

*Condensed Consolidated Financial Statements of*

**CEQUENCE ENERGY LTD.**

*June 30, 2011*

# CEQUENCE ENERGY LTD.

## Condensed Consolidated Balance Sheets (Unaudited) (Expressed in thousands of Canadian dollars)

	June 30, 2011 \$	December 31, 2010 <sup>(1)</sup> \$	January 1, 2010 <sup>(1)</sup> \$
<b>ASSETS</b>			
<b>CURRENT</b>			
Cash	1,672	1,321	18,128
Accounts receivable (Note 7)	17,288	16,439	10,144
Deposits and prepaid expenses (Note 16)	3,486	2,480	913
Commodity contracts (Note 17)	140	-	1,420
	<b>22,586</b>	<b>20,240</b>	<b>30,605</b>
Investments	-	-	13,920
Exploration and evaluation assets (Note 5)	-	-	29,411
Property and equipment (Note 5)	382,443	341,801	121,809
Deposits and prepaid expenses (Note 16)	3,146	-	-
Deferred taxes	41,583	47,340	7,681
	<b>449,758</b>	<b>409,381</b>	<b>203,426</b>
<b>LIABILITIES</b>			
<b>CURRENT</b>			
Demand credit facilities (Note 6)	50,789	56,739	-
Accounts payable and accrued liabilities (Note 8)	38,374	38,308	23,563
	<b>89,163</b>	<b>95,047</b>	<b>23,563</b>
Long-term debt related to investments	-	-	18,204
Decommissioning liabilities (Note 12)	28,337	26,130	7,310
	<b>117,500</b>	<b>121,177</b>	<b>49,077</b>
CONTINGENCIES AND COMMITMENTS (Note 16)			
SUBSEQUENT EVENTS (Note 19)			
<b>SHAREHOLDERS' EQUITY</b>			
Share capital (Note 13)	496,375	452,526	269,185
Contributed surplus	13,562	10,681	7,818
Deficit	(177,679)	(175,003)	(122,654)
	<b>332,258</b>	<b>288,204</b>	<b>154,349</b>
	<b>449,758</b>	<b>409,381</b>	<b>203,426</b>

<sup>(1)</sup> Refer to note 4 for effects of adoption of IFRS

### APPROVED BY THE BOARD

<u>"Donald Archibald"</u>	Donald Archibald, Director
<u>"Brian Felesky"</u>	Brian Felesky, Director

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

# CEQUENCE ENERGY LTD.

## Condensed Consolidated Statements of Comprehensive Loss

(Unaudited) (Expressed in thousands of Canadian dollars except per share amounts)

	Three months ended		Six months ended	
	June 30,		June 30,	
	2011	2010 <sup>(1)</sup>	2011	2010 <sup>(1)</sup>
	\$	\$	\$	\$
<b>REVENUE</b>				
Production revenue (Note 9)	23,657	8,412	44,341	15,682
Gain on derivative financial instruments (Note 17)	61	21	316	310
	<b>23,718</b>	<b>8,433</b>	<b>44,657</b>	<b>15,992</b>
<b>EXPENSES</b>				
Depletion, depreciation and impairment (Note 5)	10,520	5,668	19,657	28,532
General and administrative	1,965	1,189	3,758	1,963
Finance costs (Notes 6, 11 and 12)	804	293	1,911	444
Operating costs	7,439	3,392	14,180	6,267
Stock-based compensation (Note 14)	2,130	259	3,481	489
Transportation	1,883	840	3,712	1,584
Other expense (income) (Note 10)	(1,837)	1,032	(3,982)	325
	<b>22,904</b>	<b>12,673</b>	<b>42,717</b>	<b>39,604</b>
INCOME (LOSS) BEFORE INCOME TAXES	814	(4,240)	1,940	(23,612)
INCOME TAXES	1,515	(211)	4,616	(5,067)
<b>COMPREHENSIVE LOSS</b>	<b>(701)</b>	<b>(4,029)</b>	<b>(2,676)</b>	<b>(18,545)</b>
Loss per share, basic and diluted (Note 15)	<b>\$(0.00)</b>	<b>\$(0.10)</b>	<b>\$(0.02)</b>	<b>\$(0.45)</b>

<sup>(1)</sup> Refer to note 4 for effects of adoption of IFRS

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

# CEQUENCE ENERGY LTD.

## Condensed Consolidated Statements of Changes in Equity (Unaudited) (Expressed in thousands of Canadian dollars)

	Six months ended June 30,	
	2011	2010 <sup>(1)</sup>
	\$	\$
<b>SHARE CAPITAL</b>		
<b>Common Shares</b>		
Balance, beginning of period	452,526	269,185
Proceeds from shares issued in public offerings (Note 13)	44,168	-
Shares issued in business combinations (Note 4)	-	28,822
Shares issued on exercise of stock options (Note 13)	1,794	-
Share issue costs, net of tax of \$729 (2010 - \$13)	(2,113)	(37)
Balance, end of period	496,375	297,970
<b>CONTRIBUTED SURPLUS</b>		
Balance, beginning of period	10,681	7,818
Stock-based compensation expense (Note 14)	3,481	489
Exercise of stock options (Note 13)	(600)	-
Balance, end of period	13,562	8,307
<b>DEFICIT</b>		
Balance, beginning of period	(175,003)	(122,654)
Comprehensive loss	(2,676)	(18,545)
Balance, end of period	(177,679)	(141,199)
<b>TOTAL EQUITY</b>	<b>332,258</b>	<b>165,078</b>

<sup>(1)</sup> Refer to note 4 for effects of adoption of IFRS

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

# CEQUENCE ENERGY LTD.

## Condensed Consolidated Statements of Cash Flows (Unaudited) (Expressed in thousands of Canadian dollars)

	Three months ended		Six months ended	
	June 30,		June 30,	
	2011	2010 <sup>(1)</sup>	2011	2010 <sup>(1)</sup>
	\$	\$	\$	\$
<b>CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:</b>				
<b>OPERATING</b>				
Comprehensive loss	(701)	(4,029)	(2,676)	(18,545)
Adjustments for non-cash items:				
Depletion, depreciation and impairment	10,520	5,668	19,657	28,532
Finance costs related to decommissioning liabilities (Note 11)	250	78	508	156
Stock-based compensation (Note 14)	2,130	259	3,481	489
Valuation loss (gain) on investments (Note 10)	-	390	-	(366)
Amortization of transaction costs on financial instruments (Note 11)	153	-	320	-
Unrealized loss (gain) on derivative financial instruments	10	42	(140)	1,462
Write-down of loan premium and other derivative financial instruments	-	-	-	32
Gain on sale of assets (Note 5)	(1,835)	-	(3,951)	-
Deferred income tax (recovery)	1,515	(211)	4,623	(5,064)
	12,042	2,197	21,822	6,696
Decommissioning liabilities expenditures (Note 12)	(88)	(10)	(115)	(66)
Net change in non-cash working capital (Note 18)	(4,380)	(3,200)	(2,293)	(6,683)
	7,574	(1,013)	19,414	(53)
<b>INVESTING</b>				
Property and equipment expenditures	(16,470)	(5,057)	(62,044)	(31,469)
Acquisitions	(21,700)	-	(21,700)	(453)
Proceeds from sale of assets	7,566	-	29,210	174
Principal repayments of investments	-	-	-	4
Net change in non-cash working capital (Note 18)	(24,189)	(8,638)	(2,144)	(1,094)
	(54,793)	(13,695)	(56,678)	(32,838)
<b>FINANCING</b>				
Proceeds from demand credit facilities (Note 6)	46,305	15,358	46,305	15,467
Repayment of demand credit facilities (Note 6)	-	-	(52,518)	-
Transaction costs on financial instruments (Note 6)	-	-	(57)	-
Repayment of long-term debt related to investments	-	-	-	(54)
Issue of common shares (Note 13)	1,194	-	46,727	-
Share issue costs (Note 13)	(333)	(50)	(2,842)	(50)
	47,166	15,308	37,615	15,363
<b>NET INCREASE (DECREASE) IN CASH</b>	(53)	600	351	(17,528)
<b>CASH, BEGINNING OF PERIOD</b>	1,725	-	1,321	18,128
<b>CASH, END OF PERIOD</b>	1,672	600	1,672	600
<b>SUPPLEMENTARY INFORMATION</b>				
Income taxes paid	-	-	-	-
Interest paid	310	218	989	585

<sup>(1)</sup> Refer to note 4 for effects of adoption of IFRS

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

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 1. NATURE AND DESCRIPTION OF THE COMPANY

Cequence Energy Ltd. (the “Company” or “Cequence”) is incorporated under the laws of Alberta with common shares listed on the Toronto Stock Exchange (“TSX”). Cequence is engaged in the acquisition, exploration and production of petroleum and natural gas reserves in Western Canada. The registered office of the Company is located at Suite 700, 326 - 11<sup>th</sup> Ave. SW, Calgary, Alberta, T2R 0C5.

These interim condensed consolidated financial statements (“consolidated financial statements”) include all assets, liabilities, revenues and expenses of Cequence and its wholly-owned subsidiary, 1175043 Alberta Ltd. Effective January 1, 2011, Cequence Acquisitions Ltd., a wholly-owned subsidiary of the Company, was amalgamated with Cequence and the combined entity was continued as Cequence Energy Ltd.

