

CANACOL ENERGY LTD.

**INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
THREE AND SIX MONTHS ENDED DECEMBER 31, 2011**



INTERIM CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

(in thousands of United States dollars)

	Note	December 31, 2011	June 30, 2011 (note 24)	July 1, 2010 (note 24)
ASSETS				
Current assets				
Cash and cash equivalents		\$ 81,023	\$ 101,627	\$ 56,240
Restricted cash	9	9,179	12,604	890
Trade and other receivables	21	39,496	37,976	7,266
Prepaid expenses and deposits		3,408	2,198	563
Prepaid transportation on overlifted volumes	11	-	4,024	-
Commodity contracts		-	-	227
Assets held for sale – Brazil	7	-	3,828	-
Crude oil inventory		7,146	12,348	2,330
		140,252	174,605	67,516
Non-current assets				
Restricted cash	9	464	444	399
Trade and other receivables		-	-	395
Exploration and evaluation assets	6	122,184	33,603	11,913
Property, plant and equipment	7	142,285	88,566	77,135
Pipeline investment	8	3,602	2,589	-
Deferred tax assets		1,694	16,763	-
		270,229	141,965	89,842
Total assets		\$ 410,481	\$ 316,570	\$ 157,358
LIABILITIES AND EQUITY				
Current liabilities				
Bank debt	10	\$ 2,620	\$ -	\$ 322
Trade and other payables	21	47,133	22,208	32,587
Commodity contracts		122	577	-
Overlifted volumes payable	11	-	38,199	-
Equity tax payable	16	980	1,180	-
Assets held for sale – Brazil		-	888	-
Taxes payable		21,418	17,006	292
Warrants		-	-	10,267
		72,273	80,058	43,468
Non-current liabilities				
Decommissioning obligations	12	5,067	4,541	3,783
Convertible debentures	13	25,081	31,454	3,998
Warrants	14	1,548	-	435
Bank debt	10	10,480	-	-
Equity tax payable	16	1,961	2,774	-
Deferred tax liabilities		17,520	7,015	5,927
Total liabilities		\$ 133,930	\$ 125,842	\$ 57,611
Equity				
Share capital	14	\$ 335,366	\$ 269,732	\$ 160,937
Contributed surplus	14	27,151	21,286	12,017
Accumulated other comprehensive loss		498	347	-
Deficit		(89,574)	(100,637)	(73,207)
Equity attributable to owners of parent		273,441	190,728	99,747
Non-controlling interest		3,110	-	-
Total equity		276,551	190,728	99,747
Total liabilities and equity		\$ 410,481	\$ 316,570	\$ 157,358

Commitments and contingencies (note 22); Subsequent events (note 23)

See accompanying notes to interim condensed consolidated financial statements.

INTERIM CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

For the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in thousands of United States dollars, except per share amounts)

	Note	Three months ended December 31,		Six months ended December 31,	
		2011	2010	2011	2010
			(note 24)		(note 24)
Revenues					
Crude oil sales, net of royalties	18	\$ 40,941	\$ 15,669	\$ 67,394	\$ 30,888
Tariff revenue		14,300	1,212	23,177	2,791
		55,241	16,881	90,571	33,679
Expenses					
Operating and transportation		23,573	6,445	36,842	13,779
Pre-license costs for exploration prospects		1,699	-	3,155	-
General and administrative		4,689	5,260	7,230	8,110
Stock-based compensation	14	1,590	1,809	4,068	4,711
Depletion, depreciation and amortization	7	14,516	3,082	23,039	7,665
(Gain) loss on convertible debentures and warrants	13	516	13,152	(3,979)	27,637
Gain on overlifted volumes payable	11	-	-	(7,088)	-
Loss on sale of Brazilian assets	7	-	-	4,170	-
Impairment loss on Brazilian assets	7	-	-	-	11,742
		46,583	29,748	67,437	73,644
Net finance (income) expense	15	1,311	521	(4,374)	4,184
Income (loss) before income taxes		7,347	(13,388)	27,508	(44,149)
Income taxes					
Current		435	3,273	4,350	3,105
Deferred (recovery)		9,272	(1,743)	12,032	(2,268)
		9,707	1,530	16,382	837
Non-controlling interest		63	-	63	-
Net income (loss) for the period		(2,423)	(14,918)	11,063	(44,986)
Other comprehensive income (loss)					
Foreign currency translation adjustment		-	640	151	(142)
Comprehensive income (loss) for the period		\$ (2,423)	\$ (14,278)	\$ 11,214	(45,128)
Earnings (loss) per share					
Basic and diluted	17	\$ -	\$ (0.03)	\$ 0.02	\$ (0.10)

See accompanying notes to interim condensed consolidated financial statements.

INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

For the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in thousands of United States dollars, number of shares in thousands)

	Number of Common Shares	Share Capital	Contributed Surplus	Accumulated Other Comprehensive Loss	Deficit	Total Equity
Balance as at July 1, 2010	421,466	\$ 160,937	\$ 12,017	\$ -	\$ (73,207)	\$ 99,747
Issue of common shares	46,981	59,307	-	-	-	59,307
Conversion of convertible debentures	18,835	27,159	-	-	-	27,159
Warrants exercised	16,122	20,708	-	-	-	20,708
Stock options exercised	8,233	4,629	(2,750)	-	-	1,879
Stock-based compensation	-	-	12,019	-	-	12,019
Share issue costs	-	(3,008)	-	-	-	(3,008)
Net loss for the year	-	-	-	347	(27,430)	(27,083)
Balance at June 30, 2011	511,637	\$ 269,732	\$ 21,286	\$ 347	\$ (100,637)	\$ 190,728
Issue of common shares	100,199	64,493	(240)	-	-	64,253
Conversion of convertible debentures	833	767	-	-	-	767
Stock options exercised	617	374	(161)	-	-	213
Stock-based compensation	-	-	6,266	-	-	6,266
Net income for the period	-	-	-	151	11,063	11,214
Balance at December 31, 2011	613,286	\$ 335,366	\$ 27,151	\$ 498	\$ (89,574)	\$ 273,441

See accompanying notes to interim condensed consolidated financial statements.

INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in thousands of United States dollars)

		Three months ended December 31,		Six months ended December 31,	
	Note	2011	2010	2011	2010
Operating activities					
Net income (loss) for the period		\$ (2,423)	\$ (14,918)	\$ 11,063	\$ (44,986)
Adjustments for non-cash items:					
Stock-based compensation	14	1,590	1,809	4,068	4,711
Depletion, depreciation and amortization	7	14,516	3,082	23,039	7,665
(Gain) loss on convertible debentures and warrants		516	13,152	(3,979)	27,637
Gain on overlifted volumes payable	11	-	-	(7,088)	-
Loss on sale of Brazilian assets		-	-	4,170	-
Impairment loss on Brazilian assets		-	-	-	11,742
Net finance (revenue) expense and other		1,009	1,197	(1,064)	5,844
Deferred income tax		9,272	(1,743)	12,032	(2,268)
		24,480	2,579	42,241	10,345
Changes in non-cash working capital	18	11,278	12,815	23,653	7,540
		35,758	15,394	65,894	17,885
Investing activities					
Expenditures on exploration and evaluation assets	6	(10,941)	-	(17,664)	-
Expenditures on property, plant and equipment	7	(51,484)	(22,403)	(76,117)	(30,644)
Investment in pipeline		(611)	-	(1,013)	-
Net cash acquired in business combination		8,419	-	8,419	-
Proceeds on sale of Brazilian assets		-	-	3,152	-
Purchase of Gemini royalty	14	-	-	-	(18,000)
Change in restricted cash		1,256	19	7,759	868
Changes in non-cash working capital	18	(23,523)	1,040	(24,347)	(157)
		(76,884)	(21,344)	(99,811)	(47,933)
Financing activities					
Issue of common shares	14	63	279	213	3,317
Issue of convertible debentures	13	-	-	-	39,385
Financing and share issue costs		-	-	-	(1,892)
Change in bank debt	10	13,100	305	13,100	283
		13,163	584	13,313	41,093
Change in cash and cash equivalents		(27,963)	(5,366)	(20,604)	11,045
Cash and cash equivalents, beginning of period		108,986	72,651	101,627	56,240
Cash and cash equivalents, end of period		\$ 81,023	\$ 67,285	\$ 81,023	\$ 67,285
Cash and cash equivalents consists of:					
Cash		\$ 44,556	\$ 9,962	\$ 44,556	\$ 9,962
Cash equivalents		36,467	57,323	36,467	57,323
Cash and cash equivalents, end of period		\$ 81,023	\$ 67,285	\$ 81,023	\$ 67,285

See accompanying notes to interim condensed consolidated financial statements.

