

# **Caspian Energy Inc.**

Condensed Interim Consolidated Financial Statements  
(Unaudited)

**September 30, 2011 and 2011**  
Amended and Restated

These financial statements are being refilled on the current date because:

*In the Company's third quarter 2012 interim reporting, foreign exchange gains and losses were incorrectly presented as foreign exchange translation amounts. Although the correct foreign exchange translation amounts were properly and accurately presented in the condensed interim consolidated statement of changes in equity, they were incorrectly excluded from the condensed interim consolidated statement of loss and comprehensive loss.*

*Prior to the amendment and restatement, net loss for the three months ended September 30, 2012 was understated by \$1,150,000 (\$0.01 per share) and comprehensive loss was understated by \$611,000 (\$0.00 per share); net income for the three months ended September 30, 2011 was understated by \$1,776,000 (\$0.01 per share) and comprehensive income was overstated by \$1,823,000 (\$0.01 per share).*

*Prior to the amendment and restatement, net loss for the nine months ended September 30, 2012 was understated by \$2,098,000 (\$0.01 per share) and comprehensive loss was overstated by \$854,000 (\$0.00 per share); net income for the nine months ended September 30, 2011 was understated by \$2,413,000 (\$0.01 per share) and comprehensive income was overstated by \$1,483,000 (\$0.01 per share).*

*The Company does not believe that these inaccuracies constitute material errors. These are non-cash items in an environment where cash items and exploration results are of the most importance to our shareholders.*

## **Notice of Disclosure of No Auditor Review of Condensed Interim Financial Statements**

The accompanying unaudited condensed interim consolidated financial statements of the Company for the interim periods ended September 30, 2012 and 2011 have been prepared in accordance with International Financial Reporting Standards (“IFRS”) accounting principles as issued by the IASB and are the responsibility of the Company’s management.

The Company’s independent auditors, MNP LLP, have not performed a review of these unaudited condensed interim consolidated financial statements in accordance with the standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity’s auditor.

# Caspian Energy Inc.

Condensed Interim Consolidated Statements of Financial Position *(Unaudited)*

As at

	September 30 2012 \$	December 31 2011 \$
<i>(in thousands of Canadian dollars)</i>		
<b>Current assets</b>		
Cash and cash equivalents (note 7)	146	2,296
Trade and other receivables	546	335
Inventory (note 8)	540	987
	<b>1,232</b>	<b>3,618</b>
<b>Non-current assets</b>		
Restricted cash (note 9)	8	290
VAT receivable	2,374	1,305
Exploration and evaluation assets (note 10)	33,144	31,712
Property, plant and equipment (note 11)	15,186	7,706
<b>Total assets</b>	<b>51,944</b>	<b>44,631</b>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Trade and other payables	19,227	14,267
Loans payable (note 12)	39,536	34,538
Convertible debentures (note 13)	9,349	–
Derivative liability (note 13)	197	–
	<b>68,309</b>	<b>48,805</b>
<b>Non-current liabilities</b>		
Decommissioning liabilities (note 14)	378	249
Loans payable (note 12)	3,175	2,100
Convertible debentures (note 13)	–	6,287
Derivative liability (note 13)	–	2,363
	<b>71,862</b>	<b>59,804</b>
<b>Equity</b>		
Share capital (note 15)	143,523	143,092
Warrants (note 16)	279	272
Contributed surplus	17,193	16,055
Accumulated other comprehensive loss	2,405	1,551
Deficit	(183,318)	(176,143)
	<b>(19,918)</b>	<b>(15,173)</b>
<b>Total liabilities and equity</b>	<b>51,944</b>	<b>44,631</b>

Reporting entity and going concern (note 1)

Commitments, contingencies and operating risks (note 19)

## Approved by the Board of Directors

(signed) "WILLIAM RAMSAY" Director

(signed) "GORDON HARRIS" Director

# Caspian Energy Inc.

## Condensed Interim Consolidated Statements of Loss and Comprehensive Loss *(Unaudited)* For the three and nine months ended September 30, 2012 and 2011

<i>(in thousands of Canadian dollars)</i>	Three months ended September 30, 2012 \$	Three months ended September 30, 2011 \$	Nine months ended September 30, 2012 \$	Nine months ended September 30, 2011 \$
	(note 21)	(note 21)	(note 21)	(note 21)
<b>Revenue</b>				
Oil and natural gas revenue, net	1,131	1,428	2,681	1,737
<b>Expenses</b>				
General and administrative (note 18)	2,008	537	3,283	1,724
Operating expenses	659	965	1,783	1,091
Transportation	459	548	931	664
Depletion and depreciation	195	612	450	676
Share-based compensation	-	-	1,138	1,347
	<b>3,321</b>	2,662	<b>7,585</b>	5,502
<b>Operating loss before other items</b>	<b>(2,190)</b>	(1,234)	<b>(4,904)</b>	(3,765)
Derivative fair value adjustment (note 13)	971	4,826	2,127	4,826
Finance expense (note 17)	(421)	1,476	(4,404)	1,059
Other	-	(2)	6	-
<b>Net income (loss)</b>	<b>(1,640)</b>	5,066	<b>(7,175)</b>	2,120
Foreign exchange translation	(611)	(1,823)	854	(1,483)
<b>Comprehensive income (loss)</b>	<b>(2,251)</b>	3,243	<b>(6,321)</b>	637
<b>Income per share</b>	<b>(0.01)</b>	0.03	<b>(0.03)</b>	0.01

# Caspian Energy Inc.

## Condensed Interim Consolidated Statements of Changes in Equity *(Unaudited)* For the three and nine months ended September 30, 2012 and 2011

<i>(in thousands of Canadian dollars)</i>	Common Share capital \$	Warrants \$	Contributed surplus \$	Accumulated other comprehensive loss \$	Deficit \$	Total equity (deficit) \$
<b>Balance – January 1, 2010</b>	<b>129,121</b>	<b>255</b>	<b>13,878</b>	<b>–</b>	<b>(130,391)</b>	<b>12,863</b>
Shares issued for cash (note 15)	1,864	–	–	–	–	1,864
Shares and warrants issued for convertible debenture interest (notes 15 and 16)	1,686	151	–	–	–	1,837
Share-based compensation	–	–	530	–	–	530
Foreign currency translation	–	–	–	(2,803)	–	(2,803)
Net income	–	–	–	–	(6,717)	(6,717)
<b>Balance – December 31, 2010</b>	<b>132,671</b>	<b>406</b>	<b>14,408</b>	<b>(2,803)</b>	<b>(137,108)</b>	<b>7,574</b>
Shares issued on conversion of debentures (note 15)	9,458	–	–	–	–	9,458
Shares and warrants issued for convertible debenture interest (notes 15 and 16)	505	130	–	–	–	635
Shares issued for accounts payable (note 15)	54	–	–	–	–	54
Exercise of warrants (note 15 and 16)	404	(264)	–	–	–	140
Expiry of warrants (note 16)	–	–	–	–	–	–
Share-based compensation	–	–	1,647	–	–	1,647
Foreign currency translation	–	–	–	4,529	–	4,529
Reclass of foreign currency translation on disposition	–	–	–	(175)	–	(175)
Net loss	–	–	–	–	(39,035)	(39,035)
<b>Balance – December 31, 2011</b>	<b>143,092</b>	<b>272</b>	<b>16,055</b>	<b>1,551</b>	<b>(176,143)</b>	<b>(15,173)</b>
Shares and warrants issued for convertible debenture interest	242	149	–	–	–	391
Exercise of warrants (note 15 and 16)	103	(56)	–	–	–	47
Expiry of warrants	86	(86)	–	–	–	–
Foreign currency translation	–	–	–	854	–	854
Share-based compensation	–	–	1,138	–	–	1,138
Net loss	–	–	–	–	(7,175)	(7,175)
<b>Balance – September 30, 2012</b>	<b>143,523</b>	<b>279</b>	<b>17,193</b>	<b>2,405</b>	<b>(183,318)</b>	<b>(19,918)</b>

# Caspian Energy Inc.

Consolidated Interim Consolidated Statements of Cash Flows *(Unaudited)*  
For the nine months ended September 30, 2012 and 2011

<i>(in thousands of Canadian dollars)</i>	2011 \$	2011 \$
	(note 21)	(note 21)
<b>Cash flow provided by (used in)</b>		
<b>Operating activities</b>		
Income (loss)	(7,175)	2,120
Adjustments for		
Share-based compensation	1,138	1,347
Depletion and depreciation	450	676
Finance expense	3,745	1,354
Derivative fair value adjustment	(2,127)	(4,826)
Foreign exchange	1,480	(1,489)
Changes non-cash working capital	1,647	7,086
<b>Net cash provided by (used in) operating activities</b>	<b>(842)</b>	<b>6,268</b>
<b>Financing activities</b>		
Issuance of common shares and warrants	47	–
Proceeds from loans payable, net	7,217	(30)
<b>Net cash provided by (used in) financing activities</b>	<b>7,264</b>	<b>(30)</b>
<b>Investing activities</b>		
Purchase of property, plant and equipment	(8,216)	(7,167)
Exploration and evaluation expenditures	(3,118)	–
Increase (decrease) in restricted cash	282	(15)
Change in non-cash working capital	2,480	–
<b>Net cash used in investing activities</b>	<b>(8,572)</b>	<b>(7,182)</b>
<b>Change in cash and cash equivalents</b>	<b>(2,150)</b>	<b>(944)</b>
<b>Cash and cash equivalents – beginning of period</b>	<b>2,296</b>	<b>1,334</b>
<b>Cash and cash equivalents – end of period</b>	<b>146</b>	<b>390</b>

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 1. Reporting entity and going concern

Caspian Energy Inc. ("Caspian" or the "Company") is engaged in the exploration for and development and production of oil and gas in the Republic of Kazakhstan ("ROK"). Its primary operating activities are carried out through its wholly-owned subsidiary, Caspian Energy Ltd. ("Caspian Ltd."). Caspian's registered office is located at 396 11<sup>th</sup> Avenue S.W., Calgary, Alberta, Canada.

