

# **Caspian Energy Inc.**

Consolidated Financial Statements  
(Unaudited)  
**March 31, 2011 and 2010**

# Caspian Energy Inc.

## Consolidated Balance Sheets

(Unaudited)

For the three-months ended March 31, 2011 and 2010

	March 31, 2011 \$	December 31, 2010 \$	January 1, 2010 \$
<b>Assets</b>			
<b>Current assets</b>			
Cash and cash equivalents (note 8)	776	1,334	1,476
Accounts receivable	230	425	773
Inventories	853	728	2,478
VAT receivable	164	144	79
	2,023	2,631	4,806
<b>Non-current assets</b>			
Restricted cash	336	350	347
Exploration and evaluation assets (note 6)	28,700	29,448	30,531
Property, plant and equipment (note 5)	5,151	5,402	7,057
	36,210	37,831	42,741
<b>Total assets</b>			
	36,210	37,831	42,741
<b>Liabilities</b>			
<b>Current liabilities</b>			
Accounts payable and accrued liabilities	3,670	4,094	4,302
Loans payable (note 10)	4,465	4,249	2,751
Convertible debentures (note 11)	21,634	21,621	-
	29,769	29,964	7,053
<b>Non-current liabilities</b>			
Decommissioning liabilities (note 12)	143	146	213
Loans payable (note 10)	135	147	798
Convertible debentures	-	-	21,814
	30,047	30,257	29,878
<b>Equity</b>			
Share capital (note 9)	132,671	132,671	129,121
Warrants to purchase common shares	406	406	255
Contributed surplus	14,407	14,407	13,878
Accumulated other comprehensive income	1,766	992	-
Deficit	(143,087)	(140,902)	(130,391)
	6,163	7,574	12,863
<b>Total liabilities and equity</b>			
	36,210	37,831	42,741

The accompanying notes are an integral part of these consolidated interim financial statements.

Approved by the Board of Directors

\_\_\_\_\_ Director

\_\_\_\_\_ Director

# Caspian Energy Inc.

## Consolidated Statement of Comprehensive Income (Unaudited)

For the three-months ended March 31, 2011 and 2010

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	2011 \$	2010 \$
<b>Revenue</b>	304	492
<b>Expenses</b>		
General and administrative (note 13)	537	548
Operating expenses	121	380
Transportation	118	252
Depletion, depreciation and amortization	55	261
Stock-based compensation	-	-
Impairment of oil and gas properties	-	-
	831	1,441
<b>Operating profit (loss)</b>	(527)	(949)
Other income	-	-
Finance expense (note 14)	1,658	1,102
<b>Income before income tax</b>	(2,185)	(2,051)
<b>Income tax</b>	-	-
<b>Net income and comprehensive income for the period</b>	(2,185)	(2,051)
<b>Earnings per share:</b>		
Basic	(0.01)	(0.01)
Diluted	(0.01)	(0.01)

The accompanying notes are an integral part of these consolidated interim financial statements.

# Caspian Energy Inc.

## Consolidated Statements of Changes in Equity (Unaudited)

For the three-months ended March 31, 2011 and 2010

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	Common Share capital \$	Warrants \$	Contributed surplus \$	Accumulated other comprehensive income \$	Deficit \$	Total equity \$
<b>Balance – January 1, 2011</b>	132,672	405	14,407	992	(140,902)	7,574
Net income (loss) and comprehensive income loss	-	-	-	774	(2,185)	(1,411)
<b>Balance – March 31, 2011</b>	<b>132,672</b>	<b>405</b>	<b>14,407</b>	<b>1,766</b>	<b>(143,087)</b>	<b>6,163</b>
<b>Balance – January 1, 2010</b>	129,121	255	13,878	-	(130,391)	12,863
Issue of shares and warrants in relation to convertible debentures	721	65	-	-	-	786
Net income (loss) and comprehensive income loss	-	--	-	400	(2,051)	(1,651)
<b>Balance – March 31, 2010</b>	<b>129,842</b>	<b>320</b>	<b>13,878</b>	<b>400</b>	<b>(132,442)</b>	<b>11,998</b>

The accompanying notes are an integral part of these consolidated interim financial statements.

