EastSiberian Plc

(formerly PetroKamchatka Plc)

Consolidated Financial Statements

For the year ended May 31, 2012

# Independent Auditors' Report

To the Shareholders of EastSiberian Plc (formerly PetroKamchatka Plc):

We have audited the accompanying consolidated financial statements of EastSiberian Plc (formerly PetroKamchatka Plc) ("the Company"), which comprise the consolidated statements of financial position as at May 31, 2012, May 31, 2011 and June 1, 2010, the consolidated statements of comprehensive loss, changes in equity and cash flows for the years ended May 31, 2012 and May 31, 2011, and notes, comprising a summary of significant accounting policies and other explanatory information.

### *Management's responsibility for the consolidated financial statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditors' responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as at May 31, 2012, May 31, 2011 and June 1, 2010, and its consolidated financial performance and its consolidated cash flows for the years ended May 31, 2012 and May 31, 2011 in accordance with International Financial Reporting Standards.

***Emphasis of matter***

Without qualifying our opinion, we draw attention to note 2 in the consolidated financial statements which describes that the Company does not have sufficient funds to meet its exploration and drilling commitments and the Company currently has no cash inflows. This condition indicates the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

KPMG LLP

KPMG LLP
Chartered Accountants
Calgary, Canada

September 24, 2012

EastSiberian Plc
(formerly PetroKamchatka Plc)
Consolidated Statements of Financial Position
(United States Dollars)

| | Note | May 31, 2012 | May 31, 2011 | June 1, 2010 |
|---|---|---|---|---|
| **Assets** | | | | |
| Exploration and evaluation assets | 5 | $ - | $ - | $16,294,709 |
| Property and equipment | 6 | - | 5,133,198 | 4,447,941 |
| Investment in drilling rig | 7 | - | 4,434,210 | 4,137,260 |
| **Total non-current assets** | | - | 9,567,408 | 24,879,910 |
| Cash and cash equivalents | | 229,460 | 4,045,212 | 7,915,415 |
| Cash held in trust | 6 | 896,100 | - | - |
| Accounts receivable | | 132,515 | 252,667 | 2,758,064 |
| Prepaid expenses | | 25,478 | 27,071 | 27,958 |
| Property and equipment held for resale | 6 | 903,466 | - | - |
| Investment in drilling rig held for resale | 7 | 1,588,479 | - | - |
| **Total current assets** | | 3,775,498 | 4,324,950 | 10,701,437 |
| **Total assets** | | $ 3,775,498 | $13,892,358 | $35,581,347 |
| Equity | | | | |
| Share capital | 9 | $91,806,942 | $91,806,942 | $91,755,940 |
| Share purchase warrants | 9 | - | 1,186,971 | 1,186,971 |
| Contributed surplus | 9 | 5,760,482 | 4,540,190 | 4,247,572 |
| Foreign currency translation reserve | | 266,967 | 318,237 | - |
| Revaluation reserve | 6, 7 | - | 1,559,919 | - |
| Deficit | | (97,142,873) | (87,852,981) | (64,859,159) |
| **Total equity** | | 691,518 | 11,559,278 | 32,331,324 |
| Liabilities | | | | |
| Non-current liabilities: | | | | |
| Warrants | | - | - | 443 |
| **Total non-current liabilities** | | - | - | 443 |
| Current liabilities: | | | | |
| Accounts payable and accrued liabilities | 14 | 1,807,880 | 1,537,629 | 3,249,580 |
| Cash held in trust | 6 | 896,100 | - | - |
| Provisions | 8 | 380,000 | 795,451 | - |
| **Total current liabilities** | | 3,083,980 | 2,333,080 | 3,249,580 |
| **Total liabilities** | | 3,083,980 | 2,333,080 | 3,250,023 |
| Going concern | 2 | | | |
| Commitments and contingency | 5, 8, 13 and 15 | | | |
| Subsequent events | 6, 7 and 13 | | | |
| **Total equity and liabilities** | | $ 3,775,498 | $13,892,358 | $35,581,347 |

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

# EastSiberian Plc

(formerly PetroKamchatka Plc)
Consolidated Statements of Comprehensive Loss
Years ended May 31, 2012 and 2011
(United States Dollars)

| | Note | 2012 | 2011 |
|---|---|---|---|
| Expenses: | | | |
| Operating expenses | | $ 645,087 | $ 2,350,579 |
| General and administrative expenses | | 2,983,523 | 2,376,412 |
| Share-based compensation | 9 | 33,321 | 292,618 |
| Depreciation | 6 | 1,633,151 | 895,506 |
| Impairment | 5, 6, 7 | 3,913,308 | 17,088,977 |
| Loss before finance and income taxes | | 9,208,390 | 23,004,092 |
| Finance costs (income) | | 81,502 | (10,270) |
| **Net loss** | | **9,289,892** | **22,993,822** |
| Other comprehensive (income) loss | | | |
| Foreign exchange differences on translation of foreign operations | | 51,270 | (318,237) |
| Revaluation of property and equipment | 6, 7 | 1,559,919 | (1,559,919) |
| **Other comprehensive (income) loss** | | **1,611,189** | **(1,878,156)** |
| **Total comprehensive loss for the year** | | **$10,901,081** | **$21,115,666** |
| Net loss per share: | | | |
| Basic and diluted | | $ (1.89) | $ (4.69) |
| Weighted average number of common shares outstanding | | | |
| Basic and diluted | 11 | 4,903,998 | 4,899,877 |

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

# EastSiberian Plc

(formerly PetroKamchatka Plc)
Consolidated Statements of Changes in Equity
Years ended May 31, 2012 and 2011
(United States Dollars)

| | Note | Share Capital | Share Purchase Warrants | Contributed Surplus | Foreign Currency Translation Reserve | Revaluation Reserve | Deficit | Total Equity |
|---|---|---|---|---|---|---|---|---|
| **Balance at June 1, 2010 Transition Date under IFRS** | | **$91,755,940** | **$1,186,971** | **$ 4,247,572** | **$ -** | **$ -** | **$(64,859,159)** | **$32,331,324** |
| Net loss for the year | | - | - | - | - | - | (22,993,822) | (22,993,822) |
| Revaluation of property and equipment | | - | - | - | - | 1,559,919 | - | 1,559,919 |
| Foreign currency translation | | - | - | - | 318,237 | - | - | 318,237 |
| Shares issued for services performed | | 51,002 | - | - | - | - | - | 51,002 |
| Share-based compensation | 9 | - | - | 292,618 | - | - | - | 292,618 |
| **Balance at May 31, 2011** | | **$91,806,942** | **$1,186,971** | **$ 4,540,190** | **$ 318,237** | **$ 1,559,919** | **$(87,852,981)** | **$11,559,278** |
| | | | | | | | | |
| **Balance at May 31, 2011** | | **$91,806,942** | **$1,186,971** | **$ 4,540,190** | **$ 318,237** | **$ 1,559,919** | **$(87,852,981)** | **$11,559,278** |
| Net loss for the year | | - | - | - | - | - | (9,289,892) | (9,289,892) |
| Unexercised warrants | | - | (1,186,971) | 1,186,971 | - | - | - | - |
| Revaluation of property and equipment | | - | - | - | - | (1,559,919) | - | (1,559,919) |
| Foreign currency translation | | - | - | - | (51,270) | - | - | (51,270) |
| Share-based compensation | 9 | - | - | 33,321 | - | - | - | 33,321 |
| **Balance at May 31, 2012** | | **$91,806,942** | **$ -** | **$ 5,760,482** | **$ 266,967** | **$ -** | **$(97,142,873)** | **$ 691,518** |

