn on the line of credit facility (June 30, 2008 – \$1,444). The operating line of credit is unsecured and is guaranteed by BCH.

### f. Interest and financial expense

Interest and financial expense is comprised of both cash and non-cash components. Non-cash components relate to accretion of deferred financing charges incurred on the Corporation’s debt facilities and accretion of its Convertible Debenture which are accreted over the life of the respective loans using the effective interest rate method. During the three month period ended September 30, 2008, interest and financial expense totalled \$3,075 (2007 - \$402). Of this, \$817 (2007 - \$85) relates to the accretion of deferred financing charges on the Corporation’s debt and accretion of the Convertible Debenture.

	<b>Three Months Ended September 30,</b>	
	<b>2008</b>	2007
	\$	\$
Cash interest expense	<b>2,258</b>	<b>317</b>
Accretion of transaction costs and Convertible Debenture	<b>817</b>	<b>85</b>
<b>Total interest and financial expense</b>	<b>3,075</b>	<b>402</b>

### g. Principal repayments

Future debt principal repayments, excluding the Rancho Hermoso reserves based debt facility (note 6d), for the next five years are as follows:

	<b>2009 - 9 Months</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>Total</b>
BCH - Term debt facility <sup>1</sup>	6,235	6,234	6,234	6,234	1,559	<b>26,496</b>
	<i>US\$5,883</i>	<i>US\$5,882</i>	<i>US\$5,882</i>	<i>US\$5,882</i>	<i>US\$1,471</i>	<i>US\$25,000</i>
BCH - Convertible debenture <sup>2</sup>	-	42,396	-	-	-	<b>42,396</b>
	-	<i>US\$40,000</i>	-	-	-	<i>US\$40,000</i>
Revolving credit facility	50	3,524	-	-	-	<b>3,574</b>
	<i>US\$48</i>	<i>US\$3,325</i>	-	-	-	<i>US\$3,373</i>
	<b>6,285</b>	<b>52,154</b>	<b>6,234</b>	<b>6,234</b>	<b>1,559</b>	<b>72,466</b>
	<i>US\$5,931</i>	<i>US\$49,207</i>	<i>US\$5,882</i>	<i>US\$5,882</i>	<i>US\$1,471</i>	<i>US\$68,373</i>

<sup>1</sup> Assumes regular repayment schedule and loan is not called because of covenant violation

<sup>2</sup> Assumes that the debenture is not converted

In addition to the above, as described in note 6d, BrazAlta (through a subsidiary) and Canacol jointly borrowed from the sum of US\$25,600 as co-borrowers. The loan comprises two credit facilities: The loan comprises two credit facilities:

- a) a US\$50,000 three year senior secured borrowing base revolving credit facility with current availability of US\$14,000; and
- b) a US\$11,600 mezzanine facility.

The revolving credit facility is payable in full on August 27, 2011 and the mezzanine facility is payable by Canacol in six equal semi-annual payments beginning on February 27, 2009.

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

### 7. CAPITAL LEASE OBLIGATIONS

	September 30, 2008	June 30, 2008
	\$	\$
Vehicle and equipment leases secured by the related assets	1,146	1,642
Imputed interest	(114)	(181)
	1,032	1,461
Amounts due within one year	(769)	(974)
	263	487

The Corporation's capital leases primarily relate to vehicles and equipment used in its drilling operations. The leases bear interest at rates ranging from 13.08% to 17.88% and have remaining terms ranging from 0.25 to 2.25 years. Asset under capital leases at September 30, 2008 totalled \$2,025 (June 30, 2008 - \$2,025). Accumulated depreciation of these assets at September 30, 2008 totalled \$445 (June 30, 2008 - \$344). Amortization expense related to the capital leases for the three month period ended September 30, 2008 totalled \$101 (2007 - \$Nil).

### 8. ASSET RETIREMENT OBLIGATION

	Three Months Ended	Year Ended
	September 30, 2008	June 30, 2008
	\$	\$
Asset retirement obligation, opening balance	420	343
Liabilities incurred	3	51
Liabilities settled	-	(11)
Revision of estimates	-	1
Accretion expense	10	36
Asset retirement obligation, ending balance	433	420

As at September 30, 2008, the estimated total undiscounted amount required to settle the asset retirement obligation was \$721 (June 30, 2008 - \$711) and these costs are expected to be settled over the useful lives of the underlying assets which currently extend up to 17 years into the future. The estimated cash flow has been computed using a credit-adjusted risk free discount rate of 9.5% and a Canadian inflation rate of 2.0% for properties in Canada and a Brazilian inflation rate of 5.0% for properties in Brazil. In accordance with Brazilian regulations, as of September 30, 2008, a total of \$286 (June 30, 2008 - \$324) of cash has been reserved for future asset retirement.

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

### 9. SHARE CAPITAL

#### a. Authorized

The Corporation is authorized to issue an unlimited number of common shares.