# Caspian Energy Inc.

## Consolidated Statements of Cash Flows

(Unaudited)

For the three-months ended March 31, 2011 and 2010

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	2011 \$	2010 \$
<b>Cash flow provided by (used in)</b>		
<b>Operating activities</b>	(2,185)	(2,051)
Net income for the period		
Adjustments for		
Depreciation and amortization	55	261
Stock-based compensation	-	-
Gain on disposal of equipment	-	-
Interest on convertible debentures	530	591
Interest on loans payable	106	15
Unrealized foreign exchange loss	1,035	401
Accretion of convertible debentures	82	86
Accretion of decommissioning liabilities	1	9
Changes in items of working capital	(375)	374
<b>Net cash generated from operating activities</b>	(751)	(314)
<b>Investing activities</b>		
Purchase of property, plant and equipment	(101)	(60)
Proceeds from sale of property, plant and equipment	-	-
Increase (decrease) in restricted cash	16	(9)
<b>Net cash generated from investing activities</b>	(85)	(69)
<b>Financing activities</b>		
Issuance of common shares and warrants	-	-
Increase in loans payable	278	(328)
Repayment of loans payable	-	-
<b>Net cash generated in financing activities</b>	278	(328)
<b>Increase (decrease) in cash and cash equivalents</b>	(558)	(711)
<b>Cash and cash equivalents – Beginning of period</b>	1,334	1,476
<b>Cash and cash equivalents – End of period</b>	776	765
Cash paid for income tax		

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

**For the three-months ended March 31, 2011 and 2010**

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All tabular amounts are in thousands of Canadian dollars except as otherwise indicated.

### **1 Nature of operations 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 50% interest in Aral Petroleum Capital LLP (“Aral”), held by Caspian Ltd. Through its interest in Aral, Caspian has the right to explore and develop certain oil and gas properties in Kazakhstan, known as the North Block, a 3,458 square kilometre area located in the vicinity of the Kazakh pre-Caspian basin. The Company also has minor resource interests in Canada.

During the fourth quarter of 2010, 55% (1,909.1 square km) of the North Block territory was surrendered pursuant to Amendment No. 5 of the Exploration Contract. The North Block now constitutes 1,549 square kilometres.

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 31, 2012.

#### **Going concern**

These interim financial statements have been presented on a going concern basis. The Company reported a net loss of \$2,185 and funds used in operating activities of \$751 for the quarter ended March 31, 2011. The Company had a net working capital deficiency of \$27,746 and a cumulative deficit equal to \$143,087 at quarter end.

On March 1, 2006, the Company received US \$16 million and issued 10% per annum, convertible debentures in that amount secured with Caspian Ltd. Shares. The debentures had a maturity date of March 2, 2011 and are convertible into common shares of the Company at a conversion price of \$2.45 per share. The Company is required to pay interest on the principal plus any accrued, but unpaid, interest amount outstanding on a quarterly basis. Each debenture holder is entitled to receive current interest in cash if the Company is formally notified of this circumstance within ten business days of the quarter end and the Company is obligated to pay the applicable interest within five days from quarter end. During the 2008 fiscal year, certain debentures holders requested and were paid two cash interest payments of US \$357,260 pertaining to each of the first and second quarters and US \$129,661 pertaining to the fourth quarter. Certain debentures holders requested that interest be paid in cash pertaining to the first nine months of 2009. This payment was not made. Following negotiations with the holders of the debentures to identify alternative means by which interest payments owing under the Debentures may be satisfied in lieu of cash, the Company amended the terms of the debentures to provide for the satisfaction of quarterly interest payments due thereunder as follows:

- a) Satisfaction of the interest payments of US \$130,644 due for the quarter ended March 31, 2009 in the form of Common Shares, calculated based upon a deemed price of \$0.037 per share, being a 10% discount to the VWAP (volume weighted average price) of the Common Shares on the TSX for such quarter;

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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### For the three-months ended March 31, 2011 and 2010

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- b) Satisfaction of the interest payments of US \$521,613 due for the quarter ended June 30, 2009 in the form of Common Shares, calculated based upon a deemed price of \$0.061 per share, being a 10% discount from the VWAP per Common Share on the TSX from July 14 to July 21, 2009, inclusive;
- c) Satisfaction of the interest payments of US \$527,345 due for the quarter ended September 30, 2009 in the form of Common Shares, calculated based upon a deemed price of \$0.065 per share, being a 10% discount from the VWAP per Common Share on the TSX from July 1 to September 30, 2009, inclusive;
- d) Satisfaction of the interest payments of US \$520,874 due for the quarter ended December 31, 2009 in the form of Common Shares, calculated based upon a deemed price of \$0.082 per share, being a 10% discount from the VWAP per Common Share on the TSX from October 1 to December 31, 2009, inclusive.
- e) Satisfaction of the interest payments of US \$486,654 due for the quarter ended March 31, 2010 in the form of Common Shares, calculated based upon a deemed price of \$0.218 per share, being a 10% discount from the VWAP per Common Share on the TSX from January 1 to March 31, 2010, inclusive.
- f) Satisfaction of the interest payments of US \$486,654 due for the quarter ended June 30, 2010 in the form of Common Shares, calculated based upon a deemed price of \$0.176 per share, being a 10% discount from the VWAP per Common Share on the TSX from April 1 to June 30, 2010, inclusive; and
- g) 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 issued 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 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 (ie. 10% discount to the VWAP for the particular quarter), for a period of two years.

