Emerald Bay Energy Inc.

Financial Statements

For the three and six months ended June 30, 2012

(expressed in Canadian dollars)

(unaudited)

Emerald Bay Energy Inc.

Statement of Financial Position

June 30, 2012 and December 31, 2011

(unaudited)

	June 30, 2012	December 31, 2011
	$	$
Assets		
Current assets		
Cash and cash equivalents	**9,328**	332,301
Short-term investments	**50,018**	49,964
Trade and other receivables	**272,513**	227,231
Prepaid expenses and deposits	**56,756**	58,805
Assets held for sale (note 8)	**-**	1,500,000
Total current assets	**388,615**	2,168,301
Non-current assets		
Due from related parties (note 14(a))	**24,892**	24,623
Equity investment in PRI (note 5)	**436,202**	459,078
Property and equipment (note 6)	**1,184,986**	1,015,177
Total assets	**2,034,695**	3,667,179
Liabilities		
Current liabilities		
Bank loan (note 10)	**-**	2,675,000
Accounts payable and accrued liabilities	**2,428,108**	2,333,903
Shareholder loan (note 11)	**-**	301,157
Current portion of long-term debt (note 15(b))	**24,008**	23,345
Financial contract (note 16(d)(i))	**-**	161,770
Total current liabilities	**2,452,116**	5,495,175
Non-current liabilities		
Shareholder loan (note 11)	**1,500,000**	-
Long-term debt (note 15(b))	**54,409**	66,580
Decommissioning liabilities (note 9)	**189,729**	201,664
Total liabilities	**4,196,254**	5,763,419
Shareholders' deficit		
Share capital (note 12(b))	**8,830,483**	8,491,683
Warrants (note 12(c))	**620,420**	126,644
Contributed surplus (note 12(f))	**1,062,575**	1,048,656
Deficit	**(12,675,037)**	(11,763,223)
Total shareholders' deficit	**(2,161,559)**	(2,096,240)
Total liabilities and shareholders' deficit	**2,034,695**	3,667,179

Going concern (note 1)
Commitments (note 15)
Subsequent events (note 18)

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 three and six months ended June 30, 2012 and 2011

(unaudited)

	Three months ended June 30, 2012 $	Three months ended June 30, 2011 $	**Six months ended June 30, 2012 $**	Six months ended June 30, 2011 $
Revenue				
Petroleum and natural gas revenue	**26,527**	349,486	**88,456**	609,440
Royalties	**12,189**	(32,731)	**6,606**	(66,915)
	38,716	316,755	**95,062**	542,525
Operating expenses				
Exploration and evaluation expenditures	**-**	-	**2,409**	2,145
Production and operating expenses	**71,709**	196,665	**118,473**	344,626
Depletion, depreciation and amortization (note 6)	**21,981**	110,152	**60,921**	203,400
General and administrative	**327,845**	285,663	**607,594**	587,475
	421,535	592,480	**789,397**	1,137,646
Results from operating activities	**(382,819)**	(275,725)	**(694,335)**	(595,121)
Finance expense				
Interest income	**1,637**	1,634	**3,271**	3,748
Interest expense	**(39,280)**	(45,729)	**(88,053)**	(89,997)
Bad debt expense (note 16(b))	**(15,000)**	-	**-**	-
Foreign exchange loss	**(2,264)**	(693)	**(6,161)**	(4,292)
Shareholder loan financing expense (note 11)	**(147,195)**	-	**(147,195)**	-
Accretion of decommissioning liability (note 9)	**(1,061)**	(2,244)	**(2,121)**	(4,488)
Net finance expense	**(203,163)**	(47,032)	**(240,259)**	(95,029)
Other income and expenses				
Unrealized gain (loss) on financial contract (note 16(d)(i))	**-**	214,158	**161,770**	(38,032)
Termination payment on financial contract (note 16(d)(i))	**-**	-	**(116,114)**	-
Equity (loss) income on investment in PRI (note 5)	**(55,440)**	12,904	**(22,876)**	26,508
Realized oil and natural gas derivative(loss) gain (note 16(d)(i))	**-**	(15,935)	**-**	34,047
Gain on purchase of drilling royalty credits	**-**	70,074	**-**	70,074
Impairment on funds due from related party	**-**	(5,875)	**-**	(5,875)
Net other income and expenses	**(55,440)**	275,326	**22,780**	86,722
Net loss and comprehensive loss	**(641,422)**	(47,431)	**(911,814)**	(603,428)
Basic and fully diluted earnings per share (note 12(g))	**(0.01)**	(0.00)	**(0.01)**	(0.01)
Weighted average number of common shares outstanding during the period	**98,199,959**	73,554,530	**94,243,475**	68,610,761