Caspian's principal assets are a 40% interest in Aral Petroleum Capital LLP ("Aral"), held by Caspian Ltd. Through its interest in Aral, the Company has the right to explore and develop certain oil and gas properties in Kazakhstan, known as the North Block, a 1,549 square kilometre area located in the vicinity of the Kazakh pre-Caspian basin. The Company also has minor resource interests in Canada.

Aral's exploration and development rights to the North Block were granted pursuant to the terms of an exploration contract between the government of Kazakhstan and Aral (the "Exploration Contract"). The initial three-year term of the Exploration Contract was extended to December 29, 2012. Aral also entered a twenty-five year Production Contract ("Production Contract") for the East Zhagabulak field on July 28, 2010. The Contract stipulates export pricing on approximately 90% of production volumes.

Addendum No. 6 to the Exploration Contract was granted State Registration on July 13, 2011. The Competent Body of the ROK agreed to amend the Work Program for the years 2010, 2011 and 2012 by carrying forward the drilling of two exploration wells (estimated cost United States dollars ("US") \$13.95 million) and seismic operations (estimated cost US \$2.04 million) from 2010, 2011 and 2012, with no decrease in expenditures commitment in the extension period. Under the Exploration Agreement with the ROK, the approved work program calls for expenditures of US \$25.8 million in 2011 and US \$22.5 million in 2012. The various requirements of the work program agreed to with the Ministry of Oil and Gas for 2011, both in terms of functions and expenses, have been carried out by Aral. During 2011, Aral's total expenditures for the year exceeded the commitment, reaching a total of US \$34.3 million. At September 30, 2012, Aral had incurred US \$33.2 million of qualifying expenditures toward the 2012 commitment.

Non-fulfillment of commitments under the Work Program may result in punitive actions by the Government of Republic of Kazakhstan, including suspending or revoking the Exploration Contract.

#### Going concern

These condensed interim unaudited consolidated financial statements have been presented on a going concern basis. The Company reported a net loss of \$7.2 million and used funds for operating activities of \$842,000 for the period ended September 30, 2012. The Company had a net working capital deficiency of \$67.1 million and a cumulative deficit equal to \$183.3 million as at September 30, 2012.

On April 7, 2011, Caspian announced a new agreement that restructured an earlier arrangement with the debenture holders regarding the US \$16 million, 10-per-cent per annum, convertible debentures, which matured on March 2, 2011. It was mutually agreed to restructure the existing debentures as follows:

- Convert 44% of the principal amount plus accrued interest into common shares of Caspian at a price of \$0.19 per common share (this aggregates US \$9,790,753 convertible to common shares).
- Amend the existing Debentures to an amount of US \$12,460,958, with a conversion price of \$0.28 per common share, a floor price (minimum conversion price) of \$0.10 per common share and a 24 -month maturity date.
- Hold interest at 10% per annum, payable in cash quarterly or at the election of the holders in stock at a 5-per-cent discount to the 20-day Volume Weighted Average Price ("VWAP") plus ½ share purchase warrant (two-year life) at a 30-per-cent premium to the 20-day VWAP.
- An aggregate of 49,777,218 common shares were issued on July 8, 2011 in this regard based upon a 5% discount to the market price of the Common Shares of \$0.20.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 1. Reporting entity and going concern *(continued)*

In accordance with the shareholders' agreement in respect of Aral, Caspian is obligated to jointly fund the minimum work program of Aral pursuant to the Exploration Contract.

On February 23, 2010, the Company entered into an agreement to sell a 10% interest in Aral to AsiaStar Petroleum Limited for nominal proceeds of US \$1. AsiaStar Petroleum Limited subsequently agreed to be replaced by Asia Sixth Energy Resources Limited and its subsidiary Groenzee BV (collectively "Asia Sixth") as the party to all agreements and contracts regarding this transaction. Caspian holds a 40% interest in Aral, which it operates as a joint venture together with Azden Management Limited. The sale of 10% of Aral equated to a disposition of 20% of Caspian's original 50% interest in Aral. The agreement was subject to a number of conditions precedent and all regulatory approvals including without limitation the approval of the government of Kazakhstan. The transaction closed on December 29, 2011.

As a precursor to the finalization of the Share Purchase Agreement and Escrow Agreement, the Facility Agreement entered into with Asia Sixth regarding the sale of a 10% interest in Aral was executed on October 22, 2010. The Facility Agreement provides accelerated access to US \$2 million to Aral to permit the accomplishment of remedial action at East Zhagabulak. The Facility Agreement has been increased to US \$8 million to permit exploration and remedial activity in the Block to commence post haste. The Facility Agreement was executed in conjunction with the closing of the transaction.

As part of the transaction, Asia Sixth will make significant effort to secure US \$80 million in debt financing for Aral for further exploration and development. If successful, this transaction will achieve several strategic imperatives. It will provide the funding necessary to develop the East Zhagabulak field, phase one of which envisages the immediate drilling of development wells. It will provide the funding required for a sustained exploratory drilling campaign. Finally, it should ensure that Caspian will not have to provide additional funds for the activity in the North Block in the near term.

Asia Sixth has also agreed to enter into a facility agreement with Caspian which will provide for an advance up to US \$6 million in loans to Caspian in three, US \$2 million tranches over a two-year period. These loans will have a ten-year term, and will bear interest at a rate of 10% per annum during the first five years and 18% per annum during the second five years. The loans are to be repaid from dividends received by Caspian from Aral.

The Company's ability to continue as a going concern is in significant doubt and is dependent upon achieving profitable operating results from its Kazakhstan operations. There are no assurances that these initiatives will be successful.

The accompanying condensed interim unaudited consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets and classification of liabilities that might be necessary should the Company be unable to continue its operations. Such adjustments could be material.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 2. Basis of presentation

#### a) Statement of compliance

We prepare our financial statements in accordance with International Financial Reporting Standards ("IFRS") as issued by International Accounting Standards Board ("IASB"). These condensed interim unaudited consolidated financial statements have been prepared in accordance with IAS 34, Interim Financial Reporting ("IAS 34"). These condensed interim unaudited consolidated financial statements follow the same accounting policies and methods of application as our most recent annual financial statements. Accordingly, they should be read in conjunction with our most recent annual financial statements. The policies applied in these condensed interim unaudited consolidated financial statements are based on IFRS issued and outstanding as of November 5, 2012, the date the Board of Directors approved the statements.

#### b) Basis of measurement

The condensed interim unaudited consolidated financial statements have been prepared on the historical cost basis except for held-for-trading financial assets which are measured at fair value with changes in fair value recorded in earnings. The methods used to measure fair values are discussed in Note 5.

#### c) Functional and presentation currency

Functional currency is the currency of the primary economic environment in which a company operates.

These condensed interim unaudited consolidated financial statements are presented in Canadian dollars ("CAD"), which is the Company's functional currency. Foreign currency transactions are translated into the functional currency using the exchange rate prevailing at the dates of transactions. Foreign exchange gains and losses resulting from the settlement of such transactions or from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in finance expense within the consolidated statement of loss and comprehensive loss.

Aral's functional currency is the Kazakhstani Tenge (the "Tenge"). The Company accounts for its interest in Aral using proportionate consolidation. All amounts from Aral included in the Company's condensed interim unaudited consolidated financial statements are recorded in Tenge and converted to CAD. The assets and liabilities of Aral are translated into CAD at the exchange rate at the balance sheet date. Revenues and expenses of Aral are translated into CAD using foreign exchange rates that approximate those on the date of the underlying transaction. Foreign exchange differences are recognized in other comprehensive income and reclassified to net earnings upon disposal of the foreign operation.

At September 30, 2012 the principal rate of exchange used for translating foreign currency balances was \$1 CAD = Tenge 150.74 (December 31, 2011: \$1 CAD = 142.73 Tenge). The average principal rate of exchange used for translating foreign currency balances during the period ended September 30, 2012 and 2011 was \$1 CAD = Tenge 148.31 and \$1 CAD = 149.42 Tenge, respectively. Exchange restrictions and currency controls exist relating to converting Tenge into other currencies. At present, Tenge is not a freely convertible currency in most countries outside of the Republic of Kazakhstan.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies

The accounting policies set out below have been applied consistently by the Company to all periods presented in these condensed interim unaudited consolidated financial statements.

#### (a) **Basis of consolidation**

##### (i) Subsidiaries:

The Company's primary operating activities are carried out through its wholly-owned subsidiary, Caspian Energy Ltd. Subsidiaries are entities controlled by the Company. Control exists when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that currently are exercisable are taken into account. The financial statements of subsidiaries are included in the condensed interim unaudited consolidated financial statements from the date that control commences until the date that control ceases.

##### (ii) Jointly controlled operations and jointly controlled assets:

The Company's oil and natural gas activities involve jointly controlled assets. The condensed interim unaudited consolidated financial statements include the Company's share of these jointly controlled assets and a proportionate share of the relevant revenue and related costs.

##### (iii) Transactions eliminated on consolidation:

Intercompany balances and transactions, and any unrealized income and expenses arising from intercompany transactions, are eliminated in preparing the condensed interim unaudited consolidated financial statements.

#### (b) **Financial instruments**

All financial instruments are initially recognized at fair value on the consolidated statement of financial position. The Company has classified each financial instrument into one of the following categories: fair value through profit or loss (assets and liabilities), loans and receivables, financial assets available-for-sale, financial assets held-to-maturity, and other financial liabilities. Subsequent measurement of financial instruments is based on their classification.

