

Unaudited Condensed Interim Consolidated Financial Statements
(Expressed in United States dollars)

BUCKING HORSE ENERGY INC.

For the nine months ended September 30, 2011 and 2010

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

In accordance with National Instrument 51-102, Part 4, subsection 4.3(3) released by the Canadian Securities Administrators, the Company discloses that its auditors have not reviewed these unaudited interim financial statements as at and for the nine months ended September 30, 2011 and 2010.

BUCKING HORSE ENERGY INC.

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Unaudited - Prepared by Management)

(Expressed in United States dollars)

	Notes	As at September 30 2011	As at December 31 2010 (Note 20)
ASSETS			
Current assets			
Cash and cash equivalents		\$ 8,455,778	\$ 4,425,957
Accounts receivable	15	1,515,409	1,489,939
Derivative instruments	3c	6,184,959	6,036,956
Income taxes receivable		1,732,445	1,004,833
		17,888,591	12,957,685
Non-current assets			
Investments	6	-	168,978
Natural gas properties	9,20a&b	164,371,815	164,532,234
		\$ 182,260,406	\$ 177,658,898
LIABILITIES			
Current liabilities			
Accounts payable and accrued liabilities		\$ 3,943,763	\$ 3,124,095
State resource taxes payable		48,245	337,853
Income taxes payable		77,460	77,460
		4,069,468	3,539,408
Non-current liabilities			
Long-term credit facility	10	30,400,000	18,500,000
State resource taxes payable		455,964	286,761
Convertible debentures	11,20c	43,280,082	44,762,807
Decommissioning obligations	12,20b	1,828,640	982,104
Future income taxes		55,304,026	56,408,968
		135,338,180	124,480,048
SHAREHOLDERS' EQUITY			
Share capital	14	60,808,899	60,833,093
Equity portion of debentures payable	11	6,088,955	6,088,955
Issuer bid purchase			(4,825)
Reserves		(1,993,515)	(1,126,745)
Deficit		(17,982,113)	(12,616,453)
		46,922,226	53,178,850
		\$ 182,260,406	\$ 177,658,898

See accompanying notes to condensed interim consolidated financial statements.

Approved on Behalf of the Board:

"Gordon Nielsen"
Director

"Michael Schoen"
Director

BUCKING HORSE ENERGY INC.

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited - Prepared by Management)

(Expressed in United States dollars)

	<i>Notes</i>	For the nine months ended September 30 2011	For the three months ended September 30 2011	For the nine months ended September 30 2010 (Note 20)	For the three months ended September 30 2010 (Note 20)
Revenue:					
Oil and natural gas revenue		\$ 11,108,366	\$ 3,985,090	\$ 10,767,704	\$ 3,363,345
Direct expenses:					
Depletion and depreciation		4,521,437	1,748,640	4,373,462	1,347,545
State resource taxes		1,022,841	372,666	994,771	297,366
Operating expenses		3,994,752	1,462,506	4,073,103	1,415,196
		9,539,030	3,583,812	9,441,336	3,060,107
Net operating income		1,569,336	401,278	1,326,368	303,238
Other expenses (income):					
Finance charges		6,199,026	2,065,482	5,657,863	2,002,736
Accretion expense on debentures	11,20c	864,017	301,568	932,359	273,906
Professional fees		762,993	279,024	631,171	187,714
General and administration		522,971	(429,928)	526,337	(7,431)
Financing fees		25,000	-	105,000	80,000
Foreign exchange (gain) loss		579,159	1,003,556	367,038	463,837
Interest income and other		(10)	(10)	(19,246)	(12,919)
Write down of account receivable		275,436	-	125,752	-
Realized (gain) loss on derivative instruments	3c(ii)	(3,081,777)	(1,019,035)	(1,874,010)	(752,165)
Unrealized loss (gain) on derivative instruments	3c(ii)	(148,003)	(1,237,156)	(2,636,680)	638,346
		5,998,812	963,501	3,815,584	2,874,024
Earnings (loss) before income taxes		(4,429,476)	(562,223)	(2,489,216)	(2,570,132)
Income tax expense (recovery)					
Current		-	-	870,133	488,333
Deferred		936,185	502,002	(1,045,101)	(642,758)
		936,185	502,002	(174,968)	(154,425)
Net income (loss) for the period		(5,365,661)	(1,064,225)	(2,314,248)	(2,415,707)
Other comprehensive income					
Net unrealized gains on translating financial statements into reporting currency		-925,343	(2,433,253)	1,002,649	1,831,148
Realized gain on available for sale investments		156,895	-	30,354	48,257
Total comprehensive income (loss) for the period		(6,134,109)	(3,497,478)	(1,281,245)	(536,302)
Net (loss) earnings per common share					
Basic	3h, 13	\$ (0.24)	\$ (0.05)	\$ (0.10)	\$ (0.11)
Diluted	3h, 13	\$ (0.24)	\$ (0.05)	\$ (0.10)	\$ (0.11)
Weighted average number of shares outstanding		22,681,513	22,681,513	22,820,766	22,820,766

See accompanying notes to condensed interim consolidated financial statements.

BUCKING HORSE ENERGY INC.

CONDENSED INTERIM CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

For the nine months ended September 30, 2011

(Unaudited - Prepared by Management)

(Expressed in United States dollars)

	<i>Note</i>	Share Capital	Equity Debentures Payable	Reserve For Own Shares	Translation Reserve	Fair Value Reserve	Retained Earnings	Total Equity
Balance at January 1, 2011		\$ 60,833,093	\$ 6,088,955	\$ (4,825)	\$ (965,025)	\$ (156,895)	\$ (12,616,453)	\$ 53,178,850
Shares cancelled and returned to treasury	14	(24,194)						(19,048)
Issuer bid purchase				(98,325)				(98,325)
Net change in unrealized gains on translating financial statements into reporting currency					(925,343)			(925,343)
Realized gain on available for sale investments						156,895		156,895
Net earnings (loss) for the period							(5,365,661)	(5,365,661)
Balance at September 30, 2011		\$ 60,808,899	\$ 6,088,955	\$ (103,149)	\$ (1,890,367)	\$ -	\$ (17,982,113)	\$ 46,922,225

	<i>Note</i>	Share Capital	Equity Debentures Payable	Reserve For Own Shares	Translation Reserve	Fair Value Reserve	Retained Earnings	Total Equity
Balance at January 1, 2010		\$ 61,374,762	\$ 6,088,955	\$ (22,627)	\$ (3,338,884)	\$ (189,574)	\$ (7,254,703)	\$ 56,657,929
Shares cancelled and returned to treasury		(437,335)						
Issuer bid purchase				21,286				
Excess on cancellation of issued common shares							(11,740)	
Realized loss on available for sale investments							-	
Net change in unrealized gains on translating financial statements into reporting currency					1,002,649			1,002,649
Unrealized gain on available for sale investments						12,451		12,451
Net earnings for the period							(2,128,839)	(2,128,839)
Balance at September 30, 2010		\$ 60,937,427	\$ 6,088,955	\$ (1,341)	\$ (2,336,235)	\$ (177,123)	\$ (9,395,282)	\$ 55,116,401

See accompanying notes to condensed interim consolidated financial statements.

