# HIGH NORTH RESOURCES LTD.

Unaudited Interim Consolidated Financial Statements

December 31, 2014

**Notice for National Instrument 51-102**

The Company's independent auditor has not performed a review of the unaudited interim consolidated financial statements as at and for the three months ended December 31, 2014 and 2013 in accordance with the standards of the Chartered Professional Accountants of Canada.

## HIGH NORTH RESOURCES LTD.
**Interim Consolidated Statements of Financial Position**
(unaudited)

| | December 31, 2014 | September 30, 2014 |
|---|---|---|
| | **$** | $ |
| **ASSETS** | | |
| Current assets | | |
| Cash | **622,266** | 4,261,812 |
| Trade and other receivables | **545,587** | 609,749 |
| Prepaid expenses | **58,138** | 35,200 |
| Deferred issue costs (Note 8) | **225,927** | 447,046 |
| | **1,451,918** | 5,353,807 |
| Exploration and evaluation assets (Note 5) | **3,141,043** | 4,179,553 |
| Property and equipment (Note 6) | **13,466,755** | 15,824,589 |
| | **18,059,716** | 25,357,949 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current liabilities | | |
| Trade and other payables | **4,600,984** | 7,077,479 |
| Convertible debenture – debt component (Note 8) | **8,601,904** | 8,535,256 |
| | **13,202,888** | 15,612,735 |
| Share premium liability | **540,837** | 436,380 |
| Decommissioning obligation (Note 9) | **346,072** | 275,539 |
| | **14,089,797** | 16,324,654 |
| Shareholders' equity | | |
| Share capital (Note 10) | **16,402,304** | 14,700,610 |
| Convertible debenture – equity component (Note 8) | **198,313** | 198,313 |
| Contributed surplus | **937,635** | 810,112 |
| Warrants (Note 10) | **1,686,316** | 1,686,316 |
| Deficit | **(15,254,649)** | (8,362,056) |
| | **3,969,919** | 9,033,295 |
| | **18,059,716** | 25,357,949 |

Nature of Operations and Going Concern (Note 1)
Commitments (Note 10)

## HIGH NORTH RESOURCES LTD.
**Interim Consolidated Statements of Loss and Comprehensive Loss**
**For the three months ended December 31**
**(unaudited)**

| | 2014 | 2013 |
|---|---|---|
| | $ | $ |
| **Revenue** | | |
| Petroleum and natural gas sales | **1,698,945** | 85,700 |
| Royalties | **(214,352)** | (11,284) |
| | **1,484,593** | 74,416 |
| **Expenses** | | |
| Operating | **1,044,287** | 32,699 |
| Transportation | **99,568** | – |
| General and administrative | **659,096** | 491,117 |
| Exploration expense (Note 5) | **1,131,843** | – |
| Impairment (Note 6) | **4,044,771** | – |
| Depletion and depreciation | **900,437** | 15,056 |
| Share-based compensation | **125,219** | 83,961 |
| | **8,005,221** | 622,833 |
| Finance expense (Note 11) | **590,387** | 660 |
| **Loss before income tax** | **(7,111,015)** | (549,077) |
| **Deferred income tax reduction** | **218,422** | 54,389 |
| **Net loss and comprehensive loss** | **(6,892,593)** | (494,688) |
| **Basic and diluted loss per common share** (Note 10) | **$(0.12)** | $(0.01) |
| **Weighted average number of common shares outstanding** (Note 10) | **59,465,670** | 43,880,091 |

