



FINANCIAL STATEMENTS

December 31, 2010

Management's Report

Management has prepared the accompanying financial statements of Sure Energy Inc. in accordance with Canadian Generally Accepted Accounting Principles. Financial and operating information presented throughout the annual report and annual information form is consistent with that shown in the financial statements.

Management is responsible for the integrity and objectivity of the financial information. Where necessary, the financial statements include estimates that are based on management's informed judgments. Internal control systems are designed and maintained to provide reasonable assurance that assets are safeguarded, transactions are properly authorized and reliable accounting records are produced for financial reporting purposes.

Deloitte & Touche LLP were appointed by the Company's shareholders to express an opinion on the financial statements. Their examination included such tests and procedures as they considered necessary to provide reasonable assurance that the consolidated financial statements are presented fairly in accordance with Canadian Generally Accepted Accounting Principles.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls. It exercises its responsibilities primarily through the Audit Committee, which is composed of non-management directors. The Committee meets quarterly with management and the independent auditors to ensure that management's responsibilities are properly discharged, to review the consolidated financial statements and to recommend that the financial statements be presented to the Board of Directors for approval.

The Audit Committee has reviewed the financial statements and recommended their acceptance to the Board of Directors. The Board has approved the financial statements for issuance to the shareholders.

"signed"

Jeffrey S. Boyce
President and Chief Executive Officer
March 8, 2011

"signed"

Lance Wirth
Vice President and Chief Financial Officer
March 8, 2011

Auditor's Report

To the Shareholders of
Sure Energy Inc.:

We have audited the accompanying financial statements of Sure Energy Ltd., which comprise the balance sheets as at December 31, 2010, and 2009, and the statements of operations, and comprehensive loss and deficit, and cash flows for the years then ended, and a summary of significant accounting policies.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit 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 financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Sure Energy Ltd. as at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Calgary, Alberta
March 8, 2011

signed "Deloitte & Touche LLP"
Chartered Accountants

**SURE ENERGY INC.
BALANCE SHEETS**

As at December 31 <i>(\$000's)</i>	2010	2009
Assets		
Current assets		
Accounts receivable	\$ 3,110	\$ 1,829
Prepaid expenses	853	457
	<hr/> 3,963	<hr/> 2,286
Deferred financing costs (note 5)	2,179	-
Property, plant and equipment (note 3)	45,375	35,622
	<hr/> 51,517	<hr/> 37,908
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable and accrued liabilities	8,223	3,777
Bank debt (note 4)	440	3,046
	<hr/> 8,663	<hr/> 6,823
Note facility (note 5)	10,000	-
Asset retirement obligations (note 6)	1,276	1,031
	<hr/> 19,939	<hr/> 7,854
Commitments (note 12)		
Shareholders' equity		
Share capital (note 7)	37,055	35,732
Warrants (note 5)	2,065	-
Contributed surplus (note 7)	3,891	3,152
Deficit	(11,433)	(8,830)
	<hr/> 31,578	<hr/> 30,054
	<hr/> \$ 51,517	<hr/> \$ 37,908

See accompanying notes.

Approved by the Board of Directors

"Signed"
W. Peter Comber
Director

"Signed"
Jeffrey S. Boyce
Director

SURE ENERGY INC.
STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS AND DEFICIT

(\$000's, except per share amounts)	Year Ended December 31, 2010	Year Ended December 31, 2009
Revenue		
Petroleum and natural gas revenues	\$ 13,063	\$ 6,765
Royalties	(1,108)	(940)
Interest income	-	15
	<u>11,955</u>	<u>5,840</u>
Expenses		
Operating	3,432	2,363
Transportation	645	348
General and administration	1,328	1,330
Interest and financing	281	33
Stock compensation (note 7)	710	513
Depletion, depreciation and accretion	8,162	5,763
	<u>14,558</u>	<u>10,350</u>
Loss before future income tax recovery	(2,603)	(4,510)
Future income tax recovery	-	750
	<u>(2,603)</u>	<u>(3,760)</u>
Loss and comprehensive loss	(2,603)	(3,760)
Deficit, beginning of year	(8,830)	(5,070)
Deficit, end of year	<u>(11,433)</u>	<u>(8,830)</u>
Loss per common share (note 8)		
Basic and diluted	\$ (0.06)	\$ (0.09)

See accompanying notes.