BUCKING HORSE ENERGY INC.

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited - Prepared by Management)

(Expressed in United States dollars)

	For the nine months ended Note September 30 2011	For the nine months ended September 30 2010 (Note 20)
Cash and cash equivalents provided by (used in):		
Operations:		
Net earnings for the period	\$ (5,365,661)	\$ (2,206,631)
Items not involving cash:		
Depletion and depreciation	4,521,437	4,372,330
Accretion expense on debentures	864,016	1,180,820
Deferred income taxes	936,185	(1,045,101)
Unrealized loss (gain) on derivative instruments	3c(ii) (148,003)	(2,636,680)
Foreign exchange (gain) loss	579,159	18,595
Changes in non-cash working capital:		
Accounts receivable	(108,944)	1,618,093
Prepaid expenses	-	9
Income taxes receivable	(834,825)	(565,518)
Income taxes payable	4,245	(434,233)
Accounts payable and accrued liabilities	1,049,615	(620,657)
State resource taxes payable	(94,805)	(229,546)
	1,402,419	(548,519)
Investments:		
Oil and natural gas property expenditures	(9,545,669)	(173,075)
Financing:		
Long-term credit increase	11,900,000	-
Promissory note	-	79,924
Issuer bid purchase and shares returned to treasury	90,865	(165,810)
	11,990,865	(85,886)
Effect of foreign currency translation on cash and cash equivalents	182,207	(274,143)
(Decrease) / increase in cash and cash equivalents	4,029,821	(1,081,623)
Cash and cash equivalents, beginning of period	4,425,957	6,751,735
Cash and cash equivalents, end of period	\$ 8,455,778	\$ 5,670,112

See accompanying notes to condensed interim consolidated financial statements.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

1. NATURE OF OPERATIONS

Bucking Horse Energy Inc. (the “Company”) is a petroleum and natural gas producer engaged in the exploration and development of natural gas properties located in the United States of America. Prior to January 1, 2011 it owned a minor property interest in Alberta, Canada.

Bucking Horse Energy Inc is a publicly listed company incorporated in Canada with limited liability under the legislation of the Province of British Columbia. The Company’s shares are listed on the TSX Exchange of the TMX Group.

The head office, principal address and records office of the Company are located at 609 West Hastings Street, Suite 900, Vancouver, British Columbia, Canada, V6B 4W4. The Company’s registered address is 885 West Georgia Street, Suite 800, Vancouver, British Columbia, Canada, V6H 3H1.

These unaudited condensed interim consolidated financial statements (“interim financial statements”) have been prepared on the basis of accounting principles applicable to a going concern, which assumes that the Company will be able to continue in operation for the foreseeable future and will be able to realize its assets and discharge its liabilities and commitments in the normal course of business. It is management’s opinion that the going concern assumption is appropriate and all assets and liabilities have been valued accordingly.

2. BASIS OF PREPARATION

(a) Statement of compliance:

The interim financial statements have been prepared in accordance with IAS 34 – *Interim Financial Reporting* of the *International Financial Reporting Standards* (“IFRS”). These interim financial statements are the Company’s third interim financial statements after its transition to reporting in accordance with IFRS and before the issuance of its first publicly issued annual consolidated IFRS statements. IFRS 1 – *First-time Adoption of IFRS* (“IFRS 1”) has been applied to these interim consolidated financial statements. As a result, these interim financial statements may provide additional disclosure not normally expected in interim financial statements. These interim financial statements do not include all of the information required for full annual financial statements.

The accounting policies set out below have been applied consistently to all periods presented in preparing the opening balance sheet at January 1, 2010 (please refer to our unaudited first quarter financial statements filed on SEDAR) for purposes of transition to IFRS. The accounting policies have been applied consistently by the Company and its subsidiaries.

(b) Basis of measurement:

The interim financial statements have been prepared on the historical cost basis except for the following:

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
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For the Nine Months Ended September 30, 2011 and 2010

2. BASIS OF PREPARATION (continued)

(b) Basis of measurement (continued):

- (i) derivative financial instruments are measured at fair value; and
- (ii) held for trading financial assets are measured at fair value with changes in fair value recorded in earnings.

(c) Functional and presentation currency:

The functional currency of the Company and its subsidiaries other than Arrowhead Resources (U.S.A.) Ltd., (“Arrowhead”) is the Canadian dollar. The functional currency of the Company’s U.S. subsidiary Arrowhead is the US dollar. These interim financial statements are presented in United States dollars as the majority of the Company’s operations are in the United States.

(d) Use of estimates and judgements:

The preparation of financial statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future years affected. Significant judgements, estimates and assumptions made by management in these financial statements are outlined below.

Estimation of recoverable quantities of proven, probable and possible reserves include estimates and assumptions regarding future commodity prices, exchange rates, discount rates and production and transportation costs for future cash flows as well as the interpretation of complex geological and geophysical models and data. Changes in reported reserves can affect the impairment of assets, the decommissioning obligations and the amounts reported for depletion, depreciation and amortization of property, plant and equipment.

In determining the recoverable amount of assets, in the absence of quoted market prices, impairment tests are based on estimates of reserves, production rates, future oil and natural gas prices, future costs, discount rates and other relevant assumptions.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

2. BASIS OF PREPARATION (continued)

(d) Use of estimates and judgements (continued):

The Company estimates the decommissioning obligations for oil and natural gas wells and their associated production facilities and pipelines. In most instances, removal of assets and remediation occurs many years into the future. Amounts recorded for the decommissioning obligations and related accretion expense require judgemental assumptions regarding removal date, future environmental legislation, the extent of reclamation activities required, the engineering methodology for estimating cost, future removal technologies in determining the removal cost, and liability specific discount rates to determine the present value of these cash flows.

The accounting policy for exploration and evaluation assets is described in note 3 (e). The application of this policy will require management to make certain estimates and assumptions as to future events and circumstances as to whether economic quantities of reserves have been found.