##### (i) Non-derivative financial instruments:

Non-derivative financial instruments comprise cash, trade and other receivables, loans payable, trade and other payables and convertible debentures. Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured as described below:

##### Financial assets at fair value through profit or loss

An instrument is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Financial instruments are designated at fair value through profit or loss if the Company manages such instruments and makes purchase and sale decisions based on their fair value in accordance with the Company's risk management or investment strategy. Upon initial recognition, attributable transaction costs are recognized in profit or loss when incurred. Financial instruments at fair value through profit or loss are measured at fair value, and changes therein are recognized in the consolidated statement of loss. The Company has designated cash at fair value.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies *(continued)*

#### Other

Other non-derivative financial instruments, such as trade and other receivables, loans payable, trade and other payables and the liability component of convertible debentures are measured at amortized cost using the effective interest method, less any impairment losses.

#### (ii) Derivative financial instruments:

The Company evaluates all financial instruments for freestanding and embedded derivatives. Warrants and options do not have readily determinable fair values and therefore require significant management judgment and estimation. The Company uses the Black-Scholes pricing model to estimate the fair value of warrants at the end of each applicable reporting period. Changes in the fair value of these warrants during each reporting period are included in the consolidated statement of loss. Inputs into the Black-Scholes pricing model require estimates, including such items as estimated volatility of the Company's stock and the estimated life of the financial instruments being fair valued.

The conversion feature of convertible debentures is an embedded derivative as the US dollar principal amount is convertible into common shares at a CAD conversion price. As a result, the Company recognizes the fair values of the derivative components at the date of issuance, with the remainder of the proceeds attributed to the liability component of the convertible debentures. The derivative component is marked-to-market at each reporting date using the Black-Scholes pricing model to estimate the fair value. The liability component accretes up to the principal balance at maturity.

#### (iii) Share capital:

Common shares are classified as equity. Incremental costs directly attributable to the issue of common shares and share options are recognized as a deduction from equity, net of any tax effects.

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

Cash and cash equivalents include cash on hand, cash in bank accounts and highly liquid bank deposits with original maturities of less than three months. Restricted balances are excluded from cash and cash equivalents for the purposes of the consolidated statement of cash flows. Balances restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date are classified as other non-current assets.

#### (d) **Trade and other receivables**

Trade and other receivables, except for taxes prepaid and advances to suppliers, are initially recognized at fair value and subsequently accounted at amortized cost using the effective interest method less provision for impairment of such receivables. Taxes prepaid and advances to suppliers are accounted for at actually paid amounts. A provision for impairment of trade and other receivables is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of receivables. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. The amount of the provision is recognised in the consolidated statement of loss. The primary factors that the Company considers whether a receivable is impaired is its overdue status.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies (continued)

#### (e) Inventories

Inventories are recorded at the lower of cost and net realizable value. Costs of inventories and supplies represent purchase cost. Cost of crude oil comprises raw material, direct labour, other direct costs and related production overheads (based on normal operating capacity). Cost of inventories is assigned on a weighted average basis. Net realizable value is determined by reference to the sales proceeds of items sold in the ordinary course of business less selling expenses or to management's estimates based on prevailing market conditions. Supplies are capitalized to property, plant and equipment when used for renewals and betterments of oil and gas properties or recognized as expenses when used for daily operations. Slow-moving or obsolete inventory items are written-off to the consolidated statement of loss.

#### (f) Property, plant and equipment and exploration and evaluation assets

##### (i) Recognition and measurement

##### Exploration and evaluation expenditures

Pre-license costs are recognized in the consolidated statement of loss and comprehensive loss as incurred. Exploration and evaluation ("E&E") expenditures, including the costs of acquiring undeveloped land and drilling costs are initially capitalized until the drilling of the well is complete and the results have been evaluated. The costs are accumulated in cost centres by well, field or exploration area pending determination of technical feasibility and commercial viability. The technical feasibility and commercial viability of extracting a petroleum or natural gas resource is considered to be determinable when proved or probable reserves are determined to exist. If proved and or probable reserves are found, the drilling costs and associated undeveloped land are transferred to property, plant and equipment. The cost of undeveloped land that expires or any impairment recognized during a period is charged as additional depletion and depreciation expense.

Exploration and evaluation assets are assessed for impairment if (i) sufficient data exists to determine technical feasibility and commercial viability, and (ii) facts and circumstances suggest that the carrying amount exceeds the recoverable amount. For purposes of impairment testing, E&E assets are allocated to cash generating units ("CGUs").

##### Development and production costs

Items of property, plant and equipment, which include oil and gas development and production ("D&P") assets, are measured at cost less accumulated depletion and depreciation and accumulated impairment losses.

The cost of D&P assets includes: transfers from E&E assets, which generally include the cost to drill the well and the cost of the associated land upon determination of technical feasibility and commercial viability; the cost to complete and tie-in the wells; facility costs; the cost of recognizing provisions for future restoration and decommissioning; geological and geophysical costs; and directly attributable overheads.

Development and production assets are grouped into CGUs for the purpose of impairment testing.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies (continued)

When significant parts of an item of property, plant and equipment, including petroleum and natural gas properties, have different useful lives, they are accounted for as separate items (major components). Gains and losses on disposal of an item of property, plant and equipment, including oil and natural gas interests, are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment and are recognized in the consolidated statement of loss.

#### Subsequent costs

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property, plant and equipment are recognized as oil and natural gas interests only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in the consolidated statement of loss as incurred. Such capitalized oil and natural gas interests generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis. The carrying amount of any replaced or sold component is derecognized. The costs of the day-to-day servicing of property, plant and equipment are recognized in operating expenses as incurred.

#### (ii) Depletion and depreciation:

The net carrying value of D&P assets is depleted using the unit of production method by reference to the ratio of production in the period to the related proved plus probable reserves, taking into account estimated future development costs necessary to bring those reserves into production and the estimated salvage value of the assets at the end of their useful lives. Future development costs are estimated taking into account the level of development required to produce the reserves.

Proved plus probable reserves are estimated annually by independent qualified reserve evaluators and represent the estimated quantities of crude oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be recoverable in future years from known reservoirs and which are considered commercially producible.

For depletion purposes, 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.

Depreciation methods, useful lives and residual values of tangible assets are reviewed at each reporting date. Depreciation is calculated on a straight-line basis at the following annual rates:

#### Useful lives in years

Machinery and equipment	5-10
Vehicles and other	3-14

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies *(continued)*

#### (g) Impairment

##### (i) Financial assets

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows discounted at the original effective interest rate.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

All impairment losses are recognized in the consolidated statement of loss.

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized cost the reversal is recognized in the consolidated statement of loss.

##### (ii) Non-financial assets

The carrying amounts of the Company's non-financial assets, other than E&E assets and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated. Exploration and evaluation assets are assessed for impairment when they are transferred to property, plant and equipment, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (a CGU). The recoverable amount of an asset or a CGU is the greater of its value in use and its fair value less costs to sell.

Value in use is determined as the net present value of the estimated future cash flows expected to arise from the continued use of the asset in its present form and its eventual disposal. Value in use is determined by applying assumptions specific to the Company's continued use and can only take into account approved future development costs. Estimates of future cash flows used in the evaluation of impairment of assets are made using management's forecasts of commodity prices and expected production volumes. The latter takes into account assessments of field reservoir performance and includes expectations about proved and unproved volumes, which are risk-weighted utilizing geological, production, recovery and economic projections.

Fair value less costs to sell is determined as the amount that would be obtained from the sale of a CGU in an arm's length transaction between knowledgeable and willing parties. The fair value less costs to sell of oil and gas assets is generally determined as the net present value of the estimated future cash flows expected to arise from the continued use of the CGU, including any expansion prospects, and its eventual disposal, using assumptions that an independent market participant may take into account. These cash flows are discounted by an appropriate discount rate which would be applied by such a market participant to arrive at a net present value of the CGU.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies *(continued)*

Exploration and evaluation assets are allocated to related CGUs (determined by fields) when they are assessed for impairment, both at the time of any triggering facts and circumstances as well as upon their eventual reclassification to producing assets (oil and natural gas interests in property, plant and equipment). Accordingly, management evaluates the Aransay, Baktygaryn, Zhagabulak, Zhagabulak South, Itasay-Kuzdasay fields separately for impairment purposes.

Recoverable amounts are estimated for individual assets unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets, in which case impairment is evaluated at the cash generating unit ("CGU") level. For the purposes of assessing impairment, property, plant and equipment (specifically oil and gas properties) are grouped on a field-by-field basis. Accordingly, management considers the East Zhagabulak field as a separate CGU.

Impairment losses recognized in prior years are assessed at each reporting date to determine whether facts and circumstances indicate that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount and is only reversed to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation, if no impairment loss had been recognized. Impairment reversals are recognized in the consolidated statement of loss and comprehensive loss.

#### (h) Provisions

Provisions are recognized when the Company has a present or constructive obligation as a result of a past event that can be estimated with reasonable certainty and are measured at the amount that the Company would rationally pay to be relieved of the present obligation. To the extent that provisions are estimated using a present value technique, such amounts are determined by discounting the expected future cash flows at a risk-free pre-tax rate and adjusting the liability for the risks specific to the liability.

##### Decommissioning liability

The Company's activities give rise to dismantling, decommissioning and site disturbance re-mediation activities. Provision is made for the estimated cost of site restoration and capitalized in the relevant asset category.

The Company's decommissioning liability is measured at the present value of management's best estimate of expenditure required to settle the future obligation at the statement of financial position date. Subsequent to the initial measurement, the liability is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the liability. The increase in the provision due to the passage of time is recognized as finance costs whereas increases/decreases due to changes in the estimated future cash flows are capitalized. Actual costs incurred upon settlement of decommissioning liability are charged against the provision to the extent the provision was established.

