Emerald Bay Energy Inc.

Financial Statements

First Quarter Ended March 31, 2011

(expressed in Canadian dollars)

Management's Responsibility for Financial Reporting

The accompanying unaudited condensed interim financial statements of Emerald Bay Energy Inc. for the three months ended March 31, 2011 have been prepared by management and approved by the Board of Directors of the Company.

Approved on behalf of Emerald Bay Energy Inc.,

signed "Shelby D. Beattie"

Shelby D. Beattie
Director

signed "Gibson C. Scott"

Gibson C. Scott
Director

Dated June 29, 2011

Emerald Bay Energy Inc.

Statement of Financial Position

	March 31, 2011	December 31, 2010	January 1, 2010
	$	$	$
Assets			
Current assets			
Cash	**-**	38,334	142,728
Short-term investments	**49,707**	50,989	55,864
Trade and other receivables	**902,917**	732,805	970,257
Prepaid expenses and deposits	**14,965**	35,582	64,212
Total current assets	**967,589**	857,710	1,233,061
Due from related parties (note 13(a))	**46,990**	51,373	63,238
Equity investment in PRI (note 6)	**239,876**	226,272	-
Exploration and evaluation assets and other intangible assets (note 8)	**25,081**	25,081	11,835
Property and equipment (note 7)	**3,979,326**	4,033,093	4,709,113
Total assets	**5,258,862**	5,193,529	6,017,247
Liabilities			
Current liabilities			
Bank indebtedness	**58,026**	-	-
Accounts payable and accrued liabilities	**2,523,445**	2,596,818	2,616,909
Bank loan (note 11)	**3,225,000**	3,275,000	2,935,019
Current portion of long-term debt (note 14(b))	**22,386**	22,075	13,079
Financial contract (note 15(c)(i))	**159,518**	3,278	-
Total current liabilities	**5,988,375**	5,897,171	5,565,007
Long-term debt (note 14(b))	**84,272**	89,989	67,919
Financial contract (note 15(c)(i))	**246,439**	150,488	-
Decommissioning liabilities (note 10)	**243,078**	239,316	237,963
Total liabilities	**6,562,164**	6,376,964	5,870,889
(Deficit) Equity			
Share capital (note 12(b))	**6,897,656**	6,619,116	5,830,596
Warrants (note 12(c))	**62,073**	13,336	102,083
Contributed surplus (note 12(f))	**968,674**	962,321	766,924
Deficit	**(9,231,705)**	(8,778,208)	(6,553,245)
Total (deficit)	**(1,303,302)**	(1,183,435)	146,358
Total liabilities and (deficit) equity	**5,258,862**	5,193,529	6,017,247

Commitments (note 14)
Subsequent events (note 17)

The notes are an integral part of these financial statements.

Emerald Bay Energy Inc.

Statement of Comprehensive Loss

For the three month period ended March 31, 2011 and 2010

	March 31, 2011	March 31, 2010
	$	$
Revenue		
Petroleum and natural gas revenue	**259,954**	422,383
Royalties	**(34,184)**	(96,565)
	225,770	325,818
Operating expenses		
Exploration and evaluation expenditures	**2,145**	-
Production and operating expenses	**147,961**	144,313
Depletion, depreciation and amortization	**93,248**	122,979
General and administrative	**301,812**	357,199
	(545,166)	(624,491)
Results from operating activities	**(319,396)**	(298,673)
Finance expense		
Interest income	**(2,114)**	-
Interest expense	**44,268**	31,935
Foreign exchange loss	**3,599**	5,229
Accretion of decommissioning liability (note 10)	**2,244**	2,649
Net finance expense	**(47,997)**	(39,813)
Other income and expenses		
Unrealized loss on financial contract (note 15(c)(i))	**(252,190)**	102,060
Equity income on investment in PRI	**13,604**	-
Oil and natural gas derivative income (note 15(c)(i))	**49,982**	(24,520)
Net other income and expenses	**(188,604)**	77,540
Net loss before income taxes	**(555,997)**	(260,946)
Income taxes		
Future income tax recovery	**102,500**	162,500
Net loss and comprehensive loss after income taxes	**(453,497)**	(98,446)
Deficit, beginning of period	**(8,778,208)**	(6,553,245)
Deficit, end of period	**(9,231,705)**	(6,651,691)
Basic and fully diluted earnings per share (note 12(g))	**(0.01)**	(0.00)
Weighted average number of common shares outstanding during the period	**63,555,895**	46,659,446

The notes are an integral part of these financial statements.

