

Management's Report

The financial statements of Desmarais Energy Corporation were prepared by management in accordance with accounting principles generally accepted in Canada. The financial and operating information presented in this annual report is consistent with that shown in the financial statements.

Management acknowledges responsibility for the integrity of the financial information in this annual report. Timely release of financial information sometimes necessitates the use of estimates that are based on careful judgments made by management.

External auditors appointed by the shareholders have conducted an independent examination in order to express their opinion on the financial statements.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control.

“James G. Long” (signed)

James G. Long
President, Chief Executive Officer & Acting Chief Financial Officer
April 26, 2011



INDEPENDENT AUDITORS' REPORT

To the Shareholders of
Desmarais Energy Corporation

Report on the Financial Statements

We have audited the accompanying financial statements of Desmarais Energy Corporation, which comprises the balance sheets as at December 31, 2010 and 2009, and the statements of operations, comprehensive loss and deficit, and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these 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 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 financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Desmarais Energy Corporation as at December 31, 2010 and 2009, and its financial performance and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Emphasis of Matter

We draw attention to Note 1 to the financial statements which describes the uncertainty that may cast doubt about Desmarais Energy Corporation's ability to continue as a going concern. Our opinion has not been qualified in respect to this matter.

Calgary, Canada
April 26, 2011


Chartered Accountants, LLP

Desmarais

Energy Corporation

BALANCE SHEETS

	December 31, 2010	December 31, 2009
ASSETS		
Current		
Cash (note 3)	\$ 48,136	\$ 29,215
Accounts receivable	393,556	268,093
Deposits and prepaid expenses	11,747	19,851
	453,439	317,159
Reclamation deposits	47,271	15,460
Property and equipment (note 4)	3,852,764	3,856,986
	\$ 4,353,474	\$ 4,189,605
LIABILITIES		
Current		
Accounts payable and accrued liabilities	\$ 1,978,836	\$ 1,920,063
Due to related parties	200,775	115,783
Loan - related parties (note 5)	2,560,000	2,440,000
	4,739,611	4,475,846
Asset retirement obligations (note 6)	699,448	584,941
	5,439,059	5,060,787
SHAREHOLDERS' DEFICIENCY		
Common shares (note 7)	5,114,975	4,694,403
Warrants (note 7)	212,393	185,093
Contributed surplus (note 7)	716,716	583,699
Deficit	(7,129,669)	(6,334,377)
	(1,085,585)	(871,182)
	\$ 4,353,474	\$ 4,189,605

See accompanying notes to the financial statements.

Basis of presentation and going concern (note 1)

Commitments and contingencies (note 13)

Approved on behalf of the board of directors

"James G. Long"

James G. Long

"Douglas F. Robinson"

Douglas F. Robinson

Desmarais

Energy Corporation

STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT

	December 31, 2010	December 31, 2009
Revenue		
Petroleum and natural gas sales	\$ 484,756	\$ 412,254
Royalties	(66,423)	(455,096)
	418,333	(42,842)
Other income	61,432	5,088
Gain - debt settlements	388,502	-
	868,267	(37,754)
Expenses		
Production	412,377	443,096
General and administrative	518,064	536,999
Stock-based compensation (Note 7)	80,000	68,900
Interest	264,732	245,257
Depletion, depreciation and accretion	388,386	385,149
Writedown of capital assets (Note 4)	-	270,000
	1,663,559	1,949,401
Net and comprehensive loss	(795,292)	(1,987,155)
Deficit, beginning of period	(6,334,377)	(4,347,222)
Deficit, end of period	\$ (7,129,669)	\$ (6,334,377)
Basic and diluted loss per share	\$ (0.03)	\$ (0.12)

Weighted average number of common shares outstanding	23,360,750	16,862,133
- basic and diluted (note 9)		

See accompanying notes to the financial statements.

