FALCON OIL & GAS LTD.

Consolidated Financial Statements

Years Ended December 31, 2011 and 2010

(Presented in U.S. Dollars)

KPMG

INDEPENDENT AUDITORS' REPORT

To the Shareholders of Falcon Oil & Gas Ltd.

We have audited the accompanying consolidated financial statements of Falcon Oil & Gas Ltd. ("the Company"), which comprise the consolidated statements of financial position as at December 31, 2011, December 31, 2010 and January 1, 2010, the consolidated statements of operations and comprehensive loss, changes in equity and cash flows for the years ended December 31, 2011 and December 31, 2010, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

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

Auditors' responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

Opinion

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

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note 2(c) in the consolidated financial statements which indicates the Company incurred a loss of $34.8 million and operating cash outflows of $12.1 million during the year ended December 31, 2011 and that the Company's ability to continue as a going concern is dependent upon raising additional capital. This condition, along with other matters as set forth in Note 2(c), indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

KPMG LLP

Chartered Accountants
Calgary, Canada
April 30, 2012

FALCON OIL & GAS LTD.
Consolidated Statements of Financial Position

(thousands of US dollars)	December 31, 2011	December 31, 2010	January 1, 2010
Assets			
Current assets:			
Cash and cash equivalents	$ 15,358	$ 7,274	$ 11,804
Restricted cash	51	51	1,184
Accounts receivable	1,602	1,025	2,955
Prepaid expenses	330	391	720
Inventory held for sale	628	1,678	4,196
Total current assets	17,969	10,419	20,859
Non-current assets:			
Exploration and evaluation assets (Note 8)	70,977	98,755	207,792
Property, plant and equipment (Note 7)	5,224	5,521	6,021
Other assets	731	714	8,277
Total non-current assets	76,932	104,990	222,090
Total assets	$ 94,901	$ 115,409	$ 242,949
Liabilities			
Current liabilities:			
Accounts payable and accrued expenses	$ 3,836	$ 1,871	$ 2,683
Decommissioning provision (Note 14)	150	–	–
Provision for legal matters (Note 14)	–	3,700	–
Total current liabilities	3,986	5,571	2,683
Non-current liabilities:			
Convertible debentures (Note 11)	5,960	4,519	3,266
Derivative liabilities (Note 12)	3,314	775	1,468
Decommissioning provision (Note 14)	8,663	6,310	5,673
Total non-current liabilities	17,937	11,604	10,407
Total liabilities	21,923	17,175	13,090
Equity			
Share capital (Note 9)	339,006	331,215	331,215
Contributed surplus	39,654	37,874	34,357
Deficit	(316,838)	(282,277)	(135,713)
Equity attributable to common shareholders	61,822	86,812	229,859
Non-controlling interest	11,156	11,422	–
Total equity	72,978	98,234	229,859
Total liabilities and equity	$ 94,901	$ 115,409	$ 242,949

On behalf of the Board:

"*Gregory Smith*", Director "*Robert Macaulay*", Director

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

FALCON OIL & GAS LTD.
Consolidated Statements of Operations and Comprehensive Loss

	Year Ended December 31,	
(thousands of US dollars)	2011	2010
Revenue:		
Oil and natural gas revenue	$ 33	$ 28
Expenses:		
Exploration and evaluation expenses	1,629	1,602
Production and operating expenses	34	26
Depletion and depreciation	368	434
Impairment of non-current assets (Notes 7 and 8)	26,035	122,111
General and administrative expenses	7,703	11,323
Share based compensation (Note 13)	2,435	3,516
Write-down of inventory available for sale	641	1,186
Write off of receivable	–	4,345
(Reversal of) litigation expense (Note 14)	(1,533)	3,700
Other (income) expense	(543)	386
	36,769	148,629
Results from operating activities	(36,736)	(148,601)
Finance income (Note 5)	5,029	737
Finance expenses (Note 5)	(3,120)	(2,920)
Net finance expenses	1,909	(2,183)
Net loss and comprehensive loss for the year	$ (34,827)	$ (150,784)
Net loss and comprehensive loss attributable to:		
Common shareholders	$ (34,561)	$ (150,247)
Non-controlling interest	(266)	(537)
Net loss and comprehensive loss for the year	$ (34,827)	$ (150,784)
Net loss per share attributable to common shareholders:		
Basic and diluted (Note 10)	$ (0.05)	$ (0.25)

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

FALCON OIL & GAS LTD.
Consolidated Statements of Changes in Equity

(thousands of US dollars)	Share capital	Contributed surplus	Deficit	Equity attributable to common shareholders	Non-controlling interest	Total equity
Balance as at January 1, 2010	$ 331,215	$ 34,357	$ (135,713)	$ 229,859	$ –	$ 229,859
Share based compensation	–	3,516	–	3,516	–	3,516
Issuance of shares of subsidiary	–	–	–	–	15,642	15,642
Non-controlling interest dilution gain (loss)	–	–	3,683	3,683	(3,683)	–
Net loss for the year	–	–	(150,247)	(150,247)	(537)	(150,784)
Balance as at December 31, 2010	331,215	37,874	(282,277)	86,812	11,422	98,234
Private placement of shares	6,924	–	–	6,924	–	6,924
Issuance of shares	648	(648)	–	–	–	–
Options exercised	15	(7)	–	8	–	8
Share based compensation	–	2,435	–	2,435	–	2,435
Share bonus to employees and consultants	107	–	–	107	–	107
Private placement of shares to officers and a director	97	–	–	97	–	97
Net loss for the year	–	–	(34,561)	(34,561)	(266)	(34,827)
Balance as at December 31, 2011	$ 339,006	$ 39,654	$ (316,838)	$ 61,822	$ 11,156	$ 72,978