#### (i) Trade and other payables

Trade and other payables are accrued when the counterparty performed its obligations under the contract. Trade and other payables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies *(continued)*

#### (j) Value added tax

Value added tax ("VAT") related to sales is payable to the tax authorities when goods are shipped or services are rendered. Purchase VAT is reclaimable, except for VAT on vehicles, against sales VAT upon the receipt of a tax invoice from a supplier. Tax legislation applicable to the Company allows the settlement of VAT on a net basis. Accordingly, VAT related to sales and purchase transactions, which have not been settled at the reporting date, is recognized in the consolidated statement of financial position on a net basis.

#### (k) Loans payable

Loans payable are initially recorded at fair value including transaction costs and subsequently measured at amortized cost using the effective interest method. The Company capitalizes borrowing costs to finance construction of qualifying assets during the period of the time that is required to complete the asset for its intended use. All other borrowings costs are expensed. Interest costs on borrowings are recognized in the period in which they are incurred regardless of how the borrowings are applied. Borrowings are classified as current liabilities unless the Company has an unconditional right to defer settlement of the liability for at least twelve months after the reporting date.

#### (l) Revenue recognition

Revenue from the sale of oil and natural gas is recorded when the significant risks and rewards of ownership of the product is transferred to the buyer based on volumes delivered to customers at contractual delivery points and rates. Revenue is shown net of value-added tax, discounts and after eliminating sales within the Company.

#### (m) Finance income and expenses

Finance income and expenses comprise interest income, interest expense on borrowings and convertible debentures, accretion on convertible debentures, the unwinding of discount on the decommissioning liability and other financial assets and liabilities. Interest income and interest expense are recognized as amounts accrue in the consolidated statement of loss using the effective interest rate method.

#### (n) Operating leases

Where the Company is a lessee in a lease which does not transfer substantially all the risks and rewards incidental to ownership from the lessor, the total lease payments are charged to profit or loss on a straight-line basis over the term of the lease.

#### (o) Income taxes

Income tax expense comprises current and deferred tax. Income tax expense is recognized in the consolidated statement of loss except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies *(continued)*

Deferred tax is recognized using the liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

#### **(p) Share-based payments**

The Company grants options to purchase common shares to employees and directors under its stock option plan. Share-based payments to these individuals are measured at the fair value of the options issued and recognized as expenses over the vesting periods with a corresponding increase to contributed surplus. A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest. Proceeds received on exercise of stock options, along with amounts previously included in contributed surplus, are credited to share capital.

#### **(q) Per share amounts**

Basic earnings per share is calculated by dividing the income (loss) attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period. Diluted earnings per share is determined by adjusting the income (loss) attributable to common shareholders and the weighted average number of common shares outstanding for the effects of dilutive instruments such as options granted to employees and directors, warrants and convertible debentures. The calculation assumes the proceeds on exercise of options are used to repurchase shares at the current market price.

#### **(r) New standards and interpretations not yet adopted**

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

IFRS 10, "Condensed interim consolidated financial statements" replaces IAS 27 "Consolidated Separate Financial Statements". It introduces a new principle-based definition of control, applicable to all investees to determine the scope of consolidation. The standard provides the framework for condensed interim consolidated financial statements and their preparation based on the principle of control.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 3. Significant accounting policies (continued)

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

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

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

IAS 1 “Presentation of Items of Other Comprehensive Income” was amended in June 2011 to separate items of other comprehensive income that may be subsequently re-classified to income. The standard is required to be adopted for periods beginning on or after July 1, 2012.

IAS 27 “Separate Financial Statements” has been amended to focus solely on accounting and disclosure requirements when an entity presents separate financial statements, due to the issuance of the new IFRS 10 which is specific to condensed interim consolidated financial statements.

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

In November 2009, the IASB published IFRS 9, “Financial Instruments,” which covers the classification and measurement of financial assets as part of its project to replace IAS 39, “Financial Instruments: Recognition and Measurement.” In October 2010, the requirements for classifying and measuring financial liabilities were added to IFRS 9. Under this guidance, entities have the option to recognize financial liabilities at fair value through earnings. If this option is elected, entities would be required to reverse the portion of the fair value change due to a company’s own credit risk out of earnings and recognize the change in other comprehensive income. IFRS 9 is effective for the Company on January 1, 2015. Early adoption is permitted and the standard is required to be applied retrospectively.

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

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 4. Critical accounting estimates and judgments in applying accounting policies

The Company makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgments are continually evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Management also makes certain judgments, apart from those involving estimations, in the process of applying the accounting policies. Judgments that have the most significant effect on the amounts recognized in the condensed interim unaudited consolidated financial statements and estimates that can cause a significant adjustment to the carrying amount of assets and liabilities within the next financial year include:

(a) **Going concern**

These condensed interim unaudited consolidated financial statements have been prepared in accordance with IFRS on a going concern basis, which assumes the realization of assets and discharge of liabilities in the normal course of business within the foreseeable future. As discussed in Note 1, a number of conditions exist that indicate the existence of a material uncertainty, which may cast significant doubt about the Company's ability to continue as a going concern, and, therefore, that the Company may be unable to realize its assets and discharge its liabilities in the normal course of business. The ability of the Company to operate on a going concern basis is also dependent upon successful execution of its obligations or amending the minimum work program as specified in the Exploration and Production Contracts. These condensed interim unaudited consolidated financial statements do not include any adjustments in the carrying values of assets and liabilities, the reported revenues and expenses, and the statement of cash flow classifications used, that might result from the outcome of this uncertainty, and such adjustments may be material.

(b) **Decommissioning liabilities**

In accordance with the Exploration Contract and the Production Contract, Aral has a legal obligation to decommission its oil and gas properties and restore its site after its closure. Provision is made, based on net present values, for site restoration and rehabilitation costs as soon as the obligation arises from past oil and gas activities. The provision for site restoration is estimated based on Aral's interpretation of current environmental legislation in the Republic of Kazakhstan and Aral's related program for liquidation based on the feasibility study and engineering research in accordance with the existing rehabilitation standards and techniques. Decommissioning liabilities are subject to potential changes in environmental regulatory requirements and the interpretation of the legislation.

(c) **Impairment of exploration and evaluation assets**

Exploration and evaluation assets are reviewed for possible impairment when events or changes in circumstances indicate that their carrying amount may not be recoverable. If assets are determined to be impaired the carrying amounts of those assets are written down to their recoverable amount, which is the higher of fair value less costs to sell and value in use determined as the amount of estimated discounted future cash flows.

Estimates of future cash flows are based on management estimates of future commodity prices, market supply and demand, product margins, the expected future production volumes and the likelihood of commercial discovery on the licensed territories. The impairment review and calculations are based on assumptions that are consistent with the Company's business plan.

As of December 31, 2010 Aral returned 1,909 square kilometers (55%) of the licensed area in accordance with the Exploration Contract terms and recognized the related expense (Note 1). Management has concluded that there were no further impairment indicators in relation to exploration and evaluation assets in 2011.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 4. Critical accounting estimates and judgments in applying accounting policies *(continued)*

#### (d) Impairment of oil and gas properties

Oil and gas properties are reviewed for possible impairment when events or changes in circumstances indicate that their carrying amount may not be recoverable. If assets are determined to be impaired the carrying amounts of those assets are written down to their recoverable amount, which is the higher of fair value less costs to sell and value in use determined as the amount of estimated discounted future cash flows.

Estimates of future cash flows are based on management estimates of future commodity prices, market supply and demand, product margins and the expected future production volumes. The impairment review and calculations are based on assumptions that are consistent with the Company's business plan.

The Company's reserve reports, prepared by third party consultants, are used to calculate the discounted future cash flows and assess the recoverability of the carrying value of property, plant and equipment.

Principal assumptions having significant impact on the projected future cash flows from oil reserves are: the discount rate of 21.97% (December 31, 2010 – 29.58%; January 1, 2010 – 19.78%) and the forecast oil price of US \$90 (December 31, 2010 – US \$77; January 1, 2010 US \$71).

The application of IAS 36 requires extensive judgment on the part of management regarding the assumptions and estimates related to future cash flows and the discount rate. Given the nature of the current global economic environment such assumptions and estimates ultimately have a high degree of uncertainty associated with them. Consequently, assumptions, other than those used by management, of equal validity could give rise to materially different results.

#### (e) Estimation of oil and gas reserves

Oil and gas reserves are key elements in the Company's investment decision-making process. They are also an important element in testing for impairment.

Proved oil and gas reserves are the estimated quantities of crude oil and natural gas which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions, i.e. prices and costs as of the date the estimate is made. Proved developed reserves are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods. Estimates of oil and gas reserves are inherently imprecise, require the application of judgement and are subject to future revision. Accordingly, financial and accounting measures (such as depletion and depreciation charges, and provision for decommissioning liabilities) that are based on proved reserves are also subject to change.

Proved reserves are estimated by reference to available reservoir and well information. All proved reserves estimates are subject to revision, either upward or downward, based on new information, such as from development drilling and production activities or from changes in economic factors, including product prices, contract terms or development plans. In general, changes in the technical maturity of hydrocarbon reserves resulting from new information becoming available from development and production activities have tended to be the most significant cause of annual revisions.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 4. Critical accounting estimates and judgments in applying accounting policies *(continued)*

In general, estimates of reserves for undeveloped or partially developed fields are subject to greater uncertainty over their future life than estimates of reserves for fields that are substantially developed and being depleted. As a field goes into production, the amount of proved reserves will be subject to future revision once additional information becomes available through, for example, the drilling of additional wells or the observation of long-term reservoir performance under producing conditions. As those fields are further developed, new information may lead to revisions.

