

**NOTICE OF NO AUDITOR REVIEW OF  
INTERIM FINANCIAL STATEMENTS**

Under National Instrument 51-102, Part 4, subsection 4.3(3) (a), if an auditor has not performed a review of the interim financial statements they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim financial statements of the Corporation have been prepared by and are the responsibility of the Corporation's management.

The Corporation's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

Date: November 29, 2011

*"James G. Long" (signed)*

James G. Long  
President, CEO and acting CFO

### STATEMENTS OF FINANCIAL POSITION

(Notice of Intention to Make a Proposal - Bankruptcy and Insolvency Act as of September 26, 2011 - Note 2)

	Note	September 30, 2011	December 31, 2010
<b>ASSETS</b>			
<b>Current assets</b>			
Cash		\$ 89,184	\$ 48,136
Accounts receivable		272,233	393,556
Deposits and prepaid expenses		17,171	11,747
<b>Total current assets</b>		<b>378,588</b>	<b>453,439</b>
<b>Non-current assets</b>			
Reclamation deposits		44,651	47,271
Exploration & evaluation properties	7	65,000	65,000
Property, plant and equipment	8	3,124,446	3,462,538
<b>Total non-current assets</b>		<b>3,234,097</b>	<b>3,574,809</b>
<b>TOTAL ASSETS</b>		<b>\$ 3,612,685</b>	<b>\$ 4,028,248</b>
<b>LIABILITIES AND SHAREHOLDERS' DEFICIENCY</b>			
<b>Current liabilities</b>			
Accounts payable and accrued liabilities		\$ 1,585,127	\$ 1,978,838
Due to related parties		291,588	200,775
Loan - related parties	10	2,560,000	2,560,000
<b>Total current liabilities</b>		<b>4,436,715</b>	<b>4,739,613</b>
<b>Non current liabilities</b>			
Decommissioning liabilities	11	775,870	750,460
<b>Total non-current liabilities</b>		<b>775,870</b>	<b>750,460</b>
<b>TOTAL LIABILITIES</b>		<b>5,212,585</b>	<b>5,490,073</b>
<b>SHAREHOLDERS' DEFICIENCY</b>			
Common shares	12	5,596,906	5,114,975
Warrants	12	92,812	212,393
Contributed surplus	12	754,466	716,716
Accumulated losses		(8,044,084)	(7,505,909)
<b>TOTAL DEFICIENCY</b>		<b>(1,599,900)</b>	<b>(1,461,825)</b>
<b>TOTAL LIABILITIES AND DEFICIENCY</b>		<b>\$ 3,612,685</b>	<b>\$ 4,028,248</b>

The notes are an integral part of these financial statements

Approved on behalf of the board of directors

*"James G. Long"*

James G. Long

*"Douglas F. Robinson"*

Douglas F. Robinson

### STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(Notice of Intention to Make a Proposal - Bankruptcy and Insolvency Act as of September 26, 2011 - Note 2)

Note	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
<b>REVENUES</b>				
Petroleum and natural gas sales	\$ 106,392	\$ 138,745	\$ 354,828	\$ 374,785
Royalties	(1,158)	(9,533)	(33,403)	(37,861)
Other income	15,999	6,001	53,193	18,171
Gain on debt settlements	20,553	(33,428)	62,368	367,691
	<b>141,786</b>	<b>101,785</b>	<b>436,986</b>	<b>722,786</b>
<b>EXPENSES</b>				
Production	133,408	99,078	318,935	286,390
General and administrative	92,458	74,577	286,611	478,781
Depletion, depreciation and amortization	47,237	57,213	149,372	312,426
	<b>273,103</b>	<b>230,868</b>	<b>754,918</b>	<b>1,077,597</b>
Results from operating activities	(131,317)	(129,083)	(317,932)	(354,811)
Finance expenses	6 53,385	69,182	220,243	218,930
Net loss and comprehensive loss for the period	(184,702)	(198,265)	(538,175)	(573,741)
Net loss per share				
Basic and diluted	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.03)

*The notes are an integral part of these financial statements*

### CONDENSED STATEMENTS OF SHAREHOLDERS' DEFICIENCY

(Notice of Intention to Make a Proposal - Bankruptcy and Insolvency Act as of September 26, 2011 - Note 2)

	Note	Common shares	Warrants	Contributed surplus	Accumulated losses	Total
Balance at January 1, 2010	12	\$ 4,694,403	\$ 185,093	\$ 583,699	\$ (6,607,100)	\$ (1,143,905)
Issuance of common shares		187,500	112,500	-	-	300,000
Exercise of warrants		129,888	(24,683)	-	-	105,205
Net loss for the period		-	-	-	(573,741)	(573,741)
Balance at September 30, 2010		5,011,791	272,910	583,699	(7,180,841)	(1,312,441)
Balance at January 1, 2011	12	\$ 5,114,975	\$ 212,393	\$ 716,716	\$ (7,505,909)	\$ (1,461,825)
Exercise of warrants		453,867	(71,367)	-	-	382,500
Exercise of options		28,064		(10,464)		17,600
Expiry of warrants		-	(48,214)	48,214		-
Net loss for the period		-	-	-	(538,175)	(538,175)
Balance at September 30, 2011		5,596,906	92,812	754,466	(8,044,084)	(1,599,900)

*The notes are an integral part of these financial statements*

### STATEMENTS OF CASH FLOWS

(Notice of Intention to Make a Proposal - Bankruptcy and Insolvency Act as of September 26, 2011 - Note 2)

Note	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
<b>OPERATING ACTIVITIES</b>				
Net loss for the period	\$ (184,702)	\$ (198,265)	\$ (538,175)	\$ (573,741)
Adjustments for:				
Depletion, depreciation and amortization	47,237	57,213	149,372	312,426
Stock based compensation 12	-	-	-	80,000
Gain on debt settlements	(20,553)	33,428	(62,368)	(367,691)
Finance expenses	53,385	69,182	220,243	218,930
Interest paid	-	(113,782)	(67,134)	(185,300)
Change in non-cash working capital	52,667	71,621	135,909	88,363
	(51,966)	(80,603)	(162,153)	(427,013)
<b>FINANCING ACTIVITIES</b>				
Issue of common shares	-	40,000	400,100	405,205
Due to related party	-	60,010	-	120,020
	-	100,010	400,100	525,225
<b>INVESTING ACTIVITIES</b>				
Deposits (refunds)	39,798	50,000	2,620	(24,048)
Additions to property and equipment	(1,614)	(238,158)	(47,727)	(242,386)
Dispositions of oil and gas properties	247,567	-	247,567	12,060
Change in non-cash working capital	(282,131)	608,995	(399,359)	602,561
	3,620	420,837	(196,899)	348,187
Change in cash	(48,346)	440,244	41,048	446,399
Cash, beginning of period	137,529	35,370	48,136	29,215
Cash, end of period	\$ 89,184	\$ 475,614	\$ 89,184	\$ 475,614

The notes are an integral part of these financial statements

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 1. REPORTING ENTITY

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.

The interim financial statements of the Company are as at and for the three and nine months ended September 30, 2011. The Company conducts many of its activities jointly with others; these financial statements reflect only the Company’s proportionate interest in such activities.

## 2. BASIS OF PRESENTATION

(A) Notice of Intention to Make a Proposal - Bankruptcy and Insolvency Act Filing on September 26, 2011

On September 26, 2011, Desmarais filed a Notice of Intention to Make a Proposal (the “NOI”) to its creditors pursuant to Part III, Division I of the *Bankruptcy and Insolvency Act* (the “Act”). An Order was granted by the Court of Queen’s Bench of Alberta (the “Court”) and was initially in effect until October 26, 2011 and was subsequently extended to December 9, 2011, at which time the matter will be reviewed by the Court. While the Order is in effect the Company is working with a court-appointed Trustee.

Subsequent to the end of the third quarter, the Company filed the proposal (the “Proposal”) on November 18, 2011 and provided the details of the Proposal to be voted on at a meeting of the Affected Creditors on December 8, 2011.

The key terms of the Proposal are *inter alia* as follows:

- a) All unsecured claims filed with the Trustee pursuant to the Proposal that are admitted by the Trustee, or are otherwise determined to be valid claims by the Court (“Affected Creditors”), shall be treated as one class for purposes of both voting on the Proposal and for distributions under the Proposal. For greater certainty, to the extent that a creditor has a form of secured charge or a preferred claim, but because of the priority of that charge or claim in relation to the claim of the secured lender 323 Holdings Ltd (“323”) and the estimated liquidated value of the assets of Desmarais, that creditor would effectively be unsecured for all or a portion of its claim if Desmarais were liquidated as of the date of filing of the NOI. Consequently, such claim shall be treated as unsecured for purposes of the Proposal and the creditor shall be entitled to prove the unsecured portion of its claim as an Affected Creditor;
- b) Affected Creditors whose admitted claims are less than \$100 shall be satisfied in full by way of a cash payment;
- c) Affected Creditors whose admitted claims are greater than \$100 will be entitled to choose between the two following options:
  - i. receive common shares of Desmarais (the “Common Shares”), valued at \$0.08/common share for purposes of the Proposal, based on the full value of their admitted claim. (For greater certainty, an Affected Creditor would receive 12,500 Common shares for every \$1,000 of admitted claim);
  - or
  - ii. participate in a cash distribution from a cash pool totalling \$40,000 (the “Cash Pool”) and receive the lesser of the pro rata portion of their admitted claim in respect of those creditors electing to participate in the Cash Pool; or 10% of the admitted claim. Under this alternative, a creditor must assign its entire claim to a third party.
- d) Distributions under the terms of the Proposal are subject to the levy payable to the Office of the Superintendent of Bankruptcy as prescribed by S.147 of the Act.

The Proposal must be approved by both:

- a) a majority in number and 2/3 in dollar value of those Affected Creditors voting on the Proposal (the “Statutory Majority of Creditors”); and
- b) the Court.