Emerald Bay Energy Inc.

Statement of Changes in Equity

For the three month period ended March 31, 2011 and 2010

	Share capital	Warrants	Contributed surplus	Deficit	Total equity
Balance, January 1, 2010	5,830,596	102,083	766,924	(6,553,245)	146,358
Issuance of equity instrument	400,000	-	-	-	400,000
Tax effect of flow-through shares	(162,500)	-	-	-	(162,500)
Share issue costs	2,147	-	-	-	2,147
Loss for the period	-	-	-	(98,446)	(98,446)
Balance, March 31, 2010	6,070,243	102,083	766,924	(6,651,691)	287,559
Balance, December 31, 2010	6,619,116	13,336	962,321	(8,778,208)	(1,183,435)
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	67,000	-	-	-	67,000
Issue of flow through shares	308,185	-	-	-	308,185
Tax effect of flow-through shares	(102,500)	-	-	-	(102,500)
Issue of warrants	(48,737)	48,737	-	-	-
Share issue costs	(48,033)	-	6,353	-	(41,680)
Loss for the period	-	-	-	(453,497)	(453,497)
Balance, March 31, 2011	6,897,656	62,073	968,674	(9,231,705)	(1,303,302)

The notes are an integral part of these financial statements.

Emerald Bay Energy Inc.

Statement of Cash Flows

For the three month period ended March 31, 2011 and 2010

	March 31, 2011 $	March 31, 2010 $
Cash provided by (used in):		
Operating activities		
Net loss for the period	**(453,497)**	(98,446)
Adjustments for:		
Depletion, depreciation and amortization	**93,245**	122,979
Net finance expenses (including accretion)	**2,244**	2,649
Equity pick-up on investment in PRI	**(13,604)**	-
Unrealized gain on financial contract	**252,191**	(102,060)
Future income tax recovery	**(102,500)**	(162,500)
	(221,921)	(237,378)
Change in accounts receivable	**(170,112)**	(682,042)
Change in prepaid expenses and deposits	**20,617**	(3,657)
Change in accounts payable and accrued liabilities	**47,453**	712,725
Change in due to related party	**4,383**	-
Net cash (used in) operating activities	**(319,580)**	(210,352)
Investing activities		
Property and equipment expenditures	**4,665**	(82,875)
Proceeds from sale of investment in PRI	**-**	217,111
Change in short-term investments	**1,282**	-
Change in accounts payable and accrued liabilities	**(120,826)**	-
Net cash (used in) generated from investing activities	**(114,879)**	134,236
Financing activities		
Proceeds from issuance of common shares, net of issue costs	**333,505**	(2,147)
Receipt of related party receivable	**-**	3,203
Receipt of bank loan	**450,000**	-
Repayment of bank loan	**(500,000)**	(60,019)
Repayment of long term debt	**(5,406)**	(3,226)
Change in working capital	**60,000**	-
Net cash generated from (used in) financing activities	**338,099**	(57,895)
Change in cash	**(96,360)**	(134,011)
Cash, beginning of period	**38,334**	198,592
(Bank indebtedness) Cash, end of period	**(58,026)**	64,581

The notes are an integral part of these financial statements.

1 Reporting entity

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 Suite 3, 4015 – 1 Street South East, Calgary, Alberta, Canada T2G 4X7.

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, 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 condensed interim financial statements. In the financial statements, the term "Canadian GAAP" refers to Canadian GAAP before the adoption of IFRS.

These condensed interim financial statements have been prepared in accordance with International Accounting Standards ("IAS") 34: Interim Financial Reporting using accounting policies consistent with the International Financial Reporting Standards ("IFRS") 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 Reporting Standards. The disclosures included in these condensed interim financial statements exceed the minimum requirements under IAS 34. The Company has elected to exceed the minimum requirements in order to present the Company's accounting policies in accordance with IFRS. These standards and interpretations have been described in note 3.

These condensed interim financial statements should be read in conjunction with the Company's Canadian GAAP annual financial statements for the year ended December 31, 2010. An explanation of how the transition to IFRS has affected the reported financial position, financial performance and cash flows of the Company is provided in note 18 and note 19.

The policies applied in these condensed interim financial statements are based on IFRS issued and outstanding as of June 29, 2011, the date the Board of Directors approved the statements. Any subsequent changes to IFRS, that are given effect in the Company's annual financial statements for the year ending December 31, 2011 could result in restatement of these condensed interim financial statements, including the transition adjustments recognized on change-over to IFRS.

b) Basis of measurement:

The interim 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 and have not been audited.

c) Functional and presentation currency:

The interim 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 interim 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 cash-generating units 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 and the expected term of the issued stock option.