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

# EastSiberian Plc

(formerly PetroKamchatka Plc)
Consolidated Statements of Cash Flows
Years end May 31, 2012 and 2011
(United States Dollars)

| | 2012 | 2011 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net loss for the year | $(9,289,892) | $(22,993,822) |
| Adjustments for: | | |
| Depreciation | 1,633,151 | 895,506 |
| Share-based compensation | 33,321 | 292,618 |
| Shares issued for services performed | - | 51,002 |
| Unrealized foreign exchange loss (gain) | (10,359) | 13,778 |
| Impairments | 3,913,308 | 17,088,977 |
| Change in: | | |
| Accounts receivable | 120,152 | 2,505,397 |
| Prepaid expenses | 1,593 | 887 |
| Accounts payable and accrued liabilities | 235,733 | (1,719,518) |
| Provisions | (415,451) | 795,451 |
| Net cash (used in) operating activities | (3,778,444) | (3,069,724) |
| Cash flows from investing activities: | | |
| Additions to exploration and evaluation assets | - | (794,268) |
| Additions to property and equipment | (30,915) | - |
| Proceeds from disposition held in trust | 896,100 | - |
| Cash held in trust | (896,100) | - |
| Net cash (used in) investing activities | (30,915) | (794,268) |
| Net decrease in cash and cash equivalents | (3,809,359) | (3,863,992) |
| Cash and cash equivalents beginning of year | 4,045,212 | 7,915,415 |
| Effect of exchange rate fluctuations on cash held in foreign currencies | (6,393) | (6,211) |
| **Cash and cash equivalents end of year** | **$ 229,460** | **$ 4,045,212** |

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

## 1. Reporting entity:

EastSiberian Plc (formerly PetroKamchatka Plc) (the “Corporation”) was incorporated on December 23, 2008 under the Companies (Jersey) Law 1991. The head office of the Corporation is located at 9 Esplanade, St. Helier, Jersey, JE23QA. The Corporation has principally been engaged in exploration for oil and natural gas in eastern Russia which activity is conducted pursuant to exploration licenses granted to Russian subsidiaries and affiliates of its wholly-owned Cyprus subsidiary, PetroKamchatka Resources Ltd. (“PKR”). On August 22, 2012, shareholders of the Corporation approved a name change from PetroKamchatka Plc to EastSiberian Plc. In addition, the shareholders approved a consolidation of the Corporation’s common shares of 100 to 1. The number of shares issued and outstanding, number of warrants and stock options presented in these consolidated financial statements represent post consolidation quantities.

The Corporation has the following subsidiaries and affiliates:

| | | Percentage of Ownership | | |
|---|---|---|---|---|
| Name of Subsidiary or Affiliate | Country of Incorporation | May 31, 2012 | May 31, 2011 | June 1, 2010 |
| PetroKamchatka Resources Ltd. | Cyprus | 100% | 100% | 100% |
| OJSC LukinCholot | Russia | 90% | 90% | 90% |
| CJSC Kehta-Exploration | Russia | 100% | 100% | 100% |
| CJSC Kingi-Exploration | Russia | 100% | 100% | 100% |
| CJSC Palana-Exploration | Russia | 100% | 100% | 100% |
| CJSC Tvayan-Exploration | Russia | 100% | 100% | 100% |
| CJSC Tigil Exploration (affiliate) | Russia | 50% | 50% | 50% |
| CJSC Icha Exploration (affiliate) | Russia | 50% | 50% | 50% |
| PetroKamchatka Services Inc. | Canada | 100% | 100% | 100% |
| Nabesche River Exploration Ltd. | Canada | 100% | 100% | 100% |

PKR owns 90% of OJSC LukinCholot (“LukinCholot”) which in turn owned owns 50% of the shares of CJSC Tigil Exploration and CJSC Icha Exploration (the “joint interest entities”). PKR is the direct owner of the other subsidiaries. KNOC Kamchatka Petroleum Limited (“KKPL”), a company owned 55% by Korea National Oil Corporation (“KNOC”), owns the other 50% of the joint interest entities. This effectively provides the Corporation with an indirect, net 45% interest in the joint interest entities and the joint venture (“Joint Venture”). The other 10% of LukinCholot is owned by the Koryakia Property Fund (the “Fund”), an investment agency of the Koryakia Okrug Administration, Kamchatka. The Fund’s indirect beneficial interest in the joint interest entities is 5%, being 10% of 50%. LukinCholot and KKPL split the cost to carry the 5% interest of the Koryakia Okrug Administration, which means that the Corporation pays 47.5% of costs and KKPL pays 52.5%. On August 11, 2009, PKR increased its percentage ownership in LukinCholot from

85% to 90%. This effectively increased the Corporation's indirect share of costs from 46.25% prior to August 2009 to 47.5% after July 2009.

**2. Going concern:**

These consolidated financial statements have been prepared on the basis of accounting principles applicable to a going concern, which assumes that the Corporation will realize its assets and discharge its liabilities in the normal course of operations.

The Corporation presently does not have sufficient funds to meet all of its exploration and drilling commitments on its license in Kamchatka, Russia (note 5). It could therefore lose all or part of its interest in the license. The drilling of two dry holes in fiscal 2010 has negatively impacted the ability of the Corporation to raise additional capital. The Corporation did not raise additional equity in the fiscal years ended May 31, 2012 or 2011. At May 31, 2012, the Corporation's working capital was $691,518 which includes property and equipment of $903,466 and an investment in a drilling rig of $1,588,479 which were reclassified from non-current assets to current assets in fiscal 2012 as these assets were available for immediate sale and were sold in the first quarter of fiscal 2013 (notes 6, 7 and 13).

Management believes the going concern assumption to be appropriate for these consolidated financial statements as the Corporation has positive working capital and no debt. Management undertook significant cost reduction measures in fiscal year 2012 and continues to work towards further reductions of general and administrative and other expenses. **However, it is unable to meet its work-commitment obligations without a significant capital injection and significant doubt exists about the Corporation's ability to continue as a going concern. Under the terms of the farm-in agreement (note 14), the Corporation is required to raise a minimum of $15 million before December 31, 2012.** The Corporation has no cash inflow, nor is there any assurance that it can raise additional capital under current market conditions. If the going concern assumption was not appropriate for these consolidated financial statements, then adjustments would be necessary to adjust the carrying value of assets and liabilities, and reported expenses.

**3. Basis of preparation and adoption of International Financial Reporting Standards:**

The Corporation prepares its financial statements in accordance with Canadian generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants ("CICA Handbook"). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards ("IFRS") and require publicly accountable enterprises to apply such standards effective for fiscal years beginning on or after January 1, 2011. Accordingly, the Corporation commenced reporting on this basis in the interim consolidated financial statements for the first quarter ended August 31, 2011. In the consolidated financial statements, the term "Canadian GAAP" or "Previous GAAP" refers to "Canadian GAAP" before the adoption of IFRS.

These year end consolidated financial statements have been prepared in accordance with International Accounting Standards. PetroKamchatka's significant accounting policies under IFRS are presented in Note 4. The Corporation has consistently applied the same accounting policies in its opening IFRS statement of financial position at June 1, 2010 (the "Transition Date") and throughout the periods presented, as if these policies had always been in effect, other than in cases where certain IFRS 1 exemptions were taken. IFRS 1 - "First- time Adoption of International Financial Reporting Standards" has been applied to these consolidated financial statements. Note 16 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 Canadian GAAP consolidated financial statements for the year ended May 31, 2011.

The Board of Directors of the Corporation approved the consolidated financial statements on September 24, 2012.

**Functional and Presentation Currency**

The consolidated financial statements are presented in United States dollars. The functional currency is the United States dollar for the Jersey parent company and its Cyprus subsidiary. For the Russian subsidiaries and affiliates, the functional currency is the Russian Rouble. For the subsidiaries located in Canada, the functional currency is the Canadian dollar.