The notes are an integral part of these financial statements.

Emerald Bay Energy Inc.

Statement of Changes in Deficit

June 30, 2012 and 2011

(unaudited)

	Share capital	Warrants	Contributed surplus	Deficit	Total deficit
Balance, January 1, 2011	7,603,866	13,336	962,321	(9,786,167)	(1,206,644)
Issuance of common shares	60,000	-	-	-	60,000
Issue of flow through shares	42,625	-	-	-	42,625
Funds received pursuant to prior year private placement	310,500	-	-	-	310,500
Shares issued as consideration for lease acquisition	360,185	-	-	-	360,185
Issue of warrants	(86,967)	86,967	-	-	-
Share issue costs	(58,056)	-	6,353	-	(51,703)
Loss for the period	-	-	-	(603,428)	(603,428)
Balance, June 30, 2011	8,232,153	100,303	968,674	(10,389,595)	(1,088,465)
Balance, January 1, 2012	8,491,683	126,644	1,048,656	(11,763,223)	(2,096,240)
Issuance of common shares	712,000	-	-	-	712,000
Issue of warrants	(346,581)	346,581	-	-	-
Exercise of finders options	23,500	-	-	-	23,500
Issuance of warrants to acquire shareholder loan	-	147,195	-	-	147,195
Fair value reallocation on exercise of finders options	6,353	-	(6,353)	-	-
Share issue costs	(56,472)	-	20,272	-	(36,200)
Loss for the period	-	-	-	(911,814)	(911,814)
Balance, June 30, 2012	8,830,483	620,420	1,062,575	(12,675,037)	(2,161,559)

The notes are an integral part of these financial statements.

Emerald Bay Energy Inc.

Statement of Cash Flows

For the six months ended June 30, 2012 and 2011

(unaudited)

	Six months ended June 30, 2012	Six months ended June 30, 2011
	$	$
Cash (used in) provided by:		
Operating activities		
Net loss for the period	**(911,814)**	(603,428)
Adjustments for:		
Depletion, depreciation and amortization	**60,921**	203,400
Accretion	**2,121**	4,488
Unrealized (gain) loss on financial contract	**(161,770)**	38,033
Equity pick-up on investment in PRI	**22,876**	(26,508)
Shareholder loan financing expense	**147,195**	-
Impairment of funds due from related party	**-**	5,875
	(840,471)	(378,140)
Change in accounts receivable	**(45,282)**	(32,583)
Change in prepaid expenses and deposits	**2,049**	(8,487)
Change in accounts payable and accrued liabilities	**93,843**	(78,819)
Change in due to related party	**(269)**	12,749
	(790,130)	(485,280)
Investing activities		
Property and equipment expenditures	**(244,786)**	(76,032)
Proceeds received on disposal of oil and natural gas interests	**1,500,000**	-
Change in short-term investments	**(54)**	1,543
Change in accounts payable and accrued liabilities	**362**	(120,828)
	1,255,522	(195,317)
Financing activities		
Proceeds from issuance of common shares, net of issue costs	**374,643**	618,981
Exercise of finders options	**23,500**	-
Repayment of bank loan	**(2,675,000)**	(50,000)
Receipt of shareholder loan	**1,500,000**	-
Repayment of long term debt	**(11,508)**	(10,913)
Change in working capital	**-**	60,000
	(788,365)	618,068
Change in cash	**(322,973)**	(62,529)
Cash, beginning of period	**332,301**	38,334
Cash, end of period	**9,328**	(24,195)
Non-cash transactions		
Property and equipment acquired through shares issued	**-**	42,625
Fair value of agent options	**20,272**	6,353