Income 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 interim financial statements. Certain comparative amounts have been reclassified to conform to the current year's presentation as noted below:

Cash and cash equivalents

Cash and cash equivalents comprise cash on hand, term deposits held with banks, other short-term highly liquid investments with original maturities of three months or less. Bank overdrafts that are repayable on demand and form an integral part of the Company's cash management, whereby management has the ability and intent to net bank overdrafts against cash, are included as a component of cash and cash equivalents 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 balance sheet 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.

Non-derivative financial instruments:

Non-derivative financial instruments include cash and cash equivalents, short-term investments, trade and other receivables, trade and other payables, 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. Interest, dividends, losses and gains relating to financial assets and liabilities are recognized in net income and within operations in the statement of cash flows.

(i) Financial assets and liabilities at fair value through profit or 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, short-term investments and its oil and natural gas derivative in this category.

(ii) Held to maturity investments (“HTM”): HTM investments are measured at amortized cost using the effective interest method, less any impairment losses.

As at March 31, 2011, the Company does not have any held to maturity investments.

(iii) Available for sale investments (“AFS”): AFS investments are non-derivatives that are either designated in this category or not classified in any of the other categories.

AFS investments are recognized initially at fair value plus transaction costs and are subsequently carried at fair value. Gain or losses arising from changes in fair value are recognized in other comprehensive income. AFS investments are classified as non-current, unless the investment mature within twelve months, or management expects to dispose of them within twelve months.

Interest on AFS investments, calculated using the effective interest method, is recognized in the statement of income as part of interest income. Dividends on AFS equity instruments are recognized in the statement of income as part of other gains and losses when the Company’s right to receive payment is established. When an AFS investment is sold or impaired, the accumulated gains or losses are moved from accumulated other comprehensive income to the statement of income and included in other gains and losses.

As at March 31, 2011, the Company does not have any financial assets classified as available-for-sale and does not have any comprehensive income items requiring separate disclosure.

(iv) 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 receivables 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.

(v) Financial liabilities at amortized cost: Financial liabilities at amortized cost include trade payables, bank debt, and long-term debt. Trade payables are initially recognized at the amount required to be paid less, when material, a discount to reduce the payables to fair value. Subsequently, trade payables are measured at amortized cost using the effective interest method. Bank debt 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 profit or 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 contract 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 balance sheet at fair value. Transaction costs are recognized in profit or 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 profit or loss. The Company has not identified any material embedded derivatives in any of its financial instruments.

Property, plant and equipment and intangible exploration assets

(a) Recognition and measurement:

(i) Exploration and evaluation expenditures:

Pre-license costs are recognized in the statement of operations 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, asset retirement 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 transferred to property and equipment. When an area is determined not to be technically feasible and commercially viable of the Company decides not to continue with its activity, the unrecoverable costs are charged to comprehensive income (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, asset retirement 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, plant and equipment, including oil and natural gas interests, are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment and are recognized net within “other income” or “other expenses” in profit or 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.

(b) Subsequent costs:

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property, plant 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 profit or 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, plant and equipment are recognized in profit or 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

(i) 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 profit or loss and through the use of an allowance account.

(ii) Available for sale financial assets: The impairment loss is the difference between the original cost of the asset and its fair value at the measurement date, less any impairment losses previously recognized in profit or loss. This amount represents the cumulative loss in accumulated other comprehensive income that is reclassified to net income.

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 profit or loss or credited against the allowance account. Impairment losses on available for sale equity instruments are not reversed.

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 goodwill acquired in a business combination, for the purpose of impairment testing, is allocated to the CGU's that are expected to benefit from the synergies of the combination.

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 net income. 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 balance sheet 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 asset retirement obligations 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. Revenue is measured net of discounts, customs duties and royalties.

Tariffs and tolls charged to other entities for use of pipelines and facilities owned by the Company are recognized as revenue as they accrue in accordance with the terms of the service or tariff and tolling agreements.

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 profit or loss, using the effective interest method.

Income tax

Income tax expense comprises current and deferred tax. Income tax expense is recognized in profit or 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. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. 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.

Share Capital

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

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 period. 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 income 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) income 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 income in the period in which they are incurred.

4 Changes in accounting policies

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:

As of January 1, 2013, the Company will be required to adopt 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.

