



## **Condensed Interim Financial Statements (unaudited)**

For the three and nine months ended September 30, 2019

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**September 30, 2019**

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**Notice of No Auditor Review of Interim Financial Statements**

The accompanying interim financial statements of Kaisen Energy Corp. as at and for the three and nine-month periods ending September 30, 2019 have been prepared by and are the responsibility of the Company's Management.

The Company's independent auditors have not performed a review of these interim financial statements.

/s/ John Zahary  
Managing Director

November 22, 2019

## Interim Statements of Financial Position

(Unaudited, Canadian dollars)

|  | Note | September 30,<br>2019 | December 31,<br>2018 |
|--|------|-----------------------|----------------------|
| <b>Assets</b>                            |      |                       |                      |
| Current assets                           |      |                       |                      |
| Cash                                     |      | \$ 304,656            | \$ 328               |
| Accounts receivable                      | 9    | 2,124,722             | 292,251              |
| Prepaid expenses and deposits            |      | 237,937               | 134,933              |
| Risk management contracts                | 8    | -                     | 484,417              |
|  |      | <b>2,667,315</b>      | <b>911,929</b>       |
| Property, plant, and equipment           | 3,5  | 32,174,496            | 32,600,132           |
|  |      | <b>\$ 34,841,811</b>  | <b>\$ 33,512,061</b> |
| <b>Liabilities</b>                       |      |                       |                      |
| Current liabilities                      |      |                       |                      |
| Accounts payable and accrued liabilities |      | \$ 5,304,921          | \$ 2,126,023         |
| Risk management contracts                | 8    | 734,574               | -                    |
| Term loan                                | 6    | 1,850,000             | -                    |
| Bank loan                                | 6    | -                     | 2,095,587            |
|  |      | <b>7,889,495</b>      | <b>4,221,610</b>     |
| Risk management contracts                | 8    | 143,144               | 702,439              |
| Other long-term liabilities              | 3,12 | 12,065,415            | 11,822,343           |
|  |      | <b>20,098,054</b>     | <b>16,746,392</b>    |
| <b>Shareholders' equity</b>              |      |                       |                      |
| Share capital                            | 13   | 53,189,854            | 53,189,854           |
| Convertible debentures                   | 7    | 6,517,100             | 5,317,100            |
| Contributed surplus                      |      | 8,329,287             | 7,766,507            |
| Deficit                                  |      | (53,292,484)          | (49,507,792)         |
|  |      | <b>14,743,757</b>     | <b>16,765,669</b>    |
|  |      | <b>\$ 34,841,811</b>  | <b>\$ 33,512,061</b> |

Going concern (note 2)

See accompanying notes to the unaudited interim financial statements.

## Interim Statements of Comprehensive Income (Loss)

(Unaudited, Canadian dollars)

|   | Note | Three months ended  |                       | Nine months ended     |                       |
|---|------|---------------------|-----------------------|-----------------------|-----------------------|
|   |      | 2019                | September 30,<br>2018 | 2019                  | September 30,<br>2018 |
| <b>Revenues</b>                                     |      |                     |                       |                       |                       |
| Petroleum and natural gas sales                     |      | \$ 3,883,518        | \$ 4,714,800          | \$ 11,341,956         | \$ 12,992,630         |
| Royalties   |      | (655,587)           | (836,777)             | (1,893,308)           | (2,410,408)           |
| <b>Revenue, net of royalties</b>                    |      | <b>3,227,931</b>    | <b>3,878,023</b>      | <b>9,448,648</b>      | <b>10,582,222</b>     |
| Saskatchewan resource tax                           |      | (46,084)            | (24,931)              | (138,181)             | (72,090)              |
| Realized loss on risk management contracts          | 8    | (539,663)           | (1,216,524)           | (1,805,069)           | (2,443,616)           |
| Unrealized gain (loss) on risk management contracts | 8    | 572,700             | 616,311               | (659,696)             | (2,295,271)           |
| Other income  |      | 6,574               | 10,063                | 22,078                | 10,063                |
|   |      | <b>3,221,458</b>    | <b>3,262,942</b>      | <b>6,867,780</b>      | <b>5,781,308</b>      |
| <b>Expenses</b>                                     |      |                     |                       |                       |                       |
| Operating   |      | 2,399,155           | 2,449,490             | 6,213,465             | 6,865,309             |
| Transportation                                      |      | 183,311             | 243,283               | 573,348               | 647,583               |
| General and administrative                          |      | 250,176             | 327,136               | 853,177               | 1,363,929             |
| Net finance   | 11   | 93,176              | 98,721                | 277,764               | 288,897               |
| Share-based compensation                            | 13   | 154,280             | 386,850               | 474,275               | 1,069,950             |
| Restructuring                                       | 15   | -                   | -                     | -                     | 1,167,028             |
| Depletion and depreciation                          |      | 779,025             | 1,098,071             | 2,260,443             | 3,308,963             |
|   |      | <b>3,859,123</b>    | <b>4,603,551</b>      | <b>10,652,472</b>     | <b>14,711,659</b>     |
| Current taxes                                       |      | -                   | -                     | -                     | -                     |
| <b>Net loss and comprehensive loss</b>              |      | <b>\$ (637,665)</b> | <b>\$ (1,340,609)</b> | <b>\$ (3,784,692)</b> | <b>\$ (8,930,351)</b> |
| <b>Net loss per share</b>                           |      |                     |                       |                       |                       |
| Basic and diluted                                   | 14   | \$ (0.01)           | \$ (0.03)             | \$ (0.08)             | \$ (0.20)             |

See accompanying notes to the unaudited interim financial statements.