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

FALCON OIL & GAS LTD.
Consolidated Statements of Cash Flows

(thousands of US dollars)	Year Ended December 31, 2011	2010
Cash flows from operating activities:		
Net loss for the year	$ (34,827)	$ (150,784)
Adjustments for:		
Share based compensation	2,435	3,516
Share bonus	204	–
Depletion and depreciation	368	434
Impairment of non-current assets	26,035	122,111
Write off of receivable	–	4,345
(Reversal of) litigation expense	(1,533)	3,700
Net financing (income) expenses	(1,909)	2,183
Other	20	89
Change in non-cash working capital (Note 6)	(1,845)	5,296
Interest paid	(1,170)	(1,028)
Interest received	83	45
Net cash used in operating activities	(12,139)	(10,093)
Cash flows from investing activities:		
Exploration and evaluation assets	(13,397)	(1,442)
Proceeds from farm-out transaction, net	19,609	–
Property, plant and equipment	(157)	(51)
Net cash used in investing activities	6,055	(1,493)
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	–	5,591
Net cash from financing activities	14,433	6,723
Change in cash and cash equivalents	8,349	(4,863)
Effect of exchange rates on cash and cash equivalents	(265)	333
Cash and cash equivalents, beginning of year	7,274	11,804
Cash and cash equivalents, end of year	$ 15,358	$ 7,274

The notes are an integral part of these 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 consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") issued by the International Accounting Standards Board ("IASB") and Interpretations of the International Financial Reporting Interpretations Committee ("IFRIC"). This is the first year for which the Company has adopted IFRS. Previously, the Company prepared its annual 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 22.

(b) Reporting and functional currency

The consolidated financial statements are presented in United States dollars, the functional currency of the Company and its subsidiaries. All amounts, except as otherwise indicated, are presented in thousands of dollars.

Basis of measurement: The 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 year ended December 31, 2011, the Company incurred a net loss of $34.827 million and operating cash outflows of $12.139 million and, as at December 31, 2011, had a deficit of $316.838 million. The Company's ability to continue as a going concern in the short term is dependent upon its ability to raise additional capital from the sale of additional common shares or other debt or equity instruments and/or to secure an industry partner for its operations in Hungary and South Africa. There is no assurance that additional capital will be available to the Company on acceptable terms or at all, or that an industry partner will be secured.

The Company has worked on securing joint venture funding for its operations in the Makó Trough located in Hungary. As discussed in Note 8, 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. The transaction is subject to the execution of a definitive agreement with NIS.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, and those adjustments may be material.

(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 8 – valuation of intangible exploration assets, other intangible assets.

3. Significant Accounting Policies

The accounting policies set out below have been applied consistently to all years presented in these consolidated financial statements, and have been applied consistently by the Company and its subsidiaries.

(a) Basis of consolidation:

These consolidated financial statements include the accounts of the Company and the accounts of its subsidiaries. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

Non-controlling interest in the net assets of consolidated subsidiaries are identified separately from the Company's equity. Non-controlling interest consists of the non-controlling interest at the date of the change in ownership plus the non-controlling interest's share of changes in equity since that date.

All of the Company's subsidiaries are wholly owned except for Falcon Oil & Gas Australia Limited ("Falcon Australia") of which approximately 73% of the outstanding Common Shares are owned by Falcon. The consolidated financial statements include a non-controlling interest representing the 27% portion of Falcon Australia's assets and liabilities not owned by Falcon. The reporting dates of the Company and its subsidiaries are coterminous.

Intercompany balances and transactions, and any unrealized income and expenses arising from intercompany transactions, are eliminated in preparing the consolidated financial statements, except when losses realized on intercompany transactions are evidence of impairment.

(b) Foreign currency:

Transactions in foreign currencies are translated to United States dollars, the functional currency of all group entities, at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated to United States dollars at the period end exchange rate. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated to the functional currency at the exchange rate at the date that the fair value was determined. Foreign currency differences arising on translation are recognized in profit or loss.

(c) Financial instruments:

(i) Non-derivative financial instruments:

Non-derivative financial instruments comprise accounts receivable, cash and cash equivalents, restricted cash, convertible debentures, and accounts payable and accrued expenses. Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured as described below. Transaction costs for non-derivative financial instruments at fair value through profit or loss are recognized directly in profit or loss.

3. Significant accounting policies (continued)

(c) Financial instruments (continued):

(i) Non-derivative financial instruments (continued):

The Company classifies non-derivative financial assets into the following categories: financial assets at fair value through profit or loss, held-to-maturity loans and receivables and available for sale financial assets. Non-derivative liabilities are classified as financial liabilities at fair value through profit or loss or as other financial liabilities. As at December 31, 2011 and 2010 and as at January 1, 2010, the company did not have non-derivative financial instruments classified as available for sale financial assets or liabilities through profit or loss.

Cash and cash equivalents and restricted cash:

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

Financial assets at fair value through profit or loss:

An instrument is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Financial instruments are designated at fair value through profit or loss if the Company manages such investments and makes purchase and sale decisions based on their fair value in accordance with the Company's risk management or investment strategy. Financial instruments at fair value through profit or loss are measured at fair value, and changes therein are recognized in profit or loss. The Company has designated cash and cash equivalents and restricted cash as financial assets at fair value through profit or loss.

Loans and receivables:

Accounts receivable are initially recognized on the date they originate and are measured at amortized cost using the effective interest method, less any impairment losses.

Other liabilities

Accounts payable and accrued expenses and convertible debentures are classified as other liabilities and are measured at amortized cost using the effective interest rate method.

3. Significant accounting policies (continued)

(ii) Derivative financial instruments:

Warrants:

Warrants which do not meet the criteria to be classified as an equity instrument are classified at fair value through profit or loss and are recorded on the statement of financial position at fair value. Transaction costs are recognized in profit or loss as incurred.

Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and the combined instrument is not measured at fair value through profit or loss. Changes in the fair value of separable embedded derivatives are recognized immediately in profit or loss.

(iii) Convertible financial instruments:

Convertible debentures, of which the exercise of the conversion feature does not result in a fixed number of shares being issued for a fixed amount in the functional currency of the Company, are separated into a host contract, the note, and embedded derivatives in accordance with the accounting policies for derivative financial instruments.

(iv) Share capital:

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

(d) Property, plant and equipment and intangible exploration assets:

(i) Recognition and measurement:

Exploration and evaluation (“E&E”) expenditures:

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

Exploration and evaluation costs, including the costs of acquiring licenses and directly attributable general and administrative costs, initially are capitalized as either tangible or intangible exploration and evaluation assets according to the nature of the assets acquired, except for costs incurred in relation to projects for which exploration and evaluation activities have been temporarily suspended. The costs are accumulated in cost centers by well, field or exploration area pending determination of technical feasibility and commercial viability. No costs are charged to a cost center when operations in that cost center are suspended for more than 12 months.