Desmarais

Energy Corporation

STATEMENTS OF CASH FLOW

	December 31, 2010	December 31, 2009
Cash (used in) provided by:		
Operating activities:		
Net and comprehensive loss	\$ (795,292)	\$ (1,987,155)
Items not involving cash:		
Depletion, depreciation and accretion	388,386	385,149
Writedown of capital assets	-	270,000
Stock-based compensation (Note 7)	80,000	68,900
Gain on debt settlements	(388,502)	-
Asset retirement expenditures (Note 6)	(18,771)	-
Net change in non-cash working capital (Note 12)	220,606	734,341
	(513,573)	(528,765)
Financing activities:		
Issue of common shares: private placement	300,000	150,000
Issue of common shares: warrant exercises	145,205	-
Due to related party	120,000	-
	565,205	150,000
Investing activities:		
Deposits	(31,811)	(105)
Additions to property and equipment	(262,945)	(121,770)
Dispositions of oil and gas properties	12,060	121,054
Net change in non-cash working capital (Note 12)	249,985	315,942
	(32,711)	315,121
Increase (decrease) in cash	18,921	(63,644)
Cash, beginning of period	29,215	92,859
Cash, end of period	\$ 48,136	\$ 29,215
Supplemental cash flow information:		
Interest paid	206,433	245,257
Income taxes paid	-	-

See accompanying notes to the financial statements.

1. BASIS OF PRESENTATION AND GOING CONCERN

Desmarais Energy Corporation (the “Company” or “Desmarais”) was incorporated under the Business Corporations Act (Alberta) on June 24, 1994. The Company is listed on the TSX Venture Exchange, under the symbol “DES”. The Company is engaged in the exploration, development, production and acquisition of oil and gas reserves in Western Canada.

These financial statements have been prepared on a going concern basis in accordance with Canadian generally accepted accounting principles (“GAAP”), which assumes the Company will realize its assets and discharge its liabilities and commitments in the normal course of business.

The application of the going concern concept is dependent upon the ability of the Company to generate profitable operations, receive continued support from related parties and raise additional capital to support its ongoing development and operating activities. For the year ended December 31, 2010, the Company had a loss after income taxes of \$795,292. At December 31, 2010, the Company had negative working capital of \$1,774,310 including short-term advances from, consulting fees and payroll due to related parties of \$200,775 but excluding cash of \$48,136 and the demand loan from a related party totaling \$2,560,000. As a result, there is substantial doubt about the Company’s ability to continue as a going concern.

The Company's continuance as a going concern is dependent upon its ability to obtain adequate financing and to reach profitable levels of operation. It is not possible to predict with certainty whether financing efforts will be successful or if the Company will attain profitable levels of operations.

Management has made the necessary estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses in the preparation of the financial statements. Actual results could differ from those estimates.

Certain comparative amounts have been reclassified to conform to current period presentation. The changes do not affect prior year earnings.

2. SIGNIFICANT ACCOUNTING POLICIES

Measurement Uncertainty

The timely preparation of the Financial Statements in conformity with Canadian Generally GAAP requires that Management make estimates and assumptions and use judgment regarding the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the Financial Statements and the reported amounts of revenues and expenses during the period. Such estimates primarily relate to unsettled transactions and events as of the date of the Financial Statements. Accordingly, actual results may differ from estimated amounts as future confirming events occur. Management believes that the estimates are reasonable.

The amounts recorded for depletion and depreciation of property, plant and equipment, the provision for asset retirement obligations and the amounts used for ceiling test calculations are based on estimates of reserves and future costs. The amounts disclosed relating to fair values of stock options issued are based on estimates of future volatility of the share price, expected lives of options, and certain other assumptions. The balance of accounts receivable at the balance sheet date is subject to uncertainty regarding the estimated allowance for doubtful accounts. The valuation allowance recorded against the Company's future tax assets is subject to uncertainty regarding the magnitude of non-capital losses available for carry forward and of the balance in various tax pools as the corporate tax returns have not been prepared as of the date of financial statement preparation. By their nature all these estimates are subject to measurement uncertainty and the impact on the financial statements of changes in such estimates in future periods could be material.

Financial Instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument to another entity. Upon initial recognition all financial instruments, including derivatives, are recognized on the balance sheet at fair value. Subsequent measurement is then based on the financial instruments being classified into one of the following categories: held-for-trading, held-to-maturity, loans and receivables, available-for-sale and other liabilities.

All financial assets and liabilities except those held-for-trading and available-for-sale are measured at amortized cost determined using the effective interest rate method. Held-for-trading financial assets are measured at fair value with changes in the fair value recognized in income. Available-for-sale financial assets are measured at fair value with changes in fair value recognized in other comprehensive income and reclassified to income when derecognized or impaired.