The amounts estimated for deferred tax assets and liabilities are based on estimates as to the timing of the reversal of temporary differences, substantively enacted tax rates and the likelihood of deferred tax assets being realized. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be material.

3. SIGNIFICANT ACCOUNTING POLICIES

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

(a) Basis of consolidation

(i) Subsidiaries:

As part of its transition to IFRS, the Company elected not to restate business combinations that occurred prior to January 1, 2010.

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, Gemini Energy Corp, (“Gemini”) incorporated in the Province of British Columbia and its wholly-owned subsidiary, Arrowhead incorporated in the State of South Dakota.

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that currently are exercisable are taken into account.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(a) Basis of consolidation (continued)

(i) Subsidiaries (continued):

The financial statements of subsidiaries are included in the interim financial statements from the date that control commences until the date that control ceases.

The purchase 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. 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, liabilities and contingent liabilities acquired 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 the income statement.

(ii) Jointly controlled operations and jointly controlled assets:

Many of the Company's oil and natural gas activities involve jointly controlled assets. The interim consolidated financial statements include the Company's share of these jointly controlled assets and a proportionate share of the relevant revenue and related costs.

(iii) Transactions eliminated on consolidation:

Intercompany balances and transactions, and any unrealized income and expenses arising from intercompany transactions, are eliminated in preparing the interim consolidated financial statements.

(b) Foreign currency

Transactions in foreign currencies are translated to the respective functional currencies of the Company's subsidiaries at the exchange rates on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated into the respective functional currency at the reporting date and foreign currency gains or losses are recognized in net income (loss) for the period.

The Company's subsidiary, Arrowhead is translated into Canadian dollars at each reporting period prior to consolidation. 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

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(b) Foreign currency (continued)

accounts are recorded in other comprehensive income (loss) and accumulated in the translation reserve within equity. As the Company's reporting currency is U.S. dollars the interim consolidated financial statements are translated into U.S. dollars on the same basis.

(c) Financial instruments

(i) Non-derivative financial instruments:

Non-derivative financial instruments comprise trade and other receivables, cash and cash equivalents, loans and borrowings, trade and other payables, long-term credit facility and convertible debentures. Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured as described below.

Cash and cash equivalents:

Cash and cash equivalents comprise cash on hand with original maturities of three months or less that are readily convertible into cash and which are subject to insignificant risk of changes in value.

Financial assets at fair value through profit or loss:

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

Other:

Other non-derivative financial instruments, such as trade and other receivables, loans and borrowings, trade and other payables, long-term credit facility and convertible debentures are measured at amortized cost using the effective interest method, less any impairment losses.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(c) Financial instruments (continued)

(ii) Derivative financial instruments:

The Company has entered into certain financial derivative contracts in order to manage exposure to market risks from fluctuations in commodity prices and foreign currency. These instruments are not intended for trading or speculative purposes. The Company has not designated its financial derivative contracts as effective accounting hedges, and thus not applied hedge accounting, even though the Company considers all commodity contracts to be economic hedges. As a result, all financial derivative contracts are classified as fair value through profit or loss and are recorded on the balance sheet at fair value. Transaction costs are recognized in profit or loss when incurred.

(d) Revenue recognition

Revenue from the sale of petroleum and natural gas is recorded when title passes to an external party and is based on volumes delivered to customers at contractual delivery points, and rates and collectability are reasonably assured. The costs associated with the delivery, including operating and maintenance costs, transportation and production-based royalty expenses, are recognized during the same period in which the related revenue is earned and recorded.

(e) Natural gas properties

Exploration and evaluation assets:

Although the Company does not have any exploration and evaluation assets, it has adopted the following policy should it become involved in exploration and evaluation activities. Exploration license and unproved property acquisition costs, geological and geophysical costs and costs directly associated with an exploration well and appraisal activities will be capitalized within exploration and evaluation assets. The costs will be accumulated in cost centers by well, field or exploration area pending determination of technical feasibility and commercial viability. General prospecting or evaluation expenditures incurred in advance of obtaining the legal rights to explore an area will be expensed directly to the income statement as they are incurred.

The technical feasibility and commercial viability will be considered to be determinable when proven plus probable reserves are determined to exist. A review of each exploration license or field will be carried out, at least annually, to ascertain whether proven plus probable reserves have been discovered. Upon determination of proven plus probable reserves, exploration and evaluation assets attributable to those reserves will be first tested for impairment and then reclassified from exploration and evaluation assets to property, plant and equipment.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
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For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(e) Natural gas properties (continued)

Property, plant and equipment:

Items of property, plant and equipment included in natural gas properties which include oil and gas development assets, are measured at cost less accumulated depletion and depreciation and accumulated impairment losses. Development assets are grouped into cash generating units (“CGU’s”) for impairment testing. As at January 1, 2011, the Company has one CGU which consists of the Pinedale properties held by Arrowhead.

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

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

Depletion and depreciation:

The net carrying value of development assets is depleted using the unit of production method by reference to the ratio of production in the year to the related proven reserves. These estimates are reviewed by independent reserve engineers at least annually.

Proven reserves are estimated using independent reserve engineering reports and represent the estimated quantities of oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be recoverable in future years from known reservoirs and which are considered commercially producible. There should be a minimum 90 percent statistical probability that the actual quantity of recoverable reserves will be more than the amount estimated as proven and a maximum 10 percent statistical probability that it will be less. Such reserves may be considered commercially producible if management has the intention of developing and producing them and such intention is based upon:

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
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For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(e) Natural gas properties (continued)

Depletion and depreciation (continued):

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

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

(f) Impairment

(i) Financial assets:

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

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

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

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

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For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(f) Impairment (continued)

(ii) Non-financial assets:

The carrying amounts of the Company's non-financial assets, other than deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. For intangible assets that have indefinite lives or that are not yet available for use, an impairment test is completed each year. E&E assets, should any exist, are assessed for impairment when they are reclassified to property, plant and equipment as oil and natural gas interest, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

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

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

An impairment loss would be recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in profit or loss.

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

(g) Income taxes

Income tax expense comprises current and deferred tax. Income tax expense is recognized in profit or loss except to the extent that if the income tax expense related to items recognized directly in equity, the income tax expense would also be recognized in equity.

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(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(g) Income taxes (continued)

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

Deferred tax is recognized using the asset and liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

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

(h) Earnings per share

Basic earnings per share is calculated by dividing the net income (loss) attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed similar to basic earnings (loss) per share except that the weighted average shares outstanding are increased to include additional shares for the assumed exercise of stock options and warrants, if dilutive.

