

Consolidated Financial Statements of

**GASTEM INC.**

Years ended December 31, 2010 and 2009



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## INDEPENDANT AUDITORS' REPORT

To the Shareholders of Gastem Inc.

We have audited the accompanying consolidated financial statements of Gastem Inc., which comprise the balance sheets as at December 31, 2010 and 2009, the consolidated statements of deferred expenditures, operations, comprehensive loss and deficit and cash flows for the year then ended, 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 Canadian generally accepted accounting principles, 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 audit. We conducted our audit 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 in 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 is sufficient and appropriate to provide a basis for our audit opinion.



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*Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Gastem Inc. as at December 31, 2010 and 2009, and its results of operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

*Emphasis of Matter*

Without qualifying our opinion, we draw attention to note 1 in the financial statements which indicates that Gastem Inc. is still at the exploration stage and, as such, no revenue has been yet generated from its operating activities. Accordingly, Gastem Inc. depends on its ability to raise financing in order to discharge its commitments and liabilities in the normal course of business. These conditions, along with other matters as set forth in note 1, indicate the existence of a material uncertainty that may cast significant doubt about Gastem Inc.'s ability to continue as a going concern.

*KPMG LLP*

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Chartered Accountants

April 26, 2011

Montréal, Canada

# **GASTEM INC.**

Consolidated Financial Statements

Years ended December 31, 2010 and 2009

## **Financial Statements**

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# GASTEM INC.

Consolidated Balance Sheets

December 31, 2010 and 2009

	2010	2009
<b>Assets</b>		
Current assets:		
Cash and cash equivalents (note 4)	\$ 391,280	\$ 1,217,033
Restricted cash (note 4)	1,600,000	-
Funds reserved for exploration (note 4)	5,631,653	6,343,005
Accounts receivable (note 5)	1,178,800	2,948,404
Prepaid expenses and deposits	22,400	113,396
	<u>8,824,133</u>	<u>10,621,838</u>
Fixed assets (note 6)	201,707	62,825
Gas properties and deferred exploration costs (note 7)	26,142,826	17,494,081
Deposits on long-term assets (note 8)	285,000	948,082
	<u>\$ 35,453,666</u>	<u>\$ 29,126,826</u>

## Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable and accrued liabilities (note 9)	\$ 2,192,479	\$ 645,450
Shareholders' equity:		
Share capital and warrants (note 10)	46,628,221	37,951,898
Contributed surplus (note 12)	2,658,732	2,611,830
Deficit	(16,025,766)	(12,082,352)
	<u>33,261,187</u>	<u>28,481,376</u>
Nature of operations and going concern (note 1)		
Commitments and contingencies (note 17)		
Subsequent event (note 18)		
	<u>\$ 35,453,666</u>	<u>\$ 29,126,826</u>

See accompanying notes to consolidated financial statements.

On behalf of the Board:

\_\_\_\_\_, Director

\_\_\_\_\_, Director

# GASTEM INC.

## Consolidated Statements of Deferred Expenditures

Years ended December 31, 2010 and 2009

	2010	2009
Balance, beginning of year	\$ 11,819,555	\$ 8,716,850
Increase (decrease):		
Drilling	4,945,471	4,613,201
Seismic work	727,964	-
Geological work	99,573	660,810
Site preparation, evaluation and others	2,991,580	1,556,735
Less contribution received from a partner	(147,730)	(681,541)
Less disposal of gas properties	(2,750)	(948,316)
Less other income	-	(79,438)
Less resource tax credits	-	(2,018,746)
	8,614,108	3,102,705
Balance, end of year (note 7)	\$ 20,433,663	\$ 11,819,555

See accompanying notes to consolidated financial statements.