## Interim Statements of Cash Flows

(Unaudited, Canadian dollars)

|   | Note | Three months ended<br>September 30, |                | Nine months ended<br>September 30, |                |
|---|------|-------------------------------------|----------------|------------------------------------|----------------|
|   |      | 2019                                | 2018           | 2019                               | 2018           |
| <b>Cash provided by (used in) the following activities:</b> |      |                                     |                |                                    |                |
| <b>Operating activities</b>                                 |      |                                     |                |                                    |                |
| Net loss for the period                                     |      | \$ (637,665)                        | \$ (1,340,609) | \$ (3,784,692)                     | \$ (8,930,351) |
| Add items not affecting cash:                               |      |                                     |                |                                    |                |
| Depletion and depreciation                                  |      | 779,025                             | 1,098,071      | 2,260,443                          | 3,308,963      |
| Accretion of decommissioning obligations                    | 11   | 65,449                              | 64,917         | 193,172                            | 193,603        |
| Share-based compensation                                    | 13   | 154,280                             | 386,850        | 474,275                            | 1,069,950      |
| Restructuring   | 15   | -                                   | -              | -                                  | 257,162        |
| Unrealized (gain) loss on risk management contracts         | 8    | (572,700)                           | (616,311)      | 659,696                            | 2,295,271      |
| Other   |      | (2)                                 | (13,521)       | (1)                                | (27,099)       |
|   |      | (211,613)                           | (420,603)      | (197,107)                          | (1,832,501)    |
| Change in non-cash working capital                          | 16   | 1,276,707                           | 1,002,383      | 1,531,813                          | 1,906,922      |
| Cash from operating activities                              |      | 1,065,094                           | 581,780        | 1,334,706                          | 74,421         |
| <b>Financing activities</b>                                 |      |                                     |                |                                    |                |
| Net repayments of bank loan                                 |      | (2,161,817)                         | (1,656,598)    | (2,095,587)                        | (1,936,371)    |
| Advance of term loan, net of costs                          | 6    | 2,280,000                           | -              | 2,280,000                          | -              |
| Term loan principal repayments                              | 6    | (430,000)                           | -              | (430,000)                          | -              |
| Finance lease payments                                      | 3,12 | (24,134)                            | -              | (70,583)                           | -              |
| Issuance of convertible debentures, net of issue costs      | 7    | 1,000,000                           | 2,000,000      | 1,200,000                          | 4,016,100      |
| Cash from financing activities                              |      | 664,049                             | 343,402        | 883,830                            | 2,079,729      |
| <b>Investing activities</b>                                 |      |                                     |                |                                    |                |
| Development of oil and gas properties                       |      | (1,111,820)                         | (914,481)      | (1,646,544)                        | (2,938,030)    |
| Change in non-cash working capital                          | 16   | (312,667)                           | (112,462)      | (267,664)                          | (37,755)       |
| Cash used in investing activities                           |      | (1,424,487)                         | (1,026,943)    | (1,914,208)                        | (2,975,785)    |
| Change in cash  |      | 304,656                             | (101,761)      | 304,328                            | (821,635)      |
| Cash, beginning of the period                               |      | -                                   | 102,136        | 328                                | 822,010        |
| <b>Cash, end of the period</b>                              |      | \$ 304,656                          | \$ 375         | \$ 304,656                         | \$ 375         |
| <b>Supplementary disclosure</b>                             |      |                                     |                |                                    |                |
| Cash interest paid  |      | \$ 54,088                           | \$ 66,626      | \$ 81,332                          | \$ 95,294      |
| Cash taxes paid   |      | -                                   | -              | -                                  | -              |

See accompanying notes to the unaudited interim financial statements.

## Interim Statements of Changes in Shareholders' Equity

(Unaudited, Canadian dollars)

|   | Note | Share capital | Convertible debentures | Contributed surplus | Deficit         | Shareholders' equity |
|---|------|---------------|------------------------|---------------------|-----------------|----------------------|
| <b>Balance as at January 1, 2018</b>    |      | \$ 53,189,854 | \$ -                   | \$ 6,153,693        | \$ (16,808,513) | \$ 42,535,034        |
| Net loss                                |      | -             | -                      | -                   | (32,699,279)    | (32,699,279)         |
| Convertible debentures issued           | 7    | -             | 5,317,100              | -                   | -               | 5,317,100            |
| Share-based compensation                | 13   | -             | -                      | 1,612,814           | -               | 1,612,814            |
| <b>Balance as at December 31, 2018</b>  |      | \$ 53,189,854 | \$ 5,317,100           | \$ 7,766,507        | \$ (49,507,792) | \$ 16,765,669        |
| Net loss                                |      | -             | -                      | -                   | (3,784,692)     | (3,784,692)          |
| Convertible debentures issued           | 7    | -             | 1,200,000              | -                   | -               | 1,200,000            |
| Share-based compensation                | 13   | -             | -                      | 562,780             | -               | 562,780              |
| <b>Balance as at September 30, 2019</b> |      | \$ 53,189,854 | \$ 6,517,100           | \$ 8,329,287        | \$ (53,292,484) | \$ 14,743,757        |

See accompanying notes to the unaudited interim financial statements.