The Company has designated its financial instruments into the following categories applying the indicated measurement methods:

Financial instrument	Category
Cash	Held-for-trading
Accounts receivable and prepaid deposits	Loans and receivables
Accounts payable and accrued liabilities	Other liabilities
Due to related party	Other liabilities

The Company will assess at each reporting period whether any financial assets are impaired. An impairment loss, if any is recorded on the Statement of Operations, Comprehensive Loss and Deficit.

Desmarais is exposed to market risks resulting from fluctuations in commodity prices and interest rates. As such, the Company may in the future enter into certain financial derivative and physical delivery sales contracts in order to reduce its exposure to these risks. These instruments will not be used for trading or speculative purposes. The Company will not designate its financial derivative contracts as effective accounting hedges.

All derivative contracts will be designated as held-for-trading and will be recorded on the balance sheet at fair value, with changes in the fair value recognized in net income. The fair values of these derivative instruments are based on the estimated amounts that would have been received or paid to settle these instruments prior to maturity given future market prices and other relevant factors. Proceeds and costs realized from holding the derivative contracts are recognized in net income at the time each transaction under a contract is settled.

The Company measures and recognizes embedded derivatives separately from the host contracts when the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract, when it meets the definition of a derivative and when the entire contract is not measured at fair value. Embedded derivatives are recorded at fair value. There were no embedded derivatives during the year.

Desmarais immediately expenses all transaction costs incurred in relation to the acquisition of a financial asset or liability. The bank loan, if drawn, is presented net of deferred interest payments, with interest recognized in net income on an effective interest basis.

The Company has not entered into any physical delivery sales contracts. Should Desmarais enter into physical delivery sales contracts in the future, these settlements would be recognized in petroleum and natural gas sales at the time of the settlement and there would be no recognition of fair value on the balance sheet.

Cash

Cash is comprised of cash and short-term investments with initial maturity dates of three months or less.

Accounting for Oil and Gas Operations

Full cost accounting

The Company uses the full cost method of oil and gas accounting whereby all costs relating to the exploration for and development of petroleum and natural gas reserves are capitalized. Such costs include land acquisition, drilling of productive and non-productive wells, geological and geophysical, production facilities, carrying costs directly related to unproved properties and corporate expenses directly related to acquisition, exploration and development activities. Gains or losses on sales of properties are recognized only when crediting the proceeds to costs would result in a change of 20% or more in the depletion rate.

Depletion and depreciation

Depletion of exploration and development costs and depreciation of production equipment is provided using the unit-of-production method based upon estimated gross proved petroleum and natural gas reserves. For purposes of this calculation, petroleum and natural gas reserves are converted to a common unit of measurement on the basis of six thousand cubic feet of gas equating to one barrel of oil equivalent (BOE). The costs of significant undeveloped properties are excluded from costs subject to depletion. Unproved properties are evaluated for impairment on an annual basis.

Other capital assets are depreciated using the declining balance method based on the estimated service lives of the assets, which vary from three to five years.

Ceiling test

The net amount at which petroleum and natural gas properties are carried is limited to the fair value of those properties based on the net present value of the estimated future net revenues (the “ceiling test”). This is a two-stage process which is to be performed at least annually. The first stage is a recognition test which compares the undiscounted future cash flow from proved reserves plus the cost less impairment of unproved properties to the net book value of the petroleum and natural gas assets to determine if the assets are impaired. An impairment loss exists when the carrying amount of the petroleum and natural gas assets exceeds such undiscounted cash flows. The amount of impairment, if any, to be recorded is measured as the amount by which the carrying amount of assets capitalized exceeds the sum of: (i) the expected net present value of future net revenues from proved and probable reserves discounted at a risk-free interest rate and (ii) the costs (less any impairment) of unproved properties that have been subject to a separate test for impairment. Commodity prices used to determine future net revenues are based on the best information available to the Company and are consistent with quoted benchmark prices in the futures market (adjusted for quality differences). If the net carrying costs exceed the fair value, the impairment is recorded as additional depletion and depreciation.

