FALCON OIL & GAS LTD.

Interim Condensed Consolidated Financial Statements

Three and Nine Months Ended September 30, 2011 and 2010

(Presented in U.S. Dollars)

FALCON OIL & GAS LTD.
Interim Condensed Consolidated Statements of Financial Position
(Unaudited)

(thousands of US dollars)	September 30, 2011	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 22,458	$ 7,274
Restricted cash	51	51
Accounts receivable	1,716	1,025
Prepaid expenses and other	350	391
Inventory held for sale	1,679	1,678
Total current assets	26,254	10,419
Non-current assets:		
Exploration and evaluation costs (Note 7)	91,437	98,755
Property, plant and equipment (Note 6)	5,311	5,521
Other assets	1,285	714
Total non-current assets	98,033	104,990
Total assets	$ 124,287	$ 115,409
Liabilities		
Current liabilities:		
Accounts payable and accrued expenses	$ 4,585	$ 1,871
Decommissioning provision (Note 13)	150	–
Provision for legal matters (Note 13)	–	3,700
Total current liabilities	4,735	5,571
Non-current liabilities:		
Convertible debentures (Note 10)	5,432	4,519
Derivative liabilities (Note 11)	4,229	775
Decommissioning provision (Note 13)	8,090	6,310
Total non-current liabilities	17,751	11,604
Total liabilities	22,486	17,175
Equity		
Share capital (Note 8)	338,802	331,215
Contributed surplus	39,320	37,874
Deficit	(287,530)	(282,277)
Equity attributable to common shareholders	90,592	86,812
Non-controlling interest	11,209	11,422
Total equity	101,801	98,234
Total liabilities and equity	$ 124,287	$ 115,409

The notes are an integral part of these condensed consolidated financial statements.

FALCON OIL & GAS LTD.
Interim Condensed Consolidated Statements of Operations and Comprehensive Loss
(Unaudited)

	Three Months Ended, September 30,		Nine Months Ended September 30,	
(thousands of US dollars)	2011	2010	2011	2010
Revenue:				
Oil and natural gas revenue	$ 7	$ 12	$ 24	$ 24
Other income	80	(334)	360	(446)
	87	(322)	384	(422)
Expenses:				
Exploration and evaluation expenses	240	268	938	1,279
Production and operating expenses	6	5	25	14
Depletion, depreciation and amortization	129	99	307	319
Impairment of exploration and evaluation costs (Note 7)	–	45,275	–	45,275
General and administrative expenses	2,394	2,259	5,974	8,861
Share based compensation (Note 12)	430	350	1,994	2,918
Write-down of inventory available for sale	–	967	–	967
Write off of receivable	–	4,345	–	4,345
Litigation expense (Note 14)	–	4,741	–	4,741
Reversal of litigation expense (Note 13)	–	–	(1,654)	–
	3,199	58,309	7,584	68,719
Results from operating activities	(3,112)	(58,631)	(7,200)	(69,141)
Finance income (Note 4)	3,050	629	4,094	577
Finance expenses (Note 4)	(697)	(965)	(2,360)	(2,199)
Net finance expenses	2,353	(336)	1,734	(1,622)
Net loss and comprehensive loss for the period	$ (759)	$(58,967)	$ (5,466)	$(70,763)
Net loss and comprehensive loss attributable to:				
Common shareholders	$ (645)	$(58,875)	$ (5,253)	$(70,297)
Non-controlling interest	(114)	(92)	(213)	(466)
Net loss and comprehensive loss for the period	$ (759)	$(58,967)	$ (5,466)	$(70,763)
Net loss per share attributable to common shareholders:				
Basic and diluted (Note 9)	$ (0.001)	$ (0.098)	$ (0.008)	$ (0.117)

The notes are an integral part of these condensed consolidated financial statements.

FALCON OIL & GAS LTD.
Interim Condensed Consolidated Statements of Changes in Equity
(Unaudited)

(thousands of US dollars)	Share capital	Contributed surplus	Deficit	Equity attributable to common shareholders	Non-controlling interest	Total equity
Balance at January 1, 2010	$ 331,215	$ 34,357	$ (135,713)	$ 229,859	$ –	$ 229,859
Share based compensation	–	2,918	–	2,918	–	2,918
Net loss for the period	–	–	(70,297)	(70,297)	(466)	(70,763)
Issuance of shares of subsidiary	–	–	–	–	14,474	14,474
Non-controlling interest dilution gain (loss)	–	–	2,951	2,951	(2,951)	–
Balance at September 30, 2010	$ 331,215	$ 37,275	$ (203,059)	$ 165,431	$ 11,057	$ 176,488
Balance at January 1, 2011	$ 331,215	$ 37,874	$ (282,277)	$ 86,812	$ 11,422	$ 98,234
Private placement of stock	6,924	–	–	6,924	–	6,924
Issuance of stock	648	(648)	–	–	–	–
Options exercised	15	(7)	–	8	–	8
Share based compensation	–	1,994	–	1,994	–	1,994
Stock bonus	–	107	–	107	–	107
Net loss for the period	–	–	(5,253)	(5,253)	(213)	(5,466)
Balance at September 30, 2011	$ 338,802	$ 39,320	$ (287,530)	$ 90,592	$ 11,209	$ 101,801

The notes are an integral part of these condensed consolidated financial statements.

