Emerald Bay Energy Inc.

Financial Statements

Year Ended December 31, 2011

(expressed in Canadian dollars)

CHARTERED ACCOUNTANTS

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Independent Auditor's Report

To the Shareholders of
Emerald Bay Energy Inc.

We have audited the accompanying financial statements of Emerald Bay Energy Inc., which comprise the statements of financial position as at December 31, 2011, December 31, 2010, and January 1, 2010, and the statements of comprehensive loss, changes in shareholders' equity and cash flows for the years ended December 31, 2011 and December 31, 2010, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
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 comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the financial statements present fairly, in all material respects, the financial position of Emerald Bay Energy Inc. as at December 31, 2011, December 31, 2010, and January 1, 2010 and its financial performance and its cash flows for the years ended December 31, 2011 and December 31, 2010 in accordance with International Financial Reporting Standards.

Emphasis of matter
Without modifying our opinion, we draw attention to Note 1 to the financial statements which describes the material uncertainty that may cast significant doubt about the ability of Emerald Bay Energy Inc. to continue as a going concern.

MacKay LLP

Chartered Accountants

May 1, 2012
Calgary, Alberta

Emerald Bay Energy Inc.

Statement of Financial Position

December 31, 2011 and 2010

	December 31, 2011	December 31, 2010	January 1, 2010
	$	$	$
		(note 22)	(note 22)
Assets			
Current assets			
Cash and cash equivalents	**332,301**	38,334	142,728
Short-term investments	**49,964**	50,989	55,864
Trade and other receivables	**227,231**	732,805	970,257
Prepaid expenses and deposits	**58,805**	35,582	64,212
Assets held for sale (note 10)	**1,500,000**	-	-
Total current assets	**2,168,301**	857,710	1,233,061
Non-current assets			
Due from related parties (note 16(a))	**24,623**	51,373	63,238
Equity investment in PRI (note 6)	**459,078**	226,272	-
Exploration and evaluation assets and other intangible assets (note 8)	**-**	25,081	11,835
Property and equipment (note 7)	**1,015,177**	4,009,884	4,709,113
Total assets	**3,667,179**	5,170,320	6,017,247
Liabilities			
Current liabilities			
Bank loan (note 12)	**2,675,000**	3,275,000	2,935,019
Accounts payable and accrued liabilities	**2,333,903**	2,596,818	2,616,909
Shareholder loan (note 13)	**301,157**	-	-
Current portion of long-term debt (note 17(b))	**23,345**	22,075	13,079
Financial contract (note 18(d)(i))	**161,770**	3,278	-
Total current liabilities	**5,495,175**	5,897,171	5,565,007
Non-current liabilities			
Long-term debt (note 16(b))	**66,580**	89,989	67,919
Financial contract (note 18(d)(i))	**-**	150,488	-
Decommissioning liabilities (note 11)	**201,664**	239,316	237,963
Total liabilities	**5,763,419**	6,376,964	5,870,889
Shareholders' (Deficit) Equity			
Share capital (note 14(b))	**8,491,683**	7,603,866	6,661,596
Warrants (note 14(c))	**126,644**	13,336	102,083
Contributed surplus (note 14(f))	**1,048,656**	962,321	766,924
Deficit	**(11,763,223)**	(9,786,167)	(7,384,245)
Total shareholders' (deficit) equity	**(2,096,240)**	(1,206,644)	146,358
Total liabilities and shareholders' (deficit) equity	**3,667,179**	5,170,320	6,017,247

Going concern (note 1)
Commitments (note 17)
Subsequent events (note 12 and 20)

Approved on behalf of the Board of Directors

Signed "Shelby D. Beattie" — Director

Signed "Gibson C. Scott" — Director

The notes are an integral part of these financial statements.

Emerald Bay Energy Inc.

Statement of Comprehensive Loss

For the years ended December 31, 2011 and 2010

	December 31, 2011 $	December 31, 2010 $ (note 22)
Revenue		
Petroleum and natural gas revenue	**1,082,351**	1,311,685
Royalties	**(145,361)**	(243,103)
	936,990	1,068,582
Operating expenses		
Exploration and evaluation expenditures	**2,915**	15,867
Production and operating expenses	**595,445**	610,736
Depletion, depreciation and amortization (note 7)	**394,232**	495,003
Impairment of property and equipment (note 9)	**356,515**	897,480
Impairment of assets held for sale (note 10)	**385,341**	-
Impairment of evaluation and exploration assets and other intangible assets (note 8)	**25,081**	-
General and administrative	**1,229,864**	1,159,410
Share-based payment expense (note 14(d))	**79,982**	87,648
	(3,069,375)	(3,266,144)
Results from operating activities	**(2,132,385)**	(2,197,562)
Finance expense		
Interest income	**6,953**	9,731
Interest expense	**(353,928)**	(153,166)
Impairment of accounts receivable (note 18(b))	**(32,000)**	(5,917)
Foreign exchange loss	**(13,562)**	(9,036)
Accretion of decommissioning liability (note 11)	**(8,974)**	(8,924)
Net finance expense	**(401,511)**	(167,312)
Other income and expenses		
Unrealized loss on financial contract (note 18(d)(i))	**(8,003)**	(153,767)
Gain on disposal of oil and natural gas interests (note 7)	**377,406**	-
Equity income on investment in PRI (note 6)	**16,900**	3,103
Gain on purchase of drilling royalty credits	**73,700**	-
Impairment on funds due from related party (note 16(a))	**(9,805)**	-
Oil and natural gas derivative income (note 18(d)(i))	**106,642**	113,616
Net other income and expenses	**556,840**	(37,048)
Net loss and comprehensive loss	**(1,977,056)**	(2,401,922)
Basic and fully diluted earnings per share (note 14(g))	**(0.03)**	(0.05)
Weighted average number of common shares outstanding during the year	**75,055,833**	51,522,083

The notes are an integral part of these financial statements.

Emerald Bay Energy Inc.

Statement of Changes in (Deficit) Equity

For the years ended December 31, 2011 and 2010

	Share capital	Warrants	Contributed surplus	Deficit	Total equity (deficit)
Balance, January 1, 2010	6,661,596	102,083	766,924	(7,384,245)	146,358
Issuance of common shares	606,500	-	-	-	606,500
Issue of flow through shares	410,000	-	-	-	410,000
Issue of warrants	(13,336)	13,336	-	-	-
Expiry of warrants	-	(102,083)	102,083	-	-
Share issue costs	(60,894)	-	5,666	-	(55,228)
Share based payments	-	-	87,648	-	87,648
Loss for the year	-	-	-	(2,401,922)	(2,401,922)
Balance, December 31, 2010	7,603,866	13,336	962,321	(9,786,167)	(1,206,644)
Funds received pursuant to prior year private placement	60,000	-	-	-	60,000
Shares issued as consideration for lease acquisition	42,625	-	-	-	42,625
Issuance of common shares	622,200	-	-	-	622,200
Issue of flow through shares	360,185	-	-	-	360,185
Issue of warrants	(126,644)	126,644	-	-	-
Expiry of warrants	13,336	(13,336)	-	-	-
Share based payments	-	-	79,982	-	79,982
Share issue costs	(83,885)	-	6,353	-	(77,532)
Loss for the year	-	-	-	(1,977,056)	(1,977,056)
Balance, December 31, 2011	8,491,683	126,644	1,048,656	(11,763,223)	(2,096,240)

The notes are an integral part of these financial statements.

Emerald Bay Energy Inc.

Statement of Cash Flows

For the years ended December 31, 2011 and 2010

	December 31, 2011 **$**	December 31, 2010 $ (note 22)
Cash (used in) provided by:		
Operating activities		
Net loss for the year	**(1,977,056)**	(2,401,922)
Adjustments for:		
Depletion, depreciation and amortization	**394,232**	495,003
Impairment of property and equipment	**356,515**	897,480
Impairment of assets held for sale	**385,341**	-
Impairment of exploration and evaluation assets	**25,081**	-
Exploration and evaluation expense	**-**	15,867
Accretion	**8,974**	8,924
Unrealized loss on financial contract	**8,004**	153,767
Gain on disposal of oil and natural gas interests	**(377,406)**	-
Equity pick-up on investment in PRI	**(16,900)**	(3,103)
Impairment of account receivable	**32,000**	
Impairment of funds due from related party	**9,805**	-
Share-based payment expense	**79,982**	87,648
	(1,071,428)	(746,336)
Change in accounts receivable	**473,575**	297,452
Change in prepaid expenses and deposits	**(23,224)**	28,630
Change in accounts payable and accrued liabilities	**135,531**	(978,675)
Change in due to related party	**16,945**	-
	(468,601)	(1,398,929)
Investing activities		
Property and equipment expenditures	**(88,236)**	(680,762)
Proceeds received on disposal of oil and natural gas interests	**595,260**	-
Proceeds from sale of investment in PRI	**-**	214,500
Investment in PRI	**(215,906)**	-
Change in short-term investments	**1,025**	4,875
Change in accounts payable and accrued liabilities	**(173,446)**	923,061
	118,697	461,674
Financing activities		
Proceeds from issuance of common shares, net of issue costs	**904,853**	559,125
Receipt of related party receivable	**-**	11,865
(Repayment) receipt of bank loan	**(600,000)**	339,981
Receipt of shareholder loan	**301,157**	
Repayment of long term debt	**(22,139)**	(18,110)
Change in working capital	**60,000**	(60,000)
	643,871	832,861
Change in cash	**293,967**	(104,394)
Cash, beginning of year	**38,334**	142,728
Cash, end of year	**332,301**	38,334
Non-cash transactions		
Property and equipment acquired through shares issued	**42,625**	-
Fair value of agent options	**6,353**	5,666

The notes are an integral part of these financial statements.