SURE ENERGY INC.
STATEMENTS OF CASH FLOWS

<i>(\$000's)</i>	Year Ended December 31, 2010	Year Ended December 31, 2009
Cash provided by (used in):		
Operating		
Loss	\$ (2,603)	\$ (3,760)
Items not affecting cash:		
Depletion, depreciation and accretion	8,162	5,763
Non-cash interest expense	30	-
Stock compensation	710	513
Future income tax recovery	-	(750)
Abandonment expenditures	-	(132)
Changes in non-cash working capital (note 10)	594	24
	<u>6,893</u>	<u>1,658</u>
Investing		
Drilling and development of petroleum and natural gas properties	(17,506)	(4,245)
Corporate acquisitions, net of cash acquired (note 2)	-	(4,513)
Disposition (acquisition) of petroleum and natural gas properties	(155)	149
Other asset acquisitions	(9)	-
Changes in non-cash working capital (note 10)	2,174	(2,138)
	<u>(15,496)</u>	<u>(10,747)</u>
Financing		
Increase (decrease) in bank debt	(2,606)	3,046
Increase in note facility	10,000	-
Issue of common shares for cash, net of share issue costs	1,353	-
Deferred financing costs	(144)	-
	<u>8,603</u>	<u>3,046</u>
Net change in cash and cash equivalents	-	(6,043)
Cash and cash equivalents, beginning of year	-	6,043
Cash and cash equivalents, end of year	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes.

Supplementary cash flow information (note 10)

SURE ENERGY INC.
Notes to the Financial Statements
For the years ended December 31, 2010 and 2009

Unless otherwise stated, amounts presented in these notes are in Canadian dollars and tabular amounts are in thousands of Canadian dollars, except number of shares and per share amounts.

1. Summary of Significant Accounting Policies

Business and Basis of Presentation

Sure Energy Inc. ("Sure Energy" or the "Company") is a Calgary based oil and natural gas exploration and production company whose business activities are focused primarily in Alberta. Sure Energy is a public company and trades on the Toronto Stock Exchange.

Use of Estimates

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to use estimates and assumptions that affect the reported amounts in the financial statements such as stock-based compensation and value of warrants, the estimated future cash flows to assess the impairment of property, plant and equipment, the amounts recorded for depletion and depreciation, future estimated development costs and the provision for asset retirement obligations as at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods presented. Actual results may differ from these estimates and assumptions.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on deposit, less outstanding cheques, and deposits with a maturity at the time of investment of less than three months.

Deferred Financing Costs

Deferred financing costs include Note Facility transaction costs and are amortized over the life of the Note Facility (see Note 5).

Property, Plant and Equipment ("PP&E")

(i) Petroleum and Natural Gas Properties

The Company follows the full-cost method of accounting for petroleum and natural gas operations, whereby all costs related to the exploration and development of petroleum and natural gas reserves are capitalized. Such costs include land acquisition costs, costs of drilling both productive and non-productive wells, well equipment, flowline and plant costs, geological and geophysical costs and administrative costs directly related to exploration and development activities.

Gains or losses on disposition of properties are recognized only when crediting the proceeds to the recorded costs would result in a change in the depletion and depreciation rate of 20% or more.

Capitalized costs are depleted using the unit-of-production method based on estimated proven reserves of petroleum and natural gas before royalties as determined by independent petroleum engineers. Included in costs subject to depletion and depreciation are all costs to develop proved reserves. Costs relating to unproved properties are excluded from costs subject to depletion and depreciation until it is determined whether or not proved reserves exist or impairment occurs. Properties excluded from the depletion calculation are assessed at least on an annual basis to see if impairment has occurred. Proved natural gas reserves and production are converted to equivalent volumes of crude petroleum based on six thousand cubic feet of natural gas to one barrel of crude oil.

The net book value of the Company's petroleum and natural gas properties and equipment is subject to an impairment test (the "ceiling test"). Impairment is recognized if the carrying amount of the PP&E exceeds the sum of the undiscounted cash flows expected to result from the Company's proved reserves. If the carrying value is impaired, the amount of impairment is measured by comparing the carrying amounts of the PP&E to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves. This calculation incorporates risks and uncertainties in the expected future cash flows which are discounted using a risk-free rate. Any carrying value above the net present value of the future cash flows would be recorded as a permanent impairment and charged to earnings as additional depletion and depreciation. The Company excludes its unproved properties, net of impairment, from its ceiling test as they are subject to a separate assessment for impairment. By their nature,

these estimates are subject to measurement uncertainty and the effect on the financial statements from changes in such estimates in future years could be significant.