Asset Retirement Obligations

The Company records a liability for the fair value of legal obligations associated with the retirement of long-lived tangible assets in the period in which they are incurred, normally when the asset is purchased or developed. On recognition of the liability there is a corresponding increase in the carrying amount of the related asset known as the asset retirement cost, which is depleted on a unit-of-production basis over the life of the reserves. The liability is adjusted each reporting period to reflect the passage of time, with the accretion charged to earnings, and for revisions to the estimated future cash flows. Actual costs incurred upon settlement of the obligations are charged against the liability.

Joint Operations

Substantially all of the Company’s exploration, development and production activities are conducted jointly with others and, accordingly, these financial statements reflect only the Company’s proportionate interest in such activities.

Flow-through Shares

The resource expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with tax legislation. The estimated cost of the renounced tax deductions are reflected in share capital and future income taxes when the tax deductions are renounced.

Stock-based Compensation Plan

The Company adopted the recommendations of CICA Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments. This Section requires a fair value based method of accounting to be applied to all stock-based compensation arrangements. The fair value of each option is accounted for in operations, over the vesting period of the options, and the related credit is included in the contributed surplus. The Company’s stock-based compensation plan is described in Note 7(d). Consideration paid to the Company upon exercise of options is recorded as an increase in share capital. As the options are exercised, the related compensation amount is credited to share capital and contributed surplus is reduced.

Revenue Recognition

Revenues from the sale of oil and natural gas are recorded when title passes to the customer and when collection is reasonably assured.

Income Taxes

The Company uses the liability method of accounting for income taxes. Under the liability method of tax allocation, future income taxes are determined based on the differences between the financial reporting and tax basis of assets and liabilities. These income tax assets and liabilities are measured using the substantively enacted tax rates in which the income tax assets or liabilities are expected to be settled or realized. A valuation allowance is provided to the extent that it is more likely than not that the future income tax assets will not be realized.

Per Share Amounts

Basic loss per share is calculated using the weighted average number of shares outstanding. Diluted loss per share is calculated using the treasury stock method. In order to determine diluted loss per share, the treasury stock method assumes that any proceeds from the exercise of dilutive stock options and warrants would be used to repurchase common shares at the average market price during the period, with the incremental number of shares being included in the denominator of the diluted loss per share calculation. The diluted loss per share calculation excludes any potential conversion of options and warrants that would increase loss per share.

3. CHANGES IN ACCOUNTING POLICIES

Future accounting pronouncements

International Financial Reporting Standards (“IFRS”)

On February 13, 2008, AcSB confirmed that Canadian public reporting issuers will report under International Financial Reporting Standards (“IFRS”), which will replace Canadian generally accepted accounting principles for years beginning on or after January 1, 2011. Currently, the Company’s management is assessing the effects of adoption and developing an appropriate plan for implementation of IFRS. The Company will continue to monitor any changes in the adoption of IFRS and will update plans as necessary.

4. PROPERTY AND EQUIPMENT

	December 31, 2010	December 31, 2009
Petroleum and natural gas properties and equipment	\$ 14,581,500	\$ 14,253,750
Office equipment & other assets	115,995	114,457
Accumulated depletion and depreciation	(10,844,731)	(10,511,221)
	\$ 3,852,764	\$ 3,856,986

There were \$50,000 in costs relating to unproven properties excluded from depletion at December 31, 2010 (\$1,500,000 - December 31, 2009). In addition, there was \$423,000 of future development costs included in the costs subject to depletion at December 31, 2010 (December 31, 2008 - \$491,000). The Company has determined that no impairment exists on its unproved properties as at December 31, 2010.

Desmarais applies a ceiling test periodically on the carrying costs of petroleum and natural gas properties. The net amount at which petroleum and natural gas properties are carried is limited to the fair value of those properties based on the net present value of the future net revenues. At December 31, 2010, no provision was required (December 31, 2009 a provision of \$270,000).

The prices used in this analysis are as follows:

Years	WTI Oil (\$US/Bbl)	F/X Rate (\$Cdn/\$US)	Edmonton Oil (\$/bbl)	AECO Gas (\$/mmbtu)
2011	88.00	0.980	87.50	4.15
2012	90.00	0.980	89.50	4.65
2013	92.50	0.980	92.10	5.40
2014	95.00	0.980	94.65	5.90
2015	97.00	0.980	96.70	6.45
Annual escalation thereafter +2.0%/yr.				