1 Reporting entity and going concern

Emerald Bay Energy Inc. (the "Company") was incorporated under the Business Corporations Act of Alberta on May 9, 1997 and is listed on the TSX Venture exchange. The Company is engaged in the exploration for and development of petroleum and natural gas properties principally in Alberta and Texas and is developing a lateral drilling technology. The Company is listed on the TSX Venture Exchange under the symbol "EBY.V". The Company's registered head office is located at #1A, 4015 – 1 Street South East, Calgary, Alberta, Canada T2G 4X7.

At December 31, 2011, the Company had not yet achieved profitable operations, had accumulated a deficit of $11,763,223 since its inception (December 31, 2010 - $9,786,167, January 1, 2010 - $7,384,245) and had a working capital deficiency of $3,165,104 (December 31, 2010 - $5,036,183, January 1, 2010 - $4,331,946) (defined as current assets less current liabilities), and expects to incur further losses in the development of its business, all of which cast significant doubt as to whether the Company is a going concern. The ability to continue as a going concern is dependent on obtaining continued financial support, completing public equity financing, or generating profitable operations in the future. Management is committed to raising additional capital to meet its exploration and operating obligation, however, additional equity financing is subject to the global financial markets and economic conditions, which have recently been disrupted and are volatile, and the debt and equity markets, which have been distressed, particularly for junior petroleum and natural gas companies. These factors, together with weak natural gas prices and the current unstable economic conditions, have caused, and will likely continue to cause significant doubt as to whether the Company is a going concern. Any adjustments necessary to the financial statements if the Company ceases to be a going concern could be material.

Subsequent to December 31, 2011, management of the Company has completed certain transactions to increase working capital and substantially repay the Revolving Loan and the shareholder loan in its entirety (note 20).

2 Basis of presentation

a) Statement of compliance:

The Company prepares its financial statements in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") as set out in the Handbook of the Canadian Institute of Chartered Accountants ("CICA Handbook"). In 2010, the CICA Handbook was amended to incorporate International Financial Reporting Standards ("IFRS"), and requires publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the Company has commenced reporting on this basis in these

financial statements. In the financial statements, the term “Canadian GAAP” refers to Canadian GAAP before the adoption of IFRS.

These annual financial statements have been prepared in accordance with accounting policies consistent with IFRS as issued by the International Accounting Standards Board (“IASB”) and Interpretations of the International Financial Reporting Interpretations Committee (“IFRIC”); and with IFRS 1: First-time Adoption of International Financial Reporting Standards. Note 21 and 22 discloses the impact of the transition to IFRS on the Company’s reported equity as at the transition date of January 1, 2010 and December 31, 2010 and comprehensive loss for the year ended December 31, 2010, including the nature and effect of significant changes in accounting policies.

The policies applied in these financial statements are based on IFRS issued and outstanding as of May 1, 2012, the date the Board of Directors approved the statements.

b) Basis of measurement:

The financial statements have been prepared on the historical cost basis except for derivative financial instruments and share-based payment transactions, which are measured at fair value, as explained in note 3 – Significant Accounting Policies. The comparative figures presented in these financial statements are in accordance with IFRS.

c) Functional and presentation currency:

The financial statements are presented in Canadian dollars, which is the Company’s presentation and functional currency.

d) Use of estimates and judgments:

The preparation of the financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected. Specific amounts and disclosures affected by estimates and assumptions are:

Reserves

Amounts recorded for depreciation, depletion and amortization and amounts used for impairment calculations are based on estimates of oil and natural gas reserves. By their nature,

the estimates of reserves, including the estimates of future prices, costs, discount rates and the related future cash flows are subject to measurement uncertainty.

Determination of cash-generating units ("CGU")

Property and equipment are aggregated into CGUs based on their ability to generate largely independent cash flows and are used for impairment testing. The determination of the Company's CGUs is subject to management's judgment.

Decommissioning liabilities

The Company estimates the decommissioning obligations for oil and natural gas wells and their associated production facilities and pipelines. In most instances, removal of assets and remediation occurs many years into the future. Amounts recorded for the decommissioning obligations and related accretion expense require judgmental assumptions regarding removal date, future environmental legislation, the extent of reclamation activities required, the engineering methodology for estimating costs, future removal technologies in determining the removal costs, and liability specific discount rates to determine the present value of these cash flows.

Exploration and evaluation assets

The accounting policy for exploration and evaluation assets is described in note 3. The application of this policy requires management to make certain estimates and assumptions as to future events and circumstances as to whether economic quantities of reserves have been found.

Share-based compensation

Compensation costs accrued for share-based compensation plans are subject to the estimation of what the ultimate payout will be using pricing models such as the Black-Scholes model which is based on significant assumptions such as the future volatility of the market price of the Company's shares, the forfeiture rate, the interest rate and the expected term of the issued stock option.

Deferred taxes

The provision for income taxes is based on judgments in applying income tax law and estimates on the timing, likelihood and reversal of temporary differences between accounting and tax bases of assets and liabilities.

3 Significant accounting policies

The accounting policies set out below have been applied consistently to all years presented in these financial statements. Certain comparative amounts have been reclassified to conform to the current year's presentation as noted below:

Cash and cash equivalents

Cash consists of cash on hand. Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management, whereby management has the legally enforceable right and ability and intent to net bank overdrafts against cash, are included as a component of cash for the purpose of the statement of cash flows.

Financial instruments

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risk and rewards of ownership. Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognized amount and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

Common shares are classified as equity. Incremental costs directly attributable to the issue of common shares are recognized as a deduction from equity, net of any tax effects.

Non-derivative financial instruments:

Non-derivative financial instruments include cash and cash equivalents, short-term investments, trade and other receivables, due from related parties, accounts payable and accrued liabilities, shareholder loan, long-term debt and the bank loan. Non-derivative financial instruments are recognized initially at fair value. Subsequent to the initial recognition, non-derivative financial instruments are designated into one of the following categories and measured as described below.

(i) Financial assets and liabilities at fair value through profit or loss: Financial assets and liabilities at fair value though profit or loss are either "held for trading" or have been "designated at fair value through profit of loss". In both cases the financial assets and financial liabilities are measured at fair value with changes in fair value recognized in the statement of comprehensive loss. A financial asset or liability is classified in this category if acquired principally for the purpose of selling or repurchasing in the short-term.

The Company has designated it cash and cash equivalents and short-term investments in this category.

(ii) Loans and receivables: Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company's loans and receivables are comprised of trade and other receivables and due from related parties and are included in current assets due to their short-term nature. Loans and receivables are initially recognized at the amount expected to be received less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment.

(iii) Financial liabilities at amortized cost: Financial liabilities at amortized cost include accounts payable and accrued liabilities, shareholder loan, bank debt, and long-term debt. Accounts payable and accrued liabilities and due to related parties are initially recognized at the amount required to be paid less, when material, a discount to reduce the payables to fair value. Subsequently, accounts payables and accrued liabilities and due to related parties are measured at amortized cost using the effective interest method. The shareholder loan, the bank loan and long-term debt are recognized initially at fair value and subsequently at amortized cost using the effective interest method. Transaction costs to acquire bank debt and long-term debt are recognized in the statement of comprehensive loss.

Financial liabilities are classified as current liabilities if payment is due within twelve months. Otherwise, they are presented as non-current liabilities.

Derivative financial instruments:

The Company may enter into certain financial derivative contracts in order to manage the exposure to market risks from fluctuations in commodity prices. These instruments are not used for trading or speculative purposes. Although the Company considers all commodity contracts to be economic hedges, the Company has not designated its financial derivative contracts as effective accounting hedges, and thus not applied hedge accounting. As a result, all financial derivative contracts are classified as fair value through profit or loss and are recorded on the statement of financial position at fair value. Transaction costs are recognized in the statement of comprehensive loss when incurred.

Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related. Changes in the fair value of separable embedded derivatives are recognized immediately in the statement of comprehensive loss. The Company has not identified any material embedded derivatives in any of its financial instruments.

Property and equipment and intangible exploration assets

(a) Recognition and measurement:

(i) Exploration and evaluation expenditures:

Pre-license costs are recognized in the statement of comprehensive loss as incurred.

All costs associated with the exploration and evaluation of oil and natural gas reserves are initially capitalized. Exploration and evaluation costs are those expenditures for an area where technical feasibility and commercial viability has not yet been determined. These costs include unproved property acquisition costs, exploration costs, geological and geophysical costs, decommissioning costs, exploration and evaluation drilling, and sampling and appraisals.

When an area is determined to be technically feasible and commercially viable the accumulated costs are tested for impairment and transferred to property and equipment. When an area is determined not to be technically feasible and commercially viable or the Company decides not to continue with its activity, the unrecoverable costs are charged to the statement of comprehensive loss as exploration and evaluation expense.

(ii) Property and equipment:

All costs directly associated with the development of oil and gas reserves are capitalized on an area-by-area basis. Development costs include expenditures for areas where technical feasibility and commercial viability has been determined. These costs include proved property acquisitions, development drilling, completion, gathering and infrastructure, decommissioning costs and transfers of exploration and evaluation assets.

Costs accumulated within each area are depleted using the unit-of-production method based on proved reserves incorporating estimated future prices and costs. Costs subject to depletion include estimated future costs to be incurred in developing proved reserves. Costs of major development projects are excluded from the costs subject to depletion unless they are available for use.

Gains and losses on disposal of an item of property and equipment, including oil and natural gas interests, are determined by comparing the proceeds from disposal with the carrying amount of property and equipment and are recognized net within “other income” or “other expenses” in the statement of comprehensive loss.