#### b. Issued

<i>Issued and outstanding</i>	<b>Three Months Ended September 30, 2008</b>		<b>Year Ended June 30, 2008</b>	
	<b>Number of Securities</b>	<b>\$</b>	<b>Number of Securities</b>	<b>\$</b>
<b><i>Common Shares</i></b>				
Common shares outstanding, opening balance	<b>90,084,661</b>	<b>57,278</b>	75,556,663	47,245
Issued on private placement	-	-	10,000,000	5,500
Stock options exercised	-	-	91,700	43
Contributed surplus related to stock options exercised	-	-	-	28
Warrants exercised	-	-	4,436,298	3,549
Fair value of warrants exercised	-	-	-	1,243
Share issue costs	-	-	-	(330)
<b>Common shares outstanding, ending balance</b>	<b>90,084,661</b>	<b>57,278</b>	90,084,661	57,278
<b><i>Warrants</i></b>				
Warrants outstanding, opening balance	<b>9,172,000</b>	<b>1,326</b>	10,136,633	2,569
Issued during debt financing arrangement (note 9c)	<b>10,000,000</b>	-	3,500,000	-
Exercised	-	-	(4,436,298)	(1,243)
Cancelled (note 9c)	<b>(3,500,000)</b>	-	-	-
Expired	<b>(4,167,000)</b>	<b>(903)</b>	(28,335)	-
<b>Warrants outstanding, ending balance</b>	<b>11,505,000</b>	<b>423</b>	9,172,000	1,326
<b>Total Share Capital, ending balance</b>		<b>57,701</b>		58,604

On October 30, 2008, the Corporation completed its acquisition of Canacol in which 40,000,000 common shares of BrazAlta were issued for all of the outstanding shares and warrants of Canacol. Refer to note 19 for additional information.

#### c. BrazAlta Warrants

Previously, in conjunction with entering into the reserves based revolving credit facility (note 6b), the Corporation issued 3,500,000 warrants, which were exercisable for a period of five years at an exercise price of US\$2.00 per common share. During the three month period ended September 30, 2008, these warrants were cancelled and replaced with new warrants as part of the Rancho Hermoso debt financing (note 6d). They were replaced with 10,000,000 new warrants with an exercise price of C\$0.80 per common share which have an expiry of August 29, 2013. The warrants have a mandatory exercise clause in which they must be exercised if the closing price of BrazAlta's shares exceeds C\$0.95 per share for 60 consecutive trading days.

The net fair value of the new warrants issued was calculated to be \$1,215 using a Black-Scholes pricing model based on the following assumptions: risk-free rate of 3.0%, expected life of five years, no dividends, and an expected volatility of 84%.

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

	Three Months Ended September 30, 2008		Year Ended June 30, 2008	
	Number of Warrants	Weighted Average Exercise Price	Number of Warrants	Weighted Average Exercise Price
<b>Opening</b>	<b>9,172,000</b>	<b>\$1.87</b>	10,136,633	\$1.35
Issued	<b>10,000,000</b>	<b>\$0.80</b>	3,500,000	US \$2.00
Exercised	-	-	(4,436,298)	\$0.80
Cancelled	<b>(3,500,000)</b>	<b>US \$2.00</b>	-	-
Expired	<b>(4,167,000)</b>	<b>\$2.00</b>	(28,335)	\$0.80
<b>Ending</b>	<b>11,505,000</b>	<b>\$0.85</b>	9,172,000	\$1.87

Exercisable warrants as at September 30, 2008 had the following exercise prices and expiry dates:

Number of Warrants	Exercise Price	Expiry Date
1,505,000	\$1.20	January 8, 2009
10,000,000	\$0.80	August 29, 2013
<b>11,505,000</b>	<b>\$0.85</b>	<b>4.31 years</b>

### d. BCH Warrants

The Corporation's subsidiary, BCH, has 250,000 BCH Warrants outstanding at an exercise price of US\$10.00 per BCH Common Share with an expiry date of July 2012. There has been no exercise of these warrants during the three months ended September 30, 2008.

### e. BrazAlta Stock options

The Corporation has a stock option plan for the purpose of aligning the interest of its directors, officers, employees, and consultants in the growth and development of the Corporation by providing them with the opportunity, through share options, to acquire an interest in the Corporation. The outstanding options expire at various dates between March 2010 and March 2013. At September 30, 2008, a total of 6,786,000 options were exercisable at a weighted average exercise price of \$0.92 per common share.

	Three Months Ended September 30, 2008			Year Ended June 30, 2008		
	Number of Stock Options	Weighted Average Exercise Price \$	Fair Value Assigned \$	Number of Stock Options	Weighted Average Exercise Price \$	Fair Value Assigned \$
Opening	<b>7,571,334</b>	<b>0.91</b>	<b>4,099</b>	7,301,700	0.97	4,311
Exercised	-	-	-	(91,700)	0.46	(28)
Cancelled	<b>(206,001)</b>	<b>0.87</b>	<b>(106)</b>	(1,381,666)	1.05	(848)
Granted	-	-	-	1,743,000	0.77	663
<b>Ending</b>	<b>7,365,333</b>	<b>0.92</b>	<b>3,993</b>	7,571,334	0.91	4,098

Compensation expense for stock options is recognized using the fair value method when the stock options are granted and is amortized over the options vesting period. New option grants to directors vest immediately and option grants to employees vest in three equal amounts over 18 months. As at September 30, 2008, \$91 (June 30, 2008 - \$220) of stock based compensation expense remains unrecognized. During the three month period ended September 30, 2008, \$115 (2007 - \$477) has been recognized in the consolidated statement of loss using the Black-Scholes pricing model based on the following assumptions at the time of the option grant:

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

	<b>Three Months Ended September 30, 2008</b>	Year Ended June 30, 2008
Risk-free interest rate	-	3.4% - 4.4%
Expected life of options	-	5 years
Dividend yield	-	Nil
Expected volatility	-	72%

### f. BCH Stock options

The Corporation's subsidiary, BCH, also has a stock option plan. The options expire on January 1, 2013. At September 30, 2008, a total of 566,667 options were exercisable at a weighted average exercise price of US\$4.16 per BCH Common Share.