### 2. SIGNIFICANT ACCOUNTING POLICIES

#### Statement of compliance and authorization

International Financial Reporting Standards (“IFRS”) requires an entity to adopt IFRS in its first annual financial statements prepared under IFRS by making an explicit and unreserved statement in those financial statements of compliance with IFRS. The Company will make this statement when it issues its 2011 annual consolidated financial statements. These consolidated financial statements have been prepared in accordance with IAS 34, “Interim Financial Reporting” (“IAS 34”) as issued by the International Accounting Standards Board (“IASB”) using the accounting policies the Company expects to adopt in its consolidated financial statements for the year ending December 31, 2011. Refer to note 4 for a discussion of the effects of adoption of the above noted standards.

The consolidated financial statements were authorized for issue by the Company’s Board of Directors on August 11, 2011 and should be read in conjunction with the Audited Consolidated Financial Statements for the year ended December 31, 2010, which have been prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”).

#### Basis of presentation

The consolidated financial statements have been prepared using historical costs, except for financial instruments carried at fair value, on a going concern basis and have been presented in Canadian dollars, which is also the Company’s functional currency, rounded to the nearest thousand. The accounting policies set out below have been applied consistently in all material respects.

#### Basis of consolidation

The consolidated financial statements include the accounts of the Company and its consolidated subsidiaries, which are the entities over which the Company has control. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefit from its activities. All intercompany transactions and balances are eliminated on consolidation.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Business combinations

The acquisition method of accounting is used to account for acquisitions of subsidiaries and assets that meet the definition of a business under IFRS. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange. Acquisition-related costs are recognized in comprehensive income (loss) as incurred. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the identifiable assets and liabilities acquired and contingent liabilities for which a provision is provided is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognized immediately in comprehensive income (loss). Results of subsidiaries are included in the consolidated statement of comprehensive income (loss) from the closing date of acquisition.

#### Financial instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Financial assets and financial liabilities are recognized on the consolidated balance sheet at the time the Company becomes a party to the contractual provisions. Upon initial recognition, financial instruments are measured at fair value. Measurement in subsequent periods is dependent on the classification of the financial instrument.

The Company has made the following classifications:

- Cash and investments are classified as financial assets recorded at fair value through profit or loss and are carried at fair value. Gains and losses from revaluation are recognized in comprehensive income (loss).
- Accounts receivable are classified as loans and receivables and are initially measured at fair value plus directly attributable transaction costs. Subsequently, they are recorded at amortized cost using the effective interest method.
- Demand credit facilities, accounts payable and accrued liabilities and long-term debt related to investments are classified as other liabilities and are initially measured at fair value less directly attributable transaction costs. Subsequently, they are recorded at amortized cost using the effective interest method.
- Derivative instruments, including embedded derivative instruments, that do not qualify as hedges, or are not designated as hedges on the consolidated balance sheet, including commodity contracts, are classified as fair value through profit or loss and are recorded and carried at fair value with changes in fair value recognized in comprehensive income (loss). Derivative instruments are used by the Company to manage economic exposure to market risks relating to commodity prices. Cequence's policy is not to utilize derivative financial instruments for speculative purposes.

Transaction costs related to financial instruments classified as fair value through profit or loss are expensed as incurred. All other transaction costs related to financial instruments are recorded as part of the instrument and are amortized using the effective interest method.

Contracts that are entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the Company's expected purchase, sale or usage requirements (such as physical delivery commodity contracts) do not qualify as financial instruments and thus, are accounted for in accordance with other applicable standards and are not accounted for on the consolidated balance sheet.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Financial instruments (continued)

IFRS establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The three levels of the fair value hierarchy are described below:

**Level 1:** Values based on unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets or liabilities.

**Level 2:** Values based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the asset or liability.

**Level 3:** Values based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement.

When the inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measure in its entirety.

#### *Impairment of financial assets*

Financial assets, other than those classified as fair value through profit or loss, are assessed for indicators of impairment at the end of each reporting period. Financial assets are considered to be impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been negatively affected.

For financial assets carried at amortized cost, the amount of the impairment loss recognized in comprehensive income (loss) is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate.

The carrying amount of the financial asset is reduced by the impairment loss directly for all financial assets with the exception of trade receivables, where the carrying amount is reduced through the use of an allowance account. When a trade receivable is considered uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are credited against the allowance account. Changes in the carrying amount of the allowance accounts are recognized in comprehensive income (loss).

#### **Property and equipment and exploration and evaluation assets**

##### *Recognition and measurement*

##### *Exploration and evaluation expenditures*

Exploration and evaluation costs, including the costs of acquiring licenses and directly attributable costs, are initially capitalized as exploration and evaluation assets to the extent that they do not relate to a field with proven reserves attributed. The costs are accumulated in cost centers by field or exploration area pending determination of technical feasibility and commercial viability.

Exploration and evaluation assets are assessed for impairment if sufficient data exists to determine technical feasibility and commercial viability, or if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.



# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Property and equipment and exploration and evaluation assets (continued)

##### *Recognition and measurement (continued)*

##### *Exploration and evaluation expenditures (continued)*

The technical feasibility and commercial viability of extracting a mineral resource is considered to be determinable when proven reserves are determined to exist and are capable of economic production. A review of each exploration field is carried out, at least annually, to ascertain whether proven reserves have been discovered that are capable of economic production. Upon determination of proven reserves, exploration and evaluation assets attributable to those reserves are first tested for impairment and then reclassified from exploration and evaluation assets to development and production assets included in property and equipment.

##### *Other intangible costs*

Costs of data purchased to formulate strategy for license applications, such as seismic data, and asset purchases are accumulated and capitalized as other intangible assets to the extent that they are incurred prior to obtaining related licenses and do not relate to a field with proven reserves attributed.

##### *Development and production costs*

Items of property 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 Cash Generating Units (“CGUs”) for impairment testing. CGUs are defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. The Company evaluates the geography, geology, production profile and infrastructure of its assets in determining its CGUs. Based on this assessment, Cequence’s CGUs are generally composed of significant development areas. The Company reviews the composition of its CGUs at each reporting date to assess whether any changes are required in light of new facts and circumstances.

When significant parts of an item of property 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 and equipment, including oil and natural gas interests, are determined by comparing the proceeds from disposal with the carrying amount of the related property and equipment and are recognized net within “other expense (income)” in comprehensive income (loss).

##### *Subsequent costs*

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property 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 comprehensive income (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 area basis. The carrying amount of any replaced or sold component is derecognized. The costs of the day-to-day servicing of property and equipment are recognized in comprehensive income (loss) as incurred.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Property and equipment and exploration and evaluation assets (continued)

##### *Depletion and depreciation*

The net carrying value of development and production assets plus future development costs on proved plus probable reserves is depleted using the unit of production method based on proved and probable reserves, gross of royalties, as determined by independent engineers, on an area by area basis. For the purpose of this calculation, production and reserves of petroleum and natural gas are converted to a common unit of measurement on the basis of their relative energy content, where six thousand cubic feet of natural gas equates to one barrel of oil. Costs are only depleted once production in a given area begins.

Cequence depletes separately, where applicable, any significant components within development and production assets, such as fields, processing facilities and pipelines, which are significant in relation to the total cost of a development and production asset and have a different useful life than such assets.

Other property and equipment and other intangible assets are amortized over 3 to 5 years on a straight line basis.

##### *Impairment*

The carrying amounts of all assets, other than financial assets and deferred tax assets, are reviewed at each reporting date to determine whether there is indication of an impairment loss. If any such indication exists, the asset's recoverable amount is estimated.

For any asset that does not generate largely independent cash flows, the recoverable amount is determined for the CGU to which the asset belongs. If the carrying amount of an asset (or CGU) exceeds its recoverable amount, the asset (or CGU) is written down.

The recoverability of the carrying amount of an exploration and evaluation asset is dependent on successful development and commercial exploitation, or alternatively, sale of the respective area of interest. Where a potential impairment is indicated, assessment is performed for each field or area to which the exploration and evaluation expenditure is attributed. To the extent that capitalized expenditures are not expected to be recovered, the excess of the carrying amount over the recoverable amount is recognized immediately in comprehensive income (loss).

The recoverable amount of a development and production asset (or CGU) or other intangible asset (or CGU) is determined as the higher of its value in use and fair value less cost to sell. Value in use is determined by estimating future cash flows after taking into account the risks specific to the asset (or group of assets within a CGU) and discounting them to their present value using a pre-tax discount rate that reflects the current market assessment of the time value of money. In determining fair value less cost to sell, an appropriate valuation model is used. These calculations are corroborated by external valuation metrics or other available fair value indicators wherever possible.

Where the carrying amount of a development and production asset (or CGU) or other intangibles asset exceeds its recoverable amount, the excess is recognized immediately in comprehensive income (loss).

Where an impairment loss subsequently reverses, the carrying amount of the asset (or CGU) is increased to the revised estimate of its recoverable amount, but only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or depletion, if no impairment loss had been recognized.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### **Provisions**

Provisions are recognized when the Company has a present obligation as a result of a past event that can be estimated with reasonable certainty and are measured at the amount that the Company would rationally pay to be relieved of the present obligation. To the extent that provisions are estimated using a present value technique, such amounts are determined by discounting the expected future cash flows at a risk-free pre-tax rate and adjusting the liability for the risks specific to the liability.

#### *Decommissioning Liabilities*

The Company records the present value of the estimated cost of legal and constructive obligations to restore operating locations in the period in which the obligation arises. The nature of restoration activities includes the removal of facilities, abandonment of wells and restoration of affected areas. Provision is made for the estimated cost of restoration and capitalized in the relevant asset category.