(i) Share based payments

The grant date fair value of options granted to employees is recognized as compensation expense, within general and administrative expenses, with a corresponding increase in contributed surplus over the vesting period. A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest.

(j) Provisions

A provision is recognized if, as a result of a past event, the Company has a present obligation (legal or constructive) that can be estimated reliably, and it is probable that an expenditure will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(j) Provisions (continued)

market assessments of the time value of money and the risks specific to the liability. Provisions are not recognized for future operating losses.

(k) Decommissioning obligations

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

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

(l) Finance expenses

Finance expenses comprise interest expense on borrowings, including bank debt and convertible debentures, and the accretion of the discount on provisions and convertible debentures. Borrowing costs are recognized in net income using the effective interest method and are recognized in income in the period in which they are incurred.

(m) Pending accounting pronouncements

Certain new standards, interpretations, amendments and improvements to the existing standards were issued by the International Accounting Standards Board ("IASB") or International Financial Reporting Interpretations Committee ("IFRIC") that are mandatory for accounting periods beginning after January 1, 2010 or later periods. The standards impacted that are applicable to the Company are as follows:

IFRS 9 – Financial Instruments

In an effort to reduce the complexity of accounting for financial instruments, the IASB has engaged in a project to replace IAS 39, Financial Instruments: Recognition and Measurement. IFRS 9 introduces new requirements for classifying and measuring financial assets and liabilities, which may affect the Company's accounting for its financial assets. Under this guidance, entities have the option to recognize financial liabilities at fair value through earnings. If this option is elected, entities would be required to reverse the portion of the fair value change due to a company's own credit

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

(m) Pending accounting pronouncements (continued)

risk out of earnings and recognized the change in other comprehensive income. The standard is not applicable until January 1, 2013. The Company has yet to assess the full impact of IFRS 9.

IFRS 10 – Consolidation

IFRS 10 was issued on May 12, 2011. This standard requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC12, Consolidation – Special Purpose Entities, and parts of IAS 27, Consolidated and Separate Financial Statements. The standard is not applicable until January 1, 2013. The Company has yet to assess the full impact of IFRS 10.

IFRS 13 – Fair Value Measurement

IFRS 13 was issued on May 12, 2011. This is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and in many cases does not reflect a clear measurement basis or consistent disclosures. The standard is not applicable until January 1, 2013. The Company has yet to assess the full impact of IFRS13.

4. DETERMINATION OF FAIR VALUES

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods:

All financial instruments measured at fair value are categorized into a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). The three levels of the fair value hierarchy are described below:

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

4. DETERMINATION OF FAIR VALUES (continued)

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

Level 2 – Values based on inputs that are observable, either directly or indirectly, but do not qualify as Level 1 inputs (i.e. quoted prices for similar assets or liabilities).

Level 3 – Values based on prices or valuation techniques that require inputs which are not based on observable market data and are significant to the fair value measurement.

The carrying values of cash and cash equivalents, accounts receivable, promissory note, income tax receivable and payable, accounts payable and accrued liabilities, and state resource taxes payable approximate their fair values due to the short terms to maturity of these financial instruments.

The long term credit facility is recorded at the principal amount. The carrying value of drawings on the long term credit facility included on the consolidated balance sheets approximate their fair value based on Level 2 inputs as they have floating interest rates that approximate market rates. The Company does not consider the credit risk associated with the counterparty of the long term credit facility to be significant.

The fair values of the Company's financial assets and liabilities as of September 30, 2011 are as follows:

	Balance at September 30, 2011	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial assets:				
Held for trading:				
Cash and cash equivalents	\$ 8,455,778	\$ 8,455,778	\$ -	\$ -
Benefit under derivative financial instrument (note 5)	\$ 6,184,959	\$ -	\$ 6,184,959	\$ -

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

4. DETERMINATION OF FAIR VALUES (continued)

The fair values of the Company's financial assets and liabilities as of December 31, 2010 were as follows:

	Balance at December 31, 2010	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial assets:				
Held for trading:				
Cash and cash equivalents	\$ 4,425,957	\$ 4,425,957	\$ -	\$ -
Benefit under derivative financial instrument (note 5)	\$6,036,956	\$ -	\$ 6,036,956	\$ -
Available for sale:				
Investments in shares of a related entity	\$ 168,978	\$ 168,978	\$ -	\$ -

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

5. DERIVATIVE FINANCIAL INSTRUMENTS

(i) Commodity hedge contracts:

At September 30, 2011, the Company had 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	Active period	Price US\$/MMBTU
Swap ⁽¹⁾	3,000	Oct-Dec 2011	\$7.23
Swap ⁽¹⁾	1,000	Oct-Dec 2011	\$7.11
Swap ⁽¹⁾	1,500	Oct-Dec 2011	\$4.575
Swap ⁽¹⁾	500	Oct-Dec 2011	\$4.52
Swap ⁽¹⁾	500	Oct-Dec 2011	\$4.68
Swap ⁽¹⁾	500	Oct-Dec 2011	\$4.97
Swap ⁽¹⁾	3,500	Calendar 2012	\$7.22
Swap ⁽¹⁾	1,000	Jan-Aug 2012	\$5.095
Swap ⁽¹⁾	500	Jan-Dec 2012	\$5.075
Swap ⁽¹⁾	500	Sep-Dec 2012	\$5.15
Swap ⁽¹⁾	1,000	Jan-Dec 2012	\$5.025
Swap ⁽¹⁾	4,000	Jan-Mar 2013	\$5.44
Swap ⁽¹⁾	1,000	Jan-Mar 2013	\$5.41
Swap ⁽¹⁾	500	Jan-Mar 2013	\$5.48
Swap ⁽¹⁾	4,000	Apr-Jun 2013	\$5.06

⁽¹⁾ Commodity Swap Transaction; Dominion Appalachia reference price

At December 31, 2010, the Company had the following open commodity derivative financial contracts to manage price risk on a portion of its natural gas production for the periods referenced below.

(i) Commodity hedge contracts (continued):

Type	Volume MMBTU/Day	Contract period	Price US\$/MMBTU
Swap ⁽¹⁾	2,500	Calendar 2010	\$6.20
Swap ⁽¹⁾	1,000	Calendar 2010	\$6.48
Swap ⁽¹⁾	1,000	Calendar 2010	\$6.50
Swap ⁽¹⁾	3,000	Calendar 2011	\$7.23
Swap ⁽¹⁾	1,000	Calendar 2011	\$7.11
Swap ⁽¹⁾	3,500	Calendar 2012	\$7.22

⁽¹⁾ Commodity Swap Transaction; Dominion Appalachia reference price

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

5. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

(i) Commodity hedge contracts (continued):

Derivative financial instruments are measured at fair value with gains and losses recorded in net earnings.