Changes to the Company's estimates of proved reserves also affect the amount of depletion and depreciation recorded in the Company's condensed interim unaudited consolidated financial statements for property, plant and equipment related to oil and gas production activities. A reduction in proved reserves will increase depletion and depreciation charges (assuming constant production) and reduce income.

Management's judgement is that production life of proved reserves will not exceed expiry date under subsurface use contracts.

Proved reserve estimates of the Company as of December 31, 2011, December 31, 2010 and January 1, 2010 were based on the reports prepared by McDaniels & Associates Consultants Ltd., independent engineering consultants.

#### (f) **Stock options, warrants and derivative financial instruments**

The estimated fair value of derivative financial instruments resulting in financial assets and liabilities, by their very nature are subject to measurement uncertainty. The Company uses the Black-Scholes pricing model to estimate the fair value of stock options, warrants and derivative financial instruments, which is based on significant assumptions such as volatility, dividend yield and expected term.

#### (g) **Deferred taxes**

Tax interpretations, regulations and legislation in the various jurisdictions in which the Company operates are subject to change. As such income taxes are subject to measurement uncertainty. Deferred income tax assets are assessed by management at the end of the reporting period to determine the likelihood that they will be realized from future taxable earnings.

#### (h) **Contingencies**

By their nature, contingencies will only be resolved when one or more future events occur or fail to occur. The assessment of contingencies inherently involves the exercise of significant judgment and estimates of the outcome of future events.

### 5. Determination of fair values

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

The Company is required to classify fair value measurements using a hierarchy that reflects the significance of the inputs used in making the measurements.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 5. Determination of fair values *(continued)*

The fair value hierarchy is as follows:

- Level 1 – quoted prices in active markets for identical assets or liabilities;
- Level 2 – inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 – inputs for the asset or liability that are not based on observable market data.

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

#### a) **Property, plant and equipment and exploration and evaluation assets**

Estimates of recoverable quantities of proved and probable reserves include judgmental assumptions regarding commodity prices, exchange rates, discount rates and production and transportation costs for future cash flows. It also requires interpretation of complex geological and geophysical models in order to make an assessment of the size, shape, depth and quality of reservoirs, and their anticipated recoveries. The economic, geological and technical factors used to estimate reserves may change from period to period. Changes in reported reserves can impact asset carrying values, the provision for decommissioning liabilities and the recognition of deferred tax assets, due to changes in expected future cash flows. Reserve estimates are prepared in accordance with the Canadian Oil and Gas Evaluation Handbook and are reviewed by third party reservoir engineers.

The Company makes judgments in determining its CGUs and evaluates the geography, geology, production profile and infrastructure of its assets in making such determinations, which are based on estimates of reserves. Based on this assessment, the Company's CGUs are generally composed of significant development areas. The Company reviews the composition of its CGUs at each reporting date to assess whether any changes are required in light of new facts and circumstances. The amounts recorded for depletion and depreciation of property, plant and equipment, the provision for decommissioning liabilities, and the valuation of property, plant and equipment are based on estimates of proved and probable reserves, production rates, future petroleum and natural gas prices, future costs and the remaining lives and period of future benefit of the related assets.

#### b) **Cash and cash equivalents, trade and other receivables, trade and other payables and loans payable**

The fair value of cash and cash equivalents, trade and other receivables, trade and other payables and loans payable is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date. At September 30, 2012 and December 31, 2011 the fair value of these balances approximated their carrying value due to their short term to maturity.

#### c) **Convertible debentures**

The carrying value of convertible debentures includes the liability component and the embedded derivative related to the conversion feature of the debentures. The embedded derivative is recognized at its fair value on the date of issuance, with the remainder of the proceeds attributed to the liability component of the convertible debentures. The derivative component is marked-to-market at each reporting date using the Black-Scholes pricing model to estimate the fair value. Subsequent to issuance, the liability component is accreted up to face value using the effective interest method.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 5. Determination of fair values *(continued)*

#### d) Stock options, warrants and derivative financial instruments

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

The Black-Scholes pricing model calculations for 2012 and 2011 were based on the following significant assumptions:

	Stock options		Warrants (Note 16)	
	2012	2011	2012	2011
Risk-free interest rate	1.5%	1.70%	1.5%	1.7%
Expected volatility range	366%	129%	197%	112%
Expected life	5 years	5 years	2 years	2 years
Forfeiture rate	0%	0%	0%	0%
Dividends	0%	0%	0%	0%

### 6. Joint interest in Aral

On February 23, 2010, the Company entered into a Sale and Purchase Agreement (the "Agreement") with AsiaStar Petroleum Limited ("AsiaStar") to sell 20% of its 50% interest in Aral which it operated as a joint venture with Frasan Wood B.V. ("Frasan") which held the remaining 50% interest in Aral. Pursuant to the Agreement, Frasan will also sell its 50% interest to AsiaStar resulting in AsiaStar holding a 60% interest in Aral and Caspian holding a 40% interest in Aral.

In October 2010, AsiaStar Petroleum Limited was replaced by Asia Sixth Energy Resources Limited ("Asia Sixth") as the party to all agreements and contracts regarding this transaction.

Caspian sold a 10% interest in Aral to Asia Sixth for consideration of \$1 and:

- the undertaking by Asia Sixth to finance Aral's capital expenditures to the cumulative threshold of US \$80 million for further exploration and development of the North Block;
- a facility agreement (the "Facility Agreement") between Asia Sixth and Caspian to an advance up to US \$6 million in loans to Caspian in three, US \$2 million tranches over a two-year period. These loans will have a ten-year term, and will bear interest at a rate of 10% per annum during the first five years and 18% per annum during the second five years. Caspian shall repay the loans and pay accrued interest (a) on each date on which Caspian receives any dividends from Aral and (b) on each date on which the Borrower receives any proceeds from any disposal of any of its shares in Aral. Payments will be applied first towards payment of any accrued interest on the loans and secondly towards payment of any principal amount outstanding; and
- the assignment to Asia Sixth of 60% of Caspian's US \$101.4 million loan receivable due from Aral.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 6. Joint interest in Aral (continued)

The Agreement was subject to a number of conditions to be satisfied in order for the transaction to close, including the receipt of all regulatory approvals including without limitation the approval of the government of Kazakhstan. The transaction closed on December 29, 2011.

As at September 30, 2012, the Company held a 40% interest in Aral which is proportionately consolidated in these condensed interim unaudited consolidated financial statements. As at September 30, 2012, US \$2 million had been advanced to the Company under the Facility Agreement (note 12).

### 7. Cash and cash equivalents

	<b>September 30 2012</b>	<b>December 31 2011</b>
Cash in CAD	21	145
Cash in US dollars	3	2,098
Cash in GBP	16	10
Cash in KZT	106	43
	<hr/> 146	<hr/> 2,296

### 8. Inventory

	<b>September 30 2012</b>	<b>December 31 2011</b>
Oil inventory	301	–
Other materials	239	987
	<hr/> 540	<hr/> 987

### 9. Restricted cash

Under the terms of the Exploration Contract, Aral has an obligation to create a fund of 1% of the capital cost of exploration (“the Liquidation Fund”) and deposit cash in a restricted bank account. The Company’s share of this account balance at September 30, 2012 and December 31, 2011 was US \$8,000 and US \$290,000 respectively, for which Canadian dollars approximated US dollars. It is anticipated that the Liquidation Fund will be used to finance the cost of restoring the license area upon expiration of the Exploration Contract and the Production Contract.

# Caspian Energy Inc.

Notes to Condensed interim consolidated financial statements  
For the three and nine months ended September 30, 2012

---

## 10. Exploration and evaluation assets

Movements in the carrying amount of exploration and evaluation assets were as follows:

<b>Balance, January 1, 2010</b>	<b>30,531</b>
Additions	201
Provision for impairment	(33)
Revisions to decommissioning liability	(11)
Foreign currency translation	(1,240)
	<hr/>
<b>Balance, at December 31, 2010</b>	<b>29,448</b>
Additions	9,162
Revisions to decommissioning liability	35
Disposition (note 6)	(7,927)
Foreign currency translation	994
	<hr/>
<b>Balance, December 31, 2011</b>	<b>31,712</b>
Additions	3,118
Foreign currency translation	(1,686)
	<hr/>
<b>Balance, September 30, 2012</b>	<b>33,144</b>

As at September 30, 2012, E&E assets include intangible assets in the amount of \$1.3 million related to geological and geophysical costs, insurance of oil operations and regulatory fees and reimbursement of government costs. The Company did not recognize any impairment during 2012.