FALCON OIL & GAS LTD.
Interim Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Nine Months Ended September 30,	
(thousands of US dollars)	2011	2010
Cash flows from operating activities:		
Net loss for the period	$ (5,466)	$ (70,763)
Adjustments for:		
Share based compensation	1,994	2,918
Stock bonus	107	–
Depletion, depreciation and amortization	307	319
Impairment of exploration and evaluation costs	–	45,275
Write off of receivable	–	4,345
Litigation expense	–	4,741
Net financing (income) expenses	(1,734)	1,622
Other	51	36
Change in non-cash working capital (Note 5)	(4,215)	4,113
Interest paid	(593)	(519)
Interest received	62	39
Net cash used in operating activities	(9,487)	(7,874)
Cash flows from investing activities:		
Exploration and evaluation costs	(6,267)	(1,372)
Proceeds from farm-out transaction, net	17,709	–
Acquisition of furniture and equipment	(133)	(46)
Other assets	(600)	–
Net cash used in investing activities	10,709	(1,418)
Cash flows from financing activities:		
Decrease in restricted cash	–	1,132
Proceeds from private placement of units offering, net	13,480	–
Proceeds from private placement of warrants	945	–
Proceeds from exercise of share options	8	–
Proceeds from unit offering by subsidiary, net	–	4,438
Net cash from financing activities	14,433	5,570
Change in cash and cash equivalents	15,655	(3,722)
Effect of exchange rates on cash and cash equivalents	(471)	331
Cash and cash equivalents, beginning of period	7,274	11,804
Cash and cash equivalents, end of period	$ 22,458	$ 8,413

The notes are an integral part of these condensed consolidated financial statements.

1. Reporting Entity

Falcon Oil & Gas Ltd. (the "Company" or "Falcon") was incorporated under the laws of British Columbia, and has producing petroleum and natural gas properties in Alberta, Canada and exploration projects in Hungary, Australia and South Africa.

The Company is in the business of acquiring, exploring and developing petroleum and natural gas properties which, by its nature, involves a high degree of risk, and there can be no assurance that current exploration programs will result in profitable operations. The recoverability of the carrying value of the petroleum and natural gas properties and the Company's continued existence is dependent upon the preservation of its interests in the underlying properties, the discovery of economically recoverable reserves, the achievement of profitable operations, or the ability of the Company to obtain financing or, alternatively, upon the Company's ability to economically dispose of its interests. Certain of the Company's petroleum and natural gas properties are subject to the risks associated with foreign investment, including increases in taxes and royalties, renegotiation of contracts, currency exchange fluctuations and political uncertainty.

2. Basis of Presentation and Preparation

(a) Statement of compliance:

These interim condensed consolidated financial statements are unaudited and have been prepared in accordance with IAS 34 'Interim Financial Reporting' ("IAS 34") 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")./ The condensed consolidated interim financial statements do not however include all of the information required for full annual financial statements prepared under IFRS.

This is the first year for which the Company has adopted IFRS. Previously, the Company prepared its annual and interim consolidated financial statements in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). The disclosures concerning the transition from Canadian GAAP to IFRS are included in Note 14.

The condensed consolidated financial statements are presented in United States dollars and, except as otherwise indicated, are presented in thousands of dollars.

(b) Basis of measurement:

The condensed consolidated financial statements have been prepared on the historical cost basis except for derivative financial instruments which are measured at fair value (as discussed in Note 4).

2. Basis of Presentation and Preparation (continued)

(c) Going Concern:

For the nine months ended September 30, 2011, the Company incurred a net loss of $5,466 and, as at September 30, 2011, had a deficit of $287,530 and working capital of $21,519. As a result, the Company's ability to continue as a going concern is dependent upon its ability to raise additional capital and/or to secure an industry partner for its operations in Hungary and South Africa. Additional capital may also be sought from the sale of additional common shares or other debt or equity instruments. There is no assurance that additional capital will be available to the Company on acceptable terms or at all.

In recent months the Company has been focused on securing equity financing and joint venture funding for both its operations in the Beetaloo Basin located in the Northern Territory, Australia, and for its operations in the Makó Trough located in Hungary. As discussed in Note 7 on June 28, 2011, the conditions precedent in the Evaluation and Participation Agreement with Hess Australia (Beetaloo) Pty. Ltd. ("Hess") for the Beetaloo Basin project were satisfied, and in July 2011 the Company received $20,000 from Hess; and, on June 9, 2011 the Company entered into a Letter of Intent with Naftna Industrija Srbije, j.s.c. Novi Sad ("NIS") for the earning of an interest by NIS in producing the Algyö play within Falcon's Makó production license in Hungary (see Note 7).

In the longer term, the recoverability of the carrying value of the Company's long-lived assets is dependent upon the Company's ability to preserve its interest in the underlying petroleum and natural gas properties, the discovery of economically recoverable reserves, the achievement of profitable operations, and the ability of the Company to obtain financing to support its acquisition, exploration, development and production activities.

These consolidated financial statements are prepared in accordance with IFRS appropriate for a going concern. The going concern basis of accounting assumes the Company will continue to realize the value of its assets and discharge its liabilities and other obligations in the ordinary course of business. There is uncertainty as to whether the Company will be able to realize its assets and discharge its liabilities in the normal course of operations. Should the Company be required to realize the value of its assets in other than the ordinary course of business, the net realizable value of its assets may be materially less than the amounts shown in the consolidated financial statements. These consolidated financial statements do not include any adjustments to the amounts and classifications of assets and liabilities that may be necessary should the Company be unable to repay its liabilities and meet its other obligations in the ordinary course of business or continue operations.