(ii) Foreign exchange hedge contracts

In May 2010, the Company contracted to purchase a total of C\$2,138,565 with terms referenced as follows:

US\$	Contract period	Exchange rate
\$83,333/month	September 2010 to May 2011	1.0642
\$83,333/month	September 2010 to May 2011	1.0744

Both of these foreign exchange contract terms expired in the second quarter of 2011.

The net realized gain on derivative financial contracts for the period ended September 30, 2011 of \$3,081,777 (2010 - \$1,874,010) has been included in other income in the consolidated statement of operations.

The unrealized gain on outstanding derivative financial contracts was \$148,003 for the period ended September 30, 2011 (2010 – unrealized gain of \$2,636,680), which has been included in other expenses in the statement of operations.

6. INVESTMENTS

	Number of shares September 30, 2011	Number of shares December 31, 2010	Balance September 30, 2011	Balance December 31, 2010
Investments in:				
Investment in shares of XXL	0	933,700	\$ -	\$168,978

During 2008, the Company acquired 333,700 common shares in XXL Energy Corp. (“XXL”) for a total purchase price of \$254,085 (C\$306,045). In March 2010, the Company received an additional 600,000 common shares in XXL as a negotiated settlement from Q Investments Ltd. (“QIL”) (for further details, see note 15). These shares were classified as available for sale and were marked to market on an ongoing basis with changes in fair value recognized in other comprehensive income, net of tax. In May 2011, all shares of XXL Energy were sold (933,700 shares for net proceeds of C\$193,559).

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

7. FINANCIAL RISK MANAGEMENT

(a) Overview

The Company's activities expose it to a variety of financial risks that arise as a result of its exploration, development, production, and financing activities such as:

- market risk
- credit risk
- liquidity risk

This note presents information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk.

The Board of Directors oversees management's establishment and execution of the Company's risk management framework. Management has implemented and monitors compliance with risk management policies. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

(b) 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 85% of its production (note 5).

A 10% change in the price of natural gas during the nine-month period would have changed equity and net income by approximately \$258,320.

(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 and the Canadian dollar

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

7. FINANCIAL RISK MANAGEMENT (continued)

(b) Market risk (continued)

(ii) Currency risk (continued):

could have an effect on the Company's results of operations, financial position or cash flows.

The Company is exposed to currency risk through the following assets and liabilities denominated in Canadian dollars:

C\$	September 30, 2011	December 31, 2010
Cash and cash equivalents	\$ 2,568,592	\$ 1,862,432
Accounts receivable	121,094	126,543
Investments	-	168,066
Oil and natural gas properties	117,759,562	118,728,618
Accounts payable and accrued liabilities	(474,277)	(469,607)
Convertible debentures	(45,366,182)	(27,985,856)
Decommissioning obligations	-	(14,702)
	<u>\$ 74,608,789</u>	<u>\$ 92,418,494</u>
U.S. foreign exchange rate	1.0482	1.0054
U.S. dollar equivalent	\$ 71,178,008	\$ 92,920,263

A 10% change in the Canadian dollar relative to the United States dollar at September 30, 2011 would result in a change of approximately \$40,893 to net income and approximately \$3,177,219 to other comprehensive income.

(ii) Interest rate risk:

The majority of the Company's debt is in fixed rate debentures; however, the Company's income and cash flow are impacted by interest rate fluctuations on its bank loan of \$30,400,000. As at September 30, 2011, the Company did not have any interest rate hedges.

A change of 100 basis points in interest rates would have increased or decreased net income by approximately \$181,400.

(c) 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.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

7. FINANCIAL RISK MANAGEMENT (continued)

(c) Credit risk (continued)

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

Accounts receivable primarily consists of revenues due from the sale of oil and gas. To reduce credit risk, the Company regularly reviews the collectability of the accounts receivable. There is no indication that these amounts will not be fully recoverable. Canadian currency accounts receivable account for \$115,261 (C\$120,817) of the Company's total accounts receivable.

(d) 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.

In addition, the Company maintains a \$100,000,000 line of credit with a \$38,000,000 borrowing base with the Bank of Montreal, of which it has drawn down \$30,400,000 at September 30, 2011.

Contractual obligations (US\$)	Payments due by period				
	Total	Less than 1 year	1 - 3 years	4 - 5 years	After 5 years
Long term debt ⁽¹⁾	\$ 46,746,804	\$ -	\$ -	\$ 9,540,164	\$37,206,640
Accounts payable and accrued liabilities	3,943,763	3,943,763	-	-	-
State resource taxes payable	504,209	48,245	455,964	-	-
Other long term obligations ⁽²⁾	1,828,640	-	-	-	1,828,640
Long term credit facility	30,400,000	-	30,400,000	-	-
Development program	1,700,000	1,700,000	-	-	-
Total contractual obligations	\$ 85,123,416	\$ 5,692,008	\$ 30,855,964	\$ 9,540,164	\$39,035,280

⁽¹⁾ First, second, and third convertible debentures (C\$49,000,000 translated at current exchange rate).

⁽²⁾ Decommissioning obligation.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

8. 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 size 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 petroleum and natural gas properties; and
- provide returns for shareholders and benefits for other stakeholders.

The Board of Directors has not established 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 period. Neither the Company nor any of its subsidiaries are subject to externally imposed capital requirements other than to maintain debt covenants described in note 10. Also, any secured debt in excess of C\$49,000,000 must be approved by the Debenture Holders.

9. NATURAL GAS PROPERTIES

	2011	2010
Oil and natural gas interests	\$ 206,127,263	\$ 202,355,632
Accumulated depletion and depreciation	(41,755,448)	(37,823,398)
Net carrying amount	\$ 164,371,815	\$ 164,532,234

For the period ending September 30, 2011, the Company has not capitalized any general and administrative expenses (2010 – nil).

Due to disappointing third party drilling results in the Columbia River Basin (CRB), the Company wrote down its CRB property by \$184,018 to \$1 in 2010. Effective February 1, 2011, the Company elected to allow the undeveloped leases owned in respect of the CRB property to lapse by not paying annual rentals. As a result, the Company no longer owns any Washington State oil and gas property interests. As the CRB property was not a producing property, this disposition did not have any effect on the Company's continuing operations.

