

Consolidated Financial Statements
(Expressed in United States dollars)

BUCKING HORSE ENERGY INC.

Four months ended December 31, 2008
Year ended August 31, 2008



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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Bucking Horse Energy Inc. as at December 31, 2008 and August 31, 2008 and the consolidated statements of operations and retained earnings (deficit), comprehensive loss, accumulated other comprehensive income (loss) and cash flows for the four months ended December 31, 2008 and the year ended August 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and August 31, 2008 and the results of its operations and its cash flows for the four months ended December 31, 2008 and the year ended August 31, 2008 in accordance with Canadian generally accepted accounting principles.

Chartered Accountants

Vancouver, Canada

March 27, 2009

BUCKING HORSE ENERGY INC.

Consolidated Balance Sheets
(Expressed in United States dollars)

	December 31, 2008	August 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	\$ 8,867,314	\$ 5,391,123
Accounts receivable	2,385,081	2,388,437
Promissory note (note 4)	3,734,738	4,090,058
Prepaid expenses (note 13)	148	37,813
Benefit under derivative instruments (note 5(b))	4,333,497	2,927,776
Income tax recoverable	2,780,956	1,294,877
	<u>22,101,734</u>	<u>16,130,084</u>
Investments (note 6)	274,213	244,103
Oil and natural gas properties (note 7)	148,295,535	160,578,150
Long-term prepaids (note 13)	-	300,000
	<u>\$ 170,671,482</u>	<u>\$ 177,252,337</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 4,193,096	\$ 1,081,911
State resource taxes payable	978,826	647,698
	<u>5,171,922</u>	<u>1,729,609</u>
Non-current liabilities:		
Long-term credit facility (note 8)	18,500,000	13,500,000
State resource taxes payable	581,774	903,831
Convertible debentures (note 9)	20,588,752	23,273,493
Asset retirement obligations (note 10)	69,176	44,066
Future income taxes (note 14)	48,892,325	54,374,732
	<u>88,632,027</u>	<u>92,096,122</u>
Shareholders' equity:		
Share capital (note 12)	61,648,395	61,708,718
Equity portion of debentures payable (note 9)	25,329,139	25,329,139
Accumulated other comprehensive income (loss)	(11,239,809)	(3,203,146)
Retained earnings (deficit)	1,129,808	(408,105)
	<u>76,867,533</u>	<u>83,426,606</u>
Contingency (note 16)		
	<u>\$ 170,671,482</u>	<u>\$ 177,252,337</u>

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:

"Gordon Nielsen" Director

"Michael Schoen" Director

BUCKING HORSE ENERGY INC.

Consolidated Statements of Operations and Retained Earnings (Deficit)
(Expressed in United States dollars)

	Four months ended December 31, 2008	Year ended August 31, 2008
Revenue:		
Oil and natural gas revenue	\$ 4,085,774	\$ 15,693,354
Direct expenses:		
Depletion, depreciation and accretion	1,828,947	4,248,956
State resource taxes	348,261	1,651,499
Royalties	33,180	106,450
Operating expenses	1,690,815	2,845,718
	3,901,203	8,852,623
	184,571	6,840,731
Other expenses (income):		
Interest and other	(191,471)	(388,520)
Interest expense	2,349,097	3,648,260
Financing fees	-	325,000
Accretion expense (note 9)	295,681	929,215
General and administrative	396,895	901,529
Professional fees	412,767	685,870
Foreign exchange loss (gain)	(196,559)	173,751
Realized loss (gain) on derivative instruments (note 5(b))	(2,315,180)	88,040
Unrealized gain on derivative instruments (note 5(b))	(1,405,721)	(2,927,776)
Loss on investments (note 6)	7,520	474,265
	(646,971)	3,909,634
Earnings before income taxes	831,542	2,931,097
Income tax expense (recovery) (note 14):		
Current	(286,958)	1,150,315
Future	(480,974)	1,625,957
	(767,932)	2,776,272
Net earnings for the period	1,599,474	154,825
Deficit, beginning of period	(408,105)	(346,172)
Excess on cancellation of issued common shares (note 12(a))	(61,561)	(216,758)
Retained earnings (deficit), end of period	\$ 1,129,808	\$ (408,105)
Basic and diluted net earnings (loss) per common share (note 11)	\$ 0.07	\$ 0.01
Weighted average number of shares outstanding	23,011,045	15,567,746

See accompanying notes to consolidated financial statements.

BUCKING HORSE ENERGY INC.

Consolidated Statements of Comprehensive Loss
(Expressed in United States dollars)

	Four months ended December 31, 2008	Year ended August 31, 2008
Net earnings for the period	\$ 1,599,474	\$ 154,825
Unrealized loss on available for sale investments, net of tax of \$23,761 (2007 - \$65,277)	(159,014)	(355,867)
Realized loss on available for sale investments, net of tax of \$65,277	-	355,867
Unrealized gains and losses on translating financial statements into reporting currency	(7,877,649)	(3,299,228)
Comprehensive loss for the period	\$ (6,437,189)	\$ (3,144,403)

Consolidated Statements of Accumulated Other Comprehensive Income (Loss)
(Expressed in United States dollars)

	Four months ended December 31, 2008	Year ended August 31, 2008
Accumulated other comprehensive income (loss), beginning of period:	\$ (3,203,146)	\$ -
Opening unrealized gains and losses on translating financial statements into reporting currency (note 2)	-	96,082
Unrealized gains and losses on translating financial statements into reporting currency	(7,877,649)	(3,299,228)
Unrealized loss on available for sale investments, net of tax of \$23,761	(159,014)	(355,867)
Realized loss on available for sale investments, net of tax of \$65,277	-	355,867
Accumulated other comprehensive income (loss), end of period	\$ (11,239,809)	\$ (3,203,146)

See accompanying notes to consolidated financial statements.

BUCKING HORSE ENERGY INC.

Consolidated Statements of Cash Flows
(Expressed in United States dollars)

	Four months ended December 31, 2008	Year ended August 31, 2008
Cash and cash equivalent provided by (used in):		
Operations:		
Net earnings for the period	\$ 1,599,474	\$ 154,825
Items not involving cash:		
Depletion, depreciation and accretion	1,828,947	4,248,956
Accretion expense	295,681	929,215
Future income taxes	(480,974)	1,625,957
Loss on investments (note 6)	7,520	474,265
Unrealized gain on derivative instruments (note 5(b))	(1,405,721)	(2,927,776)
Unrealized foreign exchange gain	(155,021)	(274,799)
Non-cash interest income on promissory note	(172,976)	(289,853)
Changes in non-cash operating working capital:		
Accounts receivable	(313,071)	853,778
Prepaid expenses	305,996	(334,433)
Income taxes recoverable	(1,715,367)	103,917
Accounts payable and accrued liabilities	3,375,310	(3,840,417)
State resource taxes payable	215,058	925,162
	3,384,856	1,648,797
Investments:		
Acquisition of Gemini Energy Corp. (note 4)	-	(19,172,431)
Oil and gas property expenditures	(4,576,777)	(1,501,379)
Proceeds on sale of investment	-	397,659
Acquisition of investments	(254,085)	(235,272)
	(4,830,862)	(20,511,423)
Financing:		
Long-term credit facility	5,000,000	13,500,000
Issuance of convertible debenture (note 4)	-	1,707,307
Shares purchased for return to treasury (note 12(a))	(121,884)	(339,140)
Issuance of common shares (note 12(a))	-	8,094,709
	4,878,116	22,962,876
Effect of foreign currency translation on cash and cash equivalents	44,081	557,608
Increase in cash and cash equivalents	3,476,191	4,657,858
Cash and cash equivalents, beginning of period	5,391,123	733,265
Cash and cash equivalents, end of period	\$ 8,867,314	\$ 5,391,123

Supplementary information (note 15)

See accompanying notes to consolidated financial statements.