The Company has scheduled an application for Court approval of the Proposal on December 9, 2011.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 2. BASIS OF PRESENTATION (CONTINUED)

The Proposal provides that the following claims shall be unaffected by the Proposal and shall be paid in accordance with the existing terms, or as otherwise agreed between Desmarais and the respective parties:

- a) the claim of 323, subject to that portion of the outstanding obligation to be treated as unsecured pending the contingent reduction of the value of 323's secured claim as discussed above;
- b) any debtor-in-possession financing obligations;
- c) any claim subject to an administration charge as provided for by the October 26 order of the Court;
- d) any claim for goods and services supplied subsequent to the date of filing of the NOI; and
- e) any claim that may ultimately be determined to rank in priority to 323 including outstanding property taxes.

In the event the Proposal is not approved by both the Statutory Majority of Creditors and the Court, Desmarais shall irrevocably be deemed to have thereupon immediately made an assignment in bankruptcy in which case neither the Cash Pool nor the Common Shares will be available to Affected Creditors and 323 would proceed to appoint a Receiver to realize on the Company's assets.

### (B) Going concern uncertainty

The Company's interim financial statements have been prepared on a going concern basis, which assumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The Company has experienced consecutive losses and has accumulated losses of \$8,044,084 and as per above, has sought formal protection from creditors as at September 26, 2011.

As such, there is significant uncertainty regarding the Company's ability to continue as a going concern, which is dependent upon achieving on-going cash flow from operating activities and receiving support from its creditors through approval of the Proposal and current and future investors.

The Company is experiencing negative cash flow from operating activities. There is no certainty as to when the Company will have positive cash flow. The Company will be solely dependent upon outside sources and third party financings to obtain the necessary capital to implement a plan to explore and develop its properties or acquire further properties or restructure the Company and continue as a going concern. The Company does not have access to short term bank financing. If the Company is unable to secure sufficient financing, delays or postponement of future development or production of the Company's properties may result.

There can be no assurance that the additional capital required or other types of financing will be available if needed or even if available, the terms of such financing will be acceptable to the Company. Failure to obtain suitable financing would, in all likelihood, lead to the liquidation of the Company's assets.

These financial statements do not contain any adjustments to the amounts and classification of assets and liabilities that might be necessary should the Company be unable to continue in business.

### (C) Statement of compliance:

These interim financial statements have been prepared in accordance with International Accounting Standard ("IAS") 34, "Interim Financial Reporting". These interim financial statements for part of the period covered by the first IFRS annual financial statements and IFRS 1, "First-time Adoption of International Financial Reporting Standards" has been applied. The interim financial statements do not include all the information required for full annual financial statements.

An explanation of how the transition to IFRS has affected the reported financial position, financial performance and cash flows of the Company is provided in note 16. This note includes reconciliations of equity and total comprehensive income for comparative periods and of equity at the date of transition reported under Canadian GAAP ("previous GAAP") to those reported for those periods and at the date of transition to IFRS.

These interim financial statements were authorized for issue by the Board of Directors on November 28, 2011.

### (D) Basis of measurement:

The interim financial statements have been prepared on the historical cost basis with the exception of decommissioning liabilities and the measurement of share based payments.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 2. BASIS OF PRESENTATION (CONTINUED)

### (E) Functional and presentation currency:

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

### (F) Use of estimates and judgments:

The preparation of financial statements in conformity with IFRS requires management to make judgments, 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 recognized in the year in which the estimates are revised and in any future years affected.

Reserve estimates including production profiles, future development costs, and discount rates are a critical part of many of the estimated amounts and calculations contained in the financial statements. These estimates are verified by third party professional engineers, who work with information provided by the Company to establish reserve determinations. These determinations are updated at least on an annual basis. Significant areas of estimation, uncertainty and critical judgments in applying accounting policies that impact the amounts recognized in the interim financial statements include:

- Impairment testing – estimates of reserves, future commodity prices, future costs, production profiles, discount rates, market value of land.
- Depletion and depreciation - oil and natural gas reserves, including future prices, costs and reserve base to use on calculation of depletion.
- Decommissioning obligations – estimates relating to amounts, likelihood, timing, inflation and discount rates.
- Stock-based compensation – forfeiture rates and volatility.
- Derivatives – expected future oil and natural gas prices and expected volatility in these prices; expected interest rates; expected future foreign exchange rates.
- Deferred tax – estimates of reversal of temporary differences, tax rates substantively enacted, and likelihood of assets being realized.
- Provisions and contingencies – estimates relating to onerous contracts, including discount rates associated with long term contracts.

## 3. SIGNIFICANT ACCOUNTING POLICIES

The interim financial statements as at and for the three and nine months ended September 30, 2011 have been prepared following the same accounting policies and methods of computation as the interim financial statements as at June 30, 2011.

### (a) Recent accounting pronouncements:

In May 2011, the IASB issued four new standards and two amendments. Five of these items related to consolidation, while the remaining one addresses fair value measurement. All of the new standards are effective for annual periods beginning on or after January 1, 2013. Early adoption is permitted.

IFRS 11 "Joint Arrangements" replaces IAS 31, "Interests in Joint Ventures". IFRS 11 divides joint arrangements into two types, each having its own accounting model. A "joint operation" continues to be accounted for using proportionate consolidation, where a "joint venture" must be accounted for using equity accounting. This differs from IAS 31, where there was the choice to use proportionate consolidation or equity accounting for joint ventures. A "joint operation" is defined as the joint operators having rights to the assets, and obligations for the liabilities, relating to the arrangement. In a "joint venture", the joint ventures' have rights to the net assets of the arrangement, typically through their investment in a separate joint venture entity.

IFRS 12 "Disclosure of Interests in Other Entities" is a new standard, which combines all of the disclosure requirements for subsidiaries, associates and joint arrangements, as well as unconsolidated structured entities.

IFRS 13 "Fair Value Measurement" is a new standard meant to clarify the definition of fair value, provide guidance on measuring fair value and improve disclosure requirements related to fair value measurement.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

IAS 28 “Investments in Associates and Joint Ventures” has been amended as a result of the issuance of IFRS 11 and the withdrawal of IAS 31. The amended standard sets out the requirements for the application of the equity method when accounting for interest in joint ventures, in addition to interests in associates.

The IASB intends to replace IAS 39, “Financial Instruments: Recognition and Measurements” (“IAS39”) with IFRS 9, “Financial Instruments” (“IFRS 9”). IFRS 9 will be published in three phases, of which the first phase has been published.

The first phase addresses the accounting for financial assets and financial liabilities. The second phase will address the impairment of financial instruments, and the third phase will address hedge accounting.

For financial assets, IFRS 9 uses a single approach to determine whether a financial asset is measured at amortized cost or fair value, and replaces the multiple rules in IAS 39. The approach in IFRS 9 is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. The new standard also requires a single impairment method to be used, replacing the multiple impairment methods in IAS 39. For financial liabilities, although the classification criteria for financial liabilities will not change under IFRS 9, the approach to the fair value option for financial liabilities may require different accounting for changes to the fair value of a financial liability as a result of changes to an entity’s own credit risk. IFRS 9 is effective for annual periods beginning on or after January 1, 2013 with different transitional arrangements depending on the date of initial application.

The Company is currently evaluating the impact of adopting all of the newly issued and amended standards on our financial statements.

## 4. 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. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

(a) Property, plant and equipment and exploration and evaluation assets:

The fair value of property, plant and equipment recognized in a business combination, is based on market values. The market value of property, plant and equipment is the estimated amount for which property, plant and equipment could be exchanged on the acquisition date between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The market value of oil and natural gas interests (included in property, plant and equipment) and exploration and evaluation assets is estimated with reference to the discounted cash flows expected to be derived from oil and natural gas production based on externally prepared reserve reports. The risk-adjusted discount rate is specific to the asset with reference to general market conditions, being 10% for the three and nine months ended September 30, 2011.

The market value of other items of property, plant and equipment is based on the quoted market prices for similar items.

(b) Cash and cash equivalents, trade and other receivables, and trade and other payables:

The fair value of cash and cash equivalents, trade and other receivables, and trade and other payables is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. At September 30, 2011, the fair value of these balances approximated their carrying value due to their short term to maturity.

(c) Share options:

The fair value of employee share options is measured using a Black-Scholes option pricing model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behaviour), expected dividends, and the risk-free interest rate (based on government bonds).

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 5. FINANCIAL RISK MANAGEMENT

### (a) Overview:

The Company's activities expose it to a variety of financial risks that arise as a result of its exploration, development, production, and financing activities such as:

- credit risk;
- liquidity risk; and
- market risk.

This note presents information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk, and the Company's management of capital. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors oversees managements' establishment and execution of the Company's risk management framework. Management has implemented and monitors compliance with risk management policies. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

### (b) 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 joint venture partners and oil and natural gas marketers.

#### Trade and other receivables

All of the Company's operations are conducted in Canada. The Company's exposure to credit risk is influenced mainly by the individual characteristics of each customer.

Credit risk is primarily related to the Company's receivables from joint venture partners and petroleum and natural gas marketers and the risk of financial loss if a customer, partner or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable is with partners in the energy industry and is subject to normal industry credit risk. The Company generally grants unsecured credit but routinely assesses the financial strength of its partners.

Receivables from petroleum and natural gas marketers are normally collected on the 25<sup>th</sup> day of the month following production. The Company sells the majority of its production to a single petroleum and natural gas marketer and, therefore, is subject to concentration risk which is mitigated by management's policies and practices related to credit risk, as discussed above. The Company historically has not experienced any collection issues with its petroleum and natural gas marketers. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances is dependent on industry factors such as commodity price fluctuations, escalating costs, the risk of unsuccessful drilling and occasional disagreements between parties.

The Company attempts to mitigate the risk from joint venture receivables by obtaining partner approval of significant capital expenditures prior to expenditure.