In May 2011, the IASB issued the following standards which have not yet been adopted by the Company: IFRS 10 – “Consolidated Financial Statements”, IFRS 13 – “Fair Value Measurement” and amended IAS 28 – “Investments in Associates and Joint Ventures”. Each of the new standards is effective for annual period beginning on or after January 1, 2013 with early adoption permitted. The Company has not yet begun the process of assessing the impact that these new and amended standards will have on the Company’s financial statements or whether to early adopt any of the new requirements.

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 intangible exploration 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 trade and other payables

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

(c) Stock options, 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.

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

	CDN $
Net investment, December 31, 2010	226,272
Proportionate share of income for the period	13,604
Net investment, March 31, 2011	239,876

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 period	(443,824)	(39,370)	(483,194)
Impairment loss	(874,271)	-	(874,271)
Carrying value, December 31, 2010	3,907,351	125,742	4,033,093

	Oil and natural gas interests	Corporate and Other	Total
	$	$	$
Cost, December 31, 2010	9,998,207	298,732	10,296,939
Additions	39,478	-	39,478
Cost, March 31, 2011	10,037,685	298,732	10,336,417
Accumulated depletion, depreciation and impairment	(6,090,856)	(172,990)	(6,263,846)
Depreciation and depletion for the period	(84,217)	(9,028)	(93,245)
Carrying value, March 31, 2011	3,862,612	116,714	3,979,326

8 Intangible exploration assets

	E&E assets
	$
Cost, January 1, 2010	-
Additions	25,081
Balance, December 31, 2010 and March 31, 2011	25,081

Exploration and evaluation ("E&E") assets consist of the Company's exploration projects which are pending the determination of proven or probable reserves. As at March 31, 2011 an amount of $25,081 (December 31, 2010 - $25,081) remains in E&E assets. The additions represent the acquisition of undeveloped land within Alberta.

9 Impairment loss

During the year ended December 31, 2010, due to unexpected accelerated reserve declines within a CGU, the Company assessed this CGU for impairment.

The recoverable amount of the 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, 2010, the carrying amount of the CGU was determined to be $874,000 higher than its recoverable amount, and an impairment loss was recognized. During the three month period ended March 31, 2011, the Company reassessed its estimates and concluded the CGU remains impaired and the initial impairment has not been reversed.

10 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 $240,835 as at March 31, 2011 (December 31, 2010 - $239,316) based on an undiscounted total future liability of $280,930 (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-adjusted rate related to the liability, of 3.75% (December 31, 2010 – 2% and 3.75%, respectively).

	March 31, 2011	**December 31, 2010**
	$	**$**
Balance, beginning of period	239,316	237,963
Disposals	-	(2,736)
Liabilities incurred	1,518	56,530
Revisions (changed estimates)	-	(61,363)
Accretion	2,244	8,922
Balance, end of period	243,078	239,316

11 Bank loan

The Company has a $3,000,000 (December 31, 2010 - $3,000,000) revolving operating demand loan (the "Revolving Loan"), of which $2,825,000 (December 31, 2010 – $2,875,000), has been drawn at March 31, 2011. Interest on the Revolving Loan is calculated daily and payable monthly on the outstanding principal amount drawn at a rate per annum equal to the bank's prime rate plus 2.00% (December 31, 2010 – bank's prime rate plus 2.00%).

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.

During the year ended December 31, 2010, the Company obtained a non-revolving demand loan (the "Non-revolving Loan") of $400,000 through the same bank holding the Revolving Loan. Interest on the non-revolving loan is calculated daily and payable monthly on the outstanding principal amount at a rate per annum equal to the bank's prime rate plus 2.50% (December 31, 2010 – bank's prime plus 2.50%). The full amount has been drawn as at March 31, 2011 (December 31, 2010 - $400,000).

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 Credit Facility A) to Current Liabilities (excluding any current portion of Bank Debt). As at March 31, 2011, the Company is in violation of the Working Capital Ratio with a ratio of 0.40:1.

The bank has not made demand of the Company's credit facilities but retains the right to do so.