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 June 30, 2012, the Company had not yet achieved profitable operations, had accumulated a deficit of $12,675,037 since its inception (December 31, 2011 - $11,763,223) and had a working capital deficiency of $2,063,501 (December 31, 2011 - $3,165,104) (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.

During the six months ended June 30, 2012, management of the Company completed certain transactions to increase working capital and repay the Revolving Loan and the Non-revolving Loan (note 10).

The policies applied in these financial statements are based on IFRS issued and outstanding as of August 29, 2012, the date the Board of Directors approved the statements.

2 Basis of presentation

These interim financial statements follow the same accounting policies and methods of application as the most recent annual financial statements.

For the purposes of calculating income taxes during interim period, the Company utilizes estimated annualized income tax rates.

3 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.

4 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 June 30, 2012 and December 31, 2011, 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).

5 Equity investment

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 June 30, 2012 is as follows:

	CDN $
Net investment, December 31, 2010	226,272
Proportionate share of income for the period	16,900
Additional funds advanced	215,906
Net investment, December 31, 2011	459,078
Proportionate share of income for the period	(22,876)
Net investment, June 30, 2012	436,202

6 Property and equipment

	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

	Oil and natural gas interests $	Corporate and Other $	Total $
Cost, December 31, 2011	4,407,246	298,732	4,705,978
Additions	243,927	859	244,786
Disposal of decommissioning liability	(16,156)	-	(16,156)
Change in estimate of decommissioning liability	2,100	-	2,100
Cost, June 30, 2012	4,637,117	299,591	4,936,708
Accumulated depletion, depreciation and impairment	(3,481,697)	(209,104)	(3,690,801)
Depreciation and depletion for the period	(48,006)	(12,915)	(60,921)
Carrying value, June 30, 2012	1,107,414	77,572	1,184,986

During the year ended December 31, 2011, the Company transferred assets with a net book value of $1,500,000 to assets held for sale (note 8).

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.

7 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 than its recoverable amount, and an impairment loss was recognized.

The Company did not record an additional impairment at June 30, 2012 or reverse any previous impairment taken.

8 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 carrying value of the assets held for sale exceeded the highest purchase proposal received of $1,500,000, and consequently an impairment of $385,341 was recorded in the statement of comprehensive loss as at December 31, 2011. The disposition of the assets was completed on March 16, 2012 for gross proceeds of $1,500,000, with no gain or loss recognized on the sale. The full amount of the proceeds were used to repay the Revolving Loan (note 10).

9 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 $189,729 as at June 30, 2012 (December 31, 2011 - $201,664) based on an undiscounted total future liability of $190,242 (December 31, 2011 - $206,810). 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 2.16% (December 31, 2011 – 2% and 2.29%, respectively).

	June 30, 2012	December 31, 2011
	$	$
Balance, beginning of period	**201,664**	239,316
Disposals	**(16,156)**	(62,818)
Liabilities incurred	**-**	1,518
Revisions (changes in estimates)	**2,100**	14,674
Accretion	**2,121**	8,974
Balance, end of period	**189,729**	201,664

10 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 was reduced from $3,000,000 to $1,575,000. The per annum interest rate was increased from the Lender's prime rate plus 2.00% to the Lender's prime rate plus 3.00%. Interest continued 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. During the six months ended June 30, 2012, 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 8), and accordingly repaid the Revolving Loan in its entirety. An amending fee of $10,000 was paid to the Lender, and additionally, a $50,000 payable for the previous amendment was also paid to the Lender.