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

NOTE 1 - GENERAL INFORMATION

Canacol Energy Ltd. (the “Corporation”) and its subsidiaries are primarily engaged in petroleum and natural gas exploration and development activities in Colombia, Brazil and Guyana. The Corporation’s head office is located at 4500, 525 – 8th Avenue SW, Calgary, Alberta, T2P 1G1, Canada. The Corporation’s shares are traded on the Toronto Stock Exchange under the symbol CNE and the Bolsa de Valores de Colombia under the symbol CNE.C.

NOTE 2 - ADOPTION OF IFRS

The Corporation prepares its financial statements in accordance with Canadian generally accepted accounting principles. In 2010, the accounting principles were revised to incorporate International Financial Reporting Standards (“IFRS”) and require publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the Corporation has reported on this basis in these unaudited interim condensed consolidated interim financial statements (the “interim financial statements”). In these interim financial statements, the term “Canadian GAAP” refers to Canadian GAAP prior to the adoption of IFRS.

These interim financial statements have been prepared in accordance with IFRS applicable to the preparation of interim financial statements, including IAS 34 and IFRS 1. Subject to certain transition elections disclosed in note 24, the Corporation has consistently applied the same accounting policies in its opening IFRS statement of financial position at July 1, 2010 and throughout all periods presented, as if these policies had always been in effect. Note 24 discloses the impact of the transition to IFRS on the Corporation’s reported financial position, financial performance and cash flows, including the nature and effect of significant changes in accounting policies from those used in the Corporation’s consolidated financial statements for the year ended June 30, 2011.

The policies applied in these interim financial statements are based on IFRSs issued and outstanding as of beginning of the period. The Board of Directors approved the interim financial statements for issuance on February 8, 2012. Any subsequent changes to IFRS that are given effect in the Corporation’s annual consolidated financial statements for the year ending June 30, 2012 could result in the restatement of these interim financial statements, including the transition adjustments recognized on the change-over to IFRS.

The interim financial statements should be read in conjunction with the Corporation’s Canadian GAAP annual consolidated financial statements for the year ended June 30, 2011.

NOTE 3 - BASIS OF PREPARATION

Basis of Measurement

These interim financial statements have been prepared on an historical cost basis, except for commodity contracts, convertible debentures, warrants and overlifted volumes payable, which are measured at fair value with changes in fair value recorded in profit or loss.

The methods used to measure fair values are discussed in note 21.

These interim financial statements have been prepared on a going concern basis.

Functional and Presentation Currency

These interim financial statements are presented in United States dollars, which is both the functional and presentation currency. Tabular amounts are stated in thousands of United States dollars.

Significant Estimates and Judgements

The timely preparation of financial statements in accordance with IFRS requires that management make estimates and assumptions and use judgement regarding the measured amounts of assets and liabilities at the date of the interim financial statements and the reported amounts of revenue and expenses during the reporting period. Such estimates related primarily to unsettled transactions and events as of the date of the interim financial statements. Accordingly, actual results may differ from estimated amounts as future confirming events occur.

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

Amounts recorded for depletion, depreciation, amortization, accretion, provisions for decommissioning obligations, deferred income taxes, the valuation of convertible debentures, the valuation of warrants, and the valuation of stock options are based on their expected lives and other relevant assumptions. Further, the amounts used for impairment calculations are based on estimated crude oil and natural gas reserves, and other relevant assumptions. By their nature, these estimated reserves and their related future cash flows are subject to measurement uncertainty and the impact in the financial statements of future periods could be material.

Significant judgement is required in determining the provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain in the ordinary course of business. The Corporation has recognized a valuation allowance for the net future tax asset created from Canadian and Brazilian non-capital losses carried forward due to the uncertainty of realization of such amounts.

NOTE 4 - SIGNIFICANT ACCOUNTING POLICIES

These interim financial statements are prepared using the same accounting policies and methods of computation as disclosed in note 3 of the interim condensed consolidated financial statements as at and for the three months ended September 30, 2011.

NOTE 5 – BUSINESS ACQUISITION

In November 2011, the Corporation entered into an agreement to acquire all of the issued and outstanding shares of Carrao Energy Ltd. (“Carrao”), a private company engaged in the evaluation, acquisition, exploration and development of oil and gas properties in Colombia.

On November 29, 2011, the closing date of the transaction, the Corporation acquired approximately 96% of the issued and outstanding securities of Carrao through the issuance of an aggregate 99,930,109 common shares of the Corporation to former holders of Carrao shares, warrants and stock options. The closing price of the Corporation’s common shares on the closing date was C\$0.64 per share. On January 30, 2012, the Corporation issued a further 4,806,445 common shares to acquire the remaining 4% interest in accordance with the compulsory acquisition provisions of the *Business Corporations Act* (British Columbia).

Holders of certain options to purchase Carrao shares elected to convert their Carrao options into options to purchase 5,795,110 common shares of the Corporation. The options were fair-valued at \$0.39 per option using a Black-Scholes model. Certain warrants exercisable into Carrao shares were also exchanged for warrants exercisable into 3,286,920 common shares of the Corporation. The warrants were also fair-valued at \$0.39 per warrant using a Black-Scholes model.

The President, Chief Executive Officer and Director of the Corporation, Mr. Charle Gamba, was also an independent director of Carrao at the time of the acquisition (holding less than 1% of the common shares of Carrao). During the acquisition process, the Corporation and Carrao each struck special committees of their respective boards which excluded Mr. Gamba. Mr. Gamba had no involvement in the formulation, negotiation or acceptance of the offer to acquire Carrao either in his capacity as President, Chief Executive Officer and Director of the Corporation, or as an independent director of Carrao.

Acquisition related costs, other than share issue costs, of approximately \$0.2 million have been expensed as period costs in the interim condensed consolidated statement of operations for the periods ended December 31, 2011.

The acquisition has been accounted for using the purchase method with the results of Carrao’s operations included in the Corporation’s financial and operating results commencing November 30, 2011. The allocation of net assets acquired was based on the best available information at the time and could be subject to further change. The preliminary allocation of the purchase price based on estimated fair values was as follows:

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

Consideration:	
Issue of common shares, warrants and options	\$ 65,544
Non-controlling interest	3,047
Share issue costs	(127)
	\$ 68,464
Net assets acquired:	
Current assets	\$ 13,281
Exploration and evaluation assets	70,917
Current liabilities	(2,191)
Deferred income tax liability	(13,543)
	\$ 68,464

NOTE 6 – EXPLORATION AND EVALUATION ASSETS

Balance at July 1, 2010	\$ 11,913
Additions	21,690
Balance at June 30, 2011	33,603
Acquisition of Carrao	70,917
Additions	17,664
Balance at December 31, 2011	\$ 122,184

NOTE 7 – PROPERTY, PLANT AND EQUIPMENT

	Crude Oil Assets	Gas Processing Facilities	Corporate and Other Assets	Total
Cost or deemed cost				
Balance at July 1, 2010	\$ 75,810	\$ -	\$ 1,618	\$ 77,428
Additions	54,321	-	-	54,321
Transfer to assets held for sale	(15,401)	-	-	(15,401)
Balance at June 30, 2011	114,730	-	1,618	116,348
Additions	61,669	13,698	1,391	76,758
Balance at December 31, 2011	\$ 176,399	\$ 13,698	\$ 3,009	\$ 193,106
Accumulated depletion, depreciation and impairment losses				
Balance at July 1, 2010	-	-	(293)	(293)
Depletion and depreciation	(24,695)	-	(341)	(25,036)
Impairment loss on assets	(14,026)	-	-	(14,026)
Transfer to assets held for sale	11,573	-	-	11,573
Balance at June 30, 2011	(27,148)	-	(634)	(27,782)
Depletion and depreciation	(22,498)	-	(541)	(23,039)
Balance at December 31, 2011	\$ (49,646)	\$ -	\$ (1,175)	\$ (50,821)
Carrying amounts				
At July 1, 2010	\$ 75,810	\$ -	\$ 1,325	\$ 77,135
At June 30, 2011	\$ 87,582	\$ -	\$ 984	\$ 88,566
At December 31, 2011	\$ 126,753	\$ 13,698	\$ 1,834	\$ 142,285

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

In September 2010, the Corporation negotiated the disposition of its non-core, non-operated producing properties in Brazil for cash consideration of approximately \$3.8 million, which have been presented as assets held for sale as at December 31, 2010 and June 30, 2011. In July 2011, the Brazilian regulatory authorities approved the disposition of these non-operated producing properties and the Corporation recognized disposition adjustments, resulting in a loss on sale of Brazilian assets of \$4.2 million.