(iii) Other property and equipment:

Other property and equipment are carried at cost and amortized over the estimated useful lives of the assets at various rates per annum calculated on a declining balance basis. Amortization is charged at half rates in the year of acquisition.
The Company uses the following rates:

Asset class	**Rate**
Furniture and equipment and leasehold improvements	20%
Computer Hardware	30%
Automotive	30%

(b) Subsequent costs:

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property and equipment are recognized as oil and natural gas interests only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in the statement of comprehensive loss as incurred. Such capitalized oil and natural gas interests generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis. The carrying amount of any replaced or sold component is derecognized. The costs of the day-to-day servicing of property and equipment are recognized in the statement of comprehensive loss as incurred.

Impairment

(a) Financial assets:

A financial asset not carried at fair value through profit and loss is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

Objective evidence that financial assets are impaired can include:

- significant financial difficulty of the issuer or counterparty; or
- default or delinquency of payments; or
- it is probable that the borrower will enter bankruptcy or financial re-organization

Financial assets carried at amortized cost: An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying

amount and the present value of the estimated future cash flows discounted at the original effective interest rate. The carrying amount of the asset is reduced by this amount and losses are recognized in statement of comprehensive loss and through the use of an allowance account.

Impairment losses on financial assets carried at amortized cost are reversed in subsequent periods if the reversal can be related objectively to an event occurring after the impairment loss was recognized. The reversal is recognized in the statement of comprehensive loss or credited against the allowance account.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

(b) Non-financial assets:

The carrying amounts of the Company's non-financial assets, other than E&E assets and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. For goodwill and other intangible assets that have indefinite lives or that are not yet available for use an impairment test is completed each year. E&E assets are assessed for impairment when they are reclassified to property and equipment, as oil and natural gas interests, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (the "cash-generating unit" or "CGU").

The recoverable amount of an asset or a CGU is the greater of its value in use and its fair value less costs to sell ("FVLCTS"). Value in use is determined by estimating the present value of the future net cash flows expected to be derived from the continued use of the asset or CGU. FVLCTS is based on available market information, where applicable. In the absence of such information, FVLCTS is determined using discounted future net cash flows of proved reserves using forecast prices and costs.

An impairment loss is recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in the statement of comprehensive loss. Impairment losses recognized in respect of CGU's are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the unit (group of units) on a pro rata basis.

An impairment loss in respect of goodwill is not reversed. In respect of other assets, impairment losses recognized in prior years are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation or amortization, if no impairment loss had been recognized.

Share based payments

The Company issues stock options to directors, officers and other consultants. The fair value of options granted to employees is measured at grant date, using the Black-Scholes option pricing model, and is recognized over the vesting period. The fair value is recognized as compensation expense with a corresponding increase in contributed surplus. A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest.

Provisions

A provision is recognized if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. Provisions are not recognized for future operating losses.

Decommissioning liabilities

The Company's activities give rise to dismantling, decommissioning and site disturbance re-mediation activities. Provision is made for the estimated cost of site restoration and capitalized in the relevant asset category.

Decommissioning obligations are measured at the present value of management's best estimate of expenditure required to settle the present obligation at the statement of financial position date. Subsequent to the initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The increase in the provision due to the passage of time is recognized as finance costs whereas increases/decreases due to changes in the estimated future cash flows are capitalized. Actual costs incurred upon settlement of the decommissioning liabilities are charged against the provision to the extent the provision was established.

Revenue

Revenue from the sale of oil and natural gas is recorded when the significant risks and rewards of ownership of the product is transferred to the buyer which is usually when legal title passes to the external party. This is generally at the time product enters the pipeline.

Royalty income is recognized as it accrues in accordance with the terms of the overriding royalty agreements.

Finance income and expenses

Finance expense comprises interest expense on borrowings, accretion of the discount on provisions and impairment losses recognized on financial assets.

Interest income is recognized as it accrues in the statement of comprehensive loss, using the effective interest method.

Income tax

Income tax expense comprises current and deferred tax. Income tax expense is recognized in the statement of comprehensive loss except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

Earnings per share

Basic earnings per share is calculated by dividing the profit or loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the year. Diluted earnings per share is determined by adjusting the profit or loss attributable to common shareholders and the weighted average number of common shares outstanding for the effects of dilutive instruments such as options granted to employees.

Foreign currency transactions

Transactions denominated in foreign currencies are translated into their Canadian dollar equivalents at exchanges rates prevailing at the transaction dates. Carrying values of the monetary assets and liabilities are translated into their Canadian dollar equivalents at the exchange rates in effect on the balance sheet date. Gains and losses on translation or settlement are included in the determination of net loss for the current year.

Investments

Investments in companies subject to significant influence are accounted for using the equity method. The equity method is a basis of accounting whereby the investment is initially recorded at cost and the carrying value is adjusted thereafter to include the Company's pro-rata share of post-acquisition income or loss. The amount of the adjustment is included in the determination of net loss by the Company and the investment account of the Company is also increased or decreased to reflect the Company share of capital transactions and changes in accounting policies and corrections of errors. Profit distributions received or receivable from the investments will reduce the carrying value of the investment. Investments accounted for on the equity basis are written down to their fair value when they have a loss in value that is other than a temporary decline.

Borrowing costs

Borrowing costs attributable to the acquisition, construction or production of qualifying assets are added to the cost of those assets, until such time as the assets are substantially ready for their intended use. All other borrowing costs are recognized as interest expense in the statement of comprehensive loss in the period in which they are incurred.

Assets held for sale

Assets are classified as held for sale if the carrying amount will be recovered principally through a sale transaction rather than through continued use. The sale of these assets must be considered highly probable. A sale is considered highly probable if the assets are available for immediate sale, and management has stated their intention to sell the properties within one year. Assets classified as held for sale are measured at the lower of the carrying value and the fair value less costs to sell, and are no longer depreciated.

Flow-through shares

From time to time the Company will issue flow-through common shares to finance a portion of its exploration program. These shares transfer the tax deductibility of qualifying resources expenditures to investors. On issuance, the Company splits the flow-through shares into i) a flow-through share premium, equal to the estimated premium, if any investors pay for the flow-through feature, which is recognized as a liability, and ii) share capital. When expenses are renounced, the Company derecognizes the liability and recognizes a deferred tax liability for the amount of tax reduction renounced to the shareholders. The premium is recognized as other income and the related deferred tax is recognized as a tax provision.

Proceeds received from the issuance of flow-through shares are restricted to be used only for Canadian resources property exploration expenditures. The Company may also be subject to a Part XII.6 tax on flow-through proceeds renounced under the Look-back Rule, in accordance with Government of Canada flow-through regulations. When applicable, this tax is accrued as a financial expense until paid.

4 Recent accounting pronouncements

The Company has reviewed the new and revised accounting pronouncements that have been issued but are not yet effective and determined that the following may have an impact on the Company and will become effective beginning on or after January 1, 2013:

IFRS 9 – "Financial Instruments", which is the result of the first phase of the IASB's project to replace IAS 39 – "Financial Instruments: Recognition and Measurement". The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value. The adoption of this standard should not have a material impact on the Company's financial statements.

IFRS 10 – "Consolidated Financial Statements", which builds on existing principles and standards and identifies the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company.

IFRS 11 – "Joint Arrangements", which establishes the principles for financial reporting by entities when they have an interest in arrangements that are jointly controlled.

IFRS 12 – "Disclosure of Interest in Other Entities", which provides the disclosure requirements for interests held in other entitles including joint arrangements, associates, special purpose entities and other off balance sheet entities.

IFRS 13 – "Fair Value Measurement", which defines fair value, requires disclosure about fair value measurements and provides a framework for measuring fair value when it is required or permitted within the IFRS standards.

IAS 27 – "Separate Financial Statements", which provides amendments to IAS 27 to coincide with the changes made in IFRS 10, but retains the current guidance for separate financial statements.

IAS 28 – "Investments in Associate and Joint Ventures", which revised the existing standard and prescribes the accounting for investments and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

IFRS 7 – "Financial Instruments: Disclosures" and IAS 32 "Financial Instruments: Presentation", provides amendments to the previously issued IFRS 7 "Financial Instruments: Disclosures" and IAS 32 "Instruments: Presentation", to provide clarity over the current offsetting model and develop common disclosure requirements to enhance the understanding of the potential effects of offsetting arrangements. Amendments to IFRS 7 are effective on January 1, 2013 with required retrospective application and early adoption permitted. Amendments to IAS 32 are effective on January 1, 2014 with required retrospective application and early adoption permitted.

IAS 1 – "Presentations of Items of OCI: Amendments to IAS 1 Presentation of Financial Statements", which provides stipulates for the amendment of the presentation of net earnings and OCI and also requires that items are grouped within OCI based on whether the items may be subsequently reclassified to profit or loss. Amendments to IAS 1 are effective for the Company beginning on January 1, 2012 with retrospective application and early adoption permitted.

5 Determination of fair values

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

(a) Property and equipment and exploration and evaluation assets:

The fair value of property and equipment is the estimated amount for which property and equipment could be exchanged on the acquisition date between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties each acted knowledgeable, prudently and without compulsion. The fair value of oil and natural gas assets (included in property and equipment) and exploration and evaluation

assets is estimated with reference to the discounted cash flows expected to be derived from oil and natural gas production based on externally prepared reserve reports. The risk-adjusted discount rate is specific to the asset with reference to general market conditions.

(b) Cash and cash equivalents, trade and other receivables and accounts payable and accrued liabilities:

The fair value of cash and cash equivalents, trade and other receivables, and accounts payable and accrued liabilities is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. At December 31, 2011 and December 31, 2010, the fair value of these balances approximated their carrying value due to their short term to maturity.

(c) Share-based payments, warrants and finder's options:

The fair value of employee stock options, warrants and the finder's options are measured using a Black Scholes option pricing model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behavior), expected dividends, and the risk-free interest rate (based on government bonds).

