Questfire Energy Corp.

Audited Financial Statements

For the year ended December 31, 2012

(amounts in Canadian dollars)

Independent Auditors' Report

To the Shareholders
Questfire Energy Corp.

We have audited the accompanying financial statements of Questfire Energy Corp., which comprise the balance sheets as at December 31, 2012 and December 31, 2011, and the statements of loss and comprehensive loss, statements of changes in equity and statements of cash flows for the years ended December 31, 2012 and December 31, 2011, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Questfire Energy Corp. as at December 31, 2012 and December 31, 2011, and its financial performance and its cash flows for the years ended December 31, 2012 and December 31, 2011 in accordance with International Financial Reporting Standards.

Emphasis of Matter

We draw attention to note 2(b) to the financial statements which describes conditions that indicate the existence of a material uncertainty that may cast significant doubt about the Corporation’s ability to continue as a going concern. Our opinion is not qualified in respect of this matter.

Signed “Collins Barrow Calgary LLP”

CHARTERED ACCOUNTANTS

Calgary, Canada
April 28, 2013

Questfire Energy Corp.
Balance Sheets
(amounts in Canadian dollars)

	Note		December 31, 2012		December 31, 2011
Assets					
Current assets					
Cash and cash equivalents	17	$	395,288	$	4,473,765
Accounts receivable	4(c)		200,482		141,875
Deposits and prepaid expenses			36,948		30,000
Total current assets			632,718		4,645,640
Non-current assets					
Property and equipment	6		3,140,632		607,648
Exploration and evaluation assets	7		1,910,773		3,390,131
Total non-current assets			5,051,405		3,997,779
Total assets		$	5,684,123	$	8,643,419
Liabilities					
Current liabilities					
Accounts payable and accrued liabilities	4(d)	$	323,024	$	1,920,082
Flow-through share commitments	19		1,840,817		-
Flow-through share premium	13(e)		-		966,970
Total current liabilities			2,163,841		2,887,052
Non-current liabilities					
Decommissioning provisions	9		227,198		128,297
Convertible Class B Shares	10		3,966,350		3,638,810
Convertible debentures	11		1,352,811		-
Deferred tax liabilities	12		47,849		756,069
Total liabilities			7,758,049		7,410,228
Shareholders' Equity					
Share capital	13(b)		4,193,633		4,193,633
Equity component of convertible Class B Shares	10		(2,081,352)		(2,081,352)
Equity component of convertible debentures	11		79,767		-
Warrants	11		28,295		-
Contributed surplus			134,770		25,327
Deficit			(4,429,039)		(904,417)
Total equity attributable to equity holders of the Corporation			(2,073,926)		1,233,191
Total liabilities and shareholders' equity		$	5,684,123	$	8,643,419

Going concern (note 2(b))
Commitments (note 20)
Subsequent events (note 21)

See accompanying notes to the financial statements.

(Signed) "Richard Dahl", Director

(Signed) "Roger MacLeod", Director

Questfire Energy Corp.

Statements of Loss and Comprehensive Loss

(amounts in Canadian dollars)

	Note	Year ended December 31, 2012	Year ended December 31, 2011
Revenue			
Oil and natural gas sales		$ 509,124	$ -
Royalties		(31,057)	-
		478,067	-
Expenses			
Production and operating		180,948	-
Transportation		24,321	-
General and administrative		1,192,008	599,274
Stock-based compensation	14(b)	109,443	25,327
Flow-through share indemnity and penalties	19	1,840,817	-
Exploration and evaluation		1,251,733	177,825
Depletion and depreciation	6	299,209	8,700
Write-down of property and equipment	6(c)	313,500	-
		5,211,979	811,126
		(4,733,912)	(811,126)
Finance income	15	11,296	23,547
Finance expense	15	(513,216)	(75,305)
Net finance expense		(501,920)	(51,758)
Loss before income taxes		(5,235,832)	(862,884)
Deferred income tax recovery	12	1,711,210	15,160
Loss and comprehensive loss for the year		$ (3,524,622)	$ (847,724)
Loss per share			
Basic and diluted	13(f)	$ (0.28)	$ (0.08)

See accompanying notes to the financial statements.

Questfire Energy Corp.

Statements of Changes in Equity

(amounts in Canadian dollars)

	Note	Share capital	Equity component of convertible Class B Shares	Equity component of convertible debentures	Warrants	Contributed surplus	Deficit	Total equity
Balance at December 31, 2010		$ 1,573,679	$ -	$ -	$ -	$ -	$ (56,693)	$ 1,516,986
Issuance of Common Shares	13(d)	50,000	-	-	-	-	-	50,000
Issuance of flow-through Class A Shares	13(e)	3,088,000	-	-	-	-	-	3,088,000
Issuance of flow-through Class B Shares	10	-	(2,081,352)	-	-	-	-	(2,081,352)
Share issuance costs, net of tax	13(b)	(518,046)	-	-	-	-	-	(518,046)
Stock-based compensation related to stock options		-	-	-	-	25,327	-	25,327
Loss for the year		-	-	-	-	-	(847,724)	(847,724)
Balance at December 31, 2011		4,193,633	(2,081,352)	-	-	25,327	(904,417)	1,233,191
Issuance of convertible debenture units, net of issuance costs and income taxes	11	-	-	79,767	28,295	-	-	108,062
Stock-based compensation related to stock options	14(b)	-	-	-	-	109,443	-	109,443
Loss for the year		-	-	-	-	-	(3,524,622)	(3,524,622)
Balance at December 31, 2012		$ 4,193,633	$ (2,081,352)	$ 79,767	$ 28,295	$ 134,770	$ (4,429,039)	$ (2,073,926)

See accompanying notes to the financial statements.

Questfire Energy Corp.
Statements of Cash Flows
(amounts in Canadian dollars)

	Note	Year ended December 31, 2012	Year ended December 31, 2011
Cash and cash equivalents provided by (used in):			
Cash flows from (used in) operating activities			
Loss for the year		$ (3,524,622)	$ (847,724)
Adjustments for:			
Depletion and depreciation	6	299,209	8,700
Deferred income tax recovery	12	(1,711,210)	(15,160)
Exploration and evaluation impairment	7	999,309	-
Write-down of property and equipment	6(c)	313,500	-
Net finance expense	15	501,920	51,758
Stock-based compensation	14(b)	109,443	25,327
Change in non-cash working capital	5	1,835,842	22,754
Net cash used in operating activities		(1,176,609)	(754,345)
Cash flows from (used in) investing activities			
Additions to exploration and evaluation assets	7	(2,373,779)	(3,514,361)
Additions to property and equipment	6	(196,542)	(6,026)
Interest received	15	11,296	23,547
Change in non-cash working capital	5	(1,672,679)	1,680,165
Net cash used in investing activities		(4,231,704)	(1,816,675)
Cash flows from (used in) financing activities			
Proceeds from issuance of common shares	13(d)	-	6,226,000
Proceeds from issuance of convertible debenture units	11	1,510,000	-
Issuance costs	11	(65,503)	(690,728)
Interest paid	15	(129,702)	(13,427)
Change in non-cash working capital	5	15,041	21,378
Net cash from financing activities		1,329,836	5,543,223
Change in cash and cash equivalents		(4,078,477)	2,972,203
Cash and cash equivalents, beginning of year		4,473,765	1,501,562
Cash and cash equivalents, end of year		$ 395,288	$ 4,473,765

See accompanying notes to the financial statements.

1. General business description

Questfire Energy Corp. ("Questfire" or the "Corporation") was incorporated under the laws of Alberta on January 15, 2010. The Corporation is engaged in the exploration for and development and production of oil and natural gas and may conduct its activities jointly with others; these financial statements reflect only the Corporation's proportionate interest in such activities. The Corporation's Class A Shares and Class B Shares are listed on the TSX Venture Exchange (TSX-V). The address and principal place of business of the Corporation is Suite 400, 703 – 6th Ave S.W., Calgary, Alberta, T2P 0T9.

2. Basis of preparation and going concern

(a) Statement of compliance

These financial statements were prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) and interpretations of the International Financial Reporting Interpretations Committee.