BUCKING HORSE ENERGY INC.

Notes to Consolidated Financial Statements
(Expressed in United States dollars, unless otherwise noted)

Four months ended December 31, 2008
Year ended August 31, 2008

1. Nature of operations:

NRG Investments Inc. was incorporated under the laws of British Columbia, Canada on April 28, 2006. Effective March 4, 2008 the Company changed its name to Bucking Horse Energy Inc. (the Company or Bucking Horse) and acquired Gemini Energy Corp. (Gemini) and its wholly-owned subsidiary, Arrowhead Resources (U.S.A.) Ltd. (Arrowhead), through the purchase of 100% of the issued and outstanding shares of Gemini (note 4).

The Company's principal business activity is the exploration, development and production of petroleum and natural gas reserves located in Canada and the United States of America.

An assumption underlying the preparation of financial statements in accordance with Canadian generally accepted accounting principles is that the Company will be able to realize assets and discharge liabilities in the normal course of business.

From September 1, 2008 to March 1, 2009, natural gas prices declined by 62.60% (based on the Panhandle Eastern Pipeline Company price index). Management has reviewed the consequence of this decrease and its impact on future cash flows and determined that the Company will continue to maintain profitable operations for the foreseeable future.

Accordingly, it is managements' opinion that the going concern assumption is appropriate and all assets and liabilities have been valued accordingly.

2. Change in reporting currency:

Effective March 4, 2008, the Company changed its reporting currency to the US dollar (USD). This change in reporting currency has been adopted due to the Company's primary focus on acquisition, exploration, development and production of natural gas and oil interests in the United States. Prior to March 4, 2008, the Company reported its annual and quarterly consolidated financial statements in Canadian dollars (CAD). In making this change in reporting currency, the Company followed the recommendations of the Emerging Issues Committee (EIC) of the Canadian Institute of Chartered Accountants (CICA), set out in EIC-130, *Translation Method when the Reporting Currency Differs from the Measurement Currency or there is a Change in the Reporting Currency*.

3. Significant accounting policies:

(a) Basis of consolidation:

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles. The consolidated financial statements of the Company include its wholly-owned subsidiaries NRG Holdings Corp., incorporated in the State of Nevada, N Holdings Inc., incorporated in the State of Washington and Gemini, incorporated in the Province of British Columbia and its wholly-owned subsidiary, Arrowhead, incorporated in the State of South Dakota. All inter-company transactions and balances have been eliminated upon consolidation.

BUCKING HORSE ENERGY INC.

Notes to Consolidated Financial Statements
(Expressed in United States dollars, unless otherwise noted)

Four months ended December 31, 2008
Year ended August 31, 2008

3. Significant accounting policies (continued):

(b) Adoption of new accounting standards:

(i) Accounting changes:

Effective September 1, 2008, the Company adopted the following new CICA accounting standards:

(A) CICA Handbook Section 1535, *Capital Disclosures*:

This Section requires additional disclosures of: (1) an equity's objectives, policies and processes for managing capital; (2) quantitative data about what the entity regards as capital; (3) whether the entity has complied with any capital requirements; and (4) if it has not complied, the consequences of such non-compliance. Refer to note 18 for additional disclosures.

(B) Revision to CICA Handbook Section 1400, *General Standards of Financial Statement Presentation*:

This revision requires management to assess and disclose an entity's ability to continue as a going concern. Refer to note 1 for additional disclosures.

(C) CICA Handbook Section 3862, *Financial Instruments - Disclosure*, and CICA Handbook Section 3863, *Financial Instruments - Presentation*:

These new Sections revise and enhance the disclosure requirements and carry forward the presentation requirements for financial instruments from CICA Handbook Section 3861, *Financial Instruments – Disclosure and Presentation*. The significance of financial instruments for the entity's financial position and performance, the nature and extent of the risks arising from financial instruments and how these risks are managed are emphasized. Refer to note 17 for additional disclosures.

(c) Cash and cash equivalents:

Cash and cash equivalents are classified or designated as held-for-trading and include short-term money market instruments with terms to maturity, at the date of acquisition, not exceeding ninety days, that are readily convertible to known amounts of cash, and which are subject to an insignificant risk of change in value.

BUCKING HORSE ENERGY INC.

Notes to Consolidated Financial Statements
(Expressed in United States dollars, unless otherwise noted)

Four months ended December 31, 2008
Year ended August 31, 2008

3. Significant accounting policies (continued):

(d) Financial instruments:

(i) Financial instruments:

Financial assets and liabilities classified as held-for-trading are measured at fair value with realized and unrealized gains and losses recognized in net earnings. Financial assets classified as held-to-maturity, loans and receivables, and financial liabilities other than those classified as held-for-trading, are initially measured at fair value and subsequently measured at amortized cost. Financial assets classified as available for sale are measured at fair value with unrealized gains or losses recognized in accumulated other comprehensive income until the asset is sold and the gain or loss realized. Generally, all derivatives, including embedded derivatives that must be accounted for separately from their host contract, must be classified as held-for-trading and recorded at fair value in the consolidated balance sheet. Transaction costs for financial instruments classified as other than held-for-trading are expensed as incurred.

The Company classified or designated its financial instruments as follows:

Cash and cash equivalents	held for trading
Accounts receivable	loans and receivables
Promissory note	loans and receivables
Benefit under derivative financial instrument	held for trading
Investment in shares of a related entity	available for sale
Investment in warrants of a related entity	held for trading
Accounts payable and accrued expenses	other financial liabilities
Amounts payable to related parties	other financial liabilities
Convertible debentures	other financial liabilities
Long-term credit facility	other financial liabilities
Embedded derivatives	held for trading

(ii) Embedded derivatives:

The Company has not identified embedded derivatives other than the conversion option in the convertible debentures (note 9) to be separately accounted for at December 31, 2008.

(iii) Derivative financial instruments:

The Company utilizes derivative financial instruments to manage foreign exchange and price risk as described in note 5(b). Derivative financial instruments are measured at fair value with gains and losses recorded in net earnings (loss) for the year.