**Use of Assumptions, Judgments and Estimates**

The preparation of consolidated financial statements in conformity with IFRS requires management to make assumptions, judgments and estimates that affect the application of accounting policies and the reported amounts of assets, liabilities, and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized at the time the estimates are revised. Estimates of recoverable quantities of proven and probable reserves, if any, including estimates and assumptions regarding future commodity prices, exchange rates, discount rates, production volumes and timing of production, production and transportation costs can affect various calculations including: the impairment of assets; decommissioning obligations; the economic feasibility of exploration and evaluation assets; and the amounts reported for depletion (if any), depreciation and amortization of property and equipment and exploration and evaluation assets.

In determining the recoverable amount of assets, in the absence of quoted market prices, impairment tests are based on estimates of future reserves, production rates, oil and natural gas prices, costs, discount rates and other relevant assumptions. In determining the fair value of property and equipment and its investment in drilling rig, the Corporation may rely on independent evaluations of these assets, changing market conditions, location of equipment and transportation cost estimates, in addition to managements estimates based on information currently available.

The Corporation would, if applicable in the future, estimate decommissioning obligations for oil and natural gas wells and associated production facilities and pipelines. Usually, the removal of assets and remediation occurs many years into the future. Amounts recorded for decommissioning obligations and related accretion expense require judgmental assumptions regarding removal date, future environmental legislation, the extent of reclamation activities that will be required, the engineering methodology and future removal technologies for estimating cost, and liability specific discount rates to determine the present value of these cash flows.

Accounting for exploration and evaluation assets requires management to make certain estimates and assumptions as to future events and circumstances as to whether economic quantities of reserves have been found, if any.

The amounts recorded for share-based compensation are based on share price and estimates of expected volatility, forfeiture rates, performance factors and risk-free interest rates.

The Corporation is subject to income taxes in a number of tax jurisdictions. The tax amount expected to be settled and the actual amount can change over time, depending on the facts and circumstances. The recognition of deferred tax assets, if any, is based on assumptions about future taxable profits.

By their nature, these estimates and assumptions are subject to measurement uncertainty. The effect on the consolidated financial statements of changes in such estimates in future periods could be material.

Information about significant areas of estimation uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amounts recognized in the consolidated financial statements is included in the following notes:

- Note 4(c) – valuation of financial instruments
- Note 4(e) – valuation of equipment
- Note 8 – provisions and contingencies
- Note 9(d) – measurement of share-based payments
- Note 10 – valuation and utilization of tax losses

## 4. Significant accounting policies:

### (a) Basis of Measurement:

These consolidated financial statements have been prepared on a historical cost basis except as noted below.

**(b) Basis of consolidation**:

(i) ***Subsidiaries:***

These consolidated financial statements include the accounts of EastSiberian Plc and its subsidiaries. Subsidiaries are entities controlled by the Corporation. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

(ii) ***Joint-interest entities***:

In Russia, exploration licenses are granted to Russian entities only. Some of the Corporation's previous exploration activities were conducted on a joint venture basis with an unrelated joint venture partner. LukinCholot owns 50% of the shares of two Russian entities. The unrelated joint venture partner, KKPL, owns the other 50%. The consolidated financial statements include the Corporation's proportionate share of the accounts of the joint-interest entities.

(iii) ***Transactions eliminated on consolidation***:

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

**(c) Financial instruments:**

***Financial Assets:***

Financial assets include cash and cash equivalents and accounts receivable. The Corporation does not have any derivative financial instruments.

At the time of initial recognition, financial assets are recognized at fair value, normally being the transaction price plus, in the case of financial assets not at fair value, through profit or loss directly attributable to transaction costs.

The subsequent measurement of financial assets depends on their classification. Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such financial assets are carried at 'amortized cost' using the effective interest rate method if the time value of money is significant. Gains and losses are recognized in income when the loans and receivables are de-recognized or impaired as well as through the amortization process.

A financial asset is classified and measured at amortized cost if it is held with the objective of holding in order to collect contractual cash flows and the contractual terms give rise, on specified dates, to cash flows that are solely payments of principal and interest.

Financial assets other than those qualifying for amortized cost measurement are classified as fair value through profit or loss and measured at fair value with all changes in fair value recognized in profit or loss.

Financial assets measured at amortized cost are assessed for impairment at the end of each reporting period. Financial assets are considered impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial assets, the estimated future cash flows of the asset have been negatively affected.

***Financial Liabilities;***

At the time of initial recognition, financial liabilities are classified at fair value measured at 'amortized cost or as financial liabilities' through profit or loss. Financial liabilities measured at 'amortized cost' include accounts payable and accrued liabilities and other liabilities, if any.

**(d) Property and equipment:**

Property and equipment located in Russia has been reclassified to assets held for sale and therefore the mobile drilling rig; drill pipe and collars; spare parts and other drilling rig equipment; other oilfield service equipment; materials and other have been reclassified to current assets as at May 31, 2012. Property and equipment and the investment in the drilling rig, prior to being classified as held for sale, were measured at fair value less accumulated depletion, depreciation and amortization and accumulated impairments. Capitalized costs include the purchase price or construction cost of the asset, any costs directly attributable to bringing the asset into operation, the initial estimate of decommissioning obligations, if any, and borrowing costs for qualifying assets, if any. The purchase price or construction cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset. The capitalized value of the finance lease, if any, is also included in property and equipment.

A gain arising on remeasurement is recognized in profit or loss to the extent the gain reverses a previous impairment loss on the specific equipment; any remaining gain is recognized in other comprehensive income and presented in the revaluation reserve in equity. A loss is recognized in other comprehensive income and presented in the revaluation reserve in equity to the extent that an amount had previously been included in the revaluation reserve relating to the specific equipment; any remaining loss is recognized immediately in profit or loss.

The gain or loss from the divestiture of property and equipment is recognized in profit or loss. In addition, risk-sharing arrangements such as farm-outs, where the Corporation relinquishes a portion of its working interest to a third-party are generally considered to be disposals of property and equipment, potentially resulting in a gain or loss on disposition.

Exchanges of assets within property and equipment are measured at fair value unless the exchange transaction lacks commercial substance; or at historical cost, if the fair value of neither the asset received nor the asset given up is reliably measurable. Unless the fair value

of the asset received is more clearly evident, the cost of the acquired asset is measured at the fair value of the asset given up. Where the fair value is not used, the cost of the acquired asset is measured at the carrying amount of the asset given up. The gain or loss on de-recognition of the asset given up is recognized in profit or loss.

An asset within 'property and equipment' is de-recognized upon disposal or when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising on de-recognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in profit or loss in the period in which the item is de-recognized.

Depreciation of equipment is based on the estimated useful lives of the assets as follows:

| Asset class | Expected Life | Method | Residual |
|---|---|---|---|
| Mobile drilling rig | 7 years | Straight-line | 20% |
| Drill pipe and collars | 5 years | Straight-line | - |
| Spare parts and other drilling rig equipment | 5 years | Straight-line | - |
| Other oilfield service equipment | 5 years | Straight-line | 10% |
| Materials and other | 2 years | Straight-line | - |
| Office furniture and equipment | 3 years | Straight-line | - |

The calculation of depreciation includes assumptions regarding useful lives and residual values and is subject to change as new information becomes available.

Equipment is reviewed for impairment when events or changes in circumstances indicate that its carrying value may not be recoverable. The Corporation's operations and business environment are routinely monitored and judgment and assessments are made to determine if an event has occurred that indicates a possible impairment.