The foregoing proposals did not impact the payment of interest for any quarters subsequent to June 30, 2010, which continued to remain subject to the original Debenture terms providing for the Debenture holders to elect to receive Common Shares in lieu of cash interest payments for such periods at the deemed price.

On April 7, 2011, Caspian announced a new agreement that restructured an earlier arrangement with the debenture holders regarding the USD 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.

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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### For the three-months ended March 31, 2011 and 2010

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- An aggregate of 47,286,115 common shares will be issuable in this regard based upon a 5% discount to the market price of the Common Shares of \$0.20.

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.

As at December 31, 2010, Aral had expended US \$8.5 million toward discharging the financial obligations committed to on February 5, 2010, during a session, of the Zapkaznedra ITD Technical Council (the ROK regulatory body) that decreed that the Updated Work Program for 2010 shall have financial obligations of US \$24.5 million. The Exploration Contract extension approved in 2009, has a work obligation in the year 2010 of US \$24.5 million; 2011, US \$17 million; and 2012, US \$15 million; for a total of US \$56.5 million over three years. Aral intends to address this deficiency with the ROK by presenting to the ROK the executed transaction documents for the sale of 10% interest in Aral to Asia Sixth Energy Resources Limited ("Asia Sixth") together with a proposal that includes moving the expenditures deficiency in 2010 to 2011. The qualifying expenditures obligations would then amount to US \$34 million, in 2011; and US \$15 million in 2012. Non-fulfillment of commitments under the Updated Work Program may result in punitive actions by the Government of the Republic of Kazakhstan, including suspending or revoking the Exploration Contract; however, the ROK has historically proved amenable to the amendment of individual years within the term of an Exploration Contract.

As at March 31, 2011, Aral had expended and additional \$1.7 million of contractual expenditures towards the cumulative obligations.

On February 23, 2010, the Company announced that it had entered into an agreement to sell a 10% interest in Aral to AsiaStar Petroleum Limited for nominal proceeds of US \$1. Asia Star Petroleum Limited has subsequently agreed to be replaced by Asia Sixth as the party to all agreements and contracts regarding this transaction. Caspian currently holds an aggregate 50% interest in Aral, which it operates as a joint venture together with Azden Management Limited. The sale of 10% of Aral equates to a disposition of 20% of Caspian's total interest in Aral. The agreement is subject to a number of conditions precedent that must be satisfied during the following three months in order for the transaction to close, and also remains subject to the receipt of all regulatory approvals including without limitation the approval of the government of Kazakhstan.

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% stake 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 north Block to commence post haste. It is presently in the execution stage.

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 in the Greater Zhagabulak, Baktygaryn, and Urikhtau areas, among others. Finally, it should ensure that Caspian will not have to provide additional funds for the activity in the North Block in the near term.



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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. This agreement has not yet been finalized.

The Company's ability to continue as a going concern is in significant doubt and is dependent upon a successful outcome to the negotiations taking place with Asia Sixth and to achieving profitable operating results from its Kazakhstan operations. These are no assurances that these initiatives will be successful.

The accompanying financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence. Such adjustments could be material.

## **2 Basis of preparation**

### **(a) Basis of preparation and adoption of IFRS**

The Company prepares its financial statements in accordance with Canadian generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants ("CICA Handbook"). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards, and require publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the Company has commenced reporting on this basis in these interim financial statements. In the financial statements, the term "Previous GAAP" refers to Canadian GAAP before the adoption of IFRS

These condensed interim financial statements have been prepared in accordance with IFRS applicable to the preparation of interim financial statements, including IAS 34 and IFRS 1. Subject to certain transition elections disclosed in note 17, the Company has consistently applied the same accounting policies in its opening IFRS Balance Sheet at January 1, 2010 and throughout all periods presented, as if these policies had always been in effect. Note 17 discloses the impact of the transition to IFRS on the Company's reported financial position, financial performance and cash flows, including the nature and effect of significant changes in accounting policies from those used in the Company's financial statements for the year ended December 31, 2010.