## Notes to the Interim Financial Statements (unaudited)

As at September 30, 2019 and for the three and nine months ended September 30, 2019 and 2018

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### 1. Reporting Entity

Kaisen Energy Corp. (the "Company" or "Kaisen") is a Calgary-based energy company primarily focused on heavy oil development and production in Saskatchewan. The Company was incorporated in Canada on November 6, 2012. The Company's principal place of business is 400, 522 – 11th Avenue S.W. Calgary, Alberta, Canada, T2R 0C8.

### 2. Basis of Presentation, Statement of Compliance and Assumption of Going Concern

These condensed unaudited interim financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board and were authorized for issue by the Board of Directors on November 22, 2019. These interim financial statements are condensed as they do not include all the information required by IFRS for annual financial statements and should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2018. Unless otherwise stated, amounts presented in these interim financial statements, including tabular amounts, are stated in Canadian dollars. The functional currency of the Company is the Canadian dollar.

These interim financial statements have been prepared on a historical cost basis, except as detailed in the accounting policies disclosed in Note 2 "Basis of Presentation" of the Company's audited consolidated financial statements for the year ended December 31, 2018. All accounting policies, methods of computation, and the use of estimates or judgements used in the preparation of these interim financial statements are consistent with those used the previous financial year, except as disclosed in note 3 "Changes to Accounting Policies".

These interim financial statements have been prepared in accordance with generally accepted accounting principles applicable to a going concern, which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The Company incurred losses of \$637,665 and \$3,784,692 during the three and nine months ended September 30, 2019, respectively. Sustained low commodity prices in the fourth quarter of 2018 put pressure on the Company's cash flows which adversely affected working capital balances entering 2019, and as at the end of the current quarter, the Company's current liabilities exceeded its current assets by \$5,222,180.

As at September 30, 2019, the Company has access to \$926,000 in available financing from unissued convertible debentures. Management believes the current level of financing may not be sufficient to fund expected expenditures over the next 12 months. Although the Company has been successful obtaining financing in the past, there is no assurance that it will be able to secure adequate financing in the future or that such financing will be on terms acceptable to the Company. The recoverability of the underlying value of the Company's assets is dependent on the Company's ability to obtain the necessary financing to complete the development of its assets and achieve future profitable production. As a result, there is a material uncertainty that may cast substantial doubt on the Company's ability to continue as a going concern. These financial statements do not reflect adjustments that would be necessary if the going concern assumption were not appropriate, including adjustments to the carrying value of assets and liabilities, revenues and expenses, and balance sheet classifications. These adjustments could be material.

### 3. Changes to Accounting Policies

#### (a) Newly Adopted Accounting Policies

##### **IFRS 16 Leases ("IFRS 16")**

IFRS 16 replaced IAS 17 Leases ("IAS 17") and requires the recognition of right-of-use ("ROU") assets and lease obligations on the statement of financial position for most leases where the entity is acting as the lessee. For lessees, IFRS 16 removes the classification of leases as either operating leases or finance leases, effectively treating all leases as finance leases. IFRS 16 allows lessors to continue with the dual classification model for recognized leases, with the resultant accounting remaining unchanged from IAS 17.

The Company adopted IFRS 16 on January 1, 2019 using the modified retrospective approach. On adoption of IFRS 16, the Company recognized lease liabilities measured at the present value of remaining lease payments, discounted using the interest rate implicit in the lease or the Company's incremental borrowing rate as at January 1, 2019. The associated ROU assets were measured at the amount equal to the lease liabilities on January 1, 2019 less any amount previously recognized for onerous leases, with no impact on opening retained earnings.

The Company identified ROU lease assets and liabilities related to head office space and office equipment. The impact on the consolidated statement of financial position as at January 1, 2019 was as follows:

|  | <b>January 1,<br/>2019</b> |
|--|----------------------------|
| ROU asset (included in property, plant and equipment)  | \$ 46,586                  |
| <b>Increase in total assets</b>  | <b>\$ 46,586</b>           |
| Short-term portion of lease liability (included in accounts payable and accrued liabilities) | \$ 95,038                  |
| Onerous leases   | (61,911)                   |
| Long-term portion of lease liabilities (included in other long-term liabilities)             | 13,459                     |
| <b>Increase in total liabilities and shareholder's equity</b>                                | <b>\$ 46,586</b>           |

The following table provides a reconciliation of the contractual obligations and commitments as at December 31, 2018 to the Company's lease liabilities as at January 1, 2019:

|  | <b>January 1,<br/>2019</b> |
|--|----------------------------|
| <b>Commitments as at December 31, 2018</b>     | <b>\$ 190,166</b>          |
| Less:  |                            |
| Non-lease components                           | (77,610)                   |
| Impact of discounting                          | (4,059)                    |
| <b>Lease liabilities as at January 1, 2019</b> | <b>\$ 108,497</b>          |

Cash flows associated with lease repayments were allocated to operating activities and financing on the consolidated statement of cash flows based on their interest and principal repayments, respectively.