5. LOAN - RELATED PARTY

The Company has a \$2,560,000 facility with a company of which a director is the President. This facility is collateralized by a \$10,000,000 Floating Charge Demand Debenture over the Company's assets. There are no fixed terms for review or covenants on this facility. This facility has an interest rate of 10% per annum.

6. ASSET RETIREMENT OBLIGATION

The following table presents the reconciliation of the beginning and ending aggregate carrying amount of the obligation associated with the retirement of oil and gas properties:

	2010		2009	
Asset retirement obligation, January 1	\$	584,941	\$	521,475
Increase (decrease) in obligations		119,177		(18,313)
Settlement of liabilities		(18,772)		-
Accretion expense		54,876		81,779
Change in estimates		(40,774)		-
Ending balance	\$	699,448	\$	584,941

The total future asset retirement obligations were estimated based on the Company's net ownership interest in all wells and facilities, the estimated costs to abandon and reclaim the wells and facilities, and the estimated timing of the costs to be incurred in future periods. The total undiscounted amount of the estimated cash flows required to settle the asset retirement obligations at December 31, 2010 is approximately \$801,650 (2009 – \$675,950) which will be incurred over the next nine years. A credit adjusted risk-free rate of 7.0%, and an inflation factor of 2.5% was used to calculate the fair value of the asset retirement obligation.

7. CAPITAL STOCK
(a) Authorized

Unlimited common shares without par value

Unlimited preferred shares without par value

(b) Common shares

	Number of shares	Amount
Balance January 1, 2009	15,990,900	\$ 4,614,603
Private placement - common shares (i)	1,500,000	150,000
Fair value of warrants issued (i)	-	(70,200)
Balance January 1, 2010	17,490,900	4,694,403
Private placement - common shares (ii)	6,000,000	300,000
Fair value of warrants issued (ii)	-	(112,500)
Shares issued on settlement of debt (iii)	371,235	55,684
Ascribed value of warrants exercised	1,234,700	177,388
Balance December 31, 2010	25,096,835	\$ 5,114,975

- (i) On June 3, 2009, the Company completed a non-brokered private placement financing of 1,500,000 units (the "Units") of the Company at a price of \$0.10 per Unit for aggregate gross proceeds of \$150,000. Each Unit consists of one common share in the capital of Desmarais and one common share purchase warrant (a "Warrant"). Each Warrant entitles the holder thereof to purchase one (1) Common Share for \$0.15 from the date of issue to the date that is 12 months from the date of issue or June 2, 2010.

The fair value of the warrants was estimated using the Black-Scholes option model with the following assumptions: expected dividend yield of 0%; expected volatility 149%; risk-free interest rate of 3.34%; and an expected life of one year.

- (ii) The Company issued 6,000,000 units of the Company at a price of \$0.05 per unit ("Unit") for total gross proceeds of \$300,000. Each Unit will be comprised of one common share and one share purchase warrant, with each share purchase warrant entitling the holder thereof to acquire one Desmarais common share at a price of \$0.10 at any time prior to February 18, 2012.

The fair value of the warrants was estimated using the Black-Scholes option model with the following assumptions: expected dividend yield of 0%; expected volatility 154%; risk-free interest rate of 3.1%; and an expected life of 24 months.

- (iii) On July 15, 2010, 371,235 common shares were issued as partial consideration for payment of outstanding accounts payable balances. These shares had a deemed value of \$0.15 per common share and are subject to a four month hold period from the date of issuance.

(c) Warrants

Private placements

	Number of warrants	Amount
Balance January 1, 2009	3,300,000	\$ 119,693
Granted, private placements	1,500,000	63,800
Expired	(500,000)	(4,800)
Balance January 1, 2010	4,300,000	178,693
Granted, private placements	6,000,000	112,500
Expired	(1,065,300)	(46,617)
Exercised	(1,234,700)	(32,183)
Balance December 31, 2010	8,000,000	\$ 212,393

Finders Warrants

	Number of warrants	Amount
Balance January 1, 2009	-	\$ -
Granted, private placements	150,000	6,400
Balance January 1, 2010	150,000	\$ 6,400
Expired	(150,000)	(6,400)
Balance December 31, 2010	-	\$ -

Expiry date	Exercise price per warrant (\$)	Warrants Outstanding	Fair value of warrants
January 31, 2011	0.17/0.22	2,800,000	\$ 114,893
February 18, 2012	0.10	5,200,000	97,500
Balance December 31, 2010		8,000,000	\$ 212,393

(d) Stock-based compensation

The Company has a stock option plan under which it may grant options to directors, officers, employees or consultants. Options are granted at the discretion of the Board of Directors, vest in periods of up to one year from the date of grant and have expiry dates ranging from three to five years after the date of grant.