The policies applied in these condensed interim financial statements are based on IFRS issued and outstanding as of June 16, 2011, the date the Board of Directors approved the statements. Any subsequent changes to IFRS that are given effect in the Company's annual consolidated financial statements for the year ending December 31, 2011 could result in restatement of these interim consolidated financial statements, including the transition adjustments recognized on change-over to IFRS.

The interim financial statements should be read in conjunction with the Company's Canadian GAAP annual financial statements for the year ended December 31, 2010.

### **(b) Basis of measurement**

The financial statements have been prepared under the historical cost convention.

### **(c) Functional and presentation currency**

These 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

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

**For the three-months ended March 31, 2011 and 2010**

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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 statement of comprehensive income.

Functional currency is the currency of the primary economic environment in which the Company operates. 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 consolidated financial statements are recorded in Tenge and converted to CAD. The assets and liabilities of Aral are translated into CAD at exchange rates 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 will be reclassified to net earnings upon disposal of the foreign operation.

At March 31, 2011 the principal rate of exchange used for translating foreign currency balances was 1 CAD = Tenge 151.98 (December 31, 2010: 1 CAD = 147.55 Tenge; January 1, 2010: 1 CAD = \$141.58 Tenge). The average annual principal rate of exchange used for translating foreign currency balances during the three-month periods ended March 31, 2011 and 2010 was 1 CAD = Tenge 148.43 and 1 CAD = 141.85 Tenge, respectively. The average rate for the year ended December 31, 2010 was 1 CAD = 143.10 Tenge. 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.

### **(d) Financial Instruments**

#### *i) Classification of financial assets*

The Company's financial assets include loans and receivables. Management determines classification of financial assets at initial recognition.

Loans and receivables are unquoted non-derivative financial assets with fixed or determinable payments. Loans and receivables of the Company in the balance sheet are comprised of trade accounts receivable, and cash and cash equivalents.

#### *ii) Classification of financial liabilities*

The Company's financial liabilities represent financial liabilities carried at amortized cost. Financial liabilities in the balance sheet include loans payable, convertible debentures and accounts payable and accrued liabilities.

#### *iii) Initial recognition of financial instruments*

Financial assets and liabilities, other than those designated as fair value through profit and loss are initially recorded at fair value plus transaction costs. Fair value at initial recognition is best evidenced by the transaction price. A gain or loss on initial recognition is only recorded if there is a difference between fair value and transaction price which can be evidenced by other observable current market transactions in the same instrument or by a valuation technique whose inputs include only data from observable markets.

#### *iv) Derecognition of financial assets*

The Company derecognises financial assets when (a) the assets are redeemed or the rights to cash flows from the assets otherwise expired or (b) the Company has transferred the rights to the cash flows from the financial assets or entered into a qualifying pass-through arrangement while (i) also transferring substantially all the risks and rewards of ownership of the assets or (ii) neither transferring nor retaining substantially all risks and rewards of ownership but not retaining control. Control is retained if the counterparty does not have the practical ability to sell the asset in its entirety to an unrelated third party without needing to impose additional restrictions on the sale.

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

**For the three-months ended March 31, 2011 and 2010**

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### v) *Share capital*

Common shares issued by the Company are recorded at the proceeds received, with direct issue costs as a deduction therefrom, net of any associated tax benefit.

### (e) *Exploration and evaluation assets*

#### i) *Recognition and subsequent measurement*

Exploration and evaluation assets are measured at cost less provision for impairment, where required. Exploration and evaluation assets include capitalised expenditures on acquisition of exploration rights, geological and geophysical studies, drilling of both successful and unsuccessful exploratory wells, support equipment and facilities, as well as administrative and other general overhead costs that are directly attributable to the exploration and evaluation activities. Acquisition costs include the cost of subscription bonus and other costs incurred to acquire subsurface rights. Administrative and other general overhead costs, capitalised into the exploration and evaluation assets, include the costs incurred to finance social projects and professional training of Kazakhstani employees and other overhead costs that are directly attributable to the exploration and evaluation activities. The Company includes these expenditures in the cost of exploration and evaluation assets in the period when incurred.

The Company classifies exploration and evaluation assets as tangible and intangible according to the nature of the assets acquired. Intangible exploration and evaluation assets include subscription bonus, geological and geophysical costs, insurance of oil operations and historical costs. All other exploration and evaluation assets are classified as tangible.