Exploration and evaluation assets are assessed for impairment if (i) sufficient data exists to determine technical feasibility and commercial viability, or (ii) facts and circumstances suggest that the carrying amount exceeds the recoverable amount. For purposes of impairment testing, exploration and evaluation assets are allocated to cash-generating units.

3. Significant accounting policies (continued)

(d) Property, plant and equipment and intangible exploration assets (continued):

(i) Recognition and measurement (continued):

The technical feasibility and commercial viability of extracting a mineral resource is considered to be determinable when proven reserves are determined to exist. A review of each exploration license or field is carried out, at least annually, to ascertain whether proven reserves have been discovered. Upon determination of proven reserves, intangible exploration and evaluation assets attributable to those reserves are first tested for impairment and then reclassified from exploration and evaluation assets to a separate category within tangible assets referred to as oil and natural gas interests.

Proceeds from disposal or farm-out transactions of intangible exploration assets are used to reduce the carrying amount of the assets. When proceeds exceed the carrying amount, the difference is recognized as a gain. When the Company disposes of its' full interests, gains or losses are recognized in accordance with the policy for recognizing gains or losses on sale of plant, property and equipment.

Development and production costs:

Items of property, plant and equipment, which include oil and gas development and production assets, are measured at cost less accumulated depletion and depreciation and accumulated impairment losses. Development and production assets are grouped into CGU's for impairment testing. The cost of property, plant and equipment at January 1, 2010, the date of transition to IFRS, was determined by application of the deemed cost exemption for oil and gas companies of IFRS 1. When significant parts of an item of property, plant and equipment, including oil and natural gas interests, have different useful lives, they are accounted for as separate items (major components).

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

(ii) Subsequent costs:

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

3. Significant accounting policies (continued)

(d) Property, plant and equipment and intangible exploration assets (continued):

(iii) Depletion, depreciation and amortization:

The net carrying value of development or production assets is depleted using the unit of production method by reference to the ratio of production in the year to the related proven and probable reserves, taking into account estimated future development costs necessary to bring those reserves into production. Future development costs are estimated taking into account the level of development required to produce the reserves. These estimates are reviewed by independent reserve engineers at least annually.

Proven and probable reserves are estimated using independent reserve engineer reports and represent the estimated quantities of crude oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be recoverable in future years from known reservoirs and which are considered commercially producible. There should be a 50 percent statistical probability that the actual quantity of recoverable reserves will be more than the amount estimated as proven and probable and a 50 percent statistical probability that it will be less. The equivalent statistical probabilities for the proven component of proven and probable reserves are 90 percent and 10 percent, respectively.

Such reserves may be considered commercially producible if management has the intention of developing and producing them and such intention is based upon:

- a reasonable assessment of the future economics of such production;
- a reasonable expectation that there is a market for all or substantially all the expected oil and natural gas production; and
- evidence that the necessary production, transmission and transportation facilities are available or can be made available.

Reserves may only be considered proven and probable if the ability to produce is supported by either actual production or a conclusive formation test. The area of reservoir considered proven includes (a) that portion delineated by drilling and defined by gas-oil and/or oil-water contacts, if any, or both, and (b) the immediately adjoining portions not yet drilled, but which can be reasonably judged as economically productive on the basis of available geophysical, geological and engineering data. In the absence of information on fluid contacts, the lowest known structural occurrence of oil and natural gas controls the lower proved limit of the reservoir.

Reserves which can be produced economically through application of improved recovery techniques (such as fluid injection) are only included in the proven and probable classification when successful testing by a pilot project, the operation of an installed program in the reservoir, or other reasonable evidence (such as, experience of the same techniques on similar reservoirs or reservoir simulation studies) provides support for the engineering analysis on which the project or program was based.

For other assets, depreciation is recognized in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment of two to seven years.

3. Significant accounting policies (continued)

(d) Property, plant and equipment and intangible exploration assets (continued):

(iii) Depletion, depreciation and amortization (continued):

Depreciation methods, useful lives and residual values are reviewed at each reporting date.

(e) Leased assets:

Leases where the Company assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Minimum lease payments made under finance leases are apportioned between the finance expenses and the reduction of the outstanding liability. The finance expenses are allocated to each year during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Other leases are operating leases, which are not recognized on the Company's statement of financial position.

Payments made under operating leases are recognized in profit or loss on a straight-line basis over the term of the lease. Lease incentives received are recognized as an integral part of the total lease expense, over the term of the lease.

(f) Impairment:

(i) Financial assets:

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows discounted at the original effective interest rate.

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

All impairment losses are recognized in profit or loss. An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized cost the reversal is recognized in profit or loss.

3. Significant accounting policies (continued)

(ii) Non-financial assets:

The carrying amounts of the Company's non-financial assets, other than E&E assets and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. E&E assets are assessed for impairment when they are reclassified to property, plant and equipment, as oil and natural gas interests, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (the "cash-generating unit" or "CGU"). The recoverable amount of an asset or a CGU is the greater of its value in use and its fair value less costs to sell.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Value in use is generally computed by reference to the present value of the future cash flows expected to be derived from production of proven and probable reserves.

E&E assets are allocated to related CGU's when they are assessed for impairment, both at the time of any triggering facts and circumstances as well as upon their eventual reclassification to producing assets (oil and natural gas interests in property, plant and equipment).

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

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

(g) Share based compensation:

Share based compensation is measured at fair value at the grant date and expensed over the vesting period with a corresponding increase to contributed surplus. The amount recognized as expense is adjusted for an estimated forfeiture rate for options that will not vest, which is adjusted as actual forfeitures occur, until the shares are fully vested. Consideration paid upon the exercise of stock options, together with corresponding amounts previously recognized in contributed surplus, is recorded as an increase to share capital.

3. Significant accounting policies (continued)

(h) Provisions:

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

(i) Decommissioning provisions:

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

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

(ii) Legal matters:

A provision for legal matters is recognized when legal action is threatened or initiated, and management considers it probable that the legal actions will result in an obligation for the Company. The provision is determined based on the expected cash flows, including legal expenses, and considering the time value of money. When the legal matter relates to exploration and evaluation activities, the recognition of the provision and subsequent change in the expected cash flows is recorded in exploration and evaluation assets.

