

# **Guardian Exploration Inc.**

Management's Discussion & Analysis  
Year ended 2006

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

Management's discussion and analysis ("MD&A") of financial conditions and results of operations should be read in conjunction with the audited consolidated financial statements and notes for the 12 months ended December 31, 2006, the 4 months ended December 31, 2005 and the 12 months ended August 31, 2005. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles and are in Canadian dollars. Additional information relating to Guardian Exploration Inc. (the "Company" or Guardian or "GEI") is available on SEDAR at [www.sedar.com](http://www.sedar.com).

Natural gas reserves and volumes are converted to barrels of oil equivalent (boe) on the basis of six thousand cubic feet (mcf) of gas to one barrel (bbl) of oil. Boes may be misleading, particularly if used in isolation. A boe conversion ratio of 6 mcf to 1 bbl is based on the energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the well head.

### **Non-GAAP Information**

Cash flow from operations represents cash generated from operating activities before changes in non-cash working capital. The term is a non-GAAP measure and may not be comparable to other companies' definition of the term. Management uses cash flow from operations to evaluate the Company's operating performance and as a key measure to assess the Company's ability to finance operating activities and capital expenditures.

Operating netback is calculated as revenues from crude oil, natural gas and natural gas liquids less royalties and operating expenses on a barrel of oil equivalent basis.

The date of this Management's Discussion and Analysis is May 28, 2007.

Additional information relating to the Corporation, including the Management's Discussion and Analysis and financial statements for the year ended December 31, 2006 and the latest Annual Information Form filed by GEI, is available on SEDAR at [www.sedar.com](http://www.sedar.com).

### **FORWARD LOOKING STATEMENTS**

This disclosure includes forward-looking statements and assumptions respecting GEI's strategies, future operations, expected financial results, financing sources, commodity prices, cost of production and quantum of oil and natural gas reserves and discusses certain issues, risks and uncertainties that can be expected to impact on any of such matters.

By their nature, forward-looking statements are subject to numerous risks and uncertainties that can significantly affect future results. Actual future results may differ materially from those assumed or described in such forward-looking statements as a result of the impact issues, risks and uncertainties whether described herein or not, which GEI may not be able to control. The reader is therefore cautioned not to place undue reliance on such forward-looking statements.

GEI disclaims any intention or obligation to update or revise these forward-looking statements, as a result of new information, future events or otherwise.

## RESULTS OF OPERATIONS

| For the periods ended                                   | December 31, 2006<br>(12 months) | December 31, 2005<br>(4 months) |
|---|----------------------------------|---------------------------------|
| <b>Revenue</b>  |                                  |                                 |
| Petroleum and natural gas revenue                       | \$ 1,228,401                     | \$ 1,060,447                    |
| Royalties   | (218,567)                        | (197,323)                       |
|   | <hr/> 1,009,834                  | <hr/> 863,124                   |
| Other Income  | 0                                | 10,000                          |
|   | <hr/> 1,009,834                  | <hr/> 873,124                   |
| <b>Expenses</b>   |                                  |                                 |
| General and Administration                              | 986,964                          | 141,731                         |
| Interest and financing fees                             | 1,552,508                        | 27,461                          |
| Operating costs   | 724,511                          | 216,411                         |
| Stock-based compensation                                | 192,792                          | -                               |
| Accretion on convertible debenture                      | 336,566                          | -                               |
| Depletion and accretion                                 | 3,625,540                        | 2,043,060                       |
| Foreign Exchange  | 29,492                           | -                               |
|   | <hr/> 7,448,373                  | <hr/> 2,428,663                 |
| <b>Loss before income taxes</b>                         | (6,438,539)                      | (1,555,539)                     |
| <b>Future income taxes (recovery) F/T Recovery</b>      | (278,767)                        | (202,253)                       |
|   | <hr/> (6,159,772)                | <hr/> (1,353,286)               |
| <b>Net Loss</b>   | (6,159,772)                      | (1,353,286)                     |
| <b>Retained earnings (deficit), beginning of period</b> | (1,410,601)                      | (57,315)                        |
|   | <hr/> \$ (7,570,373)             | <hr/> \$ (1,410,601)            |
| <b>Deficit, end of period</b>                           | \$ (7,570,373)                   | \$ (1,410,601)                  |
| <b>Loss per share – basic and diluted</b>               | \$ (0.33)                        | \$ (0.11)                       |

### FORT NELSON, B.C. CLARKE LAKE E POOL

GEI increased its position in Clarke Lake early in the year and at its peak held a 73% working interest in Clarke Lake E Pool and facilities. Prior to commencing a re-entry operation mid summer on two wells, GEI successfully closed the sale of approximately 30 % working interest for the combined total of approximately 5.4 million dollars.

Shortly thereafter GEI commenced midsummer operations to re-enter the two Clarke Lake wells to snub out stuck drilling equipment and re-complete the wells. This operation was performed utilizing heavy lift helicopters to deliver the equipment into a winter access area. Upon completion of these operations, management elected to monetize this asset and as of January 2007, has sold its remaining interest for 6.5 million dollars.

## **KOTCHO**

In 2006 Guardian drilled a successful well at bA-71-H/93-P-3. The well flowed at an average rate of 1.0 mmcf/d when unrestricted by third party production plant problems, as and as high as 1.5 mmcf/d when plant capacity was unrestricted.

As of year end Guardian had two wells in the Kotcho area with an average working interest of 49%.

During Q1 of 2007 GEI completed a successful side track operation of b-100-E which is the third successful well in the area.

## **MONTANA IMDA (Indian Mineral Development Act)**

During the period GEI continued to do work necessary to retain its Blackfeet Tribal Lands in Montana and complete the #5 and #6 wells of its 2006 commitment.

GEI also spent funds necessary to fulfill its abandonment and reclamation obligations on the Blackfeet Tribal Lands, and as such remains in good standing with the Bureau of Land Management.

## **MAJOR TRANSACTIONS AFFECTING FINANCIAL RESULTS**

At a special meeting on April 13, 2006 the shareholders of the Company and the shareholders of Resilient approved an amalgamation of the two companies effective April 20, 2006. Guardian was a private oil and gas exploration and development company with current production of approximately 200 Boe/d and approximately 9,300 gross (3,000 net) acres of undeveloped lands. The Amalgamation resulted in the Resilient shareholders holding approximately 9% of the Amalco shares of the public Guardian Exploration Inc. the continuing entity (GX on the TSX venture).

As a prior condition of the amalgamation Guardian completed a private equity financing issuing 5,333,333 flow-through shares at a price of \$0.75 per flow-through share and 1,480,000 common shares at a price of \$0.65 per common share for net proceeds of \$4,495,685. The net proceeds were used to finance an acquisition of a working interest in a northeast British Columbia gas asset for \$4,000,000.

An additional condition of the amalgamation required Guardian to issue a convertible debenture, immediately prior to the amalgamation, in the principal amount of \$4,500,000 to fund the working capital requirements of Amalco. The debenture has an 18 month term, bears interest at a rate of 7% per annum and is convertible into shares of Guardian at a conversion price of \$0.75. The Lender of the debenture received a finance fee comprised of 650,000 Guardian common shares and 1,600,000 warrants exercisable into Guardian common shares at a price of \$0.75 per share until October 20, 2009. The selling agent for the debenture issue was paid a commission of \$270,000 and was issued 113,333 warrants exercisable into common shares at a price of \$0.75 per share until October 20, 2007.

During the 2006 period, Guardian paid down considerable amounts of the debenture from asset sales of its Clarke Lake Property and at the time of writing, has paid out the debenture holder in its entirety.

## **LIQUIDITY – GOING CONCERN**

The Company's financial statements have been prepared on a going concern basis which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company's ability to continue as a going concern was dependent upon the amalgamation which is outlined in detail under the heading "Major Transactions Affecting Financial Results".

The Company is subject to certain fluctuations and trends, such as market conditions, interest rate levels, commodity prices, and industry conditions which could affect its ability to raise the necessary capital to remain as a going concern. The current commodity price environment has resulted in buoyant market conditions for oil and gas focused companies, however, a significant decrease in commodity prices could have a negative effect. In addition, the Company remains focused on exploration of oil and gas prospects and the results of drilling these prospects could materially affect the Company's ability to raise additional capital.

To maintain its exploration rights on the Eastern tribal acreage for the next year the Company must pay a lease rental of \$300,000 US by April 18, 2006 and must spud two wells on the lands by September 1, 2006. Failure to meet its commitment could result in loss of the Eastern Lands, which represents the most significant portion of the Company's entire asset base. The Company has paid the 2006 lease rental payment of \$300,000 US.

As at May 28, 2007, the Company's ability to continue as a going concern and the resulting amalgamated company is dependent on it raising sufficient capital to fund ongoing overhead expenses and capital expenditures.

A detailed discussion of Going Concern Considerations is discussed in note 1. of the Consolidated Financial Statements.

## **CASH FLOW FROM OPERATIONS**

### **US Operations:**

The Company currently is in the pre-production stage of exploration and development and thus all costs associated with the exploration and development of its properties are capitalized.

### **Canadian Operations:**

|                           |             |
|---------------------------|-------------|
| Cash Flow from Operations |             |
| December 2006             | \$ 285,323  |
| Four months December 2005 | \$ 646,713  |
| August 2005               | \$ (12,545) |

## **INCOME TAXES**

The Company is not currently liable for cash taxes.

There are sufficient tax pool deductions to offset future taxable income that the company does not anticipate it will be liable for cash taxes until at least 2009.

The company's future tax assets are in excess of the future liabilities. As there is no certainty that the company will be able to realize the benefit of these tax assets in the future, no tax asset has been recognized at December 31, 2006.