#### **Update to Significant Accounting Policies**

The Company applied IFRS 16 using the modified retrospective approach; therefore, the comparative information provided continues to be in accordance with the Company's previous accounting policy found in the audited financial statements for the year ended December 31, 2018. The accounting policy set forth below is applicable from January 1, 2019.

#### **Lease Arrangements**

The Company assesses whether an arrangement is a lease based on whether the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. When the Company is a lessee, it recognizes a right-of-use asset and a corresponding lease liability at the date on which the leased asset is available for use by the Company. Assets and liabilities arising from a lease are measured on a present value basis. Lease liabilities include the net present value of fixed payments, variable lease payments that are based on an index or a rate, amounts expected to be paid by the lessee under residual value guarantees, the exercise price of penalties for terminating the lease, less any lease incentives receivable. Future lease payments are discounted using the interest rate implicit in the lease or, when that rate cannot be readily determined, the Company's incremental borrowing rate. The Company uses a single discount rate for a portfolio of leases with reasonably similar characteristics.

Lease payments are allocated between interest expense and reductions to the lease liability. Interest expense related to the leases is charged to the consolidated statements of comprehensive income (loss) within net finance expenses over the lease term.

Associated ROU assets are initially measured at cost, which comprises the initial amount of the lease liability, any direct costs incurred, and an estimate of costs to dismantle and remove the underlying asset or to restore the underlying asset, less any lease payments made at or before the commencement date. ROU assets are depreciated on a straight-line basis over the shorter of the estimated useful life of the asset or the lease term. ROU assets may be adjusted for certain remeasurements of the lease liability and impairment losses.

Lease payments for leases with terms of less than twelve months and leases on which the underlying asset is of low value are recognized as an expense in the consolidated statement of comprehensive income (loss) on a straight-line basis over the lease term.

#### **(b) Future Accounting Policies**

There are no other standards or interpretations issued, but not yet effective, that the Company anticipates may have a material effect on the financial statements once adopted.

#### 4. Use of Estimates, Judgements and Assumptions

Estimates, judgements and assumptions used in these interim financial statements are the same as those disclosed in the financial statements as at December 31, 2018 except for the following:

##### Leases

Management applies judgement in reviewing each of its contractual arrangements to determine whether the arrangements contain a lease within the scope of IFRS 16. Leases that are recognized are subject to further Management judgement and estimation in various areas specific to the contractual arrangements. In determining the lease term to be recognized, Management considers all facts and circumstances that create an economic incentive to exercise an extension option or not to exercise a termination option.

Lease obligations are estimated using a discount rate equal to the interest rate implicit in the lease or, if that rate cannot be readily determined, the Company's incremental borrowing rate. The Company's incremental borrowing rate represents the rate that the Company would incur to obtain the funds necessary to purchase an asset of a similar value, with similar payment terms and security in a similar economic environment.

#### 5. Property, Plant and Equipment

|  | Oil and gas assets   | Corporate assets  | Total assets         |
|--|----------------------|-------------------|----------------------|
| <b>Cost:</b>                                   |                      |                   |                      |
| <b>Balance, January 1, 2018</b>                | <b>\$ 77,669,337</b> | <b>\$ 195,854</b> | <b>\$ 77,865,191</b> |
| Development additions                          | 3,062,518            | 1,926             | 3,064,444            |
| Additions to decommissioning obligations       | 52,562               | -                 | 52,562               |
| Capitalized general and administrative costs   | 376,664              | -                 | 376,664              |
| Capitalized share-based compensation           | 265,905              | -                 | 265,905              |
| <b>Balance, December 31, 2018</b>              | <b>\$ 81,426,986</b> | <b>\$ 197,780</b> | <b>\$ 81,624,766</b> |
| Development additions                          | 1,458,294            | 1,050             | 1,459,344            |
| Additions to decommissioning obligations       | 53,172               | -                 | 53,172               |
| Right-of-use assets (note 3)                   | -                    | 46,586            | 46,586               |
| Capitalized general and administrative costs   | 187,200              | -                 | 187,200              |
| Capitalized share-based compensation           | 88,505               | -                 | 88,505               |
| <b>Balance, September 30, 2019</b>             | <b>\$ 83,214,157</b> | <b>\$ 245,416</b> | <b>\$ 83,459,573</b> |
| <b>Accumulated depletion and depreciation:</b> |                      |                   |                      |
| <b>Balance, January 1, 2018</b>                | <b>\$ 20,038,676</b> | <b>\$ 106,044</b> | <b>\$ 20,144,720</b> |
| Depletion and depreciation                     | 4,050,416            | 26,498            | 4,076,914            |
| Impairment                                     | 24,803,000           | -                 | 24,803,000           |
| <b>Balance, December 31, 2018</b>              | <b>\$ 48,892,092</b> | <b>\$ 132,542</b> | <b>\$ 49,024,634</b> |
| Depletion and depreciation                     | 2,216,840            | 43,603            | 2,260,443            |
| <b>Balance, September 30, 2019</b>             | <b>\$ 51,108,932</b> | <b>\$ 176,145</b> | <b>\$ 51,285,077</b> |
| <b>Net book value:</b>                         |                      |                   |                      |
| <b>Balance, December 31, 2018</b>              | <b>32,534,894</b>    | <b>65,238</b>     | <b>32,600,132</b>    |
| <b>Balance, September 30, 2019</b>             | <b>32,105,225</b>    | <b>69,271</b>     | <b>32,174,496</b>    |

During the three and nine months ended September 30, 2019, the Company capitalized general and administrative expenses in the amount of \$62,400 and \$187,200, respectively (2018 - \$92,499 and \$284,165) and capitalized share-based compensation expense in the amount of \$28,844 and \$88,505, respectively (2018 - \$121,895 and \$209,851), relating to development activities.