Decommissioning liabilities are measured at the present value of management's best estimate of expenditure required to settle the present obligation at the balance sheet date. Subsequent to the initial measurement, the obligations are adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation as well as changes to the discount rate. The increase in the provision due to the passage of time is recognized as finance cost whereas increases or decreases due to changes in the estimated future cash flows or changes in the discount rate are capitalized. Actual costs incurred upon settlement of the decommissioning liabilities are charged against the decommissioning liabilities.

#### **Borrowing costs**

Borrowing costs incurred for the acquisition or construction of qualifying assets are capitalized during the period of time that is required to complete and prepare the asset for its intended use or sale. Assets are considered to be qualifying assets when this period of time is substantial (greater than 12 months).

The interest 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.

All other borrowing costs are recognized in comprehensive income (loss) as finance costs in the period in which they are incurred.

#### **Jointly controlled assets**

A significant portion of the Company's oil and natural gas activities involve jointly controlled assets and any liabilities incurred. The consolidated financial statements include the Company's share of these jointly controlled assets and liabilities and a proportionate share of the relevant revenues and related costs, classified according to their nature.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Share-based payments

The Company has a stock option plan and issues stock options and performance warrants to directors, officers, employees and other service providers. Compensation costs attributable to stock options and performance warrants granted are measured at fair value at the date of grant and are expensed over the vesting period, using a graded vesting schedule, with a corresponding increase in contributed surplus. When stock options and performance warrants are exercised, the cash proceeds together with the amount previously recorded as contributed surplus is recorded as share capital. The Company incorporates an estimated forfeiture rate for stock options and performance warrants that will not vest, and adjusts for actual forfeitures as they occur.

#### Revenue

Revenue from the sale of petroleum and natural gas is recognized when the risks and rewards of ownership of the product are transferred to the customer, based on volumes delivered to customers at contractual delivery points and rates. The costs associated with the delivery, including operating and maintenance costs, transportation and production-based royalty expenses are recognized in the same period in which the related revenue is earned and recorded. Revenue is measured net of related royalties.

Revenue from interest income is recognized as it accrues, using the effective interest method.

#### Flow-through shares

The Company, from time to time, issues flow-through shares to finance a portion of its capital expenditure program. Pursuant to the terms of the flow-through share agreements, the tax deductions associated with the expenditures are renounced to the subscribers. The difference between the value ascribed to flow-through shares issued and the value that would have been received for common shares at the date of issuance of the flow-through shares is initially recognized as a liability on the consolidated balance sheet. When the expenditures are renounced and incurred, the liability is drawn down, a deferred tax liability is recorded equal to the estimated amount of deferred income tax payable by the Company as a result of the renunciation, and the difference is recognized in comprehensive income (loss).

#### Earnings per share

Basic per share amounts are computed by dividing the comprehensive income (loss) by the weighted average number of common shares outstanding during the period. Diluted per share amounts are calculated giving effect to the potential dilution that would occur if stock options and warrants were exercised. The dilutive effect of stock options and warrants is calculated with the assumption that proceeds received from the exercise of options and warrants for which the exercise price is less than the market price plus the unamortized portion of stock-based compensation are used to repurchase common shares at the average market price for the period.

#### Government grants

The Company receives government grants in the form of drilling royalty credits.

Government grants are not recognized until there is reasonable assurance that the Company will comply with the conditions attached to them and that the grants will be received.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Government grants (continued)

Government grants whose primary condition is that the Company should purchase, construct or otherwise acquire non-current assets are deducted from the cost of the related assets. The net amount is amortized to income over the useful life of the related assets in accordance with the Company's relevant policies.

#### Taxation

Income tax expense represents the sum of the tax currently payable and deferred tax.

##### *Current tax*

The tax currently payable is based on taxable income for the year. Taxable income differs from income as reported in the consolidated statement of comprehensive income (loss) because of items of income or expense that are taxable or deductible in other years and items that are never taxable or deductible. The Company's liability for current tax is calculated using tax rates that have been substantively enacted by the end of the reporting period.

##### *Deferred tax*

Deferred tax is recognized on temporary differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable income. Deferred tax liabilities are generally recognized for all taxable temporary differences.

Deferred tax assets are generally recognized for all deductible temporary differences to the extent that it is probable that taxable profits will be available against which those deductible temporary differences can be utilized. Such deferred tax assets and liabilities are not recognized if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither taxable income nor the accounting income.

The carrying amount of deferred tax assets is reviewed at the end of each reporting period and reduced to the extent that it is no longer probable that sufficient taxable income will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period in which the liability is settled or the asset realized, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Company expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Company intends to settle its current tax assets and liabilities on a net basis.

##### *Current and deferred tax for the period*

Current and deferred tax are recognized as an expense or income in comprehensive income (loss), except when they relate to items that are recognized outside profit or loss (whether in other comprehensive income or directly in equity), in which case the tax is also recognized outside profit or loss, or where they arise from the initial accounting for a business combination. In the case of a business combination, the tax effect is included in the accounting for the business combination.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Significant accounting judgments, estimates and assumptions

The preparation of the consolidated financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the reported amount of assets, liabilities, and contingent liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the reporting period. Estimates and judgments are continuously evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

In particular, information about significant areas of estimation uncertainty considered by management in preparing the consolidated financial statements are described in the following notes:

Note 5: Property and equipment and exploration and evaluation assets

Note 12: Decommissioning liabilities

Note 14: Stock-based compensation plans

Note 16: Contingencies and commitments

Note 17: Financial instruments and risk management

Estimates of recoverable quantities of proved and probable reserves include judgmental assumptions regarding commodity prices, exchange rates, discount rates and production and transportation costs for future cash flows. It also requires interpretation of complex geological and geophysical models in order to make an assessment of the size, shape, depth and quality of reservoirs, and their anticipated recoveries. The economic, geological and technical factors used to estimate reserves may change from period to period. Changes in reported reserves can impact asset carrying values, the provision for decommissioning liabilities and the recognition of deferred tax assets, due to changes in expected future cash flows. Reserve estimates are prepared in accordance with the Canadian Oil and Gas Evaluation Handbook and are reviewed by third party reservoir engineers.

The Company makes judgments in determining its CGUs and evaluates the geography, geology, production profile and infrastructure of its assets in making such determinations, which are based on estimates of reserves. Based on this assessment, Cequence's CGUs are generally composed of significant development areas. The Company reviews the composition of its CGUs at each reporting date to assess whether any changes are required in light of new facts and circumstances.

The amounts recorded for depletion and depreciation of property and equipment, the provision for decommissioning liabilities, and the valuation of property and equipment are based on estimates of proved and probable reserves, production rates, future petroleum and natural gas prices, future costs and the remaining lives and period of future benefit of the related assets.

Amounts recorded from joint venture partners are based on the Company's interpretation of underlying agreements and may be subject to joint approval. The Company has recorded balances due from its joint venture partners based on costs incurred and its interpretation of allowable expenditures. Any adjustment required as a result of joint venture audits are recorded in the period of settlement with joint venture partners.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Significant accounting judgments, estimates and assumptions (continued)

The amounts recorded for deferred income tax assets and deferred tax expense (recovery) are based on estimates of the probability of the Company utilizing certain tax pools and assets which, in turn, is dependent on estimates of proved and probable reserves, production rates, future petroleum and natural gas prices, and changes in legislation, tax rates and interpretations by taxation authorities.

The fair value of derivative contracts is estimated, wherever possible, based on quoted market prices, and if not available, on estimates from third-party brokers. Another significant assumption used by the Company in determining the fair value of derivatives is market data or assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. The actual settlement of derivatives could differ materially from the value recorded and could impact future results.

The above judgments, estimates and assumptions relate primarily to unsettled transactions and events as of the date of the consolidated financial statements. Actual results could differ from these estimates and the differences could be material.

### 3. FUTURE ACCOUNTING PRONOUNCEMENTS

The Company has reviewed new and revised accounting pronouncements that have been issued but are not yet effective. As of January 1, 2013, Cequence will be required to adopt the following standards and amendments, as issued by the IASB:

- IFRS 9, “Financial Instruments”, which is the result of the first phase of the IASB’s project to replace IAS 39, “Financial Instruments: Recognition and Measurement”. The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value.
- IFRS 10, “Consolidated Financial Statements”, which is the result of the IASB’s project to replace Standing Interpretations Committee 12, “Consolidation – Special Purpose Entities” and the consolidation requirements of IAS 27, “Consolidated and Separate Financial Statements”. The new standard eliminates the current risk and rewards approach and establishes control as the single basis for determining the consolidation of an entity.
- IFRS 11, “Joint Arrangements”, which is the result of the IASB’s project to replace IAS 31, “Interest in Joint Ventures”. The new standard redefines joint operations and joint ventures and requires joint operations to be proportionately consolidated and joint ventures to be equity accounted. Under IAS 31, joint ventures could be proportionately accounted.
- IFRS 12, “Disclosure of Interests in Other Entities”, which outlines the required disclosures for interests in subsidiaries and joint arrangements. The new disclosures require information that will assist financial statement users to evaluate the nature, risks and financial effects associated with an entity’s interests in subsidiaries and joint arrangements.
- IFRS 13, “Fair Value Measurement”, which provides a common definition of fair value, establishes a framework for measuring fair value under IFRS and enhances the disclosures required for fair value measurements. The standard applies where fair value measurements are required and does not require new fair value measurements.