# Caspian Energy Inc.

Notes to Condensed interim consolidated financial statements  
For the three and nine months ended September 30, 2012

## 11. Property, plant and equipment

Cost	Other Assets	Petroleum and natural gas assets	Total
<b>January 1, 2010</b>	<b>684</b>	<b>13,770</b>	<b>14,454</b>
Additions	1	300	301
Transfers	–	(65)	(65)
Disposition	(23)	(67)	(90)
Foreign currency translation	(27)	(542)	(569)
<b>December 31, 2010</b>	<b>635</b>	<b>13,396</b>	<b>14,031</b>
Additions	3	6,015	6,018
Transfers	(4)	(620)	(624)
Disposition (note 6)	(130)	(3,846)	(3,976)
Foreign currency translation	37	436	473
<b>December 31, 2011</b>	<b>541</b>	<b>15,381</b>	<b>15,922</b>
Additions	–	8,243	8,243
Dispositions	–	(27)	(27)
ARO revision	–	116	116
Foreign currency translation	7	(409)	(402)
<b>September 30, 2012</b>	<b>548</b>	<b>23,304</b>	<b>23,852</b>
<b>Accumulated depletion and depreciation</b>			
<b>January 1, 2010</b>	<b>281</b>	<b>7,116</b>	<b>7,397</b>
Depreciation and depletion	73	1,281	1,354
Foreign currency translation	(13)	(109)	(122)
<b>December 31, 2010</b>	<b>341</b>	<b>8,288</b>	<b>8,629</b>
Depreciation and depletion	63	971	1,034
Disposition (note 6)	(81)	(1,971)	(2,052)
Foreign currency translation	13	592	605
<b>December 31, 2011</b>	<b>336</b>	<b>7,880</b>	<b>8,216</b>
Depreciation and depletion	4	446	450
<b>September 30, 2012</b>	<b>340</b>	<b>8,326</b>	<b>8,666</b>
<b>Carrying amount</b>			
January 1, 2010	403	6,654	7,057
December 31, 2010	294	5,108	5,402
December 31, 2011	205	7,501	7,706
September 30, 2012	208	14,978	15,186

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 11. Property, plant and equipment *(continued)*

Continuing losses from operations have been assessed by management as indicators of potential impairment of oil and gas properties and, accordingly, as at September 30, 2012, management conducted an impairment test of oil and gas properties. Impairment tests performed at September 30, 2012 were based on fair value less cost to sell calculations using the following commodity price estimates:

	WTI Crude US\$/bbl
2012	97.50
2013	97.50
2014	100.00
2015	100.80
2016	101.70
2017	102.70
2018	103.60
2019	104.50
2020	105.40
2021	107.60
Thereafter <sup>(2)</sup>	2%

<sup>(2)</sup> Percentage change of 2.0% represents the change in future prices each year after 2012 to the end of the reserve life.

The impairment tests were primarily based on the net present value of cash flows from oil reserves of each CGU at a discount rate of 22%. Based on management's assessment, the Company's CGUs were not impaired in 2012 or 2011.

Neither a one per cent increase in the assumed after tax discount rate or five per cent decrease in the forward commodity price estimate would result in any impairment in 2012.

### 12. Loans payable

	September 30 2012	December 31 2011
<b>Current portion</b>		
Asia Sixth (a)(i)	7,251	2,977
Asia Sixth (a)(ii)	32,277	31,349
Asia Credit Bank (b)	8	34
Emir Oil (d)	—	178
	<hr/> 39,536	<hr/> 34,538
<b>Long-term portion</b>		
Asia Sixth (a)(iii)	3,119	2,041
Asia Credit Bank (b)	56	59
	<hr/> 3,175	<hr/> 2,100
	<hr/> 42,711	<hr/> 36,638

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 12. Loans payable *(continued)*

#### a) Asia Sixth

- (i) On October 22, 2010, Aral signed a four-sided facility agreement (the "Facility Agreement") where Caspian Energy Ltd. and Azden Management Limited act as Guarantors and Asia Sixth acts as lender. Under Facility Agreement, the lender makes available a US dollars term loan facility in aggregate amount equal to the Commitment. The Facility Agreement is secured a pledge of Aral's bank accounts and by the guarantors.
- (ii) In connection with the Company's sale of a 10% interest in Aral to Asia Sixth, the Company assigned 60% of the US \$101.4 million loan receivable from Aral to Asia Sixth and loans payable by Aral to Azden Management Limited were assigned 60% to Asia Sixth and 40% to the Company as described below in note 12 (c).
- (iii) In connection with the Company's sale of a 10% interest in Aral to Asia Sixth (note 6), the Company entered into a facility agreement with Asia Sixth pursuant to which Asia Sixth will advance up to US \$6 million in loans to Caspian in three, US \$2 million tranches over a two-year period. These loans will have a ten-year term, and will bear interest at a rate of 10% per annum during the first five years and 18% per annum during the second five years. As at September 30, 2012, the Company had received the first US \$2 million tranche. Additionally, Asia Sixth has discharged the Company's portion of a legal liability and it is included here. (See note 18)

The carrying amount of the Company's borrowings from Asia Sixth approximates its fair value as of September 30, 2012 and December 31, 2011 as they are short term in nature and at commercial rates available to the Company.

#### b) Asia Credit Bank

On August 24, 2009, Aral signed a loan agreement with Asia Credit Bank. The credit line amount is Tenge 90 million for 5 years and bears annual interest at 18%. The credit line is secured by the pledge of deposits with the value of US \$217,000 and EUR 413,000. The credit line expires and is expected to be repaid in full by September 4, 2014. The carrying amount of Aral's borrowing from Asia Credit Bank approximates its fair value as of September 30, 2012 and December 31, 2011.

#### c) Emir Oil

In 2011, Aral received a short-term non-interest bearing loan from Emir Oil. The loan was repaid in full on January 9, 2012.

### 13. Convertible debentures

On March 1, 2006, the Company issued US \$16 million of 10% per annum convertible debentures (the "Debentures") with a maturity date of March 2, 2011 and secured with Caspian Ltd. shares. The Debentures were convertible at any time and from time to time into common shares of the Company at a conversion price of \$1.75 per share. In addition, at the Company's option, the Debentures were repayable by the Company, in whole or in part, or convertible into common shares of the Company if the volume-weighted average trading price of the common shares, for 40 consecutive trading days, is at least \$4.08.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 13. Convertible debentures *(continued)*

On December 1, 2009, amendments to the terms of the Debentures were approved by the Company's shareholders following negotiations with the holders of the Debentures to identify alternative means by which interest payments owing under the Debentures could be satisfied in lieu of cash. As a result, the Company amended the terms of the Debentures to provide for the satisfaction of quarterly interest payments due thereunder as follows:

- at the discretion of the holders of Debentures, interest payments for the calendar quarters ended up to and including June 30, 2010 may be satisfied either in cash or by the issuance of common shares valued at a 10% discount to the Volume Weighted Average Price ("VWAP") of the common shares on the TSX for the particular quarter in question; and
- in consideration of their agreement to accept common shares in lieu of cash payments in satisfaction of interest owing under the Debentures for any particular quarter, the Company will also issue to the particular holder of the Debentures making such election, such number of share purchase warrants that is equal to 10% of the aggregate number of common shares so issued to such Debenture holder for such quarter, each such warrant entitling the holder thereof to purchase one additional common share at an exercise price equal to the deemed value of the common shares issued in satisfaction of the interest owing for such quarter (i.e. 10% discount to the VWAP for the particular quarter), for a period of two years.

On April 7, 2011, the Company concluded an arrangement with its Debenture holders with respect to fulfilment of the March 2, 2011 maturity date. Effective June 2, 2011, the Debentures were restructured as follows:

- 44% of the principal plus accrued interest was converted into common shares of the Company at the price of CAD \$0.19 per common share (this aggregates US \$9,790,753 convertible to 49,777,218 common shares).
- The remaining Debentures were amended to an amount of US \$12,460,958 maturing on June 2, 2013 and convertible at a price of CAD \$0.28 per common share (with a minimum conversion price of CAD \$0.10 per common share in the event of future equity financings by the Company at a price lower than CAD \$0.28 per common share, thereby reducing the conversion price to the price of the equity financing).
- Interest unchanged at 10% per annum, payable in cash quarterly, or at the election of the Debenture holders in common shares of the Company at a 5% discount to 20-day VWAP plus ½ of a share purchase warrant exercisable at a 30% premium to VWAP for a period two years from the date of issuance.

# Caspian Energy Inc.

Notes to Condensed interim consolidated financial statements  
For the three and nine months ended September 30, 2012

## 13. Convertible debentures (continued)

	Face value	Total	Liability component	Derivative Liability - Conversion feature
	USD 16,000 / CAD			
<b>Balance, January 1, 2010</b>	16,816	<b>21,814</b>	<b>21,814</b>	–
Interest and accretion		2,646	2,646	–
Settlement of accrued interest		(1,837)	(1,837)	–
Foreign exchange		(1,002)	(1,002)	–
<b>Balance, December 31, 2010</b>		<b>21,621</b>	<b>21,621</b>	–
Interest and accretion		835	835	–
Foreign exchange		(841)	(841)	–
Conversion – April 7, 2011		(9,458)	(9,458)	–
	USD 12,461 / CAD			
<b>Balance, June 2, 2011</b>	12,157	12,157	12,157	–
Derivative component		–	(7,722)	7,722
Interest and accretion		2,055	2,055	–
Fair value adjustment		(5,754)	–	(5,754)
Settlement of accrued interest		(635)	(635)	–
Foreign exchange		827	432	395
<b>Balance, December 31, 2011</b>		<b>8,650</b>	<b>6,287</b>	<b>2,363</b>
Settlement of accrued interest		(391)	(391)	–
Interest and accretion		3,719	3,719	–
Fair value adjustment		(2,127)	–	(2,127)
Foreign exchange		(305)	(266)	(39)
<b>Balance, September 30, 2012</b>		<b>9,546</b>	<b>9,349</b>	<b>197</b>

The conversion feature of the Debentures is an embedded derivative recognized at fair value on the date of issuance, with the remainder of the proceeds attributed to the liability component of the Debentures.

On the date of transition to IFRS, the fair value of the derivative component of the original March 2006 Debenture issuance in was determined to be \$nil.

On June 2, 2011, pursuant to the restructuring of the Debentures, the derivative component of the \$12.2 million (US \$12.5 million) principal amount of Debentures was determined to be \$7.7million (US \$7.9 million) with the remaining \$4.4 million (US \$4.5 million) attributed to the liability component.

