

**FALCON OIL & GAS AUSTRALIA  
LIMITED**

ABN 53 132 857 008

**31 DECEMBER 2010  
FINANCIAL REPORT**

All amounts are in USD unless otherwise stated

# FALCON OIL & GAS AUSTRALIA LIMITED

## Operating and Financial Review

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### *Acquisition of Beetaloo Permits*

On 30 September 2008, Falcon Oil & Gas Ltd (“Falcon”) and Falcon Oil & Gas Australia Limited (the “Company” or “Falcon Australia”) consummated the acquisition of an undivided 50% working interest in an aggregate 7,000,000 acres in four exploration permits (the “Permits”) in the Beetaloo Basin, Northern Territory (the “Beetaloo Basin Project”) pursuant to the terms of a Purchase and Sale Agreement, as amended on October 31, 2008, (the “Beetaloo PSA”) with PetroHunter Energy Corporation, PetroHunter Operating Company and Sweetpea Petroleum Pty Ltd. (“Sweetpea”) (collectively, “PetroHunter”), each of which is a non-arm’s length party.

On 11 June 2009, pursuant to a second Purchase and Sale Agreement (the “Second PSA”) with PetroHunter, the Company completed the acquisition of an additional undivided 25% working interest in the Beetaloo Basin Project. Under the terms of the Second PSA, the principal consideration being paid by the Company for this transaction was the exchange of a \$5,000,000 note receivable from PetroHunter. In addition, the Company agreed to pay certain vendors who had provided goods or services for the Beetaloo Basin Project, prior to the Company acquiring its 50% interest in September 2008, in exchange for inventory and operator bonds of approximately the same value, and Falcon has relinquished its right to the unexpended testing and completion funds of another project in which it is involved with the PetroHunter group. Upon closing, the Company became operator of the Beetaloo Basin Project.

On 7 December 2009, Falcon and Falcon Australia entered into a Binding Heads of Agreement (the “Agreement”) with PetroHunter and Sweetpea wherein Falcon Australia will issue to Sweetpea common shares of Falcon Australia in consideration for the transfer of Sweetpea’s undivided 25% working interest in the Permits. Under the terms of the Agreement, Falcon has been issued 150 million shares of Falcon Australia for conversion of a portion (\$30,000,000) of Falcon Australia’s debt payable to Falcon, which approximates Falcon’s initial acquisition cost previously paid to Sweetpea for the 75% working interest in the Permits held by Falcon Australia as of the date of the Agreement; and Falcon Australia issued 50 million shares of its common stock to Sweetpea (valued at \$10,000,000) and settled a joint interest billing receivable from Sweetpea of \$1,725,000 for Sweetpea’s remaining 25% working interest in the Permits. On 23 April 2010, Falcon Australia received notice (the “Notice”) from the Department of Resources, Northern Territory Government, that the registration of the transfer of the remaining 25% interest in the Permits was completed, and Falcon Australia now owns 100% of the Permits.

The Permits are subject to a government royalty of 10% and non-government royalties of 13%-14%.

### *Operational Highlights*

In February 2010, the Company commenced well site construction and service tendering exercises for the 2010 work program, with the intentions of commencing drilling and completion activities in July/August 2010. Abnormal rains and flooding throughout the Northern Territory, Queensland and New South Wales had significant impact and caused the service companies to re-evaluate their ability to honor their commitment to perform the required contracted services and provide the equipment required for the 2010 drilling and completion activities. Based on this, the Company requested, and received in June 2010, notice from the Northern Territory Government, Department of Resources, that its 2010 work commitment obligation for EP 98 has been extended to 31 December 2011.

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Activity has been limited to geological and geophysical analysis, engineering and analytical evaluations. The Company has submitted applications of approval to the Aboriginal Area Protection Agency and the Northern Land Council for indigenous cultural clearances of future well sites which includes heritage and environmental work that will allow the Company to enter the lands and perform work as required.

### *Future Operations*

The Company's revised minimum work program obligations to retain all of the underlying Permits in the Beetaloo Basin will be to expend A\$6,400,000 and A\$8,700,000 during the years ending December 31, 2011 and 2012, respectively.

<b>Permit</b>	<b>Permit Year Start</b>	<b>Permit Year End</b>	<b>Minimum Work Requirement</b>	<b>Estimated Expenditure</b>
<b>EP 76</b>	January 2011	December 2012	Drill 1 well, complete if warranted	A\$3,700,000
<b>EP 98</b>	January 2010	December 2011	Complete & test well Geological studies	A\$6,200,000
<b>EP 99</b>	January 2010	December 2011	G&G studies Geophysical re-evaluation	A\$100,000
	January 2012	December 2012	Drill two wells	A\$3,700,000
<b>EP 117</b>	January 2010	December 2011	Basin modelling re-evaluation	A\$100,000
	January 2012	December 2012	G&G studies Reservoir assessment Drill & complete 1 well	A\$1,300,000

# FALCON OIL & GAS AUSTRALIA LIMITED

## Directors' Report

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The Directors have pleasure in submitting their report together with the financial report of the Company and the auditor's report thereon for the year ended 31 December 2010

All amounts referred to in this report and the accompanying Financial Statements are in US dollars, unless stated otherwise.