2. Basis of Presentation and Preparation (continued)

(d) Use of estimates and judgments:

The preparation of 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. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the year in which the estimates are revised and in any future years affected.

Information about significant areas of estimation uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amounts recognized in the consolidated financial statements is included in Note 7 – valuation of intangible exploration assets, other intangible assets.

3. Significant Accounting Policies

The interim financial statements have been prepared following the same accounting policies and methods of computation as the unaudited financial statements of the Company for the period ended March 31, 2011, except as described below. These interim financial statements and notes thereto should be read in conjunction with the 2010 annual financial statements and Note 3 of the unaudited interim financial statements for the period ended March 31, 2011 which describes the Company's significant accounting policies under IFRS.

Farm-out exploration and evaluation projects

Proceeds received from farm-out transactions in relation to exploration and evaluation projects, net of directly attributable costs, are used to reduce the carrying value of the respective exploration and evaluation assets. No gains or losses are recognized, unless the net proceeds exceed the carrying value of the assets involved.

(thousands of US dollars)

4. Finance income and expenses

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Finance income:				
Interest income on bank deposits	$ 25	$ 9	$ 62	$ 39
Derivative gains – unrealized	2,992	620	4,032	538
Net foreign exchange gain	33	–	–	–
	3,050	629	4,094	577
Finance expenses:				
Interest on loans and borrowings	(628)	(372)	(1,723)	(1,313)
Accretion of provisions	(69)	(69)	(206)	(204)
Net foreign exchange loss	–	(524)	(431)	(682)
	(697)	(965)	(2,360)	(2,199)
Net finance expenses	$ 2,353	$ (336)	$ 1,734	$ (1,622)

5. Supplemented cash flow information

Changes in non-cash working capital is comprised of:

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Source (use) of cash:		
Accounts receivable	$ (747)	$ 1,516
Prepaid expenses and other	30	367
Write-down of inventory held for sale	–	967
Inventory held for sale	(1)	658
Accounts payable and accrued expenses	(3,497)	(225)
	(4,215)	3,283
Other assets	–	830
	$ (4,215)	$ 4,113

(thousands of US dollars)

6. Property, plant and equipment

	Canadian natural gas interests	Pipeline and facilities	Furniture and equipment	Total
Cost				
Balance as at January 1, 2010	$ 466	$ 3,888	$ 3,390	$ 7,744
Additions	–	–	52	52
Disposals	–	(57)	(124)	(181)
Balance as at December 31, 2010	466	3,831	3,318	7,615
Additions	–	–	133	133
Disposals	–	–	(73)	(73)
Balance as at September 30, 2011	$ 466	$ 3,831	$ 3,378	$ 7,675
Depletion, depreciation and amortization				
Balance as at January 1, 2010	$ (419)	$ –	$ (1,304)	$ (1,723)
Depletion, depreciation and amortization	(4)	–	(405)	(409)
Disposals	–	–	38	38
Balance as at December 31, 2010	(423)	–	(1,671)	(2,094)
Depletion, depreciation and amortization	(7)	–	(300)	(307)
Disposals	–	–	37	37
Balance as at September 30, 2011	$ (430)	$ –	$ (1,934)	$ (2,364)
Net book value:				
As at December 31, 2010	$ 43	$ 3,831	$ 1,647	$ 5,521
As at September 30, 2011	$ 36	$ 3,831	$ 1,444	$ 5,311

7. Exploration and evaluation costs

	Hungary	Australia	South Africa	Total
Balance as at January 1, 2010	$ 168,478	$ 39,314	$ –	$ 207,792
Additions	130	12,944	–	13,074
Impairment	(122,111)	–	–	(122,111)
Balance as at December 31, 2010	46,497	52,258	–	98,755
Additions	1,728	8,663	–	10,391
Proceeds from farm-out transaction, net of transaction costs	–	(17,709)	–	(17,709)
Balance as at September 30, 2011	$ 48,225	$ 43,212	$ –	$ 91,437

7. Exploration and evaluation costs (continued)

Exploration and evaluation ("E&E") assets consist of the Company's exploration projects which are pending the determination of proven or probable reserves. Additions represent the Company's costs incurred on E&E assets during the period.

(a) Recoverability of exploration and evaluation costs:

The Company assesses the recoverability of intangible exploration assets, before and at the moment of reclassification to property, plant and equipment, using groups of cash generating units ("CGUs"). The group of CGU includes both the E&E assets and CGU's related to oil and natural gas interests for that area, but is not larger than a segment.

The impairment of intangible exploration assets, and any eventual reversal thereof, is recognized as additional depletion, depreciation and amortization expense in the statement of operations and comprehensive loss as impairment of exploration and evaluation costs.

For the nine months ended September 30, 2010 and the year ended December 31, 2010, the Company determined that the carrying value of the Hungarian properties exceeded its estimated recoverable amount, and recorded an impairment of $45,275 and $122,111, respectively. No impairment was recognized for the nine months ended September 30, 2011. The estimated recoverable value was assessed by the Company utilizing a valuation model based on potential joint venture partners as evidenced by discussions being held and an assessment of the valuation of the prospect based on potential farm-out arrangements.