## HIGH NORTH RESOURCES LTD.
**Interim Consolidated Statements of Changes in Equity**
**(unaudited)**

| | Common Shares | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Number** | **Amount** | **Convertible Debenture** | **Contributed surplus** | **Warrants** | **Deficit** | **Total** |
| Balance, September 30, 2013 | 33,507,150 | 6,919,524 | – | 351,662 | 626,449 | (1,505,940) | 6,391,695 |
| Units and common shares issued | 14,966,256 | 3,825,097 | – | – | 1,206,534 | – | 5,031,631 |
| Warrants exercised | 525,000 | 117,684 | – | – | (27,684) | – | 90,000 |
| Options exercised | 400,000 | 129,017 | – | (69,767) | – | – | 59,250 |
| Share based compensation - expensed | – | – | – | 83,961 | – | – | 83,961 |
| Share based compensation -capitalized | – | – | – | 18,563 | – | – | 18,563 |
| Net and comprehensive loss | – | – | – | – | – | (494,688) | (494,688) |
| Balance, December 31, 2013 | 49,398,406 | 10,991,322 | – | 384,419 | 1,805,299 | (2,000,628) | 11,180,412 |
| | | | | | | | |
| Balance, September 30, 2014 | 59,184,906 | 14,700,610 | 198,313 | 810,112 | 1,686,316 | (8,362,056) | 9,033,295 |
| Common shares issued | 12,915,146 | 1,701,694 | – | – | – | – | 1,701,694 |
| Share based compensation – expensed | – | – | – | 125,219 | – | – | 125,219 |
| Share based compensation –capitalized | – | – | – | 2,304 | – | – | 2,304 |
| Net and comprehensive loss | – | – | – | – | – | (6,892,593) | (6,892,593) |
| **Balance, December 31, 2014** | **72,100,052** | **16,402,304** | **198,313** | **937,635** | **1,686,316** | **(15,254,649)** | **3,969,919** |

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

## HIGH NORTH RESOURCES LTD.
**Interim Consolidated Statements of Cash Flows**
**For the three months ended December 31**
**(unaudited)**

| | **2014** | 2013 |
|---|---|---|
| | **$** | $ |
| **Cash flows used in operating activities** | | |
| Net loss and comprehensive loss for the period | **(6,892,593)** | (494,688) |
| Add: Items not affecting cash | | |
| Share-based compensation | **125,219** | 83,961 |
| Deferred income tax reduction | **(218,422)** | (54,389) |
| Finance expense on decommissioning obligation | **1,821** | 956 |
| Finance expense on convertible debentures | **221,119** | – |
| Accretion of equity portion of debenture | **66,648** | – |
| Exploration expense | **846,843** | – |
| Impairment | **4,044,771** | – |
| Depletion and depreciation | **900,437** | 15,056 |
| | **(904,157)** | (449,104) |
| Change in non-cash working capital (Note 12) | **(164,713)** | 132,879 |
| | **(1,068,870)** | (316,225) |
| **Cash flows used in investing activities** | | |
| Purchase of short term investment | – | (3,000,000) |
| Expenditures on exploration and evaluation assets | **(27,298)** | (5,053,862) |
| Expenditures on property and equipment | **(2,297,393)** | – |
| Change in non-cash working capital (Note 12) | **(2,033,677)** | 2,938,179 |
| | **(4,358,368)** | (5,115,683) |
| **Cash flows from financing activities** | | |
| Proceeds from issuance of shares and units | **2,195,575** | 5,229,815 |
| Share issuance costs | **(171,002)** | (275,871) |
| Proceeds from exercise of options | – | 59,250 |
| Proceeds from exercise of warrants | – | 90,000 |
| Change in non-cash working capital (Note 12) | **(236,881)** | (31,500) |
| | **1,787,692** | 5,071,694 |
| **Change in cash** | **(3,639,546)** | (360,214) |
| **Cash, beginning of period** | **4,261,812** | 841,342 |
| **Cash, end of period** | **622,266** | 481,128 |
| **Cash interest paid** | **534,147** | – |

## 1. NATURE OF OPERATIONS AND GOING CONCERN

### Nature of operations

High North Resources Ltd. (the "Company" or "High North") was incorporated under the Business Corporations Act (British Columbia) on October 5, 2010. On August 24, 2011, the Company completed its Initial Public Offering ("IPO") to be classified as a Capital Pool Company as defined in the TSX Venture Exchange ("TSX-V") Policy 2.4 and began trading its stock on the TSX-V under the symbol HN.P. On February 7, 2013, the Company completed its Qualifying Transaction and as a result, the Company ceased to be a Capital Pool Company. The registered office is located at 3400, 350 - 7th Avenue SW, Calgary, Alberta T2P 3N9.

The Company's business is to acquire, explore, and develop interests in oil and gas properties in Canada.

Included in the Company's consolidated financial statements is Valleyview Exploration Inc. ("Valleyview"), a subsidiary owned 100% by the Company.