### Directors

The names of directors of the Company holding office at any time during or since the end of the financial period are:

Robert C Macaulay	Chairman appointed 31 July 2010
Evan Wasoff	Director since 21 August 2008
Martin Oring	Director appointed 31 July 2010
Kym P Livesley	Director appointed 31 July 2010
John W Carroll	Director appointed 31 July 2010
John Craven	Director appointed 10 December 2010
Marc Bruner	Resigned 10 November 2010
Carmen J Lotito	Resigned 31 July 2010
John L. Blue	Resigned 14 May 2010

### ***Robert Macaulay, PEng- Non-Executive Director, Chairman***

Mr. Macaulay has 26 years' industry experience in petroleum engineering, field development planning and business development and currently provides consulting services in these areas. He is a director of PetroGlobe Inc. (TSX – PGB), serving on the compensation committee and as chairman of the reserves committee. He held the post of V.P. Engineering and Production at Centurion Energy International Inc., a Canadian company active in Egypt which was sold at over 30,000 boepd in 2007. His past experience includes positions of increasing responsibility at Vermilion Resources (petroleum engineering for France properties and business development in Europe), Shell (reservoir engineering in Canada and the Sultanate of Oman) and PanCanadian Petroleum Ltd.

He holds a BSc (Hons) in Chemical Engineering from Queen's University, Ontario and MBA degrees from Queen's and from Cornell University, New York (with distinction). He is a member of APEGGA and SPE.

### ***Evan Wasoff - Non-Executive Director***

Mr. Wasoff has been Chief Financial Officer of Falcon Oil & Gas Ltd. since 1 April 2005. Mr. Wasoff has over 30 years of experience as a Certified Public Accountant. In 1985, he founded Wheeler Wasoff, P.C., a Denver, Colorado CPA firm specializing in companies filing with the U.S. Securities and Exchange Commission between 1985 and 2005. Mr. Wasoff has been a consultant to Chartered Accounting firms in Calgary, Alberta, and Vancouver, British Columbia in securities matters and financial reporting issues in Canada and the United States. Prior to forming Wheeler Wasoff, P.C., he was a member of the audit staffs of Pannell, Kerr, Forster & Co. and Price Waterhouse. Mr. Wasoff holds an MBA in Finance from the University of Colorado and a BS in Accounting from the State University of New York at Albany. He is a licensed CPA in Colorado and a member of the American Institute of Certified Public Accountants and the Colorado Society of Certified Public Accountants.

### ***Martin B Oring, Non-Executive Director***

Mr. Oring has been the Chairman of the Board of Directors of PetroHunter Energy Corporation since April 2009, its President and Chief Executive Officer since May 2009. Mr. Oring is an executive in the financial services and energy industries. Prior to forming his current business in 2001, Wealth Preservation, LLC, he had extensive experience as a member of management in several companies, including Prudential Securities (Managing Director of Executive Services), Chase Manhattan Corporation (Manager of Capital Planning), and Mobil Corporation

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## Directors' Report

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(Manager, Capital Markets & Investment Banking). He has served as a director of Parallel Petroleum Corporation, located in Midland, Texas, and currently serves as Chairman, CEO and President of Searchlight Minerals Corp., located in Henderson, Nevada. Mr. Oring received a B.S. degree in mechanical engineering from the Carnegie Institute of Technology in 1966 and an M.B.A. degree in production management, finance and marketing from Columbia University in 1968.

### ***Kym Pelham Livesley- Non-Executive Director***

Kym Livesley is a corporate lawyer with 32 years experience. Kym has substantial expertise in mergers and acquisitions, capital markets, takeovers and general corporate and commercial advice. Kym maintains an industry focus in the energy and resources sectors, for listed and private corporates in the Asia-Pacific region.

Kym also has experience in capital raising, IPOs, directors' duties, dual listings (AIM, TSX) and corporate governance.

Kym has a Bachelor of Laws from the University of Adelaide. Among other affiliations, Kym is a former National President of the Australian Mining and Petroleum Law Association (AMPLA), member of the Minerals Council NSW and is a fellow of the Australian Institute of Company Directors (AICD).

### ***John Carroll - Non-Executive Director***

Mr Carroll is a private consultant specialising in government relations and major project facilitation and has more than 40 years experience in a wide cross-section of public sector positions in Canberra, Queensland and the Northern Territory. Mr Carroll was Chief Executive Officer of the NT Department of Industries and Business from March 2000 until November 2001. Following that he was General Manager, Business and Trade Development, and Deputy Chief Executive and General Manager, Minerals and Energy, NT Department of Business Industries and Resource Development. In May 2005 he was appointed Chief Executive, NT Department of Primary Industry, Fisheries and Mines.

Prior to his time in the Northern Territory, Mr Carroll was Deputy Director-General, Business, Innovation and Trade in Queensland's Department of State Development. From 1996 he worked in that State's Department of Economic Development and Trade where he was Director-General until July 1998.

His earlier public sector appointments include managing the Business Regulation Review Unit in Queensland, Administration Manager, Australian National Gallery and a number of years at the Commonwealth Public Service Board, Canberra. Mr Carroll was President of the NT Branch of the Institute of Public Administration from 2001 to 2004 and in 2006/7. In November 2004 the National Council made him a Fellow of the Institute.

### ***John Craven - Non-Executive Director***

Mr Craven is the Chief Executive Officer and a director of Cove Energy plc. He is a petroleum geologist with over 35 years experience in senior technical and commercial roles in upstream oil and gas exploration and production companies. Prior to joining Cove he was the founder and Chief Executive of AIM and IEX quoted African and Mediterranean focussed exploration company Petroceltic International plc. Petroceltic grew under his stewardship to a business with a diversified portfolio of exploration and appraisal projects in Italy, Algeria and Tunisia.

Mr Craven has an MSC in Petroleum Geology from the Royal School of Mines in London and an MBA from Queens University Belfast.

# FALCON OIL & GAS AUSTRALIA LIMITED

## Directors' Report

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### Company Secretary

*Stephen Peterson – appointed 5 August 2008.*

Mr Peterson is currently Chief Financial Officer and Company Secretary. He provides financial and administrative services on a contract basis to a number of companies in the resources industry. He has over 25 years experience in senior financial roles and as company secretary with listed public companies primarily in the resources industry in Australia.