The Company is currently evaluating the impact of adoption of these standards and thus, the effect on Cequence's Consolidated Financial Statements at the time of adoption is not currently determinable.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS

The Company has adopted IFRS effective January 1, 2010 (the “Transition Date”) and has prepared its opening IFRS balance sheet as at that date. Prior to the adoption of IFRS the Company prepared its financial statements in accordance with Canadian GAAP. The Company’s consolidated financial statements for the year ending December 31, 2011 will be the first annual financial statements that comply with IFRS. The Company will ultimately prepare its opening IFRS balance sheet by applying existing IFRS with an effective date of December 31, 2011 or prior. Accordingly, the opening IFRS balance sheet and the December 31, 2010 comparative balance sheet presented in the consolidated financial statements for the year ending December 31, 2011 may differ from those presented at this time.

#### a) Elected exemptions from full retrospective application

In preparing these consolidated financial statements in accordance with IFRS 1, “First-time Adoption of International Financial Reporting Standards” (“IFRS 1”), the Company has applied certain of the optional exemptions from full retrospective application of IFRS. The optional exemptions applied are described below.

#### a) Elected exemptions from full retrospective application (continued)

##### i) Deemed cost for oil and gas assets

The Company has elected to measure oil and gas assets previously recorded in the full cost pool under Accounting Guidelines 16, “Oil and Gas Accounting – Full Cost” (“AcG 16”) of Canadian GAAP at the Transition Date as follows:

- i) the Company evaluated its existing asset base and reclassified from the full cost pool to exploration and evaluation assets those assets that met the definition of exploration and evaluation assets at the Transition Date; and
- ii) the remaining full cost pool was allocated to development and production assets pro rata using proved plus probable reserve values.

##### ii) Decommissioning liabilities included in the cost of property and equipment

The Company has elected to measure decommissioning liabilities as at the Transition Date in accordance with IAS 37, “Provisions, Contingent Liabilities and Contingent Assets” (“IAS 37”) and recognize directly in deficit the difference between that amount and the carrying amount of those liabilities at the Transition Date determined under Canadian GAAP.

##### iii) Business combinations

The Company has applied the business combinations exemption in IFRS 1 to not apply IFRS 3, “Business Combinations” (“IFRS 3”) retrospectively to past business combinations. Accordingly, the Company has not restated business combinations that took place prior to the Transition Date.

##### iv) Share-based payment transactions

The Company has elected to apply IFRS 2, “Share-based Payments” (“IFRS 2”) to equity instruments granted after November 7, 2002 that have not vested by the Transition Date.

##### v) Borrowing costs

The Company has applied the borrowing costs exemption in IFRS to not apply IAS 23, “Borrowing Costs” (“IAS 23”) retrospectively to past borrowing costs related to transactions that took place prior to the Transition Date.



# **CEQUENCE ENERGY LTD.**

## **Notes to the Condensed Consolidated Financial Statements**

**Three and six month periods ended June 30, 2011 with 2010 comparatives**

**(All figures expressed in thousands except per share amounts unless otherwise noted)**

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### **4. TRANSITION TO IFRS (Continued)**

#### **b) Mandatory exceptions to retrospective application**

##### **i) Estimates**

Hindsight was not used to create or revise estimates and accordingly the estimates previously made by the Company under Canadian GAAP are consistent with their application under IFRS.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 4. TRANSITION TO IFRS (Continued)

#### c) Reconciliation of opening balance sheet as reported under Canadian GAAP to IFRS

The following is a reconciliation of the Company's balance sheet, including total shareholders' equity, reported in accordance with Canadian GAAP to its balance sheet in accordance with IFRS as at January 1, 2010:

	Canadian GAAP \$	Adjustments \$	Notes	IFRS \$
<b>ASSETS</b>				
<b>CURRENT</b>				
Cash	18,128	-		18,128
Accounts receivable	10,144	-		10,144
Deposits and prepaid expenses	913	-		913
Commodity contracts	1,420	-		1,420
	<b>30,605</b>	-		<b>30,605</b>
Investments	13,920	-		13,920
Exploration and evaluation assets	-	29,411	(i)	29,411
Property and equipment	158,011	(29,411)	(i)	121,809
	-	(6,791)	(ii)	-
Deferred income taxes	5,575	(424)	(iii)	7,681
	-	813	(v)	-
	-	1,717	(ii)	-
	<b>208,111</b>	<b>(4,685)</b>		<b>203,426</b>
<b>LIABILITIES</b>				
<b>CURRENT</b>				
Accounts payable and accrued liabilities	23,175	388	(iv)	23,563
Deferred income taxes	424	(424)	(iii)	-
	<b>23,599</b>	<b>(36)</b>		<b>23,563</b>
Long-term debt related to investments	18,204	-		18,204
Decommissioning liabilities	4,059	3,251	(v)	7,310
	<b>45,862</b>	<b>3,215</b>		<b>49,077</b>
<b>SHAREHOLDERS' EQUITY</b>				
Share capital	267,908	1,277	(iv)	269,185
Contributed surplus	7,818	-		7,818
Deficit	(113,477)	(3,251)	(v)	(122,654)
	-	(6,791)	(ii)	-
	-	(1,665)	(iv)	-
	-	813	(v)	-
	-	1,717	(ii)	-
	<b>162,249</b>	<b>(7,900)</b>		<b>154,349</b>
	<b>208,111</b>	<b>(4,685)</b>		<b>203,426</b>

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS (Continued)

#### c) Reconciliation of opening balance sheet as reported under Canadian GAAP to IFRS (continued)

##### i) Reclassification to exploration and evaluation assets

The Company evaluated its existing asset base and reclassified from the full cost pool to exploration and evaluation assets those assets that met the definition of exploration and evaluation assets at the Transition Date in accordance with the Company's policies and IFRS 6, "Exploration for and Evaluation of Mineral Resources" ("IFRS 6"). The above resulted in a \$29,411 increase to exploration and evaluation assets and a commensurate decrease to property and equipment at the Transition Date.

##### ii) Deemed cost for oil and gas assets

As at the Transition Date, the Company tested all of its CGUs for impairment. The recoverable amount of each CGU was estimated based on the higher of the value in use and the fair value less costs to sell, being the fair value less cost to sell. The fair value less costs to sell was determined using discounted proved plus probable forecasted cash flows, with escalating prices and future development costs, as obtained from the Company's reserve report.

Based on the above assessment, the carrying amounts of the Company's CGUs were determined to be \$6,791 higher than their recoverable amounts, on an aggregate basis, and a corresponding impairment loss was recognized by reducing property and equipment by \$6,791 and increasing deficit by the same amount. The impairment loss resulted mainly from the adjustments discussed in Note 4(a)(i) as well as the application of IAS 36, "Impairment of Assets" ("IAS 36"), which has a more restrictive impairment test than under AcG 16 of Canadian GAAP.

The above adjustment resulted in a \$1,717 increase to deferred income tax assets with a corresponding decrease to the Company's deficit at the Transition Date.

##### iii) Current portion of deferred income tax

As required under Canadian GAAP, Cequence separately disclosed the portion of deferred tax related to current balances and those related to non-current balances in the consolidated balance sheet. IAS 1, "Presentation of Financial Statements" ("IAS 1") requires that all deferred taxes be presented as non-current on the balance sheet. This resulted in a decrease of \$424 to deferred income tax liability and a corresponding decrease to deferred income tax assets at the Transition Date.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS (Continued)

#### c) Reconciliation of opening balance sheet as reported under Canadian GAAP to IFRS (continued)

##### iv) Flow-through shares

Under Canadian GAAP, the proceeds from the issuance of flow-through shares were recognized as shareholders' equity. Further, the tax basis of assets related to expenditures incurred to satisfy flow-through share obligations was not reduced until the renunciation of the related tax pools at which time, the expected tax effect of the renunciation had the effect of increasing the future income tax liability and reducing shareholders' equity. As at December 31, 2009, Cequence had \$2,025 in flow-through shares outstanding for which the related expenditures had been incurred. These expenditures were renounced in the first quarter of 2010, resulting in deferred tax of \$512.

Under IFRS, the difference between the value of a flow-through share issuance and the value of a common share issuance is initially accrued as an obligation on issuance of the flow-through shares. Pursuant to the terms of the flow-through share agreements, the tax deductions associated with the expenditures are renounced to the subscribers. Accordingly, on renunciation with the Canada Revenue Agency, a deferred tax liability is recorded equal to the estimated amount of deferred income taxes payable by the Company as a result of the renunciations, the obligation on issuance of the flow-through shares is reduced and the difference is recognized in comprehensive income (loss).

The above differences resulted in an increase to shareholders' equity of \$1,277, an increase to deficit of \$1,665 and the recognition of an obligation on issuance of flow-through shares included with accounts payable and accrued liabilities of \$388, at the Transition Date.