### Going concern

The Company is in the early stages of development in its oil and gas activities and commenced production of five wells during fiscal 2014. As such, the assets associated with these activities have just recently started generating revenue and will require significant funding to further develop. Current cash resources will not be sufficient to operate and to continue the exploration and development activities. Continuing operations are dependent upon the Company's ability to obtain additional financing which will be impacted by the significant decline in commodity prices, financial markets, economic conditions, and volatility in the debt and equity markets. The convertible debentures mature in April 2015. These debentures will either need to be converted or refinanced. These factors have made, and could likely continue to make it challenging to obtain cost effective funding. There is no assurance that capital will be available and as such, there exists a material uncertainty that may cast significant doubt with respect to the Company's ability to continue as a going concern.

Management believes the use of the going concern assumption is appropriate based upon the assumption that the Company will attempt to complete further financings to ensure that sufficient cash resources exist to meet its ongoing obligations as they become due in the normal course of operations. The Company obtained a credit facility (Note 7) and closed an equity financing of $2.9 million (Note 10) during the first quarter ended December 31, 2014.

These financial statements have been prepared in accordance with generally accepted accounting principles applicable to a going concern, which assumes that the Company will be able to realize its assets and meet its obligations and continue its operations for the foreseeable future. Realization values may be substantially different from carrying values as shown and these financial statements do not reflect adjustments that would be necessary if the going concern assumption were not appropriate. If the going concern basis were not appropriate for these financial statements, then adjustments would be necessary in the carrying value of assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used. These adjustments could be material.

## 2. BASIS OF PRESENTATION

### a) Statement of compliance

These unaudited interim consolidated financial statements have been prepared by management in accordance with IAS 34 *Interim Financial Reporting* from International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. These unaudited interim consolidated financial statements do not include all of the information required for full annual financial statements and should be read in conjunction with the audited consolidated financial statements of High North Resources Ltd. for the year ended September 30, 2014 and 2013. These financial statements were authorized for issue by the Board of Directors on February 27, 2015.

Depletion and depreciation is presented on a separate line by their nature, while general and administrative expenses are presented on a functional basis.

### b) Basis of measurement

The financial statements have been prepared on a historical cost basis except for derivative financial instruments, which would be measured at fair value. The methods used to measure fair values are discussed in Note 4.

### c) Functional and presentation currency

These financial statements have been presented in Canadian dollars which is the Company's functional currency.

### d) Use of judgment and estimates

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions, and to use judgment that affects the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

**Judgment**

<u>Exploration and evaluation assets and property and equipment</u>

In determining the amount of assets to recognize, the Company uses judgment to assess the likelihood that future economic benefit exists where the determination of technical feasibility and commercial viability occurs over a longer term project. The Company considers the results from drilling test wells, seismic, and, when appropriate, reserve assessments by a third party reserve engineer.

<u>Cash generating units</u>

A cash generating unit ("CGU") is defined as the smallest group of assets that generate cash inflows from continuing use that largely are independent of the cash inflows of other assets or groups thereof. The Company allocates costs to a CGU based on geographic location, shared infrastructure, and common geological and geophysical characteristics.

**2. BASIS OF PRESENTATION** (continued)

**d) Use of judgment and estimates** (continued)

**Estimates**

Although these estimates are based on management's reasonable knowledge of the amount, event or action, actual results ultimately may differ from those estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Any change in estimate is recorded in the reporting period in which the estimate is revised. The critical accounting judgments, estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

Exploration & evaluation assets and property and equipment:

The carrying value of these assets is reviewed for impairment where there has been a trigger event (that is, an event which may have resulted in impairment) by assessing the recoverable amount. The recoverable amount is the higher of fair value less costs to sell and value in use which is determined by the present value of future cash flows. The calculation of estimated future cash flows would be based on estimates of gross reserves, production rates, oil and gas prices, future costs, discount rates, and other relevant assumptions for developed properties and the fair value for undeveloped land based on value per hectare from current land sales. These values are, therefore, subjective.

Decommissioning obligation

In accounting for the decommissioning obligation, the Company makes assumptions regarding the timing and the amount of reclamation and abandonment expenditures, inflation and discount rates, and possible changes in the legal and regulatory environment. This estimate is reviewed each reporting period.

Share based compensation

In accounting for the fair value of stock options and warrants, the Company makes assumptions regarding share price volatility, risk free rates, forfeiture rates, and the expected life in order to determine the amount of associated expense to recognize.