	<b>Three Months Ended September 30, 2008</b>			Year Ended June 30, 2008		
	Number of Stock Options	Weighted Average Exercise Price \$	Fair Value Assigned \$	Number of Stock Options	Weighted Average Exercise Price \$	Fair Value Assigned \$
<b>Opening</b>	<b>800,000</b>	<b>US \$4.16</b>	<b>201</b>	-	-	-
Exercised	-	-	-	-	-	-
Expired	-	-	-	-	-	-
Cancelled	-	-	-	-	-	-
Granted	-	-	-	800,000	US \$4.16	201
<b>Ending</b>	<b>800,000</b>	<b>US \$4.16</b>	<b>201</b>	800,000	US \$4.16	201

Compensation expense has also been recognized for the options issued by BCH using the fair value when the stock options were granted and is amortized over the options vesting period. The option grants to the directors of BCH vest immediately and the options granted to employees vest in three equal amounts over 3 years. As at September 30, 2008, \$26 (June 30, 2008 - \$37) of stock based compensation expense remains unrecognized. During the three months ended, \$11 (2007 - \$Nil) of stock compensation expense has been recognized.

### g. BCH private placement

As at September 30, 2008, there have been no conversions exercised on the Convertible Debenture and BrazAlta owns 100% of the issued and outstanding shares of BCH. If the Convertible Debenture were converted, Allis Chalmers would acquire 9,608,455 BCH Common Shares and BrazAlta would own 51% of the BCH Common Shares and Allis Chalmers would own 49%.

On October 1, 2008, BCH Ltd. was authorized to complete a non-brokered private placement of 4,474,999 BCH Common Shares at a price of US\$4.163 per BCH Common Share for aggregate gross proceeds of US\$18,629. On October 1, 2008, BrazAlta acquired 1,717,093 BCH Common Shares for consideration of US\$7,148 in conversion of loans receivable from BCH. In addition, BrazAlta has a share subscription payable to BCH of US\$2,353 relating to the purchase of an additional 565,156 shares. At the time of these financial statements, these additional shares had not yet been purchased by or issued to BrazAlta. On October 1, 2008, Allis-Chalmers Energy Inc. acquired 2,192,750 BCH Common Shares in the financing for consideration of US\$3,500 in conversion of accrued interest payable on the Debenture and cash proceeds of US\$5,628. Following the completion of the first portion of the financing, BCH will have 13,909,843 BCH Common Shares issued and outstanding of which BrazAlta will own 11,717,093 BCH Common Shares or 84.2%.

### h. Per share amounts

In calculating the basic and diluted net loss per share, the weighted average number of common shares for the three

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

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months ended September 30<sup>th</sup> used in the calculation of basic and diluted loss per share is shown below. For the three months ended September 30<sup>th</sup>, the diluted loss per share is the same as basic loss per share as the effect of the exercise of options and warrants on loss per share would be anti-dilutive.

	Three Months Ended September 30,	
	2008	2007
Basic and diluted	90,084,661	79,575,345

### 10. CONTRIBUTED SURPLUS

The following table reconciles the Corporation's contributed surplus:

	September 30, 2008	June 30, 2008
	\$	\$
Contributed surplus, opening	6,127	3,136
Fair value of warrants issued during debt financing (note 9c)	1,215	1,425
Stock compensation expense	115	1,594
Warrants expired	903	-
Stock options exercised	-	(28)
Contributed surplus, ending	8,360	6,127

### 11. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Classifications of financial instruments remain consistent at September 30, 2008 with those at June 30, 2008. The carrying value and respective fair value of financial assets and liabilities are summarized as follows:

	September 30, 2008		
	Carrying Value	Fair Value	Loss <sup>1</sup>
<b>Assets held for trading</b>			
Financial assets held for trading	8,460	8,460	-
<b>Loans and receivables</b>			
Accounts and notes receivable	13,509	13,509	-
<b>Liabilities held for trading</b>			
Financial derivatives	1,492	1,492	733
<b>Other liabilities</b>			
Accounts, interest, and notes payable	18,129	18,129	-
Debt facilities and Convertible Debenture	67,592	67,592	-

<sup>1</sup> Loss relates to realized and unrealized loss on financial derivatives for the three months ended September 30, 2008

#### Credit risk

Credit risk reflects the risk of loss if counterparties do not fulfill their contractual obligations. The majority of the Corporation's accounts receivable balances relate to the operations of BCH and from oil and gas sales from its oil and gas properties. The Corporation's policy is to enter into agreements with customers that are well established and well-financed entities in the oil industry such that the level of risk is mitigated. To date, the Corporation has not experienced any material credit loss in the collection of accounts receivable. During the three month periods ended September 30, 2008, BCH had one customer which accounted for 88% and one related party which accounted for 3% of drilling services revenue (2007 – 29% and 71% respectively). Accounts receivable outstanding from these

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

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customers totalled \$3,663 at September 30, 2008 (June 30, 2008 - \$4,999). All Brazilian oil sales made through the Joint Venture are to a single customer. The Corporation's net share of the outstanding accounts receivable relating to oil sales totalled \$365 at September 30, 2008 (June 30, 2008 - \$596). Details of the Corporation's accounts receivable balance are as follows.

<i>Trade and other receivable aging balances</i>	As at	
	September 30, 2008	June 30, 2008
Current < 30 days	4,885	5,395
30 to 60 days	344	977
60 to 90 days	2	871
Over 90 days	608	575
Total	5,839	7,818

### Market risk

Market risk is the risk or uncertainty that changes in price, such as commodity prices, foreign exchange rates, and interest rates will affect the Corporation's net earnings and the value of financial instruments.

#### a) Commodity price risk

Commodity price risk is the risk that the fair value of the future cash flows will fluctuate as a result of changes in commodity prices. Significant changes in commodity prices can also materially impact the Corporation's borrowing base under its long-term reserve based credit facilities. Commodity prices are significantly impacted by world economic events impacting the supply and demand of oil and natural gas. In addition, BCH is impacted by long-term commodity price trends which impact the demand for its services. In conjunction with the reserves based revolving line credit facility (note 6b), the Corporation entered into oil price financial derivative collars with the following terms.