The Company has agreements to participate in the development of certain oil and natural gas wells associated with the Company's Pinedale properties in Wyoming, United States. As at September 30, 2011, the Company is committed to participate in 10 wells in the Pinedale

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

9. NATURAL GAS PROPERTIES (continued)

area for a total commitment of \$11,300,000 of which approximately \$9,600,000 has been expended prior to period end. As of September 30, 2011 eight of the ten wells had been developed and turned in line to sales and two wells were waiting on completion. An additional 18 well (4.16 net) infill program at Mesa is scheduled to commence during the fourth quarter 2011 and the 18 wells will be developed sequentially and turned in line to sales through the third quarter 2012. The 18 well program required a commitment from us to invest approximately \$20 million in capital expenditures.

Failure by the Company to pay its share of a proposed capital program could result in a significant revenue penalty related to the wells.

Security:

At September 30, 2011 all of Arrowhead's properties are pledged as security for the long-term credit facility (note 10) and the convertible debentures subordinated to other debt under the credit facility (note 11).

Contingencies:

Although the Company believes that it has title to its oil and natural gas properties, it cannot control or completely protect itself against the risk of title disputes or challenges.

10. LONG-TERM CREDIT FACILITY

Bucking Horse and Gemini (Guarantors) and Arrowhead (Borrower) entered into a credit agreement dated March 4, 2008 (the Credit Agreement) for a five year senior revolving credit facility (the "Facility") in the aggregate principal amount of up to \$100,000,000, with an initial borrowing base of \$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 LIBOR rate and a spread, which increases based on the increased percentage of availability drawn, resulting in a current interest rate of approximately 2.98% at September 30, 2011. On August 23, 2010, the Credit Agreement was amended, increasing the borrowing base to \$38,000,000. The Company has drawn \$30,400,000 from the Facility and has \$7,600,000 of available credit remaining as at September 30, 2011.

We are required by certain Credit Agreement covenants 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 our current ratio is greater than 1.0 to 1.0. We were in compliance with all of these covenants at September 30, 2011.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

11. CONVERTIBLE DEBENTURES

	Nine months ended September 30, 2011	Year ended December 31, 2010
First Debentures (a)	\$18,126,312	\$ 19,103,157
Second Debentures (b)	9,540,164	10,054,293
Third Debentures (c)	19,080,328	20,108,584
	46,746,804	49,266,036
Less cumulative accretion remaining	(3,466,722)	(4,503,229)
	\$43,280,082	\$ 44,762,807

- (a) The First Debentures were issued on March 4, 2008 and mature on March 4, 2018. They are convertible into units during the first five years at a conversion price of C\$4.875 per unit and into shares at a conversion price of C\$4.875 per share during the last five years and initially bore interest at a rate of 10% during the first six years and 15% during the remaining four 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 C\$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 (C\$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.

- (b) The Second Debentures were issued on March 4, 2008, and mature on August 4, 2014. They are convertible into units up to August 4, 2009, at a conversion price of C\$4.00 per unit and into shares at a conversion price of C\$4.00 per share during the last five years and initially bore interest at a rate of 10% up to August 4, 2010 and 15% during the last four years. Effective May 16, 2008, as a result of an interest rate acceleration provision, the interest rate applicable to the Second Debentures increased from 10% to 15%.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

11. CONVERTIBLE DEBENTURES (continued)

(b) continued

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 (C\$4,567,341) upon issuance, 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.

(c) The Third Debentures were issued on March 4, 2008 and mature on March 4, 2018. They 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 C\$4.875 per unit and into shares at a conversion price of C\$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 C\$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.

The equity portion of the Third Debentures was assigned a total value of \$10,635,543 (C\$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.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

12. DECOMMISSIONING OBLIGATIONS

The Company's decommissioning obligations result from its net ownership interest in its oil and gas properties including the well site and gathering system. The Company estimates the discounted amount of cash flows required to settle its decommissioning obligations is approximately \$1,828,640. The majority of the costs will be incurred after 2050. An inflation factor of 2.7% has been applied to the estimated asset retirement cost. A risk free discount rate of 2.90% – 4.65% was used to calculate the fair value of the decommissioning obligations.

13. EARNINGS (LOSS) PER SHARE

As at September 30, 2011 and 2010, the conversion feature of the convertible debentures into 10,500,000 common shares would be anti-dilutive. Consequently, diluted net earnings (loss) per common share equates to basic net earnings (loss) per common share for both periods presented.

14. SHARE CAPITAL

(a) Share transactions:

Authorized capital at September 30, 2011 and December 31, 2010 consists of unlimited common shares without par value.

	Number of shares	Amount (net)
Balance, December 31, 2008	22,994,513	\$ 61,648,395
Shares cancelled and returned to Treasury	(102,060)	(273,633)
Balance, December 31, 2009	22,892,453	\$ 61,374,762
Shares cancelled and returned to Treasury	(202,040)	(541,669)
Balance, December 31, 2010	22,690,413	\$ 60,833,093
Shares cancelled and returned to Treasury	(8,900)	(24,194)
Balance, September 30, 2011	22,681,513	\$ 60,808,899

15. 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.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

15. RELATED PARTY TRANSACTIONS (continued)

Related party transactions are as follows:

	Nine months ended September 30, 2011	Year ended December 31, 2010
General and administrative expenses: Office, rent, administration and professional services to a company controlled by a Debenture Holder	\$ 322,053	\$ 407,806
Oil and gas consulting and management services provided by a company controlled by a Debenture Holder	140,207	10,196
Interest paid to Debenture Holders	5,635,927	7,136,345

During the year ended December 31, 2010, the Company determined that the amount receivable from Giant was no longer collectible and has accordingly written off the account.

During 2008, the company granted a promissory note receivable from QIL in the amount of C\$4,045,200. During fiscal 2009, the Company entered into an agreement to settle the promissory note whereby QIL would transfer to the Company 600,000 shares of XXL (note 8). The promissory note was therefore written down during 2009 to the estimated fair value of the 600,000 XXL shares of \$79,924. In March 2010, the Company received the 600,000 shares of XXL in settlement of the promissory note. In May 2011, the company sold the XXL shares for net proceeds of C\$198,559.

16. SUPPLEMENTAL CASH FLOW INFORMATION

	Nine months ended September 30, 2011	Year ended December 31, 2010
Interest paid	\$ 6,199,026	\$ 7,607,985
Income taxes paid (received)	-	1,110,000

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

17. SEGMENTED INFORMATION

The Company's activities consisted of the exploration and development natural gas and natural gas liquid properties in Canada and the United States until December 2010 at which time the Canadian assets were disposed of.