The financial statements were authorized for issuance by the Board of Directors on April 28, 2013.

(b) Going concern

These financial statements were prepared on the going-concern basis that assumes the Corporation will be able to realize its assets and discharge its liabilities in the normal course of operations. At December 31, 2012 the Corporation had a working capital deficit of $1,531,123 and the net cash used in operating activities for the year ended December 31, 2012 is $1,176,609. These factors indicate a material uncertainty that casts significant doubt on the Corporation's ability to continue as a going concern. The Corporation's ability to continue as a going concern depends upon its ability to attain profitable operations and to generate funds there from and/or financing from third parties sufficient to meet future obligations. Subsequent to year end (Note 21) the Corporation has signed an asset purchase agreement to acquire certain producing assets and anticipates closing this transaction on or before April 30, 2013. Assuming the transaction closes the funds generated from operations related to these assets and the available bank financing will be well in excess of the current working capital deficit. The Corporation had raised $1,510,000 through the issuance of convertible debentures during the year ended December 31, 2012, however, there is no assurance that further debt or future equity financings will be available on acceptable terms to meet the Corporation's ongoing obligations. These financial statements do not reflect the adjustments that would be necessary to the presentation and carrying amounts of the assets and liabilities if the Corporation were not able to continue operations and such adjustments and reclassifications could be material.

(c) Basis of measurement

The financial statements were prepared on the historical cost basis except for certain financial assets and financial liabilities, which are measured at fair value.

(d) Functional and presentation currency

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

(e) 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 judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Accounting estimates will, by definition, seldom equal the actual results. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future years affected.

The following discussion sets forth management's most critical estimates and assumptions in determining the value of assets, liabilities and equity:

Depletion and depreciation and valuation of property and equipment (P&E)

The amounts recorded for depletion and depreciation of P&E and the valuation of P&E are based on estimates. These estimates include proved and probable reserves, production rates, future oil and natural gas prices, future development costs, remaining lives and periods of future benefits of the related assets and other relevant assumptions.

The Corporation's reserve estimates are evaluated annually pursuant to *National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities*.

Valuation of exploration and evaluation (E&E) assets

The valuation of E&E assets depends on the discovery of economically recoverable reserves which in turn depends on future oil and natural gas prices, future capital expenditures, technical success and environmental and regulatory restrictions.

Decommissioning provisions

The value of decommissioning liabilities depends on estimates of current risk-free interest rates, future restoration and reclamation expenditures and the timing of those expenditures.

Valuation of accounts receivable

The valuation of accounts receivable is based on management's best estimate of the provision for doubtful accounts.

Income taxes

The amounts recorded for deferred income taxes are based on estimates as to the timing of the reversal of temporary differences and tax rates currently substantively enacted. They are also based on estimates of the probability of the Corporation utilizing certain tax pools and assets which, in turn, depends on estimates of proved and probable reserves, production rates, future petroleum and natural gas prices and changes in legislation, tax rates and interpretations by taxation authorities. The availability of tax pools is subject to audit and interpretation by taxation authorities.

Share-based compensation

The amounts recorded relating to the fair value of stock options and warrants granted are based on estimates of the future volatility of the Corporation's share price, estimated market price of the Corporations shares at grant date, expected lives of the options and warrants, expected dividends and other relevant assumptions.

Share capital, flow-through share premium, convertible Class B Shares and convertible debentures

The amounts recorded as share capital, flow-through share premium, convertible Class B Shares and convertible debentures are based on factors including estimated value of Class A Shares on issuance date excluding the flow-through provision, the Corporation's estimated borrowing rates if debt were incurred, estimated market interest rates for similar non-convertible instruments and other relevant assumptions.

3. Significant accounting policies

(a) Jointly controlled operations and jointly controlled assets

Many of the Corporation's oil and natural gas activities involve jointly controlled assets and are conducted under joint operating agreements. The financial statements include the Corporation's share of these jointly controlled assets, the relevant revenue and related costs.

(b) Cash and cash equivalents

Cash and cash equivalents consist of amounts on deposit with banks, term deposits and other similar short-term highly liquid investments with maturities of 90 days or less at the date of issuance. Bank overdrafts that are repayable on demand and form an integral part of the Corporation's cash management are included as a component of cash and cash equivalents.

(c) E&E and P&E expenditures

(i) E&E assets

Costs incurred prior to acquiring the legal rights to explore an area are charged to net income as E&E expense.

E&E costs include the costs of acquiring licenses, exploratory drilling, geological and geophysical activities, acquisition of mineral and surface rights and technical studies. E&E costs are capitalized as E&E assets when the technical feasibility and commercial viability of extracting oil and natural gas reserves have yet to be determined. E&E assets are measured at cost and are not depleted or depreciated. E&E assets, net of any impairment loss, are transferred to P&E when proved and/or probable reserves are recognized.

E&E assets are assessed for impairment when facts and circumstances suggest that the carrying amount exceeds the recoverable amount. E&E assets are also assessed for impairment upon their reclassification to P&E.

Exchanges or swaps that involve only E&E assets are accounted for at cost. Any gains or losses from the divestiture of E&E assets are recognized in the statement of income (loss).

(ii) P&E

All costs directly associated with the development of oil and natural gas interests are capitalized on an area-by-area basis as oil and natural gas interests and are measured at cost less accumulated depletion and depreciation and net impairment losses. These costs include expenditures for areas where technical feasibility and commercial viability have been determined. These costs include property acquisitions with proved and/or probable reserves, development drilling, completion and equipping of wells, gathering systems and other infrastructure, decommissioning liabilities and transfers from E&E assets.

Costs of replacing parts of P&E are capitalized only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in income as incurred. The carrying amount of any replaced or sold component is derecognized. The costs of the day-to-day servicing of P&E are recognized in income as incurred.

Exchanges or swaps of P&E are measured at fair value unless the transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up can be reliably estimated. When fair value is not used, the cost of the acquired asset is measured at the carrying amount of the asset given up. Any gains or losses from the divestiture of P&E are recognized in the statement of income (loss).

(iii) Depletion and depreciation

Oil and natural gas interests are depleted using the unit-of-production method by reference to the ratio of production in the year to the related proved plus probable reserves, taking into account estimated future development costs. Production and reserves of natural gas are converted to equivalent barrels of crude oil on the basis of 6,000 cubic feet of gas to 1 barrel of oil. Changes in estimates used in prior periods, such as proved plus probable reserves, that affect the unit-of-production calculations do not give rise to prior-period adjustments and are dealt with on a prospective basis.

Processing facilities and well equipment will be depleted using the unit-of-production method along with the related reserves when the assets are designed to have a life similar to the reserves of the related wells with little or no residual value. Where facilities and equipment, including major components, have differing useful lives, they are depreciated separately on a straight-line basis over the estimated useful life of the respective items.

Other assets, referred to as corporate and other, are depreciated on a declining balance basis at rates approximating their estimated useful lives.

The estimated annual rates for other assets are as follows:

Furniture and fixtures	20 %
Office equipment	20 %
Computer hardware	30 %
Computer software	50 %

(d) Impairment of non-financial assets

The carrying amounts of the Corporation's non-financial assets, other than E&E assets and deferred tax assets, are reviewed for indicators of impairment at each reporting date. If there are indicators of impairment, the recoverable amount of the asset is estimated. E&E assets are assessed for impairment when they are reclassified to P&E or if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purposes of assessing impairment, E&E assets and P&E are grouped into separate cash-generating units (CGUs), defined as the lowest level for which there is separately identifiable independent cash inflow. Goodwill, if any, is allocated to the CGUs that are expected to benefit from the synergies of the business combination creating the goodwill.

The recoverable amount of a CGU is the greater of its fair value less costs to sell and its value in use. Fair value is determined to be the amount for which the asset could be sold in an arm's-length transaction between knowledgeable and willing parties. Fair value less costs to sell may be determined using discounted future net cash flows of proved plus probable reserves using forecast prices and costs and including future development costs. These cash flows are discounted at an appropriate discount rate, which would be applied by a market participant. Value in use is determined by estimating the present value of the future net cash flows to be derived from the continued use of the CGU in its present form. These cash flows are discounted at a rate based on the time value of money and risks specific to the CGU.