(i) Revenue:

Revenue from the sale of oil and natural gas is recorded when the significant risks and rewards of ownership of the product is transferred to the buyer which is usually when legal title passes to the external party. Revenue is measured net of discounts, customs duties and royalties. Royalty income is recognized as it accrues in accordance with the terms of the overriding royalty agreements.

(j) Finance income and expenses:

Finance expense comprises interest expense on borrowings, accretion of the discount on provisions, changes in fair value of derivatives and impairment losses recognized on financial assets.

Borrowing costs incurred for the construction of qualifying assets are capitalized during the period of time that is required to complete and prepare the assets for their intended use or sale. All other borrowing costs are recognized in profit or loss using the effective interest method. The capitalization rate used to determine the amount of borrowing costs to be capitalized is the weighted average interest rate applicable to the Company's outstanding borrowings during the period.

3. Significant accounting policies (continued)

(j) Finance income and expenses (continued):

Interest income is recognized as it accrues in profit or loss, using the effective interest method.

Foreign currency gains and losses, reported under finance income and expenses, are reported on a net basis.

(k) Income tax:

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

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

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

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

(l) Earnings per share:

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

(m) New standards and interpretations not yet adopted:

Several new standards and amendments to existing standards and interpretations, which have been issued by the IASB, and which are expected to apply to the company are not yet effective and have not been applied in preparing these financial statements. The Company does not expect adoption of these new standards and interpretations, to have a material impact on the financial statements.

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.

(i) Cash and cash equivalents, restricted cash, accounts receivable and accounts payable and accrued expenses

The fair value of cash and cash equivalents, restricted cash, accounts receivable and accounts payable and accrued expenses is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. As at December 31, 2011 and 2010, the fair value of accounts receivable and accounts payable and accrued expenses approximated their carrying value due to their short term to maturity.

(ii) Derivatives

The fair value of the conversion feature embedded in the convertible note is calculated 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).

(iii) Convertible debentures

The fair value of host contract of the convertible debentures is determined for disclosure purposes by calculating the present value of the expected future cash flow using the market rate of interest at the reporting date.

(iv) Share based compensation

The Company accounts for its share based compensation using the fair value method of accounting for stock options granted to directors and employees using the 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). A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest.

(thousands of US dollars)

5. Finance income and expenses

	Year Ended December 31, 2011	2010
Finance income:		
Interest income on bank deposits	$ 83	$ 45
Derivative gains – unrealized	4,946	692
	5,029	737
Finance expenses:		
Interest on loans and borrowings	(2,429)	(1,830)
Accretion of provisions	(267)	(248)
Net foreign exchange loss	(424)	(842)
	(3,120)	(2,920)
Net finance income (expenses)	$ 1,909	$ (2,183)

6. Supplemented cash flow information

Changes in non-cash working capital is comprised of:

	Year Ended December 31, 2011	2010
Source (use) of cash:		
Accounts receivable	$ (618)	$ 1,994
Prepaid expenses and other	52	384
Write-down of inventory held for sale	641	1,186
Inventory held for sale	409	1,331
Accounts payable and accrued expenses	(2,329)	(442)
	(1,845)	4,453
Other assets	–	843
	$ (1,845)	$ 5,296

(thousands of US dollars)

7. 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	–	–	158	158
Disposals	–	–	(91)	(91)
Balance as at December 31, 2011	$ 466	$ 3,831	$ 3,385	$ 7,682
Depletion, depreciation and amortization				
Balance as at January 1, 2010	$ (419)	$ –	$ (1,304)	$ (1,723)
Depletion and depreciation	(4)	–	(405)	(409)
Disposals	–	–	38	38
Balance as at December 31, 2010	(423)	–	(1,671)	(2,094)
Depletion and depreciation	(8)	–	(360)	(368)
Impairment	(35)	–	–	(35)
Disposals	–	–	39	39
Balance as at December 31, 2011	$ (466)	$ –	$ (1,992)	$ (2,458)
Net book value:				
As at January 1, 2010	$ 47	$ 3,888	$ 2,086	$ 6,021
As at December 31, 2010	$ 43	$ 3,831	$ 1,647	$ 5,521
As at December 31, 2011	$ –	$ 3,831	$ 1,393	$ 5,224

8. Exploration and evaluation assets

	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	2,259	15,572	–	17,831
Impairment	(26,000)	–	–	(26,000)
Proceeds from farm-out transaction, net of transaction costs	–	(19,609)	–	(19,609)
Balance as at December 31, 2011	$ 22,756	$ 48,221	$ –	$ 70,977

8. Exploration and evaluation assets (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 assets:

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 CGUs 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 assets.

For the year ended December 31, 2011, the Company identified indicators that there was a potential for impairment of a portion of its Hungarian assets, specifically the depths of the Makó production license below the Algyö formation. Those identified indicators include a lack of progress in exploration activities during the year in those deeper zones, limited availability of funds to perform further exploratory activities in the near future in the deeper zones and limitation of discussions about a potential farm-out for the deeper zone play (see below for discussion of Letter of Intent with NIS for the Algyö formation).
The Company determined that the carrying value of the Hungarian properties exceeded its estimated recoverable amount and recorded an impairment of $26,000 (2010 - $122,111). 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.

8. Exploration and evaluation assets (continued)

(b) Hungary (continued):

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.

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. Discussions on this agreement are ongoing.

(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.

In June 2011, the Company's majority owned subsidiary ("Falcon Australia") and Hess Australia (Beetaloo) Pty. Ltd. ("Hess") finalized an Evaluation and Participation Agreement (the "E&P Agreement"). Under the terms of the E&P Agreement, 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 "Hess Warrants"). 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.

8. Exploration and evaluation assets (continued)

(c) Australia (continued):

Initially, 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. As of December 31, 2011, Hess had completed approximately $10 million of the seismic program.

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.

In November 2011, Falcon Australia, in accordance with the work program for Permit EP 98, completed the testing and stimulation of the Shenandoah-1 well at its sole cost, and the well has been plugged and abandoned. Falcon Australia provided Hess with the data obtained from these activities, and Hess paid Falcon Australia $2.0 million.