On August 15, 2011, the Company amended its existing non-revolving demand loan (the "Non-revolving Loan") to a maximum amount of $1,775,000. 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 5.00%. During the six months ended June 30, 2012, the Company repaid the Non-revolving loan in its entirety through the acquisition of a shareholder loan (note 11). The Company incurred professional fees of approximately $120,000 to payout the Non-revolving Loan.

11 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 was repaid in its entirety during the six months ended June 30, 2012.

During the six months ended June 30, 2012, the Company entered into a loan agreement (the "Loan Agreement") with a shareholder (the "Lender") whereby the Company received a $1,500,000 loan. Interest on the shareholder loan is 10% per annum, payable monthly, on the outstanding principal amount and compounds monthly. Pursuant to the loan agreement, the Company must make a principal repayment in the amount of $500,000 on or before August 15, 2012 with the remaining loan due on the maturity date of August 15, 2013. The Company may, at any time, repay the loan in full without notice or penalty. If the Company is in default of the requirements included in the Loan Agreement or the Lender believes the Company's ability to repay the loan is impaired, the Lender may demand repayment of the loan or accelerate the date for payment. As at June 30, 2012, the Company had accrued $5,000 in interest.

As of the filing date of the interim financial statements of August 29, 2012, the Company has not made the $500,000 principal repayment required by August 15, 2012. The Lender has agreed to reduce this amount to $300,000 and has agreed to extend the date as necessary until the Company completes an equity financing in the coming months.

Pursuant to the Loan Agreement, the Company has issued to the Lender 5,000,000 share purchase warrants (the "Warrants") (note 12(c)). Each Warrant is exercisable into one common share of the Company at a price of $0.10 per common share until the expiry date of August 15, 2013. The Warrants have been valued at $147,195 and have been recorded as a non-cash finance expense in the statement of comprehensive loss. The proceeds of the loan were used primarily to repay the Non-revolving Loan with the remaining proceeds used for general working capital.

Security for the loan consists of a $1,500,000 promissory note plus interest at the rate of 10% per annum, compounded monthly, a General Security Agreement in favour of the Lender to include a specific assignment of production proceeds, and security over the US assets of the Company. The Lender has required the Company to submit to them certain reports including monthly production reports.

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, 2010	63,309,446	7,603,866
Funds received pursuant to prior year private placement	-	60,000
Shares issued as consideration for lease acquisition (i)	532,812	42,625
Private placement (ii)	13,413,701	670,685
Value of warrants issued pursuant to private placement (ii)	-	(86,967)
Private placement (iii)	6,234,000	311,700
Value of warrants issued pursuant to private placement (iii)	-	(39,677)
Fair value reallocation on expiry of warrants (note 12(c))	-	13,336
Share issue costs (iv)	-	(83,885)
Balance, December 31, 2011	83,489,959	8,491,683
Private placement (v)	14,240,000	712,000
Value of warrants issued pursuant to private placement (v)	-	(346,581)
Shares issued on exercise of Finders Options (note 12(e))	470,000	23,500
Fair value reallocation on exercise of Finders Options (note12(f))	-	6,353
Share issue costs (v)	-	(56,472)
Balance, June 30, 2012	98,199,959	8,830,483

(i) 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.

(ii) On April 13, 2011 and June 17, 2011, the Company completed a private placement (collectively "Placement A"), issuing 9,413,701 units and 4,000,000 units, respectively. Each unit under Placement A 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 A"). Each Warrant A 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 12(c)).

(iii) 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 B"). Each unit under Placement B 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 A"). Each Warrant A 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 12(c)).

(iv) Pursuant to Placement A and Placement B, the Company incurred $77,532 in cash share issue costs and under Placement A issued 470,000 finders options (the "Finders Options") valued at $6,353 (note 12(e)).