An impairment loss is recognized if the carrying amount of an asset or its CGU exceeds its recoverable amount. An impairment loss recognized in respect of a CGU is allocated first to reduce the carrying amount of any goodwill allocated to the CGU and then to reduce the carrying amounts of the other assets in the CGU on a pro rata basis. Impairment losses are recognized in the statement of income (loss).

Impairment losses recognized in prior years are assessed at each reporting date for any indication that the loss has decreased or no longer exists. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation or amortization, if no impairment loss had been recognized. A goodwill impairment loss is not reversed.

(e) Provisions and contingent liabilities

Provisions are recognized by the Corporation when it has a legal or constructive obligation as a result of past events, the obligation's amount can be reliably estimated and it is probable that an outflow of economic resources will be required to settle it. Provisions are stated at the present value of the expected settlement expenditure. The obligation is not recorded and is disclosed as a contingent liability if it is not probable that an outflow will be required, if the amount cannot be estimated reliably or if the existence of the outflow can only be confirmed by the occurrence of a future event.

(i) *Decommissioning provisions*

Decommissioning provisions are recognized for decommissioning and restoration obligations associated with the Corporation's E&E assets and P&E. The best estimate of the expenditure required to settle the present obligation at the balance sheet date is recorded on a discounted basis using the pre-tax risk-free interest rate. The future cash flow estimates are adjusted to reflect the risks specific to the liability. The value of the obligation is added to the carrying amount of the associated E&E or P&E asset and is depleted or amortized over the useful life of the asset. The provision is accreted over time through charges to financing expenses with actual expenditures charged against the accumulated obligation. Changes in the future cash flow estimates resulting from revisions to the estimated timing or amount of undiscounted cash flows or the discount rate are recognized as changes in the decommissioning provision and related asset. Actual decommissioning expenditures up to the recorded liability at the time are charged against the provision as the costs are incurred. Any differences between the recorded provision and the costs incurred are recorded as a gain or loss in the statement of income (loss).

(f) Flow-through shares

From time to time, the Corporation finances a portion of its exploration and development activities through the issuance of flow-through shares. Under the flow-through share agreements, the tax attributes of the related expenditures are renounced to subscribers. The stated capital recorded on flow-through share issuances is equal to the estimated fair value of the Common Shares, exclusive of the flow-through component, on the date of issuance. The difference between the gross proceeds received and the stated capital recorded is a liability ("flow-through share premium") until qualifying expenditures are incurred. When the expenditures are incurred the resulting deferred tax liability is recorded through income tax expense less the reversal of the flow-through share premium previously recorded.

(g) Income taxes

Income tax expense comprises current and deferred tax. Income tax expense is recognized in the statement of income (loss) except to the extent that it relates to items recognized directly in equity or other comprehensive income.

Current tax is the expected tax payable on the taxable income for the year and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized using the liability method, providing for temporary differences between the carrying amounts of assets and liabilities and the amounts used for taxation purposes. Deferred tax liabilities are generally recognized for all taxable temporary differences. Deferred tax assets are generally recognized for all deductible temporary differences to the extent that it is probable that taxable profits will be available against which those deductible temporary differences can be utilized.

Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same taxation authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

(h) Compound financial instruments

The components of compound instruments are classified separately as financial liabilities and equity in accordance with the substance of the contractual arrangement. At the issuance date, the fair value of the liability component is estimated using the prevailing market interest rate for a similar non-convertible instrument. This amount is recorded as a liability based on amortized cost until the instrument is converted or matures. The equity component is determined by deducting the liability component from the total fair value of the compound instrument and is recognized as equity, net of income tax effects, with no subsequent re-measurement.

(i) Leases

Leases that transfer substantially all of the benefits and risks of ownership to the Corporation are accounted for at the commencement of the lease term as finance leases and are recorded as P&E at the fair value of the leased asset or, if lower, at the present value of the minimum lease payments, together with an offsetting liability. Finance charges are allocated to each period so as to achieve a constant rate of interest on the remaining balance of the liability and are charged directly against income. Capitalized leased assets are depreciated over the shorter of the estimated useful life of the asset and the lease term. All other leases are accounted for as operating leases and the lease costs are expensed as incurred.

(j) Revenue

Revenue from the production of oil and natural gas is recognized when title passes from the Corporation to the customer. Transportation costs are reported as a separate expense and are not netted against revenue.

(k) Finance income and expenses

Finance income, consisting of interest income, is recognized as it accrues in the statement of income, using the effective interest rate method.

Finance expense comprises interest expense on borrowings, including convertible debentures, and flow-through expenditures made under the "look-back rule", accretion of the discount on decommissioning provisions, accretion of the convertible Class B Share liability, accretion on convertible debenture and impairment losses recognized on financial assets.

Borrowing costs incurred for the acquisition or construction of qualifying assets are capitalized during the period required to complete and prepare the assets for their intended use or sale. A qualifying asset is one that takes substantial time to get ready for use or sale.

When funds are borrowed specifically to finance a project, the amount capitalized represents the actual borrowing costs. When the funds used to finance a project form part of general borrowing, the amount capitalized is calculated using the weighted average of rates applicable to the Corporation's relevant general borrowing during the period.

All other borrowing costs are recognized in the statement of income (loss) in the period in which they are incurred using the effective interest rate method.

(l) Share-based payments

Stock options and warrants granted to its directors, officers, employees and consultants are accounted for using the fair value method under which compensation expense is recorded based on the estimated fair value of the options and warrants at the grant date using the Black-Scholes option pricing model.

The Corporation measures share-based payments to non-employees at the fair value of the goods or services received at the date of receipt of the goods or services. If the fair value of the goods or services cannot be measured reliably, the value of the options/warrants granted will be used, measured using the Black-Scholes option pricing model.

Each tranche in an award is considered a separate award with its own vesting period and grant date fair value. Compensation cost is expensed over the vesting period with a corresponding increase in contributed surplus. When stock options are exercised, the cash proceeds along with the amount previously recorded as contributed surplus are recorded as share capital. A forfeiture rate is estimated on the grant date and is adjusted to reflect the number of options that vest.

(m) Earnings (loss) per share

Basic earnings (loss) per share is calculated by dividing net and comprehensive income or loss by the weighted average number of common shares outstanding during the period. Diluted per share information reflects the potential dilutive effect of options, warrants, convertible debentures and convertible Class B Shares. The Corporation computes the dilutive impact on common shares assuming the proceeds received from the pro forma exercise of in-the-money share options and warrants are used to purchase common shares at average market prices. The number of Class A Shares assumed to be issued upon conversion of each Class B Share will be equal to $10.00 divided by the greater of $1.00 and the weighted average trading price of the Class A Shares for the last 30 consecutive trading days as of the balance sheet date.

(n) Financial instruments

(i) *Classification and measurement*

Financial instruments are measured at fair value on their initial recognition. Measurement in subsequent periods depends on whether the financial instrument has been classified as “fair value through the statement of income”, “loans and receivables”, “available-for-sale”, “held-to-maturity”, or “financial liabilities measured at amortized cost” as defined by International Accounting Standard (IAS) 39, “Financial Instruments: Recognition and Measurement”.

Financial assets and financial liabilities at “fair value through the statement of income” are either classified as “held for trading” or “designated at fair value through the statement of income” and are measured at fair value with changes in fair value recognized in the income statement. Transaction costs are expensed when incurred. The Corporation accounts for cash and cash equivalents and derivative commodity contracts as “fair value through the statement of income”.

Financial assets and financial liabilities classified as “loans and receivables”, “held-to-maturity” or “financial liabilities measured at amortized cost” are measured at amortized cost using the effective interest method of amortization. “Loans and receivables” are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. “Held-to-maturity” financial assets are non-derivative investments that an entity has the intention and ability to hold to maturity. “Financial liabilities measured at amortized cost” are non-derivative financial liabilities not designated as “fair value through the statement of income”. The Corporation has designated accounts receivable as “loans and receivables”, and accounts payable and accrued liabilities, flow-through share commitments, convertible Class B Shares and convertible debentures as “financial liabilities measured at amortized cost”.