## OUTSTANDING SHARE DATA

As at December 31, 2006 the common shares of Guardian trade on the Venture Exchange (TSX) under the symbol "GX". The following table summarizes the common shares issued during 2006, 2005 and 2004 which are the only class of share outstanding.

|  | <u>Number</u>            |
|--|--------------------------|
| <b>Balance, August 31, 2004</b>                    | 116                      |
| Effect of 70,000 to 1 stock split, December, 2004  | 8,119,884                |
| Private placement of units for cash                | <u>722,000</u>           |
| <b>Balance, August 31, 2005</b>                    | 8,842,000                |
| Effect of 2.6 to 1 stock split, September 2005     | 14,147,200               |
| Private placement of units for cash                | 5,097,996                |
| Private placement of units for cash                | <u>1,429,575</u>         |
| <b>Balance, December 31, 2005</b>                  | 29,516,771               |
| Private placement of flow through shares for cash  | 5,333,333                |
| Private placement of common shares for cash        | 1,480,000                |
| Issued for commissions on private placement        | 68,853                   |
| Issued for financing fees on convertible debenture | 650,000                  |
| Redistribution of shares on amalgamation           | (18,903,934)             |
| Issued to Resilient shareholders on amalgamation   | 1,854,977                |
| Issued under contractual right to acquire          | <u>79,422</u>            |
| <b>Balance, December 31, 2006</b>                  | <u><u>20,079,422</u></u> |

## CRITICAL ACCOUNTING ESTIMATES

The Company's significant accounting policies are outlined in the audited financial statements. The following summarizes certain accounting estimates that are integral to the determination of reported financial results.

### Full Cost Accounting

Guardian follows the full cost method of accounting as prescribed by Accounting Guideline #16 issued by the Canadian Institute of Chartered Accountants ("CICA"). Under this method of accounting, all costs for exploration, development, land, and property acquisitions are capitalized. These costs are depleted and depreciated using the unit-of-production method based on estimated proved reserves.

The capitalized costs can not exceed a prescribed ceiling test amount. On a quarterly basis, the net capitalized costs are compared to a calculated ceiling amount. If the capitalized costs are determined to be in excess of the calculated ceiling, the excess must be expensed. The calculated ceiling is a discounted estimate of the cash flows to be realized from the future production of proved plus probable reserves and the sale of unproved properties.

Proceeds from the disposition of properties are deducted from capitalized costs without recognition of a gain or loss unless such disposition would alter the rate of depletion and depreciation by more than 20 percent.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations.

### **Reserves**

Guardian has engaged independent petroleum engineers to evaluate all of its reserves. Reserve determinations involve forecasts of future commodity prices, production rates, operating costs and timing of capital investments, all of which are subject to interpretation. Reserve estimates are used in the calculation of depletion and depreciation expense, and in determining the cost ceiling amounts. Revisions to reported reserve estimates may have a significant impact on reported depletion and depreciation expense and could potentially result in a ceiling test write-down.

### **Asset Retirement Obligations**

The Company utilizes the fair value method to provide for asset retirement obligations relating to its properties. Under this method, the estimate of future asset retirement obligations is based on current regulations, costs, technology and industry standards. The reported liability is the present value of the future estimate of asset retirement costs.

The amount of the liability is affected by factors such as the timing of future expenditures, the discount rate used, the number of properties and future changes in legislation. All of these estimates are subject to change and may impact the depletion and depreciation rate and the reported future liability. A revision of estimated future costs and changes in the estimated timing of expenditures may result in a change in the reported liability and the depletion and depreciation rate.

### **Stock-based Compensation**

The Company has a stock option plan whereby certain officers, directors and consultants are granted options to purchase common shares. Options granted under the plan have a maximum term of five years.

Guardian utilizes the fair value method of accounting for stock options granted. In determining the fair value of the stock options granted, the Black-Scholes model is used and assumptions regarding interest rates, underlying volatility of the Company's stock and expected life of the options are made.

### **Controls and Procedures**

Disclosure controls and procedures have been designed to ensure that information related to the Company is accumulated and communicated to the Company's management as appropriate to allow for timely decisions regarding required disclosure. Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles.

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures and assessed the design of the Company's internal controls over financial reporting as of December 31, 2006 pursuant to the requirements of Multilateral Instrument 52-109.

Management has concluded that as of December 31, 2006, potential weaknesses existed in the design of internal control over financial reporting due to the limited number of staff at the Company, causing a lack of segregation of duties and lack of a sufficient number of finance

personnel with the required technical knowledge to address all potential complex and non-routine accounting and taxation issues that may arise.

Neither of these weaknesses has resulted in a material misstatement of the interim or annual financial statements. Management and Board review are used to mitigate the risk of material misstatement in financial reporting to ensure internal controls remain effective. The design weaknesses can only be remedied with the addition of staff in the financial accounting area and will be done prudently only when Company growth necessitates more staffing.

Further, there are no changes in internal control from the previous quarter that the Chief Executive Officer and the Chief Financial Officer consider are required to be disclosed.

#### **Impact of New Accounting Pronouncements**

As of January 1, 2007, Guardian will be required to adopt the following sections of the CICA Handbook: Section 1530 – *Comprehensive Income*; Section 3855 – *Financial Instruments – Recognition and Measurement*, and Section 3865 - *Hedges*.

CICA Handbook Section 1530 requires a statement of comprehensive income to be included in financial statements for both interim and annual periods. CICA Handbook Section 3855 sets out requirements for the recognition and measurement of financial instruments. CICA Handbook Section 3865 sets out the criteria needed to qualify for hedge accounting and the timing for recognition of hedging gains and losses.

At this time, it is anticipated that these new accounting standards will not have a material impact on Guardian's financial statements.

### **CAPITAL EXPENDITURES AND CAPITAL RESOURCES**

#### **Clarke Lake Area**

During the year ended Dec 31, 2006 REI increased its interest in the lands for approximately \$ 3.5 MM and repaired and re-completed two gas wells for approximately \$ 3.8 MM. REI's entire interest in the Clarke Lake area was subsequently sold for \$ 6.5 MM with settlement occurring in January 2007.

#### **Kotcho Area**

During the year ended Dec 31, 2006 REI drilled one exploratory well and completed as a gas well for a total cost of \$ 2.7 MM.

#### **North East B.C.**

Gathering and pipeline facilities for both Clarke Lake and Kotcho were completed for approximately \$ 1.8 MM.

#### **Montana**

The company continued to incur substantial capital expenditures as required to meet its obligations under the K2/Blackfeet Indian Mineral Development Agreement.

All costs incurred in this cost centre have been capitalized and will commence to be amortized once commercial production levels have been attained or written-off if permanent impairment in value has been determined.

## CONTRACTUAL COMMITMENTS

| Contractual Obligations   | Payments Due By Period (\$) |             |             |             |
|---|-----------------------------|-------------|-------------|-------------|
|   | Total                       | 2006        | 2007        | 2008        |
| Office Lease  | 110,603                     | 38,943      | 38,943      | 38,943      |
| Purchase Obligations  |                             |             |             |             |
| Other Long Term Obligations<br>(Blackfeet IMDA yearly obligation) | 1,039,446                   | 300,000\$US | 300,000\$US | 300,000\$US |
| Total Contractual Obligations                                     | 1,140,049                   | 338,943     | 338,943     | 338,943     |

- (1) Under the terms of the first Amended Agreement to an exploration agreement originally signed with the Blackfeet Tribe in 1997, the Company is committed to pay to the Tribe an annual lease rental payment of \$300,000 US on April 18, 2006, 2007 & 2008 to maintain the Eastern lands.
- (2) All future commitments in US dollars have been calculated at the average exchange rate for the fourth quarter of 2005 of 1.15494.
- (3) The above data does not include cost associated with the Company's drill obligations with the Blackfeet Tribe. Please see "Commitments and Contingencies" of this document for further discussion as to these drilling obligations and their estimated associated costs.

## RELATED PARTY TRANSACTIONS

- (a) The company recorded management fees of \$ 137,300 (December 31, 2005 - \$53,800; August 31, 2005 - \$ 63,600) to a company controlled by a major shareholder and officer of the Company. Included in accounts payable are \$ 66,340 for management fees (December 31, 2005 - \$ NIL August 31, 2005 - \$ 63,600). The Company has also obtained helicopter services in conjunction with the servicing and drilling of natural gas wells in Northern B.C., from the same company, for servicing and drilling of natural gas wells in Northern B.C., from the same company, for which the Company was charged \$ 862,569 (December 31, 2005 - \$ 14,633 - August 31, 2005 - \$ 227,977), and of this amount \$ 654,509 (December 31, 2005 - \$ 14,633; August 31, 2005 - \$ 27,975 remains in accounts payable.
- (b) The Company paid \$ 58,145 (December 31, 2005 - \$46,064; August 31, 2005 - \$30,750) for financial management and accounting fees to a company of which a shareholder and a former officer, of the company, is an officer of that company.
- (c) Geological consulting fees in the amount of \$ 159,750 (December 31, 2005 - \$12,840; August 31, 2005 - \$ NIL) have been paid to a company of which a shareholder and a former officer, of the Company, is an officer of that company.
- (d) Legal fees in the amount \$ 48,965 have been paid to a legal firm of which a director of the company, appointed in 2006, is a partner.

These transactions are in the normal course of business and are recorded at the exchange amount which is the amount of consideration established and agreed to by the related parties.

## COMMITMENTS AND CONTINGENCIES

### Exploration Commitments

The Company holds its exploration rights on the Reservation under the terms of an exploration agreement originally signed with the Blackfeet Tribe in 1997 (the "Original Agreement") and subsequently three Amending Agreements have been made as follows:

- 1) First Amended Agreement, January 2003 – assigns the Company exploration rights in the 100,000 acres of Eastern Tribal lands.
- 2) Second Amended Agreement, June 2004 – deals with clarification of certain Terms and commits the Company to pay an annual rental payment of \$450,000 on April 18, 2004, 2005 and 2006. These payments relate to the 150,000 acres of Western Tribal lands.
- 3) Third Amended Agreement, March 2005 – deals with the Company surrendering the 150,000 acres of Western Tribal lands.