NOTE 8 – PIPELINE INVESTMENT

The Corporation owns a 0.5% interest in the Oleoducto Bicentenario de Colombia (“OBC”) pipeline project, operated by Ecopetrol, which will link Llanos basin oil production to the Cano Limon oil pipeline system. At December 31, 2011, the Corporation had contributed approximately \$3.6 million of the capital commitment, which is recorded at cost. Under the terms of the OBC agreement, the Corporation may be required to provide financial support or guarantees for its proportionate equity interest in any future debt financings undertaken by OBC. Shareholders of OBC are obliged to execute a transport agreement at a set rate per barrel before the completion of the first phase of the project. The Corporation will also be eligible to receive any dividends on the project.

NOTE 9 – RESTRICTED CASH

	December 31, 2011	June 30, 2011	July 1, 2010
Restricted cash – exploration commitments	\$ 9,179	\$ 12,604	\$ 890
Restricted cash – decommissioning obligations	464	444	399
	\$ 9,643	\$ 13,048	\$ 1,289

As required by the Agencia Nacional de Hidrocarburos (“ANH”) in Colombia and the Agencia Nacional de Petroleo (“ANP”) in Brazil, the Corporation is required to place funds in trust in Colombian and Brazilian banks to ensure payment of its obligations pursuant to certain exploration agreements. In addition, the Corporation was required to place funds in trust for future decommissioning obligations with respect to its Entrerrios field in Colombia.

NOTE 10 – BANK DEBT

Credit Facility – Gas Plant

The Corporation, through its wholly-owned subsidiary, Canacol Energy Colombia S.A. (the “Borrower”), entered into a credit agreement for up to \$27 million to fund the construction of a gas liquids separation facility at its Rancho Hermoso field. As at December 31, 2011, \$13.1 million was drawn on the credit facility to fund such construction costs under a predetermined schedule. The credit facility is repayable in ten equal principal payments plus interest due at the end of each three month period starting on September 1, 2012. The facility bears interest at LIBOR plus 2.50% and is unsecured.

The Borrower is subject to certain financial and operations covenants, including maintaining a Leverage Ratio of less than 2.25, an Interest Coverage Ratio of less than 1.25, both calculated with reference to the Borrower’s trailing twelve-month EBITDA, and minimum non-tariff oil production, net after royalties, of 3,000 barrels of oil per day (“bopd”) from the closing date to September 30, 2012, and 2,500 bopd thereafter.

Revolving Lines of Credit

At December 31, 2011, the Corporation had revolving lines of credit in place in Colombia with an aggregate borrowing base of \$19.6 million (COP\$ 38.1 billion). These lines of credit have interest rates ranging from 6% to 9% and are unsecured. At December 31, 2011, no amounts were drawn under the facilities.

At December 31, 2011, the Corporation had letters of credit outstanding totalling \$10.2 million to guarantee work commitments on exploration blocks. The total of these letters of credit reduce the amounts available under the revolving lines of credit described above.

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

NOTE 11 – OVERLIFTED VOLUMES

Under its contracts with Ecopetrol, the Corporation would normally deliver Ecopetrol's share of crude oil production volumes in kind at a designated delivery point. However, due to capacity restrictions at this delivery point, Ecopetrol typically takes delivery of its production volumes at the Rancho Hermoso field. Ecopetrol has not always been able to take delivery of its production volumes in kind and the Corporation has often been required to sell such volumes since sufficient on-site storage facilities were not available. When the Corporation sold these "overlifted" volumes, a liability was recorded for the amount of the sale and prepaid transportation was recorded for associated transportation costs. As overlifted volumes were to be delivered to Ecopetrol in future periods, the liability and prepaid transportation amounts were reduced with corresponding recognition of such amounts as revenue and transportation costs. Since the participation contract with Ecopetrol required delivery of production volumes in kind, the Corporation revalued the liability at each period-end to reflect the fair value of the crude oil owing to Ecopetrol at that time and gains or losses related to such were recognized in profit or loss in the period. In December 2011, the Corporation signed an agreement with Ecopetrol and repaid its outstanding overlifted volumes in cash for approximately \$24.8 million, which reflected the actual sales value the Corporation received for the crude oil less actual transportation costs. Related to this settlement, the Corporation also commenced additional discussions with Ecopetrol regarding transportation tariffs on previous shipments of crude oil. Consequently, the Corporation has not recognized the finalization of the settlement of the overlifted volumes payable pending the outcome of those discussions. There were no overlifted volumes outstanding at December 31, 2011.

A summary of overlifted volumes and the related net liability is provided below. At December 31, 2011, the Corporation did not have any overlifted volumes.

	December 31, 2011	June 30, 2011	July 1, 2010
Overlifted volumes (Mbbbls)	-	368.4	-
Average valuation price (\$/bbl)	\$ -	\$ 103.69	\$ -
Overlifted volumes payable	\$ -	\$ 38,199	\$ -
Less: transportation costs	-	(4,024)	-
Net payable on overlifted volumes	\$ -	\$ 34,175	\$ -

NOTE 12 – DECOMMISSIONING OBLIGATIONS

Balance at June 30, 2011	\$	4,541
Accretion		417
Additions, disposals and revisions		109
Balance at December 31, 2011	\$	5,067

The Corporation's decommissioning obligations result from its ownership interest in petroleum and natural gas assets, including well sites and gathering systems. The total decommissioning obligation is estimated based on the Corporation's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities, and the estimated timing of the costs to be incurred in future years. The Corporation has estimated the net present value of the decommissioning obligations to be \$5.1 million at December 31, 2011 (June 30, 2011 - \$4.5 million) based on an undiscounted total future liability of \$5.4 million (June 30, 2011 - \$4.7 million). These payments are expected to be made over the next 22 years with the majority of costs to be incurred between 2013 and 2017. The discount factor, being the risk-free rate related to the liability, is 5.0% (June 30, 2011 - 5.0%) and the inflation rate is 3.2% (June 30, 2011 - 3.5%).

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

NOTE 13 – CONVERTIBLE DEBENTURES

2015 Convertible Debentures

On July 16, 2010, the Corporation closed a Canadian dollar denominated convertible unsecured debenture financing for aggregate gross proceeds of \$39.4 million (C\$41.5 million) (the “2015 Debentures”). The 2015 Debentures bear interest at 8% per annum, payable semi-annually on the last day of June and December commencing on December 31, 2010. The 2015 Debentures mature on June 30, 2015 and are convertible at the holder’s option into common shares of the Corporation at any time prior to the earlier of either the maturity date or the business day immediately preceding the date fixed by the Corporation for redemption at a conversion price of C\$1.0526 per common share, being the ratio of 950 common shares per C\$1,000 principal amount of 2015 Debentures. The 2015 Debentures are not redeemable prior to June 30, 2013. Transaction costs in connection with the financing were \$1.9 million and were recognized in profit or loss.

The 2015 Debentures were recorded at fair value through profit or loss. Subsequent to initial recognition, these financial instruments are measured at fair value and changes therein are recognized in profit or loss. A reconciliation of the 2015 Debentures is provided below.

Balance at June 30, 2011	\$	30,426
Unrealized gain		(4,288)
Foreign exchange gain		(1,057)
Balance at December 31, 2011	\$	25,081

2011 Convertible Debentures

At December 31, 2011, no 2011 Debentures remained outstanding.

In September 2009, the Corporation closed a Canadian dollar denominated convertible unsecured subordinated debenture financing for aggregate gross proceeds of \$3.7 million (C\$4.0 million) (the “2011 Debentures”). The 2011 Debentures bear interest at 12% per annum, payable quarterly through the issue of common shares at a price equal to a 10% discount to the volume weighted-average trading price of the Corporation’s common shares for the 10 trading days immediately preceding the quarterly interest payment date. The 2011 Debentures mature within 24 months of issuance and are convertible into common shares of the Corporation at the holder’s option at a conversion price of C\$0.36 per common share.

The 2011 Debentures were recorded at fair value through profit or loss. Subsequent to initial recognition, these financial instruments are measured at fair value and changes therein are recognized in profit or loss. A reconciliation of the 2011 Debentures is provided below.

Balance at June 30, 2011	\$	1,028
Conversion to common shares		(767)
Gain on conversion to common shares		(261)
Balance at December 31, 2011	\$	-

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

NOTE 14 – SHARE CAPITAL

Authorized

The Corporation is authorized to issue an unlimited number of common shares.