### Directors' meetings

The number of directors' meetings held, including meetings held by telephone, and the number of those meetings attended by each of the directors of the Company, while a director, during the financial period are as follows:

	Board meetings	
	Number of meetings held	Number of meetings attended
Robert C Macaulay	4	4
Evan Wasoff	4	4
Martin Oring	4	4
Kym P Livesley	4	4
John Carroll	4	4
Marc Bruner	2	2
Carmen J Lotito	-	-
John Craven	1	1
John L Blue	-	-

### Principal activities

The principal activity of the Company in the course of the period was exploration for oil and gas in the Beetaloo basin of the Northern Territory.

### Financial results

The net loss after income tax attributable to members of the Company for the year ended 31 December 2010 was \$3,135,000 (2009: loss of \$600,000).

### Dividends

There were no dividends paid or declared by the Company during the year ended 31 December 2010, (2009: nil).

### State of affairs

On 23 April 2010 the Company completed the acquisition of the final 25% interest in the Beetaloo licence area from Sweetpea Petroleum for the allotment of 50,000,000 ordinary fully paid shares in the Company and the assumption of certain liabilities of Sweetpea Petroleum related to its interest in the Beetaloo licence area.

On 23 April 2010 the Company allotted 149,999,999 fully paid ordinary shares to Falcon Oil & Gas Ltd in exchange for forgiveness of \$29,999,999 of the intercompany debt owed by the Company to Falcon Oil & Gas Ltd.

A further aggregate 280,000 fully paid ordinary shares were issued to a corporate advisor and vendor as consideration for services provided.

# FALCON OIL & GAS AUSTRALIA LIMITED

## Directors' Report

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A capital raising during the year resulted in the issue of 6,113,237 fully paid ordinary shares and 6,113,237 options to private investors raising \$6,113,237.

There were no other significant changes in the state of affairs of the Company that occurred during the year under review.

### **Operating and financial review**

The operating and financial review of the Company during the year is detailed on pages 1 to 2 of this report.

### **Environmental regulation**

The Company's operations are subject to Australian Commonwealth and Northern Territory environmental regulations and legislation. The Board believes the Company has adequate systems in place for the management of its environmental requirements and is not aware of any significant breach of those environmental requirements as they apply to the Company.

### **Events subsequent to balance date**

On 28 April 2011, Falcon Australia entered into an Evaluation and Participation Agreement (the "E&P Agreement") with Hess Australia (Beetaloo) Pty Ltd. ("Hess"). By the terms of the E&P Agreement, Hess will pay \$17.5 million to Falcon Australia as a participation fee for the exclusive right to conduct operations for the exploration, drilling, development and production of hydrocarbons from three of the four Permits, and excluding an area comprising 100,000 acres surrounding the Shenandoah-1 well (the "Area of Interest"). In addition, Hess will pay Falcon \$2.5 million as consideration for warrants to acquire 10,000,000 common shares in the capital of Falcon for a period of 42 months from the date of issuance at an exercise price of CDN\$0.19 per share.

Hess shall acquire seismic data, at its sole cost of at least \$40.0 million, over the Area of Interest within 18 months of the execution of the E&P Agreement. After acquiring the seismic data, Hess shall have the right to acquire a 62.5% working interest in the Area of Interest. If Hess acquires the working interest, they commit to drill and evaluate five exploration wells at their sole cost, one of which must be a horizontal well. All costs to plug and abandon the five exploration wells will also be borne solely by Hess. The drilling and evaluation of the five exploration wells must meet the minimum work requirements of a work program. Costs to drill wells after the five exploration wells will be borne 62.5% by Hess and 37.5% by Falcon Australia.

By 31 December 2011, Falcon Australia must test and complete the Shenandoah-1 well at their sole cost, in accordance with the Work Program. After testing and completion, Falcon Australia must provide Hess copies of the data obtained from such activities, and Hess must pay Falcon Australia \$2.0 million for the data.

The Company will pay a "success fee" to two advisors in the aggregate amount of 5% for services provided in conjunction with the E&P Agreement with Hess. The success fee is based on the cash or cash-equivalent value of any net amount received directly or indirectly by the Company, including the participation fee, cost of seismic data commitment and cost of drilling commitment.

The transaction as a whole is subject to receipt of all governmental and regulatory consents, including the TSX Venture Exchange.

### **Likely developments**

Further information as to likely developments in the operations of the Company and the expected results of those operations in subsequent years has not been included in this report because disclosure of this information would be likely to result in unreasonable prejudice to the Company.

### **Indemnification of officers and auditors**

During or since the end of the financial year, the Company has not indemnified or made a relevant agreement to indemnify an officer or auditor of the Company against a liability incurred by such an officer or auditor.

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## Directors' Report

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In addition, the Company has not paid or agreed to pay, a premium in respect of a contract insuring against a liability incurred by an officer or auditor.

### Shares

In December 2009 directors issued an Information Memorandum for the purpose of raising up to US\$50 million through the issue of 50 million ordinary fully paid shares at US\$1.00 per share, with one free attaching option in respect of each share exercisable at US\$1.25 per share at any time up to three years from the date of issuance.

The offer closed on 30 September 2010 having raised US\$6,113,237 through the issue of 6,113,237 ordinary shares and 6,113,237 options. A further 397,361 options were issued to the broker managing the share issue.

In addition a further 280,000 ordinary fully paid shares were issued as consideration under a contract with a corporate advisor and vendor for services provided.

### Options

During the year a total of 6,510,598 options to subscribe for ordinary shares at US\$1.25 per share were issued. A total of 5,213,877 options were issued with an expiry date of 4 June 2013. A total of 1,296,721 options were issued with an expiry date of 15 November 2013. The fair value of these options has been estimated at \$2,083,292 using the Black Scholes methodology.

### Lead Auditor's Independence Declaration under Section 307C of the Corporations Act 2001

The lead auditor's independence declaration is set out on page 8 and forms part of the directors' report for the year ended 31 December 2010.