12 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, December 31, 2009	45,159,446	5,830,596
Funds received pursuant to prior year private placement	-	19,000
Tax effect of flow-through shares	-	(153,750)
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
Share subscription receivable	-	(60,000)
Value of warrants issued pursuant to private placement (iii)	-	(7,473)
Share issue costs (iv)	-	(60,894)
Balance, December 31, 2010	63,309,446	6,619,116
Tax effect of flow-through shares	-	(102,500)
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)	7,503,701	375,185
Value of warrants issued pursuant to private placement (vi)	-	(48,737)
Share issue costs (vii)	-	(48,033)
Balance, March 31, 2011	71,345,959	6,897,656

(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 12(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 12(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 12(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) The Company completed the first tranche of a private placement ("Placement C"), issuing 7,503,701 units for total proceeds of $375,185, ($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 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 date of Placement C. Of the total 7,503,701 units issued, 6,163,701 were issued as a FTS. The Company has allocated $48,737 of the unit value to warrants (note 12(c)).

(vii) Pursuant to Placement C, the Company incurred $41,680 in cash share issue costs and issued 470,000 finders options (the "Finders Options") valued at $6,353 (note 12(e)).

c) **Warrants**

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

	Number of warrants issued and exercisable	**Amount $**	**Weighted average exercise price $**	**Weighted average Remaining life (years)**
Balance, December 31, 2009	9,625,000	102,083	0.15	0.14
Share purchase warrants (note 12(b)(iii) and (iv))	13,150,000	13,336	0.12	0.59
Expiry of warrants	(9,625,000)	(102,083)	(0.15)	(0.14)
Balance, December 31, 2010	13,150,000	13,336	0.12	0.59
Share purchase warrants (note 12(b)(vi))	7,503,701	48,737	0.10	1.50
Balance, March 31, 2011	20,653,701	62,073	0.11	0.92

The fair value of the share purchase warrants granted during the period 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	**1.74%**	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 three month period ended March 31, 2011, there were no stock options granted, cancelled or exercised, and 1,000,000 options expired unexercised. The following table summarizes information about the Company's stock options outstanding at March 31, 2011:

	March 31, 2011		December 31, 2010	
Employee, Directors, Consultants	**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	-	-	3,450,000	0.10
Cancelled	-	-	(690,000)	0.15
Expired	**(1,000,000)**	**0.25**	(550,000)	0.25
Stock options outstanding, end of year	**3,060,000**	**0.10**	4,060,000	0.14

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

Exercise prices (\$)	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price (\$)
0.10	3,060,000	4.14	0.10

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

e) **Finders Options**

During the three month period ended March 31, 2011, the Company issued 470,000 Finders Options to the those who facilitated Placement C (note 12(b)(vii)), and no Finder Options expired unexercised. Each Finders Option granted during the 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 March 31, 2011:

	March 31, 2011		December 31, 2010	
Finder Options	**Number of options**	**Weighted Average Exercise price $**	Number of options	Weighted Average Exercise price $
Finders Options, beginning of period	**750,000**	**0.05**	1,090,617	0.12
Granted	**470,000**	**0.05**	750,000	0.05
Expired	-	-	(1,090,617)	(0.12)
Finders Options outstanding, end of period	**1,220,000**	**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**

	March 31, 2011	December 31, 2010
	$	$
Balance, beginning of period	**962,321**	766,924
Stock based compensation expense	-	87,648
Finders options (note 12(e))	**6,353**	5,666
Warrants expired unexercised (note 12(c))	-	102,083
Balance, end of period	**968,674**	962,321

g) **Per share data**

Basic earnings per share was calculated as follows:

		March 31, 2011		March 31, 2010
Loss for the period	$	**(453,497)**	$	(98,446)
Weighted average number of common shares:				
Issued common shares at January 1		**63,309,446**		45,159,446
Private placement		**168,622**		-
Shares issued to acquire interest in oil and gas lease		**77,827**		-
Shares issued to acquire equity investment in PRI		**-**		1,500,000
Weighted average number of common shares – basic and diluted		**63,555,895**		46,659,446
Loss per share – basic and diluted	$	**(0.01)**	$	(0.00)

13 Related party transactions

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

a) The following amounts are due by related parties:

	March 31, 2011	December 31, 2010
	$	$
Note receivable from officer (i)	**226,671**	225,054
Fair value allowance (ii)	**(206,710)**	(206,710)
Net note receivable	**19,961**	18,344
Advance fees (iii)	**27,029**	33,029
	46,990	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 $23,580 at March 31, 2011 (December 31, 2010 - $19,650).

(ii) The fair value allowance was determined in 2008, based on the market value of the secured shares at December 31, 2008. The Company has not provided an additional allowance to the estimated fair value of the 393,000 common shares held as security as the fair value at March 31, 2011 and December 31, 2010 exceeded the carrying amount.