BUCKING HORSE ENERGY INC.

Notes to Consolidated Financial Statements
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Four months ended December 31, 2008
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3. Significant accounting policies (continued):

(e) Investments:

Investments include investments in shares and warrants of companies as described in note 6. The Company's investments in shares of related entities are classified as available-for-sale and are measured at fair value. The Company's investment in warrants of a related entity is classified as held-for-trading and is measured at fair value with gains and losses recorded through the statement of operations. The carrying values of the investments are regularly reviewed for impairment that is considered other than temporary. When there is a decline in value that is other than temporary, the investment is written down to recognize the loss with the writedown recorded as a charge to income.

(f) Oil and natural gas properties:

The Company follows the full cost method of accounting for oil and natural gas operations whereby all costs associated with the acquisition, exploration for and development of oil and natural gas reserves are capitalized. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling both productive and non-productive wells and overhead charges directly related to acquisition, exploration and development activities.

The capitalized costs, together with the costs of production equipment, are depleted and depreciated on the unit-of-production method based on the estimated gross proven reserves as determined by external experts. Oil and natural gas reserves and production are converted into equivalent barrels of oil based upon the estimated relative energy content.

Costs of acquiring and evaluating unproven properties are initially excluded from the costs subject to depletion and depreciation. These unproven properties are assessed periodically to ascertain whether or not proved reserves are attributable to the properties or impairment has occurred. When proved reserves are attributed to the unproven properties or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to the costs subject to depletion and depreciation.

The Company evaluates the carrying amounts for impairment annually. The carrying value is not considered to be impaired when the sum of the undiscounted net cash flows expected from the production of proved reserves, less any impairment, of unproved properties and related major development projects exceeds the carrying amount of the cost centre (the "ceiling test"). When the carrying amount is not determined to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted net cash flows expected from the production of proved and probable reserves, the cost, less any impairment of unproven properties and related major development projects. The cash flows are estimated using expected future product prices and costs based on best information available and are discounted at an interest rate of 10%.

Proceeds from the sale of oil and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion and depreciation.

BUCKING HORSE ENERGY INC.

Notes to Consolidated Financial Statements
(Expressed in United States dollars, unless otherwise noted)

Four months ended December 31, 2008
Year ended August 31, 2008

3. Significant accounting policies (continued):

(f) Oil and natural gas properties (continued):

Substantially all of the Company's exploration, development and production activities are conducted jointly with others and accordingly these consolidated financial statements reflect only the Company's proportionate interest in such activities.

(g) Asset retirement obligations:

The Company uses the fair value method of recording the obligation associated with closure, reclamation and restoration of oil and natural gas properties and other asset retirement costs. The fair value of the liability for the Company's asset retirement obligation is recorded in the period in which it is incurred, discounted to its present value using the Company's credit-adjusted, risk-free interest rate and the corresponding amount is capitalized to the carrying amount of the related oil and natural gas properties. The liability amount is increased each reporting period due to the passage of time and the amount of this accretion is charged to earnings in the period. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost could also result in an increase or decrease to the obligation. Actual costs incurred upon settlement of the retirement obligation are charged against the obligation to the extent of the liability recorded.

(h) Revenue recognition:

Revenues from oil and natural gas operations are recognized when persuasive evidence of a sales agreement exists, the title and risk is transferred to the customer, collection is reasonably assured, and the price is reasonably determinable.

(i) Foreign currency translation:

The Company's functional currency is Canadian dollars and its reporting currency is U.S. dollars. Accordingly, the consolidated financial statements are translated into U.S. dollars using the current rate method.

The Company's investments in NRG Holdings Corp. and N Holdings Inc. are accounted for as integrated foreign operations and accordingly are translated into Canadian dollars using the temporal method. Under this method, monetary items denominated in foreign currencies are translated to Canadian dollars at the exchange rate in effect at the balance sheet date and non-monetary items are translated at the month end rate of exchange in effect when the assets were acquired or obligations incurred. Revenue and expense items are translated at the average exchange rate for the year. Foreign exchange gains and losses are included in net earnings (loss) for the year.

Arrowhead is accounted for as a self sustaining foreign operation and accordingly is translated into Canadian dollars in accordance with the current rate method. Assets and liabilities are translated at the exchange rates prevailing at the balance sheet dates, and revenue and expenses are translated on the basis of average exchange rates during the periods. Any recognized and unrecognized gains or losses arising from the translation of these accounts are recorded in accumulated other comprehensive income (loss). An applicable portion of gains and losses is transferred to net earnings when there is a reduction of the net investment.

BUCKING HORSE ENERGY INC.

Notes to Consolidated Financial Statements
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3. Significant accounting policies (continued):

(j) Stock-based compensation:

The Company has a stock option plan, which is described in note 12(b). The Company accounts for all stock-based payments using the fair value based method. Consideration paid on the exercise of stock options is recorded as share capital.

Under the fair value based method, stock-based payments to non-employees are measured at the fair value of the consideration received, or the fair value of the equity instruments issued, or liabilities incurred, whichever is more reliably measurable. The fair value of stock-based payments to non-employees is periodically re-measured until counterparty performance is complete, and any change therein is recognized over the period and in the same manner as if the Company had paid cash instead of paying with or using equity instruments. The cost of stock-based payments to non-employees that are fully vested and non-forfeitable at the grant date is measured and recognized at that date.

Under the fair value based method, compensation cost for grants to employees is measured at fair value at the grant date and recognized over the vesting period. For awards that vest at the end of the vesting period, compensation cost is recognized on a straight-line basis; for awards that vest on a graded basis, compensation cost is recognized on a pro-rata basis over the vesting period.

(k) Earnings per share:

Basic earnings per share are computed by dividing net earnings (loss) by the weighted average number of shares outstanding during the year. Diluted earnings per share are computed using the treasury stock method.

(l) Income taxes:

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is recorded against any future income tax asset if it is more likely than not that the asset will not be realized. The effect on future tax assets and liabilities of a change in tax rates is recognized in earnings in the same period the substantive enactment occurred.

(m) Use of estimates:

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant areas requiring the use of estimates is the evaluation of impairment of oil and natural gas properties, valuation of financial instruments, determination of asset retirement obligation, valuation allowance applied against the future income taxes assets and rates for depreciation and depletion. Actual results could differ from those estimates.

BUCKING HORSE ENERGY INC.

Notes to Consolidated Financial Statements
(Expressed in United States dollars, unless otherwise noted)

Four months ended December 31, 2008
Year ended August 31, 2008

3. Significant accounting policies (continued):

(n) Comparative figures:

Certain of the Company's comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.

(o) Recent accounting pronouncements:

(i) International Financial Reporting Standards (IFRS):

In 2006, the Canadian Accounting Standards Board (AcSB) published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian generally accepted accounting principles with IFRS over an expected five year transitional period. In February 2008, the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canada's own generally accepted accounting principles. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The transition date of January 1, 2011 will require the restatement for comparative purposes of amounts reported by the Company for the year ended December 31, 2010. While the Company has begun assessing the adoption of IFRS for 2011, the financial reporting impact of the transition to IFRS cannot be reasonably estimated at this time.