Signed at Sydney this 6 day of May 2011 in accordance with a resolution of the Board of Directors:



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**Robert Macaulay**  
Director





**Lead Auditor's Independence Declaration under Section 307C of the Corporations Act 2001  
to the Directors of Falcon Oil & Gas Australia Limited**

To: the directors of Falcon Oil & Gas Australia Limited

I declare that, to the best of my knowledge and belief, in relation to the audit for the financial year ended 31 December 2010 there have been:

- (i) no contraventions of the auditor independence requirements as set out in the Corporations Act 2001 in relation to the audit; and
- (ii) no contraventions of any applicable code of professional conduct in relation to the audit.

KPMG

Stephen Board  
Partner

Brisbane  
6 May 2011

**FALCON OIL & GAS AUSTRALIA LIMITED**

Statement of Comprehensive Income for the  
year ended 31 December 2010

Notes	Year Ended 31 December 2010 US\$'000	21 August 2008 To 31 December 2009 US\$'000
<b>Revenue</b>		
Revenue	-	-
<b>Expenses</b>		
Accounting & Audit Fees	102	54
Consultants Fees	111	61
Directors Fees	30	16
Management Fees	-	232
Legal Expenses	153	88
Travel Expenses	897	334
Miscellaneous	58	6
Joint Venture Marketing	2,057	-
<b>Results from operating activities</b>	<b>(3,408)</b>	<b>(791)</b>
Financial income	1	-
Financial expenses		
- Foreign Currency Exchange Gains	272	191
<b>Net financing gains</b>	<b>273</b>	<b>191</b>
<b>Loss before tax</b>	<b>(3,135)</b>	<b>(600)</b>
Income tax	-	-
<b>Loss for the period</b>	<b>(3,135)</b>	<b>(600)</b>
<b>Other Comprehensive Income</b>	<b>-</b>	<b>-</b>
<b>Total Comprehensive Loss for the period</b>	<b>(3,135)</b>	<b>(600)</b>

**FALCON OIL & GAS AUSTRALIA LIMITED**

Statement of Financial Position  
as at 31 December 2010

		31 December 2010 US\$'000	31 December 2009 US\$'000
	Notes		
<b>Current assets</b>			
Cash and Cash Equivalents	4	5,421	144
Receivables	5	428	2,829
<b>Total current assets</b>		<b>5,849</b>	<b>2,973</b>
<b>Non-current assets</b>			
Property Plant & Equipment	6	1,666	1,666
Exploration and Evaluation Assets	7	50,592	37,648
Other	8	487	1,027
<b>Total non-current assets</b>		<b>52,745</b>	<b>40,341</b>
<b>Total assets</b>		<b>58,594</b>	<b>43,314</b>
<b>Current liabilities</b>			
Payables and Accruals	9	391	211
Related Party Loans	10	16,015	43,463
<b>Total current liabilities</b>		<b>16,406</b>	<b>43,674</b>
<b>Non-current liabilities</b>			
Other	11	281	240
<b>Total non-current liabilities</b>		<b>281</b>	<b>240</b>
<b>Total liabilities</b>		<b>16,687</b>	<b>43,914</b>
<b>Net Assets / (Liabilities)</b>		<b>41,907</b>	<b>(600)</b>
<b>Equity</b>			
Issued Capital	12	43,559	-
Option Reserve	12	2,083	-
Retained Losses	12	(3,735)	(600)
<b>Total equity / (deficiency)</b>		<b>41,907</b>	<b>(600)</b>

**FALCON OIL & GAS AUSTRALIA LIMITED**

Statement of Cash Flows  
for the year ended 31 December 2010

	Notes	Year Ended December 2010 US\$'000	21 August 2008 to 31 December 2009 US\$'000
<b>Cash flows from operating activities</b>			
Cash payments in the course of operations		(3,206)	(3,218)
Interest Received		1	-
Realise FX gains		272	-
<b>Net cash flows from operating activities</b>	13	<b>(2,933)</b>	<b>(3,218)</b>
<b>Cash flows from investing activities</b>			
Property, Plant & Equipment		-	(1,666)
Exploration & evaluation		(1,201)	(37,408)
Other non current assets		1,216	(1,027)
<b>Net cash flows from investing activities</b>		<b>15</b>	<b>(40,101)</b>
<b>Cash flows from financing activities</b>			
Proceeds from share issue		6,313	
Cost of issue of shares		(671)	
Proceeds from related party loans		2,553	43,463
<b>Net cash flows from financing activities</b>		<b>8,195</b>	<b>43,463</b>
Net increase in Cash and Cash Equivalents		5,277	144
Cash and Cash Equivalents at the beginning of the financial period		144	-
Effect of exchange rate fluctuations on Cash and Cash Equivalents		-	-
<b>Cash and Cash Equivalents at the end of the financial period</b>	4	<b>5,421</b>	<b>144</b>

**FALCON OIL & GAS AUSTRALIA LIMITED**

Statement of Changes in Equity  
for the year ended 31 December 2010

Notes	Issued Capital US\$'000	Options Reserve US\$'000	Retained Losses US\$'000	Total Equity US\$'000
<b>Balance 1 January 2010</b>	-	-	(600)	(600)
Loss for the year	-	-	(3,135)	(3,135)
Other comprehensive income	-	-	-	-
<b>Total comprehensive income</b>	-	-	(3,135)	(3,135)
Issue of share capital, net of share issue costs	43,559	-	-	43,559
Issue of options	-	2,083	-	2,083
<b>Balance as at 31 December 2010</b>	<b>43,559</b>	<b>2,083</b>	<b>(3,735)</b>	<b>41,907</b>

Notes	Issued Capital US\$'000	Options Reserve US\$'000	Retained Losses US\$'000	Total Equity US\$'000
<b>Balance 21 August 2008</b>	-	-	-	-
Loss for the year	-	-	(600)	(600)
Other comprehensive income	-	-	-	-
<b>Total comprehensive income</b>	-	-	(600)	(600)
Issue of share capital	-	-	-	-
Issue of options	-	-	-	-
<b>Balance as at 31 December 2009</b>	<b>-</b>	<b>-</b>	<b>(600)</b>	<b>(600)</b>

# FALCON OIL & GAS AUSTRALIA LIMITED

## Notes to the Financial Statements for the year ended 31 December 2010

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### NOTE 1 - REPORTING ENTITY

Falcon Oil & Gas Australia Limited (the 'Company' or 'Falcon Australia') is a company domiciled in Australia. The Company was incorporated on 21 August 2008.