(b) Hungary:

The Company holds a long-term Mining Plot (the "Production License") granted by the Hungarian Mining Authority. The Production License, covering approximately 245,700 acres, gives the exclusive right to explore for and develop petroleum and natural gas on properties located in south central Hungary near the town of Szolnok.

On June 9, 2011, the Company's wholly owned Hungarian subsidiary ("TXM") entered into a Letter of Intent ("LOI") with NIS, for the earning by NIS of an interest in producing the Algyö play within the Makó' production license in Hungary in an area of approximately 995 square kilometers, from a depth of 2,300 meters down to the base of the Algyö Formation (the "Agreement Area"). Under the terms of the LOI, TXM will retain all rights within the entire production license deeper than the base of the Algyö Formation such as the Szolnok and Endröd formations and, upon signing of a participation agreement NIS would make a $1,500 payment to TXM. NIS shall then, at its sole cost, drill, test and complete three wells in the Agreement Area. These wells, to be drilled and tested before December 31, 2012, shall be located so that each well tests an independent Algyö prospect. NIS will earn a 50% interest in production from each prospect if the discovery well is tied in and placed on production at the sole cost of NIS. After the drilling of the three wells is completed, NIS has the right to acquire a 50% interest in production from the entire Agreement Area by paying to TXM an additional $2,750 (the "earn-in"). If NIS does not fulfill their drilling obligations under the participation agreement, TXM will retain 100% interest in the Agreement Area.

7. Exploration and evaluation costs (continued)

If the NIS earn-in is completed, NIS and TXM will share future exploration, appraisal and development costs and production in the Agreement Area in accordance with their participating interests held under a joint operating agreement. TXM shall be the Operator under both the participation agreement and the joint operating agreement.

The transaction as a whole, when entered into, is subject to receipt of all governmental and regulatory consents.

(c) Australia:

The Company is the registered owner of four exploration permits ("the Permits"), comprising 7,000,000 acres in the Beetaloo Basin, Northern Territories, Australia.

On June 28, 2011, all conditions precedent to closing of the Evaluation and Participation Agreement (the "E&P Agreement") entered into on April 28, 2011 between Falcon Australia and Hess were satisfied. By the terms of the E&P Agreement, in July 2011 Hess paid $20.0 million to the Company (i) as a participation fee for the exclusive right to conduct operations for the exploration, drilling, development and production of hydrocarbons from three of the four Permits, and excluding an area comprising 100,000 acres surrounding the Shenandoah-1 well (the "Area of Interest") and (ii) as consideration for warrants to acquire 10,000,000 common shares in the capital of Falcon exercisable from November 14, 2011 through January 13, 2015 at an exercise price of CDN$0.19 per share. The $20,000 of gross proceeds received from Hess were reduced by closing costs of $1,346 resulting in net proceeds of $18,654 which were allocated $17,709 to the farm-out transaction and $945 to the warrants.

Hess shall acquire seismic data, at its sole cost of at least $40.0 million, over the Area of Interest within 18 months of the execution of the E&P Agreement. After acquiring the seismic data, Hess shall have the right to acquire a 62.5% working interest in the Area of Interest. If Hess acquires the working interest, they commit to drill and evaluate five exploration wells at their sole cost, one of which must be a horizontal well. All costs to plug and abandon the five exploration wells will also be borne solely by Hess. The drilling and evaluation of the five exploration wells must meet the minimum work requirements of the work program. Costs to drill wells after the five exploration wells will be borne 62.5% by Hess and 37.5% by Falcon Australia.

Under existing agreements with two advisors, the Company is obligated to pay a "success fee" in the aggregate amount of 5% for services provided in conjunction with the E&P Agreement with Hess. The success fee is based on the cash or cash-equivalent value of any net amount received directly or indirectly by the Company, including the participation fee and warrants, cost of seismic data commitment and cost of drilling commitment.

7. Exploration and evaluation costs (continued)

Under a revised work program approved by the Northern Territory of Australia Government, Department of Resources on July 6, 2011 for Permits EP 76, EP 98, and EP 117, the Company's required minimum work program obligations, in order to continue to hold the underlying Permits (including EP 99) in the Beetaloo Basin, is to expend $27,100 and $13,600 during the years ending December 31, 2011 and 2012, respectively, of which $16,000 (2012 - $9,900) is for the acquisition of seismic which will be borne by Hess under the E&P Agreement.

In November 2011, Falcon Australia, in accordance with the work program, completed the testing and stimulation of the Shenandoah-1 well at its sole cost, and the well has been plugged and abandoned. Falcon Australia will provide Hess copies of the data obtained from these activities, and Hess must pay Falcon Australia $2.0 million for the data.

(d) South Africa:

The Company has applied for an exploration permit covering the Technical Cooperation Permit ("TCP") that it secured in October 2009. All expenditures associated with the TCP and with the application for the exploration permit are charged to operations as exploration and evaluation expenses.

8. Share capital

As at September 30, 2011 and December 31, 2010, the Company was authorized to issue an unlimited number of common shares, without par value.