Issued and Outstanding

	Number (000s)		Amount
Balance at July 1, 2010	421,466	\$	160,937
Issue of common shares	46,981		59,307
Issued on exercise of warrants	16,122		20,708
Issued on exercise of stock options	8,233		1,879
Issued on conversion of convertible debentures	18,835		27,159
Share issue costs	-		(3,008)
Transfer from contributed surplus for stock options exercised	-		2,750
Balance at June 30, 2011	511,637		269,732
Issued on exercise of stock options	617		213
Issued on conversion of convertible debentures	833		767
Issued on interest payments for convertible debentures	8		7
Issued to employees	71		65
Issued on conversion of restricted share units	190		244
Issued on Carrao acquisition	99,930		64,304
Share issue costs	-		(127)
Transfer from contributed surplus for stock options exercised	-		161
Balance at December 31, 2011	613,286	\$	335,366

Warrants

	Number (000s)		Amount
Balance at July 1, 2010	16,122	\$	10,702
Exercised	(16,122)		(10,702)
Balance at June 30, 2011	-		-
Issued on Carrao acquisition	3,287		1,548
Balance at December 31, 2011	3,287	\$	1,548

The warrants outstanding at December 31, 2011 are exercisable into common shares of the Corporation at C\$0.52 per share; 645,000 warrants expire on September 8, 2014 while the remaining 2,641,920 warrants expire on February 9, 2016 (note 5).

Equity Financing

In February 2011, the Corporation completed an equity financing for gross proceeds of \$58.3 million (C\$57.6 million) and net proceeds of \$55.3 million (C\$54.7 million). Pursuant to the financing, the Corporation issued 41,745,000 common shares at a price of C\$1.38 per share. Share issue costs with respect to this financing were \$3.0 million (C\$3.0 million).

Gemini Royalty Interest

In 2009, the Corporation executed a series of agreements with Gemini Oil and Gas Fund II, L.P. (“Gemini”) whereby Gemini agreed to invest up to \$9.0 million to fund a portion of the Corporation’s development and appraisal programs on its producing assets in Colombia in exchange for an overriding royalty on certain properties. Effective June 30, 2010, the Corporation agreed to acquire the overriding royalty back from Gemini for \$21.4 million. On July 16, 2010, the Corporation settled the transaction through the issue 4,421,260 common shares and a cash payment of \$18.0 million.

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Contributed Surplus

Balance at July 1, 2010	\$	12,017
Stock-based compensation		12,019
Stock options exercised		(2,750)
Balance at June 30, 2011		21,286
Stock-based compensation		6,266
Conversion of restricted share units		(240)
Stock options exercised		(161)
Balance at December 31, 2011	\$	27,151

Stock Options

The Corporation has a stock option program that entitles officers, directors, employees and certain consultants to purchase shares in the Corporation. Options are granted at the market price of the shares at the date of grant, have a five year term and vest over three years.

The number and weighted-average exercise prices of stock options are as follows:

	Number	Weighted-Average Exercise Price
	(000s)	(C\$)
Balance at July 1, 2010	24,909	0.36
Granted	17,937	1.20
Exercised	(8,233)	0.33
Forfeited and cancelled	(445)	1.06
Balance at June 30, 2011	34,168	0.81
Granted	14,732	0.75
Exercised	(617)	0.34
Forfeited and cancelled	(151)	1.26
Balance at December 31, 2011	48,132	0.77

Information with respect to stock options outstanding at December 31, 2011 is presented below.

Range of Exercise Prices (C\$)	Stock Options Outstanding			Stock Options Exercisable	
	Number of Stock Options (000s)	Weighted-Average Remaining Contractual Life (years)	Weighted- Average Exercise Price (C\$)	Number of Stock Options (000s)	Weighted- Average Exercise Price (C\$)
\$0.10 to \$0.35	10,520	2.37	0.25	10,520	0.25
\$0.36 to 0.70	11,544	3.53	0.56	3,049	0.60
\$0.71 to \$1.05	17,328	4.35	0.89	6,932	0.88
\$1.06 to \$1.40	1,610	3.20	1.21	582	1.23
\$1.41 and up	7,130	4.05	1.50	1,989	1.52
	48,132	3.51	0.77	23,072	0.62

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Restricted Share Units

In May 2010, the Corporation issued 360,000 restricted share units to an officer. The restricted share units vest as to 25% every six months from the grant date over a period of two years. In November 2010, the Corporation issued 300,000 restricted share units to an employee. The restricted share units vest as to 33% every six months from the grant date over a period of 18 months.

	Number (000s)	Weighted- Average Grant Price (C\$)
Balance at July 1, 2010	360	0.75
Granted	300	1.77
Converted	(280)	1.21
Balance at June 30, 2011	380	1.21
Converted	(190)	1.21
Balance at December 31, 2011	190	1.21

Stock-Based Compensation

The fair value of the stock options granted was estimated using the Black-Scholes option pricing model with the following weighted-average inputs:

	Six months ended December 31, 2011	Year ended June 30, 2011
Weighted-average fair value at grant date (C\$)	0.77	0.57
Share price (C\$)	0.64 - 1.06	0.07 - 1.68
Exercise price (C\$)	0.64 - 1.06	0.10 - 1.68
Volatility	77 - 82%	72 - 126%
Option life	5 years	5 years
Dividends	nil	nil
Risk-free interest rate	1.36 - 2.32%	1.85 - 4.25%

A forfeiture rate of 5% (2010 – 5%) was used when recording stock-based compensation for the three and six months ended December 31, 2011. This estimate is adjusted to the actual forfeiture rate. Stock-based compensation expense of \$1.6 million and \$4.1 million (2010 – \$1.8 million and \$4.7 million) was expensed during the three and six months ended December 31, 2011, respectively. In addition, stock-based compensation expense of \$1.1 million and \$1.1 million (2010 – \$nil and \$nil) was capitalized during the three and six months ended December 31, 2011, respectively.

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NOTE 15 – FINANCE INCOME AND EXPENSE

	Three months ended December 31,		Six months ended December 31,	
	2011	2010	2011	2010
Finance income				
Interest income on bank deposits	\$ 669	\$ 247	\$ 1,204	\$ 498
Commodity contract gain – unrealized	-	-	454	-
Net foreign exchange gain	-	2,249	4,642	1,054
	669	2,496	6,300	1,552
Finance expense				
Accretion on equity tax payable	6	-	32	-
Accretion on decommissioning obligations	273	175	417	1,077
Interest expense	1,137	1,331	1,399	2,705
Commodity contract loss – realized	-	-	78	-
Commodity contract loss – unrealized	162	1,511	-	1,954
Net foreign exchange loss	402	-	-	-
	1,980	3,017	1,926	5,736
Net finance (income) expense	\$ 1,311	\$ 521	\$ (4,374)	\$ 4,184

NOTE 16 – EQUITY TAX

Equity tax represents a tax on the capital of Colombian corporations and branches of foreign corporations. The tax was approved by the Colombian government in December 2010 and was assessed for the calendar years 2011-2014 based on 6% of the net equity of the Corporation's Colombian entities as at January 1, 2011. The assessed amount of \$5.2 million is payable in semi-annual instalments over the four-year period. The net present value of the assessed amount, being \$4.0 million, was expensed on January 1, 2011 and was classified as an operating expense in the statement of operations at that time since it is not based on income.

NOTE 17 – EARNINGS PER SHARE

Basic and diluted earnings per share were calculated as follows:

	Three months ended December 31,		Six months ended December 31,	
	2011	2010	2011	2010
Net income (loss), basic and diluted	\$ (2,423)	\$ (14,918)	\$ 11,063	\$ (44,986)
Weighted-average common share adjustments				
Weighted-average common shares outstanding, basic	546,847	446,475	529,570	438,367
Effect of warrants	-	-	1,228	-
Effect of stock options	-	-	11,195	-
Effect of restricted share units	-	-	190	-
Weighted-average common shares outstanding, diluted	546,847	446,475	542,183	438,367

For the three months ended December 31, 2011 and the three and six months ended December 31, 2010, all items were anti-dilutive due to the net losses for those periods. For the six months ended December 31, 2011, the effect of the convertible debentures was anti-dilutive.