### NOTE 2 - BASIS OF PREPARATION

#### (a) Statement of compliance

The special purpose financial report has been prepared in accordance with the requirements of the Corporations Act 2001 and the recognition and measurement aspects of all applicable Australian Accounting Standards ("AASBs") adopted by the Australian Accounting Standards Board ("AASB"). The directors have determined that the Company is not a reporting entity.

The financial report does not include the disclosure requirements of all AASBs except for the following minimum requirements:

- AASB 101 Presentation of Financial Statements
- AASB 107 Cash Flow Statements
- AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors
- AASB 1048 Interpretation and Application of Standards.

The financial report was authorised for issue by the directors on 6 May 2011.

#### (b) Basis of measurement

The financial statements have been prepared on the historical cost basis.

#### (c) Functional and presentation currency

These financial statements are presented in United States dollars, which is the Company's functional currency.

#### (d) Use of estimates and judgements

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

In particular, information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements are described in the following notes:

- Note 7 – Exploration and Evaluation Assets
- Note 11 – Asset Retirement Obligation

#### (e) Going Concern

The financial statements as of 31 December 2010 have been prepared on the basis that the Company is a going concern. That is, be able to pay its debts as and when they fall due.

The Company is reliant on its shareholders for ongoing financial assistance, in the form of the shareholder loans in order to operate as a going concern.

# FALCON OIL & GAS AUSTRALIA LIMITED

## Notes to the Financial Statements for the year ended 31 December 2010

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### NOTE 2 - BASIS OF PREPARATION (Continued)

In the near term, the Company's ability to continue as a going concern is dependent upon the continued financial support from Falcon Oil & Gas Ltd (the 73% shareholder and parent entity of the Company) as detailed in note 10 and its ability to access cash to finance its upcoming capital commitments. Additional capital may be sought from existing shareholders, the issuance of shares to other parties or the disposal of certain or parts of certain assets.

The financial statements of Falcon Oil & Gas Ltd for the year ended 31 December 2010 disclose that:

*"The Company's 2011 cash requirements for operations and spending required to maintain its Australian permits exceed available capital resources at December 31, 2010. As a result, the Company's ability to continue as a going concern is dependent upon its ability to raise additional capital.*

*The Company has been focused on securing equity financing and joint venture funding for its operations in the Beetaloo Basin located in the Northern Territory, Australia, and joint venture funding for its operations in the Makó Trough located in Hungary. As discussed in Note 15, on April 28, 2011, the Company entered into an Evaluation and Participation Agreement with Hess Australia (Beetaloo) Pty. Ltd. for the Beetaloo Basin project.*

*Additional capital may also be sought from existing shareholders and/or from the sale of additional common shares or other debt or equity instruments. As discussed in Note 15, on April 11, 2011 the Company completed a non-brokered private placement for aggregate proceeds of CDN\$13,058. There is no assurance that additional capital will be available to the Company on acceptable terms or at all.*

*In the longer term, the recoverability of the carrying value of the Company's long-lived assets is dependent upon the Company's ability to preserve its interest in the underlying petroleum and natural gas properties, the discovery of economically recoverable reserves, the achievement of profitable operations, and the ability of the Company to obtain financing to support its acquisition, exploration, development and production activities."*

Accordingly, there is an inherent uncertainty as to whether the parent entity will be able to continue to provide financial support to the Company.

Management is of the view that the Company will be able to access such funds in the near future. However, there is no assurance such additional capital will be available.

In the event that the Company does not obtain additional funding, it may not be able to continue its operations as a going concern and therefore may not be able to realise its assets and extinguish its liabilities in the ordinary course of operations and at the amounts stated in the financial report.

### NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all periods presented in financial report.

#### **Trade and other receivables**

Trade and other receivables are stated at their amortised cost less provision for doubtful debts.

#### **Cash and cash equivalents**

Cash and cash equivalents comprise cash balances and call deposits.

#### **Property Plant & Equipment**

Items of property, plant and equipment are stated at cost, less accumulated depreciation and accumulated impairment charges.

#### **Exploration and Evaluation Costs**

Exploration and evaluation expenditure, including the costs of acquiring licences, are capitalised as intangible exploration and evaluation assets on an area of interest basis, less any impairment losses. Costs incurred before the Company has obtained the legal rights to explore an area are recognised in the comprehensive income statement.

Exploration and evaluation assets are only recognised if the rights of the area of interest are current and either:

Notes to the Financial Statements  
for the year ended 31 December 2010

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**NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (Continued)**

- the expenditures are expected to be recouped through successful development and exploitation of the area of interest; or
- activities in the area of interest have not at the reporting date, reached a stage which permits a reasonable assessment of the existence or otherwise of economically recoverable reserves and active and significant operations in, or in relation to, the area of interest are continuing.

Exploration and evaluation assets are assessed for impairment if sufficient data exists to determine technical feasibility and commercial viability and facts and circumstances suggest that the carrying amount exceeds the recoverable amount. For the purposes of impairment testing, exploration and evaluation assets are allocated to cash-generating units to which the exploration activity relates. The cash generating unit shall not be larger than the area of interest.