Selected segmented information is as follows:

Nine months ended September 30, 2011	Canada	United States	Total
Oil & gas revenue	\$ -	\$11,108,366	\$11,108,366
Operating earnings (loss)	-	1,159,336	1,159,336
Capital expenditures	-	9,545,669	9,545,669
Total assets	2,689,686	179,570,720	182,260,406

Year ended December 31, 2010	Canada	States	United Total
Oil & gas revenue	\$ 114,514	\$13,737,490	\$13,852,004
Operating earnings (loss)	(75,204)	1,470,797	1,395,593
Capital expenditures	2,900	7,276,304	7,279,204
Total assets	3,499,433	174,159,465	177,658,898

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

18. CONTINGENCY

In 2006, the Company's wholly-owned subsidiary, Arrowhead and seven other unrelated defendants were served with a lawsuit alleging that they were in default of a 5% net profits interest on certain properties.

On March 23, 2010, judgment was found in favour of the plaintiffs. The Company's share of this judgment totaled \$58,234 and was paid. Management is of the opinion that the Company's share of the expenses for the years 2009 through to present are financially immaterial.

19. SUBSEQUENT EVENTS

In October 2011, two Mesa wells (0.46 net) that had been waiting on completion were successfully turned in line to sales for a total of 10 new infill wells developed in 2011. Drilling operations associated with the 18 well infill program forecast to be executed through 2012 have commenced.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

19. SUBSEQUENT EVENTS (continued)

As of November 8, 2011, a total of 41,600 Common Shares were purchased pursuant to the 2011 NCIB at an average purchase price of C\$4.25 of which 23,800 have been returned to treasury and cancelled on October 18, 2011.

20. EXPLANATION OF TRANSITION TO IFRS

These interim consolidated financial statements are the Company's third quarter financial statements under IFRS.

The adoption of IFRS requires the application of IFRS 1. IFRS 1 generally requires that an entity retrospectively apply all IFRS effective at the end of its first IFRS reporting period; however, IFRS 1 provides certain mandatory exceptions and permits limited optional exemptions. Certain IFRS 1 optional exemptions have been applied as described in the first quarter financial statements filed on SEDAR.

The accounting policies in note 3 have been applied in preparing the interim consolidated financial statements for the nine months ended September 30, 2011, the comparative information for the nine months ended September 30, 2010 and the financial statements for the year ended December 31, 2010.

In preparing the comparative information for the nine-months ended September 30, 2010, the Company has adjusted amounts previously reported in financial statements prepared in accordance with former Canadian GAAP. An explanation of how the transition from former Canadian GAAP to IFRS has affected the Company's financial position, financial performance and cash flows is summarized below and explained in detail in the notes to the first quarter financial statements filed on SEDAR.

(a) Natural gas properties:

In July 2009, the International Accounting Standards Board approved amendments and released 'Additional Exemptions for First-time Adopters' which prescribes transitional exemptions for oil and gas companies following full cost accounting. The amendment allows an entity that used full cost accounting under Canadian GAAP to elect, at its time of adoption, to measure exploration and evaluation assets at the amount determined under the Canadian GAAP and to measure oil and natural gas assets in the development or production phases by allocating the amount determined under Canadian GAAP for those assets to the underlying assets pro rata using reserve volumes or reserve values as of the date of transition (January 1, 2010), subject to an impairment test as prescribed under IFRS. The Company has applied this exemption. As part of the election, the assets were tested for impairment and there was no impairment found.

(b) Decommissioning obligations

Under Canadian GAAP, asset retirement obligations were discounted at a credit adjusted risk free rate of ten percent. Under IFRS the estimated cash flows to abandon and remediate the wells and facilities has been risk adjusted therefore the provision is discounted at the risk free

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

20. EXPLANATION OF TRANSITION TO IFRS (continued)

(b) Decommissioning obligations (continued):

rate in effect at the end of each reporting period. The change in the decommissioning obligations each period as a result of changes in the discount rate will result in an offsetting charge to natural gas properties.

As a result of the change in the discount rate, the decommissioning obligation accretion expense increased by \$6,502 during the nine-months ended September 30, 2010 as the lower discount rate more than offset the impact of the higher obligation. In addition, under the previous GAAP accretion of the discount was included in depletion and depreciation. Under IFRS it is included in finance expense.

(c) Convertible debentures and equity component of convertible debentures:

Under Canadian GAAP, the Company's convertible debentures were accounted for as a compound instrument with both a debt and equity component. The fair value of the equity component was determined with the balance of the total debenture value being assigned to the debt component. The treatment under IFRS also requires the convertible debentures to be bifurcated into its debt and equity components; however, IFRS requires the fair value of the debt component to be based on a similar stand-alone instrument with the difference between the face value and the fair value of the debt component being allocated to the equity component. Consequently, the amount allocated to debt has been determined to be \$40,607,760 with the balance of \$8,152,140 allocated to equity at the inception of the debentures on March 4, 2008. The debt component is being accreted to the face value of the convertible debentures over their term.

(d) Deferred income taxes:

The bifurcation of the convertible debentures above results in a temporary difference between the tax basis of the debt component of the debentures and its accounting basis for IFRS purposes. Under Canadian GAAP, the tax basis of the debt component was considered to be the same as its carrying amount and therefore no deferred tax was recognized

(e) Business combinations:

The Company elected not to retrospectively apply IFRS 3, *Business Combinations* to business combinations that occurred prior to the transition date and such business combinations have not been restated.

(f) Impairment:

Under IFRS, if indication of impairment is identified, the asset's carrying value is compared to the asset's discounted cash flows. If the discounted cash flows are less than the carrying value, the asset is impaired by an amount equal to the difference between the discounted cash flows and the carrying value. Under Canadian GAAP, if indication of impairment is

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

20. EXPLANATION OF TRANSITION TO IFRS (continued)

(f) Impairment (continued):

identified, the asset's carrying value is compared to the asset's undiscounted cash flows. The Company completed an impairment review of its assets at January 1, 2010 and December 31, 2010 and concluded that the assets were not impaired in accordance with IFRS.