Financial assets classified as "available-for-sale" are measured at fair value, with changes in fair value recognized in other comprehensive income. Available-for-sale financial assets are non-derivatives either designated as such or remaining unclassified in other categories.

(ii) *Derivative financial instruments*

The Corporation may enter into certain financial derivative contracts in order to manage its commodity price market risk. The Corporations policy is not to utilize derivative financial instruments for speculative purposes. All financial derivative contracts are classified as "fair value through the statement of income".

Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and the combined instrument is not measured at fair value through the statement of income. Changes in the fair value of separable embedded derivatives are recognized immediately in the statement of income. The Corporation has not identified any embedded derivatives.

(iii) *Share capital*

Class A Shares are classified as equity. Convertible Class B Shares and convertible debentures are classified as compound instruments. Incremental costs directly attributable to the issuance of Class A Shares, stock options and warrants are recognized as a reduction from equity, net of any tax effects.

(iv) *Impairment*

The Corporation assesses at each balance sheet date whether there is objective evidence that financial assets, other than those designated as "fair value through the statement of income", are impaired. If so, the cumulative loss is recognized in the statement of income. For financial assets carried at amortized cost, the amount of the impairment loss recognized is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate. When an available-for-sale financial asset is considered impaired, cumulative gains or losses previously recognized in other comprehensive income are reclassified to the statement of income in the period. Impairment losses may be reversed in subsequent periods.

(o) Recent accounting pronouncements

Accounting standards and amendments to existing standards not yet effective

The Corporation has reviewed new and revised accounting standards that have been issued but are not yet effective, and determined that the following may have an impact on the Corporation.

For the annual periods beginning on or after January 1, 2013, the Corporation will be required to adopt the following:

IFRS 7, “Financial Instruments” provides additional information about offsetting of financial assets and liabilities. Additional disclosures will be required to enable users of financial statements to evaluate the effect or potential effect of netting arrangements on the entity’s financial position.

IFRS 10, “Consolidated Financial Statements” provides a single model to be applied in control analysis for all investees including special purpose entities.

IFRS 11, “Joint Arrangements” redefines joint arrangements into two types, joint operations and joint ventures, each with their own accounting model. All joint operations will need to be proportionately consolidated and joint ventures to be equity accounted.

IFRS 12, “Disclosure of Interests in Other Entities” combines in a single standard the disclosure requirements for subsidiaries, associates and joint arrangements as well as unconsolidated structured entities.

IFRS 13 “Fair Value Measurement” defines the fair value, establishes a framework for measuring fair value and sets out disclosure requirements for fair value measurements. This standard defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

In addition to the issuance of new standards as detailed above, there have also been amendments to existing standards, which are also effective January 1, 2013, including:

IAS 1 “Presentation of Financial Statements”, amended to require presentation of an additional opening balance sheet when an entity applies an accounting policy retrospectively or makes a retrospective restatement or reclassification and to clarify the disclosure requirements.

IAS 32 “Financial Instruments: Presentation”, amended to clarify the criteria that should be considered in determining whether an entity has a legally enforceable right of offset in respect of its financial instruments and clarifying the treatment of income taxes related to distributions and transaction costs.

For annual periods beginning on or after January 1, 2015, the Corporation will be required to adopt:

IFRS 9 "Financial Instruments". The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value.

The Corporation has not yet completed its assessment and evaluation of the effect of adopting the new and amended standards and the impact it may have on its financial statements.

4. Financial instruments and risk management

(a) Risk management overview

The Corporation's activities expose it to a variety of financial risks including credit risk, liquidity risk and market risk. This note presents information about the Corporation's exposure to each of the above risks, the Corporation's objectives, policies and processes for measuring and managing risk, and the Corporation's management of capital. Further quantitative disclosure is included throughout this document. The Corporation employs risk management strategies and polices to ensure that risk exposure complies with its business objectives and risk tolerance. While the Board of Directors has overall responsibility for the Corporation's risk management framework, Questfire's management monitors the risks and administers the risk management measures.

(b) Fair value of financial instruments

The fair values of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and flow-through share commitments approximate their carrying value due to the short-term maturity of those instruments. The fair value of the convertible debentures is approximated by their carrying value given interest rates the Corporation believes it would currently have to pay on an instrument with similar terms.

The fair value of convertible Class B Shares at December 31, 2012 was determined to be $972,720 based on the market price of $1.75 per Class B Share on that date.

The fair value of financial derivatives, including commodity contracts, if any, is determined by discounting the difference between the contracted prices and published forward price curves as at the balance sheet date, using the remaining contracted oil and natural gas volumes and a risk-free interest rate adjusted for the Corporation's non-performance risk and the non-performance risk of the counterparty.

(amounts in Canadian dollars)

The significance of inputs used in making fair-value measurements is examined and classified according to a fair-value hierarchy. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly, and are based on valuation models and techniques where the inputs are derived from quoted indices. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement.

Cash and cash equivalents are measured at fair value based on their Level 1 designation. Derivative financial instruments, including commodity contracts, if any, are measured at fair value based on a Level 2 designation.

(c) Credit risk

Credit risk is the risk of financial loss to the Corporation if a customer or counterparty to a financial instrument fails to meet its contractual obligations. The Corporation is exposed to credit risk with respect to accounts receivable and cash and cash equivalents.

Substantially all of the Corporation’s accounts receivable are due from purchasers of Questfire’s oil and natural gas production, joint venture partners and government agencies and are subject to normal industry credit risk. Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. The Corporation mitigates the credit risk associated with the marketing of its petroleum and natural gas production by establishing the marketing relationships with large, credit-worthy purchasers.

Significant changes in industry conditions and risks that weaken partners' ability to generate cash flow will increase collection risk. Questfire’s management believes the risk is mitigated by the size and reputation of the companies to which the Corporation extends credit and believes all receivables will be collected.

As at December 31, 2012 and December 31, 2011, the Corporation’s accounts receivable were comprised of the following:

	Carrying amount	
	December 31, 2012	December 31, 2011
Oil and natural gas sales	$ 53,264	$ -
GST and other	147,218	141,875
	$ 200,482	$ 141,875

(amounts in Canadian dollars)

The Corporation considers all amounts greater than 90 days past due. As at December 31, 2012 $NIL are past due. The Corporation manages the credit exposure related to cash and cash equivalents by selecting financial institutions with high credit ratings and monitors all short-term deposits to ensure an adequate rate of return. Given these credit ratings, management does not expect any counterparty to fail to meet its obligations.

(d) Liquidity risk

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they are due. The Corporation's approach to managing liquidity is to ensure it will have sufficient liquidity to meet its liabilities when due. The Corporation's liquidity is affected by various external events and conditions, including commodity price fluctuations and global economic instability.

The Corporation expects to repay its financial liabilities in the normal course of operations and to fund future operational, capital and other obligations through future operating cash flow, as well as future equity and debt financings (see notes 2(b) and 21).

The Corporation's accounts payable and accrued liabilities as at December 31, 2012 and December 31, 2011 are aged as follows:

	December 31, 2012	December 31, 2011
0 to 30 days	$ 300,212	$ 1,920,082
31 to 60 days	20,358	-
61 to 90 days	2,454	-
Greater than 90 days	-	-
Total accounts payable and accrued liabilities	$ 323,024	$ 1,920,082

The Corporation expects to satisfy its obligations under accounts payable and accrued liabilities and flow-through share commitments of $1,840,817 within the next year.

The Corporation is also subject to future commitments as disclosed in note 20.