Once the technical feasibility and commercial viability of the extraction of mineral resources in an area of interest are demonstrable, exploration and evaluation assets attributable to that area of interest are first tested for impairment and then reclassified to developing mine properties.

**Impairment**

The carrying amounts of the Company's assets, other than deferred tax assets, are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the statement of comprehensive income, unless an asset has previously been re-valued, in which case the impairment loss is recognised as a reversal to the extent of that previous revaluation with any excess recognised through profit or loss.

***Calculation of recoverable amount***

The recoverable amount of assets is the greater of their fair value less costs to sell and value in use. 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. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

***Reversals of impairment***

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 depreciation or amortisation, if no impairment loss had been recognised.

**Share capital**

***Transaction costs***

Transaction costs of an equity transaction are accounted for as a deduction from equity, net of any related income tax benefit.

***Dividends***

Dividends are recognised as a liability in the period in which they are declared.

**Interest bearing borrowings**

Interest bearing borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest bearing borrowings are stated at amortised cost with any difference between cost and redemption value being recognised in the statement of comprehensive income over the period of the borrowings on an effective interest basis.

**Trade and other payables**

Trade and other payables are stated at their amortised cost. Trade payables are non-interest bearing and are normally settled on 30-day terms.



# FALCON OIL & GAS AUSTRALIA LIMITED

## Notes to the Financial Statements for the year ended 31 December 2010

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### NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Revenue

Sales revenue is recognised in the statement of comprehensive income when the significant risks and rewards of ownership have been transferred to the buyer.

#### Expenses

##### *Net financing costs*

Net financing costs comprise interest payable on borrowings calculated using the effective interest method, and interest earned.

Interest revenue is recognised in the statement of comprehensive income as it accrues, using the effective interest method. Dividend income is recognised in the statement of comprehensive income on the date the entity's right to receive payments is established.

#### Income tax

Income tax on the statement of comprehensive income for the period comprises current and deferred tax. Income tax is recognised in the statement of comprehensive income except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

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

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Additional income taxes that arise from the distribution of dividends are recognised at the same time as the liability to pay the related dividend.

#### Goods and services tax

Revenue, expenses and assets are recognised net of the amount of goods and services tax (GST), except where the amount of GST incurred is not recoverable from the taxation authority. In these circumstances, the GST is recognised as part of the cost of acquisition of the asset or as part of the expense.

Receivables and payables are stated with the amount of GST included. The net amount of GST recoverable from, or payable to, the ATO is included as a current asset or liability in the balance sheet.

Cash flows are included in the statement of cash flows on a gross basis. The GST components of cash flows arising from investing and financing activities which are recoverable from, or payable to, the ATO are classified as operating cash flows.

# FALCON OIL & GAS AUSTRALIA LIMITED

## Notes to the Financial Statements for the year ended 31 December 2010

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### NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### **Determination of fair values**

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. Where applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

#### ***Trade and other receivables***

The fair value of trade and other receivables is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date.

#### ***Non-derivative financial liabilities***

Fair value, which is determined for disclosure purposes, is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of interest at the reporting date.

#### **New standards and interpretations not yet adopted**

New Australian Accounting Standards that have been issued, but are not yet effective, are not expected to have a material impact on the Company.

**FALCON OIL & GAS AUSTRALIA LIMITED**

Notes to the Financial Statements  
for the year ended 31 December 2010

Notes	Year Ended 31 December 2010 US\$'000	21 August 2008 to 31 December 2009 US\$'000
<b>NOTE 4 – CASH &amp; CASH EQUIVALENTS</b>		
Cash at bank	5,421	144
<b>NOTE 5 – RECEIVABLES</b>		
<b>Current</b>		
Accounts receivables	254	2,148
Prepayments	12	212
Other Receivables	162	469
	<u>428</u>	<u>2,829</u>
<b>NOTE 6 – PROPERTY PLANT &amp; EQUIPMENT</b>		
<b>Cost</b>		
Opening balance	1,666	-
Additions in the period	-	1,666
Balance as at 31 December 2010	<u>1,666</u>	<u>1,666</u>
<b>Depreciation</b>		
Opening balance	-	-
Depreciation	-	-
Balance as at 31 December 2010	<u>-</u>	<u>-</u>
<b>Net Book Value at 31 December 2010</b>	<u>1,666</u>	<u>1,666</u>
<b>NOTE 7 – EXPLORATION &amp; EVALUATION ASSETS</b>		
<b>Cost</b>		
Opening balance	37,648	-
Acquisition of interests in exploration licences	11,718	31,628
Expenditure in the period	1,226	6,020
Balance as at 31 December 2010	<u>50,592</u>	<u>37,648</u>
<b>Depletion &amp; Impairment</b>		
Opening balance	-	-
Depletion & Impairment	-	-
Balance as at 31 December 2010	<u>-</u>	<u>-</u>
<b>Net Book Value at 31 December 2010</b>	<u>50,592</u>	<u>37,648</u>

# FALCON OIL & GAS AUSTRALIA LIMITED

## Notes to the Financial Statements for the year ended 31 December 2010

### NOTE 7 – EXPLORATION & EVALUATION ASSETS (continued)

On 7 December 2009, the Company entered into a Binding Heads of Agreement with PetroHunter and Sweetpea wherein the Company agreed to issue Sweetpea ordinary shares in Falcon Australia in consideration for the transfer of Sweetpea's remaining 25% working interest in the Permits. This transaction was completed on 30 June 2010.

Directors do not believe there has been any impairment in the carrying value of the Beetaloo Permits as at 31 December 2010. The ultimate recoupment of these costs is dependent on the successful development and commercial exploitation, or alternatively sale of the respective areas of interest.