Corporate assets primarily consist of office furniture and equipment which are stated at cost less accumulated depreciation where depreciation is determined on a straight-line basis over three years and assumes no residual value.

***Subsequent costs:***

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing components of equipment are recognized as property and equipment only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are expensed as incurred. Such capitalized amounts 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 de-recognized. The costs of the day-to-day servicing of property and equipment are recognized in profit or loss as incurred.

***Depletion, depreciation and amortization:***

The Corporation presently has no reserves, no production and no cash inflows from the sale of oil or natural gas. The Corporation had no properties that had been transferred from the exploration and evaluation stage to the development and/or production stage.

**(e) Assets held for sale:**

Non-current assets, or disposal groups consisting of assets and liabilities, are classified as 'held for sale' if their carrying amounts are expected to be recovered through a sale transaction rather than through continuing use. This condition is met when the sale is highly probable and the asset is available for immediate sale in its present condition.

Non-current assets classified as 'held for sale' are measured at the lower of the carrying amount and fair value less estimated costs to sell, with impairments recognized as an expense in the statement of loss in the period measured. Assets 'held for sale' are presented in current assets within the consolidated statement of financial position. Assets 'held for resale' are not depreciated, depleted or amortized.

**(f) Impairment:**

***Non-financial assets:***

The carrying amounts of the Corporation's non-financial assets, other than E&E assets and 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. E&E assets are assessed for impairment when they are reclassified to property and equipment; and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount (such as: unsuccessful drilling results; surrendered or expired exploration licenses; and/or failure to achieve work commitment bench marks within time limits established by the exploration license).

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generate cash flows from continuing use that are largely independent of the cash inflows of other assets or groups of assets or CGUs. The recoverable amount of an asset or a CGU is the greater of its value-in-use and its fair value less estimated 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 references to the present value of the future cash flows expected to be derived. For the purpose of impairment testing, goodwill acquired in a business combination, if any, is allocated to the CGUs that are expected to benefit from the synergies of the combination.

E&E assets are combined with other relevant CGUs when they are assessed for impairment, both at the time of any triggering event as well as upon their eventual reclassification to property and equipment. An impairment loss is recognized in profit or loss if the carrying

amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses recognized in respect of CGUs are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the unit or group of units on a pro rata basis.

Impairment losses recognized in prior years 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, depreciation and amortization, if no impairment loss had been recognized.

***Financial assets:***

A financial asset is assessed at each reporting date to determine whether there is any objective evidence of impairment. 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 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.

**(g) Foreign currency translation and operations:**

The assets and liabilities of foreign operations are translated to United States dollars at exchange rates at the reporting dates.

Transactions in foreign currencies are translated to United States dollars at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated to United States dollars at the period end exchange rate. Non-monetary assets and liabilities denominated in foreign currencies are measured at fair value and translated to the functional currency at the exchange rate at the date that the fair value was determined. Realized foreign currency differences are recognized in profit or loss.

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated to USD at exchange rates at the reporting date. The income and expenses of foreign operations are translated to USD at exchange rates at the dates of the transactions.

Foreign currency differences are recognized in other comprehensive income, and presented in the foreign currency translation reserve ("Translation Reserve") in equity. However, if the

operation is a non-wholly-owned subsidiary, then the relevant proportionate share of the translation difference is allocated to the non-controlling interests. When a foreign operation is disposed of such that control, significant influence or joint control is lost, the cumulative amount in the Translation Reserve related to that foreign operation is reclassified to profit or loss as part of the gain or loss on disposal. When the settlement of a monetary item receivable from or payable to a foreign operation is neither planned nor likely in the foreseeable future, foreign exchange gains and losses arising from such a monetary item are considered to form part of a net investment in a foreign operation and are recognized in other comprehensive income, and presented in the Translation Reserve in equity.

**(h) Share-based compensation:**

All share-based transactions are settled with equity instruments. Transactions with non-employees are measured at the fair value of goods or services received unless such cannot be estimated reliably in which case the measurement is based upon the fair value of the equity instruments granted. For transactions with parties other than employees the measurement date is the date the Corporation received the goods or services.

The Corporation has a share option plan for employees, consultants, officers and directors.

Fair value is determined using the Black-Scholes option pricing model. The cost is recognized as ‘share-based compensation’ expense with a corresponding increase in equity (contributed surplus) over the vesting period which ends on the date on which the recipient becomes fully entitled to the stock option awarded.

The expense is recognized over the vesting period based on the best available estimate of the number of equity instruments expected to vest. The estimate is revised, if necessary, if subsequent information in the number of equity instruments expected to vest differs from previous estimates.

**(i) Provisions:**

A provision is recognized if, as a result of a past event, the Corporation has a present obligation (legal or constructive) that can be estimated reliably, and it is probable that an outflow of economic resources 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 market assessments of the time value of money and the risks specific to the liability. Provisions are not recognized for future operating losses.

The Corporation’s activities could give rise to decommissioning obligations for dismantling, decommissioning and site restoration activities. Provision would be made, if applicable, for the estimated cost and capitalized in the relevant asset category unless it arises from the normal course of production activities in which case it is recognized in profit or loss.

Contingent liabilities are possible obligations whose existence will only be confirmed by future events not wholly within the control of the Corporation, or present obligations where it is not

probable that an outflow of resources will be required or the amount of the obligation cannot be measured with sufficient reliability. Contingent liabilities are not recognized in the financial statements but are disclosed unless the possibility of an outflow of economic resources is remote.

A provision for onerous contracts is recognized when the expected benefits to be derived by the Corporation from a contract are lower than the unavoidable cost of meeting its obligations under the contract. The provision is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract.

**(j) Income taxes:**

The Corporation is subject to income taxes in a number of tax jurisdictions. Income tax expense comprises current and deferred portions. Current tax is expected tax payable on taxable income for the reporting period, using tax rates enacted or substantively enacted at the reporting date and any adjustments to the tax payable in respect of previous years. Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes.

Deferred tax liabilities are recognized for taxable temporary differences. Deferred tax assets are recognized for deductible temporary differences, unused tax losses and unused tax credits only if it is probable that sufficient future taxable income will be available to utilize those temporary differences and losses.

Such deferred tax liabilities and assets are not recognized if the temporary differences arises from goodwill or from the initial recognition of assets and liabilities (other than in a business combination) in a transaction that affects neither the taxable income nor the accounting profit or from investments in subsidiaries, associates and interest in joint ventures to the extent that it is probable that they will not reverse in the foreseeable future. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on laws that have been enacted or substantively enacted at the reporting date.

The effect of a change in income tax rates on deferred tax assets and liabilities is recognized in profit or loss in the period the change occurs.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset tax liabilities and assets, 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.

Income tax expense is recognized in profit or loss except to the extent it relates to a business combination, or items recognized directly in equity or other comprehensive income.

**(k) Share capital:**

Common shares are classified as equity. Incremental costs directly attributable to the issue of common shares, warrants and share options are recognized as a deduction from equity, net of any tax effects.

**(l) Earnings per share:**

The Corporation presents basic and diluted earnings per share data for its common shares. Basic earnings per share is calculated by dividing the net income attributable to common shareholders of the Corporation by the weighted average number of common shares outstanding during the reporting period. Diluted per share amounts are calculated using the treasury stock method for equity based compensation arrangements. The treasury stock method assumes that any proceeds obtained on exercise of equity based compensation arrangements would be used to purchase common shares at the average market price during the period. The weighted average number of shares outstanding is then adjusted by the difference between the number of shares issued from the exercise of equity based compensation arrangements and shares repurchased from the related proceeds.