##### v) Decommissioning Liabilities

Under Canadian GAAP, decommissioning liabilities were discounted at a weighted average credit-adjusted risk-free interest rate of 7.47 percent. Under IAS 37 the estimated cash flows related to decommissioning liabilities have been risk adjusted, therefore, the provision has been discounted at a risk-free rate of 4.07 percent based on Government of Canada long-term benchmark bonds. This resulted in a \$3,251 increase to the decommissioning liabilities with a corresponding increase to the Company's deficit at the Transition Date. This further resulted in an \$813 increase to deferred income tax assets with a corresponding decrease to the Company's deficit at the Transition Date.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 4. TRANSITION TO IFRS (Continued)

#### d) Reconciliation of subsequent balance sheets as reported under Canadian GAAP to IFRS

The following is a reconciliation of the Company's balance sheet, including total shareholders' equity, reported in accordance with Canadian GAAP to its balance sheet in accordance with IFRS as at June 30, 2010:

	Canadian GAAP	Adjustments	Notes	IFRS
	\$	\$		\$
<b>ASSETS</b>				
<b>CURRENT</b>				
Cash	600	-		600
Accounts receivable	8,767	-		8,767
Deposits and prepaid expenses	1,017	-		1,017
Commodity contracts	296	-		296
	<b>10,680</b>	-		<b>10,680</b>
Investments	14,100	-		14,100
Exploration and evaluation assets	-	41,569	(i)	37,577
	-	(3,992)	(i)	-
Property and equipment	208,154	(41,569)	(i)	144,668
	-	(6,791)	4(c)(ii)	-
	-	3,286	(ii)	-
	-	(16,445)	(ii)	-
	-	718	(iii)	-
	-	(2,685)	(vi)	-
Deferred income taxes	13,609	7,559	(viii)	21,087
	-	(81)	4(c)(iii)	-
	<b>246,543</b>	<b>(18,431)</b>		<b>228,112</b>
<b>LIABILITIES</b>				
<b>CURRENT</b>				
Demand credit facilities	20,451	-		20,451
Accounts payable and accrued liabilities	15,159	-		15,159
Deferred income taxes	81	(81)	4(c)(iii)	-
	<b>35,691</b>	<b>(81)</b>		<b>35,610</b>
Long-term debt related to investments	18,000	-		18,000
Decommissioning liabilities	5,170	3,251	4(c)(v)	9,424
	-	1,003	(iii)	-
	<b>58,861</b>	<b>4,173</b>		<b>63,034</b>
<b>SHAREHOLDERS' EQUITY</b>				
Share capital	297,628	1,277	4(c)(iv)	297,970
	-	512	(iv)	-
	-	(1,447)	(vi)	-
Contributed surplus	8,307	-		8,307
Deficit	(118,253)	(9,177)	4(c)	(141,199)
	-	(3,992)	(i)	-
	-	3,286	(ii)	-
	-	(16,445)	(ii)	-
	-	12	(iii)	-
	-	(645)	(vi)	-
	-	4,015	(viii)	-
	<b>187,682</b>	<b>(22,604)</b>		<b>165,078</b>
	<b>246,543</b>	<b>(18,431)</b>		<b>228,112</b>

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 4. TRANSITION TO IFRS (Continued)

#### d) Reconciliation of subsequent balance sheets as reported under Canadian GAAP to IFRS (continued)

The following is a reconciliation of the Company's balance sheet, including total shareholders' equity, reported in accordance with Canadian GAAP to its balance sheet in accordance with IFRS as at December 31, 2010:

	Canadian GAAP \$	Adjustments \$	Notes	IFRS \$
<b>ASSETS</b>				
<b>CURRENT</b>				
Cash	1,321	-		1,321
Accounts receivable	16,439	-		16,439
Deposits and prepaid expenses	2,480	-		2,480
	<b>20,240</b>	<b>-</b>		<b>20,240</b>
Property and equipment	409,955	(6,791)	4(c)(ii)	341,801
	-	8,356	(ii)	-
	-	(58,483)	(ii)	-
	-	105	(iii)	-
	-	(13,827)	(vi)	-
	-	2,486	(vii)	-
Deferred income taxes	26,441	20,899	(viii)	47,340
	<b>456,636</b>	<b>(47,255)</b>		<b>409,381</b>
<b>LIABILITIES</b>				
<b>CURRENT</b>				
Demand credit facilities	57,125	(386)	(v)	56,739
Accounts payable and accrued liabilities	36,240	2,068	(iv)	38,308
	<b>93,365</b>	<b>1,682</b>		<b>95,047</b>
Decommissioning liabilities	14,622	3,251	4(c)(v)	26,130
	-	8,257	(iii)	-
	<b>107,987</b>	<b>13,190</b>		<b>121,177</b>
<b>SHAREHOLDERS' EQUITY</b>				
Share capital	465,963	1,277	4(c)(iv)	452,526
	-	(1,556)	(iv)	-
	-	(13,158)	(vi)	-
Contributed surplus	10,681	-		10,681
Deficit	(127,995)	(9,177)	4(c)	(175,003)
	-	8,356	(ii)	-
	-	(58,483)	(ii)	-
	-	90	(iii)	-
	-	386	(v)	-
	-	(3,623)	(vi)	-
	-	2,842	(vii)	-
	-	12,601	(viii)	-
	<b>348,649</b>	<b>(60,445)</b>		<b>288,204</b>
	<b>456,636</b>	<b>(47,255)</b>		<b>409,381</b>

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS (Continued)

#### d) Reconciliation of subsequent balance sheets as reported under Canadian GAAP to IFRS (continued)

##### i) Reclassification to exploration and evaluation assets and impairment

The change in recognition of property and equipment as exploration and evaluation assets based on the adoption of IFRS 6, as discussed in note 4(c)(i) resulted in a \$41,569 increase to exploration and evaluation assets and a commensurate decrease to property and equipment as at June 30, 2010 (December 31, 2010 - \$nil).

Based on the Company's policy under IFRS 6, exploration and evaluation assets are reviewed for impairment when facts and circumstances suggest that the carrying amount exceeds the recoverable amount. This assessment resulted in an aggregate impairment loss which reduced exploration and evaluation assets by \$nil at December 31, 2010 (June 30, 2010 - \$3,992) with a commensurate increase to deficit.

##### ii) Depletion, depreciation and impairment

Under Canadian GAAP, the Company depleted the full cost pool based on proved reserves. Under IAS 16, "Property, plant and equipment" ("IAS 16"), the Company has elected to deplete property and equipment based on proved plus probable reserves. This has resulted in a decrease to depletion and depreciation of \$8,356 for the year ended December 31, 2010 (June 30, 2010 - \$3,286) with a commensurate decrease to deficit.

Under Canadian GAAP, impairment of the full cost pool was assessed by comparing the carrying amount of the full cost pool to the sum of undiscounted cash flows expected from the production of proved reserves. If the carrying amount of the full cost pool was determined to not be recoverable based on this test, impairment was recognized to the extent that the carrying amount of the full cost pool exceeded the sum of discounted cash flows expected from the production of proved plus probable reserves. Under IAS 36, impairment is assessed by comparing the carrying amount of property and equipment to the sum of discounted cash flows expected from the production of proved plus probable reserves for each individual CGU assessed by the Company. This resulted in an aggregate impairment loss which reduced property and equipment by \$58,483 at December 31, 2010, including the \$3,992 impairment of exploration and evaluation assets discussed in note 4(d)(i) above (June 30, 2010 - \$16,445) with a commensurate increase to deficit.

##### iii) Decommissioning Liabilities

Under Canadian GAAP, accretion expense was calculated through the application of a credit-adjusted risk-free rate to the Company's discounted decommissioning liabilities. IAS 37 requires the application of a risk-free rate in determining the amount of accretion to be included with finance costs in the statement of comprehensive income (loss) for the period. The above difference, along with changes to decommissioning liabilities discussed in note 4(d)(vi) resulted in a decrease to accretion expense included as finance costs in the consolidated comprehensive statement of income (loss) of \$90 for the year ended December 31, 2010 (June 30, 2010 - \$12) with a commensurate decrease to deficit. Such changes further resulted in an increase to decommissioning liabilities of \$8,257 as at December 31, 2010 (June 30, 2010 - \$1,003) and an increase to property and equipment of \$105 at December 31, 2010 (June 30, 2010 - \$718).

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS (Continued)

#### d) Reconciliation of subsequent balance sheets as reported under Canadian GAAP to IFRS (continued)

##### iv) Flow-through shares

The change in accounting for flow-through shares discussed in note 4(c)(iv) resulted in a decrease to share capital for the year ended December 31, 2010 of \$1,556 (June 30, 2010 – \$512 increase) and the recognition of an obligation on flow-through shares included with accounts payable and accrued liabilities on the consolidated balance sheet of \$2,068 as at December 31, 2010 (June 30, 2010 - \$nil).

##### v) Transaction costs on financial instruments

The Company's policy under Canadian GAAP was to expense all transaction costs as incurred. Under IAS 39, the Company is required to capitalize transaction costs on all financial instruments other than those classified as through profit or loss and amortize such costs using the effective interest rate method. This resulted in a decrease to demand credit facilities of \$386 for the year ended December 31, 2010 (June 30, 2010 – \$nil) and a commensurate decrease to the deficit.

##### vi) Business combinations

Under Canadian GAAP, transaction costs related to business combinations are capitalized as part of the purchase equation. Under IFRS 3, transaction costs on business combinations are expensed as incurred. Also, under Canadian GAAP, shares issued as consideration in a business combination are valued based on the weighted average trading price surrounding the date of announcement of the transaction. Under IFRS 3, such shares are valued as at the acquisition date. Further, the determination of fair value assigned to assets and liabilities at the date of acquisition differs from Canadian GAAP due to the application of IFRS as opposed to Canadian GAAP in determining such fair values. These differences resulted in the following changes to Cequence's business combinations effected in the year ended December 31, 2010:

##### *Peloton Exploration Corp. Acquisition*

On June 11, 2010, the Company acquired all of the issued and outstanding shares of Peloton Exploration Corp. ("Peloton"), a private oil and gas company, for consideration of 12,059 common voting shares. Under IFRS 3, the shares were valued based on Cequence's closing trading price on the TSX on June 11, 2010. The transaction was accounted for using the acquisition method whereby the assets acquired and liabilities assumed are recorded at their fair value as determined by reference to the relevant IFRS standards. The accounts of the Company include the results of Peloton effective June 11, 2010.



# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS (Continued)

#### d) Reconciliation of subsequent balance sheets as reported under Canadian GAAP to IFRS (continued)

##### vi) Business combinations (continued)

###### *Peloton Exploration Corp. Acquisition (continued)*

The purchase price allocation with adjustments from Canadian GAAP to IFRS is as follows:

(\$000's)

<b>Cost of Acquisition</b>	<b>Canadian GAAP</b>	<b>Adjustments</b>	<b>IFRS</b>
Common shares (12,059 at \$2.39)	30,269	(1,447)	28,822
Transaction costs	645	(645)	-
<b>Total</b>	<b>30,914</b>	<b>(2,092)</b>	<b>28,822</b>

(\$000's)

<b>Fair Value of the Assets and Liabilities Acquired</b>	<b>Canadian GAAP</b>	<b>Adjustments</b>	<b>IFRS</b>
Property and equipment	29,319	(2,685)	26,634
Fair value of commodity contracts	339	-	339
Bank debt	(4,984)	-	(4,984)
Working capital deficiency	(1,031)	-	(1,031)
Decommissioning liabilities	(552)	(297)	(849)
Deferred income tax assets – non-current	7,918	795	8,713
Deferred income tax liabilities - current	(95)	95	-
<b>Total</b>	<b>30,914</b>	<b>(2,092)</b>	<b>28,822</b>

###### *Temple Energy Inc. Acquisition*

On September 10, 2010, the Company acquired all of the issued and outstanding shares of Temple Energy Inc. ("Temple"), a private oil and gas company, for consideration of 46,846 common voting shares. Under IFRS 3, the shares were valued based on Cequence's closing trading price on the TSX on September 10, 2010. The transaction was accounted for using the acquisition method whereby the assets acquired and liabilities assumed are recorded at their fair value as determined by reference to the relevant IFRS standards. The accounts of the Company include the results of Temple effective September 10, 2010.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS (Continued)

#### d) Reconciliation of subsequent balance sheets as reported under Canadian GAAP to IFRS (continued)

##### vi) Business combinations (continued)

###### *Temple Energy Inc. Acquisition (continued)*

The purchase price allocation with adjustments from Canadian GAAP to IFRS is as follows:

(\$000's)

<b>Cost of Acquisition</b>	<b>Canadian GAAP</b>	<b>Adjustments</b>	<b>IFRS</b>
Common shares (46,846 at \$2.03)	106,809	(11,711)	95,098
Transaction costs	2,838	(2,838)	-
<b>Total</b>	<b>109,647</b>	<b>(14,549)</b>	<b>95,098</b>

(\$000's)

<b>Fair Value of the Assets and Liabilities Acquired</b>	<b>Canadian GAAP</b>	<b>Adjustments</b>	<b>IFRS</b>
Property and equipment	143,990	(15,022)	128,968
Fair value of commodity contracts	4,201	-	4,201
Bank debt	(36,423)	-	(36,423)
Working capital deficiency	(3,834)	-	(3,834)
Decommissioning liabilities	(5,902)	(4,282)	(10,184)
Deferred income tax assets – non-current	8,798	3,572	12,370
Deferred income tax liabilities - current	(1,183)	1,183	-
<b>Total</b>	<b>109,647</b>	<b>(14,549)</b>	<b>95,098</b>

###### *Deep Basin Acquisition*

On September 8, 2010, the Company closed the acquisition of certain gas weighted properties located in the Simonette area of Northwest Alberta (the "Deep Basin Assets"). The purchase price, subject to final adjustments, was \$85,000 in cash. Under Canadian GAAP, the transaction was accounted for as an asset acquisition and the consideration was allocated to property and equipment and decommissioning liabilities. IFRS 3 has a broader view than Canadian GAAP as to what constitutes a business, and resultantly, the transaction was determined to be a business combination under IFRS.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS (Continued)

#### d) Reconciliation of subsequent balance sheets as reported under Canadian GAAP to IFRS (continued)

##### vi) Business combinations (continued)

###### *Deep Basin Acquisition (continued)*

The estimated purchase price allocation with adjustments from Canadian GAAP to IFRS is as follows:

(\$000's)

<b>Cost of Acquisition</b>	<b>Canadian GAAP</b>	<b>Adjustments</b>	<b>IFRS</b>
Cash consideration	85,000	-	85,000
Transaction costs	140	(140)	-
<b>Total</b>	<b>85,140</b>	<b>(140)</b>	<b>85,000</b>

(\$000's)

<b>Fair Value of the Assets and Liabilities Acquired</b>	<b>Canadian GAAP</b>	<b>Adjustments</b>	<b>IFRS</b>
Property and equipment	88,823	3,880	92,703
Decommissioning liabilities	(3,683)	(4,020)	(7,703)
<b>Total</b>	<b>85,140</b>	<b>(140)</b>	<b>85,000</b>

The aggregate differences related to the expensing of transaction costs under IFRS 3 versus capitalization under Canadian GAAP resulted in a decrease to comprehensive income (loss) of \$3,623 for the year ended December 31, 2010 (June 30, 2010 - \$645) and a commensurate increase to deficit. The above adjustments under IFRS 3 further result in an aggregate decrease to property and equipment of \$13,827 as at December 31, 2010 (June 30, 2010 - \$2,685) and an aggregate decrease to share capital of \$13,158 as at December 31, 2010 (June 30, 2010 - \$1,447).

##### vii) Gain (loss) on sale of assets

Under Canadian GAAP, no gain or loss was recognized on the sale of oil and gas properties unless the sale resulted in a change of 20 percent or more to the depletion rate applied to the full cost pool. No such provision exists under IFRS. This resulted in an increase to gain (loss) on sale of assets of \$2,842 for the year ended December 31, 2010 (June 30, 2010 - \$nil) with a commensurate decrease to deficit and an increase to property and equipment of \$2,486 at December 31, 2010 (June 30, 2010 - \$nil).

##### viii) Deferred tax

The above adjustments resulted in an increase to deferred tax assets of \$20,899 as at December 31, 2010 (June 30, 2010 - \$7,559) and an increase to deferred tax recovery of \$12,601 for the year ended December 31, 2010 (June 30, 2010 - \$4,015).

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 4. TRANSITION TO IFRS (Continued)

#### e) Reconciliation of comprehensive income (loss) under Canadian GAAP to IFRS

The following is a reconciliation of the Company's comprehensive income (loss) reported in accordance with Canadian GAAP to its comprehensive income (loss) in accordance with IFRS for the year ended December 31, 2010 and the three and six month periods ended June 30, 2010:

(\$000's)	Note	Three months ended June 30, 2010	Six months ended June 30, 2010	Year ended Dec. 31, 2010
Comprehensive income (loss) as reported under Canadian GAAP		(3,751)	(4,776)	(14,518)
Differences increasing (decreasing) reported amounts:				
Depletion, depreciation and impairment	4(d)(i)(ii)	673	(17,151)	(50,127)
Finance costs on decommissioning liabilities	4(d)(iii)	8	12	90
Transaction costs on financial instruments	4(d)(v)	-	-	386
Business combinations	4(d)(vi)	(645)	(645)	(3,623)
Gain (loss) on sale of assets	4(d)(vii)	-	-	2,842
Deferred tax on above	4(d)(viii)	(314)	4,015	12,601
Comprehensive income (loss) as reported under IFRS		(4,029)	(18,545)	(52,349)

#### f) Reconciliation of cash flow under Canadian GAAP to IFRS

The following is a reconciliation of the Company's cash flows reported in accordance with Canadian GAAP to its cash flows in accordance with IFRS for the six months ended June 30, 2010:

(\$000's)	Notes	Operating	Investing	Financing	Total
As reported under Canadian GAAP – June 30, 2010		592	(33,483)	15,363	(17,528)
Differences increasing (decreasing) reported amounts:					
Business combinations	(ii)	(645)	645	-	-
As reported under IFRS – June 30, 2010		(53)	(32,838)	15,363	(17,528)

The following is a reconciliation of the Company's cash flows reported in accordance with Canadian GAAP to its cash flows in accordance with IFRS for the year ended December 31, 2010:

(\$000's)	Notes	Operating	Investing	Financing	Total
As reported under Canadian GAAP – Dec. 31, 2010		20,308	(95,090)	57,975	(16,807)
Differences increasing (decreasing) reported amounts:					
Transaction costs on financial instruments	(i)	555	-	(555)	-
Business combinations	(ii)	(3,623)	3,623	-	-
As reported under IFRS – Dec. 31, 2010		17,240	(91,467)	57,420	(16,807)

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 4. TRANSITION TO IFRS (Continued)

#### f) Reconciliation of cash flow under Canadian GAAP to IFRS (continued)

##### i) Transaction costs on financial instruments

As discussed in note 4(d)(v), the Company's policy under Canadian GAAP was to expense transaction costs on financial instruments as incurred. These costs were included with cash flows related to operating activities in the consolidated statement of cash flows under Canadian GAAP. Under IFRS, such transaction costs are capitalized and amortized over the life of the related financial instrument. Presentation in the statement of cash flows under IFRS is to include such costs with cash flows related to financing activities. This resulted in an increase to cash flows related to operating activities of \$555 for the year ended December 31, 2010 (June 30, 2010 - \$nil) with a commensurate decrease to cash flows related to financing activities.

##### ii) Business combinations

As discussed in note 4(d)(vi), the Company's policy under Canadian GAAP was to capitalize transaction costs related to business combinations. These costs were included with cash flows related to investing activities in the consolidated statement of cash flows under Canadian GAAP. Under IFRS, such transaction costs are expensed as incurred. Presentation in the statement of cash flows under IFRS is to include such costs with cash flows related to operating activities. This resulted in a decrease to cash flows related to operating activities of \$3,623 for the year ended December 31, 2010 (June 30, 2010 - \$645) with a commensurate increase to cash flows related to investing activities.