4. Business combination:

On March 4, 2008, Bucking Horse closed an arrangement transaction (the Arrangement), pursuant to which it acquired 100% of the issued and outstanding shares and options of Gemini. The assets and liabilities of Gemini and its wholly-owned subsidiary Arrowhead, were recorded at their fair values using the purchase method of accounting.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition.

Purchase price:	
Issue of 12,836,713 common shares of Bucking Horse	\$ 51,572,778
Cash	19,959,029
Reduction in promissory note	9,537,381
Issue of convertible debentures	47,508,293
Acquisition costs	290,007
	<hr/>
	\$ 128,867,488

BUCKING HORSE ENERGY INC.

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Four months ended December 31, 2008
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4. Business combination (continued):

Net assets acquired:	
Cash and cash equivalents	\$ 1,076,605
Promissory note	15,106,980
Accounts receivable	3,290,390
Income tax receivable	1,490,340
Oil and gas properties	168,269,586
Investments (note 6)	918,552
Accounts payable and accrued liabilities	(5,832,168)
Asset retirement obligations	(41,144)
Future income taxes	(55,411,653)
	<hr/>
	\$ 128,867,488

Under the terms of the Arrangement, Bucking Horse acquired all of the 24,608,642 issued and outstanding common shares of Gemini and all of the 320,000 existing stock options. The acquisition was funded through the issuance of common shares of the Company, the issuance of convertible debentures, the reduction of a promissory note receivable, the draw down of the credit facility and the remainder in cash as described further below. Gemini will survive as a wholly owned subsidiary of the Company and its shares are now delisted from the TSX.

Prior to closing the Arrangement, Gemini had four secured convertible debentures outstanding held by two major shareholders of the Company (the Debenture Holders), each in the principal amount of CAD\$5,000,000. Prior to the Arrangement, Gemini was a related party of the Company as the Debenture Holders were also significant shareholders of Gemini. Two of these debentures were issued in March 2004 (the March Debentures) and the other two were issued in August 2004 (the August Debentures).

The March Debentures were convertible into units of Gemini at a conversion price of CAD\$2.50 per unit, with each unit consisting of one Gemini common share and one share purchase warrant. Each of the March Debentures was converted concurrent with the closing of the Arrangement and the shares issued upon conversion were sold to the Company, together with the share purchase warrants, for the total sum of \$19,083,600 (CAD\$19,000,000), as contemplated under the Arrangement. The \$19,083,600 was paid by the issuance of two new convertible debentures by the Company (note 9).

The August Debentures were convertible into Gemini units at a conversion price of CAD\$4.00 per unit. The August Debentures were cancelled and replaced with two new convertible debentures at the closing of the Arrangement for a total sum of \$10,044,000 (CAD\$10,000,000) having the same terms as the August Debentures, except that they are convertible into units of the Company (note 9).

At the closing of the Arrangement, two additional new debentures for the total sum of \$20,088,000 (CAD\$20,000,000) were issued to the Debenture Holders as consideration for the 2,500,000 and 2,075,043 Gemini shares acquired from the Debenture Holders at CAD\$4.00 per share and as consideration for the \$1,707,307 (CAD\$1,699,828) cash received from one of the Debenture Holders which was used to fund a portion of the cash required to complete the Arrangement (note 9).

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4. Business combination (continued):

As a result of the issuance of the new debentures and the assumption of the August Debentures, the Company has outstanding convertible debentures in the aggregate principal amount of \$49,215,600 (CAD\$49,000,000) held by the Debenture Holders (note 9).

Prior to closing the Arrangement, Gemini completed the sale of 12,000,000 common shares of XXL Energy Corp., (XXL) an entity related to the Company by virtue of common directors, to Q Investments Ltd. (QIL), a major shareholder of the Company which is controlled by the Debenture Holders. The total consideration of \$15,106,980 (CAD\$15,040,800) was initially paid by QIL's issuance of a promissory note in favour of Gemini which was acquired by the Company pursuant to the Arrangement. The amount owing under the promissory note was reduced by \$9,537,381 (CAD\$9,495,600) as consideration for the 2,373,900 Gemini shares acquired from QIL at CAD\$4.00 per share pursuant to the Arrangement. The amount owing under the promissory note was further reduced through the cancellation of the Company's pre-existing loan payable to QIL of \$1,506,600 (CAD\$1,500,000) together with accrued interest. The net remaining promissory note receivable from QIL of \$4,062,999 (CAD\$4,045,200) has a term of one year and bears interest at the rate of 15% per annum. The Company is currently in negotiations to extend the term of the promissory note. The promissory note is secured by a fixed charge over the XXL shares purchased by QIL. Interest of \$302,220 (CAD\$300,896) has been accrued at year end. The remaining 5,000,000 common shares and 150,000 warrants of XXL held by Gemini were acquired by the Company (note 6).

The Company issued 12,836,713 common shares of Bucking Horse to former Gemini shareholders, including 1,645,350 shares issued to one of the Debenture Holders, in exchange for 12,836,713 of the Gemini shares acquired at a deemed value of CAD\$4.00 per share for total consideration of \$51,572,778 (CAD\$51,346,852).

The Company paid cash of \$19,376,829 (CAD\$19,291,944) to acquire the remaining 4,822,986 of the Gemini shares. The Company also paid the aggregate sum of \$582,200 (CAD\$579,650) in exchange for the surrender and cancellation of existing Gemini stock options and incurred \$290,007 (CAD\$288,737) in transaction costs associated with the Arrangement.

5. Financial instruments:

(a) The carrying values of cash and cash equivalents, accounts receivable, promissory note and accounts payable and accrued liabilities approximate their fair values due to the short terms to maturity of these financial instruments.

The fair value of the long-term credit facility has been estimated by management by discounting the future contractual cash flows under current financing arrangements at discount rates which represent borrowing rates presently available to the Company for a loan with similar terms, risks and maturities. Management estimates that at December 31, 2008, the fair value of the long-term credit facility is approximately \$17 million. This reflects the actual interest rates incurred by the Company as being less than the equivalent current rates.

The fair value of the convertible debentures is not readily determinable due to their related party nature, and absence of a market for such investments.

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5. Financial instruments (continued):

(b) Derivative instruments:

The Company has entered into the following open commodity derivative financial contracts to manage price risk on a portion of its natural gas production for the periods referenced below.

Type	Volume MMBTU/Day	Contract period	Price US\$/MMBTU
Swap ⁽¹⁾	2,500	Calendar 2009	\$9.66 / MMBTU

⁽¹⁾ Panhandle Eastern basis

As at December 31, 2008, the unrealized gain on outstanding derivative financial contracts is \$4,303,247 (August 31, 2008 - \$2,927,776). The net gain on derivative financial contracts for the four months ended December 31, 2008 of \$3,720,901 (year ended August 31, 2008 - \$2,839,736) has been included in other income in the statement of operations.