Future development costs associated with proved plus probable undeveloped reserves of \$91,795,756 (December 31, 2018 - \$93,253,000) are included in the depletion calculation, net of salvage values of \$2,610,000 as at September 30, 2019 (December 31, 2018 - \$2,590,000). No other costs have been included or excluded from property plant and equipment in the determination of depletion and depreciation expense. At September 30, 2019, the Company evaluated its oil and gas assets for indicators of potential impairment or impairment reversal. No indicators were identified, and no impairment or impairment reversal was recorded.

## 6. Term Loan

On July 7, 2019, the Company completed an arrangement for a \$2,280,000 term loan with its lender to replace the Company's revolving bank loan, which was discharged. The term loan bears interest at a rate of prime plus 1.25% per annum, is payable in full on demand by the lender, and requires the Company to make the monthly principal payments up until May 31, 2020, when the term loan will be repaid in full. The term loan is classified as current on the statement of financial position and is principally secured by fixed and floating security interest over all present and after acquired assets of the Company. The term loan arrangement contains industry standard representation and warranties, positive and negative covenants and events of default, does not contain any financial covenants, and has borrowing base redeterminations semi-annually on May 31 and November 30 of each year. During the three months ended September 30, 2019, \$430,000 in scheduled monthly repayments were made.

## 7. Convertible Debentures, Promissory Note and Obligation Debentures

On May 28, 2018, the Company provided all shareholders and its Managing Director the opportunity to subscribe for an aggregate of \$7,503,000 in convertible debentures and executed an agreement for 5,426 committed convertible debentures ("Obligation Debentures"), as described in further detail in note 7(b).

During the third quarter of 2019, the Company issued an additional 1,000 convertible debentures for total gross and net proceeds of \$1,000,000. Since being introduced, the Company has issued a total of 6,577 convertible debentures representing \$6,517,100 in financing net of transaction costs (December 31, 2018 – \$5,317,100).

### (a) Convertible Debentures

The key terms of the convertible debentures are as follows:

- issuable only in denominations of \$1,000 or multiples thereof
- mature on the occurrence of a liquidity event, with a qualifying liquidity event including, but not limited to:
  - (i) an amalgamation, arrangement, merger, or other similar transaction wherein all issued and outstanding common shares are sold for cash and/or securities, or which results in all of the Company's common shares being listed on a stock exchange
  - (ii) a sale of all or substantially all of the property and assets of the Company for consideration consisting of cash and/or securities and the subsequent distribution of all of such consideration to all common shareholders, on a pro rata basis;
  - (iii) the liquidation, dissolution or winding up of the Company;
  - (iv) a public offering; and
  - (v) any combination of the events or circumstances described in subsections (i), (ii), (iii) or (iv) above.
- the debentures bear interest at a fixed rate of 8.00% per annum compounded quarterly and payable in arrears on the occurrence of a liquidity event,
- upon the occurrence of a liquidity event, the Company shall:
  - (i) satisfy its obligation to pay all accrued and unpaid Interest through a cash payment; and
  - (ii) at the election of the holder of each convertible debenture, repay all or any portion of the face value of the convertible debenture by cash payment and/or by issuing and delivering common shares at a deemed price of \$0.05 per common share;

The convertible debentures represent the Company's obligation to deliver a variable number of its own equity instruments upon a liquidity event. Management has determined that the liquidity event is a contingent settlement provision that the Company has control over. As such, the convertible debentures have been classified as equity net of issue costs. If a liquidity event occurred on September 30, 2019 and the convertible debentures were converted to common shares, 131,540,000 additional shares of the Company would have been issued. Furthermore, had the Company issued the entire subscription of convertible debentures (\$7,503,000 in aggregate since inception) in the current quarter and converted them to common shares, a total of 150,060,000 additional shares of the Company would have been issued and Kaisen would have received an additional \$926,000 of cash. As at September 30, 2019, the total face value of the convertible debentures plus accrued undeclared interest was \$7,104,000.

### (b) Obligation Debentures

Concurrent with the initial convertible debenture issuance, on May 28, 2018 the Company entered into an agreement with the subscriber for 5,426 committed Obligation Debentures, which require the subscriber to subscribe for and purchase, and for the Company to issue and sell, the remaining \$5,426,000 in convertible debentures two years from the date of issuance or at the Company's discretion. During the first nine months of the year, the Company called on the subscriber to purchase an additional 1,200 Obligation Debentures resulting in the issuance of \$1,200,000 in convertible debentures by the Company (refer to note 7(a) above). At September 30, 2019, a total of 926 Obligation Debentures remain uncalled, representing an additional \$926,000 in funding available to the Company.