(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 March 31, 2011

$27,029 (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. During the year ending December 31, 2010, the original repayment date of December 31, 2010 was extended to December 31, 2011.

b) Additional related party transactions during the three months ended March 31, 2011 are as follows:

(i) Aggregate fees of $7,350 (March 31, 2010 - $nil) were charged by directors of the Company. Of this amount $4,200 was recorded in the statement of comprehensive loss and $3,150 was capitalized to property and equipment.

(ii) Aggregate consulting fees of $48,688 (March 31, 2010 - $70,773) were charged by directors and officers of the Company and were recorded in the statement of comprehensive loss.

(iii) Aggregate fees of $13,800 (March 31, 2010 - $10,800) 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 $10,800 (March 31, 2010 - $10,800) was recorded in the statement of comprehensive loss and $3,000 was capitalized to property and equipment.

(iv) Included in accounts payable at March 31, 2011 was $26,238 owing to related parties of the Company and included in accounts receivable is $30,536 owing to the Company from related parties.

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.

14 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.

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 2011 through to 2015 are respectively as follows: $22,075, $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.

d) The Company is committed to renounce to subscribers $410,000 and $308,185 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.

15 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) 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.

The Company does not anticipate any significant defaults as it transacts with creditworthy customers and management does not expect any losses from non-performance by these customers. A provision for doubtful accounts has not been recorded at March 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.

(b) 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 (excluding Bank Loan)	$1,795,785	This amount is anticipated to be met out of additional share issuance in the 2011 fiscal period.
Bank loan (note 11)	$3,225,000	The Company anticipates issuing additional share capital to reduce this amount in 2011. This amount is secured by the Company's oil and gas assets which have value sufficient such that the Company has no reason to believe that the bank will require repayment within the next fiscal year.
Long term debt	$84,272	Vehicle loans will be paid over the next 4 years out of normal cash flow.

(c) 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 fixes the received price of natural gas at CDN 4.684 per GJ. As at March 31, 2011, based on the fair market value of the contract, the Company has recorded an unrealized loss in the statement of comprehensive loss of $30,079.

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 March 31, 2011, based on the fair market value of the contract, the Company has recorded an unrealized loss in the statement of comprehensive loss of $222,111.

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

	Option A ($)	**Option B ($)**	**Option C ($)**
Fair market value, December 31, 2010	162,458	(165,736)	(150,489)
Unrealized (loss)	(30,079)	(126,161)	(95,950)
Fair market value, March 31, 2011	132,379	(291,897)	(246,439)
Financial Contract liability:			
Current	(159,518)		
Long-term	(246,439)		

The realized gain recorded by the Company on the derivative financial instruments for the three months ended March 31, 2011 was $49,982 (March 31, 2010 – realized loss $24,520).

(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 March 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 $7,200 impact on the Company's comprehensive loss for the period.

(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 March 31, 2011 the Company's bank debt was $3,225,000 (December 31, 2010 - $3,275,000). As at March 31, 2011, if interest rates had been 1 percent higher/lower, with all other variables held constant, there would have been an impact of approximately $8,000 on the Company's comprehensive loss for the period.

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

(d) 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 period.

As at March 31, 2011, the Company is in violation of the Working Capital Ratio required to be maintained pursuant to the Bank Loan (note 11).

16 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:

			March 31, 2011 ($)
	Canada	**United States**	**Total**
Petroleum and natural gas sales	225,650	34,304	259,954
Interest income	2,114	-	2,114
Depletion, depreciation and impairment	87,650	5,598	93,248
Net loss	369,074	84,423	453,497
Property and equipment	3,732,998	246,328	3,979,326

			December 31, 2010 ($)
	Canada	**United States**	**Total**
Petroleum and natural gas sales	1,200,409	111,276	1,311,685
Interest income	9,731	-	9,731
Depletion, depreciation and impairment	1,341,322	27,952	1,369,274
Net loss	2,105,386	119,577	2,224,963
Property and equipment	3,826,136	206,957	4,033,093

17 Subsequent events

The Company entered into the following transactions subsequent to March 31, 2011:

a) The final tranche of the private placement (note 12(b)(vi)) was completed through the issuance of an additional 1,910,000 units at a price of $0.05 per unit for aggregate proceeds of $95,500. Each unit consisted of one common share of the Company and one share purchase warrant. Each full share purchase warrant entitles the holder to purchase one additional common share of the Company at $0.10 per share, exercisable for 18 months from the date of the final placement. Of the 1,910,000 common shares that were issued under this final tranche, none were issued as flow-through shares.

b) The Company closed a private placement through the issuance of 4,000,000 units for total proceeds of $200,000, ($0.05 per unit). Each unit consisted of one common share of the Company (issued as either a common share or as a flow-through share) and one share purchase warrant. Each full share purchase warrant entitles the holder to purchase one additional common share of the Company at $0.10 per share, exercisable for 18 months from the date of the private placement. Of the total 4,000,000 units issued, 1,040,000 were issued as flow-through shares.