Under the terms of the First Amended Agreement, the Company paid a \$1,000,000 US land bonus to the Blackfeet on April 23, 2003, in consideration for the exploration rights to an additional 100,000 tribal mineral acres (Eastern Lands) to be earned through the drilling of 10 wells, two per year over a five-year period between April 18th, 2003 through April 18th, 2008 ("Exploration Phase").

The outstanding Drilling Commitment as at March 31, 2006 requires the drilling of six wells, two wells per year for the last three years of the "Exploration Phase", both wells to be drilled on the Company's Eastern Land Block.

The Company has adopted a corporate strategy of seeking out and identifying joint venture partners to share in or absorb the capital cost of the above drilling commitments.

If no joint venture partners can be identified for these drilling commitments, the Company will be obligated to incur such costs and such costs could be substantial. The Company's costs for its 2005 drilling program ranged between \$1,000,000 to \$1,200,000 US for wells ranging between 4,000 and 4,500 feet.

Under the terms of the First Amended K2/Blackfeet Agreement, the Company is also obligated to pay a \$3.00 US per acre annual rental commencing in years two through five of Exploration Phase for the additional 100,000 tribal mineral acres under the Amended Agreement.

Under the terms of the "Third Amended Oil and Gas Exploration Agreement" signed by the Blackfeet Tribe on March, 2005 the Company's outstanding obligations and future exploration rights relating to the Western lands have been terminated. The company continues to retain its exploration rights and commitments relating to the Eastern Lands.

However, the Company's annual drilling obligation of 2 wells on the Eastern Lands requires the commencement of drilling operations by September 1.

This extension from April to September 1 applied to the drilling commitment in 2005 and also 2006 and 2007, but does not apply to 2008. The Company drilled two exploration wells in September 2005. The commitment of an annual rental fee of \$300,000 US remains unchanged.

Accordingly, the Company was obligated to pay to the Blackfeet Tribe by April 18, 2005 a total amount of \$550,000 US, which comprises the annual rental fee of \$300,000 US for the Eastern Lands, and an additional \$250,000 US relating to the termination of the Company's commitments for the Western lands and the extension of the drilling obligation on the Eastern Lands. The Company made the required \$550,000 US payment on April 18, 2005 and the required \$300,000 on April 18, 2006.

Following the completion of the drilling obligations and the expiration of the respective "Exploration Phase" of the agreement in 2008, the Company will become obligated to pay an annual rental of \$2.00 US per acre commencing on the first anniversary date of the expiration of the respective "Exploration Phase" for any of the exploration acreage covered under the Original or Amended Agreement that has been converted to 5-year oil and gas leasehold interests by the Company, except for those leases that are held by oil and gas production from the property.

In the event that the Company fails to comply with its obligations as outlined above, particularly its drilling obligations, it could be required within five days of receipt of written notification from the Blackfeet Tribe of the Company's failure to comply, to surrender and relinquish the entire subject lands outside of the spacing units established for any producing or capable of producing wells that have been drilled and completed prior to the failure of the Company to timely comply with the well obligations. This potential requirement under the agreement for surrender of acreage currently would account for the majority of the Company's existing assets. The Company may, however, make requests for extensions to its drilling commitments provided that said extensions shall not exceed one year and the request is not unreasonable. The Blackfeet Tribe may not unreasonably withhold its consent to the Company's requests for extensions provided that requests are not made based on economic or financial need or necessity.

In the event of certain commercial gas discoveries, the Company and/or its joint venture partner(s) may be required to incur considerable costs associated with the construction of pipelines and related gathering and production facilities. The Company's calculated maximum distance to an existing gas sales line is 22 miles in the Eastern Land Block.

The above referenced capital requirements are significant due to its contractual obligations under its agreement with the Blackfeet Tribe. The Company plans to meet its exploration and development expenditures and overhead costs through the raising of additional debt or equity financing and/or the completion of joint venture partnerships with third parties. If the Company is unsuccessful in obtaining such financing or joint ventures it could have a material adverse affect on the Company and its equity and/or debt holders.

## **GOVERNANCE**

At year end 2006, the Board of Directors of Guardian Exploration included Graydon L.M. Kowal, Director and President & CEO, Melvin H. Chambers, Director, David R.P. Mears, Director, Timothy L. Campbell, Director, and Scott Reeves as Director and Corporate Secretary.

## **OUTLOOK**

As previously outlined, effective April 20, 2006 Resilient Resources amalgamated with Guardian Exploration Inc. giving the shareholders of Resilient approximately a 9% ownership in the amalgamated company which has interests and prospects in a number of oil and gas properties in northeast British Columbia and Alberta. The amalgamated company is named Guardian Exploration Inc. and trades on the Venture Exchange (TSE) under the symbol "GX".

The amalgamated Corporation will seek to provide continued liquidity for shareholders and allow them to participate in the future growth of the oil and gas business in Western Canada and Montana.

## **OTHER BUSINESS RISKS AND UNCERTAINTIES**

This document contains statements about expected future events and/or financial results that are forward looking in nature and subject to substantial risks and uncertainties. The Company cautions the readers that actual performance will be affected by a number of factors, many of which are beyond its control, as many may respond to changes in economic and political circumstances around the world. These external factors beyond the Company's control may

affect the marketability of oil and natural gas produced, industry conditions including changes in laws and regulations, changes income tax regulations, increased competition, fluctuations in commodity prices, interest rates, and variations in the Canadian/United States dollar exchange rate.

In addition, the Company is exposed to several risks inherent to the oil and gas exploration and production industry including, but not limited to:

- . Finding and developing oil and natural gas reserves at economic costs;
- . Production of oil and natural gas in commercial quantities; and
- . Marketability of oil and natural gas produced.

The Company strives to mitigate these risks by effective and proactive management, employing qualified experienced staff and consultants in all areas of its operation, with careful regard for environmental and safety concerns.

The Company will need to raise additional capital and/or complete joint venture arrangements with third parties in order to fund the further development of its natural gas properties and ultimately achieve sufficient commercial oil and gas production to continue as a going concern. If the Company is unsuccessful in obtaining such financing or joint ventures it could have a material adverse affect on the Company and its equity and/or debt holders.

## **DISCLOSURE CONTROLS AND PROCEDURES**

The Corporation has designed disclosure controls and procedures to provide reasonable assurance that material information relating to the Corporation that is required to be disclosed is recorded, processed, summarized and reported within the time periods specified by securities regulations and that information required to be disclosed is communicated to management on a timely basis. The Chief Executive Officer and the Chief Financial Officer have evaluated the effectiveness of these disclosure controls and procedures as of the end of the period covered by the annual filings and have concluded, based on such evaluation, that the Corporation's disclosure controls and procedures as of the end of such period are effective to provide reasonable assurance that material information relating to the Corporation is made known to them by others within the Corporation, particularly during the period in which the annual filings are being prepared.

It should be noted that while the Corporation's Chief Executive Officer and Chief Financial Officer believe that the Corporation's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or the procedures may deteriorate.

At the present time the Chief Executive Officer and the Chief Financial Officer positions are held by Graydon Kowal.

## **INTERNAL CONTROLS OVER FINANCIAL REPORTING ("ICFR")**

The Chief Executive Officer and the Chief Financial Officer of the Company are responsible for designing ICFR or causing them to be designed under their supervision. Management has conducted a review of the design of its ICFR as at December 31, 2006, and believes that the Company's system of ICFR is sufficiently designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP.

As part of the evaluation of ICFR, however, the Company recognizes that its ICFR has an inherent weakness due to the limited number of staff at the Company. It is not economically feasible for the Company to achieve complete segregation of duties. Management believes that it has designed sufficient internal controls, comprised primarily of management and Board review and oversight, to mitigate these limitations. A system of ICFR, no matter how well conceived or operated can provide only reasonable, not absolute, assurance that the objectives of the ICFR are met. Also, projections of any evaluation of the effectiveness of ICFR to future periods are subject to the risk that the controls may become inadequate because of changes in conditions.

Currently, there is a lack of competent accounting personnel within the Company to efficiently discharge its financial disclosure functions. The board of directors is actively seeking such personnel in order to rectify this deficiency. As the Company continues to grow, we plan to expand the number of individuals involved in the accounting functions. At present, the Chief Executive Officer and the Chief Financial Officer oversee all material transactions and related accounting records and there is daily oversight by the senior management of the Company. In addition, on a quarterly basis the Audit Committee and the Board reviews the financial statements and key risks of the Company, and queries management about significant transactions.

#### **ADDITIONAL INFORMATION**

Additional information relating to the Company can also be found on the SEDAR system at [www.sedar.com](http://www.sedar.com).

Submitted on behalf of the Board of Directors

**“Signed by”**

Graydon L. M. Kowal  
Director; President and Chief Executive Officer



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MACK  
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STEWART<sub>LLP</sub>**  
Chartered Accountants  
www.kmss.ca

## **Guardian Exploration Inc.**

### **Consolidated Financial Statements**

**December 31, 2006, December 31, 2005,  
and August 31, 2005**

### **Auditors' Report**

To: The Shareholders of  
**Guardian Exploration Inc.**

We have audited the consolidated balance sheets of **Guardian Exploration Inc.** as at **December 31, 2006, December 31, 2005, and August 31, 2005** and the consolidated statements of loss and deficit and cash flows for the twelve month period ended December 31, 2006, the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006, December 31, 2005, and August 31, 2005, and the results of its operations and its cash flows for the twelve month period ended December 31, 2006, the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005 in accordance with Canadian generally accepted accounting principles.