(e) Market risk

Market risk is the risk that changes in market prices, such as commodity prices, interest rates and foreign exchange rates, will reduce the Corporation's net earnings or the value of financial instruments. These risks are largely outside the Corporation's control. The Corporation's objective is to manage and mitigate market risk exposure within acceptable limits, while maximizing returns. Market risks are as follows:

Foreign currency risk

Crude oil prices are determined in global markets and generally denominated in United States dollars. Natural gas prices obtained by the Corporation are influenced by U.S. and Canadian supply and demand and, to a much lesser degree, by imports of liquefied natural gas. An increase in the value of the Canadian dollar relative to the U.S. dollar will decrease the revenues received from the sale of oil and natural gas. The impact of such exchange rate fluctuations cannot be predicted. As at December 31, 2012 and December 31, 2011, the Corporation had no forward exchange rate contracts nor any working capital denominated in foreign currencies.

Interest rate risk

Interest rate risk is the risk that future cash flows will fall as a result of changes in market interest rates. The Corporation is currently not exposed to interest rate cash flow risk as its borrowing bears interest at a fixed rate. The Corporation had no interest rate swaps or financial contracts in place as at or during the year ended December 31, 2012 or the year ended December 31, 2011.

Commodity price risk

The Corporation's operations expose it to fluctuations in commodity prices. Commodity prices for oil and natural gas are affected by global economic events that influence supply and demand. Questfire's management continuously monitors commodity prices and may consider risk-management instruments when it deems appropriate.

The Corporation'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 Corporation, however, may consider the appropriateness of entering into long-term, fixed-price marketing contracts. Its policy is to enter into commodity price contracts when considered appropriate to a maximum of 50 percent of forecast production volume. The Corporation may enter into derivative financial instruments, being collars, to meet this objective. Collars ensure that the commodity prices realized will fall into a contracted range for a contracted sale volume based on the monthly index price. Monthly gains and losses are determined based on the differential between the daily settlement price and the monthly index price when the monthly index price falls between the floor and the ceiling.

(f) Capital management

The Corporation's capital management policy is to maintain a strong capital base that optimizes the Corporation's ability to grow and to maintain investor and creditor confidence, and provides a platform to create value for its shareholders. The Corporation maintains a flexible capital structure to maximize its ability to pursue oil and natural gas exploration opportunities and to sustain future development of the business. The Corporation monitors risks for each capital project to balance the proportion of debt and equity in its capital structure. The Corporation's officers are responsible for managing its capital and do so through quarterly meetings and regular reviews of financial information including budgets and forecasts. The Corporation's Board of Directors is responsible for overseeing this process. The Corporation considers its capital structure to include shareholders' equity (deficiency), convertible Class B Shares liability, convertible debentures and bank debt, if any.

The Corporation monitors capital based on its current working capital, projected cash flow from operations and anticipated capital expenditures. In order to manage its capital structure, the Corporation prepares annual capital expenditure and operating budgets, which are updated as necessary. The annual and updated budgets are prepared by management and approved by the Board of Directors. The budget results are regularly reviewed and updated as required.

In order to maintain or adjust the capital structure, the Corporation may issue shares, seek debt financing and adjust its capital spending to manage its current and projected capital structure. The Corporation's ability to raise additional debt or equity financing is affected by external conditions, including future commodity prices, particularly of natural gas, and by global economic conditions. The Corporation continually monitors business conditions including: changes in economic conditions, the risk encountered in its drilling programs, forecast commodity prices, and potential corporate or asset acquisitions.

The Corporation has no externally imposed capital requirements and has not paid or declared any dividends since the date of incorporation. Other than issuing convertible debentures (see note 11), there were no changes to the Corporation's approach to capital management during the year ended December 31, 2012 (also see note 21).

(amounts in Canadian dollars)

5. Supplemental cash flow information

Changes in non-cash working capital are comprised of:

	Year ended December 31, 2012	Year ended December 31, 2011
Source (use) of cash:		
Accounts receivable	$ (58,607)	$ (136,319)
Deposits and prepaid expenses	(6,948)	(21,728)
Accounts payable and accrued liabilities	(1,597,058)	1,882,344
Flow-through share commitments	1,840,817	-
	$ 178,204	$ 1,724,297
Related to operating activities	$ 1,835,842	$ 22,754
Related to investing activities	(1,672,679)	1,680,165
Related to financing activities	15,041	21,378
Changes in non-cash working capital	$ 178,204	$ 1,724,297

(amounts in Canadian dollars)

6. Property and equipment (P&E)

	Oil and natural gas interests	Corporate and other	Processing and other equipment	Total
Cost				
Balance at December 31, 2010	$ -	$ 30,856	$ -	$ 30,856
Transfer from E&E assets (note 7)	548,619	-	-	548,619
Additions	-	6,026	-	6,026
Decommissioning provision	35,247	-	-	35,247
Balance at December 31, 2011	583,866	36,882	-	620,748
Transfer from E&E assets (note 7)	2,907,002	-	-	2,907,002
Additions	196,542	-	-	196,542
Decommissioning provision	42,149	-	-	42,149
Balance at December 31, 2012	$ 3,729,559	$ 36,882	$ -	$ 3,766,441
Depletion, depreciation and impairment losses				
Balance at December 31, 2010	$ -	$ 4,400	$ -	$ 4,400
Depletion and depreciation for the year	-	8,700	-	8,700
Balance at December 31, 2011	-	13,100	-	13,100
Impairment loss	313,500	-	-	313,500
Depletion and depreciation for the year	292,109	7,100	-	299,209
Balance at December 31, 2012	$ 605,609	$ 20,200	$ -	$ 625,809

	Oil and natural gas interests	Corporate and other	Processing and other equipment	Total
Net book value:				
At December 31, 2010	$ -	$ 26,456	$ -	$ 26,456
At December 31, 2011	$ 583,866	$ 23,782	$ -	$ 607,648
At December 31, 2012	$ 3,123,950	$ 16,682	$ -	$ 3,140,632

(a) Contingencies

Although the Corporation believes that it has title to its oil and natural gas interests, it cannot control or completely protect itself against the risk of title disputes or challenges.

(amounts in Canadian dollars)

(b) Capitalized general and administrative and financing costs

To December 31, 2012, the Corporation has not capitalized any general and administrative expenses to P&E. No interest has been capitalized.

(c) Impairment

During the year ended December 31, 2012, the Corporation recorded an impairment of its P&E of $313,500, which was recorded as a write-down of P&E on the statement of loss and comprehensive loss. The impairment related to the Corporation's Niton ($28,500) and Richdale ($285,000) CGUs and was a result of management's assessment of expected future recoverable proved and probable reserves of the related asset being reduced from previous estimates. The impairment loss was based on the fair value less cost to sell of the CGU, estimated based on a 10 percent & 15 percent discounted cash flow model for Niton and Richdale, respectively.

7. Exploration and evaluation (E&E) assets

	E&E assets
Balance at December 31, 2010	$ 331,339
Additions	3,514,361
Transfers to P&E (note 6)	(548,619)
Decommissioning provision	93,050
Balance at December 31, 2011	3,390,131
Additions	2,373,779
Impairment	(999,309)
Transfers to P&E (note 6)	(2,907,002)
Decommissioning provision	53,174
Balance at December 31, 2012	$ 1,910,773

E&E assets consist of the Corporation's exploration projects which are pending the determination of proved and/or probable reserves. Additions represent the Corporation's share of costs incurred on E&E assets during the year.

During the year ended December 31, 2012, the Corporation recorded an impairment of its E&E assets of $999,309, upon the transfer of assets in the Niton CGU to P&E, which was recorded as E&E expense on the statement of loss and comprehensive loss. The impairment was a result of management's assessment of expected future recoverable proved and probable reserves of the related asset. The impairment loss was based on the fair value less cost to sell of the transferred assets based on a 10 percent discounted cash flow model.

(amounts in Canadian dollars)

8. Impairment

Oil and natural gas CGUs

At December 31, 2012, the Corporation tested its CGUs for impairment.