Period	Volume	Type	Price Range
Oct – Dec 2007	95 bbls/day	Financial Brent Crude Oil Collar	US\$60.00 - US\$74.72
Jan – Dec 2008	71 bbls/day	Financial Brent Crude Oil Collar	US\$60.00 - US\$74.72
Jan – Dec 2009	55 bbls/day	Financial Brent Crude Oil Collar	US\$60.00 - US\$74.72
Jan – Aug 2010	55 bbls/day	Financial Brent Crude Oil Collar	US\$60.00 - US\$74.72

For the three months ended September 30, 2008, the Corporation recognized a realized loss of \$283 (2007 – loss \$6) and an unrealized gain of \$521 (2007 - loss of \$142) relating to its oil collar.

The total fair value of these risk management liabilities at September 30, 2008 was \$967 (June 30, 2008 - \$1,488). As of September 30, 2008, if Brent crude oil prices had be US\$1.00 higher/lower, with all other variables held constant, the change in fair value would have result in a decrease/increase in earnings of approximately \$42.

#### b) Foreign currency risk

Foreign currency risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in foreign currency exchange rates. Many of the Corporation's business transactions and commitments (note 16) occur in currencies other than Canadian dollars. The Corporation's activities in Brazil use the Brazilian Real (BRL) as its functional currency. Therefore it is exposed to the risk of fluctuations in foreign exchange rates. In addition, the Corporation's sales purchase contract for the oil produced in Brazil is based on a US dollar Brent price, but paid in Brazilian Real at the effective rate on the day of the payment. The Corporation's drilling rig contracts are based on US dollar day rates and payments are received in both US\$ and BRL\$. In addition, the Corporation has embedded derivatives associated with several of its drilling rig contracts with its customers whereby the revenues received from the lease portion of these contracts is denominated in the US dollar. The Corporation has not designated any of these embedded derivatives as hedges and has therefore recorded the unrealized gain or loss on these contracts on

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

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the balance sheet with changes in their fair value recorded in the net earnings for the period.

In order to manage its exposure to US\$ dollar fluctuations, the Corporation receives revenues denominated in US\$ and in reference to US\$. In addition, to manage its exposure to currency fluctuations of the Brazilian Real, BCH receives some of its revenues denominated in BRL and has entered into a series of currency derivatives. Details of the terms of these contracts are as follows:

Period	Notional Balance	Type	Settlement	Average BRL/US Exchange Rate
June 2008 - April 2009	US\$500,000 / month	Non-Deliverable Forward	Financial	1.7621
July 2008 - April 2009	US\$200,000 / month	Deliverable Forward	Physical Delivery	1.7306
July 2008 - April 2009	US\$100,000 / month	Deliverable Forward	Physical Delivery	1.7570

For the three months ended September 30, 2008, the Corporation recognized a realized gain of \$55 (2007 – \$Nil) and an unrealized loss of \$1,026 (2007 - \$Nil) relating to its foreign currency derivative contracts. The total fair value of these risk management liabilities at September 30, 2008 was \$525 (June 30, 2008 – asset of \$501).

At September 30, 2008, the Corporation held net -\$65 (BRL -118) on deposit in Brazilian Real (June 30, 2008 – \$2,064 (BRL 3,234)) and \$6,193 (US \$5,843) on deposit in US dollar (June 30, 2008 - \$6,957 (US \$6,830)). The Corporation also has debt denominated in the US dollar. At September 30, 2008, the Corporation had \$72,466 (US\$ 68,373) in US dollar denominated debt outstanding (June 30, 2008 - \$70,562 (US\$ 69,275)).

For the three month period ended September 30, 2008, the Corporation had an unrealized foreign exchange loss of \$2,532 (2007 – gain of \$1,013) primarily due to fluctuations in the Canadian dollar compared to the US dollar for which the long term debt is denominated and depreciation of the Brazilian Real. A 1% increase/decrease in the Canadian dollar vis-a-vis the US dollar is estimated to increase/decrease the earnings of the Corporation by \$667 while a 1% increase/decrease in the Canadian dollar vis-a-vis the Brazilian Real is estimated to increase/decrease earnings of the Corporation by \$33.

### c) Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in prevailing market interest rates. The Corporation is exposed to interest rate risk on certain variable interest rate US dollar denominated debt instruments which are based upon an underlying three month LIBOR reference rate. The remainder of the Corporation's financial assets and liabilities are not exposed to interest rate risk. During the three month periods ended September 30, 2008 and 2007, the Corporation did not enter into any interest rate swaps or other financial arrangements that mitigate the Corporation's exposure to interest rate fluctuations. The effects of a 1% increase/decrease in interest rates are estimated to have \$77 decrease/increase in earnings for the three month period ended September 30, 2008.

### d) Liquidity risk

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they become due and describes the Corporation's ability to access cash. The Corporation requires sufficient cash resources in order to finance operations, fund capital expenditures, and to repay debt and other liabilities of the Corporation as they come due. The following table outlines the contractual maturities of the Corporation's financial liabilities as of September 30, 2008.