The Company has engaged in currency hedging activities and on November 25, 2008 contracted to purchase CAD\$6,113,000 during calendar 2009 at a exchange rate of CAD\$1.2226 per US\$. The unrealized gain on the outstanding currency contracts is \$30,250 (August 31, 2008 – nil).

6. Investments:

	Four months ended December 31, 2008	Year ended August 31, 2008
Investment in shares of Giant Energy Limited (Giant)	\$ 205,254	\$ 235,272
Investment in warrants of XXL	466	8,831
Investment in shares of XXL	68,493	-
	<u>\$ 274,213</u>	<u>\$ 244,103</u>

On May 21, 2008, the Company participated in a private placement conducted by Giant pursuant to which the Company acquired 1,000,000 common shares of Giant at a price of CAD\$0.25 per shares for a total cost of \$235,272 (CAD\$250,000). This is a non-arm's length transaction by virtue of a common officer of both companies and a common shareholder. The investment in shares of Giant is carried at cost as there is no active market for Giant's shares.

As at December 31, 2008 and August 31, 2008 the Company holds 150,000 warrants of XXL each of which entitles the Company to purchase one common share of XXL at an exercise price of \$20.00 per share. The warrants expire August 18, 2010. XXL is a related party by virtue of common directors. These warrants are classified as held-for-trading and are marked-to-market on an ongoing basis with changes in fair value recognized in net earnings. The unrealized loss on the warrants of \$7,520 (August 31, 2008 - \$53,121) has also been included in other expenses during the year.

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6. Investments (continued):

The warrant's fair value was determined using the Black-Scholes model using the following assumptions:

Expected life	1.63 years
Volatility	134.6%
Risk free rate	1.09%
Dividend rate	0%

During the four months ended December 31, 2008, the Company acquired 333,700 common shares in XXL for a total purchase price of \$254,085 (CAD\$306,045). These shares are classified as available for sale and are marked to market on an ongoing basis with changes in fair value recognized in other comprehensive income, net of tax. The unrealized loss on the shares of \$182,775 has been included in other comprehensive loss, net of tax of \$23,761.

7. Oil and natural gas properties:

	Four months ended December 31, 2008	Year ended August 31, 2008
Proven, explored and impaired properties:		
Exploration and drilling costs	\$ 64,074,594	\$ 60,166,711
Acquisition and lease costs	83,269,064	98,147,394
Well equipment	7,311,890	6,811,694
Asset retirement	60,649	44,066
	154,716,197	165,169,865
Less accumulated depletion and depreciation	(6,420,662)	(4,591,715)
	\$ 148,295,535	\$ 160,578,150

For the four months ended December 31, 2008, the Company has not capitalized any general and administrative expenses.

The Company has agreements to participate in the exploration of certain oil and natural gas leases. Failure by the Company to pay its share of a proposed capital program could result in the dilution or forfeiture of the Company's interest in these properties.

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7. Oil and natural gas properties (continued):

The Company performed a ceiling test calculation at December 31, 2008 for its U.S. and Canadian properties to assess the recoverable value of its oil and natural gas properties. The oil and natural gas future prices for the December 31, 2008 ceiling test are based on the December 31, 2008 commodity price forecast of the Company's independent reserve evaluators. These prices reflect commodity price differentials specific to the Company. The following table summarizes the benchmark prices used in the ceiling test calculation. Based on these assumptions, the undiscounted value of future net revenues from the Company's proved reserves exceeded the carrying value of oil and natural gas properties at December 31, 2008 and accordingly no impairment was recorded.

Year	US Benchmark NYMEX WTI \$/US/BBL	US properties NGL / OIL \$/US/BBL	US Benchmark NYMEX GAS \$/US/MMBTU	Canadian properties GAS \$/US/MMBTU	properties GAS \$/US/MMBTU
2009	\$55.00	\$40.51	\$6.50	5.94	6.51
2010	\$76.50	\$61.70	\$7.65	6.52	7.53
2011	\$88.45	\$73.37	\$8.30	7.02	7.67
2012	\$100.80	\$85.41	\$9.55	8.18	8.45
2013	\$108.25	\$92.53	\$10.30	8.84	9.18
2014	\$110.40	\$94.38	\$10.50	8.9	9.37
2015	\$112.60	\$96.31	\$10.70	8.86	9.56
2016	\$114.85	\$98.19	\$10.90	9.01	9.76
2017	\$117.15	\$100.12	\$11.15	9.1	9.95
2018	\$119.50	\$102.20	\$11.35	9.48	0.00

Escalate thereafter at 2.0% per year

8. Long-term credit facility:

In connection with the Arrangement, Bucking Horse and Gemini (Guarantors) and Arrowhead (Borrower) entered into a credit agreement dated March 4, 2008 for a five year senior revolving credit facility in the aggregate principal amount of up to US\$100,000,000, with an initial borrowing base of US\$30,000,000, available pursuant to the terms set out in the Credit Agreement. The debt is secured by mortgages on the oil and gas properties of Arrowhead.

The facility has an interest rate that floats, based on both the bank prime rate and a spread, which will increase based on the percentage of availability drawn, resulting in a current interest rate of approximately 4.0% at December 31, 2008 (August 31, 2008 - 5.5%). The Company currently has drawn \$18,500,000 from the Credit Facility, of which \$10,500,000 was drawn on March 4, 2008 to fund a portion of the cash required to complete the Arrangement (note 4) and has \$11,500,000 left available as at December 31, 2008.

The Company is required to ensure that Arrowhead's interest coverage ratio is greater than 2.5 to 1.0, that Arrowhead's ratio of total indebtedness to earnings before interest income taxes, depletion, depreciation and accretion, and exploration expenses is greater than 3.5 to 1.0, and that the Company's current ratio is greater than 1.0 to 1.0.

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9. Convertible debentures:

	Four months ended December 31, 2008	Year ended August 31, 2008
First Debentures (a)	\$ 15,599,343	\$ 17,880,670
Second Debentures (b)	8,210,181	9,410,879
Third Debentures (c)	16,420,361	18,821,758
	40,229,885	46,113,307
Less cumulative accretion remaining	(19,641,133)	(22,839,814)
	\$ 20,588,752	\$ 23,273,493

- (a) On March 4, 2008 as part of the Arrangement, two convertible debentures (the First Debentures) were issued by the Company to the Debenture Holders. Each of the First Debentures is in the principal amount of \$8,940,335 (CAD\$9,500,000). The First Debentures mature on March 4, 2018, bear interest at a rate of 10% during the first six years and 15% during the remaining four years and are convertible into units during the first five years at a conversion price of CAD\$4.875 per unit and into shares at a conversion price of CAD\$4.875 per share during the last five years. Each unit consists of one common share of the Company and one share purchase warrant. Each share purchase warrant entitles the holder to purchase one additional common share of the Company for CAD\$4.875 until the fifth anniversary of the date of issuance, at which date these share purchase warrants will expire. The Debenture Holders may elect to accelerate the maturity date to the sixth anniversary date at any time during the first five years. Effective May 16, 2008, as a result of an interest rate acceleration provision, the interest rate applicable to the First Debentures increased from 10% to 15%.