Income taxes

Tax provisions are based on enacted or substantively enacted laws. Changes in those laws could affect amounts recognized in profit or loss both in the period of change, which would include any impact on cumulative provisions, and in future periods. Deferred tax assets (if any) are recognized only to the extent it is considered probable that those assets will be recoverable. This involves an assessment of when those deferred tax assets are likely to reverse and a judgment as to whether or not there will be sufficient taxable profits available to offset the tax assets when they do reverse. This requires assumptions regarding future profitability and is therefore inherently uncertain. To the extent assumptions regarding future profitability change, there can be an increase or decrease in the amounts recognized in respect of deferred tax assets as well as the amounts recognized in earnings in the period in which the change occurs.

## 3. SIGNIFICANT ACCOUNTING POLICIES

These unaudited interim consolidated financial statements have been prepared following the same accounting policies as described in Note 3 of the audited financial statements for the year ended September 30, 2014 except as noted below.

The Company adopted the following new accounting policy:

IFRIC 21 *Levies* was released in May 2013 to provide guidance on the accounting for levies. IFRIC 21 indicates that entities are required to recognize a liability for a levy when the activity that triggers the payment of the levy, as defined by the legislation, occurs. The liability would be recognized progressively if the obligating event occurs over a period of time once the minimum threshold to trigger the level is reached. This guidance was effective for annual periods beginning on or after January 1, 2014.

There was no impact on the consolidated financial statements of the Company as a result of adopting this new accounting standard.

## 4. DETERMINATION OF FAIR VALUE

Where determination of fair value is required by the Company's accounting policies and disclosures, fair values have been determined based on the following methods:

a) Exploration and evaluation assets and property and equipment – The fair value is the estimated amount for which an asset could be exchanged between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The fair value of developed oil and natural gas interests would be estimated with reference to the discounted cash flows expected to be derived from production of oil and natural gas based on externally prepared reserve reports. The risk-adjusted discount rate is specific to the assets with reference to general market conditions. The fair value of undeveloped land would be based on the number of hectares and the price per hectare achieved in current land sales.

b) Trade and other receivables and trade and other payables – Fair value is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. At December 31, 2014, the fair value of these balances approximated their carrying value due to their short term to maturity.

c) Convertible debenture - The fair value of the debenture approximates the carrying value on the date of issuance. The interest rate of 12% on this instrument approximates market value.

d) Share based payment transactions – The fair value of stock options and warrants are measured using a Black Scholes option pricing model with inputs including share price on measurement date, exercise price, expected volatility, forfeiture rate, weighted average expected life, expected dividends, and the risk-free interest rate.

## 5. EXPLORATION AND EVALUATION ASSETS

Exploration and evaluation assets ("E&E") include costs incurred on the Company's exploration licenses in Alberta. Costs capitalized relate primarily to the acquisition of the license, seismic, drilling and completion costs for the test wells, directly attributable general and administrative expenses, and share-based compensation. CGU's are defined by geographic area. Costs are as follows:

| | **Total** |
|---|---|
| | **$** |
| Balance as at September 30, 2014 | 4,179,553 |
| Additions | 27,298 |
| Relinquished lands | (824,406) |
| Expired lands | (22,436) |
| Reclassification to property & equipment | (218,965) |
| Balance as at December 31, 2014 | 3,141,043 |

During the three months ended December 31, 2014, the Company elected to relinquish Block I and certain lands in Block A representing approximately 1,792 hectares which resulted in $1,109,406 being recognized in exploration expense, of which $824,406 was value related to the relinquished lands and $285,000 was costs incurred in the three months ended December 31, 2014. In addition, the Company elected to allow leases for approximately 256 hectares to expire and recognized $22,436 as exploration expense. The carrying value of these leases was based on an average price per hectare.

Due to the declining commodity and land prices, the Company performed an impairment test as at December 31, 2014 and determined that there was no impairment. Fair value was determined by using the public land prices and the hectares owned by the Company.