*Kennay Mack Slusarchuk Stewart LLP*

April 27, 2007 except for note 16(b),  
which is as at May 29, 2007

Chartered Accountants

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Member of DFK International  
with affiliated offices worldwide

# Guardian Exploration Inc.

## Consolidated Balance Sheets

| As at  | December 31,<br>2006 | December 31,<br>2005 | August 31,<br>2005  |
|--|----------------------|----------------------|---------------------|
| <b>Assets</b>                                    |                      |                      |                     |
| <b>Current assets</b>                            |                      |                      |                     |
| Cash   | \$ 101,556           | \$ 1,783,875         | \$ 7,397            |
| Accounts receivable (note 4)                     | 2,672,587            | 123,233              | 144,890             |
| Prepaid expenses                                 | 81,913               | 16,560               | -                   |
|  | <u>2,856,056</u>     | <u>1,923,668</u>     | <u>152,287</u>      |
| <b>Deposit (note 5)</b>                          | 349,920              | -                    | -                   |
| <b>Property and equipment (note 6)</b>           | <u>9,223,801</u>     | <u>3,598,031</u>     | <u>5,141,667</u>    |
|  | <u>\$ 12,429,777</u> | <u>\$ 5,521,699</u>  | <u>\$ 5,293,954</u> |
| <b>Liabilities and Shareholders' Equity</b>      |                      |                      |                     |
| <b>Current liabilities</b>                       |                      |                      |                     |
| Accounts payable and accrued liabilities         | \$ 7,970,854         | \$ 1,399,186         | \$ 2,422,659        |
| Demand revolving loan (note 7)                   | -                    | 1,090,000            | 1,475,000           |
| Due to related company (note 9)                  | 376,301              | 361,048              | -                   |
| Due to shareholder (note 10)                     | 138,000              | 138,000              | -                   |
| Convertible debenture (note 8)                   | 969,882              | -                    | -                   |
|  | <u>9,455,037</u>     | <u>2,988,234</u>     | <u>3,897,659</u>    |
| <b>Due to related company (note 9)</b>           | -                    | -                    | 254,437             |
| <b>Due to shareholder (note 10)</b>              | -                    | -                    | 138,000             |
| <b>Asset retirement obligations (note 11)</b>    | 1,207,667            | 70,056               | 45,562              |
| <b>Future income taxes (note 13)</b>             | -                    | -                    | <u>245,900</u>      |
|  | <u>10,662,704</u>    | <u>3,058,290</u>     | <u>4,581,558</u>    |
| <b>Shareholders' equity</b>                      |                      |                      |                     |
| Share capital (note 12(b))                       | 8,103,838            | 3,873,478            | 769,711             |
| Warrants (note 12(g))                            | 673,600              | -                    | -                   |
| Equity portion of convertible debenture (note 8) | 30,118               | -                    | -                   |
| Contributed surplus (note 12(h))                 | 529,890              | 532                  | -                   |
| Deficit  | <u>(7,570,373)</u>   | <u>(1,410,601)</u>   | <u>(57,315)</u>     |
|  | <u>1,767,073</u>     | <u>2,463,409</u>     | <u>712,396</u>      |
|  | <u>\$ 12,429,777</u> | <u>\$ 5,521,699</u>  | <u>\$ 5,293,954</u> |

Refer to nature of operations and going concern (note 1)

Commitments and contingencies (notes 15 and 16)

Approved by the Board

(signed) "Graydon Kowal"

Director

(signed) "Scott Reeves"

Director

See accompanying notes to the consolidated financial statements

## Guardian Exploration Inc.

### Consolidated Statements of Loss and Deficit

| For the periods ended                                   | December 31,<br>2006  | December 31,<br>2005  | August 31,<br>2005 |
|---|-----------------------|-----------------------|--------------------|
|   | (12 months)           | (4 months)            | (12 months)        |
| <b>Revenue</b>  |                       |                       |                    |
| Petroleum and natural gas revenue                       | \$ 1,228,401          | \$ 1,060,447          | \$ 173,415         |
| Royalties   | (218,567)             | (197,323)             | (35,400)           |
|   | 1,009,834             | 863,124               | 138,015            |
| Other income  | -                     | 10,000                | -                  |
| License approval fees                                   | -                     | -                     | 289,015            |
|   | 1,009,834             | 873,124               | 427,030            |
| <b>Expenses</b>   |                       |                       |                    |
| General and administration                              | 986,964               | 141,731               | 196,965            |
| Interest and financing fees                             | 1,552,508             | 27,461                | 88,032             |
| Operating costs   | 724,511               | 216,411               | 150,560            |
| Stock-based compensation                                | 192,792               | -                     | -                  |
| Accretion on convertible debenture                      | 336,566               | -                     | -                  |
| Depletion, depreciation and accretion                   | 3,625,540             | 2,043,060             | 573,629            |
| Foreign exchange  | 29,492                | -                     | -                  |
|   | 7,448,373             | 2,428,663             | 1,009,186          |
| <b>Loss before income taxes</b>                         | (6,438,539)           | (1,555,539)           | (582,156)          |
| <b>Future income taxes (recovery) (note 13)</b>         | (278,767)             | (202,253)             | (100,124)          |
| <b>Net loss</b>   | (6,159,772)           | (1,353,286)           | (482,032)          |
| <b>Retained earnings (deficit), beginning of period</b> | (1,410,601)           | (57,315)              | 424,717            |
| <b>Deficit, end of period</b>                           | <u>\$ (7,570,373)</u> | <u>\$ (1,410,601)</u> | <u>\$ (57,315)</u> |
| <b>Loss per share – basic and diluted (note 12(i))</b>  | <u>\$ (0.33)</u>      | <u>\$ (0.11)</u>      | <u>\$ (0.04)</u>   |

See accompanying notes to the consolidated financial statements

## Guardian Exploration Inc.

### Consolidated Statements of Cash Flows

| For the periods ended                               | December 31,<br>2006 | December 31,<br>2005 | August 31,<br>2005 |
|---|----------------------|----------------------|--------------------|
|   | (12 months)          | (4 months)           | (12 months)        |
| <b>Operating activities</b>                         |                      |                      |                    |
| Net loss  | \$ (6,159,772)       | \$ (1,353,286)       | \$ (482,032)       |
| Items not affecting cash:                           |                      |                      |                    |
| Depletion, depreciation and accretion               | 3,625,540            | 2,043,060            | 573,629            |
| Future income taxes (recovery)                      | (278,767)            | (202,253)            | (100,124)          |
| Stock-based compensation                            | 192,792              | -                    | -                  |
| Accretion on convertible debenture                  | 336,566              | -                    | -                  |
| Foreign exchange                                    | 29,492               | -                    | -                  |
| Non-cash interest and financing fees                | 1,096,100            | -                    | -                  |
| Abandonment costs incurred                          | (192,501)            | -                    | -                  |
|   | (1,350,550)          | 487,521              | (8,527)            |
| Changes in non-cash working capital items (note 17) | (377,212)            | 105,230              | (163,217)          |
|   | (1,727,762)          | 592,751              | (171,744)          |
| <b>Financing activities</b>                         |                      |                      |                    |
| Demand revolving loan                               | (1,090,000)          | (385,000)            | 35,000             |
| Debenture issued                                    | 4,500,000            | -                    | -                  |
| Debenture repaid                                    | (3,500,000)          | -                    | -                  |
| Advances from related company                       | 15,253               | 106,611              | 690,494            |
| Issuance of share capital                           | 4,962,000            | 3,223,855            | 966,500            |
| Share issuance costs                                | (874,988)            | (163,202)            | (104,488)          |
| Advances from shareholder                           | -                    | -                    | 138,000            |
| Changes in non-cash working capital items (note 17) | 100,836              | -                    | -                  |
|   | 4,113,101            | 2,782,264            | 1,725,506          |
| <b>Investing activities</b>                         |                      |                      |                    |
| Expenditures on property and equipment              | (12,356,536)         | (474,931)            | (3,688,882)        |
| Proceeds on sale of property and equipment          | 5,485,137            | -                    | -                  |
| Cash assumed on amalgamation                        | 221,990              | -                    | -                  |
| Changes in non-cash working capital items (note 17) | 2,581,751            | (1,123,606)          | 2,138,110          |
|   | (4,067,658)          | (1,598,537)          | (1,550,772)        |
| <b>Increase (decrease) in cash</b>                  | (1,682,319)          | 1,776,478            | 2,990              |
| <b>Cash, beginning of period</b>                    | 1,783,875            | 7,397                | 4,407              |
| <b>Cash, end of period</b>                          | \$ 101,556           | \$ 1,783,875         | \$ 7,397           |
| <b>Supplemental cash flow information</b>           |                      |                      |                    |
| Interest paid                                       | \$ 456,411           | \$ 27,461            | \$ 88,031          |

See accompanying notes to the consolidated financial statements

## **Guardian Exploration Inc.**

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### **1. Nature of operations and going concern**

#### *Nature of operations*

Guardian Exploration Inc. (“Guardian”) was incorporated in Alberta as Guardian Resources Inc. on March 27, 2001. On May 14, 2001 Guardian changed its name to Guardian Exploration Inc. and obtained Extraprovincial Registration in British Columbia on June 22, 2001. On April 21, 2006 Guardian amalgamated with Resilient Resources Ltd. (“Resilient”), a public company listed on the TSX Exchange. The amalgamated company continued under the name Guardian Exploration Inc. (the “Company”). The Company is engaged in the acquisition, exploration, and development of petroleum and natural gas properties in Western Canada and the State of Montana. Given the Company’s limited number of producing wells, it is currently dependent on transmission facilities owned by another company.

Pursuant to the terms of the Amalgamation Agreement, all of the issued and outstanding Resilient and Guardian shares were converted into shares of the Company based on specified conversion rates. Resilient shareholders received 0.154376 of a common share of the Company for each common share of Resilient owned, and Guardian shareholders received 0.489758 of a common share of the Company for each common share of Guardian owned. After giving effect to the transaction, former Guardian shareholders owned 18,145,023 shares and former Resilient shareholders owned 1,854,977 shares of a total of 20,000,000 shares of the Company. As part of the amalgamation, Resilient warrant holders received 237,502 warrants of the Company and Resilient agent warrant holders received 65,248 agent warrants of the Company.