(v) On February 17, 2012, the Company completed a private placement ("Placement C"), issuing 14,240,000 units. Each unit under Placement C was issued at $0.05 for total proceeds of $712,000. 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 1 year from the original issue date. The Company has allocated $346,581 of the unit value to warrants (note 12(c)).

Pursuant to Placement C, the Company incurred $36,200 in cash share issue costs and issued 650,000 finders options (the "Finders Options") valued at $20,272 (note 12(e)).

c) **Warrants**

Warrants to acquire common shares outstanding at June 30, 2012 are as follows:

	Number of warrants issued and exercisable	Amount $	Weighted average exercise price $	Weighted average Remaining life (years)
Balance, December 31, 2010	13,150,000	13,336	0.12	0.34
Share purchase warrants issued (note 12(b)(ii) and (iii))	19,647,701	126,644	0.10	0.68
Expiry of warrants	(13,150,000)	(13,336)	(0.12)	(0.34)
Balance, December 31, 2011	19,647,701	126,644	0.10	0.41
Share purchase warrants issued (note 12(b)(v)	14,240,000	346,581	0.10	0.68
Share purchase warrants issued (note 11)	5,000,000	147,195	0.10	1.13
Balance, June 30, 2012	38,887,701	620,420	0.10	0.60

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:

	2012	2011
Risk-free rate	**1.10%**	1.43%
Expected life	**1.04 years**	1.5 years
Expected volatility	**180.29%**	67.41%
Fair value per warrant	**$0.026**	$0.010

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 six months ended June 30, 2012, there were no stock options granted, cancellations or exercises, and 300,000 stock options expired unexercised. The following table summarizes information about the Company’s stock options outstanding at June 30, 2012:

	June 30, 2012		December 31, 2011	
	Number of options	**Weighted Average Exercise price $**	Number of options	Weighted Average Exercise price $
Stock options, beginning of period	**7,680,000**	**0.10**	4,060,000	0.14
Granted	**-**	**-**	4,925,000	0.10
Cancelled	**-**	**-**	(305,000)	-
Expired	**(300,000)**	**0.10**	(1,000,000)	0.25
Stock options outstanding, end of period	**7,380,000**	**0.10**	7,680,000	0.10

The total stock options outstanding at June 30, 2012 are as follows:

Exercise prices ($)	Options outstanding	Weighted average remaining term (years)	Weighted average exercise price ($)
0.10	7,380,000	3.69	0.10

As at June 30, 2012 all outstanding options have vested and are exercisable.

e) **Finders Options**

During the six months ended June 30, 2012, the Company issued 650,000 Finders Options, respectively, to the those who facilitated Placement C (note 12(b)(v)) and 470,000 Finder Options issued under Placement A were exercised. 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 June 30, 2012:

	June 30, 2012		December 31, 2011	
	Number of options	**Weighted Average Exercise price $**	Number of options	Weighted Average Exercise price $
Finders Options, beginning of period	**470,000**	**0.05**	750,000	0.05
Exercised	**(470,000)**	**0.05**	470,000	0.05
Granted	**650,000**	**0.05**	(750,000)	(0.05)
Finders Options outstanding, end of period	**650,000**	**0.05**	470,000	0.05

The Finders Options were valued at $20,272 and recorded as share issue costs with the offsetting credit to contributed surplus. 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:

	2012	2011
Risk-free interest rate	**1.12%**	1.74%
Expected life	**1 years**	1 years
Expected volatility	**176.18%**	67.41%
Fair value per option	**$0.03**	$0.01

f) **Contributed surplus**

	June 30, 2012	December 31, 2011
	$	$
Balance, beginning of period	**1,048,656**	962,321
Share-based payment expense	**-**	79,982
Finders options (note 12(e))	**20,272**	6,353
Finders options exercised (note 12(e))	**(6,353)**	-
Balance, end of period	**1,062,575**	1,048,656

g) **Per share data**

Basic earnings per share are calculated based on the weighted average number of shares outstanding during the period. 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 period. 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.