## 6. PROPERTY AND EQUIPMENT ("PP&E")

| | Oil and natural gas assets | Corporate | Total |
|---|---|---|---|
| | $ | $ | $ |
| Cost | | | |
| September 30, 2014 | 17,388,542 | 7,314 | 17,395,856 |
| Additions | 2,272,938 | 755 | 2,273,693 |
| Reclassified from exploration and evaluation assets | 218,965 | – | 218,965 |
| Addition and change in estimate for decommissioning obligations | 68,712 | – | 68,712 |
| General and administrative costs | 23,700 | – | 23,700 |
| Share-based compensation | 2,304 | – | 2,304 |
| December 31, 2014 | 19,975,161 | 8,069 | 19,983,230 |
| Accumulated depletion and depreciation | | | |
| September 30, 2014 | (1,568,693) | (2,574) | (1,571,267) |
| Depletion and depreciation | (899,733) | (704) | (900,437) |
| Impairment | (4,044,771) | – | (4,044,771) |
| December 31, 2014 | (6,513,197) | (3,278) | (6,516,475) |
| Carrying value | | | |
| December 31, 2014 | 13,461,964 | 4,791 | 13,466,755 |
| September 30, 2014 | 15,819,849 | 4,740 | 15,824,589 |

Costs subject to depletion for the three months ended December 31, 2014 included estimated future development costs of $25.8 million for proved plus probable reserves (December 31, 2013 - $nil).

Due to the declining commodity prices, the Company completed an impairment test as at December 31, 2014 and determined that an impairment of $4.0 million existed. The impairment is calculated as the difference between carrying value and fair value. Carrying value is cost less accumulated depletion and impairment losses. Value in use was based on a third party reserve report using discount rates of 10% on proved producing reserves, 12% on proved undeveloped and 15% on probable reserves. The following price assumptions were used in the reserve report:

| Year | Edmonton Light Cdn$/bbl |
|---|---|
| 2015 | 64.71 |
| 2016 | 80.00 |
| 2017 | 85.71 |
| 2018 | 91.43 |
| 2019 | 97.14 |

Escalation rate thereafter – 2%

As at December 31, 2014, the Company prepared a sensitivity analysis, using a $1.00 decrease in Edmonton Light oil price, which would have resulted in an impairment loss of approximately $4.7 million.

## 7. OPERATING LOAN FACILITY

The Company has a demand revolving operating loan facility available to a maximum of $10 million initially capped at $6.0 million (September 30, 2014 – $nil) at an interest rate of the Bank's prime plus 2%. The credit facility is subject to review, at least annually, with the next review date scheduled for February 28, 2015. This review date has been extended to March 31, 2015. The credit facility is secured by a general security agreement over all present and after acquired property and a floating charge on all lands of the Company. Pursuant to the terms of the facility, the Company is subject to a financial covenant which requires that the working capital ratio, defined as current assets plus unutilized amount of loan divided by current liabilities, excluding the convertible debenture, less amount advanced on the facility, be a minimum of 1:1, with which the Company was in compliance as at December 31, 2014. As at December 31, 2014, there was no balance outstanding on the operating loan facility.

## 8. CONVERTIBLE DEBENTURE

| | Face value $ | Debt component $ | Equity component $ |
|---|---|---|---|
| Balance, September 30, 2013 | – | – | – |
| Issued | 8,670,000 | 8,405,583 | 264,417 |
| Accretion expense | – | 129,673 | – |
| Tax effect | – | – | (66,104) |
| Balance, September 30, 2014 | 8,670,000 | 8,535,256 | 198,313 |
| Accretion expense | – | 66,648 | – |
| Balance, December 31, 2014 | 8,670,000 | 8,601,904 | 198,313 |

On April 4, 2014, High North issued secured convertible debentures in the aggregate principal amount of $8.67 million. The debentures mature on April 4, 2015 and bear interest at 12% payable semi-annually in October 2014 and April 2015. The outstanding principal of these debentures may be converted at the holder's option at any time at a conversion price of $0.85 per share. The liability component of the debentures was initially recorded at $8,405,583 representing the fair value of the obligation, net of the fair value of the conversion feature of $264,417. Transaction costs of $877,267 were incurred and are being amortized over the term of the debentures. For the three months ended December 31, 2014, $221,119 in deferred issue costs has been amortized into finance expense. The fair value of the liability component was determined based on the present value of expected future cash flows from principal and interest using a 16% discount rate in order to value the debentures as if they did not have a conversion feature. During the three months ended December 31, 2014, $66,648 of accretion (December 31, 2013 - $nil) and $262,238 of interest expense (December 31, 2013 -$nil) were recognized.