(ii) Asset Retirement Obligations

The Company recognizes the fair value of the future liability associated with removal, site restoration and reclamation of long lived assets when the assets are put into use. The carrying value of the assets is increased and a corresponding asset retirement obligation is recorded at the fair value of the future liability. The future liability is discounted using the Company's credit adjusted risk free interest rate. The asset recorded is depleted on a unit of production basis over the life of the underlying assets. The liability accretes with the passage of time until the obligation is settled. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost could also result in an increase or decrease to the obligation. Actual costs incurred upon settlement of the retirement obligation are charged against the obligation to the extent of the liability recorded.

(iii) Joint Interest Operations

Significant portions of the Company's activities are conducted jointly with third parties and, accordingly, these financial statements only reflect the Company's proportionate interest in these activities.

(iv) Office Furniture, Equipment and Leaseholds

Office furniture and equipment is depreciated on a declining-balance method at annual rates of 20% to 50%. Leasehold improvements are depreciated over the remaining lease term.

Income Taxes

The Company follows the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are measured based upon the temporary differences between the carrying values of assets and liabilities and their related income tax bases. Future income tax expense is computed based on the change during the year in the future income tax assets and liabilities. Future income tax assets are recognized to the extent it is more likely than not that sufficient future taxable income will be available to allow the future income tax assets to be realized. Effects of changes in tax laws and tax rates are recognized in the period when substantively enacted.

Stock-Based Compensation Plan

The Company has a stock-based compensation plan that is described in note 7. The Company accounts for stock options and Performance Incentive Rights issued to employees, directors, and consultants using the fair value method. Performance Incentive Rights issued to consultants are accounted for using the fair value method and are re-valued to their current value at each reporting date. The compensation expense related to the stock options granted is recognized over the vesting period of the awards. The compensation expense related to the Performance Incentive Rights is recognized over the implied life of the awards due to the contingent nature of their vesting. When the Performance Incentive Rights vest, additional compensation expense is recognized to the extent of the fair value of the vested portion of the Performance Incentive Rights. The fair value of the stock options and Performance Incentive Rights was determined at the respective grant dates using the Black-Scholes model.

Revenue Recognition

Revenues from the sale of crude oil, natural gas and natural gas liquids are recorded when title transfers to an external party. Transportation costs are presented separately as an expense and not netted against revenues.

Financial Instruments and Risk Management Activities

The nature of the Company's operations result in exposure to fluctuations in commodity prices, exchange rates and interest rates. The Company monitors and, when appropriate, may use derivative financial instruments to manage its exposure to these risks. The Company does not use derivative financial instruments for trading purposes. The Company extends unsecured credit to its customers and is exposed to credit-related losses in the event of non-performance by customers with respect to the collection of accounts receivable.

Financial Instruments

All financial instruments, including derivatives, are recognized on the balance sheet. Derivatives are measured at fair value with unrealized gains and losses reported in the statement of operations unless the derivatives are designated as cash flow or net investment hedges in which case changes in fair value are recorded in other comprehensive income until the underlying hedged transaction is recognized in net income. The Company classified its cash and cash equivalents as held-for-trading which are measured at fair value which equals the carrying value. Other financial instruments such as accounts receivable which are classified as loans and receivables, and accounts payable and accrued liabilities, bank debt and the Note Facility which are

classified as other liabilities are measured at amortized cost using the effective interest rate method. Transaction costs are added to the amount of the associated financial instrument and amortized accordingly for financial instruments classified as loans and receivables or other liabilities.

As at December 31, 2010, the Company did not have any derivatives. There were no items that needed to be recognized in other comprehensive income for the year ended December 31, 2010.

Fair Values

The carrying values of cash and cash equivalents, accounts receivable and accounts payable and accrued liabilities, approximate their fair values as at December 31, 2010 due to their short-term nature. The carrying value of bank debt approximates its fair value due to the debt bearing interest of a floating rate. The carrying value of the note facility approximates its fair value as the fixed interest rate is comparable to interest rates available to the Company.