## 8. Risk Management Contracts

|   | Three months ended<br>September 30, |                     | Nine months ended<br>September 30, |                       |
|---|-------------------------------------|---------------------|------------------------------------|-----------------------|
|   | 2019                                | 2018                | 2019                               | 2018                  |
| Realized loss                                   | \$ (539,663)                        | \$ (1,216,524)      | \$ (1,805,069)                     | \$ (2,443,616)        |
| Unrealized gain (loss)                          | 572,700                             | 616,311             | (659,696)                          | (2,295,271)           |
| <b>Gain (loss) on risk management contracts</b> | <b>\$ 33,037</b>                    | <b>\$ (600,213)</b> | <b>\$ (2,464,765)</b>              | <b>\$ (4,738,887)</b> |

For the three and nine months ended September 30, 2019, the Company recorded realized losses of \$539,663 and \$1,805,069, respectively (2018 – losses of \$1,216,524 and \$2,443,616) on contracts entered to manage commodity price risk. The change in the fair value of these contracts during the three and nine months ended September 30, 2019 produced an unrealized gain of \$572,700 and an unrealized loss of \$659,696, respectively (2018 – gain of \$616,311 and a loss of \$2,295,271).

The Company had the following risk management contracts in place as at September 30, 2019:

| Type                              | Period                               | Volume    | Price/unit <sup>(1)</sup> |
|-----------------------------------|--------------------------------------|-----------|---------------------------|
| WCS - WTI differential basis swap | January 1, 2019 – December 31, 2019  | 300 bbl/d | US\$20.80                 |
| WCS - WTI differential basis swap | February 1, 2019 – December 31, 2019 | 200 bbl/d | US\$17.55                 |
| WTI - Fixed swap                  | January 1, 2019 – December 31, 2019  | 300 bbl/d | C\$71.00                  |
| WTI - Call option <sup>(2)</sup>  | January 1, 2020 – December 31, 2020  | 500 bbl/d | US\$60.00                 |

(1) Based on the weighted average price/bbl for the duration of the contract

(2) The Call Option contract provides ATB with an option (at only their election) to exercise the contract terms (on a month to month basis) throughout the term of the contract.

As at September 30, 2019, the fair value associated with these risk management contracts was a net liability of \$877,718 (December 31, 2018 – net liability of \$218,022), of which \$734,574 is reported as a current liability reflecting contracts which will settle by September 30, 2020, and \$143,144 reported as a long-term liability for contracts that will settle after September 30, 2020.

## 9. Financial Assets and Credit Risk

Credit risk arises from the potential that the Company may incur a loss if a counterparty to a financial instrument fails to meet its obligation in accordance with agreed terms. All the Company's crude oil and natural gas production is sold, as determined by market-based prices adjusted for quality differentials, to midstream companies and intermediate producers. Typically, the Company's maximum credit exposure is petroleum sales for one month.

The Company's carrying values of accounts receivable represent the Company's maximum credit exposure. The aging of accounts receivable as at September 30, 2019 and December 31, 2018 were as follows:

|                               | September 30,<br>2019 | December 31,<br>2018 |
|-------------------------------|-----------------------|----------------------|
| Not past due                  | \$ 1,736,736          | \$ 188,597           |
| Past due greater than 90 days | 387,986               | 103,654              |
| <b>Accounts receivable</b>    | <b>\$ 2,124,722</b>   | <b>\$ 292,251</b>    |

Receivables from customers are normally collected approximately 25 days following the month of production and the Company has historically not experienced any collection issues with its oil and natural gas sales and therefore has not recorded an allowance for doubtful accounts as at September 30, 2019. As at quarter end, \$365,768 in receivables aged more than 90 days represented joint interest billings related to third quarter drilling that were collected subsequent to quarter end.

## 10. Capital Management

The Company's policy is to maintain a strong capital base to provide flexibility in the future development of the business and to maintain the confidence of investors and lenders. The Company periodically reviews certain quantitative measures of its capital structure to understand its position relative to industry peers but does not set certain limits or ranges with respect to these quantitative measures. The Company is not subject to any external restrictions on its capital structure. Management closely monitors debt leverage to ensure the Company maintains financial flexibility and balance sheet strength sufficient to manage unforeseen events and opportunities as they arise.

## 11. Net Finance Expenses

The following table summarizes net finance expenses recorded during the three and nine months ended September 30, 2019 and 2018:

|  | Three months ended |                  | Nine months ended |                   |
|--|--------------------|------------------|-------------------|-------------------|
|  | September 30,      |                  | September 30,     |                   |
|  | 2019               | 2018             | 2019              | 2018              |
| Interest expense on term and bank loans  | \$ 26,952          | \$ 33,804        | \$ 81,332         | \$ 95,294         |
| Accretion of decommissioning obligations | 65,449             | 64,917           | 193,172           | 193,603           |
| Capital lease interest expense           | 755                | -                | 3,260             | -                 |
| <b>Net finance expenses</b>              | <b>\$ 93,176</b>   | <b>\$ 98,721</b> | <b>\$ 277,764</b> | <b>\$ 288,897</b> |