The Company does not typically obtain collateral from petroleum and natural gas marketers or joint venture partners; however in certain circumstances, it may cash call a partner in advance of the work. As well, the Company does have the ability to withhold production from joint venture partners in the event of non-payment.

The Company establishes an allowance for doubtful accounts as determined by management based on their assessment of collection and, therefore the carrying amount of accounts receivable generally represents the maximum credit exposure.

### (c) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due (see note 2). The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 5. FINANCIAL RISK MANAGEMENT (CONTINUED)

### (c) Liquidity risk (continued):

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Company utilizes authorizations for expenditures on both operated and non operated projects to further manage capital expenditure. The Company also attempts to match its payment cycle with collection of oil and natural gas revenue on the 25th of each month. To facilitate the capital expenditure program, the Company relies on working capital and cash flows from operations (see note 2).

### (d) Market risk:

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

The Company utilizes commodity price contracts to manage market risks relevant to commodity prices. All such transactions are conducted in accordance with the risk management policy that has been approved by the Board of Directors.

#### Currency risk

Prices for oil are determined in global markets and generally denominated in United States dollars. Natural gas prices obtained by the Company are influenced by both US and Canadian demand and the corresponding North American supply, and recently, by imports of liquefied natural gas. The exchange rate effect cannot be quantified but generally an increase in the value of the \$CDN as compared to the \$US will reduce the prices received by the Company for its petroleum and natural gas sales.

#### Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company has only fixed rate loans or borrowings at September 30, 2011 and, accordingly, has minimal exposure to interest rate risk.

#### Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for oil and natural gas are impacted by not only the relationship between the Canadian and United States dollar but also world economic events that dictate the levels of supply and demand

It is the Company's policy to economically hedge some oil and natural gas sales through the use of various financial derivative forward sales contracts and physical sales contracts. The Company does not apply hedge accounting for these contracts. The Company's production is usually sold using "spot" or near term contracts, with prices fixed at the time of transfer of custody or on the basis of a monthly average market price. The Company, however, may give consideration in certain circumstances to the appropriateness of entering into long term, fixed price marketing contracts. The Company does not enter into commodity contracts other than to meet the Company's expected sale requirements.

As at September 30, 2011 and December 31, 2010, the Company did not have any outstanding commodity contracts.

### (e) Capital management:

The Company's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The Company manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying oil and natural gas assets. The Company considers its capital structure to include shareholders' equity and working capital. In order to maintain or adjust the capital structure, the Company may issue shares and adjust its capital spending to manage current and projected debt levels.

The Company prepares annual capital expenditure budgets, which are updated as necessary depending on varying factors including current and forecast prices, successful capital deployment and general industry conditions. The annual and updated budgets are approved by the Board of Directors.

The Company has not paid or declared any dividends since the date of incorporation.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 6. FINANCE EXPENSES

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
Interest – loan – related parties	64,526	62,782	191,474	184,779
Interest expense (recovery) – other	(15,871)	-	14,479	521
Accretion of decommissioning liabilities	4,730	5,400	14,290	33,630
Finance expenses	53,385	68,182	220,243	218,930

## 7. EXPLORATION AND EVALUATION ASSETS

	Exploration and Evaluation assets \$
Cost:	
At January 1, 2010	127,072
Additions	5,996
Impairments	(68,068)
Balance, December 31, 2010	65,000
Balance, September 30, 2011	65,000

Exploration and evaluation (E&E) assets consist of the Company's exploration projects which are pending the determination of proven or probable reserves. Additions represent the Company's share of costs incurred on E&E assets during the period. As at September 30, 2011, \$65,000 (December 31, 2010 - \$65,000) remains in exploration and evaluation assets in respect of the undeveloped lands at Medicine Hat.

### (a) Amortization and impairment charge:

The impairment of exploration and evaluation assets, and any eventual reversal thereof, is recognized as additional depletion and depreciation expense in the statement of loss and comprehensive loss. The impairment of other intangible assets and goodwill, and any eventual reversal thereof (excluding goodwill), is recognized as amortization expense in the statement of loss and comprehensive loss.

### (b) Recoverability of exploration and evaluation assets:

The Company assesses the recoverability of exploration and evaluation assets, before and at the moment of reclassification to property, plant and equipment, using CGU's. The CGU includes both the E&E CGU and CGU's related to oil and natural gas interests for that area, but not larger than a segment.

## 8. PROPERTY, PLANT AND EQUIPMENT

### Amortization and impairment charge:

The depletion, depreciation and impairment of property, plant and equipment, and any eventual reversal thereof, are recognized in depletion, depreciation and amortization in the statement of loss and comprehensive loss.

The calculation of depletion expense for the three and nine months ended September 30, 2011 included estimated future development costs of \$467,000 (December 31, 2010 - \$467,000) associated with the development of the Company's non-impaired proved plus probable reserves.

In the periods ended September 30, 2011 and December 31, 2010, the Company did not capitalize any general and administrative expenses or share-based compensation expenses.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 8. PROPERTY, PLANT AND EQUIPMENT (CONTINUED)

	Property, plant and equipment \$
Cost:	
January 1, 2010	3,493,800
Additions	284,418
Divestitures	(62,060)
Change in decommissioning liabilities	30,117
December 31, 2010	3,746,275
Additions	47,727
Divestitures	(247,567)
Change in decommissioning liabilities	11,120
September 30, 2011	3,557,555
Accumulated depletion, depreciation and impairment losses:	
January 1, 2010	-
Depletion and depreciation expense	(125,007)
Impairment losses	(158,730)
December 31, 2010	(283,737)
Depletion and depreciation expense	(149,372)
September 30, 2011	(433,109)
Carrying amount:	
January 1, 2010	\$ 3,493,800
December 31, 2010	\$ 3,462,538
September 30, 2011	\$ 3,124,446

## 9. IMPAIRMENTS LOSSES

During the year ended December 31, 2010, the Company recorded an impairment loss of \$158,730 on its development and production oil and gas properties due to declining natural gas prices.

The Company also evaluated its E&E Medicine Hat CGU for impairment at December 31, 2010. As a result, the Company recorded an impairment loss of \$68,080 on its E&E assets as due to a land license expiry on this property.

## 10. DUE TO RELATED PARTY

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.

## 11. DECOMMISSIONING LIABILITIES

The Company's decommissioning liabilities result from its ownership interest in oil and natural gas assets including well sites and gathering systems. The total decommissioning liabilities is estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities and the estimated timing of the costs to be incurred in future years. The Company has estimated the net present value of the decommissioning liabilities to be \$775,870 as at September 30, 2011 (December 31, 2010: \$750,460) based on an undiscounted total future liability of \$875,092 (December 31, 2010 - \$865,350). These payments are expected to be made over the next 15 years. The discount factor, being the risk-adjusted rate related to the liability, is 3.75% (December 31, 2010: 4.1 %).

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 11. DECOMMISSIONING LIABILITIES (CONTINUED)

	\$
Decommissioning liabilities	
Balance, January 1, 2010	621,550
Adjustments to assumptions	(21,700)
Liabilities incurred	(18,750)
Accretion expense	39,140
Acquisition of abandonment liability	130,220
Balance, December 31, 2010	750,460
Adjustments to assumptions	11,120
Accretion expense	14,290
Balance, September 30, 2011	775,870

## 12. CAPITAL STOCK

- (a) Authorized:  
 Unlimited common shares without par value  
 Unlimited preferred shares without par value
- (b) Common shares issued and outstanding:

	Number of Common Shares	\$
Balance, January 1, 2010	17,490,900	4,694,403
Private placement – common shares (i)	6,000,000	300,000
Fair value of warrants issued (i)	-	(112,500)
Shares issued on settlement of debt (ii)	371,235	55,684
Ascribed value of warrants exercised	1,234,700	177,388
Balance, December 31, 2010	25,096,835	5,114,975
Ascribed value of warrants exercised	1,875,000	453,867
Ascribed value of options exercised	110,000	28,064
Balance, September 30, 2011	27,081,835	5,596,906

- (i) 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.
- (ii) 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 were subject to a four month hold period from the date of issuance.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 12. CAPITAL STOCK (CONTINUED)

### (c) Warrants issued and outstanding:

	Number of warrants	\$
Balance, January 1, 2010	4,450,000	185,093
Granted, private placements	6,000,000	112,500
Exercised	(1,234,700)	(32,183)
Expired	(1,215,300)	(53,017)
Balance, December 31, 2010	8,000,000	212,393
Exercised	(1,875,000)	(71,367)
Expired	(1,175,000)	(48,214)
Balance, September 30, 2011	4,950,000	92,812

A total of 4,950,000 warrants are exercisable on or before February 18, 2012 at an exercise price of \$0.10 per share.

### (d) Contributed surplus:

	\$
Balance, January 1, 2010	583,699
Stock-based compensation expense	80,000
Expired warrants	53,017
Balance, December 31, 2010	716,716
Stock-based compensation – option exercises	(10,464)
Expired warrants	48,214
Balance, September 30, 2011	754,466

### (e) Stock option plan:

The Company grants stock options to employees, officers, directors and consultants of the Company pursuant to an incentive plan. Under this plan, the exercise price of options granted cannot be less than the closing market price for the Company's common shares on the date of grant. Options vest immediately and expire three years from the date of grant.