Repayment of the First Debentures is guaranteed by the Company's subsidiary Arrowhead, which has provided a mortgage and security agreement to each of the Lenders which is subordinated to other debt under the credit facility. The First Debentures are redeemable by the Company upon thirty days written notice without penalty or bonus; however, the Debenture Holders may elect to convert all or any of the First Debentures during the thirty day notice period.

The equity portion of the First Debentures was assigned a total value of \$10,103,765 (CAD\$10,054,257) upon issuance of the First Debentures, which was recorded in equity portion of debentures payable. The First Debentures were initially recorded net of the Conversion Option and are being accreted to their face value over their term. For the four months ended December 31, 2008, accretion of \$78,243 (year ended August 31, 2008 - \$305,039) has been included in accretion expense. Accretion of the First Debentures is calculated using an effective interest rate of 39.36%.

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9. Convertible debentures (continued):

- (b) On March 4, 2008 as part of the Arrangement, two additional convertible debentures (the Second Debentures) were issued by the Company to Debenture Holders. Each of the Second Debentures is in the principal amount of \$4,705,439 (CAD\$5,000,000). The Second Debentures mature on August 4, 2014, bear interest at a rate of 10% up to August 4, 2010 and 15% during the last four years and are convertible into units up to August 4, 2009 at a conversion price of CAD\$4.00 per unit and into shares at a conversion price of CAD\$4.00 per share during the last five years. Each unit consists of one common share of the Company and one share purchase warrant. Each share purchase warrant entitles the holder to purchase one additional common share of the Company for CAD\$4.00 until August 4, 2009, at which date these share purchase warrants will expire. The Debenture Holders may elect to accelerate the maturity date to August 4, 2010 at any time up to August 4, 2009. Effective May 16, 2008, as a result of an interest rate acceleration provision, the interest rate applicable to the First Debentures increased from 10% to 15%.

Repayment of the Second Debentures is guaranteed by the Company's subsidiary Arrowhead, which has provided a mortgage and security agreement to each of the Lenders which is subordinated to other debt under the credit facility. The Second Debentures are redeemable by the Company upon thirty days written notice without penalty or bonus; however, the Debenture Holders may elect to convert all or any of the Second Debentures during the thirty day notice period.

The equity portion of the Second Debentures was assigned a total value of \$4,589,831 (CAD\$4,567,341) upon issuance of the Second Debentures, which was recorded in equity portion of debentures payable. The Second Debentures were initially recorded net of the Conversion Option and are being accreted to their face value over their term. For the four months ended December 31, 2008, accretion of \$135,077 (year ended August 31, 2008 - \$303,082) has been included in accretion expense. Accretion on the Second Debentures is calculated using an effective interest rate of 39.94%

- (c) On March 4, 2008 as part of the Arrangement, two more convertible debentures (the Third Debentures) were issued by the Company to the Debenture Holders. Each of the Third Debentures is in the principal amount of \$9,410,879 (CAD\$10,000,000). The Third Debentures mature on March 4, 2018, bear interest at a rate of 10% during the first six years and 15% during the last four years and are convertible into units during the first five years at a conversion price of CAD\$4.875 per unit and into shares at a conversion price of CAD\$4.875 per share during the last five years. Each unit consists of one common share of the Company and one share purchase warrant. Each share purchase warrant entitles the holder to purchase one additional common share of the Company for CAD\$4.875 until the fifth anniversary of the date of issuance, at which date these share purchase warrants will expire. The Debenture Holders may elect to accelerate the maturity date to the sixth anniversary date at any time during the first five years. Effective May 16, 2008, as a result of an interest rate acceleration provision, the interest rate applicable to the Third Debentures increased from 10% to 15%.

Repayment of the Third Debenture is guaranteed by the Company's subsidiary Arrowhead, which has provided a mortgage and security agreement to each of the Lenders which is subordinated to other debt under the credit facility. The Third Debentures are redeemable by the Company upon thirty days written notice without penalty or bonus; however, the Debenture Holders may elect to convert all or any of the Third Debentures during the thirty day notice period.

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9. Convertible debentures (continued):

(c) Continued:

The equity portion of the Third Debentures was assigned a total value of \$10,635,543 (CAD\$10,583,428) upon issuance of the Third Debentures, which was recorded in equity portion of debentures payable. The Third Debentures were initially recorded net of the Conversion Option and are being accreted to their face value over their term. For the four months ended December 31, 2008, accretion of \$82,361 (year ended August 31, 2008 - \$321,094) has been included in accretion expense. Accretion on the Third Debentures is calculated using an effective interest rate of 39.36%.

10. Asset retirement obligations:

The Company's asset retirement obligations result from net ownership interest in oil and gas properties including well sites, gathering systems and processing facilities. The Company estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately \$1,433,840. The majority of the costs will be incurred after 2050. An inflation factor of 2.0% has been applied to the estimated asset retirement costs. A rate of 10% was used to calculate the fair value of the asset retirement obligations. A reconciliation of the asset retirement obligations is provided below:

	Four months ended December 31, 2008	Year ended August 31, 2008
Balance, beginning of period	\$ 44,066	\$ 8,280
Additions during the period	18,225	34,357
Accretion expense	6,885	1,429
Balance, end of period	\$ 69,176	\$ 44,066

11. Earnings per share:

The conversion feature of the convertible debentures into 10,500,000 common shares would be anti-dilutive. Therefore, diluted net earnings (loss) per common share equals basic net earnings (loss) per common share.

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12. Share capital:

(a) Share transactions:

Authorized capital at December 31, 2008 and August 31, 2008 consists of unlimited common shares without par value.

Share transactions for the four months ended December 31, 2008 and year ended August 31, 2008 were as follows:

	Number of shares	Amount (net)
Balance, August 31, 2007	8,225,000	\$ 2,136,701
Shares issued for cash:		
Private placement	2,000,000	8,094,709
Plan of Arrangement	12,836,713	51,599,690
Shares repurchased	(44,700)	(122,382)
Balance, August 31, 2008	23,017,013	61,708,718
Shares repurchased	(22,500)	(60,323)
Balance, December 31, 2008	22,994,513	\$ 61,648,395

On March 3, 2008, the Company closed a private placement of 2,000,000 common shares at CAD\$4.00 per share, for gross proceeds of \$8,094,709 (CAD\$8,000,000). The proceeds from the private placement were used to provide a portion of the funds required to complete the Arrangement (note 4).

On March 4, 2008, the Company issued 12,836,713 shares to former Gemini shareholders at a deemed price of CAD\$4.00 per share for total consideration of \$51,599,690 (CAD\$51,346,852) in connection with the Arrangement (note 4).