**(m) New standards and interpretations not yet adopted**

The following pronouncements from the IASB will become effective for financial reporting periods beginning on or after January 1, 2013. All of these new or revised standards permit early adoption with transitional arrangements depending upon the date of initial application:

- IFRS 10 – *Consolidated Financial Statements* - builds on existing principles and standards and identifies the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company.
- IFRS 11 – *Joint Arrangements* – establishes the principles for financial reporting by entities when they have an interest in arrangements that are jointly controlled.
- IFRS 12 – *Disclosure of Interest in Other Entities* – provides the disclosure requirements for interests held in other entities including joint arrangements, associates, special purpose entities and off balance sheet entities.
- IFRS 13 – *Fair Value Measurement* – defines fair value, requires disclosure about fair value measurements and provides a framework for measuring fair value when it is required or permitted within the IFRS standards.
- IAS 19 – *Employee Benefits* – revises the existing standard to eliminate options to defer the recognition of gains and losses in defined benefit plans, requires remeasurement of a defined benefit plan's assts and liabilities to be presented in other comprehensive income and increases disclosure.

- IAS 27 – *Separate Financial Statements* – revised the existing standard which addresses the presentation of parent company financial statements that are not consolidated financial statements.
- IAS 28 – *Investments in associate and Joint Ventures* – revised the existing standard and prescribes the accounting for investments and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

The following pronouncement from the IASB will become effective for financial reporting period beginning on or after January 1, 2015:

- IFRS 9 – *Financial Instruments* - addresses the classification and measurement of financial assets.

The Corporation is assessing the impact that these new standards will have on its consolidated financial statements.

## 5. Exploration and evaluation assets:

Exploration and evaluation assets consist of the Corporation's exploration projects which have no proven or probable reserves assigned.

| | Icha | Ichinskaya | Vorovskaya | Total |
|---|---|---|---|---|
| Balance at June 1, 2010 | $ 16,267,828 | $ 15,688 | $ 11,193 | $ 16,294,709 |
| Additions to May 31, 2011 | 746,104 | 28,320 | 19,844 | 794,268 |
| Impairments to May 31, 2011 | (17,013,932) | (44,008) | (31,037) | (17,088,977) |
| Balance at May 31, 2011 and May 31, 2012 | $ - | $ - | $ - | $ - |

Exploration licenses in Russia are issued by the Federal Ministry of Natural Resources ("MNRF") and conditionally grant the holder of the license the right to explore for oil and natural gas reserves within the area specified in the license. In the event of a commercial discovery, the license holder has the right to convert parts of the exploration license into a production license. Exploration licenses have an associated license agreement, which specify the required geological and geophysical work program required to retain the license. Exploration licenses are granted based on successful bids detailing work commitments, with no cash bonus required at time of bid or grant. Exploration licenses are granted to Russian entities only.

The Corporation elected to measure its E&E assets at the Transition Date at the amount previously capitalized under Canadian GAAP. Under the exemption provisions, the Corporation continued to aggregate its costs in CGUs. More specifically, the Corporation recognizes cost centers based on exploration licenses granted by the Russian Federal Ministry of Natural Resources ("MNRF"). The Corporation's cost centers at the Transition Date were: 'Icha';

'Ichinskaya'; and ''Vorovskaya'; each of which are located in Kamchatka, Russia. At the Transition Date, the E&E assets were tested for impairment in accordance with IFRS 6 "*Exploration for and Evaluation of Mineral Resources*", IFRS 1 and IAS 36. No impairment charge was required.

The Tigil license expired in December 2010 after the Corporation and its joint venture partner drilled two unsuccessful wells on that Block; and the Icha license was surrendered back to MNFR in March 2011. The cumulative E&E costs for Icha of US $17,013,932 were fully impaired in the reporting year ended May 31, 2011.

At May 31, 2012, the only exploration license held by a Russian subsidiary of the Corporation's wholly-owned Cyprus subsidiary was the Tigilskaya Exploration License located in Kamchatka, Russia. The geological license PTR 15209 NP was issued by the Federal Agency of Subsoil Use and bears State registration on September 10, 2011. The exploration license expires on September 10, 2016 and covers 416,400 gross hectares (4,164 $km^2$). The work commitment requires the shooting of 500 km of 2D seismic by September 10, 2014 with 200 km of this amount to be shot by September 10, 2013; the commencement of drilling of one exploration well by September 10, 2014; and the commencement of drilling a second exploration by September 10, 2016. The work commitment required approval of the exploration program by September 10, 2012. Approval of the exploration program was not submitted by September 10, 2012 and while the Corporation may apply for an extension to submit the exploration program it has yet to do so. There is not assurance that any extension will be granted and therefore the Corporation may lose the license. The Corporation estimates expenditures of approximately $51 million will be required to meet the work commitments of the Tigilskaya exploration license.

### 6. Property and equipment held for resale:

Property and equipment consists primarily of a mobile drilling rig and other exploration equipment. On April 26, 2012, the Corporation entered into an agreement to sell all of the property and equipment for proceeds totaling RUR 31,000,000 or approximately $926,000. At May 31, 2012 the Corporation had received partial payment for the sale amounting to $896,100 and the sale closed on June 28, 2012 upon receipt of the balance of the funds owing (note 13). Under IFRS, depreciation is recognized even during periods when assets are idle unless the assets are being held-for-sale.

| | Mobile Drilling Rig and Other Exploration Equipment |
|---|---|
| Fair value at June 1, 2010 | $ 4,447,941 |
| Depreciation to May 31, 2011 | (895,506) |
| Foreign currency translation difference | 317,794 |
| Revaluation adjustment | 1,262,969 |
| Balance at May 31, 2011 | 5,133,198 |
| Additions | 30,915 |
| Depreciation to May 31, 2012 | (1,633,151) |
| Revaluation adjustment | (1,262,969) |
| Impairment | (1,364,527) |
| Balance at May 31, 2012 | $ 903,466 |

### 7. Investment in drilling rig held for resale:

The Corporation owns a 46.25% interest in a drilling rig, delivered new in November 2008 and stored since delivery in a bonded export facility in Shanghai, China. It was determined that this rig was not suited for the Russian drilling program for which it was originally intended. An impairment of $2,548,781 and revaluation adjustment of $296,950 was recognized at May 31, 2012 to reduce the carrying value of the investment in drilling rig to $1,588,479. At May 31, 2012, the rig is available for immediate sale which sale occurred in the first quarter of fiscal year 2013 for proceeds equal to the carrying value at May 31, 2012.

**8. Provisions:**

| | Joint Venture Wind-up |
|---|---|
| Balance at June 1, 2010 | $ - |
| Provisions made during the year | 795,451 |
| Balance, May 31, 2011 | $ 795,451 |
| | |
| Provisions made during the year | 380,000 |
| Payments made during the year | (795,451) |
| Balance, May 31, 2012 | $ 380,000 |

The operating agreement with the Corporation's joint venture partner expired with the relinquishment of the Icha exploration license in March 2011. The estimate of the Corporation's share of costs to wind-up the Joint Venture was $795,451 at May 31, 2011. During the year ended May 31, 2012, the Corporation recorded a further provision of $380,000 for its share of additional wind-up costs. It is expected the wind-up of the Joint Venture will be completed by December 31, 2012.

Subsequent to May 31, 2012 the Corporation's Joint Venture partner initiated a joint venture audit. The results of the joint venture audit are indeterminable and therefore no accrual for additional expenses or recoveries has been made at May 31, 2012. Any amounts owing to or from the joint venture as a result of the audit will be recorded when they become known and agreed to by all parties.

**9. Share Capital:**

(a) Authorized:

An unlimited number of common shares and an unlimited number of preferred shares.