Per Share Information

Basic earnings per share is calculated using the weighted average number of shares outstanding during the year. Diluted per share amounts reflect the potential dilution that could occur if options and vested Performance Incentive Rights to purchase common shares were exercised. Diluted earnings per share is calculated using the treasury stock method to determine the dilutive effect of stock options and Performance Incentive rights. The treasury stock method assumes that proceeds from the exercise of "in-the-money" stock options and Performance Incentive Rights are used to re-purchase common shares at the average prevailing market price during the period.

2. Corporate Acquisitions

a) Conifer Exploration Ltd.

On August 14, 2009, the Company acquired the outstanding common shares of Conifer Exploration Ltd. ("Conifer"), a private oil and gas company. The total consideration of \$8.9 million included 9,214,754 common shares of the Company and \$6.0 million cash issued in exchange for all of the outstanding Conifer common shares. The common shares issued by the Company were valued based on the trading price of the Company's shares for several days before and after the announcement date. The business combination has been accounted for as a purchase. Conifer was amalgamated with Sure Energy on August 14, 2009. The allocation of the consideration paid to the fair value of the identifiable assets and liabilities is as follows:

Allocation of purchase price	
Conifer net assets acquired and liabilities assumed	
Cash and cash equivalents	1,579
Accounts receivable	1,316
Prepaid expenses	306
Petroleum and natural gas properties	7,172
Accounts payable	(1,422)
Asset retirement obligations	(95)
	<u>8,856</u>
Consideration comprised of:	
Cash	5,990
Issuance of common shares	2,764
Transaction costs	102
	<u>8,856</u>

3. Property Plant and Equipment

	December 31, 2010	December 31, 2009
Petroleum & natural gas properties	65,678	47,860
Furniture, fixtures and leaseholds	37	28
	<u>65,715</u>	<u>47,888</u>
Accumulated depletion and depreciation	(20,340)	(12,266)
Net book value	<u>45,375</u>	<u>35,622</u>

As of December 31, 2010, unproved oil and gas properties of \$3.9 million (December 31, 2009 - \$5.0 million) have been excluded from costs subject to depletion and depreciation. These costs relate to the Company's undeveloped land base.

Estimated future development costs of \$38.5 million have been included in costs subject to depletion and depreciation as at December 31, 2010 (December 31, 2009 - \$11.3 million).

During the year ended December 31, 2010, the Company capitalized \$342,000 (2009 - \$426,000) of general and administrative expenses directly related to exploration and development activities.

The benchmark prices used in the ceiling test are as follows:

Year	Edmonton Light Crude oil (\$CDN/ bbl)	Natural Gas at AECO (\$CDN/mmbtu)
2011	93.08	4.04
2012	93.85	4.66
2013	93.43	4.99
2014	93.54	6.58
2015	94.95	6.69
Thereafter	+1.5%	+1.5%

No impairment was required to be recognized at December 31, 2010 or December 31, 2009.

4. Bank Indebtedness

On October 22, 2010, Sure Energy increased its credit facilities to \$20.0 million consisting of a \$15.0 million revolving operating demand loan and a \$5.0 million non-revolving acquisition/development demand loan. The non-revolving acquisition development demand loan was cancelled upon closing of the Note Facility in Note 5. The revolving operating demand facility is provided by a Canadian chartered bank, is subject to periodic review by the bank and is secured by a \$50.0 million first floating charge debenture over all of the Company's assets. The facility bears interest at a rate of bank prime plus 1.00 percent.

5. Note Facility

On December 20, 2010, Sure Energy entered into an agreement for a \$20 million secured subordinated term loan facility (the "Note Facility") from Deans Knight Capital Management Ltd. ("Deans Knight") on behalf of certain investors (the "Note Holders"). Deans Knight had control over 6.4 million common shares and 2.5 million warrants or 18.08 percent of the outstanding shares of the Company assuming the exercise of the warrants at December 31, 2010. The drawn portion of the Secured Note Facility bears interest at 6.25 percent per annum. The undrawn portion bears a standby fee of 0.25 percent. Warrants to purchase 2.5 million common shares at a price of \$1.80 per share were issued as additional consideration to the Note Holders. The Company has the ability to force the Note Holders to exercise the warrants if the weighted average price per share of Sure Energy equals or exceeds \$2.80 per share for 20 consecutive trading days. The notes mature and the warrants expire 37 months from the date of closing. Draws on the Note Facility may be made at the Company's discretion in minimum tranches of \$2.5 million. The fair value of the warrants issued was estimated using the Black-Scholes option pricing model using the following assumptions:

Weighted average fair value of warrants	\$ 0.826
Risk free interest rate	3.0%
Expected life	3 years
Volatility	70.9%

The fair value of the warrants was recorded as shareholders' equity and deferred financing costs on the balance sheet.