## 12. Other Long-Term Liabilities

|  | September 30,<br>2019 | December 31,<br>2018 |
|--|-----------------------|----------------------|
| Decommissioning obligations              | \$ 12,063,939         | \$ 11,817,595        |
| Onerous lease                            | -                     | 4,748                |
| Lease liabilities                        | 1,476                 | -                    |
| <b>Total other long-term liabilities</b> | <b>\$ 12,065,415</b>  | <b>\$ 11,822,343</b> |

### (a) Decommissioning Obligations

The total future decommissioning obligations were estimated by Management based on the expected cost to reclaim and abandon its net ownership interest in well sites and facilities and the estimated timing of the costs to be incurred in future periods. Decommissioning obligations acquired as part of an acquisition are initially measured at fair value using a credit-adjusted risk-free rate. Management estimates the total undiscounted amount of cash flows required to settle its decommissioning obligations at September 30, 2019 is \$13.8 million, which will be incurred over the next 10-15 years with the majority of costs incurred between 2020 and 2025. The Bank of Canada's long-term risk-free rate of 2.2% (December 31, 2018 – 2.2%) and an inflation rate of 2.0% (December 31, 2018 – 2.0%) were used to calculate the present value of the decommissioning obligation at September 30, 2019.

A reconciliation of the changes to the decommissioning obligations during the periods is as follows:

|                                     | September 30,<br>2019 | December 31,<br>2018 |
|-------------------------------------|-----------------------|----------------------|
| <b>Balance, beginning of period</b> | <b>\$ 11,817,595</b>  | <b>\$ 11,506,151</b> |
| Liabilities incurred                | 53,172                | 40,409               |
| Accretion                           | 193,172               | 258,882              |
| Change in estimate                  | -                     | 12,153               |
| <b>Balance, end of period</b>       | <b>\$ 12,063,939</b>  | <b>\$ 11,817,595</b> |

### (b) Lease Liabilities

The following table details the movements of the Company's lease liabilities for the period ended September 30, 2019:

|  | Total             |
|--|-------------------|
| <b>Balance, January 1, 2019</b> (note 3)                       | <b>\$ 108,497</b> |
| Interest expense   | 3,260             |
| Payments   | (73,843)          |
| <b>Balance, September 30, 2019</b>                             | <b>\$ 37,914</b>  |
| Current (included in accounts payable and accrued liabilities) | 36,438            |
| Non-current (included in other long-term liabilities)          | 1,476             |
| <b>Total</b>   | <b>\$ 37,914</b>  |

The Company has lease liabilities for head office space and office equipment. The lease contracts are effective from one to two years. Discount rates used in calculating the present value of lease payments were between 5 and 10 percent. Leases are negotiated on an individual basis and contain varying terms and conditions. The following table details the undiscounted cash flows associated with these leases, which include both principal and interest components of the Company's lease liabilities as at September 30, 2019.

|   | September 30,<br>2019 |
|---|-----------------------|
| Less than one year  | \$ 37,213             |
| 1 to 2 years  | 1,500                 |
| <b>Undiscounted cash flows related to lease liabilities</b> | <b>\$ 38,713</b>      |

### 13. Share Capital

#### (a) Issued and Outstanding Common Shares

The Company is authorized to issue an unlimited number of voting common shares and an unlimited amount of special voting shares. The following table is a continuity schedule of the Company's common shares outstanding and share capital:

|   | Number of Shares | Amount        |
|---|------------------|---------------|
| <b>December 31, 2018 and September 30, 2019</b> | 45,420,029       | \$ 53,189,854 |

#### (b) Share Based Compensation

The Company's stock option plan allows for the granting of options to directors, officers, employees and contractors serving in capacity of employees of the Company. The exercise price of each option shall be fixed by the Board of Directors when such option is granted, provided that from and after the date that the common shares are listed on a stock exchange (an "Exchange"), such price shall not be less than the price permitted by such Exchange. Unless otherwise determined by the Board of Directors, vesting typically occurs one third on each of the next three anniversaries of the date of the grant as recipients render continuous service to the Company, and the share options typically expire five years from the date of the grant. The maximum number of common shares issuable on the exercise of outstanding share options at any time is limited to 10% of the issued and outstanding common shares.

The follow table summarizes the Company's outstanding equity compensation units:

|                      | September 30, 2019                |   |  | December 31, 2018                 |   |  |
|----------------------|-----------------------------------|---|--|-----------------------------------|---|--|
|                      | Number of<br>units<br>outstanding | Weighted<br>average<br>exercise price<br>(\$ per share) | Weighted<br>average<br>remaining<br>life (years) | Number of<br>units<br>outstanding | Weighted<br>average<br>exercise price<br>(\$ per share) | Weighted<br>average<br>remaining<br>life (years) |
| <b>Issued</b>        |                                   |   |  |                                   |   |  |
| Incentive options    | 10,700,000                        | 0.05  | 1.8  | 4,500,000                         | 0.05  | 2.5  |
| Share options        | 11,000,000                        | 0.05  | 3.9  | 10,931,000                        | 0.11  | 4.5  |
| Performance warrants | 34,250,999                        | 0.49  | 3.4  | 33,480,999                        | 0.50  | 4.1  |
| Units outstanding    | 55,950,999                        | 0.32  | 3.2  | 48,911,999                        | 0.37  | 4.0  |
| <b>Exercisable</b>   |                                   |   |  |                                   |   |  |
| Incentive options    | 5,375,000                         | 0.05  | 1.8  | 2,250,000                         | 0.05  | 2.6  |
| Share options        | 3,400,000                         | 0.05  | 3.8  | 281,000                           | 2.25  | 0.7  |
| Performance warrants | -                                 | -   | -  | -                                 | -   | -  |
| Units outstanding    | 8,775,000                         | 0.05  | 2.6  | 2,531,000                         | 0.29  | 2.3  |