# GASTEM INC.

## Consolidated Statements of Operations, Comprehensive Loss and Deficit

Years ended December 31, 2010 and 2009

	2010	2009
Revenue:		
Interest income	\$ 93,456	\$ 78,126
Other income	-	2,640
	93,456	80,766
Expenses:		
Professional fees	800,958	610,595
Office, trustees and reports to shareholder	708,786	605,178
Stock-based compensation (note 11)	135,775	506,720
Salaries and benefits	538,690	376,273
Travel and promotion	166,528	181,372
Rent	93,884	71,478
Amortization	30,523	11,292
Financial expense	80,202	8,480
Foreign exchange loss	15,015	72,446
Fees related to subscription to the Oslo Stock Exchange	547,692	-
Loss (gain) on disposal of properties	2,620	(350,862)
Write-off of properties	102,750	-
	(3,223,423)	2,092,972
Loss before income taxes	(3,129,967)	(2,012,206)
Future income taxes (note 13)	1,487,451	(376,000)
Net loss and comprehensive loss	(1,642,516)	(1,636,206)
Deficit, beginning of year	(12,082,352)	(9,910,490)
Share issue expense	(813,447)	(535,656)
Future taxes arising from flow-through shares	(1,706,268)	-
Future taxes arising from share issuance costs	218,817	-
Deficit, end of year	\$ (16,025,766)	\$ (12,082,352)
Loss per share, basic and diluted	\$ (0.02)	\$ (0.03)

See accompanying notes to consolidated financial statements.

# GASTEM INC.

## Consolidated Statements of Cash Flows

Years ended December 31, 2010 and 2009

	2010	2009
Cash flows from operating activities:		
Net loss and comprehensive loss	\$ (1,642,516)	\$ (1,636,206)
Adjustments for:		
Amortization	30,523	11,292
Future income taxes	(1,487,451)	(376,000)
Write-off of properties	102,750	-
Loss (gain) on disposal of properties	2,620	(350,862)
Stock-based compensation	135,775	506,720
Changes in non-cash working capital items:		
Accounts receivable	(100,665)	752,416
Prepaid expenses and deposits	90,996	(96,321)
Accounts payable and accrued liabilities	1,547,029	(1,795,697)
	(1,320,939)	(2,984,658)
Cash flows from financing activities:		
Proceeds from share issuance	8,587,450	6,343,005
Share issue expenses	(813,447)	(535,656)
	7,774,003	5,807,349
Cash flows from investing activities:		
Gas properties and deferred exploration costs	(8,751,496)	(6,435,371)
Amounts received from resource tax credits	1,320,269	1,798,000
Deposits on long-term assets	663,082	(752,420)
Additions to fixed assets	(172,024)	(35,313)
Proceeds on disposal of properties	-	902,154
Balance receivable on sale of properties	550,000	-
Funds reserved for exploration	711,352	(6,343,005)
Restricted cash	(1,600,000)	-
	(7,278,817)	(10,865,955)
Net decrease in cash and cash equivalents	(825,753)	(8,043,264)
Cash and cash equivalents, beginning of year	1,217,033	9,260,297
Cash and cash equivalents, end of year	\$ 391,280	\$ 1,217,033
Additional information concerning cash flows:		
Other non-cash activities:		
Share issue expenses representing cost of options exercised	\$ 88,873	\$ -
Acquisition of properties against share issuance	-	1,855,000
Balance receivable on sale of properties	-	550,000
Resource tax credits netted against deferred exploration costs	-	2,018,746

See accompanying notes to consolidated financial statements.

# GASTEM INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2010 and 2009

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Gastem inc. ("Gastem" or the "Company") is incorporated under the *Canada Business Corporations Act*. The Company was set up to hold interests in gas properties, which are presently at the exploration stage and it has not yet been determined whether the properties contain reserves that are economically recoverable.

## 1. Nature of operations and going concern:

The Company holds gas properties or interest in such properties and permits ("properties") in the province of Québec and in the United States.

Although the Company has taken steps to verify title to gas properties in which it has an interest in accordance with industry standards for the current stage of exploration of such properties, these procedures do not guarantee the Company's title. Property title may be subject to unregistered prior agreements and non-compliance with regulatory requirements.

The financial statements were prepared under the assumption of going concern, which presumes that the Company will continue its operations in the foreseeable future and will be able to realize its assets and discharge its liabilities in its normal course of operations.

The Company is in the process of exploring and evaluating its gas properties and projects and has not yet determined whether its properties and projects contain reserves that are economically recoverable. The ability of the Company to meet its commitments as they become payable, including the acquisitions of gas properties and the development of projects, is dependent on the ability of the Company to obtain necessary financing. The recoverability of amounts shown for gas properties is dependent upon the ability of the Company to obtain necessary financing to complete the acquisition, exploration and development thereof, and upon future profitable production or proceeds from the disposal of properties.