The following table summarizes stock option transactions:

	Number of options	Weighted average exercise price (\$)
Balance, January 1, 2010	1,625,500	0.160
Granted	800,000	0.125
Forfeited	(100,000)	0.160
Balance, December 31, 2010	2,325,500	0.148
Exercised	(110,000)	0.160
Expired	(885,500)	0.160
Balance, September 30, 2011	1,330,000	0.139

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 12. CAPITAL STOCK (CONTINUED)

- (e) Stock option plan (continued):

The following table reflects the stock options outstanding as at June 30, 2011:

Exercise Price (\$)	Options Outstanding	Remaining Life (Years)	Options Exercisable
0.160	530,000	0.8	530,000
0.125	800,000	1.7	800,000
0.139	1,330,000	1.3	1,330,000

- (f) Loss per share:

The number of shares used to calculate the diluted net loss per share for the three and nine month periods ended September 30, 2011 included the weighted average number of Desmarais common shares outstanding of 27,081,835 and 26,828,886 for the year plus nil shares related to the dilutive effect of the conversion of stock options and warrants (2010 – 24,610,221 and 24,103,620 for the three month and nine month periods plus nil shares) as the stock options and warrants would be anti-dilutive.

## 13. COMMITMENTS AND CONTINGENCIES

- (a) Claims and Litigation

The Company is involved in various claims and potential litigation arising during the normal course of business. The outcome of these matters is uncertain and there can be no assurance that such matters will be resolved in the Company's favour. If the outcome is unfavourable, it could have a materially adverse impact on the Company's financial position and/or results of operations.

- (b) Office Lease

Desmarais' sublease for office premises expired as of September 30, 2011 and is currently on a month to month basis. The Company is committed to pay \$3,500 per month and provide one month's written notice to terminate.

See also Note 16 - Subsequent Events

- (c) 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 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.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 14. SUPPLEMENTAL CASH FLOW INFORMATION

Changes in non-cash working capital balances are comprised of the following as at September 30:

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2011	2010	2011	2010
	\$	\$	\$	\$
Accounts receivable	153,380	(266,107)	121,323	(276,397)
Deposits and prepaid expenses	(668)	25,605	(5,424)	1,704
Accounts payable and accrued liabilities	(382,175)	867,350	(379,349)	965,617
	(229,464)	626,848	(263,450)	690,924
Attributable to operating activities	52,667	17,583	135,909	88,363
Attributable to investing activities	(282,131)	608,995	(399,359)	602,561

## 15. 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.

A director has ownership in a private company that is a sublease tenant of Desmarais. During the nine month period ending September 30, 2011, Desmarais received office space and related service fees of \$13,500 (2010 - \$13,500). At both September 30, 2011 and December 31, 2010 \$nil was due to Desmarais from these companies.

A director is the President of a company that advanced \$2,560,000 under a demand facility to Desmarais. At September 30, 2011, interest totaling \$191,474 (2010 - \$184,779) was recorded by Desmarais to this company. At September 30, 2011, \$180,959 (December 31, 2010 - \$58,298) relating to interest was due and payable 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 \$90,500 as at September 30, 2011 (December 31, 2010 - \$71,250).

The President and Chief Executive Officer has partial ownership in a company that exchanged assets with Desmarais in January 2010 and is an ongoing joint venture partner in the Barrhead area. At September 30, 2011, a total of \$2,142 is due to this company (December 31, 2010 - \$5,895).

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 nine months ended September 30, 2011, the total of these royalties was \$3,674 (2010 - \$3,767) of which a balance of \$8,487 remained outstanding at September 30, 2011 (December 31, 2010 - \$5,841).

In 2010, Desmarais entered into joint venture agreements with companies controlled by a director. For the three months ended September 30, 2011, net amounts payable from net income arising from these ventures totaled \$5,249, of which \$1,125 remains payable at September 30, 2011. All amounts relating to capital activities were invoiced and paid in full as at September 30, 2011.

All related party transactions are in the normal course of business and have been measured at the agreed to exchange amounts, which are the amounts of consideration established and agreed to by the related parties and which are similar to those negotiated with third parties.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 16. SUBSEQUENT EVENTS

### Office Lease

On November 1, 2011, the Company received notice that the current sublease of office space would be terminated effective November 30, 2011.

In November 2011, the Company has entered into a new office lease agreement for a term of six months ending May 31, 2012 at a rate of \$4,400 per month starting on December 1, 2011.

The new address is: Suite 751, 815 – 8<sup>th</sup> Avenue S.W., Calgary, Alberta, T2P 3P2.

Telephone and fax numbers will remain unchanged.

## 17. FIRST TIME ADOPTION OF IFRS

The adoption of IFRS requires the application of IFRS 1. IFRS 1 generally requires that an entity retrospectively apply all IFRS effective at the end of its first IFRS reporting period; however IFRS 1 provides certain mandatory exceptions and permits limited optional exemptions. Certain IFRS 1 optional exemptions have been applied including:

- Deemed cost exemption for full cost oil and gas entities whereby exploration and evaluation assets were classified from the full cost pool to intangible exploration assets at the amount that was recorded under previous GAAP and the remaining full cost pool was allocated to the development assets and components pro rata using reserve values.
- Decommissioning liabilities exemption that allows any changes in decommissioning liabilities on transition to IFRS to be adjusted through opening deficit.
- Share-based compensation exemption that allows a company to only have to evaluate share-based compensation awards that were unvested as of the date of transition and that were issued subsequent to November 7, 2002.
- Business combinations exemption that allows a company to not have to restate any business combinations that occurred prior to the date of transition.

The accounting policies in note 3 (refer to the interim financial statements as at and for the three months ended March 31, 2011 for details) have been applied in preparing the interim financial statements for the three and nine months ended September 30, 2011, the comparative information for the three and nine months ended September 30, 2010, the financial statements for the year ended December 31, 2010 and the preparation of the opening IFRS statement of financial position at January 1, 2010, the Company's date of transition to IFRS. In preparing its opening IFRS statement of financial position, comparative information for the three and nine months ended September 30, 2010 and financial statements for the year ended December 31, 2010, the Company adjusted amounts previously reported in financial statements prepared in accordance with previous GAAP. An explanation of how the transition from previous GAAP to IFRS has affected the Company's financial position and financial performance is set out in the following tables and the notes accompanying the tables.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 17. FIRST TIME ADOPTION OF IFRS (CONTINUED)

(a) Reconciliation of statement of financial position from previous GAAP to IFRS:

At September 30, 2010:

	Note 16 (d)	Previous GAAP	Effect of transition to IFRS	IFRS
<b>ASSETS</b>				
<b>Current assets</b>				
Cash		\$ 475,614	\$ -	\$ 475,614
Accounts receivable		544,490	-	544,490
Deposits and prepaids		18,147	-	18,147
<b>Total current assets</b>		<b>1,038,251</b>	<b>-</b>	<b>1,038,251</b>
<b>Non-current assets</b>				
Reclamation deposits		39,508	-	39,508
Exploration and evaluation	(i)	-	133,068	133,068
Property, plant and equipment	(ii)	3,945,855	(438,240)	3,507,615
<b>Total non-current assets</b>		<b>3,985,313</b>	<b>(305,172)</b>	<b>3,680,191</b>
<b>TOTAL ASSETS</b>		<b>\$ 5,023,614</b>	<b>\$ (305,172)</b>	<b>\$ 4,718,442</b>
<b>LIABILITIES AND SHAREHOLDERS' DEFICIENCY</b>				
<b>LIABILITIES</b>				
<b>Current liabilities</b>				
Accounts payable and accrued liabilities		\$ 2,407,180	\$ -	\$ 2,407,180
Due to related parties		170,908	-	170,908
Loan – related parties		2,560,020	-	2,560,020
<b>Total current liabilities</b>		<b>5,138,108</b>	<b>-</b>	<b>5,138,108</b>
<b>Non-current liabilities</b>				
Decommissioning liabilities	(iii)	702,284	54,809	757,093
<b>Total non-current liabilities</b>		<b>702,284</b>	<b>54,809</b>	<b>757,093</b>
<b>TOTAL LIABILITIES</b>		<b>5,840,392</b>	<b>54,809</b>	<b>5,895,201</b>
<b>SHAREHOLDERS' DEFICIENCY</b>				
Common shares		5,067,475	-	5,067,475
Warrants		219,893	-	219,893
Contributed surplus		716,716	-	716,716
Accumulated losses	(vii)	(6,820,862)	(359,981)	(7,180,813)
<b>TOTAL DEFICIENCY</b>		<b>(816,778)</b>	<b>(359,981)</b>	<b>(1,176,759)</b>
<b>TOTAL LIABILITIES AND DEFICIENCY</b>		<b>\$ 5,023,614</b>	<b>\$ (305,172)</b>	<b>\$ 4,718,442</b>

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 17. FIRST TIME ADOPTION OF IFRS (CONTINUED)

(b) Reconciliation of statement of operations and comprehensive loss from previous GAAP to IFRS:

For the three months ended September 30, 2010:

	Note 16 (d)	Previous GAAP	Effect of transition to IFRS	IFRS
<b>REVENUE</b>				
Petroleum and natural gas revenue		\$ 138,745	\$ -	\$ 138,745
Royalties		(9,533)	-	(9,533)
Other income		6,001	-	6,001
Loss – debt settlements		(33,428)	-	(33,428)
		101,785	-	101,785
<b>EXPENSES</b>				
Production		88,450	10,628	99,078
General and administrative	(iv)	74,577	-	74,577
Depletion, depreciation and amortization	(v)	83,045	(25,829)	57,213
		246,069	(15,201)	230,868
Results from operating activities		(144,284)	(15,201)	(129,083)
Finance expenses (recoveries)	(iii), (vi)	63,782	5,400	69,182
Net income (loss) and comprehensive income (loss) for the period		\$ 208,066	\$ (20,601)	\$ (228,667)
Net income (loss) per share - Basic & diluted		\$ -	\$ -	\$ -

ii) For the nine months ended September 30, 2010:

	Note 16 (d)	Previous GAAP	Effect of transition to IFRS	IFRS
<b>REVENUE</b>				
Petroleum and natural gas revenue		\$ 374,785	\$ -	\$ 374,785
Royalties		(37,861)	-	(37,861)
Other income		18,171	-	18,171
Gain – debt settlements		367,691	-	367,691
		722,786	-	722,786
<b>EXPENSES</b>				
Production		265,109	21,281	286,390
General and administrative	(iv)	478,781	-	478,781
Depletion, depreciation and amortization	(v)	280,079	32,347	312,426
		1,023,969	53,628	1,077,597
Results from operating activities		(301,183)	(53,628)	(354,811)
Finance expenses	(iii), (vi)	185,300	33,630	218,930
Net loss and comprehensive loss for the period		\$ (486,483)	\$ (87,258)	\$ (573,741)
Net loss per share				
Basic & diluted		\$ (0.02)	\$ -	\$ (0.02)

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 17. FIRST TIME ADOPTION OF IFRS (CONTINUED)

### (c) Statements of Cash Flows

As the transition from former previous GAAP had no material impact on the cash flows generated by the Company, no comparative tables have been prepared.