6. Asset Retirement Obligations

The total future asset retirement obligation was estimated by management based on the Company's working interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements from changes in such estimates in future years could be significant. The Company has estimated the net present value of its asset retirement obligations to be \$1.3 million as at December 31, 2010 based on a total future liability of \$3.2 million. These payments are expected to be made over the next 20 years. The Company used a credit adjusted risk free rate of 8% and an inflation rate of 2% to calculate the present value of the asset retirement obligation.

The following table reconciles the Company's total asset retirement obligation as at December 31:

	2010	2009
Carrying amount, beginning of year	\$ 1,031	\$ 866
Acquisition of liabilities	-	95
Abandonment costs incurred	-	(132)
Additions	157	16
Revision of liabilities	-	113
Accretion expense	88	73
Carrying amount, end of year	1,276	\$ 1,031

7. Share Capital

(i) Authorized

An unlimited number of common voting shares, no par value

An unlimited number of voting preferred shares, Series A

(ii) Issued and Outstanding Common Shares

<i>Issued and Outstanding Common Shares</i>	Number of Shares	Amount
Balance December 31, 2008	37,659,208	33,718
Issued pursuant to the acquisition of Conifer	9,214,754	2,764
Tax effect of flow-through shares	-	(750)
Balance December 31, 2009	46,873,962	35,732
Issued pursuant to options exercised	843,666	607
Issued pursuant to Performance Incentive Rights exercised	745,000	745
Cancelled	(31,498)	(29)
Balance December 30, 2010	48,431,130	37,055

On August 14, 2009, the Company acquired the outstanding common shares of Conifer Exploration Ltd. ("Conifer"), a private oil and gas company. The total consideration of \$8.9 million included 9,214,754 common shares of the Company and \$6.0 million cash issued in exchange for all of the outstanding Conifer common shares.

On January 15, 2010, 31,498 shares were cancelled pursuant to the acquisition of Argent Energy Inc. as the related Argent shares were not presented for exchange into Sure Energy shares. Contributed surplus was credited to reflect the cancellation.

(iii) Performance Incentive Rights

Each Performance Incentive Right entitles the holder to acquire one Sure Energy share for a price of \$1.00 per share. The Performance Incentive Rights have a seven-year term and are exercisable by a holder only during the period that the holder is a director, employee, consultant or service provider of Sure Energy. Should a holder cease to be a director of Sure Energy or should such holder's employment terminate prior to exercise of the Performance Incentive Rights, all of such holder's Performance Incentive Rights will terminate. Certain provisions exist that will permit acceleration of the vesting of the Performance Incentive Rights upon a change of control of Sure Energy. The Performance Incentive Rights do not vest for a period of one year following the date of grant and thereafter vest in accordance with the following schedule based on the 20-day weighted average trading price of the Sure Energy Common Shares:

Percentage Vesting	Vesting Price
50%	\$1.25
50%	\$1.50

Total activity related to the performance incentive rights was as follows:

	Outstanding
December 31, 2009 and 2008	3,625,000
Exercised	(745,000)
December 31, 2010	2,880,000

Half of the performance rights vested on August 14, 2007 as the 21 day weighted average trading price of Sure Energy shares exceeded \$1.25. On October 27, 2010, the remaining 1,752,500 PIR's vested as a result of the preceding 21 day weighted average trading price exceeding the second vesting hurdle of \$1.50. 50,000 performance rights are held by consultants.