It should also be noted that the Minister of Sustainable Development, Environment and Parks has released a report to the Bureau d'audiences publiques sur l'environnement ("BAPE") filed on February 28, 2011 about the sustainable development of the shale gas industry in Quebec. In its report the commission of inquiry of the BAPE presents a number of findings and recommendations. Among others, all fracturing operations in the oil and gas industry in Quebec will now be subject to the Strategic Environmental Study ("SES"). Thus, all the fracturation activities will be authorized only for the purpose of developing scientific knowledge of environmental assessment, until the end of the SES.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## 1. Nature of operations and going concern (continued):

The Company's gas properties located in Quebec and the related deferred exploration costs, totalling \$18,166,001 as at December 31, 2010, include fracture wells affected by these new procedures. In addition, as part of a farm-out contract, the operator of the St-Hyacinthe project and the Company are required to complete work on fracture wells of this property totalling approximately 6 million dollars by June 1, 2011, without which the society and its partner will lose their interest in the property. The amounts capitalized as gas properties and deferred exploration costs for this property totalled \$5,559,239 as at December 31, 2010. To date, management is unable to determine when the exploration will continue on these properties.

These conditions indicate the existence of a significant uncertainty which may cast significant doubt on the ability of the Company to continue as a going concern.

These financial statements do not reflect adjustments that should be made to the book value of assets and liabilities, if the going concern assumption was inappropriate.

## 2. Change in accounting policies:

*Future accounting pronouncements:*

International financial reporting standards ("IFRS"):

In February 2008, the Accounting Standards Board ("AcSB") announced that accounting standards in Canada were to converge with IFRS and that public companies would be required to present their financial statements, with comparative data, under these standards for fiscal years beginning on or after January 1, 2011. The Company is currently evaluating the impact of these requirements on its financial statements.

## 3. Significant accounting policies:

(a) Basis of consolidation:

These consolidated financial statements include the accounts of Gastem and its wholly-owned subsidiary, Gastem USA inc. Intercompany transactions and balances were eliminated upon consolidation.

(b) Cash and cash equivalents, restricted cash and funds reserved for exploration:

Cash and cash equivalents, restricted cash and funds reserved for exploration include temporary investments with a maturity date of three months or less.

The restricted cash corresponds to an amount extended as an irrevocable letter of credit to a supplier. This letter of credit has a short-term expiry.

The funds reserved for exploration represent proceeds from private placements of flow through shares not yet expensed. The Company must use these funds for exploration of gas properties in accordance with restrictions imposed by these private placements.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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### 3. Significant accounting policies (continued):

(c) Gas properties and deferred exploration costs:

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

If economically profitable gas reserves are developed, the capitalized costs of the properties in question are amortized using units of production for the year, based on probable and proven gas reserves. If it is determined that capitalized acquisition, exploration and development costs are not recoverable over the estimated useful life of the property, or if the project is abandoned, the project is written down to its net realizable value. The recovery of amounts recorded as gas properties and the related deferred exploration costs depends on the discovery of economically recoverable reserves, the Company's ability to obtain the necessary financing to complete development and future profitable production or the proceeds from disposal of such properties. Amounts recorded under properties and deferred exploration costs do not necessarily represent the present or future value.

(d) Property and equipment:

Property and equipment consist of computers and furniture and equipment and are carried at cost. Depreciation is calculated using the diminishing balance method at the rate of 20%.

(e) Depreciation of long-term assets:

The Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3063, *Impairment of Long-Lived Assets*, provides guidance on the recognition, measurement and disclosure of the impairment of long-lived assets. The provisions of the Section require an impairment loss for a long-lived asset to be held and used to be recognized when its carrying amount exceeds the sum of the undiscounted cash flows expected from its use and eventual disposition. The impairment loss is measured at the amount by which its carrying amount exceeds its fair value.

(f) Income taxes:

The Company uses the asset and liability of accounting for income taxes. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment or substantive enactment date.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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### 3. Significant accounting policies (continued):

(f) Income taxes (continued):

The Company renounces tax deductions relating to resource expenditures that are financed by the issuance of flow-through shares for the benefit of its shareholders, as permitted by the tax legislation. Under the asset and liability method used to account for income taxes, future income taxes related to the temporary differences created by this renouncement are recorded in accordance with EIC-146, when the Company renounces these deductions and a corresponding cost of issuing the securities is also recorded.

(g) Stock option plan:

The Company records stock-based compensation to its participants at fair value. According to the fair value method, a compensation expense is charged to operating expenses and credited to contributed surplus based on the fair value of the stock options issued over their vesting period. Upon the exercise of stock options, capital stock is credited in the amount paid plus the corresponding employee compensation amount previously recorded in contributed surplus.