(b) Common shares issued and outstanding:

| | May 31, 2012 | | May 31, 2011 | |
|---|---|---|---|---|
| | Number | Amount | Number | Amount |
| Share capital, beginning of year | 4,903,998 | $ 91,806,942 | 4,890,672 | $ 91,755,940 |
| Issued for services (note 9 (b) (i) and (ii)) | – | – | 13,326 | 51,002 |
| Share capital, end of year | 4,903,998 | $ 91,806,942 | 4,903,998 | $ 91,806,942 |

*On August 22, 2012 the shareholders of the Corporation approved a share consolidation of 100 to 1, which is reported retroactively.*

(i) On July 7, 2010, the Corporation issued 6,761 common shares to directors at a price of CAD $5.00 per share for services rendered for the three months ended June 30, 2010 in the amount of $31,875, representing a portion of the fees owed.

(ii) On December 8, 2010, the Corporation issued 6,565 common shares to directors at a ‘deemed price’ of CAD $5.00 per share, pursuant to the rules and regulations of The Toronto Venture Stock Exchange which was approximately CAD $2.00 per share higher than the ‘actual trading price’ at the time of issue. The shares were issued for services rendered for the three months ended September 30, 2010 in the amount of $19,127, representing only a portion of the fees owed (note 14).

(c) Share purchase warrants:

At May 31, 2012 there were no share purchase warrants outstanding. During the year ended May 31, 2012, 195,170 share purchase warrants expired unexercised.

(d) Stock options:

There were no stock options granted or exercised during the year ended May 31, 2012 or the year ended May 31, 2011. At May 31, 2012, there were 146,700 stock options outstanding at exercise prices ranging from $1.00 to $5.00 (note 13).

The Corporation recognized share-based compensation expense for the fiscal year ended May 31, 2012 of $33,321 (May 31, 2011 - $292,618).

(e) Contributed surplus:

Changes in contributed surplus were as follows:

| | May 31, 2012 | May 31, 2011 |
|---|---|---|
| Balance, beginning of year | $ 4,540,190 | $ 4,247,572 |
| Share purchase warrants expired | 1,186,971 | - |
| Share-based compensation (note 9(d)) | 33,321 | 292,618 |
| Balance, end of year | $ 5,760,482 | $ 4,540,190 |

**10. Income taxes:**

The Corporation has no history of generating taxable income. The Corporation carries on business in Jersey, Cyprus, Russia and Canada. In these jurisdictions where corporate income taxes apply, the allocations of loss carry forwards would offset any tax expense.

The income tax provision differs from the amount that would be obtained by applying the Corporation's May 31, 2012 income tax rate of 0% (May 31, 2011 - 0%). The main differences between expected and actual tax provisions are as follows:

| | May 31, 2012 | May 31, 2011 |
|---|---|---|
| Net loss | $ (9,289,892) | $ (22,993,822) |
| Tax rate | 0% | 0% |
| Expected income tax | – | – |
| Change in tax rate due to operating jurisdiction and other | (2,154,949) | (1,202,273) |
| Change in unrecognized tax assets | 2,154,949 | 1,202,273 |
| Income tax expense | $ – | $ – |

Unrecognized deferred tax assets

Deferred tax assets have not been recognized for the following deductible temporary differences:

| | May 31, 2012 | May 31, 2011 |
|---|---|---|
| Non-capital loss carried forward | $32,270,388 | $21,542,505 |
| Property and equipment | 2,061,338 | 2,070,102 |
| Balance, end of year | $ 34,331,726 | $23,612,607 |

Deferred tax assets have not been recognized as the Corporation and its subsidiaries and affiliates have no history of generating taxable earnings.

The Corporation has Russian tax losses of approximately $31.8 million (2011 - $21.1 million) expiring between the years 2015 and 2021. The Corporation also has Canadian non-capital losses of approximately $426,000 (2011 - $426,000) expiring between the years 2027 and 2031. The tax losses are based on the Corporation's tax filings, which are subject to audit and potential reassessment and are restricted in use to the jurisdictions to which they arose. The final results are not reasonably determinable at this time and management believes that it has adequately provided for current and future income taxes. Upon the liquidation of any of the Corporation's subsidiaries and affiliates any applicable unrecognized deferred tax asset will be relinquished.

## 11. Loss per share:

Basic and diluted loss per share for the years ended May 31, 2012 and 2011 was calculated as follows:

| | May 31, 2012 | May 31, 2011 |
|---|---|---|
| Net loss for the period | $ (9,289,892) | $ (22,993,822) |
| Weighted average number of common shares: | | |
| Basic | 4,903,998 | 4,899,877 |
| Diluted | 4,903,998 | 4,899,877 |

As the exercise prices of all options and warrants were out-of-the-money compared to market prices and the Corporation incurred net losses during the years ended May 31, 2012 and 2011, the impact of options and warrants was anti-dilutive.

## 12. Financial instruments and risk management:

(a) Capital management:

As an exploration company, the Corporation's operations are financed principally through shareholders' equity. The Corporation's objectives when managing capital are to: finance planned exploration activities; continue as a going concern; maximize returns for shareholders; provide benefits for other stakeholders; and provide resources to facilitate growth.

The Corporation manages the capital structure and responds to changes in economic conditions and planned requirements. It will continue to use cash from equity offerings to fund operations and invest in its capital expenditure program. Future capital strategies may include debt financing and obtaining strategic partners funding of a portion of its projects.

Current economic conditions continue to affect capital markets and the allocation of capital. This situation, together with the impact of unsuccessful drilling results, stress the need for greater conservation of capital and careful monitoring of the Corporation's rate of spending on capital projects in Russia and to fund general and administrative costs, especially given the absence of adequate financing at May 31, 2012 (note 2).

There are no external restrictions on the Corporation's capital.

(b) Fair values:

The fair value of the Corporation's financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximated their carrying values as at May 31, 2012, May 31, 2011 and June 1, 2010.

(c) Financial instrument risk exposure and management:

The Corporation is exposed to various risks associated with its financial instruments. These risks are categorized as market risk, credit risk and liquidity risk.

(i) Market risk:

Market risk is the risk that changes in market conditions, such as commodity prices, exchange rates and interest rates, will affect the Corporation's net earnings or the value of its financial instruments. The objective of market risk management is to manage and control exposures within acceptable limits, while maximizing returns.

(ii) Commodity risk:

Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in commodity prices. Significant changes in commodity prices can also reduce 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. In the future, the Corporation may attempt to mitigate commodity price risk through the use of financial derivatives. The Corporation does not have any oil or gas production and did not have any risk management contracts in place as at or during the years ended May 31, 2011 and May 1, 2012, or thereafter.

(iii) Foreign currency risk:

The Corporation is exposed to foreign currency fluctuations as it holds cash and incurs expenditures in foreign currencies. The Corporation incurs expenditures in Russian rubles, Pound sterling, Euros and Canadian dollars and is exposed to fluctuations in exchange rates in these currencies. There were no exchange rate contracts in place as at or during the years ended May 31, 2011 or May 31, 2012, or thereafter.

A 1% change in foreign exchange rates between the Russian rouble and the U.S. dollar would have resulted in approximately a $1,000 change in net loss for the year ended May 31, 2012.

(iv) Credit risk:

Financial instruments that potentially subject the Corporation to concentration of credit risk consist of accounts receivable. There is low credit risk on accounts receivable which consist of Russian Value Added Taxes and accounts receivable from the Corporation's joint ventures. At May 31, 2012 and May 31, 2011, the Corporation's receivables were current.

(v) 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 financial liabilities consist of accounts payable and accrued liabilities. Accounts payable consists primarily of invoices payable to trade suppliers or professionals for services rendered (Note 2).

The Corporation prepares budgets for its corporate operations and capital expenditure programs which are regularly monitored and updated as considered necessary.