(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.

9. Share capital

As at December 31, 2011 and 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 December 31, 2011, the fair value of the Warrants is $2,652 with the change in fair value since issue date of $3,889 included in net finance expenses (see Notes 5 and 12).

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 at that date. In 2011 the common shares were issued and the aggregate related value of $648 was reclassified from contributed surplus to share capital.

(thousands of US dollars)

9. Share capital (continued)

In October 2011, the Company granted 676,800 common shares to non–executive employees and consultants as a bonus consideration for services. These shares were valued at $107 based on $0.16 (CDN$0.15) per share. In October 2011, the Company issued 660,900 common shares in a private placement to certain officers and a director for $97, at a price of $0.16 (CDN$0.15) per share.

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
Shares issued to employees and consultants	676,800	107
Issuance of shares in a private placement to officers and a director	660,900	97
Balance as at December 31, 2011	695,654,500	$ 339,006

10. Net loss per share

Net loss per share – basic and diluted was calculated as follows:

	Year Ended December 31, 2011	2010
Net loss for the year	$ (34,561)	$ (150,247)
Weighted average number of common shares – basic and diluted		
Issued common shares as at beginning of period	602,216,801	602,216,801
Shares issued in a private placement	63,916,164	–
Shares issued to two former officers	3,208,219	–
Share options exercised	46,712	–
Shares issued to employees and consultants	146,485	–
Shares issued in a private placement to officers and a director	143,044	–
Weighted average number of common shares – basic and diluted	669,677,425	602,216,801

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.

11. 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.

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 12).

As at December 31, 2011, the face value of the convertible debentures, due on maturity at June 30, 2013, is $10,512 (CDN$10,719).

As at December 31, 2011, convertible debentures are recorded at $5,960 (2010-$4,519).

12. 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 December 31, 2011 and 2010, and the changes therein for the years then ended, are as follows:

(thousands of US dollars)

12. Derivative liabilities (continued)

Fair value of:	Agent Warrants (Note 11)	Convertible Debt Conversion Feature (Note 11)	Private Placement Warrants (Note 9)	Hess Warrants (Note 8)	Total
Balance as at January 1, 2010	$ 46	$ 1,421	$ –	$ –	$ 1,467
Derivative gains - unrealized	(46)	(646)	–	–	(692)
Balance as at December 31, 2010	–	775	–	–	775
Fair value of derivatives	–	–	6,541	945	7,486
Derivative gains - unrealized	–	(734)	(3,889)	(324)	(4,947)
Balance as at December 31, 2011	$ –	$ 41	$ 2,652	$ 621	$ 3,314

13. Share based compensation

The Company, in accordance with the policies of the TSX Venture Exchange (“TSXV”), 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 TSXV 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 at December 31, 2011 and 2010, and changes during the years 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 year	21,764,500	$ 1.81	41,975,000	$ 1.90
Granted	17,810,000	0.15	5,725,000	0.16
Expired	(8,623,333)	1.28	(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 year	29,764,500	$ 0.41	21,764,500	$ 1.81
Exercisable as at end of year	15,021,000	$ 0.57	14,402,633	$ 2.35

(thousands of US dollars)

13. Share based compensation (continued)

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

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	4.42
0.15	16,910,000		0.15	4.39
0.15	1,000,000		0.15	3.98
0.16	3,619,500		0.16	3.66
0.54	600,000		0.54	0.62
0.98	1,000,000		0.98	1.35
1.19	6,485,000		1.19	1.43
	29,764,500	$	0.41	3.47

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 $2,435 (2010 - $3,516) was recorded during the year ended December 31, 2011. There was no share based compensation expense capitalized during 2011 and 2010.

(thousands of US dollars)

14. Provisions

(a) Decommissioning provision:

A reconciliation of the decommissioning provision for the years ended December 31, 2011 and 2010 is provided below:

		2011		2010
Balance as at beginning of year	$	6,310	$	5,673
Assumed on an acquisition of assets		–		363
Provisions incurred		–		–
Revision to provisions		2,236		–
Accretion		267		274
Balance as at end of year	$	8,813	$	6,310
Current	$	150	$	–
Long-term		8,663		6,310
Balance as at end of year	$	8,813	$	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 $8,813 as at December 31, 2011 (2010 – $6,310) based on an undiscounted total future liability of $13,124 (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 2.57% as at December 31, 2011 (2010 – 4.13%).

(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.

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 resulting in a reduction of the provision of $1,533. All obligations due to the vendor have been paid as at December 31, 2011.

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.

(thousands of US dollars)

14. Provisions (continued)

A reconciliation of the litigation provision for the years ended December 31, 2011 and 2010 is provided below:

	2011	2010
Balance as at beginning of year	$ 3,700	$ –
(Reversal of) litigation expense	(1,533)	3,700
Paid	(2,167)	–
Balance as at end of year	$ –	$ 3,700

15. Income taxes

The provision for income taxes in the consolidated financial statements differs from the results that would have been obtained by applying the combined federal and provincial tax rates to the Company's loss before income taxes. The difference results from the following:

	Year Ended December 31, 2011	Year Ended December 31, 2010
Loss before income taxes, including non-controlling interests	$ (34,561)	$ (150,247)
Combined federal and provincial tax rate	26.5%	28.5%
Computed income tax benefit	(9,159)	(42,820)
Increase (decrease) in income taxes resulting from:		
Effect of foreign income tax rates	4,437	25,171
Change in income tax rates	887	8,962
Effect of change in foreign exchange rates	688	(5,954)
Unrecognized benefit of loss carryforwards	(1,348)	(685)
Non-deductible stock based compensation	645	955
Derivatives	(937)	(186)
Other	(119)	(113)
Change in deferred tax benefits not recognized	4,906	14,670
Income tax expense	$ –	$ –

(thousands of US dollars)

15. Income taxes (continued)

Income tax rates changed from 28.5% in 2010 to 26.5% in 2011 due to a reduction in both federal and provincial statutory income tax rates. The deductible temporary differences included in the Company's unrecognized deferred income tax assets are as follows:

	Year Ended December 31, 2011	2010
Non-capital losses	$ 142,458	$ 127,626
Exploration and evaluation assets and property, plant and equipment	163,419	127,806
Other	8,387	9,255
	$ 314,264	$ 264,687

The Company has accumulated loss carryforwards as at December 31, 2011 to reduce future years' taxable income as follows:

	2011	Expiration
Canada	25,764	2015 to 2031
United States	15,557	2027 to 2031
Hungary	34,598	No expiration
Australia	66,539	No expiration
	$ 142,458	

The other deductible temporary differences do not expire under current tax legislation. Deferred tax assets have not been recognized in respect of the tax losses, exploration and evaluation assets and other as it is not probable that future tax profit will be available against which the Company can utilize the benefits.