The recoverable amount of the CGU was estimated based on the higher of the value in use and the fair value less costs to sell. The estimate of fair value less costs to sell was determined using a discount rate of 10 percent for properties with oil or high-energy content natural gas and natural gas liquids as their principal reserves and a discount rate of 15 percent for properties with natural gas as their principal reserves, and forecast cash flows, with escalating prices and future development costs, as obtained from externally prepared reserve estimates. The forecast prices used to estimate the fair value less costs to sell are those used by independent industry reserve engineers. One oil and one natural gas CGU was considered impaired during the year ended December 31, 2012 (note 6(c) and note 7).

The prices used in the impairment test of the Corporations CGUs at December 31, 2012 were:

	Oil	**Natural Gas**
	Edmonton Par Benchmark *(Cdn$/bbl)*	**AECO-C Hub Benchmark** *(Cdn$/mmbtu)*
2013	85.00	3.38
2014	91.50	3.83
2015	94.00	4.28
2016	96.50	4.72
2017	96.50	4.95
2018	96.50	5.22
2019	97.54	5.32
2020	99.51	5.43

Prices are assumed to increase at a rate of approximately 2.0 percent per year after 2020. Adjustments were made to the benchmark prices, for purposes of the impairment test, to reflect varied delivery points and quality differentials in the products to be delivered.

(amounts in Canadian dollars)

9. Decommissioning provisions

The Corporation's decommissioning provisions result from its ownership interest in oil and natural gas assets, including well sites and gathering systems. The total decommissioning provision is estimated based on the Corporation's net ownership interest in all wells, estimated costs to reclaim and abandon these wells, and the estimated timing of the costs to be incurred in future years. The total estimated, inflated undiscounted risked cash flows required to settle the provisions, before considering salvage, are approximately $261,840 at December 31, 2012, which was discounted using a risk-free interest rate of 1.6 percent at December 31, 2012. These obligations are to be settled based on the economic lives of the underlying assets, which currently extend up to 19 years into the future and will be funded from general corporate resources at the time of abandonment.

The following table summarizes changes in the decommissioning provisions for the year ended December 31, 2012:

		December 31, 2012		**December 31, 2011**
Decommissioning provisions, beginning of year	$	128,297	$	-
Accretion		3,578		-
Liabilities incurred		29,114		128,297
Change in estimates		66,209		-
Decommissioning provisions, end of year	$	227,198	$	128,297

10. Convertible Class B Shares

On October 18, 2011, the Corporation completed its initial public offering (note 13(e)) which included the issuance of 555,840 Class B Shares with a face value of $5,558,400 ($10.00 per Class B Share).

The Class B Shares are convertible (at the Corporation's option) into Class A Shares at any time after September 30, 2014 and on or before November 30, 2016. The number of Class A Shares to be issued upon conversion of one Class B Share is calculated by dividing $10 by the greater of $1 and the then-current market price of the Class A Shares. If conversion has not occurred by the close of business on November 30, 2016, the Class B Shares become convertible (at the option of the shareholder) into Class A Shares on the same basis. Effective at the close of business on December 31, 2016, all remaining Class B Shares will be automatically converted into Class A Shares. The Class B Shares are listed and posted for trading on the TSX-V under the symbol "Q.B".

The Class B Shares were determined to be compound financial instruments. As the Class B Shares are convertible into Class A Shares, based on the conversion formula above, the number of Class A Shares is unknown, and therefore is presented as a liability. The Class B Share liability, estimated at issuance to be $3,576,932 based on the present value of discounted cash flows using a discount rate of 9 percent, is accreted using the effective interest rate method over the term of the Class B Shares, such that the carrying amount of the financial liability will be equal to the principal of $5,558,400 at maturity.

(amounts in Canadian dollars)

The following table is a continuity of the convertible Class B Shares liability:

	Year ended December 31, 2012	Year ended December 31, 2011
Balance, beginning of year	$ 3,638,810	$ -
Liability component on date of initial public offering	-	3,576,932
Accretion of convertible Class B Shares liability (note 15)	327,540	61,878
Balance, end of year	$ 3,966,350	$ 3,638,810

Upon issuance of the Class B Shares, the Corporation recognized the equity component of the convertible Class B Shares as a conversion option of $1,585,985 and $495,367 related to the deferred income tax effect of the Class B Shares, for a total of $2,081,352.

11. Convertible debentures

On June 28, 2012, the Corporation completed the issuance of unsecured senior convertible debentures for gross proceeds of $1,510,000 ($1,444,497 net), of which $750,000 was raised from officers and directors of the Corporation. The Corporation issued 302 units at a price of $5,000 per unit, with each unit being comprised of one $5,000 debenture and 5,000 Class A Share purchase warrants. The debentures bear interest at a rate of 12 percent per annum, which is payable quarterly in arrears commencing on September 30, 2012, mature on June 30, 2014 and can be converted into common shares of Questfire at any time at the option of the holders at a conversion price of $0.50 per Class A Share. In aggregate the Corporation issued 1,510,000 share purchase warrants and each warrant entitles the holder to acquire one Class A Share at a price of $0.75 until June 30, 2014.

The debentures have been classified as debt, net of issuance costs and net of the fair value of the conversion feature and the warrants (the “Conversion Features”) at the date of issuance, which have been classified in shareholders’ equity. The issuance costs will be amortized over the term of the debentures and the debt portion will accrete up to the original face value at maturity. The accretion, amortization of issuance costs and interest paid are expensed on the statement of loss and comprehensive loss. The fair value of the Conversion Features was determined at the time of issuance as the difference between the face value of the debentures and the discounted cash flows assuming an 18 percent effective interest rate, which was the estimated rate for debt with similar terms but without any Conversion Features. If the debentures or the warrants are converted to Class A Shares, a portion of the value of the Conversion Features under shareholders’ equity will be reclassified to share capital along with the conversion price paid.

(amounts in Canadian dollars)

The following table sets forth a reconciliation of the convertible debentures for the year ended December 31, 2012:

	Liability component	Warrants	Equity conversion feature	Total
Balance, January 1, 2012	$ -	$ -	$ -	$ -
Gross cash proceeds	1,360,946	39,028	110,026	1,510,000
Accretion on discount (note 15)	52,396	-	-	52,396
Issuance costs	(60,531)	(1,302)	(3,670)	(65,503)
Deferred tax liability	-	(9,431)	(26,589)	(36,020)
Balance, December 31, 2012	$ 1,352,811	$ 28,295	$ 79,767	$ 1,460,873

12. Income tax expense

Reconciliation of effective tax rate:

	December 31, 2012	December 31, 2011
Loss before income tax	$ (5,235,832)	$ (862,884)
Statutory federal-provincial corporate income tax rate	25.0%	26.5%
Expected income tax recovery	(1,308,958)	(228,664)
Non-deductible expenses	90,119	874
Statutory rate changes and other	-	12,512
Non-deductible stock-based compensation	27,361	6,712
Reversal of flow-through share premium	(966,970)	(448,544)
Flow-through expenditures incurred	447,238	656,830
Recognition of previously unrecognized tax losses	-	(14,880)
Total income tax recovery	$ (1,711,210)	$ (15,160)

In 2012, $NIL (2011 - $14,880) of the previously unrecognized tax losses and other deductions were recognized to offset the existing taxable temporary differences.

The decrease in the statutory rate from 2011 to 2012 is due to a reduction in the federal corporate tax rate from 16.5% to 15% as part of a series of corporate rate reductions previously enacted by the Canadian federal government. The Alberta provincial tax rate remains unchanged at 10%.