### (d) Impact of transition to IFRS on 2010 results:

- (i) Exploration and Evaluation assets (“E&E”) – As required under IFRS 6, upon transition to IFRS, Desmarais reclassified \$127,072 from Property, Plant and Equipment (“PP&E”) to E&E, which primarily consisted of undeveloped exploration lands. The Company reclassified \$65,000 at December 31, 2010 (September 30, 2010 - \$133,068).

On transition to IFRS, the Company did not record an impairment loss on E&E assets. For the year ended December 31, 2010, the Company recorded impairment losses on E&E assets of \$68,068 (three and nine months ended June 30, 2010 - \$nil) due to the expiry of an exploration license due to non-development.

The following table summarizes the changes to E&E assets resulting from the transition to IFRS:

E&E assets	January 1, 2010 \$	September 30, 2010 \$	December 31, 2010 \$
Transferred from PP&E assets	127,072	133,068	133,068
Impairment losses	-	-	(68,068)
E&E assets as reported under IFRS	127,072	133,068	65,000

- (ii) Property, Plant and Equipment (“PP&E”) – The Company’s PP&E assets were allocated to CGU’s unlike under previous GAAP where all oil and natural gas assets are accumulated into one cost centre. The deemed cost of the Company’s oil and natural gas assets were allocated to CGU’s based on total proved plus probable reserve values as at January 1, 2010, in accordance with IFRS 1.

Under IFRS, impairment tests for PP&E are performed at a CGU level as opposed to the entire Company’s PP&E balance being subjected to a full cost ceiling test under previous GAAP. Impairment is recognized if the carrying value exceeds the recoverable amount for a CGU. The recoverable amount is determined using the greater of the fair value less costs to sell based on discounted future cash flows of proved plus probable reserves using forecast prices and costs, and the value in use. The Company recorded an impairment loss of \$236,114 on January 1, 2010, on transition to IFRS.

The following table summarizes the changes to PP&E assets resulting from the transition to IFRS:

PP&E assets	January 1, 2010 \$	September 30, 2010 \$	December 31, 2010 \$
PP&E assets as reported under previous GAAP	3,856,986	3,945,855	3,852,764
Transferred to E&E assets	(127,072)	(133,068)	(133,068)
Capitalized lease rentals expensed	-	(21,281)	(25,075)
Change in depletion, depreciation and amortization	-	(92,753)	(26,086)
Change impairment losses	(236,114)	(236,114)	(236,114)
Change in decommissioning liabilities	-	30,117	30,117
PP&E assets as reported under IFRS	3,493,800	3,492,756	3,462,538

- (iii) Decommissioning liabilities – Under previous GAAP, Desmarais’s decommissioning liabilities were discounted based on a credit adjusted risk-free rate which was 7 percent at December 31, 2009. Under IFRS, the Company is required to revalue its obligation at each balance sheet date using a current liability-specific discount rate. At transition, Desmarais revalued the obligation based on a risk-free rate of 4.1% resulting in a \$36,609 increase to the liability. Further, as a result of the change in the discount rate applied, accretion of decommissioning liabilities expense for the three and nine months ended September 30, 2010 was an decrease of \$4,064 and a decrease of \$11,917, respectively (year ended December 31, 2010 - decrease of \$15,736). The accretion of decommissioning liabilities expense has been included in finance expenses.

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 17. FIRST TIME ADOPTION OF IFRS (CONTINUED)

(d) Impact of transition to IFRS on 2010 results (continued):

(iii) Decommissioning liabilities (continued):

The following table summarizes the changes to decommissioning liabilities resulting from the transition to IFRS:

Decommissioning liabilities	January 1, 2010 \$	September 30, 2010 \$	December 31, 2010 \$
Decommissioning liabilities as reported under previous GAAP	584,941	702,284	699,448
Increase resulting from change in discount rate	36,609	36,609	36,609
Change in accretion expense	-	(11,917)	(15,736)
Change in net additions/(disposals) & abandonments	-	30,117	30,095
Decommissioning liabilities as reported under IFRS	621,550	757,093	750,460

(iv) Divestitures – Under previous GAAP, proceeds from divestitures were deducted from the full cost pool without recognition of a gain or loss unless the divestiture resulted in a change in the depletion rate of 20% or greater in which case, a gain or loss was recorded. Under IFRS, gains and losses are recorded on divestitures and are calculated as the difference between the proceeds and the net book value of the asset disposed of.

There was no impact on the transactions in 2010 as proceeds equaled net book value in all transactions.

(v) Depletion, depreciation and amortization expense – Under IFRS, Desmarais has chosen to calculate depletion expense based on proved plus probable reserves as opposed to proved reserves under previous GAAP. This has resulted in an decrease of depletion, depreciation and amortization expense for the three and nine month periods ended September 30, 2010 of \$25,829 and \$126,383, respectively (year ended December 31, 2010 - \$26,086). The Company has included impairment losses on PP&E in depletion, depreciation and amortization expense in the statement of loss and comprehensive loss.

The following table summarizes the changes to depletion, depreciation and amortization expense resulting from the transition to IFRS:

	Three months ended September 30, 2010 \$	Nine months ended September 30, 2010 \$	Year ended December 31, 2010 \$
Depletion, depreciation and amortization expense as reported under previous GAAP	83,042	280,079	333,510
Decrease in depletion, depreciation and amortization expense	(25,829)	(126,383)	(132,644)
Increase in impairment losses on PP&E	-	158,730	158,730
Depletion, depreciation and amortization as reported under IFRS	57,213	312,416	359,596

(vi) The following table summarizes the changes to accumulated losses resulting from the transition to IFRS:

	January 1, 2010 \$	September 30, 2010 \$	December 31, 2010 \$
Accumulated losses as reported under previous GAAP	(6,334,377)	(6,820,862)	(7,129,669)
Change in decommissioning liabilities	(36,609)	(33,630)	(20,895)
Change in depletion, depreciation and amortization	(236,114)	(312,426)	(262,200)
Change in capitalized lease rentals expensed	-	(21,281)	(25,075)
Change in impairment of E&E assets	-	-	(68,068)
Accumulated losses as reported under IFRS	(6,607,100)	(7,180,843)	(7,505,907)

# Desmarais Energy Corporation

Notes to the Financial Statements (Unaudited)

For the periods ended September 30, 2011

## 17. FIRST TIME ADOPTION OF IFRS (CONTINUED)

(d) Impact of transition to IFRS on 2010 results (continued):

(vii) The following table summarizes the changes to net loss and comprehensive loss resulting from the transition to IFRS:

	Three months ended September 30, 2010 \$	Nine months ended September 30, 2010 \$	Year ended December 31, 2010 \$
Net income (loss) and comprehensive income (loss) as reported under previous GAAP	(208,066)	(486,483)	(795,292)
Change in exploration and evaluation expenses	-	-	(68,068)
Change in depletion, depreciation and amortization expense	21,765	126,383	132,644
Change in impairment losses included in depletion, depreciation and amortization expense	-	(158,730)	(158,730)
Change in accretion of decommissioning liabilities	4,064	(33,630)	15,716
Change in capitalized lease rentals expensed	(10,628)	(21,281)	(25,075)
Net loss and comprehensive loss as reported under IFRS	(198,265)	(573,741)	(898,809)

# Desmarais Energy Corporation

Management's Discussion and Analysis

Third Quarter 2011

This Management's Discussion and Analysis ("MD&A") of financial results and related data of Desmarais Energy Corporation ("Desmarais" or the "Company") is reported in Canadian dollars and has been prepared in accordance with International Financial Reporting Standard 1, "First-time Adoption of International Financial Reporting Standards", and with International Accounting Standard 34 "Interim Financial Reporting", as issued by the International Accounting Standards Board. Previously, the Company prepared its Interim and Annual Financial Statements in accordance with Canadian generally accepted accounting principles ("previous GAAP"). To the extent which may be appropriate, this MD&A should be read in conjunction with the audited financial statements for the year ended December 31, 2010 and the unaudited interim condensed financial statements for the three and nine months ended September 30, 2011 and the three months ended March 31, 2011.

The commentary is as of November 29, 2011. The reader should be aware that historical results are not necessarily indicative of future performance.

In conformity with Canadian Securities Administrator's National Instrument ("NI") NI 51-101 "Standards of Disclosure for Oil and Gas Activities", natural gas volumes have been converted to equivalent barrels of oil ("BOE") using a conversion ratio of nine thousand cubic feet ("mcf") of natural gas to one BOE. This ratio is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. Readers are cautioned that BOE may be misleading, particularly if used in isolation.