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 18 – SUPPLEMENTED INFORMATION

The Corporation records crude oil sales net of royalties. Royalties incurred were as follows:

	Three months ended December 31,		Six months ended December 31,	
	2011	2010	2011	2010
Royalties	\$ 6,092	\$ 1,263	\$ 9,369	\$ 2,552

Income taxes and interest paid were as follows:

	Three months ended December 31,		Six months ended December 31,	
	2011	2010	2011	2010
Income taxes paid	\$ -	\$ -	\$ -	\$ -
Interest paid	\$ 1,136	\$ -	\$ -	\$ -

Changes in non-cash working capital are comprised of:

	Three months ended December 31,		Six months ended December 31,	
	2011	2010	2011	2010
Change in:				
Trade and other receivables	\$ (12,158)	\$ (1,221)	\$ (4,305)	\$ (4,491)
Prepaid expenses and deposits	(1,024)	(138)	(637)	(153)
Prepaid transportation on overlifted volumes	4,088	-	4,024	-
Crude oil inventory	799	-	5,202	-
Trade and other payables	26,776	13,948	22,734	10,934
Overlifted volumes payable	(31,856)	-	(31,111)	-
Equity tax payable	(43)	-	(1,013)	-
Taxes payable	1,173	1,266	4,412	1,093
	(12,245)	13,855	(694)	7,383
Attributable to:				
Operating activities	11,278	12,815	23,653	7,540
Investing activities	(23,523)	1,040	(24,347)	(157)
	\$ (12,245)	\$ 13,855	\$ (694)	\$ 7,383

NOTE 19 – SIGNIFICANT SUBSIDIARIES

The Corporation has the following significant subsidiaries:

	Country of Incorporation	Ownership Interest	
		December 31, 2011	June 30, 2011
Canacol Energy Inc.	Canada	100%	100%
Canacol Energy Colombia S.A.	Colombia	100%	100%
Canacol Energy Inc. (Sucursal Colombia)	Colombia	100%	100%
Canacol Energy (Guyana) Inc.	Guyana	100%	100%
Carrao Energy Ltd.	Canada	96% ⁽¹⁾	-
Brazalta Brazil Norte Ltda.	Brazil	100%	100%

(1) The Corporation acquired the remaining 4% ownership on January 30, 2012 (note 5).

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 20 – SEGMENTED INFORMATION

IFRS 8 requires operating segments be identified based on the Corporation's internal system for reporting information to senior management to allocate resources to the segments and to assess their performance.

The Corporation's reportable and geographical segments are Colombia, Guyana, Brazil and Corporate. Corporate activities include the Corporation's corporate office in Canada. The accounting policies used for the reportable segments are the same as the Corporation's accounting policies.

For the purposes of monitoring segment performance and allocating resources between segments, the Corporation's executive officers monitor the tangible, intangible and financial assets attributable to each segment. All assets are allocated to reportable segments. The following tables show information regarding the Corporation's reportable segments.

	Colombia	Brazil	Guyana	Corporate and Other	Total
Three months ended December 31, 2011					
Revenues	\$ 55,241	\$ -	\$ -	\$ -	\$ 55,241
Expenses, excluding income taxes	(38,460)	(57)	(3)	(9,374)	(47,894)
	16,781	(57)	(3)	(9,374)	7,347
Income taxes	9,707	-	-	-	9,707
Non-controlling interest	-	-	-	63	63
Net income (loss)	\$ 7,074	\$ (57)	\$ (3)	\$ (9,437)	\$ (2,423)
Capital expenditures, net	\$ 61,251	\$ 399	\$ -	\$ 775	\$ 62,425
Six months ended December 31, 2011					
Revenues	\$ 90,571	\$ -	\$ -	\$ -	\$ 90,571
Expenses, excluding income taxes	(53,910)	(1,826)	(3)	(7,324)	(63,063)
	36,661	(1,826)	(3)	(7,324)	27,508
Income taxes	16,382	-	-	-	16,382
Non-controlling interest	-	-	-	63	63
Net income (loss)	\$ 20,279	\$ (1,826)	\$ (3)	\$ (7,387)	\$ 11,063
Capital expenditures, net	\$ 90,789	\$ 399	\$ 1,202	\$ 1,391	\$ 93,781
Three months ended December 31, 2010					
Revenues	\$ 15,946	\$ 935	\$ -	\$ -	\$ 16,881
Expenses, excluding income taxes	(10,516)	(1,120)	-	(18,633)	(30,269)
	5,430	(185)	-	(18,633)	(13,388)
Income taxes	(1,530)	-	-	-	(1,530)
Net income (loss)	\$ 3,900	\$ (185)	\$ -	\$ (18,633)	\$ (14,918)
Capital expenditures, net	\$ 19,451	\$ 380	\$ 2,521	\$ 51	\$ 22,403
Six months ended December 31, 2010					
Revenues	\$ 31,885	\$ 1,794	\$ -	\$ -	\$ 33,679
Expenses, excluding income taxes	(22,828)	(15,817)	-	(39,183)	(77,828)
	9,057	(14,023)	-	(39,183)	(44,149)
Income taxes	(837)	-	-	-	(837)
Net income (loss)	\$ 8,220	\$ (14,023)	\$ -	\$ (39,183)	\$ (44,986)
Capital expenditures, net	\$ 25,592	\$ 725	\$ 4,276	\$ 51	\$ 30,644

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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(in United States dollars (tabular amounts in thousands) except as otherwise noted)

	Colombia	Brazil	Guyana	Corporate and Other	Total
As at December 31, 2011					
Total assets	\$ 304,986	\$ 14,066	\$ 25,820	\$ 65,609	\$ 410,481
Total liabilities	\$ 80,434	\$ 233	\$ -	\$ 53,263	\$ 133,930
As at June 30, 2011					
Total assets	\$ 210,365	\$ 13,651	\$ 24,813	\$ 67,741	\$ 316,570
Total liabilities	\$ 90,601	\$ 1,046	\$ 1,155	\$ 33,040	\$ 125,842
As at December 31, 2010					
Total assets	\$ 125,806	\$ 25,720	\$ 11,403	\$ 23,175	\$ 186,104
Total liabilities	\$ 30,896	\$ 1,827	\$ -	\$ 67,004	\$ 99,727

NOTE 21 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Fair Value of Financial Instruments

The carrying values and respective fair values of financial assets and liabilities at December 31, 2011 are summarized as follows:

	Carrying Value	Fair Value
Fair value through profit or loss		
Cash and cash equivalents	\$ 81,023	\$ 81,023
Restricted cash	9,179	9,179
Commodity contracts	122	122
Convertible debentures	25,081	25,081
Warrants	1,548	1,548
Loans and receivables		
Bank debt	13,100	13,100
Trade and other receivables	39,496	39,496
Other liabilities		
Trade and other payables	47,133	47,133

The Corporation classifies the fair value of financial instruments measured at fair value according to the following hierarchy based on the amount of observable inputs used to value the instrument.

- Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2 valuations are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.
- Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

The Corporation's financial instruments have been assessed on the fair value hierarchy described above. Cash and cash equivalents and convertible debentures are classified as Level 1. Commodity contracts payable are classified as Level 2. Warrants are classified as Level 3. Assessment of the significance of a particular input to the fair value measurement requires judgement and may affect the placement within the fair value hierarchy level.

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Commodity Price Risk

Commodity price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate as a result of changes in commodity prices. Lower commodity prices can also impact the Corporation's ability to raise capital. Commodity prices for crude oil are impacted by world economic events that dictate the levels of supply and demand. From time to time the Corporation may attempt to mitigate commodity price risk through the use of financial derivatives. The Corporation's policy is to only enter into commodity contracts considered appropriate to a maximum of 50% of forecasted production volumes.

At December 31, 2011, the Corporation had one financial WTI oil collar outstanding under the following terms:

Period	Volume	Type	Price Range
Dec 2011 – Jun 2012	1,000 bbls/day	Financial WTI Oil Collar	\$85.00 – \$108.50

For the three and six months ended December 31, 2011, a \$1.00/bbl increase/decrease in the price of a barrel of crude oil is estimated to increase/decrease the Corporation's earnings and operating cash flows by \$291,000 and \$504,000, respectively, assuming all other variables are held constant.

Foreign Currency Risk

Foreign currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate as a result of changes in foreign currency exchange rates. The Corporation is exposed to foreign currency fluctuations as certain expenditures are denominated in Colombian pesos, Brazilian reais and Canadian dollars.

The Corporation had no forward exchange rate contracts in place as at or during the three and six months ended December 31, 2011.

For the three months ended December 31, 2011, a 1% increase/decrease in the US dollar vis-à-vis the Colombian peso, Brazilian real and Canadian dollar is estimated to increase/decrease the Corporation's earnings and operating cash flows by \$179,000, \$3,000 and \$44,000, respectively, assuming all other variables are held constant. For the six months ended December 31, 2011, a 1% increase/decrease in the US dollar vis-à-vis the Colombian peso, Brazilian real and Canadian dollar is estimated to increase/decrease the Corporation's earnings and operating cash flows by \$371,000, \$30,000 and \$61,000, respectively, assuming all other variables are held constant.

Interest Rate Risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate as a result of changes in market interest rates. The Corporation is exposed to interest rate risk on certain variable interest rate Colombian peso denominated debt instruments, to the extent they are drawn, and interest rate price risk on fixed rate convertible debentures. The remainder of the Corporation's financial assets and liabilities are not exposed to interest rate risk. The Corporation had no interest rate swap or financial contracts in place as at or during the three and six months ended December 31, 2011.