6 Equity investment

On March 4, 2010, the Company announced that it had acquired 50% of the shares of a private Texas based oil company, Production Resources Inc ("PRI"). As consideration for the purchase, the Company issued 5,000,000 common shares ($0.08 CDN per share) and an 18 month consulting agreement valued at $36,800 USD, for total consideration of $425,000 USD.

On March 15, 2010, the Company sold 50% of its interest in the shares of PRI to a private Alberta company (the "PrivateCo") for consideration of $214,750. As a result, the Company's ownership interest in PRI decreased to 25%. The Company has accounted for the investment using the equity method.

During the year ended December 31, 2011, the Company advanced an additional $215,906 to PRI, which was deemed to form part of the value of the Company's net investment in PRI.

The investment in PRI as at December 31, 2011 is as follows:

	CDN $
Net investment, January 1, 2010	-
Purchase of 50% interest in PRI	437,919
Disposition of 50% interest in PRI to PrivateCo	(214,750)
Share of income for the period	3,103
Net investment, December 31, 2010	226,272
Proportionate share of income for the year	16,900
Additional funds advanced	215,906
Net investment, December 31, 2011	459,078

7 Property and equipment

	Oil and natural gas interests	**Corporate and Other**	**Total**
	$	**$**	**$**
Cost, January 1, 2010	9,367,929	247,565	9,615,494
Additions	630,278	51,167	681,445
Cost, December 31, 2010	9,998,207	298,732	10,296,939
Accumulated depletion, depreciation and impairment	(4,772,761)	(133,620)	(4,906,381)
Depreciation and depletion for the year	(443,824)	(39,370)	(483,194)
Impairment of property and equipment	(897,480)	-	(897,480)
Carrying value, December 31, 2010	3,884,142	125,742	4,009,884

	Oil and natural gas interests	**Corporate and Other**	**Total**
	$	**$**	**$**
Cost, December 31, 2010	9,998,207	298,732	10,296,939
Additions	154,352	-	154,352
Transfers to assets held for sale	(4,568,178)	-	(4,568,178)
Disposal of oil and natural gas interests	(1,177,135)	-	(1,177,135)
Cost, December 31, 2011	4,407,246	298,732	4,705,978
Accumulated depletion, depreciation and impairment	(6,114,065)	(172,991)	(6,287,056)
Disposal of oil and natural gas interests	664,165	-	664,165
Depreciation and depletion for the year	(358,119)	(36,113)	(394,232)
Impairment of property and equipment	(356,515)	-	(356,515)
Impairment upon transfer of assets held for sale	(385,341)	-	(385,341)
Transfer of accumulated depletion, depreciation and impairment of assets held for sale	3,068,178	-	3,068,178
Carrying value, December 31, 2011	925,549	89,628	1,015,177

During the year ended December 31, 2011, the Company disposed of various Canadian and US oil and natural gas interests with a net book value of $512,970 for total proceeds of $820,260. Of the total proceeds, $595,260 was received in cash and the remaining proceeds of $225,000 were used to reduce outstanding payables the Company had owing to the purchaser. A gain on the sale of $377,406 was recognized as the proceeds received were greater that the carrying amount of the assets and the associated decommissioning liabilities of $70,118. At December 31, 2011, the Company transferred assets with a net book value of $1,500,000 to assets held for sale (note 10).

8 Exploration and evaluation and other intangible assets

	E&E assets $
Cost, January 1, 2010	-
Additions	25,081
Balance, December 31, 2010	25,081
Impairment of exploration and evaluation assets	(25,081)
Balance, December 31, 2011	-

Exploration and evaluation (“E&E”) and other intangible assets consist of the Company’s exploration projects which are pending the determination of proven or probable reserves. As at December 31, 2010 an amount of $25,081 of E&E assets were acquired and represent the acquisition of undeveloped land within Alberta. At December 31, 2011, the Company determined that it no longer had the rights to the undeveloped land and recorded an impairment of the aggregate value.

9 Impairment loss

During the year ended December 31, 2011, due to unexpected accelerated reserve declines, the Company tested its property and equipment for impairment.

The recoverable amount of each CGU was estimated based on the higher of the value in use and the FVLCTS. The estimate of FVLCTS was determined using a discount rate of 10% percent and forecasted cash flows, with escalating prices and future development costs, as obtained from the reserve report. The prices used to estimate the FVLCTS are those used by independent industry reserve engineers.

Based on the assessment at December 31, 2011, the carrying amount of the property and equipment was determined to be $356,515 higher (December 31, 2010 - $897,480) than its recoverable amount, and an impairment loss was recognized.

10 Assets held for sale

Prior to December 31, 2011, management was committed to selling certain oil and gas assets and was actively marketing and accepting purchase proposals. Accordingly at December 31, 2011, these assets were presented as assets held for sale. The disposition of the assets was completed on March 16, 2012 (note 20) for gross proceeds of $1,500,000. The carrying value of the assets held for sale exceeded the highest purchase proposal received, and consequently an impairment of $385,341 was recorded in the statement of comprehensive loss. The full amount of the proceeds were used to repay a portion of the Revolving Loan (note 12).

11 Decommissioning obligations

The Company's decommissioning obligations result from its ownership interest in oil and natural gas assets including well sites and gathering systems. The total decommissioning obligation is estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future years. The Company has estimated the net present value of the decommissioning obligations to be $201,664 as at December 31, 2011 (December 31, 2010 - $239,316) based on an undiscounted total future liability of $206,810 (December 31, 2010 - $279,130). These payments are expected to be made over the next 20 years. The obligations have been calculated using an inflation rate of 2% and a discount factor, being the risk-free rate related to the liability, of 2.29% (December 31, 2010 – 2% and 3.75%, respectively).

	December 31, 2011	December 31, 2010
	$	$
Balance, beginning of year	239,316	237,963
Disposals	(62,818)	(2,736)
Liabilities incurred	1,518	56,530
Revisions (changes in estimates)	14,674	(61,363)
Accretion	8,974	8,922
Balance, end of year	201,664	239,316

12 Bank loan

On June 23, 2011, the Company amended its revolving operating demand loan (the "Revolving Loan") with a Chartered Canadian Bank (the "Lender"). Pursuant to the amendment, the maximum amount available under the Revolving Loan has been reduced from $3,000,000 to $1,575,000. The per annum interest rate has been increased from the Lender's prime rate plus 2.00% to the Lender's prime rate plus 3.00%. Interest continues to be calculated daily and payable monthly on the outstanding principal amount drawn. At December 31, 2011, the Company had drawn $1,550,000 of the Revolving Loan (December 31, 2010 - $2,875,000).

The Company is subject to a standby fee of 0.25% per annum on the undrawn portion of the Revolving Loan, which is payable monthly. The Company is also subject to an issue fee of 2.00% per annum of the issued amount, which is payable at the time of issue.

Also on June 23, 2011, the Company cancelled its existing non-revolving demand loan (the "Non-revolving Loan A") of $400,000 with the Lender and obtained a new non-revolving demand loan (the "Non-revolving Loan B") in the maximum amount of $1,825,000, which was reduced by the Lender on August 15, 2011 to a maximum amount of $1,775,000. The funds received under the Non-revolving Loan B were used to reduce the excess of the Revolving Loan down to the amended maximum and to repay amounts owing under cancelled Non-revolving Loan A. Interest on the Non-revolving Loan B is calculated daily and payable monthly on the outstanding principal amount at a rate per annum equal to the bank's prime rate plus 5.00% (Non-revolving Loan A – bank's prime plus 2.50%). At December 31, 2011 the Company had a remaining balance of $1,125,000 owing.

Under the June 23, 2011 amended agreement, the Company was required to permanently reduce Non-Revolving Loan B by $700,000 on or before July 29, 2011 and the Revolving Loan and Non-revolving Loan B would expire on July 29, 2011, unless further extended by the Lender. The Company failed to permanently reduce Non-revolving Loan B by $700,000 on the stipulated date and further requested the Lender to extend the loans beyond July 29, 2011. On August 15, 2011, a second amending agreement was established between the Lender and the Company, pursuant to which the Lender reduced the maximum amount available under the Non-revolving Loan B to $1,775,000 and that the Company permanently repay and cancel the Non-revolving Loan B by October 14, 2011. During August 2011, the Company fulfilled the requirement to permanently reduce the Non-revolving Loan by $700,000.

A Loan Amending Fee of $50,000 is payable by the Company to the Lender.

Subsequent to December 31, 2011, the Company entered into an additional amending agreement whereby the Company was to reduce the Revolving Loan by $1,500,000 through the sale of certain oil and gas assets, which the Company fulfilled (note 20). An amending fee of $10,000 was paid to the Lender, and additionally, the $50,000 payable for the previous amendment was also paid to the Lender.

Security for the loans consists of a $10,000,000 Debenture with a floating charge over all assets of the Company with a negative pledge and undertaking to provide fixed charges on the Borrower's major producing petroleum properties at the request of the bank. The bank has required the Company to submit to them certain reports and to maintain certain covenants, including maintaining a Working Capital Ratio of not less than 1.0 to 1.0 at all times. The Working Capital ratio for this purpose is defined as Current Assets (including the un-drawn availability under the

Non-revolving Loan B) to Current Liabilities (excluding any current portion of Bank Debt). As at December 31, 2011, the Company is in violation of the Working Capital Ratio with a ratio of 0.83:1.

13 Shareholder loan

During the year ended December 31, 2011, the Company received a shareholder loan for $301,157. The funds received under the shareholder loan were used to provide additional working capital to the Company. Interest on the shareholder loan is calculated daily and payable monthly on the outstanding principal amount at a rate of 10% per annum. The shareholder loan is to be repaid through monthly reductions of $12,500 commencing on May 1, 2012, but can be repaid in full at any time prior to that. The shareholder loan can be renewed or extended if mutually agreed upon. Subsequent to December 31, 2011, the shareholder loan was repaid (note 20).