## Forward Looking Statements

*This MD&A contains forward-looking statements. Management's assessment of future plans and operations, capital expenditures, methods of financing capital expenditures and the ability to fund financial liabilities, expected commodity prices and the impact on Desmarais, future operating costs, future transportation costs, expected change in royalty rates, interest rates and the timing of and impact of adoption of IFRS and other accounting policies may constitute forward-looking statements under applicable securities laws and necessarily involve risks including, without limitation, risks associated with oil and gas exploration, development, exploitation, production, marketing and transportation, loss of markets, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, inability to retain drilling rigs and other services, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions, the inability to fully realize the benefits of the acquisitions, delays resulting from or inability to obtain required regulatory approvals, ability to access sufficient capital from internal and external sources, and litigation risks. As a consequence, the Company's actual results may differ materially from those expressed in, or implied by, the forward looking statements. Forward looking statements or information are based on a number of factors and assumptions which have been used to develop such statements and information but which may prove to be incorrect. Although Desmarais believes that the expectations reflected in such forward-looking statements or information are reasonable, undue reliance should not be placed on forward looking statements because the Company can give no assurance that such expectations will prove to be correct. In addition to other factors and assumptions which may be identified in this document and other documents filed by the Company, assumptions have been made regarding, among other things: the impact of increasing competition; the ability of the Company to obtain qualified staff, equipment and services in a timely and cost efficient manner; drilling results; the ability of the operator of the projects which the Company has an interest in to operate the field in a safe, efficient and effective manner; Desmarais's ability to obtain financing on acceptable terms; field production rates and decline rates; the ability to reduce operating costs; the ability to replace and expand oil and natural gas reserves through acquisition, development or exploration; the timing and costs of pipeline, storage and facility construction and expansion; the ability of the Company to secure adequate product transportation; future oil and natural gas prices; currency, exchange and interest rates; the regulatory framework regarding royalties, taxes and environmental matters in the jurisdictions in which the Company operates; and Desmarais's ability to successfully market its oil and natural gas products. Readers are cautioned that the foregoing list of factors is not exhaustive. Additional information on these and other factors that could affect the Company's operations and financial results are included in reports on file with Canadian securities regulatory authorities and may be accessed through the SEDAR website ([www.sedar.com](http://www.sedar.com)). Furthermore, the forward looking statements contained in this document are made as at the date of this document and the Company does not undertake any obligation to update publicly or to revise any of the included forward looking statements, whether as a result of new information, future events or otherwise, except as may be required by applicable securities laws.*

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### Non-IFRS Measurements

The MD&A contains the term cash flow from operations ("cash flow"), which should not be considered an alternative to or more meaningful than, "cash flow from operating activities" as determined in accordance with IFRS as an indicator of the Company's financial performance. Desmarais' determination of cash flow from operations may not be comparable to that reported by other companies. The reconciliation between net earnings and cash flow from operations can be found in the statements of cash flows in the financial statements. The Company evaluates its performance based on net income and cash flow from operations. The Company considers cash flow from operations to be a key measure as it demonstrates the Company's ability to generate the cash necessary to repay debt and to fund future growth through capital investment. Cash flow from operations per share is calculated using the diluted weighted average number of shares for the period.

### RESULTS OF OPERATIONS

(\$, except boe/d)	Three months ended September 30		Nine Months ended September 30	
	2011	2010	2011	2010
Production				
Oil and liquids	15	11	7	12
Natural gas	181	250	178	166
Boe/d (6:1)	45	53	37	40
Petroleum and natural gas sales	106,392	138,745	354,828	374,785
Royalties	(1,158)	(9,533)	(33,403)	(37,861)
Operating	(133,408)	(99,078)	(318,935)	(286,390)
Operating (loss) netback	(28,174)	30,134	2,490	50,534
Other income	15,999	6,001	53,193	18,171
General and administrative	(92,458)	(74,577)	(286,611)	(398,781)
Financing - interest paid	-	(113,782)	(67,134)	(185,300)
Cash flow used in operations	(104,633)	(152,224)	(298,062)	(515,376)
Depletion, depreciation and amortization	(47,237)	(57,213)	(149,372)	(312,426)
Stock-based compensation	-	-	-	(80,000)
Gain - debt settlements	20,553	(33,428)	62,368	367,691
Financing - accretion & unpaid interest	(53,385)	44,600	(153,109)	(33,630)
Net loss	(184,702)	(198,265)	(538,175)	(573,741)

### Production

An average of 45 BOE/d and 37 BOE/d was produced in the three and nine month periods ended September 30, 2011, down from the 53 BOE/d and 40 BOE/d in the corresponding periods last year, primarily due to natural declines in production during 2011.

### Revenue

For the three months ended September 30, 2011, revenues were down compared to the same period in 2010 due to lower natural gas sales volumes and prices along with lower oil & natural gas liquids production that were partially offset by improved oil and natural gas liquids sales prices.

For the nine months ended September 30, 2011, revenues were down compared to the same period in 2010 due to lower natural gas sales prices along with lower oil & natural gas liquids production that were partially offset by increased natural gas sales volumes and improved oil and natural gas liquids sales prices.

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(\$)	Three months ended September 30		Nine Months ended September 30	
	2011	2010	2011	2010
Revenue				
Oil and liquids	47,772	72,940	178,870	201,798
Natural gas	58,620	65,805	176,558	172,987
<b>Total</b>	<b>106,392</b>	138,745	<b>355,428</b>	374,785
Desmarais average prices				
Oil and liquids (\$/bbl)	92.58	54.55	89.26	63.18
Natural gas (\$/mcf)	3.45	3.51	3.64	3.75
Oil equivalent (\$/boe)	25.91	32.09	32.71	34.93

### Royalties

	Three months ended September 30		Nine Months ended September 30	
	2011	2010	2011	2010
Royalties	\$ 1,158	\$ 9,533	\$ 33,403	\$ 37,861
Per boe	\$ 0.28	\$ 2.20	\$ 3.08	\$ 3.47
Percentage of revenue	1.1%	6.9%	9.4%	10.1%

Royalties on current production for the three and nine month periods ended September 30, 2011 were lower primarily due to higher oil and liquids selling prices being offset by decreased natural gas sales prices and drilling credit recoveries in the third quarter of 2011.

### Operating Costs

(\$, except per boe)	Three months ended September 30		Nine Months ended September 30	
	2011	2010	2011	2010
Operating costs	133,408	99,078	318,935	286,390
Per boe	\$ 32.49	\$ 22.91	\$ 29.41	\$ 26.23

The increase in operating costs for the third quarter and first nine months of 2011 reflects additional amounts due to inclement weather and annual maintenance activities performed in the third quarter of 2011.

This was partially offset by the reduced cost of natural gas processing achieved through the acquisition of the Barrhead area pipeline infrastructure. This allows Desmarais to utilize a lower cost production facility and continue profitable natural gas operations in the area.

### Other Income

Other income totaled \$15,999 for the third quarter of 2011 and \$53,193 for the first nine months of 2011 as compared to \$6,001 and \$18,171 for the corresponding periods in 2010. In 2011, other income reflects increased

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third party recoveries for usage of Desmarais' Barrhead area pipeline infrastructure and equipment rental recoveries compared to the same periods in 2010.

### Gain – Debt Settlements

A total of \$20,553 and \$62,368 was recorded in the three and nine months, respectively, ended September 30, 2011 (\$33,428) and \$367,691 for the three and nine months ended September 30, 2010) as the result of ongoing settlement agreements and resolutions reached with trade creditors.

### General and Administrative

(\$, except per boe)	Three months ended September 30		Nine Months ended September 30	
	2011	2010	2011	2010
General and administrative	92,458	74,577	286,611	478,781
Per boe	\$ 22.52	\$ 17.25	\$ 26.43	\$ 43.84

The expenditures for general and administrative expenses have increased during the third quarter due to increased costs. The reduction for the first nine months of 2011 is due to decreased shareholders relations activities. Stock based compensation is \$nil for the three and nine month periods ended September 30, 2011 as compared to \$80,000 for the corresponding periods in 2010.

The reduction in total expenditures reflects ongoing cost minimization efforts.

### Financing Costs

(\$)	Three months ended September 30		Nine Months ended September 30	
	2011	2010	2011	2010
Interest	48,655	64,052	205,953	185,570
Accretion - decommissioning liabilities	4,730	5,130	14,290	33,360
Financing expenses	53,385	69,182	220,243	218,930
Interest paid	-	113,782	67,134	185,300

Interest for the three and nine months ended September 30, 2011 totaled \$48,655 and \$205,953 as compared to \$64,054 and \$185,570 in 2010.

Accretion of decommissioning liabilities is now classified as a financing cost. Accretion for the three months and nine months ended September 30, 2011 totaled \$4,730 and \$14,290 as compared to \$5,130 and \$33,360 for the corresponding periods in 2010.

The Company suspended interest payments in the second quarter of 2011.

### Depletion, Depreciation and Amortization

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(\$, except per boe)	Three months ended September 30		Nine Months ended September 30	
	2011	2010	2011	2010
Depletion, depreciation and accretion Per BOE	47,237 \$ 11.50	57,213 \$ 13.23	149,372 \$ 13.77	312,426 \$ 28.61

Depletion, depreciation and amortization during the three and nine months ended September 30, 2011 totaled \$47,237 and \$149,372 respectively as compared to \$57,213 and \$312,426 for the corresponding 2010 periods. In 2011, lower total depletion provisions include additional yearend 2010 reserve additions while the 2010 amounts include impairment provisions.

### Taxes

No tax expense was recorded in either the third quarter or first nine months of 2011 and 2010.

No tax asset has been recognized due to the uncertainty of future utilization.

### Cash and Funds from Operations and Net Loss

(\$, except per share amounts)	Three months ended September 30		Nine Months ended September 30	
	2011	2010	2011	2010
Funds used in operating activities	(51,966)	(80,603)	(162,153)	(427,013)
Change in non-cash working capital	(52,667)	(71,621)	(135,909)	(88,363)
Cash flow used in operations	(104,633)	(72,224)	(298,062)	(515,376)
Per share - basic and diluted	\$ -	\$ -	\$ (0.01)	\$ (0.02)
Net loss	(184,702)	(198,265)	(538,175)	(573,741)
Per share - basic and diluted	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.03)

### Capital Expenditures

Capital expenditures for the three and nine months ended September 30, 2011 totaled \$1,614 and \$47,727 compared to \$238,158 and \$242,386 during the corresponding period in 2010. Under IFRS, no amounts are included for non-productive lease rentals in both periods as they are recorded as operations expenses.