<b>Year Ended</b>	21 August 2008 to
<b>31 December 2010</b>	31 December 2009
<b>US\$'000</b>	US\$'000

### NOTE 8 – OTHER NON CURRENT ASSETS

Deferred asset acquisition costs	-	407
Deferred share issue costs	-	138
Security deposits	<b>487</b>	482
	<b>487</b>	1,027

### NOTE 9 – PAYABLES & ACCRUALS

Trade payables	<b>327</b>	210
Accruals	<b>64</b>	1
	<b>391</b>	211

### NOTE 10 – RELATED PARTY LOANS

#### Current

Mako Energy Corporation	<b>487</b>	487
Falcon Oil & Gas Limited	<b>15,528</b>	42,976
	<b>16,015</b>	43,463

The Company's acquisition and exploration expenditure has been primarily funded by way of loans from its holding company, Falcon Oil & Gas Ltd. These loans have been advanced on an interest free basis, repayable on demand, subject to the financial support of Falcon Oil & Gas Ltd noted below.

The Company is dependent upon the financial support of Falcon Oil & Gas Ltd to support the ongoing operations of the Company. The financial support referred to is for a period of 12 months from the date of these financial statements, has been confirmed in writing by Falcon Oil & Gas Ltd, and includes:

- Obligations and commitments as may be required from time to time to enable the Company to finance its ongoing operating, financing and investing activities and to enable it to meet all of its debts and liabilities in the normal course of business as and when they fall due;
- An indemnity to cover any and all losses incurred by the Company;
- Make available to the Company when required sufficient funds to allow the repayment of loans raised by the Company.

# FALCON OIL & GAS AUSTRALIA LIMITED

## Notes to the Financial Statements for the year ended 31 December 2010

	Year Ended 31 December 2010 US\$'000	21 August 2008 to 31 December 2009 US\$'000
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### NOTE 11 – OTHER LIABILITIES

Asset retirement obligation	281	240
	281	240

The Company makes provision for the rehabilitation of drill sites on a discounted basis. The rehabilitation provision represents the present value of estimated rehabilitation expenditure which would be required to rehabilitate the site at the conclusion of current exploration activities.

### NOTE 12 – CAPITAL & RESERVES

	31 December 2010 Number	31 December 2009 Number
<b>Share capital</b>		
Opening balance	1	-
Issued during the year	206,363,236	1
Ordinary shares on issue – fully paid	206,363,237	1
<b>Options</b>		
Opening balance	-	-
Issued during the year - expiry 4 June 2013	5,213,877	-
Issued during the year - expiry 15 November 2013	1,296,721	-
Options on issue	6,510,598	-

Options holders are entitled to receive 1 fully paid ordinary share for each option exercised by payment of \$1.25 per option at any time up to the expiry date.

Holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at shareholders' meetings. The Company does not have authorised capital or par value in respect of its issued shares.

In the event of winding up of the Company, ordinary shareholders rank after creditors and are fully entitled to any proceeds of liquidation.

### Dividends

There were no dividends paid or declared by the Company during the period ended 31 December 2010.

	Note	Share capital US\$'000	Options Reserve US\$'000	Retained losses US\$'000	Total equity US\$'000
<b>Balance at 1 January 2010</b>		-	-	(600)	(600)
<b>Shares issued</b>		44,357	-	-	44,357
<b>Costs of issue of shares</b>		(798)	-	-	(798)
<b>Issuance of options</b>		-	2,083	-	2,083
<b>Total recognised income and expense</b>		-	-	(3,135)	(3,135)
<b>Balance at 31 December 2010</b>		43,559	2,083	(3,735)	41,907

# FALCON OIL & GAS AUSTRALIA LIMITED

## Notes to the Financial Statements for the year ended 31 December 2010

### NOTE 12 – CAPITAL & RESERVES - Continued

	Note	Share capital US\$'000	Reserves US\$'000	Retained losses US\$'000	Total equity US\$'000
Balance at 21 August 2008		-	-	-	-
Total recognised income and expense		-	-	(600)	(600)
Balance at 31 December 2009		-	-	(600)	(600)

Notes	Year Ended 31 December 2010 US\$	21 August to 31 December 2009 US\$
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### NOTE 13 – STATEMENT OF CASH FLOWS

#### Reconciliation of loss for the period to net cash from operating activities

Loss for the period	(3,135)	(600)
Non cash costs	23	
Decr/(incr) in receivables	179	(2,829)
Incr/(decr) in payables	-	211
<b>Net cash from operating activities</b>	<b>(2,933)</b>	<b>(3,218)</b>

### NOTE 14 – CAPITAL COMMITMENTS

Under a work program approved by the Northern Territory Government, Department of Resources, on 31 March 2010, and subsequently amended on 25 June 2010 and 4 January 2011, the Company is obligated to complete the following minimum work requirements in order to retain the exploration permits in the Beetaloo Basin:

Permit	Permit Year Start	Permit Year End	Minimum Work Requirement	Estimated Expenditure
EP 76	January 2011	December 2012	Drill 1 well, complete if warranted	A\$3,700,000
EP 98	January 2010	December 2011	Complete & test well Geological studies	A\$6,200,000
EP 99	January 2010	December 2011	G&G studies Geophysical re-evaluation	A\$100,000
EP 117	January 2012	December 2012	Drill two wells	A\$3,700,000
	January 2010	December 2011	Basin modelling re-evaluation	A\$100,000
	January 2012	December 2012	G&G studies Reservoir assessment Drill & complete 1 well	A\$1,300,000

# FALCON OIL & GAS AUSTRALIA LIMITED

## Notes to the Financial Statements for the year ended 31 December 2010

Notes	Year Ended 31 December 2010 US\$	21 August to 31 December 2009 US\$
<b>NOTE 15 – AUDITOR REMUNERATION</b>		
Audit of financial report	<b>25,000</b>	23,155

The above fees were paid to KPMG during the year ended 31 December 2010 (2009: Ernst & Young).