As at September 30, 2012 and December 31, 2011, the fair value of the derivative component was determined to be \$197,000 and \$2.2 million, respectively.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 13. Convertible debentures (continued)

The fair value of the derivative component was estimated using the Black-Scholes pricing model based on the following assumptions:

	Issue Date	September 30, 2012
Risk-free interest rate	1.45%	0.95%
Expected volatility	161%	109%
Expected life	2 years	8 months
Dividends	—	—

### 14. Decommissioning liability

The Company's decommissioning liability is based on the cost of dismantling oil and gas production facilities, including abandonment and restoration costs and engineering estimates for the anticipated method and extent of site restoration in accordance with current legislation, industry practices and costs. In accordance with the Production Contract and Exploration Contract, the Company has an obligation to perform a rehabilitation of the well sites. Uncertainties in the estimates of such costs include the potential changes in regulatory requirements, alternative liquidation and restoration of disturbed land plots and level of discount and inflation rates.

The total undiscounted amount of estimated cash flows required to settle the decommissioning liability are approximately \$404,000 (December 31, 2010 – \$146,000; January 1, 2010 \$213,000) which will be incurred over the next 24 years, between 2014 and 2035. A risk-free rate of 7.3% (2010 – 6.6%) and an inflation rate of 5.9% (2010 – 5.21%) were used to calculate the net present value of the decommissioning liability.

Movements in the decommissioning liability are as follows:

<b>Balance, January 1, 2010</b>	<b>213</b>
Revisions	(77)
Accretion	18
Foreign currency translation	(8)
<b>Balance, December 31, 2010</b>	<b>146</b>
Additions and revisions	122
Accretion	38
Disposition (note 6)	(63)
Foreign currency translation	6
<b>Balance, December 31, 2011</b>	<b>249</b>
Additions and revisions	116
Accretion	26
Disposition	1
Foreign currency translation	(14)
<b>Balance, September 30, 2012</b>	<b>378</b>

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

### 15. Share Capital

#### a) Authorized

Unlimited number of voting common shares, without stated par value

#### b) Issued

	Number of shares	Amount \$
<b>Balance, January 1, 2010</b>	<b>144,922,737</b>	<b>129,121</b>
Convertible debenture interest obligation (i)	11,893,781	1,686
Private Placement (ii)	9,320,000	1,864
<b>Balance, December 31, 2010</b>	<b>166,136,518</b>	<b>132,671</b>
Exercise of share purchase warrants (iii)	2,406,787	404
Convertible debenture conversion (iv)	49,777,218	9,458
Convertible debenture interest obligation (v)	4,472,557	505
Settlement of indebtedness (vi)	500,000	54
<b>Balance, December 31, 2011</b>	<b>223,293,080</b>	<b>143,092</b>
Expiry of warrants	-	86
Exercise of share purchase warrants (vii)	567,999	103
Convertible debenture interest obligation (viii)	2,308,376	242
<b>Balance, September 30, 2012</b>	<b>226,169,455</b>	<b>143,523</b>

- (i) To settle interest accrued on convertible debentures (note 13), the Company issued 11,893,781 common shares valued at an average of \$0.14 per share (based on the trading price at the time of the settlements) and 1,189,377 warrants (note 17).
- (ii) On May 27, 2010, the Company closed a non-brokered private placement issuing 9,320,000 common shares at a price of \$0.20 per share to raise gross proceeds of \$1,864,000.
- (iii) During 2011, the Company issued 2,406,787 common shares on the exercise of 2,406,787 share purchase warrants at a weighted average exercise price of \$0.06 for gross proceeds of \$141,330 and a pro-rata share of warrant fair value in the amount of \$263,558.
- (iv) On July 8, 2011, 49,777,218 shares valued at \$0.19 per share, were issued to the holders of the Convertible Debentures to retire 44% of their accumulated principal plus interest balance. See note 13.
- (v) Convertible debentures interest obligation - 2011
- On August 12, 2011, the Company issued 1,438,087 common shares at \$0.18 per share and 719,044 share purchase warrants with an exercise price of \$0.289. See note 13. The common shares were valued at the trading price at the time of issue.
  - On October 31, 2011, the Company issued 3,034,470 common shares at \$0.08 per share and 1,517,236 share purchase warrants with an exercise price of \$0.146. See note 13. The common shares were valued at the trading price at the time of issue.
- (vi) In November 2011, the Company issued 500,000 common shares at \$0.11 per share as settlement of \$53,771 of legal fees. The common shares were valued at the trading price at the time of issue.
- (vii) During 2012, the Company issued 567,999 common shares on the exercise of 567,999 share purchase warrants at a weighted average exercise price of \$0.08 for gross proceeds of \$46,684 and a pro-rata share of warrant fair value in the amount of \$56,345.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

### 15. Share Capital (continued)

(viii) On April 16, 2012, 1,672,012 common shares and 836,007 share purchase warrants were issued to satisfy the 4Q 2011 interest obligation on the Company's Convertible Debentures. The deemed price of the stock issued is \$0.139625 per share and the warrant exercise price is \$0.191065.

On July 9, 2012, 636,364 common shares and 318,182 share purchase warrants were issued to satisfy the 2Q 2012 interest obligation on the Company's Convertible Debentures. The deemed price of the stock issued is \$0.13443 per share and the warrant exercise price is \$0.183957.

### 16. Warrants

A continuity of warrants outstanding as at June 30, 2012 is summarized as follows:

	Number of warrants	Weighted average exercise price	Amount \$
<b>Balance, January 1, 2010</b>	<b>11,014,165</b>	<b>\$0.367</b>	<b>255</b>
Issued (note 16(b)(i))	1,189,377	0.132	151
<b>Balance, December 31, 2010</b>	<b>12,203,542</b>	<b>0.345</b>	<b>406</b>
Issued (note 16(b)(v))	2,236,280	0.192	130
Exercised	(2,406,787)	0.059	(264)
Expired	(8,694,711)	0.045	-
<b>Balance, December 31, 2011</b>	<b>3,338,324</b>	<b>0.174</b>	<b>272</b>
Expired	(534,045)	0.218	(50)
Exercised	(567,999)	0.082	(56)
Issued	1,154,189	0.191	118
<b>Balance, September 30, 2012</b>	<b>3,390,469</b>	<b>0.191</b>	<b>648</b>

The fair value of warrants issued in 2012 and 2011 was determined using the Black-Scholes pricing model as disclosed in note 5(d).

Information about warrants as at September 30, 2012 is summarized in the following table:

Exercise price	Number of warrants outstanding	Weighted average exercise price	Weighted average remaining contractual life (years)
\$ 0.146	1,517,236	0.146	1.1
\$ 0.184	318,182	0.184	1.9
\$ 0.191	836,007	0.191	1.5
\$ 0.289	719,044	0.289	.80
	<b>3,390,469</b>	<b>\$ 0.191</b>	<b>1.33</b>

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 17. Finance expense

	2012	2011
	\$	\$
Other Interest	(225)	–
Interest on convertible debentures	(954)	(1,165)
Accretion of convertible debentures	(2,695)	(82)
Interest expense on loans payable and other	(192)	(106)
Accretion of decommissioning liabilities	(26)	(1)
Net foreign exchange gain (loss)	(312)	2,413
<b>Net finance expense</b>	<b>(4,404)</b>	<b>1,059</b>

### 18. General and administrative expense

During this fiscal quarter, upon finalization of a legal settlement, \$1,270,000 has been included in General and administrative expense.

### 19. Commitments, contingencies and operating risks

**Operating environment.** The Company's principal business activities are within the Republic of Kazakhstan. Laws and regulations affecting businesses operating in the Republic of Kazakhstan are subject to rapid changes and the Company's assets and operations could be at risk in the event of negative changes in the political and business environment.

**Taxation.** Kazakhstani tax legislation and practice is in a state of continuous development and therefore is subject to varying interpretations and frequent changes, which may be retroactive. Further, the interpretation of tax legislation by tax authorities as applied to the transactions and activities of the Company may not coincide with that of management. As a result, tax authorities may challenge transactions and the Company may be assessed additional taxes, penalties and interest. Tax periods remain open to review by the tax authorities for five years.

Management believes that its interpretation of the relevant legislation is appropriate and the Company's tax, currency legislation and customs positions will be sustained. Accordingly, at September 30, 2012 and December 31, 2011 no provision for potential tax liabilities has been recorded.

**Transfer pricing.** A law on transfer pricing was introduced, effective January 1, 2009. This law replaced a previous law on transfer pricing and prescribes Kazakhstani companies to maintain and, if required, to provide economic rationale and method of the determination of prices used in international transactions, including existence of the documentation supporting the prices and differentials. Additionally, differentials could not be applied to the international transactions with companies registered in off-shore countries. In case of deviation of transaction price from market price the tax authorities have the right to adjust taxable items and to impose additional taxes, fines and interest penalties.

The transfer pricing policy of Aral with respect to its export sales has not been changed in 2011 as it is considered to be in accordance with transfer pricing legislation. The Aral's management believes that its transfer pricing policies will be sustained and all documentation supporting determination of export prices will be provided to the government authorities, if required.

Regardless of the inherent risks that the tax authorities may question transfer pricing policy of Aral, management believes that it will be able to sustain its position in case the transfer pricing policy of Aral will be challenged by the tax authorities. Therefore, no additional tax obligations were recorded in these condensed interim unaudited consolidated financial statements.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

**Royalties.** In accordance with Kazakhstani tax legislation applicable to the Company before January 1, 2009, Aral should have paid royalties in relation to the oil produced. However, Aral's management believed that, in accordance with the Exploration Contract, the test production phase was not subject to royalties and that Aral would be liable to pay royalties only at the experimental-industrial phase or when the Production Contract is signed. Should tax authorities consider Aral's position as incorrect, additional taxes and fines in the amount of CAD 1.2 million may be imposed relating to the 2007 and 2008 years.