Incentive Options vest quarterly over one year, expire three years from the anniversary of the grant and each Incentive Option entitles the holder to receive one common share of the Company without the payment of an exercise price. The Share options vest evenly over a three-year period and expire five years from the anniversary of the grant. Performance warrants vest upon a qualifying liquidity event and expire 5 years from the grant date. During the three and nine months ended September 30, 2019, the Company recorded share-based compensation expenses of \$154,280 and \$474,275, respectively (2018 - \$386,850 and \$1,069,950).

During the nine months ended September 30, 2019, the Company granted 6,200,000 Incentive Options, 800,000 share options and 2,000,000 performance warrants to directors, employees and contractors serving in capacity of employees of the Company. The weighted average fair value of Incentive Options, share options, and performance warrants granted during was \$0.05, \$0.03, and \$0.02 per unit, respectively, as estimated on the date of grant using the Black-Scholes option pricing model. Vesting and expiry conditions associated with the grants are similar to prior year grants.

#### 14. Net Loss per Common Share

|   | Three months ended<br>September 30, |                  | Nine months ended<br>September 30, |                  |
|---|-------------------------------------|------------------|------------------------------------|------------------|
|   | 2019                                | 2018             | 2019                               | 2018             |
| Net loss  | \$ (637,665)                        | \$ (1,340,609)   | \$ (3,784,692)                     | \$ (8,930,351)   |
| Weighted number of average common shares outstanding: |                                     |                  |                                    |                  |
| Basic and diluted                                     | 45,420,029                          | 45,420,029       | 45,420,029                         | 45,420,029       |
| <b>Basic and diluted net loss per share</b>           | <b>\$ (0.01)</b>                    | <b>\$ (0.03)</b> | <b>\$ (0.08)</b>                   | <b>\$ (0.20)</b> |

For the purpose of calculating net loss per diluted share for the three and nine months ended September 30, 2019 and 2018, none of the outstanding options, performance warrants, incentive options, or convertible debentures are included as these instruments are anti-dilutive.

#### 15. Restructuring Expenses

In the second quarter of 2018, the Company's employee base and office space requirements were significantly reduced resulting in the Company recording \$1,167,028 in restructuring expenses. Cash based restructuring expenses comprised of severance payments of \$720,000, legal fees of \$55,888 and other costs of \$133,978. Non-cash expenses contain onerous lease charges of \$102,470 and \$154,692 relating to the impairment of the due from shareholder loan (note 17). The Company still intends on actively pursuing re-payment in full for this amount. The Company incurred nil restructuring costs in 2019.

#### 16. Supplemental Cash Flow Information

The net change in non-cash working capital is comprised of:

|   | Three months ended<br>September 30, |              | Nine months ended<br>September 30, |              |
|---|-------------------------------------|--------------|------------------------------------|--------------|
|   | 2019                                | 2018         | 2019                               | 2018         |
| Accounts receivable                                 | \$ (897,320)                        | \$ (39,963)  | \$ (1,832,471)                     | \$ 347,296   |
| Prepaid expenses and deposits                       | (15,787)                            | (105,543)    | (103,004)                          | (135,725)    |
| Accounts payable and accrued liabilities, and other | 1,877,147                           | 1,035,427    | 3,199,624                          | 1,657,596    |
| Change in non-cash working capital                  | \$ 964,040                          | \$ 889,921   | \$ 1,264,149                       | \$ 1,869,167 |
| Related to operating activities                     | 1,276,707                           | 1,002,383    | 1,531,813                          | 1,906,922    |
| Related to investing activities                     | \$ (312,667)                        | \$ (112,462) | \$ (267,664)                       | \$ (37,755)  |

#### 17. Related Party Transactions

On December 23, 2015, the Company provided a loan in the amount of \$250,000 to a shareholder on competitive commercial interest-bearing terms with a maturity period of 5 years. In the second quarter of 2018, a portion of the individual's severance was applied against the loan and the Company impaired \$154,692, the remaining balance owing at that time, to restructuring expenses. The individual is still personally liable to Kaisen for the remaining balance and the Company will continue to seek repayment in full.

The corporate secretary of the Company is a partner of the Company's legal counsel, Burnet, Duckworth & Palmer LLP ("BDP"). As at September 30, 2019, \$139,222 in related party amounts were included in accounts payable and accrued liabilities (December 31, 2018 - \$180,300). The Managing Director of Kaisen is the President and Chief Executive Officer of a transloading company that the Company occasionally engages for emulsion treating of a portion of its production volumes. As at September 30, 2019, \$nil in related party amounts owing in respect of emulsion treating were included in accounts payable and accrued liabilities (December 31, 2018 - \$nil).