14 Share capital

a) **Authorized**

Unlimited number of common shares with voting rights
Unlimited number of preferred shares, issuable in series

b) **Issued**

	Number of Common Shares	Amount $
Balance, January 1, 2010	45,159,446	6,661,596
Funds received pursuant to prior year private placement	-	19,000
Shares issued on purchase of PRI (i)	5,000,000	400,000
Private placement (ii)	8,850,000	442,500
Value of warrants issued pursuant to private placement (ii)	-	(5,863)
Private placement (iii)	4,300,000	215,000
Value of warrants issued pursuant to private placement (iii)	-	(7,473)
Share subscription receivable	-	(60,000)
Share issue costs (iv)	-	(60,894)
Balance, December 31, 2010	63,309,446	7,603,866
Funds received pursuant to prior year private placement	-	60,000
Shares issued as consideration for lease acquisition (v)	532,812	42,625
Private placement (vi)	13,413,701	670,685
Value of warrants issued pursuant to private placement (vi)	-	(86,967)
Private placement (vii)	6,234,000	311,700
Value of warrants issued pursuant to private placement (vii)	-	(39,677)
Fair value reallocation on expiry of warrants (note 14(c))	-	13,336
Share issue costs (viii)	-	(83,885)
Balance, December 31, 2011	83,489,959	8,491,683

(i) On March 4, 2010, the Company issued 5,000,000 common shares with a value of $400,000 ($.08 per share). These shares were issued as consideration for the purchase of 50% of the share of a private Texas based oil and gas company, PRI (note 6).

(ii) The Company completed a private placement ("Placement A"), issuing 8,850,000 units for total proceeds of $442,500, ($0.05 per unit). Each unit consists of one common share of the Company (issued either as a common share or as a flow-through share (the "FTS")) and one common share purchase warrant (the "Warrant A"). Each whole Warrant A entitles the holder to purchase one additional common share of the Company at $0.12 per share, exercisable for 1 year from the date of Placement A. Of the total 8,850,000 units issued, 6,900,000 were issued as a FTS. The Company has allocated $5,863 of the unit value to warrants (note 14(c)).

(iii) The Company completed a private placement ("Placement B"), issuing 4,300,000 units for total proceeds of $215,000, ($0.05 per unit). Each unit consists of one common share of the Company (issued either as a common share or as a FTS) and one Warrant A. Of the total 4,300,000 units issued, 1,300,000 were issued as a FTS. The Company has allocated $7,473 of the unit value to warrants (note 14(c)).

(iv) Pursuant to Placement A and Placement B, the Company incurred $55,228 in cash share issue costs and issued 750,000 finders options (the "Finders Options") valued at $5,666 (note 14(e)).

(v) On March 18, 2011, the Company issued 532,812 common shares with a value of $42,625 ($0.08 per share). The common shares were issued as consideration for the purchase of a 100% interest in an oil and gas lease in Texas.

(vi) On April 13, 2011 and June 17, 2011, the Company completed a private placement (collectively "Placement C"), issuing 9,413,701 units and 4,000,000 units, respectively. Each unit under Placement C was issued at $0.05 for total proceeds of $670,685. Each unit consists of one common share of the Company (issued either as a common share or as a FTS) and one share purchase warrant ("Warrant B"). Each Warrant B entitles the holder to purchase one additional common share of the Company at $0.10 per share, exercisable for 18 months from the original issue date. Of the total 13,413,701 units issued, 7,203,701 were issued as a FTS. The Company has allocated $86,967 of the unit value to warrants (note 14(c)).

(vii) On August 19, 2011 and October 7, 2011, the Company completed a private placement issuing 4,600,000 units and 1,634,000 units, respectively ("Placement D"). Each unit under Placement D was issued at $0.05 for total proceeds of $311,700. Each unit

consists of one common share of the Company and one share purchase warrant ("Warrant B"). Each Warrant B entitles the holder to purchase one additional common share of the Company at $0.10 per share, exercisable for 18 months from the original issue date. The Company has allocated $39,677 of the unit value to warrants (note 14(c)).

(viii) Pursuant to Placement C and Placement D, the Company incurred $77,532 in cash share issue costs and under Placement C issued 470,000 finders options (the "Finders Options") valued at $6,353 (note 14(e)).

c) **Warrants**

Warrants to acquire common shares outstanding at December 31, 2011 are as follows:

	Number of warrants issued and exercisable	Amount $	Weighted average exercise price $	Weighted average Remaining life (years)
Balance, January 1, 2010	9,625,000	102,083	0.15	0.14
Share purchase warrants (note 14(b)(ii) and (iii))	13,150,000	13,336	0.12	0.59
Expiry of warrants	(9,625,000)	(102,083)	(0.15)	-
Balance, December 31, 2010	13,150,000	13,336	0.12	0.34
Share purchase warrants issued (note 14(b)(vi) and (vii))	19,647,701	126,644	0.10	0.93
Expiry of warrants	(13,150,000)	(13,336)	(0.12)	-
Balance, December 31, 2011	19,647,701	126,644	0.10	0.93

The fair value of the share purchase warrants granted during the year are estimated at the grant date using the Black-Scholes option pricing model and have been credited to warrants within shareholders' equity. A weighted average of the assumptions used in the calculation is noted below:

	2011	2010
Risk-free rate	**1.43%**	1.50%
Expected life	**1.5 years**	1 year
Expected volatility	**67.41%**	61.93%
Fair value per warrant	**$0.01**	$0.001

d) **Stock options**

The Company established a share option plan (the "Plan") for the benefit of officers, directors, employees and consultants of the Company. Under the Plan, the number of common shares to be reserved and authorized for issuance pursuant to options granted under the Plan cannot exceed 10% of the total number of issued and outstanding shares of the Company. The term,

the vesting period and the exercise price are determined at the discretion of the Board of Directors. However, the maximum option term shall not exceed five years.

During the year ended December 31, 2011, there were 4,925,000 stock options granted, 305,000 stock option cancellations, 1,000,000 stock options expiries and there were no stock options exercised. The following table summarizes information about the Company's stock options outstanding at December 31, 2011:

	December 31, 2011		December 31, 2010	
	Number of options	**Weighted Average Exercise price $**	Number of options	Weighted Average Exercise price $
Stock options, beginning of year	**4,060,000**	**0.14**	1,850,000	0.24
Granted	**4,925,000**	**0.10**	3,450,000	0.10
Cancelled	**(305,000)**	**-**	(690,000)	0.15
Expired	**(1,000,000)**	**0.25**	(550,000)	0.25
Stock options outstanding, end of year	**7,680,000**	**0.10**	4,060,000	0.14

The total stock options outstanding at December 31, 2011 are as follows:

Exercise prices ($)	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price ($)
0.10	7,680,000	4.16	0.10

As at December 31, 2011 all outstanding options have vested and are exercisable.

The terms of the granted stock options are consistent with the Plan and are all exercisable at $0.10 per option and expire 5 years after the grant date. All options vest immediately. The fair value of the options granted is estimated as at the grant date using the Black-Scholes option pricing model. The weighted average assumptions used in the calculation are noted below:

Risk-free interest rate	1.40%
Expected life	5 years
Expected volatility	67.41%
Fair value per option	0.02

Compensation expense recognized during the year ended December 31, 2011 was $79,982 (December 31, 2010 - $87,648), all of which has been recorded as an offsetting credit to contributed surplus.

e) **Finders Options**

During the year ended December 31, 2011, the Company issued 470,000 Finders Options, respectively, to the those who facilitated Placement C (note 14(b)(viii)), there were no Finder Options that were exercised and 750,000 expired unexercised. Each Finders Option granted pursuant to Placement C is exercisable into one unit consisting of one common share and one common share purchase warrant ("Finder Warrant") of the Company at $0.05 per unit. Each Finder Warrant is exercisable into one common share of the Company at $0.10 per common share. The Finders Options expire one year from the original grant date.

The following table summarizes information about the Company's Finder Options outstanding at December 31, 2011:

	December 31, 2011		December 31, 2010	
	Number of options	**Weighted Average Exercise price $**	Number of options	Weighted Average Exercise price $
Finders Options, beginning of year	**750,000**	**0.05**	1,090,617	0.12
Granted	**470,000**	**0.05**	750,000	0.05
Expired	**(750,000)**	**(0.05)**	(1,090,617)	(0.12)
Finders Options outstanding, end of year	**470,000**	**0.05**	750,000	0.05

The Finders Options were valued at $6,353. The fair value of the Finders Options granted is estimated as at the grant date using the Black-Scholes option pricing model. The assumptions used in the calculation are noted below:

	2011	2010
Risk-free interest rate	**1.74%**	1.44%
Expected life	**1 years**	1 years
Expected volatility	**67.41%**	61.93%
Fair value per option	**$0.01**	$0.01

f) **Contributed surplus**

	December 31, 2011	December 31, 2010
	$	$
Balance, beginning of year	**962,321**	766,924
Share-based payment expense	**79,982**	87,648
Finders options (note 14(e))	**6,353**	5,666
Finder Options expired unexercised (note 14(c))	-	102,083
Balance, end of year	**1,048,656**	962,321

g) **Per share data**

Basic earnings per share are calculated based on the weighted average number of shares outstanding during the year. The treasury stock method is used for the calculation of diluted loss per share. Under this method, it is assumed that proceeds from the exercise of dilutive securities are used by the Company to repurchase Company shares at the average price during ,the year. All warrants, finders options, finder warrants and stock options have been excluded from the calculation of diluted shares outstanding as they would be anti-dilutive due to the loss position of the Company.