**Export sales.** According to the Exploration Contract, Aral is required to sell 100% of oil extracted during the exploration period for refining in Kazakhstan. Commencing September 2005, Aral applied to the Ministry of Energy and Mineral Resources ("Ministry") on a monthly basis to arrange for its production for the succeeding month to be included in the export quota for transportation by rail. Should the government authorities determine that export quotas received by Aral were in violation of Exploration Contract terms, Aral may be subject to fines and penalties which cannot be estimated reliably, and/or termination of the Exploration Contract.

During 2010 and previous years, Aral's export sales related to the crude oil extracted only from East Zhagabulak. According to Production Contract Aral is obliged to sell 20% of produced crude oil on domestic market. Aral's management believes that the Production Contract is not enforced, as the required technical documentation is not approved by the government and thus the Exploration Contract continues to be valid for the East Zhagabulak oilfield.

**Minimum Working Program.** During 2009 Aral signed an addendum to the Exploration Contract which, among other changes, stipulated US \$21.4 million Work Program commitments for 2009 and US \$50.4 million for the remaining three years with drilling of the an additional eightwells until December 29, 2012. However, as of December 31, 2009 Aral's actual expenditures were significantly less than the amounts committed for 2009. Following correspondence with the government authorities in February 2010, this shortfall was accepted with the following conditions: an increase in Work Program commitments to US \$24.5 million, drilling of additional four wells, and an increase in total work program commitments to US \$56.8 million for subsequent three years.

On December 27, 2010, Aral signed Addendum No. 6 to its Subsurface Use Contract No. 1081 (dated December 29, 2002). The addendum specifies an increase in work program commitments of US \$14 million, the drilling of two additional wells, and an increase in total work program commitments for 2011 and 2012, and a corresponding decrease in the 2010 work program. According to the amended work program during 2011, Aral had commitments for the amount of US \$25.8 million. Actual execution amounted to US \$34.3 million (133%). Aral fulfilled all commitments except for 2D and 3DS seismic works in the amount of US \$3.1 million. Corresponding works should have been done on the Urikhtau location (North block – exploration territory). This territory has been in the process of transferring to National Company KazMunaiGas since 2010. As at September, 2012, the final approval of the Ministry of Oil and Gas has been obtained. The work program could not be amended to exclude corresponding works due to absence of the approval of the Ministry of Oil and Gas for territory submission.

Non-fulfillment of commitments under the work program may result in punitive actions by the Government of the Republic of Kazakhstan, including suspending or revoking the Exploration Contract. Aral's management is confident that no measures are to be taken in regards to the non-compliance as work program reports were submitted to the regulator and no notification in regards to non-compliance were received.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 19. Commitments, contingencies and operating risks *(continued)*

**Social and training commitments.** In accordance with the Production Contract, Aral is obliged to finance certain social infrastructure projects and training of the Kazakhstani staff engaged in the works to be executed under the Exploration Contract in the amount of 0.1% of Aral's annual extraction cost. For the year ended December 31, 2011, Aral fulfilled its social obligations under the Exploration Contract in full. In accordance with the Production Contract, Aral is obliged to finance certain social infrastructure and training projects annually. The annual amount of social obligation is equal to US \$100,000. Management believes that as Aral has signed the Production Contract in the middle of 2010 and the Annual Program was not yet developed and approved with the relevant government authorities, no training obligations arise in 2011 and 2012.

**Environmental matters.** Aral believes it is currently in compliance with all existing environmental laws and regulations of the Republic of Kazakhstan. However, Kazakhstani environmental laws and regulations may change in the future. Aral's management is unable to predict the timing or extent to which these environmental laws and regulations may change. Such change, if it occurs, may require Aral to employ newer technology to meet more stringent standards.

**Restoration.** Under the terms of the Exploration Contract, Aral should be required to create a liquidation fund (see Note 9). The full extent of Aral's obligation to restore the license area will not be known until it submits and agrees to a proposed program for restoration of the license area which is required to be submitted within two years after the Production Contract signing.

**Dispute with drilling subcontractor.** Aral has had a dispute with a drilling subcontractor since 2007 in relation to a mechanical failure at the drilling site that resulted in the loss of a well and the re-drilling of part of the well. Aral considers the contractor to be responsible for the failure. The litigation process is ongoing as of December 31, 2011. Aral lost the lawsuit under the court of first and second jurisdiction (Almaty City special court on economic disputes) and submitted an appeal to the Supreme Court. The amount of the claim made by the drilling subcontractor and approved by the courts of first and second jurisdiction is \$3.2 million. This amount has been accrued by Aral as at December 31, 2011. The Company provided indemnification for half of any amounts payable relating to this dispute and, as such, \$1.6 million has been accrued by the Company as at June 30, 2012.

**Gas utilization.** On October 3, 2008, a "Gas utilization program" was approved and agreed with the Ministry. According to this Gas utilization program, Aral was obliged to install all required equipment by the end of 2009, otherwise gas flared during the period from October 3, 2008 to December 31, 2009 would be recognized as gas flared above the limits with consequent fines and penalties and no further gas flaring permitted. The total estimated capital expenditure to fulfill the Gas utilization program commitments is equal to CAD 12.5 million. On July 2, 2009 Aral conducted a meeting with the Ministry regarding the fulfillment of the Gas utilization program. As a result of this meeting, Aral was allowed to postpone the installation of the required equipment until December 31, 2010.

In 2011, Aral reconsidered and resubmitted a gas utilization program to the Ministry. According to the new program, Aral is obliged to construct a pipeline to the gas processing plant of Kazakh Oil Aktobe (a subsidiary of KazMunaiGas and Lukoil). As of December 31, 2011, Aral received confirmation from Kazakh Oil Aktobe, that the quality and parameters of Aral's gas meets the technical requirements of its gas processing plant. As of March 31, 2012, the gas utilization program is under consideration by the Ministry of Oil and Gas. Management is confident that the gas utilization program is to be approved.

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

---

### 20. Events after the Reporting Date

On October 2, 2012, 787,212 common shares and 393,606 share purchase warrants were issued to satisfy the 3Q 2012 interest obligation on the Company's Convertible Debentures. The deemed price of the stock issued is \$0.102798 per share and the warrant exercise price is \$0.140672.

### 21. Amendment and Restatement of Condensed Interim Consolidated Financial Statements

(a) The Company's unaudited condensed interim consolidated statement of loss and comprehensive loss for the three and nine months ended September 30, 2012 and 2011 has been amended and restated to correct the presentation of:

- (i) foreign exchange gains and losses on the translation of foreign currency transactions; and
- (ii) foreign exchange translation differences on the translation of the Company's interest in Aral whose functional currency is the Tenge.

Foreign exchange gains and losses were incorrectly presented as foreign exchange translation amounts. Although the correct foreign exchange translation amounts were properly and accurately presented in the condensed interim consolidated statement of changes in equity, they were incorrectly excluded from the condensed interim consolidated statement of loss and comprehensive loss.

Prior to the amendment and restatement, net loss for the three months ended September 30, 2012 was understated by \$1,150 and comprehensive loss was understated by \$611; net income for the three months ended September 30, 2011 was understated by \$1,776 and comprehensive income was overstated by \$1,823 as shown in the following table:

	Three months ended September 30, 2012			Three months ended September 30, 2011		
	Original	Amendment	Restated	Original	Amendment	Restated
Operating loss before other items	(2,190)	–	(2,190)	(1,234)	–	(1,234)
Derivative fair value adjustment	971	–	971	4,826	–	4,826
Finance expense	729	(1,150)	(421)	(300)	1,776	1,476
Other	–	–	–	(2)	–	(2)
Net income (loss)	(490)	(1,150)	(1,640)	3,290	1,776	5,066
Per share (basic and diluted)		(\$0.01)			\$0.01	
Foreign exchange translation	(1,150)	539	(611)	1,776	(3,599)	(1,823)
Comprehensive income (loss)	(1,640)	(611)	(2,251)	5,066	(1,823)	3,243
Per share (basic and diluted)		\$(0.00)			\$(0.01)	

# Caspian Energy Inc.

## Notes to Condensed interim consolidated financial statements For the three and nine months ended September 30, 2012

Prior to the amendment and restatement, net loss for the nine months ended September 30, 2012 was understated by \$2,098 and comprehensive loss was overstated by \$854; net income for the nine months ended September 30, 2011 was understated by \$2,413 and comprehensive income was overstated by \$1,483 as shown in the following table:

	Nine months ended September 30, 2012			Nine months ended September 30, 2011		
	Original	Amendment	Restated	Original	Amendment	Restated
Operating loss before other items	(4,904)	–	(4,904)	(3,765)	–	(3,765)
Derivative fair value adjustment	2,127	–	2,127	4,826	–	4,826
Finance expense	(2,306)	(2,098)	(4,404)	(1,354)	2,413	1,059
Other	6	–	6	–	–	–
Net income (loss)	(5,077)	(2,098)	(7,175)	(293)	2,413	2,120
Per share (basic and diluted)		(\$0.01)			\$0.01	
Foreign exchange translation	(2,098)	2,952	854	2,413	(3,896)	(1,483)
Comprehensive income (loss)	(7,175)	854	(6,321)	2,120	(1,483)	637
Per share (basic and diluted)		\$0.00			\$(0.01)	

In addition, the Company's unaudited condensed interim consolidated statement of cash flows for the nine months ended September 30, 2012 and 2011 has been amended and restated to correct the following typographical errors:

- (i) The foreign exchange adjustment to cash flow from (used by) operating activities for the nine months ended September 30, 2012 was originally shown as a \$(1,480) deduction from the loss for the nine months ended September 30, 2012 rather than as a \$1,480 addition; and
- (ii) The derivative fair value adjustment to cash flows from (used by) operating activities for the nine months ended September 30, 2011 was originally shown as a \$4,826 addition to the loss for the nine months ended September 30, 2011 rather than as a \$(4,826) deduction.

Net cash provided by (used in) operating activities did not change.