## Notes to the Consolidated Financial Statements

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	Recognized on Financial Statements	Payments Due By Period <sup>1,2</sup>				Total
		Less than 1 year	1 -2 years	2-5 years	After 5 years	
Accounts payable and accrued liabilities	Yes - Liability	7,624	-	-	-	<b>7,624</b>
Capital leases	Yes - Liability	769	263	-	-	<b>1,032</b>
Financial derivative instruments	Yes - Liability	1,027	464	-	-	<b>1,491</b>
BCH - Long-term debt	Yes - Liability	7,794	10,909	7,793	-	<b>26,496</b>
Reserves based credit facility	Yes - Liability	50	3,524	-	-	<b>3,574</b>
Convertible Debenture	Yes - Liability	-	42,396	-	-	<b>42,396</b>
Office and equipment leases	No	312	833	-	-	<b>1,145</b>
Round 7 minimum exploration commitments	Yes - Liability	440	-	-	-	<b>440</b>
Other minimum exploration commitments <sup>3</sup>	No	-	1,204	-	-	<b>1,204</b>
<b>Total</b>		<b>18,016</b>	<b>59,593</b>	<b>7,793</b>	<b>-</b>	<b>85,402</b>

<sup>1</sup> Payments exclude ongoing operating costs and interest on debt facilities

<sup>2</sup> Payments denominated in foreign currencies have been translated at the respective September 30, 2008 exchange rate

<sup>3</sup> Minimum work commitments reflect financial settlement liability if not satisfied through the completion of exploration work

In addition to the above, as described in note 6d, BrazAlta (through a subsidiary) and Canacol jointly borrowed from the sum of US\$25,600 as co-borrowers. The loan comprises two credit facilities: The loan comprises two credit facilities:

- a) a US\$50,000 three year senior secured borrowing base revolving credit facility with current availability of US\$14,000; and
- b) a US\$11,600 mezzanine facility.

The revolving credit facility is payable in full on August 27, 2011 and the mezzanine facility is payable by Canacol in six equal semi-annual payments beginning on February 27, 2009.

### Derivatives

The fair value of these transactions is based upon the estimated amounts that would have been paid to or received from counter parties in order to settle the transactions outstanding with reference to the estimated forward prices as of the date of the consolidated balance sheet. The contracts are short-term in nature and are transacted with counter parties with whom management believes represent minimal credit risk and therefore no adjustment has been made in determining the estimated settlement price. The actual amounts realized will be based on the settlement prices at the time of settlement and may differ from these estimates.

The Corporation has not designated any of these financial contracts as hedges and has therefore recorded the unrealized gains and losses on these contracts in the balance sheet as assets or liabilities with changes in their fair value recorded in net earnings for the period.

## 12. CAPITAL DISCLOSURES

The Corporation's objectives when managing capital are to ensure the Corporation will have the sufficient financial capacity, liquidity, and flexibility to fund the operations, growth, and expansion of BCH as well as to fund the operations and ongoing exploration and development activities of its oil and gas assets. The Corporation is dependent upon funding these activities through a combination of debt and equity financings. Due to operational shortfalls and long lead cycles of some of its exploration and developments activities, the Corporation's capital requirements exceed its operational cash flow generated by the Corporation. As such, the Corporation is dependent upon financing in order to maintain its financial flexibility and liquidity

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

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The Corporation regularly monitors its capital structure and as necessary adjusts to changing economic circumstances and the underlying risk characteristics of its assets in order to meet current and upcoming obligations and investments by the Corporation.

The Corporation defines and computes its capital as follows:

	September 30, 2008	June 30, 2008
	\$	\$
Shareholder's equity	25,642	31,500
Long-term debt, including current portion	29,294	29,287
Convertible Debenture	38,298	36,191
Cash	(7,281)	(9,983)
	<b>85,953</b>	<b>86,995</b>

The Corporation's financial objectives and strategy as described above have remained substantially unchanged over the last two completed fiscal years. The objectives and strategy of the Corporation are reviewed on a regular basis.

Through its debt facilities, the Corporation is subject to financial covenants. The key financial covenants relating to its various debt facilities are as follows:

a) *BCH term debt facility*

The following debt covenants are based on the consolidated financial statements of BCH Ltd.

- Current ratio (current assets to current liabilities) of greater than 1.25 to 1.0.
- Senior debt coverage ratio of less than 2.5 to 1 calculated as EBITDA to senior debt interest expense annualized on a proportionate basis for the immediately preceding three consecutive fiscal quarters. For the purposes of the financial covenant calculations EBITDA shall mean consolidated net income before interest, income taxes, depreciation and amortization, amortization of intangibles, any extraordinary unusual or non-recurring non-cash expenses, losses or gains, and any non cash charges or income.
- Senior debt interest coverage ratio of 4 to 1 measured as total senior debt to EBITDA
- Total debt coverage ratio of less than 3.5 to 1 measured as total debt to EBITDA
- Total debt interest coverage ratio of greater than 3.5 to 1 measured as EBITDA less non-recurring capital expenditures to total debt interest expense.

As noted in note 6a, BCH is in violation of its covenants relating to its term debt facility pertaining to minimum working capital balances, debt coverage, and interest coverage as at September 30, 2008. The Corporation has and continues to seek cost reductions in order to generate positive cash flow from operations. Also, the Corporation will need to either obtain a new debt facility or negotiate amendments and/or extensions of its existing debt facilities. The Corporation has not yet obtained the waivers from its lenders regarding the covenant violations. While the Corporation is focusing its best efforts on these matters and continues to negotiate with its lender, the outcome cannot be certain at this time.

b) *Convertible Debenture*

There are no financial covenants relating to the Convertible Debenture. The Corporation is in compliance with its non-financial covenants on the Convertible Debenture as of September 30, 2008.

c) *Reserves based revolving line of credit*

The financial covenants relating to the reserve base revolving line of credit are based upon those of the Corporation's Brazilian Joint Venture partner W. Washington Petroleo S.A.

d) *Rancho Hermoso reserves based revolving line of credit*

## *Notes to the Consolidated Financial Statements*

*For the three months ended September 30, 2008 and September 30, 2007*

*(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)*

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The financial covenants relating to the reserves based revolving line of credit will be based upon those of Canacol Energy Inc. As of September 30, 2008, the Corporation had been in violation of the terms and conditions of this credit facility as a result of the failure to complete the acquisition of Canacol Energy Inc. by September 29, 2008. This has since been rectified with the completion of the acquisition on October 30, 2008 as disclosed in note 19.