During the year ended August 31, 2008, the Company repurchased 44,700 shares through a normal course issuer bid at a cost of \$122,382. The excess cost of the shares over the assigned value totaled \$216,758 and has been charged to retained earnings. The shares repurchased were cancelled November 17, 2008.

During the four months ended December 31, 2008, the Company repurchased 22,500 shares through a normal course issuer bid at a cost of \$121,884. The excess cost of the shares over the assigned value totaled \$61,561 and has been charged to retained earnings. The shares repurchased were cancelled and returned to treasury on November 17 (14,600 shares) and December 23, 2008 (7,900 shares).

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12. Share capital (continued):

(b) Stock option plan:

The Company has a stock option plan for its key employees, directors and certain other persons under certain conditions. Under the plan, options may be granted to purchase up to 10% of the outstanding shares of the Company to a maximum of 822,500 options. Options granted under the plan vest at a rate of 25% per year and expire five years after the date of grant. The exercise price of options granted may not be less than the closing trading price of the Company's shares on the last trading day preceding the date on which the options are granted. As at December 31, 2008 and August 31, 2008, no stock options have been issued under the plan.

The stock option plan was amended to increase the maximum number of options available to be granted to 2,306,000 options. The Company received regulatory approval December 1, 2008.

13. Related party transactions:

Related party transactions are in the normal course of operations and measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

Related party transactions are as follows:

	Four months ended December 31, 2008	Year ended August 31, 2008
General and administrative expenses:		
Office, rent, administration and professional services charged by a company controlled by one of the Debenture Holders	\$ 112,580	\$ 226,483
Oil and gas consulting, operational, technical and business management services provided by Giant which has a common officer and shareholder with Bucking Horse	247,850	228,995
Directors fees	1,706	7,947
Interest paid to Debenture Holders	2,089,552	3,124,352
Interest paid on a loan to a Company with a common director	-	115,436

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13. Related party transactions (continued):

Amounts due to or prepaid to related parties are as follows:

	Four months ended December 31, 2008	Year ended August 31, 2008
General and administrative expenses:		
Prepayment of fees for office, rent, administration and professional services	\$ 148	\$ 37,813
Long-term prepaid to Giant providing oil and gas consulting, operational, technical and business management services.	-	300,000
Amount receivable from Giant providing oil and gas consulting, operational, technical and business management services	275,436	-
Amount payable to related party providing oil and gas consulting, operational, technical and business management services as at August 31, 2008.	-	74,928

In addition to the amount receivable from Giant, the Company has an investment in Giant shares as disclosed in note 6. The Company terminated its agreement with Giant during the period under which Giant provided oil and gas consulting, operations, technical and business management services to the Company. The Company is currently in negotiations with Giant in respect of recovering the amount receivable as at December 31, 2008. There is no active market for the Company's investment in Giant shares. Therefore, the recoverability of the amount due from Giant is dependent upon the profitable operation of its business and/or the ability of Giant to raise additional financing.

On November 10, 2006, the Company entered into a loan agreement with QIL pursuant to which QIL provided the Company with a loan in the principal amount of \$1,327,434 (CAD\$1,500,000). The loan was cancelled as part of the Arrangement. As part of the Arrangement, a promissory note was given by QIL to the Company for a principal amount of \$15,106,980 (note 4). The recoverability of this amount is dependent upon the profitable operation of its business and/or the ability of QIL to raise additional financing.

Other related party transactions are disclosed in notes 4, 6 and 9.

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14. Income taxes:

The Company's provision for income taxes differs from the amounts computed by applying a combined US and Canadian income tax rate of 41% (August 31, 2008 - 34%) for the following reasons:

	Four months ended December 31, 2008	Year ended August 31, 2008
Computed tax provision	\$ 344,926	\$ 996,573
Increase in valuation allowance	543,534	1,474,904
State and withholding taxes	411,335	(34,835)
Permanent differences	(2,165,101)	287,650
Other	97,374	51,980
	<u>\$ (767,932)</u>	<u>\$ 2,776,272</u>

Significant components of the Company's future tax assets and liabilities are shown below:

	Four months ended December 31, 2008	Year ended August 31, 2008
Future tax assets:		
Write-down of investment	\$ 23,760	\$ -
Non-capital loss carry forwards	3,970,368	4,565,372
Capital loss carry forwards	13,391	-
Petroleum and natural gas interests	64,878	53,051
Share issue costs	62,560	-
Unclaimed exploration and development expenditures	266,254	316,937
	<u>4,401,211</u>	<u>4,935,360</u>
Less valuation allowance	(4,401,211)	(4,935,360)
Net future tax assets	-	-
Future tax liabilities:		
Oil and natural gas properties	(47,436,481)	(53,392,967)
Derivative instrument	(1,473,389)	(995,444)
Asset retirement obligation	17,545	13,679
Net future tax liabilities	<u>(48,892,325)</u>	<u>(54,374,732)</u>
Net future income tax liability	<u>\$ (48,892,325)</u>	<u>\$ (54,374,732)</u>

In assessing the realizability of future tax assets, management considers whether it is more likely than not that some portion or all of the future tax assets will not be realized. The ultimate realization of future tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of future tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. The amount of the future tax assets considered realizable could change materially in the near term based on future taxable income during the carry forward period.

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14. Income taxes (continued):

A valuation allowance has been provided against all future tax assets as the realization of such assets is uncertain.

The Company has losses for tax purposes of approximately \$15,270,772 (August 31, 2008 - \$14,170,471) which are available to offset future years' taxable income in Canada, expiring between 2009 and 2028.

15. Supplementary cash flow information:

	Four months ended December 31, 2008	Year ended August 31, 2008
Interest paid	\$ 2,334,748	\$ 3,510,325
Income taxes received	344,019	302,894
Non-cash investing and financing activities:		
Offset of loan payable against promissory note (note 13)	-	1,506,600
Issuance of common shares as consideration in Gemini acquisition (note 4)	-	51,572,778
Issuance of convertible note as consideration in Gemini acquisition (note 4)	-	47,508,293
Reduction in promissory note as consideration in Gemini acquisition (note 4)	-	9,537,381

16. Contingency:

During 2006, the Company's wholly-owned subsidiary Arrowhead and other unrelated defendants were served with a lawsuit alleging that certain properties, including some of the properties owned by Arrowhead, are subject to a 5% net profits interest. Arrowhead leases that remain encumbered by this lawsuit consist of five leases totaling 2,040 gross acres and at the time 13 developed wells. During August 2007, the trial court granted partial summary judgment in favor of the plaintiffs, holding that they owned the 5% net profits interest contract. On April 14, 2008, the court found in favor of the plaintiffs in the amount of \$4,896,589 against the defendants, jointly and severally. The Company filed its Notice of Appeal with the Wyoming Supreme Court on June 16, 2008. On July 1, 2008, the court issued an order granting the plaintiffs' Motion for Attorney Fees and entered a judgment in the amount of \$3,917,289 against the operator defendants. Arrowhead is not an operator and therefore not subject to this judgment. The Company, together with the other defendants, have filed appeals and have presented defenses. Although the Company and other defendants believe their position will be sustained, the outcome and potential liability to the Company cannot be determined. Therefore, no amounts have been accrued in these consolidated financial statements.