The Corporation's sensitivity to interest rates in the three and six month periods ended December 31, 2011 was immaterial.

Liquidity Risk

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they become due. The Corporation's approach to managing liquidity is to ensure, within reasonable means, sufficient liquidity to meet its liabilities when due, under both normal and unusual conditions, without incurring unacceptable losses or jeopardizing the Corporation's business objectives. The Corporation prepares annual capital expenditure budgets which are monitored regularly and updated as considered necessary. Crude oil production is monitored daily to provide current cash flow estimates and the Corporation utilizes authorizations for expenditures on projects to manage capital expenditures.

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The following table outlines the contractual maturities of the Corporation's financial liabilities at December 31, 2011:

	Less than 1 year		1-2 years		Thereafter		Total
Bank debt	\$	2,620	\$	10,480	\$	-	\$ 13,100
Trade and other payables		47,133		-		-	47,133
Commodity contracts		122		-		-	122
Equity tax payable		1,135		2,270		-	3,405
Convertible debentures – principal		-		-		25,092	25,092
Warrants		1,548		-		-	1,548
	\$	52,558	\$	12,750	\$	25,092	\$ 90,400

In addition to the above, the Corporation has issued letters of credit totalling \$10.2 million to guarantee certain obligations under its exploration contracts. Such amounts only become payable should the Corporation not meet those obligations.

Credit risk reflects the risk of loss if counterparties do not fulfill their contractual obligations. The majority of the Corporation's trade accounts receivable balances relate to crude oil sales. The Corporation's policy is to enter into agreements with customers that are well established and well financed entities in the oil and gas industry such that the level of risk is mitigated. To date, the Corporation has not experienced any material credit loss in the collection of trade accounts receivable. In Colombia, a significant portion of crude oil sales and tariff oil revenue are with three customers: Hocol, Ecopetrol and Petrobras Colombia. Ecopetrol and Petrobras Colombia are government controlled entities while Hocol is controlled by Ecopetrol. The Corporation has also entered into sales agreements with certain Colombian private sector companies.

Details of the Corporation's trade and other accounts receivable balances are as follows:

	December 31, 2011		June 30, 2011	
Trade receivables – Hocol, Ecopetrol and Petrobras Colombia	\$	11,465	\$	25,542
Trade receivables – Hidrocarburos Casanares S.A.		8,088		-
Trade receivables – Emerald Energy Plc		2,763		-
Trade receivables – other entities		145		1,165
Total trade receivables		22,461		26,707
Cash calls receivable		6,745		9,140
Taxes receivable		10,290		2,129
Total trade and other receivables	\$	39,496	\$	37,976
Aging of trade receivables:				
Less than 30 days	\$	22,459	\$	26,550
31 – 60 days		-		21
61 – 90 days		-		90
Over 90 days		2		46
	\$	22,461	\$	26,707

The Corporation's trade receivables primarily relate to sales of crude oil, which are normally collected within 45 days of the month of production. The Corporation has historically not experienced any collection issues with its crude oil customers.

The cash calls receivable balance at December 31, 2011 is considered collectible. The cash calls receivable related to the Corporation's joint operations in Brazil were written off as part of the sale of the producing properties during the six months ended December 31, 2011.

The taxes receivable balance at December 31, 2011 can be applied to future required tax payments.

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Market Risk

Market risk is the risk that changes in market factors, such as foreign exchange rates, commodity prices, and interest rates will affect the Corporation's cash flows, profit or loss, liquidity or the value of financial instruments. The objective of market risk management is to mitigate market risk exposures where considered appropriate and maximize returns.

Capital Management

The Corporation's policy is to maintain a strong capital base in order to provide flexibility in the future development of the business and maintain investor, creditor and market confidence. The Corporation manages its capital structure and makes adjustments in response to changes in economic conditions and the risk characteristics of the underlying assets. The Corporation considers its capital structure to include common share capital, convertible debentures, bank debt and working capital, a non-IFRS measure defined as current assets less current liabilities. In order to maintain or adjust the capital structure, from time to time the Corporation may issue common shares or other securities, sell assets or adjust its capital spending to manage current and projected debt levels.

The Corporation monitors leverage and adjusts its capital structure based on the ratio of net debt to cash flow from operations before changes in non-cash working capital. This ratio is calculated as net debt, a non-IFRS measure the Corporation defines as outstanding bank debt plus the principal amount of its convertible debentures, unless the debentures are in-the-money, and working capital deficiency, divided by cash flow from operations before changes in non-cash working capital for the most recent calendar quarter, annualized. At December 31, 2011, the Corporation was not in a net debt position due to its working capital surplus. The Corporation uses the ratio of net debt to cash flow as a key indicator of the Corporation's leverage and to monitor the strength of its financial position. In order to facilitate the management of this ratio, the Corporation prepares annual budgets, which are updated as necessary depending on varying factors including current and forecast crude oil prices, changes in capital structure, execution of the Corporation's business plan and general industry conditions. The annual budget is approved by the Board of Directors and updates are prepared and reviewed as required.

NOTE 22 – COMMITMENTS AND CONTINGENCIES

Presented below are the Corporation's contractual commitments at December 31, 2011:

	Less than 1 year		1-3 years		Thereafter		Total
Exploration contracts ⁽¹⁾	\$	63,900	\$	13,000	\$	-	\$ 76,900
Office leases		865		1,569		1,968	4,402
	\$	64,765	\$	14,569	\$	1,968	\$ 81,302

(1) Pursuant to exploration contracts, the Corporation has work commitments totalling \$76.9 million to be completed during the next three years. The work commitments are normal course of business exploration activities that include property costs, acquisition and processing of seismic data and drilling exploration wells. The Corporation has issued letters of credit totalling \$10.2 million to guarantee the obligations under these exploration contracts.

Gas Purchases and Gas Plant

On August 31, 2011, the Corporation was awarded a contract by Ecopetrol to purchase produced natural gas from the Rancho Hermoso field at a fixed price of \$6.50/MMBtu, which includes the associated liquids – natural gasoline, propane and butane. The contract is effective on January 1, 2012 and is for a period of 5 years. The Corporation has initiated the construction of a gas liquids separation facility with the intention of processing the future natural gas production and selling the resulting liquids. The gas plant construction is underway and is expected to cost approximately \$30.8 million in total with all ancillary projects. At December 31, 2011, the Corporation had spent \$13.7 million towards the construction of the gas plant; the remaining amount is expected due within a year. The Corporation has funded the construction of the gas plant through its \$27 million term loan (note 10).

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Trucking Contract

The Corporation has signed an agreement with a Colombian trucking company for the exclusive use of 100 trucks for transportation of crude oil from the Corporation's operations in Colombia for a period of three years. The Corporation will pay transportation fees plus an additional 7.5% for administrative costs. Any excess or shortage of the fees charged over the actual operating costs will be shared equally between the Corporation and the trucking company at the end of each year. The Corporation has the option to purchase up to 50 trucks at the end of the three year agreement.

Contingencies

In the normal course of operations, the Corporation has disputes with industry participants for which it currently cannot determine the ultimate results. The Corporation has a policy to record contingent liabilities as they become determinable and the probability of loss is more likely than not.

NOTE 23- SUBSEQUENT EVENTS

On January 30, 2011, the Corporation issued an additional 4,806,445 common shares to acquire the remaining Carrao shares pursuant to the compulsory acquisition provisions of the *Business Corporations Act* (British Columbia) (note 5).

On January 10, 2012 the Corporation, through a subsidiary, entered into an arm's length agreement for the acquisition of an additional 9% interest in the LLA 23 block and an additional 10% interest in the Santa Isabel block, both in Colombia. The consideration of approximately \$4.5 million is subject to adjustments and payable in cash or in common shares of the Corporation, at the Corporation's election. The agreement also provides for the Corporation, through a subsidiary, to lend the vendor on a secured basis up to \$4.5 million for a 90 day period. In February 2012, the transaction was partially completed with the loan advance and the execution of the transfer documents for the two blocks.

In February 2012, a company in which the Corporation has a non-operated 25% equity participation interest was awarded a 15 year incremental production contract by the national oil company of Ecuador ("Petroecuador" or "EPPE") for the Libertador and Atacapi mature fields in Northern Ecuador. The operator is required to spend a total of \$334 million (\$92.9 million, net to the Corporation) over the 15 year period of the contract. The Corporation's net share of such work program commitments during calendar 2012 is \$10.2 million. In return for increased production at EPPE's mature fields, the operator will receive a fixed price tariff of \$39.56 for each incremental barrel of oil produced, which is insensitive to oil price fluctuations. All operating expenses are paid for by EPPE.