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

20. EXPLANATION OF TRANSITION TO IFRS (continued)

The Canadian GAAP statement of financial position at December 31, 2010 has been reconciled to IFRS as follows:

		December 31, 2010		
	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
Assets				
Current assets				
Cash and cash equivalents		\$ 4,425,957		\$ 4,425,957
Accounts receivable		1,489,939		1,489,939
Promissory note		-		-
Prepaid expenses		-		-
Derivative instruments		6,036,956		6,036,956
Income taxes receivable		1,004,833		1,004,833
		12,957,685		12,957,685
Investments				
Oil and natural gas properties	a,b	168,979		168,979
		163,854,788	677,446	164,532,234
		176,981,452	677,446	177,658,898
Liabilities and Shareholders' Equity				
Current liabilities				
Accounts payable and accrued liabilities		3,124,095		3,124,095
State resource taxes payable		337,853		337,853
Income taxes payable		77,460		77,460
		3,539,408		3,539,408
Non-current liabilities				
Long-term credit facility		18,500,000		18,500,000
State resource taxes payable		286,761		286,761
Convertible debentures	c	28,134,784	16,628,023	44,762,807
Decommissioning obligation	b	137,562	844,542	982,104
Deferred income taxes	d	56,360,899	48,069	56,408,968
		106,959,414	17,520,634	124,480,048
SHAREHOLDERS' EQUITY				
Share capital		60,833,093		60,833,093
Equity portion of debentures payable	c,d	25,329,139	(19,240,184)	6,088,955
Issuer bid purchase		(4,825)		(4,825)
Accumulated other comprehensive income		(1,121,920)		(1,121,920)
Retained earnings (deficit)		(15,013,449)	2,396,996	(12,616,453)
		70,022,038	(16,843,188)	53,178,850
		\$ 176,981,452	\$ 677,446	\$ 177,658,898

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

20. EXPLANATION OF TRANSITION TO IFRS (continued)

The Canadian GAAP statements of income (loss) and comprehensive income (loss) for the three-months ended September 30, 2010 and the nine-months ended September 30, 2010 have been reconciled to IFRS as follows:

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

		Three Months Ended September 30, 2010		
	<i>Note</i>	Canadian GAAP	Effect of transition to IFRS	IFRS
Revenue:				
Oil and natural gas revenue		\$3,363,345		\$3,363,345
Direct expenses:				
Depletion, depreciation and accretion	<i>b</i>	1,347,545	(654)	1,346,891
State resource taxes		297,366		297,366
Royalties		-		-
Operating expenses		1,415,196		1,415,196
		<u>3,060,107</u>	<u>(654)</u>	<u>3,059,453</u>
Net operating income		303,238	654	303,892
Other expenses (income):				
Finance charges	<i>b</i>	1,994,449	8,287	2,002,736
Accretion expense on debentures	<i>c</i>	373,453	(99,547)	273,906
Professional fees		187,714		187,714
General and administration		(7,431)		(7,431)
Foreign exchange (gain) loss	<i>c</i>	(84,212)	548,049	463,837
Financing fees		80,000		80,000
Interest income and other		(12,919)		(12,919)
Realized (gain) loss on derivative instruments		(752,165)		(752,165)
Unrealized loss (gain) on derivative instruments		638,346		638,346
		<u>2,417,235</u>	<u>456,789</u>	<u>2,874,024</u>
Earnings (loss) before income taxes		(2,113,997)	(456,135)	(2,570,132)
Income tax expense (recovery)				
Current		488,333		488,333
Deferred		(642,758)		(642,758)
		<u>(154,425)</u>	<u>-</u>	<u>(154,425)</u>
Net income (loss) for the period		(1,959,572)	(456,135)	(2,415,707)
Other comprehensive income				
Net unrealized gains on translating financial statements into reporting currency		1,831,148		1,831,148
Realized gain on available for sale investments		48,257		48,257
Total comprehensive income (loss) for the period		<u>(80,167)</u>	<u>(456,135)</u>	<u>(536,302)</u>
Basic and diluted loss per common share		\$ (0.09)		\$ (0.11)
Weighted average number of shares outstanding		22,820,766		22,820,766

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

	Nine Months Ended September 30, 2010			
	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
Revenue:				
Oil and natural gas revenue		\$10,767,704		\$10,767,704
Direct expenses:				
Depletion, depreciation and accretion	<i>b</i>	4,372,330	1,132	4,373,462
State resource taxes		994,771		994,771
Operating expenses		4,073,103		4,073,103
		9,440,204	1,132	9,441,336
Net operating income		1,327,500	(1,132)	1,326,368
Other expenses (income):				
Finance charges	<i>b</i>	5,651,361	6,502	5,657,863
Accretion expense on debentures	<i>c</i>	1,180,820	(248,461)	932,359
Professional fees		631,171		631,171
General and administration		526,337		526,337
Foreign exchange (gain) loss	<i>c</i>	18,594	348,444	367,038
Financing fees		105,000		105,000
Interest income and other		(19,246)		(19,246)
Property write down		125,752		125,752
Realized (gain) loss on derivative instruments		(1,874,010)		(1,874,010)
Unrealized loss (gain) on derivative instruments		(2,636,680)		(2,636,680)
		3,709,099	106,485	3,815,584
Earnings (loss) before income taxes		(2,381,599)	(107,617)	(2,489,216)
Income tax expense (recovery)				
Current		870,133		870,133
Deferred		(1,045,101)	-	(1,045,101)
		(174,968)	-	(174,968)
Net income (loss) for the period		(2,206,631)	(107,617)	(2,314,248)
Other comprehensive income				
Net unrealized gains on translating financial statements into reporting currency		1,002,649		1,002,649
Realized gain on available for sale investments		30,354		30,354
Total comprehensive income (loss) for the period		(1,173,628)	(107,617)	(1,281,245)
Basic and diluted loss per common share		\$ (0.10)		\$ (0.10)
Weighted average number of shares outstanding		22,820,766		22,820,766

BUCKING HORSE ENERGY INC.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited – Prepared by Management)
(Expressed in United States dollars, unless otherwise noted)

For the Nine Months Ended September 30, 2011 and 2010

20. EXPLANATION OF TRANSITION TO IFRS (continued)

The Canadian GAAP Consolidated Statement of Changes in Equity at September 30, 2010 has been converted to IFRS as follows:

	Share Capital	Equity Debentures Payable	Reserve For Own Shares	Translation Reserve	Fair Value Reserve	Retained Earnings	Total Equity
Balance at September 30, 2010 - GAAP	60,937,427	25,329,139	(1,341)	(2,336,235)	(177,123)	(12,431,081)	71,320,786
Effect of transition to IFRS	-	(19,240,184)	-	-	-	3,035,799	(16,204,385)
Balance at September 30, 2010 - IFRS	60,937,427	6,088,955	(1,341)	(2,336,235)	(177,123)	(9,395,282)	55,116,401