The amalgamation was accounted for as a reverse take-over of Resilient by Guardian. For accounting purposes, Guardian is the acquirer and the combined entity is considered to be the continuation of Guardian, except for the authorized and issued number of shares which is that of the Company.

#### *Going concern*

These financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and accordingly, have been prepared using the same principles as those for a going concern. As at December 31, 2006, the Company had a working capital deficiency of \$6,598,981 (December 31, 2005 – \$1,064,566; August 31, 2005 – \$3,745,372), long-term debt of \$1,207,667 (December 31, 2005 – \$70,056; August 31, 2005 – \$437,999) and an accumulated deficit of \$7,570,373 (December 31, 2005 – \$1,410,601; August 31, 2005 – \$57,315). The Company has an obligation to incur \$3,929,224 of qualifying expenditures prior to December 31, 2007. See note 15 (a). Should the Company be unsuccessful in realizing the value of its current and future projects, it may not be able to realize its assets and discharge its liabilities in the normal course of business.

## Guardian Exploration Inc.

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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#### 1. Nature of operations and going concern, continued

##### *Going concern, continued*

The Company's efforts and resources are directed at developing a portfolio of projects and realizing on the value of such projects in the future. Due to numerous risks inherent in these projects, there can be no assurance the Company will be successful. While the Company seeks to mitigate risks by working with joint venture partners and developing a stable production base, the Company's success will, largely, depend on its continued ability to finance the development of existing projects and the acquisition and development of new projects.

#### 2. Business combination

On April 21, 2006, Guardian and Resilient amalgamated under the terms of an amalgamation agreement. The share allocation was determined by arm's length negotiation based on each company's respective net asset value.

The transaction has been accounted for as an acquisition of Resilient by Guardian using the purchase method.

The purchase price has been recorded at the fair value of the assets and liabilities acquired, as follows:

##### Allocation of purchase price:

|  |    |                    |
|--|----|--------------------|
| Petroleum and natural gas property and equipment | \$ | 1,392,194          |
| Deposit  |    | 350,280            |
| Asset retirement obligations                     |    | (312,879)          |
| Working capital (deficiency)                     |    | <u>(1,429,595)</u> |
|  | \$ | <u>-</u>           |
| Consideration                                    |    |                    |
| Issue of 1,854,977 common shares                 | \$ | <u>-</u>           |

The results of operations of Resilient are included in the accounts of the Company from April 22, 2006.

#### 3. Significant accounting policies

##### (a) Consolidation

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, K2 America Corp. and K2 Operating Corp. They were incorporated under the General and Business Corporate Law of the State of Montana on November 16, 1995 and February 12, 1998, respectively.

## **Guardian Exploration Inc.**

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### **3. Significant accounting policies, continued**

#### **(b) Property and equipment – Canadian cost center**

##### *Capitalized costs*

The Company follows the full cost method of accounting for its petroleum and natural gas properties. Under this method, all costs related to the acquisition of, exploration for, and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses, overhead directly related to exploration and development activities and costs of drilling both productive and non-productive wells.

Proceeds from the sales of properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would alter the rate of depletion and depreciation by 20% or more.

##### *Impairment*

The impairment calculation, or “ceiling test”, is calculated by comparing the carrying value of property and equipment to the sum of undiscounted cash flows expected to result from the future production of proved reserves and the carrying value of unproved properties, net of any impairments. Estimates of future net revenues are based on expected future commodity prices and costs rather than those existing at the measurement date.

Should the ceiling test result in an excess of carrying value, the Company would then measure the amount of impairment by comparing the carrying value of property and equipment to an amount equal to the estimated net present value of future cash flows from proved plus probable reserves and the carrying value of unproved properties, net of any impairments. A risk-free interest rate is applied to arrive at the net present value of the future cash flows. Any excess is recorded as a permanent impairment and charged as additional depletion and depreciation.

Undeveloped and unproved properties are assessed periodically to determine whether impairment has occurred.

##### *Depletion*

Depletion of petroleum and natural gas properties and depreciation of production equipment is calculated using the unit-of-production method based upon estimated proven petroleum and natural gas reserves, before royalties, as determined by an independent engineer. In determining its depletion base, the Company includes estimated future costs to be incurred in developing proven reserves and excludes the costs of the unproved properties.

Relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

## **Guardian Exploration Inc.**

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### **3. Significant accounting policies, continued**

#### **(c) Property and equipment – United States cost center**

The Company's petroleum and natural gas activities conducted in the United States cost center are regarded to be in the pre-production stage as exploration and development work continues and planned principle operations have not commenced. Accordingly, all costs incurred in this cost center have been capitalized and will commence to be depleted and amortized once commercial production levels have been attained or written-off if permanent impairment in value has been determined. Minor revenues are offset against capitalized costs until commercial production has commenced. The total costs in this cost center are assessed periodically to determine whether impairment has occurred.

#### **(d) Asset retirement obligations**

The fair value of the liability for the Company's asset retirement obligations is recorded in the period it is incurred with a corresponding increase in the carrying value of the related long-lived asset. Fair value is estimated using the present value of the estimated future cash outflows to reclaim and abandon wells and facilities, using the Company's credit-adjusted risk-free interest rate. The liability is subsequently adjusted due to the passage of time and the increase is recorded as an accretion expense. The liability is also adjusted for revisions in either the timing or the amount of the original estimated cash flows associated with the liability. Actual asset retirement obligations paid are deducted from the liability in the year incurred.

#### **(e) Future income taxes**

The Company uses the liability method of accounting for income taxes. Temporary differences arising from the difference between the tax basis of an asset or liability and the carrying amount on the balance sheet are used to calculate future income tax assets or liabilities. Future income tax assets or liabilities are calculated using the substantively enacted tax rates anticipated to apply in the period that the temporary differences are expected to reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized in net income in the period in which the change is substantively enacted. To the extent that the Company does not consider it to be more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

#### **(f) Joint ventures**

A portion of the exploration, development and production activities is conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

## **Guardian Exploration Inc.**

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### **3. Significant accounting policies, continued**

#### **(g) Cash and cash equivalents**

Cash and cash equivalents include cash on hand, balances with banks and short-term deposits with original maturities of less than three months.

#### **(h) Flow-through shares**

Resource expenditure deductions funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. To recognize the foregone tax benefits to the Company, the future income tax liability and the carrying value of the shares issued are adjusted by the effect of the tax benefits renounced to subscribers when the corresponding exploration and development expenditures are renounced.

#### **(i) Revenue recognition**

Revenue from petroleum and natural gas is recognized based on volumes delivered to customers at contractual delivery points and rates. The costs associated with the delivery, including operating, transportation, and production based royalties are recognized in the same period in which the related revenue is earned.

The license fee revenue is recognized when license approval is received from the government.

#### **(j) Stock-based compensation**

The Company follows the fair value method of accounting for stock options granted to directors, officers, employees and consultants. Fair value is determined at the grant date using the Black-Scholes option-pricing model. The value attributed to options is recognized over the vesting period as stock-based compensation expense with a corresponding credit to contributed surplus. The contributed surplus balance is reduced as the options are exercised with the amount initially recorded being credited to share capital.

#### **(k) Foreign currency translation**

Operations of the Company's subsidiary are considered to be integrated and therefore the financial statements of the subsidiary are included in these consolidated financial statements on the basis that monetary assets and liabilities are translated at the exchange rate in effect at year end, non-monetary assets and liabilities are translated at historical rates and revenues and expenses are translated at the average rate for the period.

## **Guardian Exploration Inc.**

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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#### **3. Significant accounting policies, continued**

##### **(l) Use of estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the period. The amounts recorded for depletion of petroleum and natural gas properties and equipment, the provision for asset retirement obligation costs, and the petroleum and natural gas properties and equipment impairment test calculation are based on estimates of gross proven reserves, future production rates, future petroleum and natural gas prices, future costs, and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements in future years could be significant.

##### **(m) Per share information**

Per share information is calculated on the basis of the weighted average number of common shares outstanding during the fiscal year. Diluted per share information reflects the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. Diluted per share information is calculated using the treasury stock method that assumes any proceeds received by the Company upon the exercise of in-the-money stock options would be used to buy back common shares at the average market price for the period.

#### **4. Accounts receivable**

Included in accounts receivable is \$1,572,000 from one joint venture partner, for which the Company has undertaken legal proceedings for collection of the amount. It is Management's opinion that the amount will be collected and no allowance has been recorded in the Company's records. See note 16(b).

#### **5. Deposit**

As part of the finalization of the Amended Agreement with the Blackfeet Nation, the Company has placed a deposit of \$349,920 (\$USD 300,000), with the Bureau of Indian Affairs-Blackfeet Agency to cover the costs of future site restoration and abandonment liabilities. This deposit is considered to be refundable, subject to application for refund, which may or may not be granted. Accordingly, the deposit is shown as a long-term asset.

## Guardian Exploration Inc.

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### 6. Property and equipment

| <u>December 31, 2006</u>                         | <u>Cost</u>          | <u>Accumulated<br/>Depletion and<br/>Depreciation</u> | <u>Net</u>          |
|--|----------------------|---|---------------------|
| Petroleum and natural gas property and equipment | <u>\$ 15,547,604</u> | <u>\$ 6,323,803</u>                                   | <u>\$ 9,223,801</u> |
| <u>December 31, 2005</u>                         |                      |   |                     |
| Petroleum and natural gas property and equipment | <u>\$ 6,373,622</u>  | <u>\$ 2,775,591</u>                                   | <u>\$ 3,598,031</u> |
| <u>August 31, 2005</u>                           |                      |   |                     |
| Petroleum and natural gas property and equipment | <u>\$ 5,875,067</u>  | <u>\$ 733,400</u>                                     | <u>\$ 5,141,667</u> |

#### Canadian cost center:

There were no capitalized general and administrative expenses for the periods ended December 31, 2006, December 31, 2005 or August 31, 2005.