In the three and nine month periods ended September 30, 2011, the Company continued to minimize capital activity to conserve working capital. These expenditures in the first nine months of 2011 include the Company's share of acquiring additional lands in the Barrhead area and minor field and office equipment replacement.

Effective January 1, 2010, Desmarais acquired significant additional interests in wells and infrastructure in the Barrhead area in a non-cash exchange of assets. Desmarais assumed the current asset retirement obligations for these properties and exchanged the Company's rights to a gross overriding royalty. See also related party transactions.

Dispositions totaled \$247,567 for the third quarter and nine months ended September 30, 2011. This was the result of the recovery of costs related to a joint venture partner failing to complete an agreement. In 2010, \$nil & \$12,060 was realized on a disposition in the corresponding periods.

### LIQUIDITY AND CAPITAL RESOURCES

Funding for the Company's capital expenditure program has come from joint venture partners and equity raised during the last year. The Company had negative cash flow from operations for the period and this trend is

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expected to continue until such time as the Company is able to establish a higher production base, which it hopes to achieve through a combination of drilling and strategic acquisitions. Desmarais currently does not have a credit facility with any commercial lending institution. Desmarais will require significant additional financing and creditor co-operation in order to execute its business plan.

### Working Capital

As at September 30, 2011, the Company had a non-cash working capital deficiency, excluding the loan from a related party, of \$1,587,311 compared to \$1,744,310 at December 31, 2010. In addition, there was \$89,184 in the Company's bank accounts as at September 30, 2011 (\$48,136 as at December 31, 2010).

### Share Capital

As at the date of this report, 27,081,835 common shares of Desmarais are outstanding. (September 30, 2011 - 27,081,835).

There are no off-balance sheet financing arrangements.

### Notice of Intention to Make a Proposal - Bankruptcy and Insolvency Act Filing on September 26, 2011

On September 26, 2011, Desmarais filed a Notice of Intention to Make a Proposal (the "NOI") to its creditors pursuant to Part III, Division I of the *Bankruptcy and Insolvency Act* (the "Act"). An Order was granted by the Court of Queen's Bench of Alberta (the "Court") and was initially in effect until October 26, 2011 and was subsequently extended to December 9, 2011, at which time the matter will be reviewed by the Court. While the Order is in effect the Company is working with a court-appointed Trustee.

Subsequent to the end of the third quarter, the Company filed the proposal (the "Proposal") to its creditors on November 18, 2011 and provided the details of the Proposal to be voted on at a meeting of the Affected Creditors on December 8, 2011.

The key terms of the Proposal are *inter alia* as follows:

- a) All unsecured claims filed with the Trustee pursuant to the Proposal that are admitted by the Trustee, or are otherwise determined to be valid claims by the Court ("Affected Creditors"), shall be treated as one class for purposes of both voting on the Proposal and for distributions under the Proposal. For greater certainty, to the extent that a creditor has a form of secured charge or a preferred claim, but because of the priority of that charge or claim in relation to the claim of the secured lender 323 Holdings Ltd ("323") and the estimated liquidated value of the assets of Desmarais, that creditor would effectively be unsecured for all or a portion of its claim if Desmarais were liquidated as of the date of filing of the NOI. Consequently, such claim shall be treated as unsecured for purposes of the Proposal and the creditor shall be entitled to prove the unsecured portion of its claim as an Affected Creditor;
- b) Affected Creditors whose admitted claims are less than \$100 shall be satisfied in full by way of a cash payment;
- c) Affected Creditors whose admitted claims are greater than \$100 will be entitled to choose between the two following options:
  - i. receive common shares of Desmarais (the "Common Shares"), valued at \$0.08/common share for purposes of the Proposal, based on the full value of their admitted claim. (For greater certainty, an Affected Creditor would receive 12,500 Common shares for every \$1,000 of admitted claim);

or

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ii. participate in a cash distribution from a cash pool totalling \$40,000 (the "Cash Pool") and receive the lesser of the pro rata portion of their admitted claim in respect of those creditors electing to participate in the Cash Pool; or 10% of the admitted claim. Under this alternative, a creditor must assign its entire claim to a third party.

d) Distributions under the terms of the Proposal are subject to the levy payable to the Office of the Superintendent of Bankruptcy as prescribed by S.147 of the Act.

The Proposal must be approved by both:

- a) a majority in number and 2/3 in dollar value of those Affected Creditors voting on the Proposal (the "Statutory Majority of Creditors"); and
- b) the Court.

The Company has scheduled an application for Court approval of the Proposal on December 9, 2011.

The Proposal provides that the following claims shall be unaffected by the Proposal and shall be paid in accordance with the existing terms, or as otherwise agreed between Desmarais and the respective parties:

- a) the claim of 323, subject to that portion of the outstanding obligation to be treated as unsecured pending the contingent reduction of the value of 323's secured claim as discussed above;
- b) any Debtor-in-Possession financing obligations;
- c) any claim subject to the Administration Charge as provided for by the October 26 order of the Court;
- d) any claim for goods and services supplied subsequent to the date of filing of the NOI; and
- e) any claim that may ultimately be determined to rank in priority to 323 including outstanding property taxes.

In the event the Proposal is not approved by both the Statutory Majority of Creditors and the Court, Desmarais shall irrevocably be deemed to have thereupon immediately made an assignment in bankruptcy in which case neither the Cash Pool nor the Common Shares will be available to Affected Creditors and 323 would proceed to appoint a Receiver to realize on the Company's assets.

### **RELATED PARTY TRANSACTIONS AND MANAGEMENT AND BOARD COMPENSATION**

A director is the President of a company that advanced \$2,560,000 under a demand facility to Desmarais. At September 30, 2011, interest totaling \$191,474 (2010 - \$184,779) was recorded by Desmarais to this company. At September 30, 2011, \$180,959 (December 31, 2010 - \$58,298) relating to interest was due and payable 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 \$90,500 as at September 30, 2011 (December 31, 2010 - \$71,250).

The President and Chief Executive Officer has partial ownership in a company that exchanged assets with Desmarais in January 2010 and is an ongoing joint venture partner in the Barrhead area. At September 30, 2011, a total of \$2,142 is due to this company (December 31, 2010 - \$5,895).

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 nine months ended September 30, 2011, the total of these royalties was \$3,674 (2010 - \$3,767) of which a balance of \$8,487 remained outstanding at September 30, 2011 (December 31, 2010 - \$5,841).

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In 2010, Desmarais entered into joint venture agreements with companies controlled by a director. For the three months ended September 30, 2011, net amounts payable from net income arising from these ventures totaled \$5,249, of which \$1,125 remains payable at September 30, 2011. All amounts relating to capital activities were invoiced and paid in full as at September 30, 2011.

All related party transactions are in the normal course of business and have been measured at the agreed to exchange amounts, which are the amounts of consideration established and agreed to by the related parties and which are similar to those negotiated with third parties.

### CONTINGENCIES AND COMMITMENTS

#### Claims and Litigation

The Company is involved in various claims and potential litigation arising during the normal course of business. The outcome of these matters is uncertain and there can be no assurance that such matters will be resolved in the Company's favour. If the outcome is unfavourable, it could have a materially adverse impact on the Company's financial position and/or results of operations.

#### Office Lease

Desmarais' sublease for office premises expired as of September 30, 2011 and is currently on a month to month basis. The Company is committed to pay \$3,500 per month. On November 1, 2011, the Company received notice that the current sublease of office space would be terminated effective November 30, 2011.

In November 2011, the Company has entered into a new office lease agreement for a term of six months ending May 31, 2012 at a rate of \$4,400 per month starting on December 1, 2011. The new address is: Suite 751, 815 – 8<sup>th</sup> Avenue S.W., Calgary, Alberta, T2P 3P2. Telephone and fax numbers will remain unchanged.

#### 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 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.

### OUTLOOK

The Company anticipates the required level of Affected Creditor support resulting in acceptance of the Proposal to Creditors at the meeting on December 8, 2011.

Currently, completion of a third farm out well is underway in the Barrhead core area. This drilling program has resulted in two Banff oil discoveries and a potential gas well. All the locations defined with Desmarais' proprietary 3-D seismic. Going forward, two vertical well locations and the Company's first horizontal well location have been selected for the next phase of drilling to follow up our recent successes. With a significant drill ready project inventory in a multi-zone environment, strong land position and more than 25 kilometers of operated pipeline infrastructure, Desmarais has positioned itself for a strong return to profitable operations.

Desmarais expects natural gas prices to remain in the range of \$3.00 to \$4.00 per MCF through the end of 2011. No hedging contracts are in place or contemplated for the Company in the near future. Combined with the Company outlook for oil to remain strong at approximately \$85.00 per barrel (WTI), our plans to increase drilling activity in our West Central Alberta core area should yield the financial strength and flexibility to take advantage of new opportunities.

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### ADDITIONAL DISCLOSURES

#### Risk Assessment

There are a number of risks facing participants in the Canadian oil and gas industry. Some risks are common to all businesses while others are specific to the Company. The following are a number of identifiable business risks faced by Desmarais which will evolve and additional risks will emerge periodically. The risks shown are those identified by management at the date of completion of this report and may not describe all of the risks faced by the Company.

#### Substantial Capital Requirements

The Company anticipates making substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the future. As the Company's revenues may decline as a result of decreased commodity pricing, it may be required to reduce capital expenditures. In addition, uncertain levels of near term industry activity coupled with the present global credit crisis exposes the Company to additional financing risks. There can be no assurance that debt or equity financing, or funds generated by operations will be available or sufficient to meet these requirements or for other corporate purposes or, if debt or equity financing is available, that it will be on terms acceptable to the Company. The inability of the Company to access sufficient capital for its operations could have a material adverse effect on the Company's business financial condition, results of operations and prospects.