(amounts in Canadian dollars)

Recognized deferred tax assets and liabilities:

Deferred tax assets and liabilities are attributable to the following:

	December 31, 2012	December 31, 2011
Deferred tax liabilities		
P&E and E&E assets	$ 757,735	$ 690,820
Decommissioning provisions	(56,800)	(32,074)
Convertible debentures	39,297	-
Convertible Class B Shares liability	398,013	479,897
	1,138,245	1,138,643
Less deferred tax assets		
Unamortized share issuance costs	(117,002)	(138,580)
Cumulative eligible capital	(248,545)	-
Non-capital losses	(724,849)	(243,994)
Net deferred tax liability	$ 47,849	$ 756,069

The Corporation has available the following estimated non-capital loss carry-forwards for which a deferred tax asset is recognized in the financial statements:

Year of Expiry	Amount
2030	$ 112,821
2031	863,155
2032	1,923,420
	$ 2,899,396

(amounts in Canadian dollars)

Movement in the deferred tax liability or asset during the year:

	Balance December 31, 2011	Recognized in profit or loss	Recognized against flow-through share premium	Recognized directly in equity	Balance December 31, 2012
P&E and E&E assets	$ 690,820	$ 66,915	$ -	$ -	$ 757,735
Decommissioning provisions	(32,074)	(24,726)	-	-	(56,800)
Cumulative eligible capital	-	(248,545)	-	-	(248,545)
Non-capital tax losses	(243,994)	(480,855)	-	-	(724,849)
Share issuance costs	(138,580)	21,578	-	-	(117,002)
Convertible Class B Shares liability	479,897	(81,884)	-	-	398,013
Exploration expenditures	-	(966,970)	966,970	-	-
Convertible debentures	-	3,277	-	36,020	39,297
	$ 756,069	$(1,711,210)	$ 966,970	$ 36,020	$ 47,849

Movement in the deferred tax liability or asset during 2011:

	Balance December 31, 2010	Recognized in profit or loss	Recognized against flow-through share premium	Recognized directly in equity	Balance December 31, 2011
P&E and E&E assets	$ 10,865	$ 679,955	$ -	$ -	$ 690,820
Decommissioning provisions	-	(32,074)	-	-	(32,074)
Non-capital tax losses	(25,173)	(218,821)	-	-	(243,994)
Share issuance costs	(572)	34,674	-	(172,682)	(138,580)
Convertible Class B Shares liability	-	(15,470)	-	495,367	479,897
Exploration expenditures	-	(448,544)	448,544	-	-
Unrecognized (recognized) deferred tax asset	14,880	(14,880)	-	-	-
	$ -	$ (15,160)	$ 448,544	$ 322,685	$ 756,069

(amounts in Canadian dollars)

13. Share capital

(a) Authorization

At December 31, 2012, the Corporation was authorized to issue the following:

Unlimited number of voting Class A Shares

Unlimited number of voting Class B Shares (note 10)

Unlimited number of preferred shares, issuable in series

(b) Issued

Class A Shares	Number of shares	Amount
Balance, December 31, 2010	9,475,001	$ 1,573,679
Issued for cash pursuant to private placement (note 13(d))	250,000	50,000
Issued as flow-through shares for cash pursuant to initial public offering (note 13(e))	3,088,000	3,088,000
Share issuance costs (net of $172,682 tax effect)	-	(518,046)
Balance, December 31, 2011 and December 31, 2012	12,813,001	$ 4,193,633

(c) During 2010, the Corporation issued 9,475,000 Class A Shares, on a flow-through basis, at $0.20 per share for total proceeds of $1,895,000. The Corporation estimates that the Class A Shares issued without a flow-through provision would have been issued at a 16.8 percent discount to the flow-through price and, therefore, the flow-through premium of $318,461 was recorded as a liability with the remainder of $1,576,539 recorded as share capital.

(d) On August 18, 2011, the Corporation issued 250,000 Class A Shares at $0.20 per share for total proceeds of $50,000.

(e) On October 18, 2011, the Corporation completed its initial public offering for gross proceeds of $6,176,000. A total of 6,176 units at a price of $1,000 per unit were sold, each consisting of 500 Class A Shares at a price of $0.20 per share and 90 Class B Shares (note 10) at a price of $10.00 per share, all of which were issued on a flow-through basis under the Income Tax Act (Canada). The Corporation estimates that had these shares been issued without a flow-through provision they would have been issued at a 17.8 percent discount to the flow-through price and, therefore, the flow-through share premium of $1,097,053 was recorded as a liability at the time of issuance.

The value of the Class A Shares on issuance, reduced by the flow-through share premium, was determined to be $3,088,000 ($1.00 per Class A Share).

(amounts in Canadian dollars)

(f) Basic and diluted loss per share was calculated based on the weighted average common shares outstanding of 12,813,001 for the year ended December 31, 2012, and 10,193,527 for the year ended December 31, 2011. The potential dilutive effect of stock options, warrants, convertible Class B Shares and convertible debentures was not included in the calculation as the effect would be anti-dilutive.

(g) Shares in escrow

At December 31, 2011, 7,375,500 Class A Shares were held in escrow pursuant to TSX-V requirements. On April 25, 2012 and October 25, 2012, 1,229,250 and 1,229,250 Class A Shares, respectively, were released from escrow and a total of 4,917,000 Class A Shares remained in escrow at December 31, 2012. The remaining shares will be released from escrow in equal installments at six-month intervals, commencing April 25, 2013 with the last release on October 25, 2014. The above escrow release schedule is subject to acceleration in accordance with National Policy 46-201 - *Escrow for Initial Public Offerings* and the policies of the TSX-V in the event that the Corporation subsequently meets certain listing requirements.

14. Stock-based compensation

(a) Stock options

On August 30, 2011, the Corporation adopted a stock option plan under which it is authorized to issue stock options to employees, officers, directors and consultants for up to 10 percent of the total issued and outstanding number of Class A and Class B Shares. Options under the stock option plan cannot have an exercise price less than the closing market price on the day immediately preceding the date of grant and will expire a maximum of ten years from the date of grant. It is the Corporation's intention that options granted will generally vest as to one-third on each of the first, second and third anniversaries of the date of grant and expire ten years from the date of grant.

The following options have been awarded under the stock option plan:

	Year ended December 31, 2012		**Year ended December 31, 2011**	
	Number	**Exercise Price**	**Number**	**Exercise Price**
Outstanding, beginning of year	1,281,000	$ 0.20	-	$ -
Granted	-	-	1,281,000	0.20
Forfeited	-	-	-	-
Outstanding at December 31	1,281,000	$ 0.20	1,281,000	$ 0.20
Exercisable at December 31	427,000	$ 0.20	-	$ -

(amounts in Canadian dollars)

The following table summarizes the expiry terms and exercise prices of the Corporation's outstanding stock options as at December 31, 2012:

Date of grant	Exercise price	Outstanding options	Weighted average remaining contractual life (years)	Number of stock options exercisable
October 18, 2011	$ 0.20	1,281,000	8.8	427,000
	$ 0.20	1,281,000	8.8	427,000

(b) Stock-based compensation expense

Compensation costs of $109,443 for the year ended December 31, 2012 (2011 - $25,327) have been expensed, with a corresponding increase in contributed surplus.

The fair value of stock options granted during the year ended December 31, 2011 was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	December 31, 2011
Risk-free interest rate	2.0%
Expected volatility	75%
Expected life	10 years
Expected dividend yield	0%
Estimated forfeiture rate	0%
Fair value per option	$ 0.1574

The Corporation's expected volatility is based on volatility assumptions used by similar publicly-traded companies in the same industry, as well as management's expectation of future stock price fluctuations. A forfeiture rate of nil was used when recording stock-based compensation as it is expected that all officers, directors, employees and consultants will continue with the Corporation over the vesting period. This estimate is adjusted to the actual forfeiture rate.

(amounts in Canadian dollars)

15. Finance income and expense

	Year ended December 31, 2012	December 31, 2011
Finance income		
Interest income on cash and cash equivalents	$ 11,296	$ 23,547
Finance expense		
Part XII.6 tax on flow-through share expenditures	(37,420)	(13,427)
Interest on convertible debentures	(92,282)	-
Accretion on decommissioning provisions (note 9)	(3,578)	-
Accretion on convertible Class B Shares liability (note 10)	(327,540)	(61,878)
Accretion on convertible debenture (note 11)	(52,396)	-
	(513,216)	(75,305)
Net finance expense recognized in profit or loss	$ (501,920)	$ (51,758)

16. Personnel expenses

The aggregate payroll expense of employees, officers and directors was $750,000 for the year ended December 31, 2012 (2011 - $375,000).