Unproven property costs of \$NIL (December 31, 2005 - \$797,582; August 31, 2005 - \$NIL) have been excluded from capitalized costs subject to depletion.

There were no future development costs related to proved undeveloped reserves included in the depletion calculation for the periods ended December 31, 2006, December 31, 2005 or August 31, 2005.

In conducting the ceiling test in the Canadian cost center as at December 31, 2006, the Company's carrying value of the petroleum and natural gas properties exceeded the estimated future cash flows plus the proceeds of the property sold subsequent to year end, resulting in a write-down of \$2,056,789 included as additional depletion and depreciation. The following prices used in the ceiling test calculation have been adjusted for quality and transportation costs specific to the Company, as follows:

|            | <b>Natural Gas<br/>B.C. (spot sales)<br/>(CAD\$/mcf)</b> |
|------------|--|
| 2007       | \$ 6.00  |
| 2008       | 6.57   |
| 2009       | 6.53   |
| 2010       | 6.49   |
| 2011       | 6.62   |
| Thereafter | increasing by 2%   |

#### United States cost center:

The Company assessed an impairment of undeveloped properties in the US cost center of \$832,513, which is included as additional depletion and depreciation.

The Company capitalized general and administrative expenses of \$65,915.

## **Guardian Exploration Inc.**

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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#### **7. Demand revolving loan**

The Company had a revolving demand credit facility (the "facility") with a Canadian chartered bank in the amount of \$1,500,000. Borrowings under the facility bore interest at the bank's prime rate plus 1.5% per annum and were secured by a demand fixed and floating charge debenture conveying a first charge on all assets of the Company. Repayment of the facility was also guaranteed by a related company, Guardian Helicopters Inc.

As at December 31, 2005, \$1,090,000 (August 31, 2005 - \$1,475,000) was drawn on the facility. The facility was due and payable November 30, 2005, however the bank granted an extension to the facility until February 8, 2006 when the facility was converted into a term loan with monthly payments of \$100,000 plus interest at the bank's prime rate plus 1.5% per annum. The term loan became due and was paid on June 30, 2006.

#### **8. Convertible debenture**

Immediately prior to the amalgamation, in April 2006, Guardian issued a convertible debenture (the "debenture financing") in the amount of \$4,500,000 to mature 18 months from the date of issuance and bearing interest at an annual rate of 7%, increasing to an annual rate of 10% if the principal amount has not been re-paid within one year of its issuance. If the Company was to go in default, the interest rate would increase to 14% per annum. The debenture was convertible into common shares of the Company at a conversion price of \$0.75 per share. As security for the debenture, certain assets of the Company had been pledged. The debenture may have been prepaid in its entirety prior to the maturity of the debenture, provided the Company was not in default under the terms of the debenture, upon 5 days notice to the lender, where the lender then had the option to either accept the pre-payment or convert the debenture financing into common shares of the Company.

If the Company raises new equity or debt capital, excluding proceeds from the exercising of warrants and stock options, subsequent to the closing of the debenture, the holder has the right to require that these funds be used to repay all or part of the outstanding principal amount of the debenture, excluding the first \$4,000,000 of funds received from the issuance of flow-through shares by the Company.

In conjunction with the debenture financing the lender immediately received 650,000 common shares of the Company, valued at \$422,500, as a finance fee. The lender also received warrants to acquire 1,600,000 common shares of the Company. Upon amalgamation these converted to warrants to acquire 783,613 common shares of the Company, at an exercise price of \$1.53 per common share expiring 42 months from the date of issuance. The warrants were valued at \$673,600. See note 12(g).

On August 18, 2006 the Company repaid \$3,500,000 of the debenture financing. The remaining amount of \$1,000,000 was subject to a restructuring agreement whereby all terms as indicated in the original agreement remained with only the interest terms changed to be fixed at an annual rate of 7% and if the Company was to go in default, the interest rate would increase to 14% per annum. Also the requirement of any funds received from the issuance of flow-through shares by the Company was removed.

The balance of the convertible debenture was repaid in January 2007.

## Guardian Exploration Inc.

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### 8. Convertible debenture, continued

The debenture is a financial instrument that contains both a liability and equity component. The liability component and the equity component must be presented separately, as determined at initial recognition. The Company has valued the equity component of this debenture using the residual value method, whereby the liability component was valued first using management's best estimate of the current market rate for comparable instruments at the time of issuance and the difference between the proceeds of the debenture issued and the fair value of the liability is assigned to the equity component.

The resulting liability and equity values determined using this method based on an estimated 14% interest rate were as follows:

|                                   | <u>Liability<br/>Component</u> | <u>Equity<br/>Component</u> | <u>Total</u>       |
|-----------------------------------|--------------------------------|-----------------------------|--------------------|
| Balance, December 31, 2005        | \$ -                           | \$ -                        | \$ -               |
| Issuance of convertible debenture | 4,133,316                      | 366,684                     | 4,500,000          |
| Payment on convertible debenture  | <u>(3,163,434)</u>             | <u>(336,566)</u>            | <u>(3,500,000)</u> |
| Balance, December 31, 2006        | <u>\$ 969,882</u>              | <u>\$ 30,118</u>            | <u>1,000,000</u>   |

Accretion expense related to the liability component of the convertible debenture was recognized upon payment on the debenture and the equity portion was reclassified to contributed surplus. See note 12 (h).

### 9. Due to related company

Amounts owing to a company, related by common management, are unsecured, bear no interest and have no fixed terms of repayment.

### 10. Due to shareholder

Amounts owing to the controlling shareholder of the Company are unsecured, bear no interest and have no fixed terms of repayment.

## Guardian Exploration Inc.

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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#### 11. Asset retirement obligations

|   | <u>December 31,</u><br><u>2006</u> | <u>December 31,</u><br><u>2005</u> | <u>August 31,</u><br><u>2005</u> |
|---|------------------------------------|------------------------------------|----------------------------------|
| Asset retirement obligations, beginning of period | \$ 70,056                          | \$ 45,562                          | \$ 9,218                         |
| Obligations incurred in the period                | 138,018                            | 23,624                             | 33,765                           |
| Liabilities transferred upon amalgamation         | 312,879                            | -                                  | -                                |
| Acquisitions                                      | 826,669                            | -                                  | -                                |
| Dispositions                                      | (25,388)                           | -                                  | -                                |
| Expenditures made on asset retirements            | (192,501)                          | -                                  | -                                |
| Revisions to obligations                          | 608                                | -                                  | -                                |
| Accretion   | 77,326                             | 870                                | 2,579                            |
|   | <hr/>                              | <hr/>                              | <hr/>                            |
| Asset retirement obligations, end of period       | \$ 1,207,667                       | \$ 70,056                          | \$ 45,562                        |

The total undiscounted amount of cash flows required to settle the obligations as measured at December 31, 2006 are estimated to be \$2,113,469 (December 31, 2005 - \$ 80,602; August 31, 2005 - \$80,602). These obligations are expected to be settled at various times over the 17 years subsequent to December 31, 2006. The timing of the settlements of the obligations for the Ronalane, Cherry, Antole and Alderson areas could have a significant range due to the status of the wells. Management has used an estimate of 5 years for purposes of this calculation. Included in acquisitions is \$787,000 related to these properties for which title transfer to the Company from the vendor may not be completed due to regulatory restrictions. The credit-adjusted risk free rate at which the estimated cash flows were discounted was 8% during the year ended December 31, 2006 (December 31, 2005 - 6%; August 31, 2005 - 6%) and the estimated inflation rate used to project future costs was 1.5% (December 31, 2005 - 2 %; August 31, 2005 - 2%).

#### 12. Share capital

##### (a) Authorized

Unlimited number of Class A common voting shares

Unlimited number of Class B non-voting common shares

Unlimited number of Class A voting preferred shares, 7% non-cumulative, redeemable by the Company.

## Guardian Exploration Inc.

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

#### 12. Share capital, continued

##### (b) Issued

|  | <u>Number</u>     | <u>Amount</u>       |
|--|-------------------|---------------------|
| <b>Balance, August 31, 2004</b>                              | 116               | \$ 255,951          |
| Effect of 70,000 to 1 stock split, December, 2004            | 8,119,884         | -                   |
| Private placement of units for cash (i)                      | 722,000           | 902,500             |
| Share issue costs  | -                 | (104,488)           |
| Tax effect of share issue costs                              | -                 | 37,218              |
| Tax effect of flow-through shares                            | -                 | (321,470)           |
| <b>Balance, August 31, 2005</b>                              | 8,842,000         | 769,711             |
| Effect of 2.6 to 1 stock split, September 2005               | 14,147,200        | -                   |
| Private placement of units for cash (ii)                     | 5,097,996         | 2,294,098           |
| Private placement of units for cash (iii)                    | 1,429,575         | 929,224             |
| Share issue costs  | -                 | (163,202)           |
| Tax effect of share issue costs                              | -                 | 43,647              |
| <b>Balance, December 31, 2005</b>                            | 29,516,771        | 3,873,478           |
| Private placement of flow through shares for cash (iv)       | 5,333,333         | 4,000,000           |
| Private placement of common shares for cash (iv)             | 1,480,000         | 962,000             |
| Issued for finance fee on private placement (iv)             | 68,853            | -                   |
| Issued for financing fee on convertible debenture (v)        | 650,000           | 422,500             |
| Consolidation of shares on amalgamation (note 2)             | (18,903,934)      | -                   |
| Issued to Resilient shareholders on<br>amalgamation (note 2) | 1,854,977         | -                   |
| Share issue costs  | -                 | (874,988)           |
| Tax effect of flow-through shares                            | -                 | (279,152)           |
|  | <u>20,000,000</u> | <u>8,103,838</u>    |
| Issued under contractual right to acquire (iii)              | 79,422            | -                   |
| <b>Balance, December 31, 2006</b>                            | <u>20,079,422</u> | <u>\$ 8,103,838</u> |

- (i) On December 31, 2004, the Company closed private placements of 722,000 units at \$1.25 per unit for gross proceeds of \$902,500. Each unit consists of one flow-through common share and one-half share purchase warrant. Each whole warrant entitles the holder to purchase one additional common share at a price of \$1.50 per share 12 months from the date of closing. The corporation issued warrants to the agents in an amount equal to 7.5% of the aggregate number of units sold under the private placement, with each warrant being issuable into one common share at a price of \$1.25 per share for a period of 18 months from the date of the closing.