### **13. RELATED PARTY TRANSACTIONS**

During the three month period ended September 30, 2008, companies controlled by directors or officers of the Corporation were paid a total \$47 (2007 - \$106) in professional and consulting fees and office rent. All of the transactions were completed on normal industry terms. None of these amounts remained outstanding at each respective period end.

The Corporation has working interests in certain Canadian properties which are operated by a company controlled by a director of the Corporation. The Corporation also has an operating agreement under standard industry terms on the properties in Brazil and paid a total \$261 during the three month period (2007 - \$85) in management fees included in general and administrative expenses to a Brazilian company related by virtue that it is controlled by a director of the Corporation. These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties. At September 30, 2008, \$1,092 (June 30, 2008 - \$2,009) was cash call receivable and \$88 (June 30, 2008 - \$91) was included in accounts payable and accrued liabilities.

The Corporation's oilfield services subsidiary, BCH, performed drilling services for W. Washington, the operator and 52.5% working interest holder in the Brazil Joint Venture. These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties. During the three months ended September 30, 2008, the Corporation recorded \$324 (2007 - \$1,098) for drilling services revenue from this related party representing their share of drilling costs. At September 30, 2008, \$136 (June 30, 2008 - \$Nil) was receivable by the Corporation.

### **14. SEGMENTED INFORMATION AND INTEREST IN JOINT VENTURE**

The Corporation's reportable operating segments, as determined by management, are based on the strategic business operations:

- E&P Brazil includes the Corporation's exploration for, and development and production of, oil and natural gas in the Recôncavo, Sergipe, and Tucano basins of Brazil. Note that substantially all of the operating activities of the Brazil E&P segment are carried out through a joint venture;
- E&P Canada includes the Corporation's exploration for, and development and production of, oil and natural gas in Alberta, Canada;
- E&P Ireland includes the Corporation's exploration for, and development and production of, oil and natural gas in South Larne, Ireland;
- Services include drilling and related services for the oil and gas industry performed in Brazil; and
- The Corporate segment provides management and administrative services to all of its subsidiaries and their respective operations.

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For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

	Three Months Ended September 30, 2008					
	E&P Brazil	E&P Canada	E&P Ireland	Services	Corporate & Eliminations	Total
	\$	\$	\$	\$	\$	\$
<b>REVENUE</b>						
Petroleum and natural gas sales	1,570	42	-	-	-	1,612
Sales tax	(130)	-	-	-	-	(130)
Royalties	(128)	(4)	-	-	-	(132)
Petroleum and natural gas, net	1,312	38	-	-	-	1,350
Drilling services revenue	-	-	-	9,825	-	9,825
Inter-segment sales	-	-	-	44	(44)	-
Sales tax	-	-	-	(736)	-	(736)
Drilling services	-	-	-	9,133	(44)	9,089
Interest income	20	-	-	4	9	33
<b>Total Revenues</b>	1,332	38	-	9,137	(35)	10,472
<b>EXPENSES</b>						
Operating - petroleum and natural gas	665	12	-	-	-	677
Operating - drilling services	-	-	-	7,474	-	7,474
Inter-segment eliminations <sup>1</sup>	-	-	-	36	(36)	-
Depletion, depreciation and accretion	963	21	-	1,014	24	2,022
General and administrative	657	-	-	1,078	723	2,458
Interest and financial expenses	205	-	-	2,870	-	3,075
Foreign exchange (gain) loss	1,174	-	-	1,544	(297)	2,421
Realized loss on financial derivatives	283	-	-	(55)	-	228
Unrealized loss on financial derivatives	(521)	-	-	1,026	-	505
Stock compensation expense	-	-	-	11	115	126
<b>Total Expenses</b>	3,426	33	-	14,998	529	18,986
<b>EARNINGS (LOSS)</b>						
<b>Loss before income taxes</b>	(2,094)	5	-	(5,861)	(564)	(8,514)
Current income tax	-	-	-	677	-	677
Future income tax	-	-	-	(2,003)	-	(2,003)
<b>Net Income (Loss)</b>	(2,094)	5	-	(4,535)	(564)	(7,188)
<b>Total assets</b>	26,523	398	687	72,519	15,929	116,056
<b>Capital expenditures, net</b> <sup>1</sup>	1,746	-	31	1,015	(675)	2,117

<sup>1</sup> Intersegment sales have been netted against exploration and production capital expenditures on consolidation