(iv) Stock Options

The Company has a stock-based compensation plan (the "Plan") under which options to purchase common shares of the Company have been issued to employees, officers and directors. Under the Plan, all options awarded have a maximum term of five years, and vest over three years on the basis of one-third per year. The plan has 10 percent of the common shares issued and outstanding, reserved for issuance. Activity related to the Plan during the year was as follows:

	Number of Options	Weighted Average Price
December 31, 2009 and 2008	3,239,000	0.94
Granted	1,483,000	1.15
Exercised	(843,666)	0.72
Forfeited	(85,000)	1.01
December 31, 2010	3,793,334	1.07

The following table summarizes information about the stock options as at December 31, 2010:

Number Outstanding	Weighted Average Remaining Term (years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
325,000	6.9	\$1.76	-	\$1.76
1,385,000	0.6	\$1.28	1,385,000	\$1.28
1,158,000	4.4	\$0.98	-	\$0.98
347,500	3.8	\$0.95	347,500	\$0.95
47,500	4.0	\$0.92	47,500	\$0.92
530,334	2.9	\$0.39	237,667	\$0.39
3,793,334	3.2	\$1.07	2,017,667	\$1.11

(v) Stock-based Compensation

The fair value of each option and performance right granted is estimated on the date of grant using the Black-Scholes option pricing model with weighted average assumptions for grants during the year as follows:

	December 31, 2010
Weighted average fair value of options granted	\$ 0.79
Risk free interest rate	2.5%
Expected lives (years)	5.4
Weighted average expected volatility	80%

No options were granted in 2009. During the year, \$710,000 (2009 - \$513,000) was expensed for stock-based compensation expense related to stock options and Performance Incentive Rights. The corresponding credit was to contributed surplus.

8. Per Share Amounts

For the year ended December 31, the calculation of basic and diluted net loss per share is based on the following weighted average number of common shares outstanding:

	2010	2009
Loss	\$ (2,603)	\$ (3,760)
Loss per share		
Basic and diluted	\$ (0.06)	\$ (0.09)
Weighted average shares outstanding		
Basic and Diluted ⁽¹⁾	46,958,260	41,168,388

(1) Options, Performance Incentive Rights and Warrants have been excluded from the weighted average diluted shares outstanding for the year ended December 31, 2010 and 2009 as they are anti-dilutive.

9. Income Taxes

As at December 31, the Company has an unrecorded future income tax asset comprised of the following temporary differences:

	December 31, 2010	December 31, 2009
Property, plant and equipment	\$ 1,086	\$ 1,531
Non-capital losses	6,342	5,476
Share issue costs	46	26
Asset retirement obligations	319	258
	7,793	7,291
Valuation allowance	(7,793)	(7,291)
	\$ -	\$ -

The provision for income tax differs from the amount that would have been computed if the reported loss had been subject only to the statutory Canadian income tax rates.

	December 31, 2010	December 31, 2009
Loss before income taxes	\$ (2,602)	\$ (3,760)
Corporate tax rate	28.50%	29.00%
Expected tax expense recovery	(742)	(1,090)
Other non-deductible items	1	1
Stock compensation expense	202	149
Unrecognized future income tax recovery	539	190
Provision for (recovery of) future income taxes	\$ -	\$ (750)

10. Supplemental Cash Flow Information

Changes in non-cash working capital items increased (decreased) cash and cash equivalents as follows:

	December 31, 2010	December 31, 2009
Accounts receivable	(1,281)	\$ 357
Prepaid expenses	(396)	90
Accounts payable and accrued liabilities	4,445	(2,561)
	\$ 2,768	\$ (2,114)
Operating activities	\$ 594	24
Investing activities	2,174	(2,138)
	\$ 2,768	\$ (2,114)
Other Cash Flow Information:		
Cash taxes paid	\$ -	\$ -
Cash interest received	-	21
Cash interest paid	\$ 261	\$ 33

11. Related Party Transactions

The Note Facility was provided by Deans Knight on behalf of the Note Holders. As at December 31, 2010, Deans Knight had control over 6,444,873 common shares and 2.5 million warrants or 18.08 percent of the outstanding shares and warrants of the Company.

12. Commitments

The Company has the following commitments:

	Minimum lease payments	Debt repayments	Fixed rate interest payments
2011	\$ 375	-	\$ 625
2012	312	-	625
2013	-	-	625
2014	-	10,000	-
2015	-	-	-
	\$ 687	\$ 10,000	\$ 1,875

13. Financial Instruments

(i) Fair Value of Financial Instruments

The Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3862 "Financial Instruments – Disclosures" requires disclosure of a three-level hierarchy for fair value measurements based upon transparency of inputs to the valuation of financial instruments carried on the balance sheet at fair value. The three levels are defined as follows:

- Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets and liabilities in active markets.
- Level 2 – inputs to valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

At December 31, 2010, the Company had no financial instruments carried on the balance sheet at fair value.