## **Guardian Exploration Inc.**

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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#### **12. Share capital, continued**

##### **(b) Issued, continued**

- (ii) On October 26, October 31, November 4 and November 9, 2005, the Company closed private placements of 5,097,996 units at \$0.45 per unit for gross proceeds of \$2,294,098. Each unit consists of one common share and one-half share purchase warrant. Each whole warrant entitles the holder to purchase one additional common share at a price of \$0.75 per share for a period of 12 months from the date of closing.
- (iii) On December 30, 2005, the Company closed private placements of 1,429,575 units at \$0.65 per unit for gross proceeds of \$929,224. Each unit consists of one flow-through common share and one-half share purchase warrant. Each whole warrant entitles the holder to purchase one additional common share at a price of \$1.00 per share for a period of 12 months from the date of closing. The Company issued a further 79,422 common shares to certain individuals as a result of a penalty provision whereby the Company was obliged to issue a penalty of 5% of the shares originally issued to such parties for every 30 days after March 15, 2006 that the Company remained unlisted on a recognized stock exchange. This penalty provision expired on May 11, 2006, the date of listing of the Company's common shares on the TSX Venture Exchange.
- (iv) On March 30, 2006, the Company closed private placements of 5,333,333 common shares on a flow-through basis at a price of \$0.75 per flow-through share for gross proceeds of \$4,000,000. An additional placement of 1,480,000 common shares was completed at a price of \$0.65 per common share for gross proceeds of \$962,000. The Company paid a cash commission of 7% of the gross proceeds received from the private placement, reduced to 3% on sales of common shares or flow through shares to or by directors or officers of the Company on a maximum of \$2,000,000 in gross proceeds. The Company issued warrants to the agents in an amount equal to 7.0% of the aggregate number of common shares and flow-through common shares sold under the private placement, with each warrant being issuable into one common share at a price of \$0.65 per share for a period of 18 months from the date of the closing, reduced to 3% in respect to the reduced commission orders referred to above. The Company has also paid a finance fee of 2% of the gross proceeds raised directly by the agent under the private placement, such finance fee satisfied half by way of cash payment and half by way of issuance of 68,853 common shares at a deemed price of \$0.65 per share.
- (v) In accordance with the convertible debenture agreement (note 8), the Company paid a finance fee of \$422,500 by the issuance of 650,000 common shares. The Company also granted the holder warrants to acquire 1,600,000 common shares, with an exercise price of \$0.75 per share exercisable for a period of forty-two months from the amalgamation date.

## Guardian Exploration Inc.

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### 12. Share capital, continued

#### (c) Escrowed shares

At December 31, 2006 the Company is holding 5,109,427 common shares in escrow arising from an agreement that provides for a release subject to approval by regulatory authorities. Pursuant to the terms of an escrow agreement in TSX Venture Exchange Form 5D among the Company, certain insiders of the Company and Computershare Trust Company of Canada, as escrow agent, one quarter of the escrowed shares were released on the date of closing of the Resilient/Guardian amalgamation, with all remaining escrowed shares released as to one-third every six months following the date of closing of the Resilient/Guardian amalgamation.

#### (d) Stock options

During 2006, the Company adopted a stock-based compensation plan for its directors, officers and consultants which provides for granting of options to purchase common shares of the Company. The stock options issued shall not exceed 10% of the issued shares of the Company at the time of granting of options. The exercise price and vesting terms of any options granted are fixed by the Board of Directors of the Company at the time of grant.

|   | <b>Number</b>      | <b>Weighted</b>      |
|---|--------------------|----------------------|
|   | <b>Outstanding</b> | <b>Average Price</b> |
|   |                    | <b>Per share</b>     |
| <b>Balance, August 31, 2005 and December 31, 2005</b> | -                  | \$ -                 |
| Granted   | 1,650,000          | 1.10                 |
| Cancelled   | (375,000)          | (1.10)               |
| Exercised   | -                  | -                    |
|   | <u>1,275,000</u>   | <u>\$ 1.10</u>       |
| <b>Balance, December 31, 2006</b>                     | <u>1,275,000</u>   | <u>\$ 1.10</u>       |
| <b>Exercisable, December 31, 2006</b>                 | <u>240,000</u>     | <u>\$ 1.10</u>       |

Effective May 29, 2006, the Company issued 1,650,000 options to directors, officers and consultants with an exercise price of \$1.10 per share and expiring May 29, 2007. The options have vesting terms as follows:

240,000 options vested immediately, 515,000 on May 29, 2007, 590,000 on May 29, 2008 and 300,000 on May 29, 2009. Of these options, 575,000 have been cancelled subsequent to year end.

Assumptions used in the calculation of the fair value of options granted are as follows:

|                                 |         |
|---------------------------------|---------|
| Risk free interest rate         | 4.19%   |
| Expected life                   | 5 years |
| Volatility                      | 100 %   |
| Dividends                       | NIL     |
| Resulting fair value per option | \$0.803 |

## Guardian Exploration Inc.

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### 12. Share capital, continued

#### (e) Warrants

|                                     | <b>Number<br/>Outstanding</b> | <b>Weighted<br/>Average Price<br/>Per share</b> |
|-------------------------------------|-------------------------------|---|
| <b>Balance, August 31, 2004</b>     | -                             | \$ -  |
| Granted                             | 361,000                       | 1.50  |
| <b>Balance, August 31, 2005</b>     | 361,000                       | 1.50  |
| Granted                             | 3,263,786                     | 0.80  |
| Expired                             | (361,000)                     | (1.50)  |
| <b>Balance, December 31, 2005</b>   | 3,263,786                     | 0.80  |
| Amalgamation adjustment             | (1,665,321)                   | -   |
|                                     | 1,598,465                     | 1.64  |
| Issued to Resilient warrant holders | 237,502                       | 5.83  |
| Expired                             | (1,598,465)                   | (1.64)  |
| <b>Balance, December 31, 2006</b>   | 237,502                       | \$ 5.83   |

#### (f) Agent Warrants

|   | <b>Number<br/>Outstanding</b> | <b>Weighted<br/>Average Price<br/>Per share</b> |
|---|-------------------------------|---|
| <b>Balance, August 31, 2005</b>           | -                             | \$ -  |
| Granted                                   | 54,150                        | 1.25  |
| <b>Balance, December 31, 2005</b>         | 54,150                        | 1.25  |
| Granted                                   | 590,266                       | 0.67  |
| Amalgamation adjustment                   | (328,808)                     | -   |
|   | 315,608                       | 1.47  |
| Issued to Resilient agent warrant holders | 65,248                        | 6.54  |
| Expired                                   | (91,768)                      | (5.39)  |
| <b>Balance, December 31, 2006</b>         | 289,088                       | \$ 1.37   |

## Guardian Exploration Inc.

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### 12. Share capital, continued

#### (g) Debenture warrants

|   | <b>Number<br/>Outstanding</b> | <b>Weighted<br/>Average Price<br/>Per share</b> |
|---|-------------------------------|---|
| <b>Balance, August 31, 2005 and December 31, 2005</b> | -                             | \$ -  |
| Granted   | 1,600,000                     | 0.75  |
| Amalgamation adjustment                               | <u>(816,387)</u>              | <u>-</u>  |
| <b>Balance, December 31, 2006</b>                     | <u>783,613</u>                | <u>\$ 1.53</u>                                  |

The fair value of the debenture warrants of \$673,600 was determined at the grant date using the Black-Scholes option-pricing model. The value attributed to the debenture warrants was recognized as interest and financing fees with a corresponding credit to warrants.

Assumptions used in the calculation of the fair value of debenture warrants granted are as follows:

|                                 |           |
|---------------------------------|-----------|
| Risk free interest rate         | 4.16%     |
| Expected life                   | 3.5 years |
| Volatility                      | 100 %     |
| Dividends                       | NIL       |
| Resulting fair value per option | \$0.421   |

#### (h) Contributed surplus

|   |                   |
|---|-------------------|
| <b>Balance, August 31, 2005 and December 31, 2005</b> | \$ 532            |
| Stock-based compensation                              | 192,792           |
| Conversion right of debenture repaid                  | <u>336,566</u>    |
| <b>Balance, December 31, 2006</b>                     | <u>\$ 529,890</u> |

#### (i) Earnings per share

Basic per share amounts are calculated using the weighted average number of common shares outstanding of 18,581,549 (December 31, 2005 – 12,329,086; August 31, 2005 – 10,951,847).

The Company's dilutive instruments have not been included in the computation of earnings per share as the effect would be anti-dilutive.