13 Income tax

Significant components of the deferred tax liability are as follows:

	June 30, 2012	December 31, 2011
	$	$
Property and equipment	**(233,933)**	(215,436)
Non-capital loss carried forward	**(1,311,875)**	(1,090,555)
Decommissioning liabilities	**(47,432)**	(50,416)
Share issue costs	**(45,071)**	(42,993)
Scientific research and experimental development	**(150,663)**	(150,663)
Attributed Canadian royalty income	**(110,080)**	(110,080)
Investment tax credits	**(195,000)**	(195,000)
Deferred tax asset not recognized	**2,094,054**	1,855,143
	-	-

The Company has estimated tax pools totaling:

	Rate of Claim	**June 30, 2012**
		$
Canadian exploration expenditures	100%	**574,181**
Canadian oil and gas property expense	10%	**17,242**
Foreign development expenditures	100%	**281,058**
Undepreciated capital cost	Various	**1,248,237**
Share issue costs	20%	**180,283**
Scientific research and experimental development		**602,650**
Attributed Canadian royalty income		**1,100,800**
Non-capital loss carry forward		**5,247,499**
		9,251,950

14 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:

	June 30, 2012	December 31, 2011
	$	$
Note receivable from officer (i)	**234,878**	231,609
Fair value allowance (ii)	**(216,515)**	(216,515)
Net note receivable	**18,363**	15,094
Advance fees (iii)	**6,529**	9,529
	24,892	24,623

(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 $18,363 at June 30, 2012 (December 31, 2011 - $15,094).

(ii) The fair value allowance was initially determined on December 31, 2008 based on the market value of the secured shares. During the three and six months ended June 30, 2012, the Company did not provide an additional allowance to the estimated fair value of the 393,000 common shares held as security as the fair value was in excess of the carrying value (December 31, 2011 – allowance of $9,805).

(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 June 30, 2012 $6,529 (December 31, 2011 - $9,529) 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:

For the three months ended June 30:

(i) Aggregate fees of $57,300 (June 30, 2011 - $95,138) were charged by directors of the Company. Of this amount $57,300 (June 30, 2011 - $10,500) was recorded in the statement of comprehensive loss and $nil (June 30, 2011 - $84,638) was capitalized to property and equipment.

(ii) Aggregate fees of $nil (June 30, 2011 - $28,675) 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 $nil (June 30, 2011 - $13,125) was recorded in the statement of comprehensive loss and $nil (June 30, 2011 - $15,550) was capitalized to property and equipment.

For the six months ended June 30:

(iii) Aggregate fees of $127,125 (June 30, 2011 - $151,125) were charged by directors of the Company. Of this amount $127,125 (June 30, 2011 - $133,275) was recorded in the statement of comprehensive loss and $nil (June 30, 2011 - $17,850) was capitalized to property and equipment.

(iv) Aggregate fees of $nil (June 30, 2011 - $42,475) 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 $nil (June 30, 2011 - $23,925) was recorded in the statement of comprehensive loss and $nil (June 30, 2011 - $18,550) was capitalized to property and equipment.

(v) Included in accounts payable at June 30, 2012 was $99,270 owing to related parties of the Company (December 31, 2011 - $37,410).

Key management compensation

	June 30, 2012	December 31, 2011
	$	$
Compensation	**175,825**	362,912
Share based payments	**-**	60,393
Total	**175,825**	423,305

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.

15 Commitments

a) Under a lease agreement ending June 30, 2014, the Company has committed to payments of $2,771 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 2012 through to 2015 are respectively as follows: $23,345, $24,688, $26,110 and $15,846.

c) 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 June 30, 2012, the Company has incurred approximately $88,002 (December 31, 2011 - $88,002) as eligible flow through expenditures against the December 31, 2011 commitment.

16 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, accounts payable and accrued liabilities, shareholder loan and long-term debt.