(h) Resource tax credits:

The Company incurs exploration expenses that are eligible for tax credits. The tax credits are recorded based on the estimated amounts to be recovered. The amounts claimed are subject to an audit by the tax authorities.

Tax credits on exploration costs relating to gas and exploration assets are deducted from the related asset.

(i) Use of estimates:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant areas requiring the use of estimates relate to assessing the realizable values of properties and deferred exploration costs, the valuation of accounts receivable and the fair value estimation of stock options. Consequently, actual results could differ from those estimates.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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### 3. Significant accounting policies (continued):

(j) Financial instruments:

Sections 3855 and 3865 of CICA Handbook establish standards for recognizing and measuring financial assets, financial liabilities and derivatives. Under these standards, financial instruments are now classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other financial liabilities, and measurement in subsequent periods depends on their classification. Transaction costs are expensed as incurred for financial instruments classified as held-for-trading. For other financial instruments, transaction costs are capitalized on initial recognition and presented as an adjustment to the underlying financial instruments, depending on their classification:

- Financial assets and financial liabilities held-for-trading are measured at fair value with changes recognized in income.
- Available-for-sale financial assets are measured at fair value or at cost, in the case of financial assets that do not have a quoted market price in an active market, and changes in fair value are recorded in comprehensive income.
- Financial assets held-to-maturity, loans and receivables, and other financial liabilities are measured at amortized cost using the effective interest method of amortization.

The Company has classified its cash, restricted cash and funds reserved for exploration and short-term investments as held-for-trading. Accounts receivable and deposits on long-term assets were classified as loans and receivables. All of the Company's financial liabilities were classified as other financial liabilities.

The CICA Handbook Section 3862, *Financial Instruments - Disclosures*, also requires a three-level hierarchy that reflects the significance of the inputs used in making the fair value measurements. The hierarchy of fair values includes the following levels:

Level 1: inputs are unadjusted quoted prices of identical instruments in active markets.

Level 2: inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3: one or more significant inputs used in a valuation technique are unobservable in determining the fair values of the instruments.

(k) Foreign currency translation:

The Company uses the temporal method to record its foreign currency transactions and the financial statements of the integrated foreign operations. Under this method, monetary items are translated at the rate of exchange in effect at the balance sheet date, non-monetary items are translated at the historical exchange rate while revenue and expenses are translated at the rate of exchange in effect on the date they occur. Gains or losses resulting from these translations are reflected in the statement of earnings.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

## 4. Cash and cash equivalents, restricted cash and funds reserved for exploration:

	2010	2009
Cash	\$ 1,658,177	\$ 502,893
Money market funds and guaranteed investment certificates	5,964,756	7,057,145
Less exploration funds	(5,631,653)	(6,343,005)
Less restricted cash, which was released on March 3, 2011	(1,600,000)	-
	\$ 391,280	\$ 1,217,033

## 5. Accounts receivable:

	2010	2009
Resource tax credit	\$ -	\$ 1,320,269
Sales tax	388,177	134,144
Partners' contribution	336,739	657,953
Balance on sale of properties, maturing in February 2010	-	550,000
Amounts receivable from related parties <sup>(i)</sup>	420,726	251,801
Other	33,158	34,237
	\$ 1,178,800	\$ 2,948,404

<sup>(i)</sup> As at December 31, 2010, following a cost sharing agreement, included in the accounts receivable, is an amount of \$296,949 (2009 - \$251,801) receivable from companies in which an officer of the Company is also an administrator, as well as an amount of \$123,777 (2009 - nil) receivable from an officer of the Company as an advance for expenses incurred.