## Guardian Exploration Inc.

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

#### 13. Future income taxes

|  | <u>December 31,</u><br><u>2006</u> | <u>December 31,</u><br><u>2005</u> | <u>August 31,</u><br><u>2005</u> |
|--|------------------------------------|------------------------------------|----------------------------------|
| Loss before income taxes                     | \$ (6,438,539)                     | \$ (1,555,539)                     | \$ (582,156)                     |
| Statutory tax rate                           | 34.49%                             | 35.62%                             | 35.62%                           |
| Expected tax expense (recovery)              | \$ (2,220,652)                     | \$ (554,083)                       | \$ (207,364)                     |
| Increase (decrease) resulting from:          |                                    |                                    |                                  |
| Non-deductible crown royalties               | 25,845                             | 45,686                             | 8,618                            |
| Non-deductible stock-based compensation      | 67,626                             | -                                  | -                                |
| Non-deductible accretion on debenture        | 116,082                            | -                                  | -                                |
| Resource allowance                           | 27,117                             | (33,249)                           | 31,642                           |
| Non-deductible expenses                      | 112,849                            | -                                  | -                                |
| Tax rate changes                             | -                                  | (38,802)                           | 66,980                           |
| Lower effective rate due to decreasing rates | 238,570                            | 80,195                             | -                                |
| Increase in valuation allowance              | 1,353,796                          | 298,000                            | -                                |
| Future income tax expense (recovery)         | <u>\$ (278,767)</u>                | <u>\$ (202,253)</u>                | <u>\$ (100,124)</u>              |

The components of the net Canadian future tax asset (liability) are as follows:

|   | <u>December 31,</u><br><u>2006</u> | <u>December 31,</u><br><u>2005</u> | <u>August 31,</u><br><u>2005</u> |
|---|------------------------------------|------------------------------------|----------------------------------|
| Future income tax assets related to:      |                                    |                                    |                                  |
| Property and equipment                    | \$ 224,100                         | \$ 208,300                         | \$ -                             |
| Non-capital losses                        | 925,200                            | -                                  | 93,900                           |
| Asset retirement obligations              | 310,200                            | 21,000                             | 16,200                           |
| Share issue costs                         | 432,500                            | 68,700                             | 29,800                           |
|   | 1,892,000                          | 298,000                            | 139,900                          |
| Valuation allowance                       | <u>(1,892,000)</u>                 | <u>(298,000)</u>                   | <u>-</u>                         |
| Total future income tax assets            | -                                  | -                                  | 139,900                          |
| Future income tax liabilities related to: |                                    |                                    |                                  |
| Property and equipment                    | -                                  | -                                  | (385,800)                        |
| Future income tax asset (liability)       | <u>\$ -</u>                        | <u>\$ -</u>                        | <u>\$ (245,900)</u>              |

For income tax purposes, the Company's loss carried forward in Canada from the current year can be applied to reduce future years' taxable income and expires in 2026.

## **Guardian Exploration Inc.**

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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#### **14. Related party transactions**

- (a) The Company recorded management fees of \$137,300 (December 31, 2005 - \$52,800; August 31, 2005 - \$63,600) to a company controlled by a major shareholder and officer of the Company. Included in accounts payable are \$66,340 for management fees (December 31, 2005 - \$NIL; August 31, 2005 - \$63,600). The Company has also obtained helicopter services in conjunction with the servicing and drilling of natural gas wells in Northern B.C., from the same company, for which the Company was charged \$862,569 (December 31, 2005 - \$14,633; August 31, 2005 - \$227,977) and of this amount \$654,509 (December 31, 2005 - \$14,633; August 31, 2005 - \$27,975) remains in accounts payable.
- (b) The Company paid \$58,145 (December 31, 2005 - \$46,064; August 31, 2005 - \$30,750) for financial management and accounting fees to a company of which a shareholder and a former officer of the Company, is an officer of that company.
- (c) Geological consulting fees in the amount of \$159,750 (December 31, 2005 - \$12,840; August 31, 2005 - \$NIL) have been paid to a company of which a shareholder and a former officer of the Company, is an officer of that company.
- (d) Legal fees in the amount of \$201,889 have been paid to a legal firm of which a director of the Company, appointed in 2006, is a partner.

These transactions are in the normal course of business and are recorded at the exchange amount which is the amount of consideration established and agreed to by the related parties.

#### **15. Commitments**

##### **(a) Flow-through renunciation expenditure commitments**

Pursuant to the flow-through share issuance completed in December 2005 the Company was committed to incur \$929,774 of qualified expenditures by December 31, 2006. At December 31, 2006 the obligation has been fulfilled. The costs were renounced to investors in February 2006. The future tax liability of \$279,152 was recorded in 2006.

Pursuant to the flow-through share issuance completed in March 2006 the Company is committed to incur \$4,000,000 of qualified expenditures by December 31, 2007. At December 31, 2006, \$70,776 of the obligation has been fulfilled with the remaining \$3,929,224 to be incurred by December 31, 2007. The costs were renounced to investors in February 2007. The estimated future tax liability of \$1,200,000 will be recorded in 2007.

## Guardian Exploration Inc.

Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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### 15. Commitments, continued

#### (b) Blackfeet Tribal agreement

The Company owns the rights to explore for petroleum and natural gas on approximately 100,000 tribal mineral acres titled the Eastern Lands on the Blackfeet Indian Reservation in northern Montana.

As at December 31, 2006 the Company's commitments to retain its exploration rights in the lands are as follows:

- payments to the Blackfeet Tribe of annual rental fees of \$USD 300,000 until 2008.
- an obligation to drill a total of 4 wells; 2 wells by September 1, 2007 and the remaining 2 wells by April 18, 2008, when the exploration agreement with the Blackfeet Tribe expires.

#### (c) Office lease obligation

The Company's total obligations, under a property lease agreement, exclusive of occupancy costs, are as follows:

|      |    |               |
|------|----|---------------|
| 2007 | \$ | 38,943        |
| 2008 |    | <u>32,453</u> |
|      | \$ | <u>71,396</u> |

#### (d) Employment contract

Under the terms of an employment contract with the Chief Executive Officer, the Company is committed to pay severance under certain circumstances equal to 2 years salary plus 15%.

### 16. Contingencies

- (a) The Company was named as a defendant in a lawsuit where a service company claims breach of contract due to non-collection of payment for wire line services and equipment rendered to the Company. On February 23, 2007, the service company filed a statement of claim and is seeking \$709,311 in damages. The Company has filed a statement of defence on March 23, 2007. The Company has included \$643,072 of the claim in accounts payable.
- (b) The Company has begun legal action against a joint venture partner at December 31, 2006. See note 4. It is Management's opinion that the amount will be collected and no allowance has been recorded in the Company's records. Subsequently, the joint venture partner has filed a counter-claim for damages in the amount of \$1,900,000. It is Management's opinion that the claim is without merit and accordingly no accrual has been made in these financial statements.

## Guardian Exploration Inc.

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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#### 17. Changes in non-cash working capital

|                                      | <u>December 31,<br/>2006</u> | <u>December 31,<br/>2005</u> | <u>August 31,<br/>2005</u> |
|--------------------------------------|------------------------------|------------------------------|----------------------------|
| Changes in non-cash working capital: |                              |                              |                            |
| Accounts receivable                  | \$ (2,422,333)               | \$ 21,657                    | \$ (99,971)                |
| Prepays                              | (48,471)                     | (16,560)                     | -                          |
| Accounts payable                     | 4,776,179                    | (1,023,473)                  | 2,074,864                  |
|                                      | <u>\$ 2,305,375</u>          | <u>\$ (1,018,376)</u>        | <u>\$ 1,974,893</u>        |
| Relating to:                         |                              |                              |                            |
| Operating activities                 | \$ (377,212)                 | \$ 105,230                   | \$ (163,217)               |
| Financing activities                 | 100,836                      | -                            | -                          |
| Investing activities                 | 2,581,751                    | (1,123,606)                  | 2,138,110                  |
|                                      | <u>\$ 2,305,375</u>          | <u>\$ (1,018,376)</u>        | <u>\$ 1,974,893</u>        |

#### 18. Segmented disclosures

Effective April 21, 2006 the Company's business was conducted in Canada and the United States.

|                                       | <u>December 31,<br/>2006</u> |                      |               |
|---------------------------------------|------------------------------|----------------------|---------------|
|                                       | <u>Canada</u>                | <u>United States</u> | <u>Total</u>  |
| Petroleum and natural gas revenue     | \$ 1,228,401                 | \$ -                 | \$ 1,228,401  |
| Interest expense                      | 456,408                      | -                    | 456,408       |
| Depletion, depreciation and accretion | 2,793,027                    | 832,513              | 3,625,540     |
| Loss for the period                   | 5,264,206                    | 895,566              | 6,159,772     |
| Property and equipment                | 8,223,801                    | 1,000,000            | 9,223,801     |
| Capital expenditures                  | \$ 11,916,217                | \$ 440,319           | \$ 12,356,536 |

## **Guardian Exploration Inc.**

### Notes to the Consolidated Financial Statements

For the twelve month period ended December 31, 2006; the four month period ended December 31, 2005 and the twelve month period ended August 31, 2005

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#### **19. Financial instruments**

##### Credit Risk

The Company's accounts receivable are with customers in the petroleum and natural gas industry and are subject to normal industry credit risk. See note 4.

##### Fair Value

The Company's carrying value of cash and cash equivalents, accounts receivable, accounts payable and convertible debenture approximates its fair value due to the immediate or short-term maturity of these instruments.

The fair value of the amounts due to shareholder and due to related party are less than carrying value, as the amounts are non-interest bearing. As the amounts have no terms of repayment, the fair value could not be calculated with any degree of certainty.

##### Commodity and price risk

The nature of the Company's operations results in exposure to fluctuations on commodity prices, exchange rates and interest rates. The Company monitors and when appropriate, will use derivatives or financial instruments to manage its exposure to these risks. At December 31, 2006, December 31, 2005 and August 31, 2005 the Company has no forward contracts outstanding or any financial instruments related to exchange rates or interest rates.

#### **20. Subsequent events**

##### **(a) Sale of Clarke Lake property**

In January 2007, the Company sold its working interest in the Clarke Lake area for total proceeds of \$6,500,000, less net revenues for the month of December 31, 2006.

##### **(b) Renegotiation of accounts payable balances**

Subsequent to year end, the Company negotiated a reduction of certain accounts payable with vendors of approximately \$1,350,000.

##### **(c) Debt obligation**

In March 2007, the Company purchased from Aquilon Capital Corp. for a cost of \$550,000, the net revenues for the life of the production from the Company's producing petroleum and natural gas wells in the Palmer/Tesoro Unit and the Kye Trout field in Montana. These net revenues were originally assigned as repayment of a convertible debenture in March 1, 2005.