The application of IFRS further resulted in numerous changes to non-cash items in the consolidated statement of cash flows from the amounts reported under Canadian GAAP as well as reclassifications between asset acquisitions and corporate acquisitions included under investing activities resulting from changes discussed in note 4(d)(vi). These changes did not affect the classification of cash flows between operating, investing and financing.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 5. PROPERTY AND EQUIPMENT AND EXPLORATION AND EVALUATION ASSETS

	Property and equipment	Exploration and evaluation assets	Total
<b>Cost or deemed cost:</b>			
Balance at January 1, 2010	121,809	29,411	151,220
Acquisitions	248,043	-	248,043
Additions	52,367	12,158	64,525
Disposals	(1,851)	(41,569)	(43,420)
Balance at December 31, 2010	420,368	-	420,368
Additions	65,729	-	65,729
Acquisitions	21,700	-	21,700
Disposals	(29,065)	-	(29,065)
Balance at June 30, 2011	478,732	-	478,732
<b>Depletion, depreciation and impairment:</b>			
Balance at January 1, 2010	-	-	-
Depletion and depreciation	(24,076)	-	(24,076)
Impairment loss	(54,491)	(3,992)	(58,483)
Disposals	-	3,992	3,992
Balance at December 31, 2010	(78,567)	-	(78,567)
Depletion and depreciation	(19,657)	-	(19,657)
Disposals	1,935	-	1,935
Balance at June 30, 2011	(96,289)	-	(96,289)
<b>Carrying amounts:</b>			
At January 1, 2010	121,809	29,411	151,220
At December 31, 2010	341,801	-	341,801
At June 30, 2011	382,443	-	382,443

Costs subject to depletion include \$206,333 of estimated future capital costs (June 30, 2010 – \$69,707; December 31, 2010 – \$250,830).

The Company's credit facilities are secured by a demand debenture with a first floating charge over all assets of the Company (see note 6).

Exploration and evaluation assets consist of the Company's exploration projects which are pending the determination of proven reserves that are capable of economic production. Costs consist primarily of undeveloped land and drilling costs until the drilling of the well is complete and proven reserves which are capable of economic production have been established.

#### **Impairment**

The Company reviewed each CGU comprising its property and equipment at June 30, 2011 for indicators of impairment and determined that no such indicators were present.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 5. PROPERTY AND EQUIPMENT AND EXPLORATION AND EVALUATION ASSETS (Continued)

#### *Impairment (continued)*

As discussed in note 4(d)(ii), the Company recognized an aggregate of \$54,491 in impairment losses on property and equipment in the year ended December 31, 2010 resulting from an excess of the carrying value of the Company's CGUs over their fair value less cost to sell. Such excess resulted largely from decreasing future natural gas prices used to estimate the fair value less cost to sell of each of the Company's CGUs through 2010. Total impairment recognized by CGU in the year ended December 31, 2010 is as follows:

	<u>2010</u> <u>Impairment</u>
Northeast British Columbia	\$ 17,445
Peace River Arch	37,046
Central Alberta	-
Deep Basin	-
Total	<u>\$ 54,491</u>

#### *Sale of Assets*

On March 23, 2011, the Company closed the sale of certain oil and gas properties located in central Alberta for total cash consideration of \$22,000, subject to adjustments. The sale resulted in a gain recognized in the condensed consolidated statement of comprehensive income (loss) of \$2,116.

On April 15, 2011, the Company closed the sale of certain oil and gas properties located in Northwest Alberta for total cash consideration of \$7,500, subject to adjustments. The sale resulted in a gain recognized in the condensed consolidated statement of comprehensive income (loss) of \$1,835.

### 6. DEMAND CREDIT FACILITIES

The Company has established two credit facilities with a syndicate of Canadian chartered banks; a \$100,000 extendible revolving term credit facility and a \$10,000 operating facility. As at June 30, 2011, the Company has drawn \$50,912 under the extendible revolving term credit facility and \$nil under the operating facility (December 31, 2010 – \$57,125 and \$nil for the revolving and operating facilities, respectively) and is in compliance with all covenants. The next scheduled review is to take place in November, 2011. During the six months ended June 30, 2011 the Company capitalized transaction costs related to its credit facilities of \$57 (December 31, 2010 – \$555; June 30, 2010 – \$nil).

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 6. DEMAND CREDIT FACILITIES (Continued)

A reconciliation of the Company's credit facilities to the amount presented on the condensed consolidated balance sheet is as follows:

	<b>June 30, 2011</b>	December 31, 2010	January 1, 2010
Credit facilities	<b>50,912</b>	57,125	-
Less: transaction costs capitalized (net of accumulated amortization)	<b>(123)</b>	(386)	-
	<b>50,789</b>	56,739	-

### 7. ACCOUNTS RECEIVABLE

	<b>June 30, 2011</b>	December 31, 2010	January 1, 2010
Trade receivables	<b>7,159</b>	5,356	2,494
Less: allowance for doubtful accounts	<b>(492)</b>	(490)	(274)
Net trade receivables	<b>6,667</b>	4,866	2,220
Accrued revenue	<b>9,080</b>	9,082	4,111
Other receivables	<b>1,541</b>	2,491	3,813
Total accounts receivable	<b>17,288</b>	16,439	10,144

### 8. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

	<b>June 30, 2011</b>	December 31, 2010	January 1, 2010
Accounts payable	<b>9,890</b>	12,663	15,080
Accrued liabilities	<b>26,914</b>	23,577	8,095
Obligations related to flow-through shares (note 13)	<b>1,570</b>	2,068	388
Total accounts payable and accrued liabilities	<b>38,374</b>	38,308	23,563

### 9. PRODUCTION REVENUE

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2011</b>	2010	<b>2011</b>	2010
Sales of oil and natural gas	<b>27,222</b>	9,111	<b>51,149</b>	17,495
Less: royalties	<b>(3,565)</b>	(699)	<b>(6,808)</b>	(1,813)
Total production revenue	<b>23,657</b>	8,412	<b>44,341</b>	15,682



# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 10. OTHER EXPENSE (INCOME)

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Gain on sale of property and equipment	(1,835)	-	(3,951)	-
Loss (gain) on investment in MAV 2 notes	-	390	-	(366)
Transaction costs on business combinations	-	645	-	645
Other	(2)	(3)	(31)	46
Total other income	(1,837)	1,032	(3,982)	325

### 11. FINANCE COSTS

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Interest expense on demand credit facilities	401	145	1,083	145
Interest expense on long-term debt related to investments	-	70	-	143
Accretion expense on decommissioning liabilities	250	78	508	156
Amortization of transaction costs on financial instruments	153	-	320	-
Total finance costs	804	293	1,911	444

### 12. DECOMMISSIONING LIABILITIES

The following table summarizes the changes in decommissioning liabilities for the six months ended June 30, 2011 and the year ended December 31, 2010:

	June 30, 2011	December 31, 2010
Balance - Beginning of period	26,130	7,310
Acquisitions	1,539	18,736
Property dispositions (Note 5)	(1,870)	(722)
Accretion expense	508	495
Liabilities incurred	2,202	837
Abandonment costs incurred	(115)	(126)
Revisions in estimated cash flows	(151)	(1,175)
Revisions due to change in discount rates	94	775
Balance - End of period	28,337	26,130

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 12. DECOMMISSIONING LIABILITIES (Continued)

The Company's decommissioning liabilities result from its ownership in oil and natural gas assets including well sites, facilities and gathering systems. The total estimated, undiscounted cash flows, inflated at 2 percent, required to settle the obligations are \$48,105 (December 31, 2010 - \$44,359). These cash flows have been discounted using a risk-free interest rate of 3.53 percent (December 31, 2010 - 3.54 percent) based on Government of Canada long-term benchmark bonds. The Company expects these obligations to be settled in approximately 2 to 30 years. As at June 30, 2011, no funds have been set aside to settle these liabilities.

### 13. SHARE CAPITAL

Cequence has an unlimited number of common voting shares and common non-voting shares with no par value.

	Six months ended June 30, 2011		Year ended December 31, 2010	
	Number (000's)	Stated Value \$	Number (000's)	Stated Value \$
<b>Issued common voting shares</b>				
Balance, beginning of period	128,750	452,526	39,530	269,185
Corporate acquisition - Peloton	-	-	12,059	28,822
Flow-through share private placement	-	-	4,070	8,547
Subscription receipts	-	-	21,045	44,195
Corporate acquisition - Temple	-	-	46,846	95,098
Common share private placement	-	-	2,950	6,195
Flow-through share private placement	-	-	2,250	3,886
Common shares	13,398	38,183	-	-
Flow-through shares	2,100	5,985	-	-
Common shares on exercise of stock options	600	1,794	-	-
	<b>144,848</b>	<b>498,488</b>	128,750	455,928
Share issue costs, net of taxes of \$729 (2010 - \$1,178)	-	(2,113)	-	(3,402)
Balance, end of period	<b>144,848</b>	<b>496,375</b>	128,750	452,526

On March 17, 2011, the Company completed the sale of 13,398 common voting shares at a price of \$2.85 per share for total proceeds of \$38,183.