## 9. DECOMMISSIONING OBLIGATION

The following table presents the reconciliation of the carrying amount of the obligations associated with the reclamation and abandonment of the Company's exploration and evaluation assets and property and equipment:

| | | |
|---|---|---|
| Balance, September 30, 2014 | $ | 275,539 |
| Additions | | 51,893 |
| Change in estimate | | 16,819 |
| Finance expense | | 1,821 |
| Balance, December 31, 2014 | $ | 346,072 |

The following significant assumptions were used to estimate the decommissioning obligation:

| | | December 31, 2014 |
|---|---|---|
| Undiscounted cash flows | $ | 521,310 |
| Risk free rate | | 2.33% |
| Inflation rate | | 2.00% |
| Weighted average expected timing of cash flows | | 18 years |

## 10. SHAREHOLDER'S EQUITY

### a) Common shares

**Issued**

| | Number | | Amount |
|---|---|---|---|
| September 30, 2014 | 59,184,906 | $ | 14,700,610 |
| Issue of flow-through shares | 12,915,146 | | 2,195,575 |
| Flow-through share premium liability | – | | (322,879) |
| Share issue costs | – | | (171,002) |
| December 31, 2014 | 72,100,052 | $ | 16,402,304 |

On December 30, 2014, the Company issued 12.9 million common shares issued on a flow-through share basis at a price of $0.17 per share for gross proceeds of $2.2 million. Costs of $171,002 were incurred and recognized in share issue costs. A share premium liability of $322,879 was recognized which represents the difference between the flow-through share price of $0.17 and the share price of $0.145 on the announcement date. The Company is required to incur qualifying exploration expenditures of $2,195,575 by December 31, 2015 of which $nil were incurred by December 31, 2014.

On September 10, 2014, the Company issued 7,273,000 common shares issued on a flow-through share basis at a price of $0.55 per share for gross proceeds of $4,000,150. The Company is required to incur qualifying exploration expenditures of $4,000,150 by December 31, 2015 of which approximately $2.0 million were incurred by December 31, 2014.

**10. SHAREHOLDER'S EQUITY** (continued)

**b) Escrow shares**

As at December 31, 2014, the Company has 6,499,400 shares (September 30, 2014 – 6,499,400 shares) which are held in escrow and a certain percentage of shares will be released to shareholders in accordance with TSX-V Policy 2.4 every six months. This includes the shares that were issued initially and the shares issued in conjunction with the purchase of Valleyview.

**c) Warrants**

The following is a continuity of the warrants outstanding:

| | Number of warrants | Amount | Weighted average exercise price |
|---|---|---|---|
| Outstanding and exercisable at December 31, 2014 and September 30, 2014 | 11,457,092 | $ 1,686,316 | $ 0.46 |

The following summarizes information about the warrants outstanding as at December 31, 2014, all of which are exercisable:

| Exercise Price | Number of Warrants outstanding & exercisable | Weighted average remaining contractual life (years) | Weighted average exercise price |
|---|---|---|---|
| $0.15 | 920,000 | 3.11 | $0.15 |
| $0.155 | 250,000 | 0.19 | $0.155 |
| $0.50 | 10,287,092 | 0.75 | $0.50 |
| | 11,457,092 | 0.93 | $0.46 |

**d) Options**

The following is a continuity of the stock options outstanding:

| | Number of options | Weighted average exercise price |
|---|---|---|
| Outstanding at December 31, 2014 and September 30, 2014 | 3,465,000 | $ 0.39 |

The following summarizes information about the options outstanding and exercisable as at December 31, 2014:

| Exercise Price | Number of options outstanding | Weighted average remaining contractual life (years) | Number of options exercisable | Weighted average exercise price |
|---|---|---|---|---|
| $0.10 | 200,000 | 1.65 | 200,000 | $0.10 |
| $0.155 | 150,000 | 3.16 | 150,000 | $0.155 |
| $0.35 | 2,015,000 | 3.80 | 1,361,250 | $0.35 |
| $0.56 | 1,100,000 | 4.44 | 275,000 | $0.56 |
| | 3,465,000 | 3.85 | 1,986,250 | $0.34 |

As at December 31, 2014, 2,500,000 of the options outstanding are held by key management personnel (September 30, 2014 – 3,050,000).