### NOTE 16 – SUBSEQUENT EVENTS

On 28 April 2011, Falcon Australia entered into an Evaluation and Participation Agreement (the “E&P Agreement”) with Hess Australia (Beetaloo) Pty Ltd. (“Hess”). By the terms of the E&P Agreement, Hess will pay \$17.5 million to Falcon Australia as a participation fee for the exclusive right to conduct operations for the exploration, drilling, development and production of hydrocarbons from three of the four Permits, and excluding an area comprising 100,000 acres surrounding the Shenandoah-1 well (the “Area of Interest”). In addition, Hess will pay Falcon \$2.5 million as consideration for warrants to acquire 10,000,000 common shares in the capital of Falcon for a period of 42 months from the date of issuance at an exercise price of CDN\$0.19 per share.

Hess shall acquire seismic data, at its sole cost of at least \$40.0 million, over the Area of Interest within 18 months of the execution of the E&P Agreement. After acquiring the seismic data, Hess shall have the right to acquire a 62.5% working interest in the Area of Interest. If Hess acquires the working interest, they commit to drill and evaluate five exploration wells at their sole cost, one of which must be a horizontal well. All costs to plug and abandon the five exploration wells will also be borne solely by Hess. The drilling and evaluation of the five exploration wells must meet the minimum work requirements of a work program. Costs to drill wells after the five exploration wells will be borne 62.5% by Hess and 37.5% by Falcon Australia.

By 31 December 2011, Falcon Australia must test and complete the Shenandoah-1 well at their sole cost, in accordance with the Work Program. After testing and completion, Falcon Australia must provide Hess copies of the data obtained from such activities, and Hess must pay Falcon Australia \$2.0 million for the data.

The Company will pay a “success fee” to two advisors in the aggregate amount of 5% for services provided in conjunction with the E&P Agreement with Hess. The success fee is based on the cash or cash-equivalent value of any net amount received directly or indirectly by the Company, including the participation fee, cost of seismic data commitment and cost of drilling commitment.

The transaction as a whole is subject to receipt of all governmental and regulatory consents, including the TSX Venture Exchange.

# FALCON OIL & GAS AUSTRALIA LIMITED

## Directors' Declaration

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- 1 In the opinion of the directors of Falcon Oil & Gas Australia Limited:
- (a) the Company is not a reporting entity;
  - (b) the financial statements and notes, set out on pages 9 to 22, are in accordance with the Corporations Act 2001, including:
    - (i) giving a true and fair view of the financial position of the Company as at 31 December 2010 and of its performance, as represented by the results of its operations and its cash flows, for the financial year ended on that date in accordance with the statement of compliance and basis of preparation described in Notes 2 and 3; and
    - (ii) complying with Australian Accounting Standards and other mandatory professional reporting requirements to the extent described in Notes 2 and 3 and the Corporations Regulations 2001; and
  - (c) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable

Signed at Sydney this 6th day of May 2011 in accordance with a resolution of the Board of Directors:



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**Robert Macaulay**  
**Director**





## **Independent Audit Report to the members of Falcon Oil & Gas Australia Limited**

### **Report on the financial report**

We have audited the accompanying financial report, being a special purpose financial report, of Falcon Oil & Gas Australia Limited (the company), which comprises the statement of financial position as at 31 December 2010, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year ended on that date, notes 1 to 16 comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration.

### **Directors' responsibility for the financial report**

The directors of the company are responsible for the preparation of the financial report and have determined that the basis of preparation described in Notes 2 and 3 to the financial report is appropriate to meet the requirements of the Corporations Act 2001 and is appropriate to meet the needs of the members. The directors' responsibility also includes such internal control as the directors determine necessary to enable the preparation of a financial report that is free from material misstatement, whether due to fraud or error.

### **Auditor's responsibility**

Our responsibility is to express an opinion on the financial report based on our audit. We conducted our audit in accordance with Australian Auditing Standards. These Auditing Standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether the financial report is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial report, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the financial report that gives a true and fair view 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 the directors, as well as evaluating the overall presentation of the financial report.

These procedures have been undertaken to form an opinion whether, in all material respects, the financial report is presented fairly in accordance with the basis of accounting described in Notes 2 and 3 to the financial statements so as to present a true and fair view which is consistent with our understanding of the company's financial position, and of its performance.

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

### **Independence**

In conducting our audit, we have complied with the independence requirements of the *Corporations Act 2001*.



### **Auditor's opinion**

In our opinion the financial report of Falcon Oil & Gas Australia Limited is in accordance with the *Corporations Act 2001*, including:

- (a) giving a true and fair view of the company's financial position as at 31 December 2010 and of its performance for the year ended on that date in accordance with the accounting policies described in Notes 2 and 3; and
- (b) complying with Australian Accounting Standards to the extent described in Notes 2 and 3 and the Corporations Regulations 2001.

### **Material uncertainty regarding continuation as a going concern**

Without qualifying our opinion, we draw attention to Note 2(e) to the financial statements which indicates that the Company's ability to continue as a going concern is dependent upon the ongoing financial support of its parent entity, and that the ability of the parent entity to continue as a going concern is dependent upon it raising additional capital. This condition, along with other matters as set forth in Note 2(e), indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern and, therefore, whether the Company will realise its assets and settle its liabilities in the normal course of business and at the amounts stated in the financial report.

### **Basis of Accounting**

Without modifying our opinion, we draw attention to Note 2 to the financial report, which describes the basis of accounting. The financial report has been prepared for the purpose of fulfilling the directors' financial reporting responsibilities under the Corporations Act 2001. As a result, the financial report may not be suitable for another purpose.

KPMG

Stephen Board  
Partner

Brisbane  
6 May 2011