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

	<b>Three Months Ended September 30, 2007</b>					
	E&P Brazil \$	E&P Canada \$	E&P Ireland \$	Services \$	Corporate & Eliminations \$	<b>Total</b> \$
<b>REVENUE</b>						
Petroleum and natural gas sales	957	85	-	-	-	1,042
Sales tax	(89)	-	-	-	-	(89)
Royalties	(62)	(29)	-	-	-	(91)
Petroleum and natural gas, net	806	56	-	-	-	<b>862</b>
Drilling services revenue	-	-	-	1,343	-	1,343
Inter-segment sales	-	-	-	994	(994)	-
Sales tax	-	-	-	(340)	-	(340)
Drilling services	-	-	-	1,997	(994)	<b>1,003</b>
Interest income	99	-	-	-	23	<b>122</b>
<b>Total Revenues</b>	<b>905</b>	<b>56</b>	<b>-</b>	<b>1,997</b>	<b>(971)</b>	<b>1,987</b>
<b>EXPENSES</b>						
Operating - petroleum and natural gas	627	32	-	-	-	<b>659</b>
Operating - drilling services	-	-	-	1,758	-	<b>1,758</b>
Inter-segment eliminations	-	-	-	863	(863)	-
Depletion, depreciation and accretion	275	55	-	154	7	<b>491</b>
General and administrative	268	-	-	945	544	<b>1,757</b>
Interest and financial expenses	114	-	-	288	-	<b>402</b>
Foreign exchange (gain) loss	(181)	-	-	(806)	4	<b>(983)</b>
Realized loss on financial derivatives	6	-	-	-	-	<b>6</b>
Unrealized loss on financial derivatives	142	-	-	-	-	<b>142</b>
Stock compensation expense	-	-	-	-	477	<b>477</b>
<b>Total Expenses</b>	<b>1,251</b>	<b>87</b>	<b>-</b>	<b>3,202</b>	<b>169</b>	<b>4,709</b>
<b>EARNINGS (LOSS)</b>						
<b>Income (loss) before income taxes</b>	<b>(346)</b>	<b>(31)</b>	<b>-</b>	<b>(1,205)</b>	<b>(1,140)</b>	<b>(2,722)</b>
Current income tax	165	-	-	-	-	<b>165</b>
Future income tax	(165)	-	-	-	-	<b>(165)</b>
<b>Net Income (Loss)</b>	<b>(346)</b>	<b>(31)</b>	<b>-</b>	<b>(1,205)</b>	<b>(1,140)</b>	<b>(2,722)</b>
<b>Total assets</b>	<b>20,401</b>	<b>730</b>	<b>642</b>	<b>35,700</b>	<b>4,281</b>	<b>61,754</b>
<b>Capital expenditures<sup>1</sup></b>	<b>4,772</b>	<b>82</b>	<b>-</b>	<b>18,800</b>	<b>9</b>	<b>23,663</b>

<sup>1</sup> Intersegment sales have been netted against exploration and production capital expenditures on consolidation

Included in the Corporation's balance sheet for the Brazilian Joint Venture are the following balances:

	<b>September 30, 2008</b>	<b>June 30, 2008</b>
	\$	\$
<b>Assets</b>		
Current	<b>1,424</b>	3,981
Long-term	<b>25,174</b>	23,358
<b>Liabilities</b>		
Current	<b>632</b>	690
Long-term	<b>3,524</b>	4,355

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

Geographic information related to the Corporation's activities:

	Revenue		Property, plant, and equipment	
	Three Months Ended September 30,		As At	
	2008	2007	September 30, 2008	June 30, 2008
	\$	\$	\$	\$
Brazil	10,425	1,908	82,358	81,575
Canada	47	79	6,231	6,224
Ireland	-	-	687	656
	10,472	1,987	89,276	88,455

### 15. SUPPLEMENTAL INFORMATION

The changes in non-cash working capital are as follows:

	Three Months Ended	
	September 30, 2008	September 30, 2007
	\$	\$
<b>Operating Activities</b>		
Decrease (increase) in current assets		
Accounts receivable	1,386	260
Prepaid expenses and deposits	45	9
Increase (decrease) in current liabilities		
Accounts payable and accrued liabilities	(691)	941
Interest payable	1,609	246
	2,349	1,456
<b>Investing activities</b>		
Decrease (increase) in current assets		
Cash call receivable	760	-
Note receivable	(6,598)	-
Increase (decrease) in current liabilities		
Accounts payable and accrued liabilities	1,429	2,496
Foreign exchange		
	(4,409)	2,496

As at September 30, 2008, a total of \$Nil of the cash and cash equivalents balance was held in cash equivalents consisting of short-term investments (June 30, 2008 - \$8,433). All investments had a maturity of less than 90 days and the investments were convertible into cash at anytime by the Corporation. Details of the cash balances and the interest rates earned on those balances at September 30, 2008 and June 30, 2008 are as follows:

September 30, 2008		June 30, 2008	
Balance	Average Interest Rate	Balance	Average Interest Rate
C\$0	N/A	C\$0	N/A
C\$0		C\$0	
US\$0	N/A	US\$4,999	1.90%
C\$0		C\$5,092	
BRL\$0	N/A	BRL\$5,234	11.33%
C\$0		C\$3,341	
C\$0		C\$8,433	

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

### 16. COMMITMENTS AND GUARANTEES

#### Minimum exploration program

As at September 30, 2008, BrazAlta has minimum exploration program (“MEP”) work unit commitments to complete negotiated exploration work on its onshore blocks awarded by the Agência Nacional do Petróleo, Gás Natural e Biocombustível (“ANP”), Brazil’s National Petroleum Agency. MEP work units are satisfied through completion of exploration wells, seismic programs, and other exploration survey methods all of which have prescribed work units for completion. Therefore, although actual dollars spent on projects do not directly correlate to reducing the MEP work units, the financial guarantees related to non-performance are shown in the table below. These properties are operated within the Brazilian Joint Venture and the commitment will be reduced as work is performed.

Bid Round	Basin	Commitment Date	Gross Remaining MEP Work Units	Gross Financial Guarantee	Net Remaining MEP Work Units	Net Financial Guarantee <sup>1</sup>
7	Recôncavo & Sergipe	August 26, 2008	2,086	\$3,450 BRL \$6,258	266	\$440 BRL \$798
9	Recôncavo	March 12, 2010	1,600	\$2,646 BRL \$4,800	320	\$529 BRL \$960
9	Espirito Santo	March 12, 2011	1,020	\$1,687 BRL \$3,060	408	\$675 BRL \$1,224

<sup>1</sup>Net financial guarantee based on BrazAlta’s net working interest.