## 10. SHAREHOLDER'S EQUITY (continued)

### e) Basic and diluted loss per common share

The calculation of basic and diluted loss per common share for the three months ended December 31, 2014 was based on weighted average number of common shares outstanding of 59,465,670 (December 31, 2013 – 43,880,091). Escrow shares are included in the calculation of weighted average number of common shares from February 7, 2013, the date the Qualifying Transaction was completed. Diluted loss per common share did not include warrants, options and convertible debentures as the effect would be anti-dilutive.

## 11. FINANCE EXPENSE

| | December 31, 2014 | December 31, 2013 |
|---|---|---|
| Finance Income: | | |
| Interest income | $ 806 | $ 7,809 |
| Finance expense: | | |
| Issue costs of convertible debenture | $ 221,119 | $ – |
| Interest expense for convertible debentures | 262,238 | – |
| Accretion on convertible debentures | 66,648 | – |
| Interest on operating loan | 13,947 | – |
| Accretion on decommissioning obligation | 1,821 | 956 |
| Financing fees and other | 25,420 | 7,513 |
| | 591,193 | 8,469 |
| Finance expense (net) | $ 590,387 | $ 660 |

## 12. CHANGE IN NON-CASH WORKING CAPITAL

| | December 31, 2014 | December 31, 2013 |
|---|---|---|
| Trade and other receivables | $ 64,162 | $ (330,750) |
| Prepaid expenses | (22,938) | 11,929 |
| Trade and other payables | (2,476,495) | 3,358,379 |
| | $ (2,435,271) | $ 3,039,558 |

The change in non-cash working capital has been allocated to the following activities:

| | December 31, 2014 | December 31, 2013 |
|---|---|---|
| Operating | $ (164,713) | $ 132,879 |
| Financing | (236,881) | (31,500) |
| Investing | (2,033,677) | 2,938,179 |
| | $ (2,435,271) | $ 3,039,558 |

## 13. RELATED PARTY TRANSACTIONS

The Company entered into the following transactions with related parties:

a) The Company incurred management fees of $20,000 (December 31, 2013 - $30,000) to a former director and Chief Financial Officer of the Company in accordance with a management agreement dated December 1, 2013 whereby compensation is payable at $10,000 per month for a term of one year. As at December 31, 2014, the Company had a balance owing in the amount of $nil (September 30, 2014 – $14,805).

b) The Company incurred management fees of $nil (December 31, 2013 - $9,000) to a former director and officer of the Company in accordance with a management agreement dated December 1, 2013 whereby compensation was payable at $3,000 per month for a term of six months which ended on May 31, 2014. As at December 31, 2014 and September 30, 2014, the Company had a balance owing to this director and officer in the amount of $nil.

c) The Company incurred management fees of $36,129 (December 31, 2014 - $42,000) to a company controlled by a previous director and president of the Company in accordance with a management agreement dated May 1, 2013 whereby the related company is entitled to compensation of $14,000 per month for a term of two years. In accordance with the agreement, the Company advanced in May 2013 to the related company, $84,000 being one-half the first year's management fees. As at December 31, 2014, the Company had a balance owing to the related company in the amount of $nil (September 30, 2014 - $14,700). In addition, this company was paid $71,250 (December 31, 2013 - $nil) in delay drilling penalties and $27,403 royalties of which $206,250 is outstanding as at December 31, 2014 (September 30, 2014 - $146,672),

d) The Company incurred management fees of $36,000 (December 31, 2013 - $36,000) to a company controlled by a director of the Company in accordance with a management agreement dated May 1, 2013 whereby the related company is entitled to compensation of $12,000 per month for a term of two years. In accordance with the agreement, the Company advanced in May 2013 to the related company, $72,000 being one-half the first year's management fees. As at December 31, 2014, the Company had a balance owing to the related company in the amount of $nil (September 30, 2014 - $12,600).

e) The Company paid rent of $4,000 (December 31, 2013 - $16,500) and office expenses of $nil ((December 31, 2013 - $6,000) which is included in general and administrative expense, to a company with common directors.

f) The Company incurred legal fees of $241,691 (December 31, 2013 - $nil) to a law firm with a partner who is also a director of the Company. As at December 31, 2014, the Company had a balance owing to the law firm in the amount of $255,303 (September 30, 2014 - $471,770).

g) The Company incurred management fees of $30,173 (December 31, 2013 - $29,680) to a company controlled by the Chief Financial Officer of the Company. As at December 31, 2014, the Company had a balance owing to this related company in the amount of $27,836 (September 30, 2014 – $30,612).