(thousands of US dollars)

16. Segment Information

All of the Company's operations are in the petroleum and natural gas industry with its principal business activity being in the acquisition, exploration and development of petroleum and natural gas properties. The Company has producing petroleum and natural gas properties located in Canada and considers the results from its operations to relate to the petroleum and natural gas properties. The Company has unproven petroleum and natural gas properties in Hungary and Australia. An analysis of the Company's geographic areas is as follows:

	Canada	United States	Hungary	Australia	South Africa	Total
Year ended December 31, 2011:						
Revenue	$ 31	$ –	$ 2	$ –	$ –	$ 33
Net income (loss)	(2,577)	(2,279)	(28,717)	(708)	(280)	(34,561)
Balance as at December 31, 2011:						
Capital assets	–	166	27,814	48,221	–	76,201

	Canada	United States	Hungary	Australia	South Africa	Total
Year ended December 31, 2010:						
Revenue	$ 24	$ –	$ 4	$ –	$ –	$ 28
Net income (loss)	(7,647)	(2,640)	(136,949)	(2,598)	(413)	(150,247)
Balance as at December 31, 2010:						
Capital assets	44	286	51,688	52,258	–	104,276

(thousands of US dollars)

17. Related party transactions

Remuneration of Directors and Senior Management

	For the year ended December 31, 2011	2010
Directors' fees	$ 158	$ 198
Short-term wages and benefits	1,286	890
Share based compensation	1,222	872
Termination benefits	–	720
	$ 2,666	$ 2,680

Remuneration of Directors and Senior Management includes all amounts earned and awarded to the Company's Board of Directors and Senior Management. Senior Management includes the Company's Chief Executive Officer and President, Chief Operating Officer and Chief Financial Officer.

Directors' fees include Board and Committee Chair retainers and meeting fees. Short-term wages and benefits include salary, benefits and bonuses earned or awarded during the year. Share-based compensation includes expenses related to the Company's long-term incentive compensation plans as disclosed in Note 13 and shares granted as disclosed in Note 9.

(thousands of US dollars)

18. Commitments and contingencies

(a) Environmental:

Petroleum and natural gas producing activities are subject to extensive environmental laws and regulations. These laws, which are changing, regulate the discharge of materials into the environment and may require the Company to remove or mitigate the environmental effects of the disposal or release of petroleum or chemical substances at various sites. Environmental expenditures are expensed or capitalized depending on the future economic benefit of the cause of the expenditure. Expenditures that relate to an existing condition caused by past operations and that have no future economic benefit are expensed. Liabilities for expenditures of a non-capital nature are recorded when environmental assessment and/or remediation is probable, and the costs can be reasonably estimated.

(b) Lease commitments:

The Company has entered into lease agreements for office space in Denver, Colorado, for the period from January 2012 through April 2017, and in Budapest, Hungary, for the period from November 2010 through October 2013. The Company is obligated to pay the following minimum future rental commitments under non-cancelable operating leases with a remaining term of at least one year:

Year ending December 31,		
2012	$	247
2013		291
2014		195
2015		202
2016		210
Thereafter		71
	$	1,216

(c) Australia Work Program:

Under a revised work program approved by the Northern Territory of Australia Government, Department of Resources, on July 6, 2011, the Company is obligated to complete minimum work requirements by expending the following amounts in order to continue to hold the underlying permits in the Beetaloo Basin Project.

Year ending December 31,		
2012	$	18,152
Less: Acquisition of seismic by Hess under the E&P Agreement		(16,626)
	$	1,526

(thousands of US dollars)

19. Financial Instruments and Risk Management

(a) Fair Value

The following tables provide fair value measurement information for financial assets and liabilities as at December 31, 2011 and 2010. The carrying value of cash and cash equivalents, restricted cash, accounts receivable, and accounts payable and accrued expenses included in the consolidated statement of financial position approximate fair value due to the short term nature of those instruments. These assets and liabilities are not included in the following tables.

	December 31, 2011		December 31, 2010	
	Carrying value	Fair value	Carrying value	Fair value
Financial assets:				
Held for trading:				
Cash and cash equivalents, including restricted cash	$ 15,409	$ 15,409	$ 7,325	$ 7,325
Loans and receivables:				
Accounts receivable	$ 1,602	$ 1,602	$ 1,025	$ 1,025
Financial liabilities:				
Other financial liabilities:				
Accounts payable and accrued expenses	$ 3,836	$ 3,836	$ 1,871	$ 1,871
Convertible debentures	$ 5,960	$ 9,670	$ 4,519	$ 9,227

The table below analyses financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

Level 1 Fair Value Measurements

Level 1 fair value measurements are based on unadjusted quoted market prices.

Level 2 Fair Value Measurements

Level 2 fair value measurements are based on valuation models and techniques where the significant inputs are derived from quoted indices.

Loans and borrowing – The fair value of the loans and borrowings is determined based on current risk free rates adjusted for estimated credit risk, industry risk and market risk premiums.

Level 3 Fair Value Measurements

Level 3 fair value measurements are based on unobservable information. No financial assets or liabilities have been valued using the Level 3 fair value measurements.

(thousands of US dollars)

19. Financial Instruments and Risk Management (continued)

December 31, 2011	Carrying amount	Fair value
Financial liabilities:		
Conversion feature – convertible debt	41	41
Private placement warrants	2,652	2,652
Hess warrants	621	621
December 31, 2010		
Financial liabilities:		
Conversion feature – convertible debt	775	775

All instruments in the table are Level 2 instruments.

(b) Financial risk disclosures

The Company thoroughly examines the various financial instrument risks to which it is exposed and assesses the impact and likelihood of those risks. These risks may include credit risk, liquidity risk, market risk and other price risks. Where material, these risks are reviewed and monitored by the Board of Directors.