Key management personnel include executive officers and non-executive directors. Executive officers were paid a salary commencing in July 2011 and participate in the Corporation's stock option program. The executive officers are the Chief Executive Officer, Chief Financial Officer, Vice President, Land, Vice President, Engineering & Operations, Vice President, Exploration and Vice President, Exploitation. Non-executive directors also participate in the Corporation's stock option program. At December 31, 2012 the Corporation has no employees not considered key management personnel.

Compensation of key management personnel is as follows:

	Year ended December 31, 2012	December 31, 2011
Salaries and short-term benefits (*of which $500,000 (2011 - $250,000) is included in general and administrative expense and $250,000 (2011 - $125,000) is included in E&E expenditures for the year ended December 31, 2012*)	$ 750,000	$ 375,000
Amortization of share-based payments	109,443	25,327
	$ 859,443	$ 400,327

(amounts in Canadian dollars)

17. Cash and cash equivalents

	December 31, 2012	December 31, 2011
Bank balances	$ 395,288	$ 4,473,765
Term deposits	-	-
Cash and cash equivalents in the statements of cash flows	$ 395,288	$ 4,473,765

18. Related-party transactions

A director of Questfire is a partner of a law firm that provided legal services to Questfire. For the year ended December 31, 2012, Questfire incurred a total of $80,339 (2011 – $147,975) to this firm for legal fees and disbursements, of which $34,000 (2011 – $NIL) was charged to debenture issuance costs, $46,339 (2011 - $14,300) was charged to general and administrative expenses and $NIL (2011 - $133,675) was charged to share issuance costs. Of the $34,000 related to debenture issuance costs, $31,419 was charged to the convertible debenture liability, while $1,904 and $677 were charged to the equity component of convertible debentures and warrants, respectively. As at December 31, 2012, $24,824 (December 31, 2011 - $15,000) of the total incurred during 2012 was included in accounts payable and accrued liabilities.

19. Flow-through share commitments

(a) 2010 flow-through shares

During the period ended December 31, 2010, the Corporation completed an offering of flow-through shares, for total proceeds of $1,895,000. Pursuant to the offering, the Corporation was committed to renouncing the tax deductions to subscribers effective December 31, 2010 and was required to incur $1,895,000 of qualifying expenditures no later than December 31, 2011. The tax filings to effect the renunciations were filed in early 2011 in accordance with the applicable legislation and were effective December 31, 2010.

As at December 31, 2011, the Corporation had incurred $1,895,000 of qualifying flow-through expenditures related to this offering. As at December 31, 2012, however, the Corporation is amending its calculation to allocate additional expenditures to the 2011 flow-through shares (see 19(b) below) resulting in qualifying expenditures being incurred totaling $267,318, resulting in a shortfall of $1,627,682. Pursuant to the flow-through share agreements, the Corporation had agreed to indemnify subscribers for the amount of tax benefits lost in the event the amount of qualifying expenditures renounced to subscribers was reduced. Accordingly, at December 31, 2012, the Corporation has recorded a provision of $832,564 related to flow-through share indemnification amount and penalties.

In 2012, the Corporation recorded a commitment of $634,796 related to the flow-through shares, representing the estimated amount payable to indemnify the subscribers for the reduced renunciations. The Corporation also made a provision of $197,768 in additional penalties relating to the December 31, 2011 shortfall of $1,627,682. The liability for flow-through share commitments at December 31, 2012 includes the $634,796 flow-through share indemnification amount plus the $197,768 of penalties. The additional Part XII.6 taxes are recorded in accounts payable and accrued liabilities.

(b) 2011 flow-through shares

During the year ended December 31, 2011, the Corporation completed its initial public offering, for total proceeds of $6,176,000 issued on a flow-through basis. Pursuant to the offering, the Corporation was committed to renouncing the tax deductions to subscribers effective December 31, 2011 and was required to incur $6,176,000 of qualifying expenditures no later than December 31, 2012. The tax filings to effect the renunciations were filed in early 2012 in accordance with the applicable legislation and were effective December 31, 2011.

As at December 31, 2012, the Corporation has incurred $4,148,953 of qualifying flow-through expenditures related to this offering, resulting in a shortfall of $2,027,047. Pursuant to the flow-through share agreements, the Corporation had agreed to indemnify subscribers for the amount of tax benefits lost in the event the amount of qualifying expenditures renounced to subscribers was reduced. Accordingly, at December 31, 2012, the Corporation has recorded a provision of $1,008,253 related to flow-through share indemnification amount and penalties.

In 2012, the Corporation recorded a commitment of $790,548 related to the flow-through shares, representing the estimated amount payable to indemnify the subscribers for the reduced renunciations. The Corporation also made a provision of $217,705 in additional penalties relating to the December 31, 2012 shortfall of $2,027,047. The liability for flow-through share commitments at December 31, 2012 includes the $790,548 flow-through share indemnification amount plus the $217,705 of penalties. Part XII.6 taxes are recorded in accounts payable and accrued liabilities.

In aggregate the liability for the flow-through share commitments at December 31, 2012 related to the unexpended portion of the 2010 flow-through shares and the 2011 flow-through shares amounted to $1,840,817.

20. Commitments

(a) Office lease

The Corporation is committed under a lease on its office premises expiring August 31, 2013 for future minimum rental payments, excluding estimated operating costs, of $45,480 for 2013.

(b) Software license

The Corporation is committed under a software license agreement expiring January 1, 2014 for future minimum payments of $65,215 for 2013.

21. Subsequent events

The Corporation signed an asset purchase and sale agreement dated February 5, 2013, as amended March 12, 2013, to acquire certain producing oil & natural gas assets as well as certain derivative forward swap contracts from Advantage Oil & Gas Ltd. (“Advantage”) for total consideration of $94 million consisting of $40 million of cash, $44 million in Convertible Senior Secured Debentures (the “Debentures”) and 1.5 million Class B Shares of the Corporation. The acquisition is anticipated to close on or before April 30, 2013 and is subject to satisfaction of customary closing conditions. All closing adjustments between the effective date of November 1, 2012 and the closing date will be applied to the Debentures.

The Corporation will fund the cash portion of the purchase price by entering into credit facilities with National Bank of Canada (“National Bank”). The National Bank facility will provide for a revolving operating demand loan of $60 million, subject to closing conditions. The facility will bear interest at a range of prime plus 1% to prime plus 3% per annum depending on the Corporation’s senior net debt to cash flow ratio, will require the Corporation to maintain an adjusted working capital ratio of at least 1:1 and will be secured by all assets of the Corporation. In addition to other customary banking fees, Questfire has agreed to pay National Bank Financial Inc. a success fee conditional on closing of the Asset purchase and the Credit Facilities.

The Debentures will have a three-year term and will be secured but will be subordinate to the National Bank facility. Interest will be payable quarterly in arrears at the following per annum rates commencing June 30, 2013:

- 6% for the period from closing to April 30, 2014;
- 7% for the period from May 1, 2014 to April 30, 2015;
- 9% for the period from May 1, 2015 to maturity.

The Corporation may elect, from time to time, subject to applicable regulatory approval, to satisfy its obligation to pay interest on the Debentures (i) in cash; (ii) by delivering freely tradable Class A Shares to the debenture trustee, for sale, to satisfy the interest obligations in which event holders of the Debentures will be entitled to receive a cash payment equal to the interest payable, from the proceeds of the sale of such Class A Shares; or (iii) any combination of (i) and (ii) above.

The Debentures will be convertible into Class A Shares at the 20 day volume-weighted average trading price at the option of the holder for a period of 30 days following the occurrence of any of the events listed below:

(i) if the Corporation chooses to pay interest by delivering shares to the debenture trustee as described above;
(ii) any event of default;
(iii) any conversion by the Corporation of Class B Shares into Class A Shares;
(iv) the date 30 months from closing;
(v) upon the occurrence of a Change of Control; or upon an equity financing by the Corporation whereby the holder of a Debenture has the option of conversion (at the financing price), up to a maximum of 50% of the total shares issued in the financing, unless mutually agreed to otherwise.

As the above transaction is subject to shareholder, regulatory and final TSXV approval, the Corporation can give no assurances that the transaction will be completed as described.