15 Income tax

Income tax expense differs from that which would be expected from applying the combined effective Canadian federal and provincial corporate tax rates of 26.50% (December 31, 2010 – 28.00%) to income before income taxes as follows:

	December 31,2011	December 31, 2010
	$	$
Loss per statement of comprehensive loss	**(1,977,056)**	(2,401,922)
Tax rate	**26.50%**	28.00%
Expected income tax provision	**(523,920)**	(672,538)
Increase (decrease) resulting from:		
Change in rates	**29,558**	64,146
Share-based payments	**21,195**	24,541
Other	**(12,478)**	49,741
Share issue costs	**(20,971)**	(15,224)
Change in estimates	**(66,807)**	-
Change in deferred tax asset not recognized	**573,423**	549,334
	-	-

Significant components of the deferred tax liability are as follows:

	December 31, 2011	December 31, 2010	January 1, 2010
	$	$	$
Property and equipment	**(215,436)**	(19,105)	331,951
Non-capital loss carried forward	**(1,090,555)**	(703,764)	(503,985)
Decommissioning liabilities	**(50,416)**	(59,829)	(59,491)
Share issue costs	**(42,993)**	(43,279)	(45,118)
Scientific research and experimental development	**(150,663)**	(150,663)	(150,663)
Attributed Canadian royalty income	**(110,080)**	(110,080)	(110,080)
Investment tax credits	**(195,000)**	(195,000)	(195,000)
Deferred tax asset not recognized	**1,855,143**	1,281,720	732,386
	-	-	-

The Company has estimated tax pools totaling:

	Rate of Claim	**December 31,2011**
		$
Canadian exploration expenditures	100%	**1,204,141**
Canadian development expenditures	30%	**795,046**
Foreign development expenditures	100%	**54,848**
Undepreciated capital cost	Various	**1,322,881**
Share issue costs	20%	**171,973**
Scientific research and experimental development		**602,650**
Attributed Canadian royalty income		**1,100,800**
Non-capital loss carry forward		**4,362,221**
		9,614,560

The accumulated non-capital loss carry forwards expire as follows:

2031	1,547,164
2030	799,119
2029	1,185,990
2028	402,658
2027	178,670
2014	248,620

16 Related party transactions

Related party transactions not disclosed elsewhere in these financial statements are as follows:

a) The following amounts are due from related parties:

	December 31, 2011	December 31, 2010
	$	$
Note receivable from officer (i)	**231,609**	225,054
Fair value allowance (ii)	**(216,515)**	(206,710)
Net note receivable	**15,094**	18,344
Advance fees (iii)	**9,529**	33,029
	24,623	51,373

(i) A promissory note was issued to an officer of the Company bearing interest at 3% per annum and repayable by December 31, 2012, unless the officer's employment is terminated or he is petitioned into bankruptcy wherein the note and accrued interest becomes immediately payable. The note is secured by 393,000 common shares of the Company which had a fair value of $15,094 at December 31, 2011 (December 31, 2010 - $19,650).

(ii) The fair value allowance was initially determined on December 31, 2008 based on the market value of the secured shares. During the year ended December 31, 2011, the Company provided an additional allowance of $9,805 to the estimated fair value of the 393,000 common shares held as security as the carrying amount exceeded the fair value (December 31, 2010 - $nil).

(iii) During the year ended December 31, 2008, a director was advanced $59,473 in relation to efforts to finance and advance the Company's drilling technology. At December 31, 2011 $9,529 (December 31, 2010 - $33,029) remains outstanding. There is no guarantee that such efforts will be successful and if such efforts are not successful, the full balance will be repaid. The original repayment date of December 31, 2010 has been extended to December 31, 2012.

b) Additional related party transactions not disclosed elsewhere in these financial statements are as follows:

(i) Aggregate fees of $96,300 (December 31, 2010 - $85,000) were charged by directors of the Company. Of this amount $78,450 (December 31, 2010 - $24,100) was recorded in the statement of comprehensive loss and $17,850 (December 31, 2010 - $60,900) was capitalized to property and equipment.

(ii) Aggregate consulting fees of $179,347 (December 31, 2010 - $256,500) were charged by directors and officers of the Company and were recorded in the statement of comprehensive loss.

(iii) Aggregate fees of $72,275 (December 31, 2010 - $43,200) were charged by a U.S. corporation, which is owned and controlled by an officer and a director of the Company for costs it incurred for operation of the Company's U.S. properties. Of this amount $53,725 (December 31, 2010 - $43,200) was recorded in the statement of comprehensive loss and $18,550 was capitalized to property and equipment.

(iv) Included in accounts payable at December, 2011 was $37,410 owing to related parties of the Company (December 31, 2010 - $51,636).

Key management compensation

	December 31, 2011	December 31, 2010
	$	$
Compensation	362,912	327,856
Share based payments	60,393	67,872
Total	423,305	395,728

Transactions in the normal course of operations are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

17 Commitments

a) Under a lease agreement for five years commencing April 1, 2009 and ending March 31, 2014, the Company has committed to payments of $5,420 per month for the lease of its office space. Subsequent to December 31, 2011, the Company terminated its existing lease agreement and negotiated a new lease agreement for a smaller office space extending until March 31, 2014 for payments of $2,771 per month.

b) The Company has entered into various vehicle loan agreements with estimated minimum annual payments of approximately $27,800 per year through 2015. Total annual principal repayments for fiscal years 2012 through to 2015 are respectively as follows: $23,345, $24,688, $26,110 and $15,846.

c) As partial consideration for the non-controlling acquisition of the shares of a Texas oil and gas company, the Company has entered into a consulting contract aggregating $37,919 (USD -$36,800). The contract commences March 1, 2010 and has a term of 18 months. During the year ended December 31, 2011, this commitment was fulfilled.

d) The Company is committed to renounce to subscribers $321,998 and $360,185 of expenditures that qualify as cumulative exploration expenditures (“CEE”) for Canadian income tax purposes and to incur these expenditures no later than December 31, 2011 and December 31, 2012, respectively. At December 31, 2011, the Company has incurred approximately $88,002 as eligible flow through expenditures against the December 31, 2011 commitment.

18 Financial risk management

The Board of Directors oversees managements’ establishment and execution of the Company’s risk management framework. Management has implemented and monitors compliance with risk management policies. The Company’s risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company’s activities.

(a) Fair values

The Company’s financial instruments consist of cash and cash equivalents, short-term investments, trade and other receivables, due from related parties, financial contracts, accounts payable and accrued liabilities, shareholder loan, the bank loan and long-term debt.

Financial Instrument	**Classification**	**Carrying Value $**	**Fair Value $**
Cash and cash equivalents	Fair value through profit and loss	332,301	332,301
Short-term investments	Fair value through profit and loss	49,964	49,964
Trade and other receivables	Loans and receivables	227,231	227,231
Due from related parties	Loans and receivables	24,623	24,623
Shareholder loan	Other financial liabilities	301,157	301,157
Financial contract liability	Fair value through profit and loss	161,770	161,770
Accounts payable and accrued liabilities	Other financial liabilities	2,333,903	2,333,903
Bank loan	Other financial liabilities	2,675,000	2,675,000
Long-term debt	Other financial liabilities	66,580	66,580

The significance of inputs used in making fair value measurements are examined and classified according to a fair value hierarchy. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement.

At December 31, 2011, the Company's cash has been subject to Level 1 valuation.

(b) Credit risk:

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from joint venture partners and oil and natural gas marketers.

Receivables from oil and natural gas marketers are normally collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any collection issues with its oil and natural gas marketers. Receivables from joint venture partners are typically collected within one to three months of the joint venture bill being issued. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner pre-approval of significant capital expenditures. However, the receivables are from participants in the oil and natural gas sector, and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition, further risk exists with joint venturers; as disagreements occasionally arise that increase the potential for non-collection. The Company does not typically obtain collateral from oil and natural gas marketers or joint venturers; however, the Company does have the ability to withhold production from joint venturers in the event of non-payment.

A provision for doubtful accounts of $32,000 has been recorded at December 31, 2011 (December 31, 2010 - $5,917).

Cash and cash equivalents consist of cash bank balances held in both interest and non-interest bearing accounts. The Company manages credit exposure of cash by selecting financial institutions with high credit ratings.

(c) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation.

To achieve this objective, the Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non operated projects to further manage capital expenditures. The Company also attempts to match its payment cycle with collection of oil and natural gas revenue on the 25th of each month.

The Company's net current liabilities and other liabilities and the manner in which they are expected to be met are as follows:

Net working capital deficiency (as defined by the Bank Loan terms)	$465,104	This amount is anticipated to be met out of additional share issuance in the 2012 and asset sales (note 20).
Bank loan (note 12) and shareholder loan (note 13)	$2,976,157	Subsequent to December 31, 2011, Company reduced the Revolving Loan by $1,500,000 through the sale of certain oil and gas assets and repaid the shareholder loan in its entirety through a private placement (note 20).
Long term debt	$66,580	Vehicle loans will be paid over the next 4 years out of normal cash flow.

(d) Market risk:

Market risk is the risk that changes in market prices, such as commodity prices, foreign exchange rates and interest rates will affect the Company's income or the value of the financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while maximizing returns.

(i) Commodity price risk:

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for oil and natural gas are impacted by not only the relationship between the Canadian and United States dollar but also world economic events that dictate the levels of supply and demand. All of the Company's oil and gas production is sold at spot rates exposing the Company to the risk of price movements.

As a means to mitigate the exposure to commodity price volatility, the Company entered into the following derivative financial instruments:

During 2010, the Company entered into a derivative financial instrument, which became effective on January 1, 2011 to December 31, 2011 ("Option A"). This instrument fixed the received price of natural gas at CDN 4.684 per GJ.