Credit Risk

The Company's credit risk is limited to cash and receivables. The Company maintains cash accounts at three financial institutions. The Company periodically evaluates the credit worthiness of financial institutions, and maintains cash accounts only in large high quality financial institutions, thereby minimizing exposure for deposits in excess of federally insured amounts. On occasion, the Company may have cash in banks in excess of federally insured amounts. The Company believes that credit risk associated with cash is minimal. Receivables are not significant to the Company. The Company's credit risk has not changed significantly from the prior year.

Liquidity Risk

The Company has in place a planning and budgeting process to help determine the funds required to support the Company's normal operating requirements on an ongoing basis and its planned capital expenditures. The Company's overall liquidity risk has not changed from the prior year. Also see Note 1.

The following are the contractual maturities of financial liabilities, including estimated interest payments:

(thousands of US dollars)

19. Financial Instruments and Risk Management (continued)

December 31, 2011	Carrying amount	Contractual cash flows	One year or less	One to three years
Non-derivative financial liabilities:				
Accounts payable and accrued expenses	$ 3,836	$ 3,836	$ 3,836	$ –
Convertible debentures	5,960	12,245	1,160	11,085
	$ 9,796	$ 16,081	$ 4,936	$ 11,085
Derivative financial liabilities:				
Convertible debt conversion feature	$ 41	$ –	$ –	$ –
Private placement warrants	2,652	–	–	–
Hess warrants	621	–	–	–
	$ 3,314	$ –	$ –	$ –

December 31, 2010	Carrying amount	Contractual cash flows	One year or less	One to three years
Non-derivative financial liabilities:				
Accounts payable and accrued expenses	$ 1,871	$ 1,871	$ 1,871	$ –
Convertible debentures	4,519	16,382	1,181	15,201
	$ 6,390	$ 18,253	$ 3,052	$ 15,201
Derivative financial liabilities:				
Convertible debt conversion feature	$ 775	$ –	$ –	$ –
	$ 775	$ –	$ –	$ –

Currency Risk

Financial instruments that impact the Company's net income (loss) and comprehensive income (loss) due to currency fluctuations include Canadian dollar, Hungarian forint, Euro and Australian dollar denominated cash and cash equivalents, accounts receivable, reclamation deposits, accounts payable, and capital commitments for Hungarian and Australian operations.

19. Financial Instruments and Risk Management (continued)

The Company has a CDN$6,077 convertible debenture, which exposes Falcon to fluctuations in exchange rates between Canadian and U.S. dollars. Such an exposure does also arise as a result of revenue being realized in and expense items, including certain general and administrative and production costs and interest expense on the convertible debt, being incurred in Canadian dollars. A one cent strengthening/weakening of the Canadian dollar against the U.S. dollar would decrease/increase total shareholders' equity and income/loss by less than $100.

The Company's exposure to other currencies, including the Hungarian forint, Euro and Australian dollar, does not result in a significant change to total shareholders' equity and income when the respective currencies strengthen or weaken by one cent against the U.S. dollar.

Interest Rate Risk

The Company has no significant exposure to interest rate risk as its debentures have a fixed rate of interest.

20. Management of Capital

The Company's objectives when managing capital are to safeguard its ability to continue as a going concern in order to explore and develop its petroleum and natural gas properties. The Company manages the components of shareholders' equity and its cash as capital, and makes adjustments to these components in response to the Company's business objectives and the economic climate. To maintain or adjust its capital structure, the Company may issue new common shares or debt instruments, or borrow money or acquire or convey interests in other assets. The Company does not anticipate the payment of dividends in the foreseeable future.

The Company's investment policy is to hold excess cash in highly-liquid, short-term instruments, such as bankers' acceptances and guaranteed investment certificates issued by major Canadian chartered banks or United States financial institutions, with initial maturity terms of less than three months from the original date of acquisition, selected with regard to the Company's anticipated liquidity requirements.

The Company does not expect its current capital resources will be sufficient to meet future acquisition, exploration, development and production plans, operating requirements and convertible debenture obligations, and is dependent upon future debt and equity, or joint venture arrangements, to meet the obligations. See Note 2(c).

(thousands of US dollars)

21. Supplemental Disclosure

The Company's consolidated statements of operations and comprehensive loss are prepared primarily by nature of expense, with the exception of compensation costs which are included in both exploration and evaluation expenses and general and administrative expenses, and share based compensation which is reflected as a separate financial statement component. The following is a summary of total compensation:

	For the year ended December 31, 2011	2010
Exploration and evaluation expenses	$ 20	$ –
General and administrative expenses	2,535	2,351
Share based compensation	2,435	3,516
	$ 5,590	$ 5,867

(thousands of US dollars)

22. Explanation of transition from Canadian GAAP to IFRS

Consolidated statement of financial position as at January 1, 2010:

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Assets				
Current assets:				
Cash and cash equivalents		$ 11,804	$ –	$ 11,804
Restricted cash		1,184	–	1,184
Accounts receivable		2,955	–	2,955
Prepaid expenses and other		720	–	720
Inventory held for sale		4,196	–	4,196
Total current assets		20,859	–	20,859
Non-current assets:				
Exploration and evaluation assets	(a)	207,889	(97)	207,792
Property, plant and equipment	(a)	5,974	47	6,021
Other assets		8,277	–	8,277
Total non-current assets		222,140	(50)	222,090
Total assets		$ 242,999	$ (50)	$ 242,949
Liabilities				
Current liabilities:				
Accounts payable and accrued expenses		$ 2,683	$ –	$ 2,683
Non-current liabilities:				
Convertible debentures	(c)	4,031	(765)	3,266
Derivative liabilities	(c) (d)	–	1,468	1,468
Decommissioning provision	(e)	6,106	(433)	5,673
Total non-current liabilities		10,137	270	10,407
Total liabilities		12,820	270	13,090
Equity:				
Share capital		331,215	–	331,215
Contributed surplus	(d) (f)	31,829	2,528	34,357
Equity component of convertible debentures	(c)	5,057	(5,057)	–
Deficit		(137,922)	2,209	(135,713)
Total equity		230,179	(320)	229,859
Total liabilities and equity		$ 242,999	$ (50)	$ 242,949