As at December 31, 2010 there were outstanding options to acquire 2,325,500 common shares (December 31, 2009 – 1,625,500 common shares). The maximum available for grant at December 31, 2010 was 2,509,683 common shares (December 31, 2009 – 1,749,090 common shares). The maximum number available for grant is subject to shareholder approval at the annual meeting of the Company.

The following table summarizes the status of the stock option plan:

	Number of stock options	Weighted average exercise price (\$)
Balance January 1, 2009	1,155,500	0.16
Granted	530,000	0.16
Forfeited	(60,000)	0.16
Exercised	-	-
Balance January 1, 2010	1,625,500	0.16
Granted	800,000	0.125
Forfeited	(100,000)	0.16
Balance December 31, 2010	2,325,500	0.15

The following table reflects the stock options outstanding as at December 31, 2010:

Exercise Price	Options Outstanding	Remaining Life (Years)	Options Exercisable
\$0.16	995,500	0.6	995,500
\$0.16	530,000	1.5	530,000
\$0.125	800,000	2.4	800,000
\$0.15	2,325,500	1.5	2,325,500

In June 2010, stock options to purchase a total of 800,000 common shares were granted to consultants, directors and officers, at an exercise price of \$0.125 per share pursuant to the Company's stock option plan. The stock options fully vested upon issuance and shall expire three years from the date of issue. The \$80,000 fair value of the stock options was estimated using the Black-Scholes option model with the following assumptions: expected dividend yield of 0%; expected volatility 149%; risk-free interest rate 3.1%; and an expected life of three years.

In July 2009, stock options to purchase a total of 530,000 common shares were granted to consultants, directors and officers, at an exercise price of \$0.16 per share pursuant to the Company's stock option plan. The stock options fully vested upon issuance and shall expire three years from the date of issue. The \$68,900 fair value of the stock options was estimated using the Black-Scholes option model with the following assumptions: expected dividend yield of 0%; expected volatility 151%; risk-free interest rate 3.1%; and an expected life of three years.

(e) Contributed Surplus

	Amount
Balance January 1, 2009	\$ 509,999
Stock-based compensation	68,900
Expired warrants	4,800
Balance January 1, 2010	583,699
Stock-based compensation	80,000
Expired warrants	53,017
Balance December 31, 2010	\$ 716,716

8. INCOME TAXES

The provision for income taxes is different from the amount computed by applying the combined Canadian Federal and Provincial tax rates to net loss before income taxes. The reasons for the difference are as follows:

	2010	2009
Future income tax asset (liability)	\$	\$
Property and equipment less than tax basis	(344,991)	(387,888)
Asset retirement obligations	174,872	175,482
Share issue costs	528	984
Income tax losses	1,128,382	1,155,241
	958,791	943,819
Valuation allowance	(958,791)	(943,819)
Future income tax asset	\$ -	\$ -

The future income tax asset is composed of temporary differences and future income tax reductions. The following table shows the tax-affected amounts of those items:

	2010	2009
Loss before taxes	\$ (795,292)	\$ (1,987,156)
Income tax rate	28%	30.0%
Expected income tax recovery	(222,682)	(596,150)
Increase (decrease) in taxes resulting from:		
Stock-based compensation	22,400	20,670
Benefits relating to change in income tax rates	185,310	77,720
	(14,972)	(497,760)
Valuation allowance	14,972	497,760
Income tax expense	\$ -	\$ -

As at December 31, Desmarais has the following pools available for use to reduce future taxable income:

	2010	2009
Canadian oil and gas property expense	\$ 21,887	\$ -
Canadian development expense	232,637	340,923
Canadian exploration expense	1,379,102	1,379,102
Undepreciated capital cost	839,174	844,000
Non-capital losses carried forward	4,513,530	3,843,459
Share issue costs	2,111	3,167
	\$ 6,988,441	\$ 6,410,651

The non-capital losses carried forward expire between 2027 and 2030.