On March 17, 2011, the Company completed the sale of 2,100 common voting shares on a CEE "flow-through" basis at \$3.50 per share for total gross proceeds of \$7,350. Under the terms of the respective agreements, Cequence is required to renounce \$7,350 of CEE expenditures in February 2012. The qualifying CEE expenditures must be incurred by December 31, 2012 pursuant to the terms of the related agreements. As at June 30, 2011, the Company has incurred \$5,000 of the qualifying CEE expenditures. In accordance with IFRS, the above transaction resulted in an increase to share capital of \$5,985 and the recognition of an obligation related to flow-through shares of \$1,365 included with accounts payable and accrued liabilities in the condensed consolidated balance sheet at June 30, 2011.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

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### 13. SHARE CAPITAL (Continued)

On June 20, 2011, a total of 600 stock options were exercised resulting in the issuance of 600 common voting shares at \$1.99 per share for total gross proceeds of \$1,194. The exercise of stock options further resulted in a reduction to contributed surplus of \$600 and a commensurate increase to share capital to account for stock based compensation previously expensed related to the exercised options.

As at June 30, 2011, there were no issued or outstanding non-voting shares (December 31, 2010 – none).

### 14. STOCK BASED COMPENSATION PLANS

The Company has a stock option plan for directors, officers, employees and consultants of the Company and its subsidiaries. The number of common shares granted with respect to options may not exceed a rolling maximum of 10 percent of the Company's outstanding common shares. Options typically vest over a three year period, expire five years from the date of grant and are settled by issuing shares of the Company.

During the six months ended June 30, 2011, the Company issued 1,985 stock options at prices ranging from \$2.96 to \$3.81 to employees and directors. The options have a five year life and one third vest annually commencing one year following the grant date. The Company utilized a Black-Scholes option pricing model to price the options. During the six months ended June 30, 2011, 240 options were forfeited and 600 options were exercised.

A summary of the inputs used to value stock options is as follows:

	June 30, 2011 \$	December 31, 2010 \$
Risk-free interest rate	2.3% - 2.8%	1.9% - 2.9%
Expected life of options	5 years	5 years
Expected volatility	60%	50% - 60%
Expected dividend rate	0%	0%
Expected forfeiture rate	15%	6% - 15%
Weighted average fair value	\$1.96	\$1.00

Expected volatility is determined by reference to the Company's industry peers as, due largely to changes in the size and structure of the Company in recent years, this was determined to be a more meaningful measure than the historical volatility of the Company's shares.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 14. STOCK BASED COMPENSATION PLANS (Continued)

A summary of the status of the Company's stock option plan and changes during the six months ended June 30, 2011 and year ended December 31, 2010 is as follows:

	June 30, 2011		December 31, 2010	
	Number of Options (000's)	Weighted Average Exercise Price, \$	Number of Options (000's)	Weighted Average Exercise Price, \$
Outstanding, beginning of period	9,713	1.99	839	4.40
Granted	1,985	3.74	10,958	1.92
Cancelled	-	-	(880)	3.50
Forfeited	(240)	1.99	(1,204)	2.72
Exercised (Note 13)	(600)	1.99	-	-
Outstanding, end of period	10,858	2.31	9,713	1.99

The following table summarizes information about stock options outstanding at June 30, 2011:

Range of Exercise Price, \$	Options Outstanding		Options Exercisable		
	Weighted Average Exercise Price, \$	Number of Options Outstanding (000's)	Weighted Average Contractual Life Remaining (years)	Number of Options (000's)	Weighted Average Exercise Price, \$
1.76 – 1.99	1.98	8,868	4.2	-	-
2.96 – 3.81	3.74	1,985	4.8	-	-
8.36	8.36	5	6.3	4	8.36
	2.31	10,858	4.3	4	8.36

During the six months ended June 30, 2011, \$3,481 (2010 - \$473) in compensation expense related to equity-settled stock options has been recognized in the condensed consolidated statement of comprehensive income (loss).

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 15. LOSS PER SHARE

Comprehensive loss per share has been calculated based on the weighted average number of common shares outstanding during the period. The following table reconciles the denominators used for the basic and diluted comprehensive loss per share calculations. No stock options or warrants have been included in the calculation of diluted shares outstanding for the three and six months ended June 30, 2011 (2010 – none) as their inclusion would be anti-dilutive.

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Basic weighted average shares	144,314	42,048	137,774	40,796
Effect of dilutive stock options and warrants	-	-	-	-
Diluted weighted average shares	144,314	42,048	137,774	40,796

### 16. CONTINGENCIES AND COMMITMENTS

	2011	2012	2013	2014	2015	Total
Office leases	\$ 732	1,451	1,341	1,106	281	\$ 4,911
Subleases	(107)	(40)	-	-	-	(147)
Pipeline transportation	838	1,663	1,663	1,663	1,522	7,349
Total	\$ 1,463	3,074	3,004	2,769	1,803	\$ 12,113

The Company has a pipeline transportation contract that expires on November 30, 2015.

During the period ended June 30, 2011, the Company entered into a drilling service agreement whereby the Company made a deposit of \$3,500 to obtain a right of first refusal on the use of two drilling rigs over the five years following the date that use of the rigs commences. The deposit is to be drawn down as the Company incurs costs related to the use of the drilling rigs and Cequence expects to reduce the deposit by \$552 in the twelve months ended June 30, 2012, which amount is included with deposits and prepaid expenses in the condensed consolidated balance sheet. The portion of the outstanding deposit expected to be drawn down in the period subsequent to June 30, 2012 of \$2,948 is carried as a non-current asset in the condensed consolidated balance sheet as at June 30, 2011.

During the six months ended June 30, 2011, the Company recognized \$519 (June 30, 2010 – \$303) of expense related to office leases, included with general and administrative expense in the condensed consolidated statement of comprehensive income (loss).

### 17. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company's financial instruments, including derivative financial instruments and embedded derivative financial instruments, recognized in the condensed consolidated balance sheet consist of cash, accounts receivable, commodity contracts, demand credit facilities and accounts payable and accrued liabilities.

The Company's accounts receivable, demand credit facilities and accounts payable and accrued liabilities approximate their carrying values due to their short terms to maturity and the floating interest rate on the Company's debt.

# CEQUENCE ENERGY LTD.

## Notes to the Condensed Consolidated Financial Statements

Three and six month periods ended June 30, 2011 with 2010 comparatives

(All figures expressed in thousands except per share amounts unless otherwise noted)

### 17. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (Continued)

The Company's fair value hierarchy for those assets and liabilities measured at fair value as of June 30, 2011 comprises cash, which is considered a level 1 financial instrument and commodity contracts. Cequence's commodity contracts are measured at level 2 under the Company's fair value hierarchy as of June 30, 2011. The fair value of commodity contracts is determined by discounting the difference between the contracted price and published forward price curves as at the balance sheet date, using the remaining contracted petroleum and natural gas volumes at a credit-adjusted risk-free rate of 6 percent.

The Company has exposure to market risk, credit risk and liquidity risk from its use of financial instruments. There have not been any changes to the Company's exposure to risks, or the objectives, policies and processes to manage these risks from December 31, 2010 other than as noted below:

The Company entered into a commodity derivative financial instrument contract effective February 1, 2011. The following information presents all outstanding positions for commodity derivative financial instruments at June 30, 2011.

	Volume	Price	Basis
February 1, 2011 to December 31, 2011	5,000 GJ/day	\$3.83	AECO

For the six months ended June 30, 2011 realized gains from commodity derivative contracts recognized in comprehensive income (loss) were \$176 compared to a gain of \$1,772 in the six months ended June 30, 2010.

The fair value of the commodity contracts outstanding at June 30, 2011 was an asset of \$140 (December 31, 2010 - \$nil; January 1, 2010 - \$1,420). For the six months ended June 30, 2011 the Company recorded an unrealized gain of \$140 from derivative commodity contracts compared to a loss of \$1,462 for the six months ended June 30, 2010. An estimate of credit risk has been made in the valuation of all derivative commodity contracts.

As at June 30, 2011, an increase in gas price of \$0.50/gj results in a decrease in the fair value of the commodity contract of \$432 (\$318 after tax) and a commensurate increase to comprehensive income (loss).

### 18. CHANGES IN NON-CASH WORKING CAPITAL

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Accounts receivable	(3,461)	1,887	(849)	2,278
Deposits and prepaid expenses	(4,350)	379	(4,152)	340
Accounts payable and accrued liabilities	(20,758)	(14,104)	564	(10,395)
Net change in non-cash working capital	(28,569)	(11,838)	(4,437)	(7,777)
Allocated to:				
Operating activities	(4,380)	(3,200)	(2,293)	(6,683)
Investing activities	(24,189)	(8,638)	(2,144)	(1,094)
	(28,569)	(11,838)	(4,437)	(7,777)

# **CEQUENCE ENERGY LTD.**

## **Notes to the Condensed Consolidated Financial Statements**

**Three and six month periods ended June 30, 2011 with 2010 comparatives**

**(All figures expressed in thousands except per share amounts unless otherwise noted)**

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### **19. SUBSEQUENT EVENTS**

On August 11, 2011, Cequence filed a short form prospectus to qualify the distribution of 10,400 common voting shares at \$3.85 per share for gross proceeds of \$40,040 and 2,110 common voting shares on a CEE “flow-through” basis at \$4.75 per share for gross proceeds of \$10,023. The sale is to occur on a bought deal basis with gross proceeds totalling \$50,063 and is expected to close on August 18, 2011. Cequence further granted the underwriters an over-allotment option to purchase an additional 1,560 common voting shares at \$3.85 per share for gross proceeds of \$6,006, for a period of up to 30 days following the closing of the offering. There can be no assurance that the over-allotment option will be exercised.

On August 11, 2011, Cequence completed the sale of certain non-core oil and gas properties in Northeast British Columbia for total cash consideration of \$14,000, subject to adjustments.