Financial Instrument	Classification	Carrying Value $	Fair Value $
Cash and cash equivalents	Fair value through profit and loss	9,328	9,328
Short-term investments	Fair value through profit and loss	50,018	50,018
Trade and other receivables	Loans and receivables	272,513	272,513
Due from related parties	Loans and receivables	24,892	24,892
Accounts payable and accrued liabilities	Other financial liabilities	2,428,108	2,428,108
Shareholder loan	Other financial liabilities	1,500,000	1,500,000
Long-term debt	Other financial liabilities	54,409	54,409

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 June 30, 2012, 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.

During the three and six months ended June 30, 2012, the Company recorded a recovery of $15,000 on bad debts recognized during the year ended December 31, 2011 and subsequently re-established the amount as a bad debt (December 31, 2011 – provision for doubtful accounts of $32,000).

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 (defined as current assets less current liabilities)	$2,063,501	This amount is anticipated to be met out of additional share issuance in the 2012.
Shareholder loan (note 11)	$1,500,000	The Company anticipates issuing additional share capital to reduce this amount in 2012. This amount is secured by the Company's oil and gas assets.
Long term debt	$54,409	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.

During 2010, the Company entered into a commodity call option effective from January 1, 2012 to December 31, 2012 at a strike price of USD $90.00 per BBL. During the six months ended June 30, 2012, the Company terminated the commodity call option for consideration of $116,114 and recognized an unrealized gain of $161,770 (June 30, 2011 – ($38,032) and $214,158, respectively) to reverse the financial contract liability recorded at December 31, 2011.

The realized gain recorded by the Company on the commodity call option for the three and six months ended June 30, 2012 was $nil (June 30, 2011 – ($15,935) and $34,047, respectively).

(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 June 30, 2012, 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 $12,525 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 June 30, 2012 the Company's bank debt was $nil; if interest rates had been 1% higher/lower, with all other variables held constant, there would have been an impact of approximately $8,300 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 and six months ended June 30, 2012.

(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.

17 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:

			Three months June 30, 2012 ($)
	Canada	**United States**	**Total**
Petroleum and natural gas sales	10,341	16,186	26,527
Other income	(55,440)	-	(55,440)
Depletion, depreciation and impairment	9,448	12,533	21,981
Net loss income	576,404	65,018	641,422
Property and equipment	867,986	317,000	1,184,986

			Three months ended June 30, 2011 ($)
	Canada	**United States**	**Total**
Petroleum and natural gas sales	300,307	49,179	349,486
Other income	275,326	-	275,326
Depletion, depreciation and impairment	100,550	9,602	110,152
Net loss	52,615	(5,184)	47,431
Property and equipment	3,688,895	260,973	3,949,868

			Six months June 30, 2012 ($)
	Canada	**United States**	**Total**
Petroleum and natural gas sales	42,427	46,029	88,456
Other income	22,780	-	22,780
Depletion, depreciation and impairment	33,216	27,705	60,921
Net loss income	794,150	117,664	911,814
Property and equipment	867,986	317,000	1,184,986

			Six months ended June 30, 2011 ($)
	Canada	**United States**	**Total**
Petroleum and natural gas sales	525,957	83,483	609,440
Other expenses	86,722	-	86,722
Depletion, depreciation and impairment	188,200	15,200	203,400
Net loss	524,189	79,239	603,428
Property and equipment	3,688,895	260,973	3,949,868

18 Subsequent events

Subsequent to June 30, 2012, the Company closed a private placement through the issuance of 4,841,730 units for gross proceeds of $338,921. Each unit consists of one common share of the Company and one share purchase warrant (the “Warrant”). Each 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. The Warrants are subject to an acceleration clause whereby if after four months and one day following the date the Warrants are issued, the closing price of the common shares of the Company is equal to or exceeds $0.15 for 30 consecutive trading days, the Warrant expiry date shall accelerate to the date which is 30 calendar days following the date a press release is issued by the Company announcing the reduced Warrant term and all Warrant holders are notified.