The Corporation and W. Washington have cross-guaranteed the working interest of the other partner for the non-performance guarantee placed with a Brazilian insurance company which has insured the performance of the MEP work units or the corresponding financial payment in lieu thereof to the ANP on certain of Round 7 exploration blocks. A large percentage of the Round 7 exploration commitments have been farmed-out and as such the Net Remaining MEP Work Units attributable to BrazAlta for Round 7 in the table above is only 266 units which, at September 30, 2008, equated to approximately \$440 (June 30, 2008 – 1,867 units or \$3,576). Based on actual work performed, the Corporation has made an accrual as a contingent liability of \$440 (June 30, 2007 - \$1,119), relating to its net share of expected MEP work units yet to be fulfilled by means of financial settlement.

#### Reserves based revolving line of credit

As discussed in note 6b, BrazAlta and its Brazil Joint Venture partner, W. Washington have jointly entered into a reserves based revolving line of credit facility. The revolving line of credit facility is cross guaranteed by BrazAlta. BrazAlta records its 47.5% net share of revolving line of credit facility in the consolidated financial statements, however, is guarantor on the gross balance of the facility. At September 30, 2008, there was a total draw on the facility of gross US\$7,100 (net US\$3,373) (June 30, 2008 gross US\$9,000 (net US\$4,275)).

#### Other

The Corporation has commitments for leases and its office premises. As of September 30, 2008, the payments required in each of the next five years are as follows:

	\$
2009 - 9 Months	312
2010	416
2011	416
2012	Nil
2013	Nil

## Notes to the Consolidated Financial Statements

For the three months ended September 30, 2008 and September 30, 2007

(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)

### 17. ASSET HELD FOR SALE

At September 30, 2008, the Corporation held \$Nil equipment for sale (June 30, 2008 - \$975). The equipment was sold during the three month ended September 30, 2008 for net proceeds of US\$950. During the year ended June 30, 2008, the Corporation recorded an impairment relating to the disposition of the equipment totalling \$292. The following table provides additional information with respect to the amounts included in the balance sheet as assets and liabilities held for sale.

	September 30, 2008	June 30, 2008
	\$	\$
Equipment held for sale	-	975
Total assets held for sale	-	975
Liabilities held for sale	-	132
Total liabilities held for sale	-	132

### 18. NON-CONTROLLING INTEREST

The components of the Corporation's non-controlling interest relating to BCH are as follows:

	September 30, 2008	June 30, 2008
	\$	\$
Non-controlling interest, opening balance	2,757	-
Issuance of Convertible Debenture by subsidiary (note 6c)	-	2,480
Fair value of warrants issued by subsidiary (note 10d)	-	164
Stock based compensation of subsidiary (note 10f)	11	113
Non-controlling interest, ending balance	2,768	2,757

As at September 30, 2008, there have been no conversions exercised on the Convertible Debenture and BrazAlta owns 100% of the issued and outstanding shares of BCH.

### 19. SUBSEQUENT EVENTS

#### *Canacol Energy Inc.*

On October 30, 2008, BrazAlta closed the acquisition of all of the issued and outstanding common shares and warrants of Canacol Energy Inc. The transaction was completed by way of three cornered amalgamation such that Canacol is now a wholly owned subsidiary of BrazAlta. The aggregate consideration paid by BrazAlta for all of the Canacol common shares and warrants was a total of 40,000,000 common shares in the capital of BrazAlta. Upon completion of the transaction, there are 130,084,655 BrazAlta Common Shares issued and outstanding.

#### *BCH private placement*

On October 1, 2008, BCH Ltd. was authorized to complete a non-brokered private placement of 4,474,999 BCH Common Shares at a price of US\$4.163 per BCH Common Share for aggregate gross proceeds of US\$18,629. On October 1, 2008, BrazAlta acquired 1,717,093 BCH Common Shares for consideration of US\$7,148 in conversion of loans receivable from BCH. In addition, BrazAlta has a share subscription payable to BCH of US\$2,353 relating to the purchase of an additional 565,156 shares. At the time of these financial statements, these additional shares had not yet been purchased by or issued to BrazAlta. On October 1, 2008, Allis-Chalmers Energy Inc. acquired 2,192,750 BCH Common Shares in the financing for consideration of US\$3,500 in conversion of accrued interest payable on the Debenture and cash proceeds of US\$5,628. Following the completion of the first portion of the

*Notes to the Consolidated Financial Statements*

*For the three months ended September 30, 2008 and September 30, 2007*

*(Unless otherwise stated, amounts presented are in thousands of Canadian dollars) (unaudited)*

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financing, BCH will have 13,909,843 BCH Common Shares issued and outstanding of which BrazAlta will own 11,717,093 BCH Common Shares or 84.2%.

# Corporate Information

## Management Team

Charle Gamba – President & Chief Executive Officer

Mark Holliday - Chief Operating Officer

Arthur Halleran – Vice President Exploration

Luiz Azevedo, MBA – Brazil Country Manager

## Board of Directors

David R.P. Mears – Chairman, Director

Charle Gamba President, CEO, Director

Lyle F. Dunkley – Director

Stuart Hensman – Director

Louis (Lou) W. MacEachern – Director

Jason Bednar – Director

Alverra Barrera – Director

Michael Hibberd – Director

## Corporate Information

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### Auditors

Deloitte & Touché LLP Calgary, Alberta

### Bankers

HSBC Bank Canada and Brasil

Calgary, Alberta and Rio de Janeiro - RJ, Brazil

### Independent Reserve Engineers

DeGolyer and MacNaughton Canada Limited

Calgary, Alberta

### Legal Counsel

Davis & Company LLP

Calgary, Alberta

Schmidt, Valois, Miranda, Ferreira e Agel –

Advogados Rio de Janeiro - RJ, Brazil

### Stock Exchange Listing

TSX Venture Exchange: BRX

### Transfer Agent & Registrar

Olympia Trust Company

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