**13. Subsequent events:**

(a) On June 26, 2012, the Corporation completed the sale of the mobile drilling rig and equipment for RUR 31,000,000 or approximately U.S. $926,000.

(b) On June 26, 2012, the Corporation completed the sale of the HighKelly rig, which the Corporation owns a 46.25% working interest. The gross proceeds from the sale were Cdn. $3,500,000 with Cdn. $1,618,750 being the Corporation's share.

(c) On June 26, 2012, the Corporation entered into a farm-in agreement with East Siberian Resources Ltd. ("ESR") of Tortola, British Virgin Islands. The Farm-in Agreement provides that the Corporation may earn up to a 51% equity interest in two wholly-owned Cyprus subsidiaries of ESR, Elranio Holdings Ltd. ("Elranio") and Lesona Holdings Ltd. Elranio indirectly holds a 100% interest in an exploration and production license located on the eastern onshore portion of the Sakhalin Island. Lesona indirectly holds one oil production license and one exploration and production license located in Eastern Siberia.

The Farm-in Agreement is subject to a conditional work program which includes expenditures of approximately U.S. $51 million over a period of three years.

The farm-in for 51% of the Elranio shares is based upon the funding of the following potentially staged earn-in work programs to be performed in relation to the Prizalivnaya License held by Elranio:

(i) 20% shareholding in Elranio will be earned following a U.S. $15 million investment by the Corporation in Elranio for drilling the first development well. This development well will be drilled to the target reservoir zone of interest and tested, to a minimum depth of 4,000 metres;

(ii) a 20% shareholding in Elranio will be earned following an additional U.S. $10 million investment by the Corporation in Elranio for drilling of a second development or delineation well. This second development or delineation well will be drilled to the same reservoir zone of interest and tested, to a minimum depth of 4,000 metres; and

(iii) an 11% shareholding in Elranio will be earned following an additional U.S. $5 million investment by the Corporation in Elranio for shooting 200 km of 2D seismic or an equivalent agreed upon 3D seismic program.

The farm-in for 51% of the Lesona shares is based upon the following potentially staged earn-in funding for work program performed in relation to the Verkhnepitskaya Licence and Borschevskaya Licences held by Lesona:

(i) a 26% shareholding in Lesona will be earned following a U.S. $10 million investment by the Corporation in Lesona for drilling the first delineation well on the Borschevskaya License. This well will be drilled updip from the oil water contact in the reservoir zone of interest and tested, to a minimum depth of 2,700 metres ; and

(ii) a 25% shareholding in Lesona will be earned following an additional U.S. $10 million investment by the Corporation in Lesona for shooting 300 km of 2D seismic on the Borschevskaya License; and shooting 700 km of 2D seismic on the Verkhnepitskaya License.

(d) In August, 2012, a director of the Corporation agreed to lend the Corporation U.S. $100,000 by way of a one year, interest free unsecured convertible note. The Corporation or the director may require, at any time during the term of the note, the conversion of all or any portion of the principal amount of the note into fully paid and non-assessable common shares of the Corporation at a price of $0.50 per share.

(e) Effective August 31, 2012, all stock option holders agreed to forfeit their options, which were subsequently cancelled. As at August 31, 2012, the Corporation had no outstanding stock options.

**14. Directors and key management remuneration:**

The Corporation considers its directors and executives to be key management personnel. Compensation attributed to key management personnel comprising salaries and directors fees for the year ended May 31, 2012 was $914,283 (May 31, 2011 - $884,250). At May 31, 2012, there was $402,709 (May 31, 2011 - $127,800) owing to directors and officers for services performed in the normal course of operations. Subsequent to May 31, 2012, the directors and officers had signed agreements to accept common shares of the Corporation at $0.50 per share for $322,151 of the amount owing at May 31, 2012. The agreements are subject to regulatory approval.

**15. Commitments and contingencies:**

The Corporation estimates expenditures of approximately $51 million will be required to meet the work commitments of the Tigilskaya exploration license (note 5).

At September 24, 2012, an audit of the joint venture expenditures is currently in progress and any receivable owed to or liability owed by the Corporation is not known. The Corporation believes any such amounts, if any, will be insignificant and will be recorded when known.

**16. Reconciliation of statement of financial position from Previous Canadian GAAP to IFRS:**

These financial statements are the Corporation's first under IFRS. The adoption of IFRS requires the application of IFRS 1, which generally requires that an entity retrospectively apply all IFRS effective at the end of its first IFRS reporting period, however, IFRS 1 imposes certain mandatory exceptions and permits limited optional exemptions. IFRS 1 optional exemptions applied by the Corporation include:

(a) to measure its E&E assets at the Transition Date at the amount previously capitalized under Previous Canadian GAAP;

(b) to use fair value for equipment reported on its statement of financial position;

(c) stock-based compensation exemption that allows a corporation to evaluate only stock-based compensation awards that were unvested as of the date of transition;

(d) business combinations exemption that allows a corporation not to restate any business combinations that occurred prior to the date of transition; and

(e) to reset its cumulative translation adjustment account to $nil.

The accounting policies in note 4 were applied in preparing financial statements for the year ended May 31, 2012, the comparative information for the year ended May 31, 2011, the financial statements for the year ended May 31, 2011 and the preparation of the opening IFRS based statement of financial position at June 1, 2010, the Corporation's date of transition to IFRS.

In preparing the opening IFRS statement of financial position and comparative information for the year ended May 31, 2011, the Corporation adjusted certain amounts previously reported in financial statements prepared in accordance with Previous GAAP. A financial summary and explanation of how the transition from Previous GAAP to IFRS affected the Corporation's financial position, financial performance and cash flows are set out in the following tables and accompanying notes:

IFRS opening consolidated statement of financial position as at June 1, 2010

| | Note | Canadian GAAP | Effect of transition to IFRS | IFRS |
|---|---|---|---|---|
| **Assets** | | | | |
| Non-current assets: | | | | |
| Exploration and evaluation assets | a(i) | $ - | $ 16,294,709 | $16,294,709 |
| Property and equipment | a(i)(ii) | 27,375,366 | (22,927,425) | 4,447,941 |
| Investment in drilling rig | a(i) | - | 4,137,260 | 4,137,260 |
| Non-current assets | | 27,375,366 | (2,495,456) | 24,879,910 |
| Current assets: | | | | |
| Cash and cash equivalents | | 7,915,415 | - | 7,915,415 |
| Accounts receivable | | 2,758,064 | - | 2,758,064 |
| Prepaid expenses | | 27,958 | - | 27,958 |
| Current assets | | 10,701,437 | - | 10,701,437 |
| Total Assets | | $38,076,803 | $ (2,495,456) | $35,581,347 |
| **Equity** | | | | |
| Share capital | | $91,755,940 | $ - | $91,755,940 |
| Share purchase warrants | f | 7,038,779 | (5,851,808) | 1,186,971 |
| Contributed surplus | c | 3,903,396 | 344,176 | 4,247,572 |
| Cumulative translation adjustment | d | 1,018,864 | (1,018,864) | - |
| Deficit | a,c,d,f | (68,889,756) | 4,030,597 | (64,859,159) |
| Total equity | | 34,827,223 | (2,495,899) | 32,331,324 |
| **Liabilities** | | | | |
| Non-current liabilities: | | | | |
| Warrants | f | - | 443 | 443 |
| Non-current liabilities | | - | 443 | 443 |
| Current liabilities: | | | | |
| Accounts payable and accrued liabilities | | 3,249,580 | - | 3,249,580 |
| Current liabilities | | 3,249,580 | - | 3,249,580 |
| Total Liabilities | | 3,249,580 | 443 | 3,250,023 |
| Total Equity and Liabilities | | $38,076,803 | $ (2,495,456) | $35,581,347 |