All transactions were recorded at the exchange amount which is the amount agreed to amongst the related parties.

## 14. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

The Company's financial instruments include cash, trade and other receivables, trade and other payables and convertible debenture. The carrying values of these financial instruments approximate their fair values due to their relatively short periods to maturity.

The Company is required to classify fair value measurements using a hierarchy that reflects the significance of the inputs used in making the measurements.

## 14. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT (continued)

The fair value hierarchy is as follows:

- Level 1 - quoted prices in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

The fair value of cash is considered level 1 as they are determined by investments held at financial institutions.

The risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The Company has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments. This note presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these financial statements. The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with risk management policies.

### a) Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. As at December 31, 2014, the maximum credit exposure is the carrying amount of cash of $622,266 (September 30, 2014 - $4,261,812) and trade and other receivables of $545,587 (September 30, 2014 – $609,749). As at December 31, 2014, $92,531 of the Company's receivables consisted of GST (September 30, 2014 - $19,123), $377,515 for revenue (September 30, 2014 – $590,094), and $75,541 in other receivables (September 30, 2014 - $532). Revenue from marketers is typically collected on the 25th day of the following month. All of the trade and other receivables is considered current. There are no balances outstanding in excess of 90 days. The Company did not write off any doubtful accounts and based on a review of the balances, no allowance is deemed necessary. If the circumstances warrant it, an estimate would be made and the Company would only choose to write-off a receivable balance, as opposed to providing an allowance, after all reasonable avenues of collection have been exhausted.

### b) Liquidity risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as they are 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, under both normal and distressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

As the Company pursues additional opportunities, annual budgets will be prepared, regularly monitored and updated as considered necessary. The Company's financial liabilities are comprised of trade and other payables, operating loan, and convertible debentures. Reference is also made to Note 1 of these financial statements.

## 14. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT (continued)

### c) Market risk

Market risk consists of currency risk, commodity price risk and interest rate risk. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may use both financial derivatives and physical delivery sales contracts to manage market risks.

All such transactions are conducted in accordance with a risk management policy as set out herein:

i) Currency risk

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. All of the Company's sales are denominated in Canadian dollars; however, 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 has not entered into any forward exchange rate contracts as at December 31, 2014.

ii) Commodity price risk

Commodity price risk is the risk that the fair value of 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 as well as the relationship between the Canadian and United States dollar, as outlined above. Should the Company choose to mitigate commodity price risk through the use of financial derivatives and physical delivery fixed price sales contracts, all such contracts would require approval of the Board of Directors.

iii) Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate risk primarily on its cash and operating loan balances. For the three months ended December 31, 2014, if interest rates had been 1% higher with all other variables held constant, the change in the net loss would be insignificant. The Company had no interest rate contracts outstanding at December 31, 2014.

## 15. CAPITAL MANAGEMENT

The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute on its capital expenditure program. The Company considers its capital structure to include working capital and shareholders' equity:

| | | December 31, 2014 | | September, 2014 |
|---|---|---|---|---|
| Working capital (deficiency) | $ | (11,750,970) | $ | (10,258,928) |
| Shareholders' equity | | 3,969,919 | | 9,033,295 |

The Company monitors capital based on funds from operations and capital expenditure budgets, which are updated as necessary and are reviewed and periodically approved by the Company's Board of Directors. The Company manages its capital structure and makes adjustments by monitoring its business conditions including the current economic conditions, the risk characteristics of the Company's petroleum and natural gas assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other facts that influence commodity prices and funds from operations.

In order to maintain or adjust the capital structure, the Company will consider the potential level of credit facilities that may be attainable, availability of other sources of debt with different characteristics than conventional debt, the sale of assets, limiting the size of the capital expenditure program and new equity if available on favorable terms.

There has been no change in the Company's approach to capital management during the three months ended December 31, 2014. The Company is not subject to external restrictions. The Company has not paid or declared any dividends since the date of incorporation, nor are any contemplated in the foreseeable future. Reference is also made to Note 1 of these financial statements.