NOTE 24 - TRANSITION TO IFRS

The Corporation adopted IFRS on July 1, 2011 with a transition date of July 1, 2010. This note sets out how the transition from Canadian GAAP to IFRS has affected the Corporation's financial position and comprehensive income (loss). The accounting policies set out in note 4 have been applied in preparing the interim financial statements for the periods ended December 31, 2011, the comparative information presented in these interim financial statements for the periods ended December 31, 2010 and June 30, 2010, and in the preparation of an opening IFRS statement of financial position at July 1, 2010 (the "Transition Date").

IFRS employs a conceptual framework that is similar to Canadian GAAP. While the adoption of IFRS has not changed the actual cash flows of the Corporation, the adoption has resulted in changes to the reported financial position and results of operations of the Corporation. The differences between IFRS and Canadian GAAP that affect the Corporation are described in the notes following the reconciliation tables below.

Under IFRS 1, "First Time Adoption of International Financial Reporting Standards", IFRS is applied to all accounts retrospectively at the Transition Date unless a specific exemption was available and is taken. The following are the significant exemptions the Corporation has elected to apply:

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Deemed cost exemption for property, plant and equipment – The Corporation has elected to report items of property, plant and equipment on Transition Date at deemed cost instead of the actual cost that would be determined under IFRS. The deemed cost of an item may be either its fair value at the Transition Date or an amount determined by a previous revaluation under Canadian GAAP. The exemption can be applied on an asset-by-asset basis. Petroleum and natural gas assets that were part of the full cost pool and determined to be developed or producing assets were allocated to Cash Generating Units on the Transition Date pro rata using proved plus probable reserve volumes, subject to an impairment test on the Transition Date.

Share-based payments – The Corporation has elected not to apply IFRS 2, “Share-Based Payments”, to equity instruments which vested before the Transition Date. As such, adjustments were made only to share-based payments that were granted before the Transition Date but had not vested.

Decommissioning liabilities – In accounting for changes in obligations to dismantle, remove and restore items of property, plant and equipment, the guidance under IFRS requires changes in such obligations to be added to or deducted from the cost of the asset to which it relates. The adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life. Rather than recalculating the effect of all such changes throughout the life of the obligations, the Corporation has elected to measure the liability and the related depreciation effects at the Transition Date.

Borrowing costs – The Corporation applied an IFRS transitional exemption to prospectively capitalize borrowing costs from the Transition Date.

Cumulative translation differences – The Corporation elected to set the cumulative translation account, which is included in accumulated other comprehensive income, to \$nil at July 1, 2010. This exemption has been applied to all subsidiaries.

Business combinations – IFRS allows entities to apply IFRS 3 on business combinations to transactions which take place subsequent to the IFRS transition date without retrospectively restating any transactions that occurred prior to that date. The Corporation has taken this exemption and has not applied IFRS 3 to any business combinations that occurred prior to July 1, 2010. Accordingly, no amounts have been adjusted for previous business combinations.

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Reconciliation of statement of financial position from Canadian GAAP to IFRS

At the date of IFRS transition – July 1, 2010:

	Note	Canadian GAAP	Effect of Transition to IFRS	IFRS
ASSETS				
Current assets				
Cash and cash equivalents		\$ 56,240	\$	\$ 56,240
Restricted cash		890		890
Trade and other receivables		7,266		7,266
Prepaid expenses and deposits		563		563
Commodity contracts		227		227
Crude oil inventory		2,330		2,330
		67,516		67,516
Non-current assets				
Restricted cash		399		399
Trade and other receivables		395		395
Exploration and evaluation assets	a	-	11,913	11,913
Property, plant and equipment	a,e	90,452	(13,317)	77,135
		91,246	(1,404)	89,842
Total assets		\$ 158,762	\$ (1,404)	\$ 157,358
LIABILITIES AND EQUITY				
Current liabilities				
Bank debt		\$ 322	\$	\$ 322
Trade and other payables		32,587		32,587
Taxes payable		292		292
Warrants	g	-	10,267	10,267
		33,201	10,267	43,468
Non-current liabilities				
Decommissioning obligations	b	2,899	884	3,783
Convertible debentures	f	1,145	2,853	3,998
Warrants	g	-	435	435
Deferred tax liabilities	d	7,864	(1,937)	5,927
Total liabilities		\$ 45,109	\$ 12,502	\$ 57,611
Equity				
Share capital	g	\$ 161,535	\$ (598)	\$ 160,937
Contributed surplus	c	12,088	(71)	12,017
Equity component of convertible debentures	f	159	(159)	-
Accumulated other comprehensive loss	a	(842)	842	-
Deficit		(59,287)	(13,920)	(73,207)
Total equity		113,653	(13,906)	99,747
Total liabilities and equity		\$ 158,762	\$ (1,404)	\$ 157,358

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(in United States dollars (tabular amounts in thousands) except as otherwise noted)

Reconciliation of statement of financial position from Canadian GAAP to IFRS

At the end of the last reporting year under Canadian GAAP – June 30, 2011:

	Note	Canadian GAAP	Effect of Transition to IFRS	IFRS
ASSETS				
Current assets				
Cash and cash equivalents		\$ 101,627	\$	\$ 101,627
Restricted cash		12,604		12,604
Trade and other receivables		37,976		37,976
Prepaid expenses and deposits		2,198		2,198
Prepaid transportation on overlifted volumes		4,024		4,024
Assets held for sale – Brazil	i	-	3,828	3,828
Crude oil inventory		12,348		12,348
		170,777	3,828	174,605
Non-current assets				
Restricted cash		444		444
Exploration and evaluation assets	a	-	33,603	33,603
Property, plant and equipment	a,e	125,260	(36,694)	88,566
Pipeline investment		2,589		2,589
Deferred tax assets		16,763		16,763
		145,056	(3,091)	141,965
Total assets		\$ 315,833	\$ 737	\$ 316,570
LIABILITIES AND EQUITY				
Current liabilities				
Trade and other payables		\$ 22,208	\$	\$ 22,208
Commodity contracts		577		577
Overlifted volumes payable		38,199		38,199
Equity tax payable	h	1,239	(59)	1,180
Assets held for sale – Brazil	i	-	888	888
Taxes payable		17,006		17,006
		79,229	829	80,058
Non-current liabilities				
Decommissioning obligations	b	4,400	141	4,541
Convertible debentures	f	19,657	11,797	31,454
Equity tax payable	h	3,211	(437)	2,774
Deferred tax liabilities	d	9,038	(2,023)	7,015
Total liabilities		\$ 115,535	\$ 10,307	\$ 125,842
Equity				
Share capital	f,g	\$ 243,733	\$ 25,999	\$ 269,732
Contributed surplus	c	21,783	(497)	21,286
Equity component of convertible debentures	f	5,427	(5,427)	-
Accumulated other comprehensive loss	a	(495)	842	347
Deficit		(70,150)	(30,487)	(100,637)
Total equity		200,298	(9,570)	190,728
Total liabilities and equity		\$ 315,833	737	\$ 316,570

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

Reconciliation of statement of financial position from Canadian GAAP to IFRS

At December 31, 2010:

	Note	Canadian GAAP	Effect of Transition to IFRS	IFRS
ASSETS				
Current assets				
Cash and cash equivalents		\$ 67,285	\$	\$ 67,285
Trade and other receivables		12,152		12,152
Prepaid expenses and deposits		716		716
Assets held for sale – Brazil	i	-	3,828	3,828
Crude oil inventory		1,669		1,669
		81,822	3,828	85,650
Non-current assets				
Restricted cash		421		421
Exploration and evaluation assets	a	-	17,335	17,335
Property, plant and equipment	a,e	103,392	(20,694)	82,698
		103,813	(3,359)	100,454
Total assets		\$ 185,635	\$ (469)	\$ 186,104
LIABILITIES AND EQUITY				
Current liabilities				
Bank debt		\$ 605	\$	\$ 605
Trade and other payables		25,521		25,521
Commodity contracts		1,716		1,716
Assets held for sale – Brazil	i	-	823	823
Taxes payable		1,385		1,385
Warrants	g	-	10,879	10,879
		29,227	11,702	40,929
Non-current liabilities				
Decommissioning obligations	b	3,584	367	3,951
Convertible debentures ⁽¹⁾	f	17,986	33,202	51,188
Deferred tax liabilities	d	5,081	(1,422)	3,659
		\$ 55,878	\$ 43,849	\$ 99,727
Equity				
Share capital	g	\$ 177,034	\$ 13,172	\$ 190,206
Contributed surplus	c	15,597	(192)	15,405
Equity component of convertible debentures ⁽¹⁾	f	13,834	(13,834)	-
Accumulated other comprehensive loss	a	(984)	842	(142)
Deficit		(75,724)	(43,368)	(119,092)
		129,757	(43,380)	86,377
Total liabilities and equity		\$ 185,635	\$ (469)	\$ 186,104

(1) Adjusted for a change in the discount rate from 26% to 16%, as previously presented – see audited consolidated financial statements for the year ended June 30, 2011.