## 6. Fixed assets:

	2010		
	Cost	Accumulated amortization	Net book value
Furniture and tools	\$ 191,414	\$ 26,443	\$ 164,971
Computer equipment	61,271	24,535	36,736
	\$ 252,685	\$ 50,978	\$ 201,707

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

## 6. Fixed assets (continued):

	2009		
	Cost	Accumulated amortization	Net book value
Furniture and tools	\$ 32,771	\$ 5,032	\$ 27,739
Computer equipment	52,355	17,269	35,086
	<u>\$ 85,126</u>	<u>\$ 22,301</u>	<u>\$ 62,825</u>

## 7. Gas properties and deferred exploration costs:

	2010		
	Cost of gas properties	Deferred exploration cost	Net book value
Magdalen Island	\$ 5,420	\$ 406,022	\$ 411,442
St-Jean	86,560	289,641	376,201
Dundee	338,257	716,391	1,054,648
Matapédia	181,099	985,816	1,166,915
Yamaska	18,868	4,578,339	4,597,207
Miguasha	79,584	2,900	82,484
St-Hyacinthe	2,437,500	3,121,739	5,559,239
Joly	–	4,917,865	4,917,865
New York	2,561,875	5,414,950	7,976,825
	<u>\$ 5,709,163</u>	<u>\$ 20,433,663</u>	<u>\$ 26,142,826</u>

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

## 7. Gas properties and deferred exploration costs (continued):

In 2010, the cost of the St-Simon property, as well as the deferred exploration costs incurred on this property in the total amount of \$102,285, were written-off following the decision by the operator to abandon the well.

			2009
	Cost of gas properties	Deferred exploration cost	Net book value
Magdalen Island	\$ 3,669	\$ 216,556	\$ 220,225
St-Jean	85,661	258,149	343,810
Dundee	327,446	411,491	738,937
Matapédia	167,074	420,337	587,411
Yamaska	22,726	3,964,194	3,986,920
Miguasha	80,002	2,900	82,902
Shell Saint-Simon	100,000	2,285	102,285
St-Hyacinthe	2,437,500	1,007,084	3,444,584
Joly	-	2,168,429	2,168,429
New York	2,450,448	3,368,130	5,818,578
	\$ 5,674,526	\$ 11,819,555	\$ 17,494,081

In 2004, the Company acquired an interest in 15 permits for the oil and natural gas properties of St-Jean, Dundee, Matapédia and Yamaska in consideration of the issue of 3,757,408 common shares to Ditem Exploration Inc. In addition, the Company obtained 117,000 hectares of exploration permits in the Gaspé Peninsula adjacent to the existing Matapédia blocks.

In 2005, the Company acquired an interest of 10% in the Shell Saint-Simon property by issuing 1,000,000 common shares and by assuming 10% of the future development costs. In 2011, the operator decided to abandon this well.

In 2006, the Company acquired an interest of 10% in the Haldimand 1 (Petrolia 3) exploratory well by issuing 1,000,000 common shares and by assuming 10% of the future development costs. The interest was sold in 2009.

In 2007, the Company granted Forest Oil Corporation the right to earn up to a 60% working interest in the Yamaska property, which covers 45,381 hectares, by spending up to \$10,000,000 in exploration. In 2008, Forest Oil notified the Company of its election to exercise its financial commitments option on the Yamaska property. The Yamaska property was subject to a 7.5% convertible gross overriding royalty ("GORR") with another partner, which was converted into a 20% working interest.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## **7. Gas properties and deferred exploration costs (continued):**

In 2007, the Company acquired an interest of 35% in the permit of Joly property. The Company maintained an option to drill a second well before September 1, 2010.

In 2008, the Company signed an agreement with Covalent Energy (now Utica Energy) for an option to acquire a working interest up to 65% on exploration permits covering 29,000 hectares in consideration of the cost of an exploration program (New York property). In September 2009, Gastem signed a final Amendment to the agreement. The Company paid an amount of US\$35,000, issued 3,500,000 common shares to Utica and completed an exploratory vertical well and acquired an 80% interest in 34,150 acres. Utica retains a 2% overriding royalty interest ("ORRI") in existing permits and in new permits within the area of mutual interest in New York state. Utica also retains a participation right to a 20% working interest in new land acquisitions within the area of mutual interest.

In 2008, the Company signed, together with its partner Canbriam Energy, a farm-in agreement for a total of 85% working interest in the two St-Hyacinthe (formerly Mundiregina) permits (92,104 acres) situated in the St-Lawrence Lowlands. According to the terms of the Agreement, Gastem may earn a 17% interest and Canbriam, 68%, with the sellers maintaining a 15% carried interest. Under the terms of the Agreement, Gastem paid to the seller an upfront consideration of \$2.5M and committed to pay 20% of a 6-well and seismic program to be carried out.

In 2008, Gastem acquired the petroleum and gas exploration permits to the Magdalen Islands known to be prospective for gas and situated in the Magdalen Basin from the Québec Natural Resources Department. The Magdalen permit is located in the central part of the Gulf of St-Lawrence.