9. RELATED PARTY TRANSACTIONS

Except as disclosed elsewhere in these financial statements, the Company has undertaken transactions with entities which are considered related parties. Transactions in the normal course of operations are measured at the exchange amount equaling the consideration established and agreed to by the related parties.

The Corporate Secretary is a Partner in a legal firm. During the year ending December 31, 2009, legal fees totalling \$18,286 (2009 - \$10,129) with this firm were recorded. At December 31, 2010, a balance of \$38,825 remains outstanding (2009 - \$24,180).

A director has ownership in private companies that are sublease tenants of Desmarais. During the year ending December 31, 2010, Desmarais received office space and related service fees of \$18,000 (2009 - \$22,963). At both December 31, 2010 and 2009 \$nil was due to Desmarais from these companies.

As described in note 5, a director is the President of a company that advanced \$2,560,000 under a demand facility to Desmarais. At December 31, 2010, interest totaling \$249,984 (2009 - \$244,000) was recorded by Desmarais to this company. At December 31, 2010, \$58,298 (2009 - \$20,000) was due to this company from Desmarais.

The President and Chief Executive Officer is an employee of the Company with an employment contract that provides for an annual salary of \$150,000 payable in semi-monthly instalments. By mutual agreement, he has agreed to defer a portion of these payments. As a result, the Company is in arrears a total of \$71,250 as at December 31, 2009 (2009 - \$31,250).

A director is the President of a company that provides engineering consulting services to the Company. In 2010, Desmarais paid consulting fees totalling \$nil (2009 - \$56,700). At December 31, 2010, \$5,880 (2009 - \$5,880) remained payable by Desmarais.

The President and Chief Executive Officer has partial ownership in a company that Desmarais exchanged a non core gross overriding royalty property for a core pipeline and additional working interest properties and associated liabilities in the Barrhead area of Alberta. As at December 31, 2010, a total of \$5,895 is due to this company (2009 - \$nil).

In January 2009, Desmarais entered into an arrangement for corporate development services with a company controlled by a significant shareholder. The term was for a minimum of one year that expires on 90 days written notice by either Desmarais or the other company. The contract provides for monthly payments of \$5,000 and reimbursement of reasonable and mutually agreed upon travel expenses. To December 31, 2010, a total of \$30,000 was incurred (2009 - \$60,000) of which \$15,750 was outstanding at December 31, 2010 (2009 - \$15,750).

Desmarais has an arrangement to pay gross overriding royalties to a company controlled by a significant shareholder on properties developed as a direct result of their fund raising initiatives. For the year ended December 31, 2010, the total of these royalties was \$5,841 (2009 - \$3,649) of which \$4,813 remained outstanding at December 31, 2010 (2009 - \$3,649).

All of the above transactions are in the normal course of operations. All transactions are measured at the exchange amount equaling the consideration established and agreed to by the related parties, which does not exceed the arm's length equivalent value for these services.

10. NET LOSS PER SHARE

The number of shares used to calculate the diluted net loss per share for the periods ended December 31, 2009 included the weighted average number of Desmarais common shares outstanding of 23,360,750 for the year plus nil shares related to the dilutive effect of the conversion of stock options and warrants (2009 – 16,862,133 for the year plus nil shares) as the stock options and warrants would be anti-dilutive.

11. FINANCIAL INSTRUMENTS

Overview

The Company has exposure to credit, liquidity and market risks from its use of financial instruments. This note provides information about the Company's exposure to each of these risks, the Company's objectives, policies and processes for measuring and managing risk. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with risk management policies. The Company's risk management policies are designed to identify and analyze the material risks faced by the Company, set and maintain appropriate risk limits and controls and to ensure adherence to risk management policies as appropriate under prevailing market conditions.

Fair value

Canadian generally accepted accounting principles require that the Company disclose information about the fair value of its financial assets and liabilities. Fair value estimates are made at the balance sheet date, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties in significant matters of judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect these estimates.

The carrying value of cash, accounts receivable, accounts payable and accrued liabilities reflected in the balance sheets approximate fair value because of the short term to maturity of these instruments.