On April 11, 2011, Falcon issued 87,050,000 units (the "Units") at $0.16 (CDN$0.15) per unit by way of a non-brokered private placement for aggregate gross proceeds of $13,674 (CDN$13,058), before offering costs of $194. Each Unit consists of one common share in the capital of Falcon (each, a "Common Share") and three-quarters of one Common Share purchase warrant (each, a "Warrant"), each whole Warrant being exercisable into a Common Share for a period of 36 months from the date of its issuance at an exercise price of $0.19 (CDN$0.18) per share. As at the date of the close of the offering, the Warrants were valued at $6,541 and included in derivative liabilities. As at September 30, 2011, the fair value of the Warrants is $3,543, with the change in fair value since issue date of $2,998 included in net finance expenses (see Notes 4 and 11).

In 2010, the Company agreed to issue five million shares of common stock to two former officers (valued at $648). As these shares had not been issued at December 31, 2010 the value of the shares was included in contributed surplus. On February 28, 2011, 1,000,000 shares of common stock were issued, and the related value of $168 was reclassified from contributed surplus to share capital. On May 30, 2011, the remaining 4,000,000 shares were issued, and the related value of $480 was reclassified from contributed surplus to share capital.

In October 2011, the Company issued 676,800 common shares to non–executive employees and consultants as a bonus consideration for services. These shares were valued at $107, $0.16 (CDN$0.15) per share, and included in contributed surplus at September 30, 2011.

(thousands of US dollars)

8. Share capital (continued)

The following is a reconciliation of issued and outstanding common shares:

	Number of shares	Share capital
Balance as at January 1, 2010 and 2011	602,216,800	$ 331,215
Issuance of shares in a private placement, net of offering costs	87,050,000	6,924
Issuance of shares to two former officers	5,000,000	648
Options exercised	50,000	15
Balance as at September 30, 2011	694,316,800	$ 338,802

9. Net loss per share

Net loss per share – basic was calculated as follows:

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Net loss for the period	$ (645)	$(58,875)	$ (5,253)	$(70,297)
Weighted average number of common shares – basic				
Issued common shares as at beginning of period	602,217	602,217	602,217	602,217
Shares issued in a private placement	87,050	–	56,120	–
Shares issued to two former officers	5,000	–	2,604	–
Share options exercised	50	–	46	–
Weighted average number of common shares – basic	694,317	602,217	660,987	602,217

All outstanding convertible securities, options and warrants were excluded from the calculation of net loss per share as the effect of these assumed conversions and exercises was anti-dilutive.

10. Convertible debentures

On June 30, 2009, the Company completed an offering of 11,910 units at a price of $865 (CDN$1,000) per unit (the "Offering"). Each unit consisted of one 11% convertible unsecured debenture in the principal amount of $779 (CDN$900) (each, a "Debenture") that matures on the fourth anniversary of its issuance (June 30, 2013) pursuant to the terms of a trust indenture dated June 30, 2009 (the "Trust Indenture"), and 250 common shares in the capital of Falcon (the "Unit Shares") (collectively, a "Unit"). The Debentures bear interest at an annual rate of 11% calculated and payable semi-annually in arrears on January 1 and July 1 in each year commencing January 1, 2010. The Debentures are unsecured direct obligations of the Company. In certain circumstances the Trust Indenture may restrict the Company from incurring additional indebtedness for borrowed money or from mortgaging, pledging or charging its property to secure any additional indebtedness.

(thousands of US dollars)

10. Convertible debentures (continued)

Optional Conversion Privilege

Each Debenture may be convertible into common shares of the Company ("Debenture Shares") at the option of the Debenture holder (the "Optional Conversion Privilege") at any time prior to the close of business on the earlier of the maturity date and the business day immediately preceding the date fixed by the Company for redemption of the Debentures (either of such dates, the "Optional Conversion Date"), at a conversion price of CDN$0.60 per common share (the "Conversion Price"), being a conversion ratio of approximately 1,667 Debenture Shares for each CDN$1,000 principal amount of Debentures. The Conversion Price is subject to adjustment upon the occurrence of certain events. Debenture holders converting their Debentures will receive accrued and unpaid interest in cash thereon up to, but not including, the Optional Conversion Date. No fractional shares will be issued. Notwithstanding the foregoing, no Debentures may be converted during the 10 business days preceding and including January 1 and July 1 in each year, commencing January 1, 2010 as the registers of the Indenture Trustee (as defined in the Trust Indenture) will be closed during such periods. The optional conversion privilege is an embedded derivative for accounting purposes and recorded as a liability at fair value (see Note 11).

The face value of the convertible debentures, due on maturity at June 30, 2013, is $10,974 (CDN$10,719).

As at September 30, 2011, convertible debentures are recorded at $5,432 (2010-$4,519).

11. Derivative liabilities

Derivative liabilities consist of the fair value of the convertible debt conversion feature, the fair value of the private placement warrants and the fair value of the Hess warrants. Changes in the fair value of the derivative liabilities are recorded as part of net finance expenses. The composition of the derivative liabilities as at September 30, 2011 and December 31, 2010 is as follows:

		2011		2010
Fair value of convertible debenture conversion feature (see Note 10)	$	3	$	775
Fair value of private placement warrants (see Note 8)		3,543		–
Fair value of Hess warrants (see Note 7)		683		–
	$	4,229	$	775

(thousands of US dollars)

12. Share based compensation

The Company, in accordance with the policies of the TSX-V, may grant options to directors, officers, employees and consultants, to acquire up to 10% of the Company's issued and outstanding common stock. The exercise price of each option is based on the market price of the Company's stock at the date of grant, which may be less a discount in accordance with TSX-V policies. The exercise price of all options granted has been based on the market price of the Company's stock at the date of grant, and no options have been granted at a discount to the market price. The options can be granted for a maximum term of five years. The Company records compensation expense over the vesting period based on the fair value at the grant date of the options granted. These amounts are recorded as contributed surplus. Any consideration paid on the exercise of these options together with the related contributed surplus associated with the exercised options is recorded as share capital.