In January 2009, the Company acquired permits in the Appalache area in order to carry out exploration and development programs.

## **8. Deposits on long-term assets:**

Deposits on long-term assets consist principally of payments made to the government of Québec to restore drilling sites in the event of the termination of a project.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## 9. Accounts payable and accrued liabilities:

	2010	2009
Trade payables	\$ 2,018,404	\$ 525,585
Accrued liabilities	127,546	80,000
Salaries and benefits	46,529	39,865
	<hr/> \$ 2,192,479	<hr/> \$ 645,450

## 10. Share capital:

Authorized:

An unlimited number of common shares, without par value

	2010	2009
Issued:		
89,787,007 common shares (2009 - 74,302,300)	\$ 46,628,221	\$ 37,951,898

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# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

## 10. Share capital (continued):

	2010	2009
Issuance during the year:		
For cash:		
15 274 707 common shares and warrants (2009 - 9,758,469) pursuant to private placements <sup>(i)</sup> <sup>(ii)</sup>	\$ 8,515,750	\$ 6,343,005
210,000 common shares (2009 - nil) pursuant to exercise of options (including the cost of options of \$88,873 (2009 - nil))	160,573	-
For acquisition of a property: (2009 - 3,500,000 shares)	-	1,855,000
	<u>\$ 8,676,323</u>	<u>\$ 8,198,005</u>
Weighted average number of outstanding shares during the year	82,926,962	62,630,364

(i) In March 2010, 6,764,707 flow-through shares were issued. Each share was issued for \$0.85, for a total financing of \$5,750,000. Each unit sold consisted of one flow-through share and one warrant. Each warrant entitles the holder to purchase one common share at a price of \$1.05 for an 18-month period.

(ii) In August 2010, 8,510,000 common shares were issued at a price of \$0.325 per share, for a total financing of \$2,765,750. Each unit sold consists of one common share and one warrant. Each warrant entitles the holder to purchase one common share at a price of \$0.45 for a 24-month period.

Share purchase warrants:

The Company has granted share purchase warrants and could be required to issue shares as follows, upon the exercise of such warrants:

Number of options	Exercise price	Expiring date
8,107,691	\$ 0.85	June 4, 2011
1,507,693	0.85	June 9, 2011
143,085	0.85	June 30, 2011
6,764,706	1.05	September 24, 2011
8,510,000	0.45	August 17, 2012

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

## 11. Stock option plan:

Under the stock option plan for the benefit of the directors and officers of the Company, 5,822,612 common shares are available; the life of the options cannot exceed five or ten years and the options vest immediately or over a period of one, two or three years.

The number of outstanding stock options changed as follows:

	2010	Average exercisable price	2009	Average exercisable price
Balance, beginning of year	4,733,000	\$ 0.55	3,553,000	\$ 0.55
Issued	100,000	0.41	1,180,000	0.56
Exercised	(210,000)	0.34	–	–
Cancelled	(1,265,606)	0.59	–	–
<b>Balance, end of year</b>	<b>3,357,394</b>	<b>\$ 0.55</b>	<b>4,733,000</b>	<b>\$ 0.55</b>
<b>Exercisable options, end of year</b>	<b>3,279,771</b>	<b>\$ 0.55</b>	<b>3,453,000</b>	<b>\$ 0.55</b>

As at December 31, 2010, the following options were outstanding:

Number of options	Exercise price	Expiring date
295,000	\$ 0.26	December 19, 2011
400,000	0.35	December 22, 2011
425,000	0.65	August 31, 2012
761,189	0.60	December 14, 2012
25,000	0.62	January 28, 2013
500,000	0.63	February 21, 2013
25,000	2.18	July 28, 2013
25,000	0.58	January 28, 2014
25,000	0.37	July 28, 2014
85,000	0.37	July 31, 2014
691,205	0.58	October 29, 2014
50,000	0.53	February 6, 2015
50,000	0.28	August 31, 2020

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## 11. Stock option plan (continued):

During the year ended December 31, 2010, the Company granted 100,000 stock options (2009 - 1,180,000) at a price from \$0.28 to \$0.53 per share (2009 - \$0.37 to \$0.58). The fair value of each option granted was determined using the Black-Scholes option pricing model. At the date of the grant, this weighted average fair value of stock options granted was \$0.36 per option (2009 - \$0.39). The following assumptions were used in these calculations:

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	2010	2009
Risk-free interest rate	3 to 4%	2.5%
Expected life	5 to 10 years	2 years
Expected volatility	102 to 132%	138 to 144%
Expected dividend yield	0%	0%

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## 12. Contributed surplus:

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	2010	2009
Balance, beginning of year	\$ 2,611,830	\$ 2,105,110
Stock-based compensation	135,775	506,720
Cost of warrants exercised	(88,873)	—
Balance, end of year	\$ 2,658,732	\$ 2,611,830

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# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

## 13. Income taxes:

Income tax expense (recovery) differs from the amounts computed by applying the combined federal and provincial income tax rate of 29.9% (2009 - 30.9%) as a result of the following:

	2010	2009
Loss before taxes	\$ (3,129,967)	\$ (2,012,206)
Computed "expected" tax recovery	\$ (935,860)	\$ (621,772)
Increase in income taxes resulting from:		
Non-deductible stock-based compensation	40,597	156,576
Income tax at future rate	74,272	89,200
Valuation allowance	(1,487,451)	(17,000)
Current year losses not recognized	770,451	—
Other	50,540	16,996
Total income tax expenses	\$ (1,487,451)	\$ (376,000)

The income tax effect of temporary differences that give rise to future tax assets and liabilities is as follows:

	2010	2009
Future tax assets:		
Operating losses	\$ 1,871,000	\$ 1,074,000
Share issuing costs	369,000	301,000
Fixed assets	10,000	2,000
Other eligible capital expenditures	104,000	—
	2,354,000	1,377,000
Valuation allowance	(566,000)	(1,283,000)
	1,788,000	94,000
Future tax liabilities:		
Deferred exploration expenditures	(1,788,000)	(94,000)
Net future tax liabilities	\$ —	\$ —

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## 13. Income taxes (continued):

As at December 31, 2010, the Company has tax losses of approximately \$6,234,000 at the federal and provincial levels and approximately \$583,000 of tax losses for foreign jurisdiction available to apply against future taxable income as follows:

Expiry date	USA	Canada
2027	\$ 14,000	\$ -
2028	296,000	1,469,000
2029	88,000	2,039,000
2030	185,000	2,726,000
	<hr/>	<hr/>
	\$ 583,000	\$ 6,234,000

The Company also has Canadian exploration expenditures and other costs of approximately \$11,307,000 which may be deducted from future income, with no defined period.

The future tax benefit resulting from these items which will serve to decrease future taxable revenues was not recorded.

## 14. Related party transactions:

During the year, the Company paid its share of the cost of the lease and other office costs to a company controlled by a director of the Company in the amount of \$111,687 (2009 - \$102,848). These transactions were recorded at the exchange amount.

## 15. Financial instruments:

Exposure and risk management:

The Company is exposed to various financial risks resulting from both its operations and its investment activities. The Company's management monitors financial risks. The Company does not enter into financial instrument agreements including derivative financial instruments for speculative purposes.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## 15. Financial instruments (continued):

Exposure and risk management (continued):

The Company's main financial risk exposure and its financial risk management policies are as follows:

### (a) Credit risk:

Credit risk results from the possibility that a loss may occur from the failure of another party to perform according to the terms of the contract. Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, restricted cash and funds reserved for exploration, partners' contribution receivable, balance receivable on sale of properties and long-term deposits which consist of advance payments made to contractors and partners. Cash is maintained with high-credit, quality financial institutions. Cash equivalents consist of money market funds and guaranteed investment certificates.

The Company grants credit to its debtors in the normal course of business. The credit risk of the Company is also attributable to the following debtors:

- Receivables from partners in the amount of \$336,739, of which \$88,314 has been outstanding for more than 90 days.
- Receivable from a company controlled by an officer of Gastem Inc., in the amount of \$296,950, which has been outstanding for more than 90 days.
- Receivable from an officer of the Company, in the amount of \$123,776, with no stated due date.
- Receivable from a mining company in the amount of \$33,118 which has been outstanding for more than 90 days.

The Company extends credit in its normal course of operations. The Company regularly monitors its receivables, ensures a follow-up on outstanding amounts and evaluates the need for a provision on these receivables. A provision is based on the best estimates made by the Company as to the eventual collection of these doubtful accounts. As at December 31, 2010, no such provision has been accounted for (2009 - nil).