During 2010, the Company entered into two commodity call options. The first option ("Option B") is effective from January 1, 2011 to December 31, 2011 and the second option ("Option C") is effective from January 1, 2012 to December 31, 2012. Both Options have a strike price of USD $90.00 per BBL.

As at December 31, 2011, based on the fair market value of the contracts, the Company has recorded an unrealized loss of $8,003 (December 31, 2010 - $153,767) in the statement of comprehensive loss.

The following table summarizes the fair value of the Options as at December 31, 2011:

	Option A ($)	Option B ($)	Option C ($)
Fair market value, January 1, 2010	-	-	-
Unrealized (loss)	162,458	(165,736)	(150,489)
Fair market value, December 31, 2010	162,458	(165,736)	(150,489)
Unrealized (loss)	(162,458)	165,736	(11,281)
Fair market value, December, 2011	-	-	(161,770)
Financial Contract asset (liability):			
Current	(161,770)		

The realized gain recorded by the Company on the derivative financial instruments for the year ended December 31, 2011 was $106,642 (December 31, 2010 – $113,616).

(ii) Currency risk:

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company operates in Canada and the United States and a portion of its expenses are incurred in US dollars. The Company does not hedge its exposure to fluctuations in the exchange rate. Future changes in exchange rates could have a material effect on the Company's business including its intended capital plans, its financial condition and results of operations.

Certain of the Company's financial instruments are exposed to fluctuations in the US dollar, including cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities. As at December 31, 2011, an increase or decrease of 10% to the foreign exchange rate between the US dollar and the Canadian dollar applied to the average level of US denominated cash and cash equivalents would have had approximately a $37,200 (December 31, 2010 - $5,170) impact on the Company's comprehensive loss for the year.

(iii) Interest rate risk:

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank debt which bears a floating rate of interest. At December 31, 2011 the Company's bank debt was $2,675,000 (December 31, 2010 - $3,275,000). As at December 31, 2011, if interest rates had been 1% higher/lower, with all other variables held constant, there would have been an

impact of approximately $29,700 (December 31, 2010 - $29,000) on the Company's comprehensive loss for the year.

The Company has no interest rate swaps or financial contracts in place as at or during the year ended December 31, 2011 or during the year ended December 31, 2010.

(e) Capital management:

The Company's capital consists of shareholders' equity, bank debt and working capital. The Company will adjust its capital structure to manage its current and future debt, drilling programs and potential corporate acquisitions through the issuance of shares, increasing the credit facility line and adjustments to capital spending. The Company's objective for managing capital is to maximize long-term Shareholder value by ensuring adequate capital to achieve the Company's objectives.

Management reviews its capital management approach on an ongoing basis and believes its current approach is reasonable given the size of the Company. There has been no change in managements approach to capital management during the year.

As at December 31, 2011, the Company is in violation of the Working Capital Ratio required to be maintained pursuant to the Bank Loan (note 12).

19 Segmented information

The Company's primary operations are limited to a single industry being the acquisition, exploration for, and development of petroleum and natural gas. Geographical segmentation is as follows:

			December 31, 2011 ($)
	Canada	**United States**	**Total**
Petroleum and natural gas sales	919,777	162,574	1,082,351
Other income	556,840	-	556,840
Depletion, depreciation and impairment	1,090,599	45,489	1,136,088
Net loss (income)	1,944,929	32,127	1,977,056
Property and equipment	855,694	159,483	1,015,177
Assets held for sale	1,500,000	-	1,500,000
Total liabilities	5,418,204	345,215	5,763,419

			December 31, 2010 ($)
	Canada	**United States**	**Total**
Petroleum and natural gas sales	1,200,409	111,276	1,311,685
Other income	37,048	-	37,048
Depletion, depreciation and impairment	1,352,722	39,761	1,392,483
Net loss	2,282,169	119,753	2,401,922
Property and equipment	3,802,927	206,957	4,009,884
Exploration and evaluation assets	25,081	-	25,081
Total liabilities	6,350,911	26,053	6,376,964

			January 1, 2010 ($)
	Canada	**United States**	**Total**
Property and equipment	4,380,093	329,020	4,709,113
Exploration and evaluation assets	11,835	-	11,835
Total liabilities	5,837,990	32,899	5,870,889

20 Subsequent events

Subsequent to December 31, 2011, the Company entered into the following transactions:

a) The Company closed a private placement through the issuance of 14,240,000 units for gross proceeds of $712,000. Each unit consists of one common share of the Company and one share purchase warrant. Each share purchase warrant entitles the holder thereof to purchase 1 additional common share of the Company for a period of 12 months from the issuance of the units at a price of $0.10 per common share. Part of the proceeds from the private placement were used to repay the shareholder loan of $301,157 in its entirety.

b) The Company closed a transaction to sell various interests in certain oil and gas properties to an arm’s length party. The total consideration received on the disposition was $1,500,000. The full amount of the proceeds have been used to reduce the Revolving Loan.

21 Transition to IFRS

As stated in note 2, these are the Company’s first financial statements for the period covered by the first annual financial statements prepared in accordance with IFRS.

The accounting policies in note 3 have been applied in preparing the financial statements for the year ended December 31, 2011, the comparative information for the year ended December 31, 2010, and the statement of financial position for the transition date of January 1, 2010.

IFRS employs a conceptual framework that is similar to Canadian GAAP. While the adoption of IFRS has not changed the actual cash flows of the Company, the adoption has resulted in changes to the reported financial position and results of operations of the Company. The Company followed the provisions of IFRS 1 in preparing its opening IFRS statement of financial

position. Certain of the Company's IFRS accounting policies used for this opening statement of financial position differed from its Canadian GAAP policies applied at the same date. The resulting adjustments arose from events and transactions before the date of transition to IFRS. Therefore as required by IFRS 1, those adjustments were recognized directly through retained earnings (or another category of equity where appropriate) as of January 1, 2010, the transition date, in accordance with the general rules of IFRS 1 which is to apply IFRS retrospectively, unless a specific exemption was available and taken. The following are the significant exemptions the Company has elected to apply:

- Deemed cost exemption for property and equipment – the Company has elected to report items of property and equipment on transition date at deemed cost instead of the actual cost that would be determined under IFRS. The deemed cost of an item may be either its fair value at the transition date or an amount determined by a previous revaluation under Canadian GAAP. The exemption can be applied on an asset-by-asset basis. Oil and gas assets that were part of the full cost pool and determined to be developed or producing assets were allocated to CGU's on the transition date pro rata using reserve values, subject to an impairment test on the transition date.

- Share-Based Payments – The Company has elected not to apply IFRS 2 "Share-Based Payments" to equity instruments which vested before the transition date. As such, adjustments were made only to Share-Based Payments that were granted before the transition date but had not vested.

- Decommissioning liabilities – In accounting for changes in obligations to dismantle, remove and restore items of property and equipment, the guidance under IFRS requires changes in such obligations to be added to or deducted from the cost of the asset to which it relates. The adjusted depreciable amount of the asset is then depreciated prospectively over its remaining life. Rather than recalculating the effect of all such changes throughout the life of the obligation, the Company has elected to measure the liability and the related depreciation effects at the transition date.

22 Reconciliation of statement of financial position from Canadian GAAP to IFRS

Statement of Financial Position

The following tables reconcile the statements of financial position of the Company from the amounts previously reported under Canadian GAAP to IFRS as at the transition date of January 1, 2010 and December 31, 2010.

January 1, 2010

	Canadian GAAP	Effect on transition to IFRS			IFRS
	$		$		$
		a	b	g	
Assets					
Current assets					
Cash	142,728	-	-		142,728
Short-term investments	55,864	-	-		55,864
Trade and other receivables	970,257	-	-		970,257
Deposits and prepaid expenses	64,212	-	-		64,212
Total current assets	1,233,061	-	-		1,233,061
Non-current assets					
Due from related parties	63,238	-	-		63,238
Exploration and evaluation assets and other intangible assets	11,835	-	-		11,835
Property and equipment	5,053,833	(344,720)	-		4,709,113
Total assets	6,361,967	(344,720)	-		6,017,247
Liabilities					
Current liabilities					
Accounts payable and accrued liabilities	2,616,909	-	-		2,616,909
Bank loan	2,935,019	-	-		2,935,019
Current portion of long-term debt	13,079	-	-		13,079
Total current liabilities	5,565,007	-	-		5,565,007
Non-current liabilities					
Long-term debt	67,919	-	-		67,919
Decommissioning liabilities	131,757	-	106,206		237,963
Total liabilities	5,764,683	-	106,206		5,870,889
Equity					
Share capital	5,830,596	-	-	831,000	6,661,596
Warrants	102,083	-	-		102,083
Contributed surplus	766,924	-	-		766,924
Deficit	(6,102,319)	(344,720)	(106,206)	(831,000)	(7,384,245)
Total deficit	597,284	(344,720)	(106,206)	-	146,358
Total liabilities and deficit	6,361,967	(344,720)	-	-	6,017,247

December 31, 2010:

	Canadian GAAP $	Effect of transition to IFRS $							IFRS $
		a	b	c	d	e	f	g	
Assets									
Current assets									
Cash	38,334	-	-	-	-	-	-	-	38,334
Short-term investments	50,989	-	-	-	-	-	-	-	50,989
Trade and other receivables	732,805	-	-	-	-	-	-	-	732,805
Deposits and prepaid expenses	35,582	-	-	-	-	-	-	-	35,582
Total current assets	857,710	-	-	-	-	-	-	-	857,710
Non-current assets									
Due from related party	51,373	-	-	-	-	-	-	-	51,373
Investment	226,272	-	-	-	-	-	-	-	226,272
Exploration and evaluation assets and other intangible assets	-	-	-	25,081	-	-	-	-	25,081
Property and equipment	5,251,140	(1,242,200)	(42,700)	(25,081)	84,592	-	(15,867)	-	4,009,884
Total assets	6,386,495	(1,242,200)	(42,700)	-	84,592	-	(15,867)	-	5,170,320
Liabilities									
Current liabilities									
Accounts payable and accrued liabilities	2,596,818	-	-	-	-	-	-	-	2,596,818
Bank loan	3,275,000	-	-	-	-	-	-	-	3,275,000
Current portion of long-term debt	22,075	-	-	-	-	-	-	-	22,075
Financial contract	3,278	-	-	-	-	-	-	-	3,278
Total current liabilities	5,897,171	-	-	-	-	-	-	-	5,897,171
Non-current liabilities									
Long-term debt	89,989	-	-	-	-	-	-	-	89,989
Financial contract	150,488	-	-	-	-	-	-	-	150,488
Decommissioning liabilities	176,768	-	62,548	-	-	-	-	-	239,316
Total liabilities	6,314,416	-	62,548	-	-	-	-	-	6,376,964
Deficit									
Share capital	6,619,116	-	-	-	-	-	-	984,750	7,603,866
Warrants	13,336	-	-	-	-	-	-	-	13,336
Contributed surplus	984,233	-	-	-	-	(21,912)	-	-	962,321
Deficit	(7,544,606)	(1,242,200)	(105,248)	-	84,592	21,912	(15,867)	(984,750)	(9,786,167)
Total deficit	72,079	(1,242,200)	(105,248)	-	84,592	-	(15,867)	-	(1,206,644)
Total liabilities and deficit	6,386,495	(1,242,200)	(42,700)	-	84,592	-	(15,867)	-	5,170,320

Statement of Comprehensive Loss

The following tables reconcile the statement of comprehensive loss of the Company from the amounts previously reported under Canadian GAAP to IFRS for the year ended December 31, 2010:

	Canadian GAAP $	**Effect of transition to IFRS $**							**IFRS $**
		a	**b**	**c**	**d**	**e**	**f**	**g**	
Revenue									
Petroleum and natural gas revenue	1,311,685	-	-	-	-	-	-	-	1,311,685
Royalties	(243,103)	-	-	-	-	-	-	-	(243,103)
	1,068,582	-	-	-	-	-	-	-	1,068,582
Operating expenses									
Exploration and evaluation expenditures	-	-	-	-	-	-	15,867	-	15,867
Production and operating expenses	610,736	-	-	-	-	-	-	-	610,736
Depletion, depreciation and amortization	589,477	-	-	(9,882)	(84,592)	-	-	-	495,003
Impairment of property and equipment	-	897,480	-	-	-	-	-	-	897,480
General and administrative	1,159,410	-	-	-	-	-	-	-	1,159,410
Bad debt expense	5,917	-	-	(5,917)	-	-	-	-	-
Share-based payment expense	109,560	-	-	-	-	(21,912)	-	-	87,648
Interest expense	153,166	-	-	(153,166)	-	-	-	-	-
Foreign exchange loss	9,036	-	-	(9,036)	-	-	-	-	-
	(2,637,302)	(897,480)	-	178,001	84,592	21,912	(15,867)	-	(3,266,144)
Results from operating activities	(1,568,720)	(897,480)		178,001	84,592	21,912	(15,867)	-	(2,197,562)
Finance expenses									
Interest income	-	-	-	9,731	-	-	-	-	9,731
Interest expense	-	-	-	(153,166)	-	-	-	-	(153,166)
Impairment of accounts receivable	-	-	-	(5,917)	-	-	-	-	(5,917)
Foreign exchange loss	-	-	-	(9,036)	-	-	-	-	(9,036)
Accretion of decommissioning liability	-	-	958	(9,882)	-	-	-	-	(8,924)
Net finance expense	-	-	958	(168,270)	-	-	-	-	(167,312)
Other income and expenses									
Unrealized (loss) on financial contract	(153,767)	-	-	-	-	-	-	-	(153,767)
Natural gas derivative income	113,616	-	-	-	-	-	-	-	113,616
Equity gain from investment in PRI	3,103	-	-	-	-	-	-	-	3,103
Interest income	9,731	-	-	(9,731)	-	-	-	-	-
Net other income and expenses	(27,317)	-	-	(9,731)	-	-	-	-	(37,048)
Net loss before income taxes	(1,596,037)	(897,480)	958	-	84,592	21,912	(15,867)	-	(2,401,922)
Income taxes									
Deferred income tax recovery	153,750							(153,750)	-
Net loss and comprehensive loss after income taxes	(1,442,287)	(897,480)	958	-	84,592	21,912	(15,867)	(153,750)	(2,401,922)
Deficit, beginning of year	(6,102,319)	(344,720)	(106,206)	-	-	-	-	(831,000)	(7,384,245)
Deficit, end of year	(7,544,606)	(1,242,200)	(105,248)	-	84,592	21,912	(15,867)	(984,750)	(9,786,167)

Statement of Cash Flows

The adoption of IFRS had no significant impact on cash flows generated by the Company except that, under IFRS, cash flows relating to interest payments were classified as operating, investing or financing in a consistent manner each period. Under Canadian GAAP, cash flows relating to interest payments were classified as operating.

Notes to the IFRS Reconciliations

a) Impairment

(i) Exploration and evaluation (“E&E”) assets

E&E assets consist of the Company’s exploration projects where technical feasibility and commercial viability have not yet been determined. Under Canadian GAAP these costs were grouped with property and equipment. Under IFRS, E&E assets are classified as a separate line in the statement of financial position. E&E costs of $223,726 were identified and deemed to be impaired upon transition.

(ii) Impairment of development and production (“D&P”) assets

The net book value under Canadian GAAP at January 1, 2010 was allocated between CGU’s based on total proven reserve values. Each CGU was tested for impairment on the transition date, a requirement when applying the “deemed cost” exemption under IFRS 1. The Company determined that an impairment of $120,994 was required upon transition to IFRS.

IAS 36 “Impairment of Assets” requires that an assessment must be made at each reporting period whether there is any indication that an asset or CGU may be impaired. The Company determined that an impairment of $897,480 was required as at December 31, 2010.

b) Decommissioning liability

Under Canadian GAAP, decommissioning liabilities were discounted at a credit adjusted risk free rate of 7.5%. Under IFRS, the estimated cash flow to abandon and remediate the wells has been risk adjusted and therefore the entire decommissioning liability is discounted at a risk free rate of 3.75%. This resulted in an increase in the carrying amount of the decommissioning liabilities of $106,206 at January 1, 2010 and $62,548 at December 31, 2010, and a reduction in accretion expense of $958 at December 31, 2010.

c) Reclassifications

(i) E&E assets

E&E assets consist of the Company’s exploration projects where technical feasibility and commercial viability have not yet been determined. Under Canadian GAAP these costs were grouped with property and equipment. Under IFRS, E&E assets are classified as a separate

line in the statement of financial position. At December 31, 2010, $25,081 of undeveloped land and unproven properties were reclassified from property and equipment to E&E.

(ii) Accretion on decommissioning liability

Under Canadian GAAP, unwinding of the discount on the decommissioning liability, or accretion, was included in depletion and depreciation. Under IFRS it is included in finance expense.

(ii) Interest income, interest expense, and foreign exchange gains and losses

Under IFRS interest income, interest expense, and foreign exchange gains and losses are required to be included in finance expense.

d) Depletion:

Upon transition to IFRS, the Company adopted a policy of depleting oil and natural gas interests on a unit of production basis over total proven reserves. The depletion policy under Canadian GAAP was based on units of production over proved reserves. In addition depletion was done on the Canadian cost centre under Canadian GAAP. IFRS requires depletion and depreciation to be calculated based on individual components. This resulted in a reduction in depletion expense under IFRS during the year ended December 31, 2010 of $84,952.

e) Share-based payments

Under IFRS each tranche of an award with different vesting dates is considered a separate grant for the calculation of fair value, and the resulting fair value is amortized over the vesting period of the respective tranches. The Company followed this treatment under Canadian GAAP.

Under Canadian GAAP, forfeitures of awards were recognized as they occurred. Under IFRS, forfeiture estimates are recognized on the grant date and revised for actual experiences in subsequent periods. The estimate of the forfeiture rate used is based on historical forfeitures. This resulted in a reduction of share-based payment expense under IFRS during the year ended December 31, 2010 of $21,912.

f) Pre-license costs

Under Canadian GAAP, the Company capitalized pre-license assets. The Company incurred these expenditures prior to obtaining a legal right to explore an area. Under IFRS, the Company is required to expense pre-license costs and resulted in a reduction of $15,867 in the property and equipment balance at December 31, 2010, with a corresponding charge to deficit.

g) Flow-through shares

The Company has financed a portion of its exploration and development activities through the issuance of flow-through shares. Pursuant to the terms of the flow-through subscription agreements, the tax attributes of the related expenditures are renounced to the subscribers. Under Canadian GAAP, recognition of the foregone tax benefits to the Company is recognized by reducing the carrying value of the shares issued by the amount equal to the tax effect on the expenditures renounced to the subscriber.

Under IFRS, common shares issued on a flow-through basis are recorded at the fair value, excluding any premium to the current market price. The premium is recorded as a current liability and when expenses are incurred, the Company derecognizes the liability and recognizes a deferred tax liability for the amount of the tax reduction renounced to the shareholders. The premium is recognized as other income and the related deferred tax is recognized as a tax provision. As a result of the differences in accounting for flow-through shares, at January 1, 2010 and December 31, 2010, the Company increased its deficit and its share capital by $831,000 and $984,750, respectively.