A summary of the Company's stock option plan as of September 30, 2011 and December 31, 2010, and changes during the nine months and the year then ended, is presented below:

	2011		2010	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding as at beginning of period	21,764,500	$ 1.81	41,975,000	$ 1.90
Granted	17,810,000	0.15	5,725,000	0.16
Expired	(7,697,333)	1.43	(23,908,500)	0.87
Forfeited	(1,136,667)	0.46	(2,027,000)	1.44
Exercised	(50,000)	0.16	–	–
Outstanding as at end of period	30,690,500	$ 0.49	21,764,500	$ 1.81
Exercisable as at end of period	15,947,000	$ 0.70	14,402,633	$ 2.35

Of the options granted during the nine months ended September 30, 2011 and the year ended December 31, 2010, all vest 1/3 at the date of grant, with the remainder vesting ratably at the anniversary date over the two years thereafter.

(thousands of US dollars)

12. Share based compensation (continued)

The exercise prices of the outstanding options are as follows:

Exercise price	Number of Options	Weighted average exercise price	Weighted average contractual life (years)
$ 0.15	150,000	$ 0.15	4.67
0.15	16,910,000	0.15	4.64
0.15	1,000,000	0.15	4.23
0.16	3,619,500	0.16	3.92
0.54	600,000	0.54	0.88
0.98	1,000,000	0.98	1.60
1.19	6,485,000	1.19	1.68
2.83	926,000	2.83	0.19
	30,690,500	$ 0.49	3.61

The fair value of the options was estimated using a Black Scholes model with the following weighted average inputs:

	2011	2010
Fair value as at grant date	$ 0.15	$ 0.11 – 0.12
Share price	0.15	0.15 – 0.17
Exercise price	0.15	0.15 – 0.17
Volatility	105% – 106%	112%
Option life	5.00 years	5.00 years
Dividends	Nil	Nil
Risk-free interest rate	2.23% – 2.44%	1.39% – 2.04%

A forfeiture rate of 16% (2010 - 16%) is used when recording share based compensation. This estimate is adjusted based on the actual forfeiture rate. Share based compensation cost of $430 and $1,994 (2010 - $350 and $2,918) was recorded during the three and nine months ended September 30, 2011, respectively. There was no share based compensation expense capitalized during 2011 and 2010.

(thousands of US dollars)

13. Provisions

(a) Decommissioning provision:

A reconciliation of the decommissioning provision for the nine months ended September 30, 2011 and for the year ended December 31, 2010 is provided below:

	2011	2010
Balance as at beginning of period	$ 6,310	$ 5,673
Assumed on an acquisition of assets	–	363
Provisions incurred	2,593	–
Revision to provisions	(869)	–
Accretion	206	274
Balance as at end of period	$ 8,240	$ 6,310
Current	$ 150	$ –
Long-term	8,090	6,310
Balance as at end of period	$ 8,240	$ 6,310

The Company's decommissioning provision results from its ownership interest in oil and natural gas assets. The total decommissioning provision is estimated based on the Company's net ownership interest in the wells, estimated costs to reclaim and abandon these wells and the estimated timing of the costs to be incurred in future years. The Company has estimated the net present value of the decommissioning provision to be $8,240 as at September 30, 2011 (2010 – $6,310) based on an undiscounted total future liability of $11,989 (2010 – $14,094). These payments are expected to be made over the next 20 years with the majority of costs to be incurred between 2027 and 2031. The discount factor, being the risk free rate related to the liability, was 4.13% as at September 30, 2011 (2010 – 4.58%).

(b) Legal:

The Company may, from time to time, be involved in various claims, lawsuits, disputes with third parties, or breach of contract incidental to the operations of its business. The Company is not currently involved in any claims, disputes, litigation or other actions with third parties which it believes could have a material adverse effect on its financial condition or results of operations.

On November 10, 2009, as amended on March 16, 2011, the Company was served with a Complaint by a former vendor (the "Vendor") of TXM arising out of a dispute related to TXM's alleged failure to pay for certain oilfield equipment.

On July 29, 2011, TXM and the Vendor entered into a settlement agreement and all obligations due to the vendor have been paid. Included in accounts payable in the consolidated statement of financial position at September 30, 2011 is a liability for fees and costs related to the settlement of this matter of $175.