18 Transition to IFRS

As stated in note 2, these are the Company's first condensed interim 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 condensed interim financial statements for the three months ended March 31, 2011, the comparative information for the three months ended March 31, 2010, the financial statements for the year ended December 31, 2010 and the preparation of an opening IFRS statement of financial position on January 1, 2010, the Company's transition date.

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 balance sheet. Certain of the Company's IFRS accounting policies used for this opening balance sheet 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.

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

Condensed 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, March 31, 2010 and December 31, 2010.

Transition date: January 1, 2010:

	Canadian GAAP	Effect on transition to IFRS		IFRS
	$	$		$
		a	b	
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
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
	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
Long-term debt	67,919	-	-	67,919
Decommissioning liabilities	131,757	-	106,206	237,963
	5,764,683	-	106,206	5,870,889
Equity				
Share capital	5,830,596	-	-	5,830,596
Warrants	102,083	-	-	102,083
Contributed surplus	766,924	-	-	766,924
Deficit	(6,102,319)	(344,720)	(106,206)	(6,553,245)
	597,284	(344,720)	(106,206)	146,358
	6,361,967	(344,720)	-	6,017,247

March 31, 2010:

	Canadian GAAP $	Effect of transition to IFRS $ a	b	c	d	IFRS $
Assets						
Current assets						
Cash	13,791	-	-	-	-	13,791
Short-term investments	50,790	-	-	-	-	50,790
Trade and other receivables	1,652,299	-	-	-	-	1,652,299
Deposits and prepaid expenses	67,869	-	-	-	-	67,869
Financial contract	102,060	-	-	-	-	102,060
Total current assets	1,886,809	-	-	-	-	1,886,809
Due from related parties	60,035	-	-	-	-	60,035
Investment in PRI	220,808	-	-	-	-	220,808
Exploration and evaluation assets and other intangible assets	9,396	-	-	25,081	-	34,477
Property and equipment	4,990,822	(344,720)	-	(25,081)	25,346	4,646,367
	7,167,870	(344,720)	-	-	25,346	6,848,496
Liabilities						
Current liabilities						
Accounts payable and accrued liabilities	3,329,634	-	-	-	-	3,329,634
Bank loan	2,875,000	-	-	-	-	2,875,000
Current portion of long-term debt	37,755	-	-	-	-	37,755
Total current liabilities	6,242,389	-	-	-	-	6,242,389
Long-term debt	77,936	-	-	-	-	77,936
Decommissioning liabilities	134,406	-	106,206	-	-	240,612
	6,454,731	-	106,206	-	-	6,560,937
Equity						
Share capital	6,070,243	-	-	-	-	6,070,243
Warrants	102,083	-	-	-	-	102,083
Contributed surplus	766,924	-	-	-	-	766,924
Deficit	(6,226,111)	(344,720)	(106,206)	-	25,346	(6,651,691)
	713,139	(344,720)	(106,206)	-	25,346	287,559
	7,167,870	(344,720)	-	-	25,346	6,848,496

At the end of the last reporting year under Canadian GAAP – December 31, 2010:

	Canadian GAAP $	Effect of transition to IFRS $						IFRS $
		a	b	c	d	e	f	
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
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	(1,218,991)	(42,700)	(25,081)	84,592	-	(15,867)	4,033,093
	6,386,495	(1,218,991)	(42,700)	-	84,592	-	(15,867)	5,193,529
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
Long-term debt	89,989	-	-	-	-	-	-	89,989
Financial contract	150,488	-	-	-	-	-	-	150,488
Decommissioning liabilities	176,768	-	62,548	-	-	-	-	239,316
	6,314,416	-	62,548	-	-	-	-	6,376,964
Deficit								
Share capital	6,619,116	-	-	-	-	-	-	6,619,116
Warrants	13,336	-	-	-	-	-	-	13,336
Contributed surplus	984,233	-	-	-	-	(21,912)	-	962,321
Deficit	(7,544,606)	(1,218,991)	(105,248)	-	84,592	21,912	(15,867)	(8,778,208)
	72,079	(1,218,991)	(105,248)	-	84,592	-	(15,867)	(1,183,435)
	6,386,495	(1,218,991)	(42,700)	-	84,592	-	(15,867)	5,193,529