Credit Risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from petroleum and natural gas marketers and joint venture partners and the fair value of derivative instruments.

The Company's accounts receivable are with customers in the oil and gas industry and are subject to normal industry credit risks. The carrying value of accounts receivable reflects management's assessment of the credit risk associated with these customers. Management believes the credit risk is mitigated by the size and reputation of the companies to

which they extend credit. Joint venture receivables are usually collected within one to three months of the joint venture bill being issued to the partner. The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to the expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances can be impacted by industry factors such as commodity price fluctuations, limited capital availability and unsuccessful drilling programs. The Company does not typically obtain collateral from petroleum and natural gas joint venture partners; however the Company does have the ability in many cases to recover amounts from production in the event of non-payment. The Company has not experienced significant credit loss in the collection of accounts receivable.

The carrying amount of accounts receivable and derivatives represents the maximum credit exposure. As at December 31, 2010 the Company's receivables consisted of \$382,502 (2009 – \$252,635) from joint venture partners of which \$80,263 has been subsequently collected, and \$22,801 (2009 – \$26,068) of prepaids and other accounts receivable. The Company does not consider any receivables to be past due. There were no derivative instruments held at December 31, 2010.

Market Risk

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

Commodity Price Risk

Commodity price risk is the risk that future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollar along with global economic events that dictate the levels of supply and demand. Lower commodity prices can also reduce the Company's ability to raise capital. From time to time the Company may attempt to mitigate commodity price risk through the use of financial derivatives.

Based on average production levels achieved in 2010, a \$1.00 increase in the sales price of crude oil would increase annual revenues by \$3,400 and a \$0.10 increase in natural gas sales price would increase annual revenues by \$6,500. Conversely, a decrease of such amounts would result in a corresponding decrease in annual revenues.

Liquidity Risk

Liquidity risk is the risk that the Company will encounter difficulty in meeting obligations associated with the financial liabilities. The Company's financial liabilities consist of accounts payable, notes payable and loans payable.

The Company prepares annual capital expenditure budgets, which are monitored and updated as considered necessary. Production is monitored regularly to provide current cash flow estimates and the Company utilizes authorizations for expenditures on projects to monitor capital expenditures.

Accounts payable consists of invoices payable to trade suppliers for office, field operating activities and capital expenditures. The Company processes invoices within a normal payment period. Accounts payable have contractual maturities of less than one year.

12. CAPITAL MANAGEMENT

The Company considers its capital structure to include shareholders' equity, working capital and long-term debt. The Company is not subject to any externally imposed capital requirements. The Company's total capital is computed as follows:

	2010	2009
Shareholders' deficiency	\$ (1,085,585)	\$ (871,182)
Due to related party	2,560,000	2,440,000
Working capital deficiency	1,774,310	1,718,687
Total capital	\$ 3,248,725	\$ 3,287,505

The Company manages its capital to maximize its ability to be able to continue as a going concern and have sufficient capital to develop its projects and take them to production. In order to maintain the capital structure, the Company may from time to time issue shares and adjust its capital spending to manage current and projected debt levels. The Company's present overall capital risk management strategy remains unchanged from 2009.

13. SUPPLEMENTAL CASH FLOW INFORMATION

	Year December 31, 2010	Year December 31, 2009
Changes in non-cash working capital:		
Accounts receivable	\$ (125,463)	\$ (63,123)
Deposits and prepaid expenses	8,104	34,910
Accounts payable and accrued liabilities	587,950	1,078,496
	\$ 470,591	\$ 1,050,283
Operating activities	\$ 220,606	\$ 734,341
Investing activities	249,985	315,942
	\$ 470,591	\$ 1,050,283

14. COMMITMENTS AND CONTINGENCIES

Office Lease

Desmarais has a sublease for office premises with a term to September 30, 2011. The Company is committed to pay \$31,500 in 2011.

Employment Contract

Desmarais has an employment contract with the President and Chief Executive Officer that provides for payment of a lump sum payment of 2 years salary, currently \$150,000 per annum, and 20% in lieu of benefits along with any outstanding holiday pay in the event of a change in control or dismissal without cause.

The Company has legal claims, guarantees and other commitments in the normal course of business which would not have a material adverse effect on the Company's liquidity, financial condition or results of operations.