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

Reconciliation of statement of operations and comprehensive loss from Canadian GAAP to IFRS

For the year ended June 30, 2011:

	Note	Canadian GAAP	Effect of Transition to IFRS	IFRS
Revenue				
Crude oil sales, net of royalties		\$ 91,680	\$	\$ 91,680
Tariff revenue		21,144		21,144
		112,824		112,824
Expenses				
Operating and transportation		39,213		39,213
General and administrative		13,995		13,995
Stock-based compensation	c	12,202	(183)	12,019
Depletion, depreciation and amortization	b,e	32,463	(7,427)	25,036
Loss on convertible debentures	f	-	16,256	16,256
Loss on overlifted volumes payable		5,093		5,093
Impairment loss on assets	i	9,673	4,353	14,026
Equity tax	h	5,169	(496)	4,673
		117,808	12,503	130,311
Net finance expense	b,g,h	671	4,448	5,119
Loss before income taxes		5,655	16,951	22,606
Income tax expense (reduction)		5,208	(384)	4,824
Net loss for the year		10,863	16,567	27,430
Other comprehensive loss				
Foreign currency translation adjustment		(347)		(347)
Net loss and comprehensive loss for the year		\$ 10,516	\$ 16,567	\$ 27,083

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As at and for the three and six months ended December 31, 2011 and 2010 (UNAUDITED)

(in United States dollars (tabular amounts in thousands) except as otherwise noted)

Reconciliation of statement of operations and comprehensive loss from Canadian GAAP to IFRS

For the three months ended December 31, 2010:

	Note	Canadian GAAP	Effect of Transition to IFRS	IFRS
Revenue				
Crude oil sales, net of royalties		\$ 15,669	\$	\$ 15,669
Tariff revenue		1,212		1,212
		16,881		16,881
Expenses				
Operating and transportation		6,445		6,445
General and administrative		5,260		5,260
Stock-based compensation	c	1,923	(114)	1,809
Depletion, depreciation and amortization	b,e	5,771	(2,689)	3,082
Loss on convertible debentures	f	-	13,152	13,152
Impairment loss on Brazilian assets	i	9,673	(9,673)	-
		29,072	676	29,748
Net finance (income) expense	b,g	599	(78)	521
Loss before income taxes		12,790	598	13,388
Income tax expense		1,045	485	1,530
Net loss for the period		13,835	1,083	14,918
Other comprehensive loss				
Foreign currency translation adjustment		(640)	-	(640)
Net loss and comprehensive loss for the period		\$ 13,195	\$ 1,083	\$ 14,278

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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(in United States dollars (tabular amounts in thousands) except as otherwise noted)

Reconciliation of statement of operations and comprehensive loss from Canadian GAAP to IFRS

For the six months ended December 31, 2010:

	Note	Canadian GAAP	Effect of Transition to IFRS	IFRS
Revenue				
Crude oil sales, net of royalties		\$ 30,888	\$	\$ 30,888
Tariff revenue		2,791		2,791
		33,679		33,679
Expenses				
Operating and transportation		13,779		13,779
General and administrative		8,110		8,110
Stock-based compensation	c	4,911	(200)	4,711
Depletion, depreciation and amortization	b,e	11,823	(4,158)	7,665
Loss on convertible debentures	f	-	27,637	27,637
Impairment loss on Brazilian assets	i	9,673	2,069	11,742
		48,296	25,348	73,644
Net finance expense	b,g	1,498	2,686	4,184
Loss before income taxes		16,115	28,034	44,149
Income tax expense (reduction)		322	515	837
Net loss for the period		16,437	28,549	44,986
Other comprehensive loss				
Foreign currency translation adjustment		142	-	142
Net loss and comprehensive loss for the period		\$ 16,579	\$ 28,549	\$ 45,128

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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The adoption of IFRS did not impact the amounts reported as operating, investing or financing cash flows in the consolidated statements of cash flows.

Notes to IFRS Reconciliations

a) Reclassifications

(i) Exploration and Evaluation (“E&E”) Assets

E&E assets consist of the Corporation’s exploration projects where technical feasibility and commercial viability have not yet been determined. Under Canadian GAAP, these costs were grouped with property, plant and equipment. Under IFRS, E&E assets are classified as a separate line in the statement of financial position; and

(ii) the remaining full cost pool was allocated to the producing / development assets and components pro rata using proved plus probable reserve volumes. This resulted in an \$11.9 million increase in E&E assets at the Transition Date with a corresponding decrease in property, plant and equipment.

(ii) Accumulated Other Comprehensive Income

On Transition Date, the Corporation elected to reclassify foreign exchange translation losses included in other comprehensive income recognized under Canadian GAAP to deficit. These accumulated translation differences were generated when the Corporation changed its reporting currency from the Canadian dollar to the United States dollar on June 30, 2010. As a result, accumulated other comprehensive income at July 1, 2010 was reclassified to deficit.

b) Decommissioning Obligations

Under Canadian GAAP, asset retirement obligations were discounted at a credit adjusted risk free rate of 7.5% for Canadian assets and 9.5% for Colombian and Brazilian assets. Under IFRS, the estimated cash flows to abandon and remediate the wells and facilities has been risk adjusted; therefore the provision is discounted at a risk free rate of 5% for Colombian and Brazilian assets. Upon transition to IFRS, this resulted in a \$0.9 million increase in decommissioning obligations with a corresponding increase in deficit.

As a result of the change in decommissioning obligations, accretion expense increased by \$1.1 million during the year ended June 30, 2011 under IFRS compared to Canadian GAAP. Under Canadian GAAP, accretion of the discount was included in depletion and depreciation. Under IFRS, it is included in finance expenses.

Under Canadian GAAP, expenditures on remediation and abandonment were not included in changes in non-cash working capital as is done under IFRS.

c) Stock-Based Compensation

Under Canadian GAAP, the Corporation did not incorporate a forfeiture multiple when determining the fair value of stock options and restricted share units. Under IFRS, the Corporation is required to estimate a forfeiture rate.

Restricted share units are considered equity-settled awards under IFRS and the fair value determined at the grant date is recognized over the vesting period of the awards. Under Canadian GAAP, the awards were valued at the trading price of the underlying common shares at each reporting date, with changes in fair value recorded in profit and loss.

d) Deferred Taxes

The change in the deferred tax liability is mainly the result of the change in the accounting basis of the decommissioning liability on transition to IFRS, the change in accounting basis of property, plant and equipment, and as a result of decreased depletion and the change in accounting for foreign exchange gains and losses resulting from taxes denominated in foreign currencies.

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e) Depletion

Upon transition to IFRS, the Corporation adopted a policy of depleting petroleum and natural gas interests on a units-of-production basis over proved plus probable reserves. The depletion policy under Canadian GAAP was based on units-of-production over proved reserves. Further, depletion was performed by country under Canadian GAAP whereas IFRS requires depletion and depreciation to be calculated based on individual components (i.e. fields or combinations thereof).

f) Convertible Debentures

Under Canadian GAAP, the convertible debentures were classified as a compound financial instrument whereby the instrument was bifurcated into debt and equity components and the equity component was recognized at its fair value. Under IFRS, the convertible debenture is considered a derivative liability and is required to be fair valued at each reporting period, with changes in that fair value being recorded in profit or loss. Further, conversions are recognized in share capital at the fair value of the shares issued, with any difference from the carrying value recorded in profit or loss.

g) Warrants

Under Canadian GAAP, the warrants were classified as a component of equity. Under IFRS, because the specified exercise price is denominated in Canadian dollars (a currency other than the functional currency of the Corporation), the warrants are considered derivative liabilities. The warrants are required to be fair valued at each reporting period, with changes in that fair value being recorded in profit or loss.

h) Equity Tax Payable

IFRS requires discounting of liabilities where the impact is considered significant. As the equity tax is scheduled to be paid over a three year term, the liability has been discounted.

i) Assets Held for Sale – Brazil

Certain non-core, non-operated producing assets in Brazil have been presented as assets held for sale following the commitment of the Corporation's management, on September 1, 2010, to a plan to sell such assets. Effective September 1, 2010, depletion charges ceased and an impairment charge was recorded to reflect the fair value of the assets. The impairment was recorded in profit or loss in the six months ended December 31, 2010.