(thousands of US dollars)

13. Provisions (continued)

A reconciliation of the litigation provision for the nine months ended September 30, 2011 and for the year ended December 31, 2010 is provided below:

	2011	2010
Balance as at beginning of period	$ 3,700	$ -
(Reversal of) litigation expense	(1,654)	3,700
Reclassified to accounts payable and accrued expenses	(2,046)	-
Balance as at end of period	$ -	$ 3,700

(thousands of US dollars)

14. Explanation of transition from Canadian GAAP to IFRS

Consolidated statement of financial position as at September 30, 2010:

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Assets				
Current assets:				
Cash and cash equivalents		$ 8,413	$ –	$ 8,413
Restricted cash		51	–	51
Accounts receivable		1,362	–	1,362
Prepaid expenses and other		376	–	376
Inventory held for sale		2,571	–	2,571
Total current assets		12,773	–	12,773
Non-current assets:				
Exploration and evaluation costs	(a) (b)	175,514	(381)	175,133
Property, plant and equipment	(a)	5,702	36	5,738
Other assets		758	–	758
Total non-current assets		181,974	(345)	181,629
Total assets		$ 194,747	$ (345)	$ 194,402
Liabilities				
Current liabilities:				
Accounts payable and accrued expenses	(a)	$ 7,062	$ (4,741)	$ 2,321
Provision for legal matters	(a)	–	4,741	4,741
Total current liabilities		7,062	–	7,062
Non-current liabilities:				
Convertible debentures	(c)	5,186	(1,159)	4,027
Derivative liabilities	(c) (d)	–	929	929
Decommissioning provision	(e)	6,441	(545)	5,896
Total non-current liabilities		11,627	(775)	10,852
Total liabilities		18,689	(775)	17,914
Equity:				
Share capital		331,215	–	331,215
Contributed surplus	(d) (f)	35,649	1,626	37,275
Equity component of convertible debentures	(c)	5,057	(5,057)	–
Deficit		(206,920)	3,861	(203,059)
		165,001	430	165,431
Non-controlling interest		11,057	–	11,057
Total equity		176,058	430	176,488
Total liabilities and equity		$ 194,747	$ (345)	$ 194,402

(thousands of US dollars)

14. Explanation of transition from Canadian GAAP to IFRS (continued)

Consolidated statement of operations and comprehensive loss

For the nine months ended September 30, 2010

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Revenue:				
Oil and natural gas revenue		$ 24	$ –	$ 24
Other income		(446)	–	(446)
		(422)	–	(422)
Expenses:				
Exploration and evaluation expenses	(a) (b)	–	1,279	1,279
Production and operating expenses		14	–	14
Depletion, depreciation and amortization	(e)	636	(317)	319
Impairment of exploration and evaluation costs	(a) (b)	51,000	(5,725)	45,275
General and administrative expenses		8,861	–	8,861
Share based compensation	(f)	3,819	(901)	2,918
Write-down of inventory available for sale		967	–	967
Write off of receivable		4,345	–	4,345
Litigation expense	(a)	–	4,741	4,741
		69,642	(923)	68,719
Results from operating activities		(70,064)	923	(69,141)
Finance income		39	538	577
Finance expenses		(2,390)	191	(2,199)
Net finance expenses	(c) (d) (e)	(2,351)	729	(1,622)
Net loss and comprehensive loss for the period		$ (72,415)	$ 1,652	$ (70,763)
Net loss and comprehensive loss attributable to:				
Common shareholders		(71,949)	1,652	(70,297)
Non-controlling interest		(466)	–	(466)
Net loss and comprehensive loss for the period		$ (72,415)	$ 1,652	$ (70,763)

(thousands of US dollars)

14. Explanation of transition from Canadian GAAP to IFRS (continued)

Consolidated statement of operations and comprehensive loss

For the three months ended September 30, 2010

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Revenue:				
Oil and natural gas revenue		$ 12	$ –	$ 12
Other income		(334)	–	(334)
		(322)	–	(322)
Expenses:				
Exploration and evaluation expenses	(a) (b)	–	268	268
Production and operating expenses		5	–	5
Depletion, depreciation and amortization	(e)	206	(107)	99
Impairment of exploration and evaluation costs	(a) (b)	51,000	(5,725)	45,275
General and administrative expenses		2,259	–	2,259
Share based compensation	(f)	633	(283)	350
Write-down of inventory available for sale		967	–	967
Write off of receivable		4,345	–	4,345
Litigation expense	(a)	–	4,741	4,741
		59,415	(1,106)	58,309
Results from operating activities		(59,737)	1,106	(58,631)
Finance income		9	620	629
Finance expenses		(897)	(68)	(965)
Net finance expenses	(c) (d) (e)	(888)	552	(336)
Net loss and comprehensive loss for the period		$ (60,625)	$ 1,658	$ (58,967)
Net loss and comprehensive loss attributable to:				
Common shareholders		$ (60,533)	$ 1,658	$ (58,875)
Non-controlling interest		(92)	–	(92)
Net loss and comprehensive loss for the period		$ (60,625)	$ 1,658	$ (58,967)

14. Explanation of transition from Canadian GAAP to IFRS (continued)

Notes to reconciliations:

(a) IFRS 1 election for full cost oil and gas entities:

The Company elected to use the IFRS 1 exemption whereby the Canadian GAAP full cost pool was measured upon transition to IFRS as follows:

(i) exploration and evaluation assets were reclassified from the full cost pool to intangible exploration assets at the amount that was recorded under Canadian GAAP; and

(ii) the remaining full cost pool as at September 30, 2010 of $36 was allocated to the Canadian producing assets, and reclassified to property, plant and equipment.