17. Financial risk exposure and risk management:

The Company is exposed in varying degrees to a number of risks arising from financial instruments. The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. Management's close involvement in the operations allows for the identification of risks and variances from expectations. The Board approves and monitors the risk management process.

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17. Financial risk exposure and risk management (continued):

The types of risk exposure and the way in which such exposures are managed are as follows:

(a) Credit risk:

Credit risk is the risk of financial loss to the Company if a counterparty to a financial instrument fails to meet its payment obligations. The Company's exposure to credit risk includes cash and cash equivalents, accounts receivable, promissory note, and derivative instruments. The risk exposure is limited to their carrying amounts at the balance sheet date.

Cash and cash equivalents and derivative instruments are maintained with one financial institution. The risk is mitigated because the financial institution is a major institution with high credit rating.

Accounts receivable primarily consist of revenues due from the sale of oil and gas. To reduce credit risk, the Company regularly reviews the collectability of the accounts receivable and there is no indication that these amounts will not be fully recoverable. Accounts receivable in Canada account for \$111,904 (CAD\$136,299) of the Company's total accounts receivable.

The promissory note is due from QIL, which has sufficient assets to cover the repayment of the note.

(b) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company manages its liquidity risk by actively forecasting, planning, reviewing and monitoring expenditures and commitments and anticipated financial requirements.

Cash and cash equivalents on hand at December 31, 2008 and expected cash flows for the next 12 months are sufficient to fund the Company's ongoing operational needs.

In addition, the company maintains a \$30,000,000 long-term credit facility, of which it had drawn down \$18,500,000 at the end of the period.

Contractual Obligations (US\$)	Payments Due by Period				
	Total	Less than 1 year	1 - 3 years	4 - 5 years	After 5 years
Accounts payable and accrued Liabilities	\$ 5,453,696	\$ 5,171,922	\$ 581,774	\$ -	\$ -
Long-term debt ⁽¹⁾	40,229,885	-	-	-	40,229,885
Other long-term obligations ⁽²⁾	69,176	-	-	-	69,176
Line of credit	18,500,000	-	-	18,500,000	-
Total contractual obligations	\$ 64,552,767	\$ 5,171,922	\$ 581,774	\$18,500,000	\$ 40,299,061

⁽¹⁾ First, second, and third convertible debentures

⁽²⁾ Asset retirement obligation

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17. Financial risk exposure and risk management (continued):

(c) Market risk:

Market risk is the risk that changes in market prices, such as natural gas prices, foreign exchange rates and interest rates will affect the Company's income. The object of market risk management is to manage and control market risk exposures within acceptable parameters, while optimizing the return on risk.

The Company buys and sells derivatives in the ordinary course of business in order to manage market risks.

(i) Commodity risk:

The Company is exposed to fluctuations in the price of oil and natural gas. It mitigates its risk by negotiating hedging contracts for up to 50% of its production (note 5(b)).

A 10% change in the price of natural gas during the period would have changed equity and net income by \$229,819 and the fair value of the derivative instrument by \$437,188. If the Company had not entered into the derivative instrument, net income and equity would have changed by \$314,710.

(ii) Currency risk:

The Company is exposed to the financial risk related to the fluctuation of foreign exchange rates. The Company operates in Canada and the United States and a portion of its expenses are incurred in Canadian dollars. A significant change in the currency exchange rates between the US dollar relative to Canadian dollar could have an effect on the Company's results of operations, financial position or cash flows. The Company has hedged its exposure to currency fluctuations as described in note 5(b).

At December 31, 2008, the Company is exposed to currency risk through the following assets and liabilities denominated in Canadian dollars:

	December 31, 2008	August 31, 2008
Cash and cash equivalents	\$ 1,650,526	\$ 1,902,560
Accounts receivable	136,299	314,326
Promissory note	4,548,911	4,346,096
Prepaid expenses	180	40,180
Investments	333,992	259,384
Oil and natural gas properties	123,325,309	124,133,684
Accounts payable and accrued liabilities	(205,944)	(136,456)
Convertible debentures	(25,077,100)	(24,730,414)
Asset retirement obligations	(21,405)	(11,290)
	<u>\$ 104,690,768</u>	<u>\$ 106,118,070</u>
US dollar equivalent (period end)	\$ 85,953,011	\$ 99,886,431

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17. Financial risk exposure and risk management (continued):

(c) Market risk (continued):

(ii) Currency risk (continued):

A 10% change in the Canadian dollar against the United States dollar at December 31 would result in a change of \$256,000 to net income and \$8,070,000 to other comprehensive income.

(iii) Interest rate risk:

The majority of the Company's debt is in fixed rate debentures; however, the Company's income and cash flow is impacted by interest rate fluctuations on its bank loan of \$18,500,000. As at December 31, 2008, the Company did not have any interest rate hedges.

A change of 100 basis points in interest rates would have increased or decreased cash and equity by \$47,000.

18. Capital management:

The Company considers its capital structure to include working capital and shareholders' equity. Management's objective is to ensure that there is sufficient capital to minimize liquidity risk and to continue as a going concern. Management reviews its capital management approach on an ongoing basis and believes that its approach, given the relative of the Company is reasonable.

The Company's objectives when managing capital are to:

- ensure there are adequate capital resources to safeguard the Company's ability to continue as a going concern,
- maintain adequate levels of funding to support the acquisition, exploration and development of oil and natural gas properties,
- provide returns for shareholders and benefits for other stakeholders.

The Board of Directors does not establish quantitative return on capital criteria for management, but rather relies on the expertise of the Company's management to sustain future development of the business.

There were no changes in the Company's approach to capital management during the year.

Neither the Company nor any of its subsidiaries are subject to externally imposed capital requirements.

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19. Segmented information:

The Company's activities consist of the exploration and development of oil and natural gas properties in Canada and the United States.

Selected segmented information is as follows:

Four months ended December 21, 2008	Canada	United States	Total
Revenue	\$ 127,283	\$ 3,958,491	\$ 4,085,774
Operating earnings (loss)	(31,084)	215,655	184,571
Capital expenditures	-	4,576,777	4,576,777
Total assets	6,035,131	164,636,351	170,671,482

Year ended August 31, 2008	Canada	United States	Total
Revenue	\$ 631,520	\$ 15,061,834	\$ 15,693,354
Operating earnings (loss)	148,884	6,691,847	6,840,731
Capital expenditures	-	1,501,379	1,501,379
Total assets	7,620,657	169,631,680	177,252,337

The Company's revenues are derived from sales to customers in the oil and gas industry. One customer buys all of the oil and gas produced by the Canadian property. The sales of the United States properties are made to three customers.