### (b) Interest rate risk:

The certified investment certificates bear interest at a fixed rate and the Company is, therefore, not exposed to the risk of changes in fair value resulting from interest rate fluctuations. The money market funds bear interest at a variable rate and therefore expose the Company to the risk of changes in fair value arising from interest rate fluctuations. The Company's other financial assets and liabilities limit the Company's interest rate risk since they expire on a short-term basis.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## 15. Financial instruments (continued):

Exposure and risk management (continued):

(c) Liquidity risk:

Management strives to maintain a sufficient amount of cash and cash equivalents, and to ensure that the Company has at its disposal sufficient sources of financing such as private placements. The Company establishes cash budgets to ensure it has the necessary funds to meet its obligations as they come due. Being able to obtain new funds allows the Company to pursue its activities and even though the Company was successful in the past, there is no guarantee that it will succeed in the future.

The accounts payable and accrued liabilities have stated repayment terms of less than six months.

(d) Foreign exchange risk:

The Company incurs exploration costs in US dollars and is consequently exposed to foreign exchange risk as follows:

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	2010	2009
	US\$	US\$
(Bank indebtedness) cash	(36,616)	49,395
Accounts receivable	269,701	-
Trade accounts payable and accrued liabilities	(58,942)	(299,590)

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As at December 31, 2010, if the exchange rate (\$CA/\$US) has increased or decreased by 5%, the impact on the net results would not have been significant.

Fair value:

The fair value of the accounts receivable, accounts payable and accrued liabilities approximates their carrying value due to their short-term nature.

The fair value of the deposits on long-term assets approximates its carrying value, given that there has been no significant variations in the risk-free interest rates and in the economic situation of the Company since these deposits were made.

The level of significance of the inputs used by the Company in valuing its money market funds and its guaranteed investment certificates is Level 2.

# GASTEM INC.

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## 16. Capital disclosures:

The Company's objectives when managing its capital are to safeguard the Company's ability to continue as a going concern in order to support ongoing exploration programs and the development of its gas assets, to provide sufficient working capital to meet its ongoing obligations and to pursue potential investments.

In the management of capital, the Company includes the components of shareholders' equity.

The Company manages its capital structure and makes adjustments to it in accordance with the aforementioned objectives, as well as in light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust its capital structure, the Company may issue new shares, or acquire or sell gas properties to improve its flexibility and financial performance. The Company does not use long-term debts since it does not generate operating revenues. There is no dividend policy. The Company is not subject to externally imposed capital requirements.

The Company's management of capital remained unchanged since the last period.

## 17. Commitments and contingencies:

Under the terms of exploration permits granted by the ministère des Ressources naturelles, the Company is committed to pay annuity of \$26,869 until 2013. In addition, the Company is required to perform yearly, on the land covered by its permits, work for which the minimum expenditure varies according to the age of the permit; for the first year, such work must be no less than the greater of \$0.50 per hectare or \$3,000, \$1.00 or \$6,000 for the second year, \$1.50 or \$9,000 for the third year, \$2.00 or \$12,000 for the fourth year and \$2.50 or \$15,000 for the fifth year of the permit. For subsequent renewal years, minimum costs are the greater of \$2.50 per hectare or \$20,000.

	Annuities	Expenditures	Total
2011	\$ 17,852	\$ 1,027,704	\$ 1,075,161
2012	5,537	363,910	381,762
2013	3,480	15,000	18,480
	\$ 26,869	\$ 1,406,614	\$ 1,433,483

# **GASTEM INC.**

Notes to Consolidated Financial Statements, Continued

Years ended December 31, 2010 and 2009

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## **17. Commitments and contingencies (continued):**

Environment:

The Company's operations are subject to governmental laws and regulations regarding environmental protection. Environmental consequences, their impact and their duration are difficult to determine. Management endeavours to carry out its activities in compliance with all applicable laws and regulations and ensures to follow instructions and recommendations of competent authorities when potential issues are encountered.

As at December 31, 2010, a provision for site restoration is not considered necessary.

## **18. Subsequent event:**

In March 2011, following an issue of public opinion relative to a gas leak, it is possible that one of the wells of the St-Hyacinthe property (vertical well) will be abandoned by the operator.

## **19. Comparative figures:**

Certain of the 2009 comparative figures have been reclassified to conform with the financial statement presentation adopted for the current year.