IFRS consolidated statement of financial position as at May 31, 2011

| | Note | Canadian GAAP | Effect of transition to IFRS | IFRS |
|---|---|---|---|---|
| **Assets** | | | | |
| Non-current assets: | | | | |
| Property and equipment | a(i)(ii)(iii) | $10,816,759 | $(5,683,561) | $ 5,133,198 |
| Investment in drilling rig | a(i) | - | 4,434,210 | 4,434,210 |
| Non-current assets | | 10,816,759 | (1,249,351) | 9,567,408 |
| Current assets: | | | | |
| Cash and cash equivalents | | 4,045,212 | - | 4,045,212 |
| Accounts receivable | | 252,667 | - | 252,667 |
| Prepaid expenses | | 27,071 | - | 27,071 |
| Total current assets | | 4,324,950 | - | 4,324,950 |
| Total Assets | | $15,141,709 | $(1,249,351) | $13,892,358 |
| **Equity** | | | | |
| Share capital | | 91,806,942 | - | 91,806,942 |
| Share purchase warrants | f | 7,038,779 | (5,851,808) | 1,186,971 |
| Contributed surplus | c | 4,289,815 | 250,375 | 4,540,190 |
| Cumulative translation adjustment | d | 1,018,864 | (1,018,864) | - |
| Foreign currency translation reserve | d | - | 318,237 | 318,237 |
| Revaluation reserve | a(ii) | - | 1,559,919 | 1,559,919 |
| Deficit | a,c,d,f | (91,345,771) | 3,492,790 | (87,852,981) |
| Total equity | | 12,808,629 | (1,249,351) | 11,559,278 |
| **Liabilities** | | | | |
| Current liabilities: | | | | |
| Accounts payable and accrued liabilities | | $ 1,537,629 | $ - | $ 1,537,629 |
| Provisions | | 795,451 | - | 795,451 |
| Total current liabilities | | 2,333,080 | - | 2,333,080 |
| Total Liabilities | | 2,333,080 | - | 2,333,080 |
| Total Equity and Liabilities | | $15,141,709 | $(1,249,351) | $13,892,358 |

Net loss and comprehensive loss for the year ended May 31, 2011:

| | Notes | Canadian GAAP | Effect of transition to IFRS | IFRS |
|---|---|---|---|---|
| Expenses: | | | | |
| Equipment operating expenses and other | | $ 2,350,579 | $ - | $ 2,350,579 |
| General and administrative expenses | | 2,376,413 | - | 2,376,412 |
| Share-based compensation | c | 386,419 | (93,801) | 292,618 |
| Depreciation | a(iii) | 263,898 | 631,608 | 895,506 |
| Write down of property and equipment | | 17,088,976 | - | 17,088,977 |
| Loss before interest and income taxes | | 22,466,285 | 537,807 | 23,004,092 |
| Finance loss (income) | | (10,270) | - | (10,270) |
| Net loss | | 22,456,015 | 537,807 | 22,993,822 |
| Other comprehensive loss | | | | |
| Foreign exchange differences on translation of foreign operations | d | - | (318,237) | (318,237) |
| Revaluation of property and equipment | a(ii) | - | (1,559,919) | (1,559,919) |
| Net comprehensive income | | - | (1,878,156) | (1,878,156) |
| Net loss and comprehensive loss for the year | | $22,456,015 | $(1,340,349) | $21,115,666 |
| Net loss per share: | | | | |
| Basic | | $ (4.58) | $ (0.11) | $ (4.69) |
| Diluted | | $ (4.58) | $ (0.11) | $ (4.69) |
| Weighted average number of common shares outstanding | | | | |
| Basic | | 4,899,877 | - | 4,899,877 |
| Diluted | | 4,899,877 | - | 4,899,877 |

**Transition from Canadian GAAP to IFRS – Notes to Reconciliations**

(a) **Property and equipment and exploration and evaluation assets:**

(i) The Corporation elected an IFRS 1 exemption whereby exploration and evaluation assets were reclassified from the full cost pool under Canadian GAAP to exploration and evaluation assets at the amount that was recorded under Canadian GAAP. The Corporation had no reserves and no producing or development assets on the Transition Date.

This resulted in a $16,294,709 increase in exploration and evaluation assets and a $4,137,260 increase in investment in drilling rig at the Transition Date and a corresponding decrease in 'property and equipment' presented under Canadian GAAP.

At May 31, 2011, an increase in investment in drilling rig of $4,434,210 was recorded with a corresponding decrease in 'property and equipment'.

(ii) IFRS 1 also provides an optional exemption to measure assets using the estimated fair value on the Transition Date and apply IAS 16 as the fair value measurement model. The Corporation elected this exemption such that equipment costs were adjusted to the independently appraised fair value at the Transition Date of $4,447,941 compared to carrying value of $6,853,286 under Canadian GAAP. At May 31, 2011, equipment costs were adjusted to the independently appraised fair vale of $5,133,198, subsequent to an adjustment for additional depreciation, resulting in a fair value adjustment of $617,743 with an offsetting adjustment to 'revaluation reserve' in equity.

(iii) In addition, depreciation is measured on a more detailed component-by-component basis under IFRS. This change in approach resulted in differences in the estimates of expected life and residual values of some components of the Corporation's equipment. Under IFRS depreciation must be recorded on equipment that is available for use, whether it is currently in use or idle. This resulted in additional depreciation for the year ended May 31, 2011 of $631,608.

(b) **Decommissioning obligations:**

As under Canadian GAAP, there was no need for the Corporation to record any decommissioning obligations at the Transition Date or subsequent thereto.

Accounts payable and accrued liabilities at the Transition Date include an accrual of $156,700 for estimated site reclamations and other environmental impact damages relating to exploration licenses that either expired subsequent to the Transition Date or were surrendered back to the MNFR early. These liabilities are not discounted to a present value because settlement was required in the current period.

**(c) Share-based payments:**

Under Canadian GAAP, the Company recognized an expense related to their share-based payments on a straight-line basis through the date of full vesting and did not incorporate a forfeiture multiple. Under IFRS, the Company is required to recognize the expense over the individual vesting periods for graded vesting awards and estimate a forfeiture rate. Accordingly, a $344,176 increase to accumulated deficit was recorded upon transition to IFRS, offset by a $93,801 decrease to share-based compensation for the fiscal year May 31, 2011.

**(d) Foreign currency translation adjustment:**

The Effects of Changes in Foreign Exchange Rates ("IAS 21") requires the functional currency of each entity of the consolidated group to be determined separately based on primary and secondary indicators. During the year ended May 31, 2011, the Corporation recorded foreign exchange differences on translation of foreign operations totaling $318,237 as other comprehensive income.

In addition, IFRS 1 provides an optional exemption to set accumulated foreign currency translation balances reported in other comprehensive income to 'nil'. Upon transition to IFRS, the Corporation elected to use this exemption. The cumulative translation balance at June 1, 2010 of $1,018,864 was set to nil and offset to retained earnings.

**(e) Share purchase warrants:**

Under Canadian GAAP the Corporation classified warrants previously issued to purchase common shares with exercise prices in Canadian dollars and British pounds as equity instruments. Under IFRS, warrants issued to purchase common shares for a fixed price, in a currency other than the functional currency of the parent and not offered pro rata to all existing shareholders of the same class at the time issuance are considered derivative financial liabilities. Such warrants are required to be measured and recognized at fair value with changes subsequent to the initial recognition charged to profit or loss. The fair value of the warrants at June 1, 2010 was $443. The Corporation used the Black-Scholes pricing model to determine the fair value.

**(f) Cash Flow Statement**

The transition from Canadian GAAP to IFRS had no material effect upon the reported cash flows generated by the Corporation.