(ii) Risk Management

The Company manages its exposure to financial risks by operating in a manner that minimizes its exposure to the extent practical. The main financial risks affecting the Company are as follows:

Credit Risk

Credit risk is primarily related to the Company's receivables from petroleum and natural gas marketers and joint venture partners and the risk of financial loss if a customer, partner or counterparty to a financial instrument fails to meet its contractual obligations. Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production and the Company could be at risk for up to 55 days of production from any marketer. The Company sells its production to several petroleum and natural gas marketers so that the exposure to any one entity is minimized. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to expenditure. The Company does not typically obtain collateral from joint venture partners; however in certain circumstances, it may cash call a partner in advance of the work being performed. The Company establishes an allowance for doubtful accounts as determined by management based on their assessment of collection therefore the carrying amount of accounts receivable generally represents the maximum credit exposure. The maximum exposure to credit risk at the balance sheet date was equal to the carrying value of cash, cash equivalents and accounts receivable. As of December 31, 2010, a majority of receivables were current and there were no receivables provided for or written off during 2010.

Market Risk

Market risk consists of commodity price, foreign currency and interest rate risks.

a) Commodity Price Risk

Commodity price risk is the risk that future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand. The Company has no financial derivative sales contracts in place as at or during the year ended December 31, 2010.

b) Foreign Currency Exchange Risk

Foreign currency exchange rate risk is the risk that future cash flows will fluctuate as a result of changes in foreign exchange rates. Although substantially all of the Company's petroleum and natural gas sales are denominated in Canadian dollars, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange

rate between the Canadian and United States dollar. The Company had no forward exchange rate contracts in place as at or during the year ended December 31, 2010.

c) Interest Rate Risk

Interest rate cash flow risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its credit facility which bears a floating rate of interest. There was no floating debt outstanding at December 31, 2010.

Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due without incurring unacceptable losses or risking harm to the Company's reputation. The Company prepares capital expenditures budgets which are regularly monitored and updated as considered necessary. As well, the Company utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditure program, the Company has a revolving credit facility that is reviewed periodically by the lender and a Note Facility (see note 5).

14. Capital Management

The Company's policy is to maintain a strong capital base for the objectives of maintaining financial flexibility, creditor and market confidence, and to sustain future investing in oil and gas activities which may or may not be successful. The objective is to balance the proportion of debt and equity in its capital structure. The Company defines its capital structure to include shareholders' equity, bank debt and working capital. The key measures that the Company utilizes in evaluating its capital structure are net debt to funds flow from operations, net debt as a percent of total capitalization and the current credit available from its creditors in relation to the Company's budgeted capital program. Funds flow from operations is a non-GAAP measure and it is used by the Company to analyze operating performance, leverage and liquidity. The Company's capitalization and calculation of funds flow from operations is as follows:

	December 31, 2010	December 31, 2009
Net debt		
Working capital		
Accounts receivable	(3,110)	(1,829)
Prepaid expenses	(853)	(457)
Accounts payable and accrued liabilities	8,223	3,777
	4,260	1,491
Note facility	10,000	-
Bank debt	440	3,046
Total net debt	14,700	4,537
Market capitalization		
Common shares outstanding	48,431,130	46,873,962
Closing price, TSX	1.75	0.61
Total market capitalization	84,754	28,593
Total net debt and market capitalization	99,454	33,130
Net debt as a percent of total capitalization	15%	14%
Funds flow from operations:		
Loss	(2,603)	(3,760)
Add items not affecting cash:		
Depletion, depreciation and accretion	8,162	5,763
Non-cash interest expense	30	-
Stock compensation	710	513
Future income tax recovery	-	(750)
Total funds flow from operations	6,299	1,766
Net debt to funds flow from operations ratio	2.33	2.57

The Company also assesses its capital structure by forecasting cash flows and estimated debt levels. There are several strategies to maintain or adjust capital structure including increasing bank credit as a result of reserve growth, decreasing capital spending and new equity issues.

The Company is subject to a covenant on its credit facility to maintain its ratio of current assets (including the undrawn portion of the demand credit facility) to current liabilities (not including current bank debt) at a 1.0:1.0 level. As at December 31, 2010, the ratio was 2.25 (December 31, 2009 - 2.45).