During 2010, certain costs reflected as petroleum and natural gas properties, including pre-license costs, have been charged to exploration and evaluation expenses in the consolidated statement of operations and comprehensive loss. As at September 30, 2010, this resulted in a net decrease of $345 to exploration and evaluation costs, and a $50 increase to deficit in the consolidated statement of financial position. For the three and nine months ended September 30, 2010, exploration and evaluation expenses increased by $268 and $1,279, respectively; however, the impact to net loss was reduced by a $984 reduction to the impairment of exploration and evaluation costs.

As at September 30, 2010, the Company reflected a $4,741 addition to the full cost pool with a corresponding credit reflected in accounts payable and accrued expenses. The treatment of the $4,741 has been revised and is reflected in the consolidated statement of operations and comprehensive loss for the nine months ended September 30, 2010 as litigation expense; however, there was no impact to net loss as a result of a corresponding reduction to the impairment of exploration and evaluation costs. In addition, the treatment of the $4,741 credit has been revised and is reflected as a provision for legal matters in the consolidated statement of financial position at September 30, 2010 with a corresponding reduction to accounts payable and accrued expenses.

(b) Exploration and evaluation expenses:

For assets with activities that are temporarily suspended, the Company's accounting policy is to reflect exploration and evaluation expenses in its consolidated statements of operations and comprehensive loss. Under Canadian GAAP, these costs were capitalized as part of the full cost pool. The effect of these adjustments of $984 to capitalized costs as at September 30, 2010 that were expensed under IFRS for the nine months then ended ($102 for the three months ended September 30, 2010) are included in the net amounts discussed in (a) above.

IFRS does not permit capitalization of expenditures incurred before an exploration license is obtained. Accordingly, expenditures capitalized as part of the full cost pool under Canadian GAAP of $345 as at September 30, 2010 have been expensed under IFRS, including $295 for the nine months then ended ($166 for the three months ended September 30, 2010).

14. Explanation of transition from Canadian GAAP to IFRS (continued)

(c) Convertible debentures conversion feature:

Under Canadian GAAP, the convertible debentures conversion feature was reflected in equity. The debentures are convertible into shares of the Company's common stock at a price fixed in Canadian dollars and, consequently, because of changes in the Canadian dollar to US dollar exchange rate, the equivalent US dollar amount would not be known until the date of conversion. Therefore, under IFRS, the conversion debenture conversion feature is reflected as a liability. As the economic characteristics and risks of the conversion feature are not closely related to those of the host contract, the conversion feature is considered to be an embedded derivative. At each reporting period, the conversion feature is recognized at fair value, with changes in fair value being recognized in results of operations.

As at January 1, 2010, this resulted in an increase to derivative liabilities of $1,421, a decrease to equity component of convertible debentures of $5,057, and a decrease to the deficit of $3,636. As at September 30, 2010, the derivative liability was decreased to its fair value of $929, with the change in fair value of $492 recognized as a decrease to net finance expenses for the nine months ended September 30, 2010 (a decrease to net finance expenses of $610 for the three months ended September 30, 2010).

(d) Agents warrants:

Agents warrants are classified as a derivative instrument under IFRS as the currency in which the exercise price is denominated is different from the Company's functional currency, and are reflected in the consolidated statement of financial position at fair value as at each reporting period. Changes in fair value are reflected in the consolidated statement of operations and comprehensive loss. Under Canadian GAAP, the warrants were reflected in equity at the fair value at the date of issuance.

This resulted in a reduction to contributed surplus of $263, a reduction to deficit of $217, and an increase to derivative liabilities of $46 as at January 1, 2010. As at September 30, 2010, the derivative liability was decreased to its fair value of nil, with the change in fair value of $46 recognized in net finance expenses for the nine months ended September 30, 2010 ($9 for the three months ended September 30, 2010).

(e) Decommissioning provision:

Under Canadian GAAP, asset retirement obligations were discounted at credit adjusted risk fee rates and for inflation. Under IFRS, the estimated cash flow to abandon and remediate wells and facilities has been adjusted for a risk free rate of interest, and a corresponding inflation factor, which resulted in a $433 decrease in the decommissioning provision with a corresponding decrease in deficit as at January 1, 2010.

As a result of the change in the decommissioning provision, accretion expense decreased by $112 during the nine months ended September 30, 2010 ($37 during the three months ended September 30, 2010) under IFRS as compared to Canadian GAAP. In addition, under Canadian GAAP, accretion of the discount of $317 for the nine months ended September 30, 2010 ($107 for the three months ended September 30, 2010) was included in depletion, depreciation and amortization. Under IFRS, it is included in net finance expenses.

14. Explanation of transition from Canadian GAAP to IFRS (continued)

(f) Share based compensation:

Under Canadian GAAP, the Company recognized an expense related to their share based compensation on a straight-line basis through the date of full vesting and did not incorporate a forfeiture multiple. Under IFRS, the Company is required to recognize the expense over the individual vesting periods for the graded vesting awards and estimate a forfeiture rate.

This resulted in an increase to contributed surplus and deficit of $2,791 as at January 1, 2010, and a decrease to share based compensation of $901 for the nine months ended September 30, 2010 ($283 for the three months ended September 30, 2010).

Adjustments to the statements of cash flows

For the nine months ended September 30, 2010, pre-license costs of $295 and costs associated with assets whose activities have been temporarily suspended of $984 were previously capitalized and reflected as investing activities in the statement of cash flows. Under IFRS, these aggregate costs of $1,279 are expensed and reflected as operating activities in the statement of cash flows.