Condensed 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 three months ended March 31, 2010 and the twelve months ended December 31, 2010:

Reconciliation of income statement for the three months ended March 31, 2010:

	Canadian GAAP	Effect of transition to IFRS				IFRS
	$		$			$
		a	b	c	d	
Revenue						
Petroleum and natural gas revenue	422,383	-	-	-	-	422,383
Royalties	(96,565)	-	-	-	-	(96,565)
	325,818	-	-	-	-	325,818
Operating expenses						
Exploration and evaluation expenditures	-	-	-	-	-	-
Production and operating expenses	144,313	-	-	-	-	144,313
Depletion, depreciation and amortization	150,974	-	-	(2,649)	(25,346)	122,979
General and administrative	357,199	-	-	-	-	357,199
Interest expense	31,935	-	-	(31,935)	-	-
Foreign exchange loss	5,229	-	-	(5,229)	-	-
	(689,650)	-	-	39,813	25,346	(624,491)
Results from operating activities	(363,832)	-	-	39,813	25,346	(298,673)
Finance expense						
Interest expense	-	-	-	31,935	-	31,935
Foreign exchange loss	-	-	-	5,229	-	5,229
Accretion of decommissioning liability	-	-	-	2,649	-	2,649
Net finance expense	-	-	-	(39,813)	-	(39,813)
Other income and expenses						
Unrealized gain on financial contract	102,060	-	-	-	-	102,060
Natural gas derivative income	(24,520)	-	-	-	-	(24,520)
Net other income and expenses	77,540	-	-	-	-	77,540
Net loss before income taxes	(286,292)	-	-	-	25,346	(260,946)
Income taxes						
Future income tax recovery	162,500	-	-	-	-	162,500
Net loss and comprehensive loss after income taxes	(123,792)	-	-	-	25,346	(98,446)
Deficit, beginning of period	(6,102,319)	(344,720)	(106,206)	-	-	(6,553,245)
Deficit, end of period	(6,226,111)	(344,720)	(106,206)	-	25,346	(6,651,691)

Reconciliation of income statement for the year ended December 31, 2010:

	Canadian GAAP			Effect of transition to IFRS				IFRS
	$			$				$
		a	b	c	d	e	f	
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 impairment	589,477	874,271	-	(9,882)	(84,592)	-	-	1,369,274
General and administrative	1,159,410	-	-	-	-	-	-	1,159,410
Bad debt expense	5,917	-	-	(5,917)	-	-	-	-
Stock-based compensation	109,560	-	-	-	-	(21,912)	-	87,648
Interest expense	153,166	-	-	(153,166)	-	-	-	-
Foreign exchange loss	9,036	-	-	(9,036)	-	-	-	-
	(2,637,302)	(874,271)	-	178,001	84,592	21,912	(15,867)	(3,242,935)
Results from operating activities	(1,568,720)	(874,271)		178,001		21,912		(2,174,353)
Finance expenses								
Interest income	-	-	-	(9,731)	-	-	-	(9,731)
Interest expense	-	-	-	153,166	-	-	-	153,166
Bad debt expense	-	-	-	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)	(874,271)	958	-	84,592	21,912	(15,867)	(2,378,713)
Income taxes								
Future income tax recovery	153,750							153,750
Net loss and comprehensive loss after income taxes	(1,442,287)	(874,271)	958	-	84,592	21,912	(15,867)	(2,224,963)
Deficit, beginning of year	(6,102,319)	(344,720)	(106,206)	-	-	-	-	(6,553,245)
Deficit, end of year	(7,544,606)	(1,218,991)	(105,248)	-	84,592	21,912	(15,867)	(8,778,208)

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 balance sheet. E&E costs of $344,720 were identified and deemed to be impaired upon transition.

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

The net book value at December 31, 2009 under Canadian GAAP 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.

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 $874,281 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%.

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 balance sheet.

(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 expense, foreign exchange gains and losses and bad debt expense

Under IFRS interest expense, foreign exchange gains and losses and bad debt expense 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 three months ended March 31, 2010 and the year ended December 31, 2010.

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 lower stock-based compensation expense under IFRS. This resulted in a reduction of stock-based compensation expense under IFRS during the year ended December 31, 2010.

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 in the property and equipment balance at December 31, 2010, with a corresponding charge to deficit.