(thousands of US dollars)

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

Consolidated statement of financial position as at December 31, 2010:

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Assets				
Current assets:				
Cash and cash equivalents		$ 7,274	$ –	$ 7,274
Restricted cash		51	–	51
Accounts receivable		1,025	–	1,025
Prepaid expenses and other		391	–	391
Inventory held for sale		1,678	–	1,678
Total current assets		10,419	–	10,419
Non-current assets:				
Exploration and evaluation assets	(a)	99,262	(507)	98,755
Property, plant and equipment		5,477	44	5,521
Other assets		714	–	714
Total non-current assets		105,453	(463)	104,990
Total assets		$ 115,872	$ (463)	$ 115,409
Liabilities				
Current liabilities:				
Accounts payable and accrued expenses	(a)	$ 5,571	$ (3,700)	$ 1,871
Provision for legal matters	(a)	–	3,700	3,700
Total current liabilities		5,571	–	5,571
Non-current liabilities:				
Convertible debentures		4,519	–	4,519
Derivative liabilities	(c) (d)	–	775	775
Decommissioning provision	(e)	6,893	(583)	6,310
Total non-current liabilities		11,412	192	11,604
Total liabilities		16,983	192	17,175
Equity:				
Share capital		331,215	–	331,215
Contributed surplus	(d) (f)	36,150	1,724	37,874
Equity component of convertible debentures	(b)	5,057	(5,057)	–
Deficit		(284,955)	2,678	(282,277)
Equity attributable to common shareholders		87,467	(655)	86,812
Non-controlling interest		11,422	–	11,422
Total equity		98,889	(655)	98,234
Total liabilities and equity		$ 115,872	$ (463)	$ 115,409

(thousands of US dollars)

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

Consolidated statement of operations and comprehensive loss for the year ended December 31, 2010

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Revenue:				
Oil and natural gas revenue		$ 28	$ –	$ 28
Other income (expense)		(386)	–	(386)
		(358)	–	(358)
Expenses:				
Exploration and evaluation expenses	(a) (b)	–	1,602	1,602
Production and operating expenses		26	–	26
Depletion, depreciation and amortization	(e)	832	(398)	434
Impairment of exploration and evaluation assets	(a) (b)	127,000	(4,889)	122,111
General and administrative expenses		11,323	–	11,323
Share based compensation	(f)	4,321	(805)	3,516
Write-down of inventory available for sale		1,186	–	1,186
Write off of receivable		4,345	–	4,345
Litigation expense	(a)	–	3,700	3,700
		149,033	(790)	148,243
Results from operating activities		(149,391)	790	(148,601)
Finance income	(c) (d)	45	692	737
Finance expenses	(e)	(1,907)	(1,013)	(2,920)
Net finance expenses		(1,862)	(321)	(2,183)
Net loss and comprehensive loss for the period		$ (151,253)	$ 469	$ (150,784)
Net loss and comprehensive loss attributable to:				
Common shareholders		(150,716)	469	(150,247)
Non-controlling interest		(537)	–	(537)
Net loss and comprehensive loss for the period		$ (151,253)	$ 469	$ (150,784)

22. 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 was allocated to the Canadian producing assets.

During 2010, certain costs capitalized as petroleum and natural gas properties under Canadian GAAP, including pre-license costs, have been charged to exploration and evaluation expenses in the consolidated statement of operations and comprehensive loss under IFRS. As at January 1, 2010 and December 31, 2010, this resulted in decreases of $50 and $463, respectively, to exploration and evaluation assets, and as at January 1, 2010, a $50 increase to deficit in the consolidated statement of financial position. For the year ended December 31, 2010, this resulted in an increase to exploration and evaluation expenses of $413.

As at December 31, 2010, the Company reflected $3,700 of litigation expense incurred as an addition to the full cost pool with a corresponding credit reflected in accounts payable and accrued expenses. The treatment of the $3,700 has been revised under IFRS and is reflected in the consolidated statement of operations and comprehensive loss for the year ended December 31, 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 amount is reflected as a provision for legal matters in the consolidated statement of financial position at December 31, 2010.

As at January 1, 2010 and December 31, 2010, all but $47 and $44, respectively, of the Company's petroleum and natural gas properties were exploration and evaluation assets. These items have been reclassified to property, plant and equipment.

(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. This has resulted in a reduction of $1,189 to capitalized costs as at December 31, 2010. The reduction to capitalized costs has resulted in a corresponding reduction to impairment of exploration and evaluation assets for the year ended December 31, 2010.

Additionally, IFRS does not allow capitalization of expenditures incurred before an exploration license is obtained. As a result, expenditures capitalized as part of the full cost pool under Canadian GAAP of $50 and $413 as at January 1, 2010 and December 31, 2010, respectively, were expensed under IFRS.

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

(c) Convertible debentures:

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 convertible 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. This has resulted in a reduction to equity of $3,636, an increase to liabilities as at January 1, 2010 and December 31, 2010 of $1,421 and $775, respectively, and an increase to finance income for the year ended December 31, 2010 of $646.

(d) Agent warrants:

Agent warrants are classified as a derivative instrument under IFRS, 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 has resulted in a reduction to contributed surplus of $263 and a reduction to deficit of $217 as at January 1, 2010, an increase to liabilities as at January 1, 2010 of $46, no change to liabilities as at December 31, 2010, and an increase to finance income for the year ended December 31, 2010 of $46.

(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 results in a $433 decrease in the decommissioning provision with a corresponding decrease in deficit.

As a result of the change in the decommissioning provision, accretion expense decreased by $150 during the year ended December 31, 2010 under IFRS as compared to Canadian GAAP. In addition, under Canadian GAAP accretion of the discount of $398 for the year ended December 31, 2010 was included in depletion, depreciation and amortization. Under IFRS, it is included in finance expense.

(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 has 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 $805 for the year ended December 31, 2010.

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

Material adjustments to the statements of cash flows

For the year ended December 31, 2010, pre-license costs of $413, and costs associated with assets whose activities have been temporarily suspended of $1,189 were previously capitalized and reflected as investing activities in the statement of cash flows. Under IFRS, these aggregate costs of $1,602 are expensed and reflected as operating activities in the statement of cash flows.

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