#### Third Party Credit Risk

The Company may be exposed to third party credit risk through its contractual arrangements with its current or future joint venture partners, marketers of its petroleum and natural gas production and other parties. In the event such entities fail to meet their contractual obligations to the Company, such failures may have a material adverse effect on the Company's business, financial condition, results of operations and prospects. In addition, poor credit conditions in the industry and of joint venture partners may impact a joint venture partner's willingness to participate in the Company's ongoing capital program, potentially delaying the program and the results of such program until the Company finds a suitable alternative partner.

### QUARTERLY RESULTS

(\$, except per share amounts)	IFRS							Canadian GAAP	
	Sep-11	Jun-11	Mar-11	Dec-10	Sep-10	Jun-10	Mar-10	Dec-09	Sep-09
Petroleum and natural gas sales	106,392	131,746	116,690	109,970	138,745	95,195	140,845	139,671	113,573
Cash flow used in operations	(104,633)	(66,570)	(126,859)	(221,313)	(91,596)	(173,036)	(102,158)	(933,030)	(38,442)
Funds (used in) from operating activities	(51,966)	28,623	(138,810)	(101,235)	(80,350)	(154,157)	(138,810)	(101,752)	(80,603)
Net loss	(184,702)	(144,667)	(208,806)	(325,065)	(198,265)	(30,726)	(344,750)	(884,674)	(421,708)
Per share - basic and diluted	(0.01)	-	(0.01)	(0.01)	(0.01)	-	(0.02)	(0.05)	(0.03)
Total assets	3,612,685	4,146,730	4,589,396	4,028,428	4,718,442	3,917,126	4,123,524	4,189,605	4,669,598

Desmarais' petroleum and natural gas sales, cash flow and funds from operating activities and net income are all impacted by production levels and volatile commodity pricing. From 2009 to 2011, these performance measures have fluctuated as a result of volatile commodity prices and escalating cost of royalties and operations.

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Significant factors and trends that have impacted the Company's results during the above periods include:

- Revenue is directly impacted by the Company's ability to replace existing declining production and add incremental production through its on-going capital expenditure program
- Cash flow from operations over the past two years is a cumulative negative amount as production levels have not increased enough to support operating costs and the requisite staffing levels required to operate a publicly listed oil and gas company
- The working capital deficiency has increased due to a minimal amount of new equity
- Total assets have not grown materially due to capital expenditure activities being funded by joint venture partners

## SIGNIFICANT ACCOUNTING POLICIES

### Changes in accounting policies and practices

The following discussion explains the significant differences between Desmarais' previous GAAP accounting policies and those applied by the Company under International Financial Reporting Standards ("IFRS"). IFRS policies have been retrospectively and consistently applied except where specific IFRS 1 optional and mandatory exemptions permitted an alternative treatment upon transition to IFRS for first-time adopters.

The most significant changes to the Company's accounting policies relate to the accounting for exploration and evaluation costs and decommissioning liabilities. Refer to Note 16 of the September 30, 2011 Financial Statements as well as Notes 3 and 16 of the March 31, 2011 Financial Statements for additional disclosures and illustrative information for differences between IFRS and previously applied GAAP.

### Recent accounting pronouncements

In May 2011, the IASB issued four new standards and two amendments. Five of these items related to consolidation, while the remaining one addresses fair value measurement. All of the new standards are effective for annual periods beginning on or after January 1, 2013. Early adoption is permitted.

IFRS 11 "Joint Arrangements" replaces IAS 31, "Interests in Joint Ventures". IFRS 11 divides joint arrangements into two types, each having its own accounting model. A "joint operation" continues to be accounted for using proportionate consolidation, where a "joint venture" must be accounted for using equity accounting. This differs from IAS 31, where there was the choice to use proportionate consolidation or equity accounting for joint ventures. A "joint operation" is defined as the joint operators having rights to the assets, and obligations for the liabilities, relating to the arrangement. In a "joint venture", the joint ventures' have rights to the net assets of the arrangement, typically through their investment in a separate joint venture entity.

IFRS 12 "Disclosure of Interests in Other Entities" is a new standard, which combines all of the disclosure requirements for subsidiaries, associates and joint arrangements, as well as unconsolidated structured entities.

IFRS 13 "Fair Value Measurement" is a new standard meant to clarify the definition of fair value, provide guidance on measuring fair value and improve disclosure requirements related to fair value measurement.

IAS 28 "Investments in Associates and Joint Ventures" has been amended as a result of the issuance of IFRS 11 and the withdrawal of IAS 31. The amended standard sets out the requirements for the application of the equity method when accounting for interest in joint ventures, in addition to interests in associates.

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The IASB intends to replace IAS 39, "Financial Instruments: Recognition and Measurements" ("IAS39") with IFRS 9, "Financial Instruments" ("IFRS 9"). IFRS 9 will be published in three phases, of which the first phase has been published.

The first phase addresses the accounting for financial assets and financial liabilities. The second phase will address the impairment of financial instruments, and the third phase will address hedge accounting.

For financial assets, IFRS 9 uses a single approach to determine whether a financial asset is measured at amortized cost or fair value, and replaces the multiple rules in IAS 39. The approach in IFRS 9 is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. The new standard also requires a single impairment method to be used, replacing the multiple impairment methods in IAS 39. For financial liabilities, although the classification criteria for financial liabilities will not change under IFRS 9, the approach to the fair value option for financial liabilities may require different accounting for changes to the fair value of a financial liability as a result of changes to an entity's own credit risk. IFRS 9 is effective for annual periods beginning on or after January 1, 2013 with different transitional arrangements depending on the date of initial application.

The Company is currently evaluating the impact of adopting all of the newly issued and amended standards on our financial statements.

### **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

Desmarais' significant accounting policies are disclosed in Note 3 to the September 30, 2011 and March 31, 2011 financial statements.

Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. These accounting policies are discussed below and are included to aid the reader in assessing the critical accounting policies and practices of the Company and the likelihood of materially different results being reported. Desmarais' management reviews its estimates regularly. The emergence of new information and changed circumstances may result in actual results or changes to estimate amounts that differ materially from current estimates.

The following assessment of significant accounting policies and associated estimates is not meant to be exhaustive. The Company might realize different results from the application of new accounting standards promulgated, from time to time, by various rule-making bodies.

### **Exploration and Evaluation and Impairment Evaluation**

Fair value of exploration and evaluation assets is determined based on market value to an arm's length buyer as described in property and equipment above. As E&E assets are not proven assets, they have uncertainties that make it difficult to assess future cash flows; as such market conditions and assessment by management are used to determine fair value.

Exploration and evaluation assets are assessed for impairment if:

- (i) sufficient data exists to determine technical feasibility and commercial viability, and
- (ii) facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For purposes of impairment testing, exploration and evaluation assets are allocated to cash-generating units.

The technical feasibility and commercial viability of extracting an oil and gas resource is considered to be determinable when proven reserves are determined to exist. Upon determination of proven reserves, intangible exploration and evaluation assets attributable to those reserves are first tested for impairment and then reclassified from exploration and evaluation assets to a separate category within tangible assets referred to as oil and natural gas development and production assets.

# Desmarais Energy Corporation

### Reserves

Estimation of reported recoverable quantities of proved and probable reserves include judgmental assumptions regarding production profile, commodity prices, exchange rates, remediation costs, timing and amount of future development costs, and production, transportation and marketing costs for future cash flows. It also requires interpretation of geological and geophysical models in order to make an assessment of the size, shape, depth and quality of reservoirs, and their anticipated recoveries. The economical, geological and technical factors used to estimate reserves may change from period to period. Changes in reported reserves can impact the carrying values of the Company's petroleum and natural gas properties and equipment, the calculation of depletion and depreciation, the provision for decommissioning obligations, and the recognition of deferred tax assets due to changes in expected future cash flows. The recoverable quantities of reserves and estimated cash flows from Desmarais' petroleum and natural interests are independently evaluated by reserve engineers at least annually.

The Company's petroleum and natural gas reserves represent the estimated quantities of crude oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be economically recoverable in future years from known reservoirs and which are considered commercially producible. Such reserves may be considered commercially producible if management has the intention of developing and producing them and such intention is based upon (i) a reasonable assessment of the future economics of such production; (ii) a reasonable expectation that there is a market for all or substantially all the expected oil and natural gas production; and (iii) evidence that the necessary production, transmission and transportation facilities are available or can be made available.

Reserves may only be considered proven and probable if productive capacity is supported by either production or conclusive formation tests. Desmarais' oil and gas reserves are determined pursuant to National Instrument 51-101, Standard of Disclosures for Oil and Gas Activities.

### Decommissioning obligations

The Company estimates future remediation costs of production facilities, well sites and gathering systems at different stages of development and construction of assets or facilities. In most instances, removal of assets occurs many years into the future. This requires judgment regarding abandonment date, future environmental and regulatory legislation, the extent of reclamation activities, the engineering methodology for estimating cost, future removal technologies in determining the removal cost and liability-specific discount rates to determine the present value of these cash flows.

### Stock-based compensation

All share-based awards issued by the Company are fair valued using the Black-Scholes option-pricing model. In assessing the fair value of share-based compensation, estimates have to be made regarding the expected volatility in share price, option life, dividend yield, risk-free rate and estimated forfeitures at the initial grant date.

### Impairment of assets

The impairment testing of PP&E is based on estimates of proved plus probable reserves, production rates, forecasted petroleum and natural gas prices, future costs and other relevant assumptions. Desmarais assets are aggregated into cash-generating units, for the purpose of calculating impairment, based on their ability to generate largely independent cash flows. By their nature, these estimates and assumptions are subject to measurement uncertainty and may impact the carrying value of the Company's assets in future periods.

### Income Tax Accounting

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment subsequent to the financial statement reporting period. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded by management.