An exploration and evaluation asset is no longer classified as such when the technical feasibility and commercial viability of extracting a mineral resource is demonstrable. Once commercial reserves are found, exploration and evaluation assets are transferred to oil and gas properties and to intangible assets and amortised using the unit-of-production method based on total proved reserves. If commercial reserves are not found, the exploration and evaluation assets are considered impaired and are charged to expense in the statement of comprehensive income.

#### ii) *Impairment of exploration and evaluation assets*

Exploration and evaluation assets are tested for impairment when reclassified to oil and gas properties or to intangible assets or whenever facts and circumstances indicate impairment. Indicators of potential impairment may include, but are not limited to, the expiration of mineral licenses or rights to explore, a strategic decision by the Company to halt future exploration activity or when data exists to indicate that the exploration and evaluation assets are unlikely to be recovered from successful development or by sale.

An impairment loss is recognised for the amount by which exploration and evaluation assets' carrying amount exceeds their recoverable amount. The recoverable amount is the higher of the exploration and evaluation assets' fair value less costs to sell and their value in use.

For the purposes of assessing impairment, the exploration and evaluation assets subject to testing are grouped on a field-by-field basis. Accordingly, the management of the Company evaluates the Aransay, Baktygaryn, Zhagabulak, Zhagabulak South, Itasay-Kuzdasay fields separately for impairment purposes.

### (f) *Property, plant and equipment.*

#### i) *Recognition and subsequent measurement*

Property, plant and equipment are stated at cost, less accumulated depreciation and impairment provisions, where required. The cost of property, plant and equipment comprises construction cost or purchase price, including import duties

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**For the three-months ended March 31, 2011 and 2010**

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and non-refundable taxes, and any directly attributable costs of bringing the asset to working condition for its intended use, and development costs of oil and gas properties.

Development costs include the cost of development wells to produce proved reserves, the cost of production facilities (such as flow lines, separators, treaters, heaters, storage tanks, improved recovery systems and gas processing facilities) and other overhead costs related to development of mineral resources.

The individual significant parts of an item of property, plant and equipment (components), whose useful lives are different from the useful life of the given asset as a whole are depreciated individually, applying depreciation rates reflecting their anticipated useful lives. Cost of replacing major parts or components of property, plant and equipment items are capitalized and the replaced part is retired.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. All other repairs and maintenance costs are charged to the statement of comprehensive income during the financial period in which they are incurred.

Specialized spare parts and servicing equipment with a significant initial value and a useful life of more than one year are recognized as an item of property, plant and equipment. Other spare parts and servicing-related equipment are recognized as inventories and accounted for in the statement of comprehensive income at the moment they are used.

Gains and losses on disposals of property, plant and equipment (or component of an item of property, plant and equipment) determined by comparing proceeds with carrying amount are recognized in other income within the statement of comprehensive income.

### *ii) Depreciation*

The cost of each item of property, plant and equipment is depreciated using the straight-line method to their residual values over their estimated useful lives, except for oil and gas properties which are depreciated using the unit of production method applied to the net book value of assets at end of period plus estimated future costs to be incurred in developing proved undeveloped reserves, net of estimated salvage values and based on total proved reserves as determined by independent consulting engineers. The expected useful lives are as follows:

### **Useful lives in years**

Machinery and equipment	5-10
Vehicles and other	3-14
Oil and gas properties	Unit of production method

The residual value of an asset is the estimated amount that the Company would currently obtain from disposal of the asset less the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. The residual value of an asset is nil if the Company expects to use the asset until the end of its physical life. The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

### *iii) Impairment*

Property, plant and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Whenever the carrying amount of an asset exceeds its recoverable amount, an impairment loss is recognized in the statement of comprehensive income. The recoverable amount is the higher of fair value less costs to sell and value in use. Fair value less costs to sell is the amount obtainable from the sale of the asset in an arm's length transaction less selling expenses while value in use is the present value of estimated future cash flows

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expected to arise from the continuing use of the asset and from its disposal at the end of its useful life. In assessing value-in-use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. In determining fair value less costs to sell, recent market transactions are taken into account, if available. If no such transactions can be identified, an appropriate valuation model is used. These calculations are corroborated by valuation multiples, quoted share prices for publicly traded subsidiaries or other available fair value indicators.

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, the management of the Company considers the East Zhagabulak field as a separate CGU.

Impairment losses are recognized in statement of comprehensive income.

An assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such indication exists, the Company estimates the asset's or CGU's recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognized. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years.

### ***(g) Intangible assets.***

All of the Company's intangible assets have definite useful lives and primarily include capitalized computer software and capitalized development intangible assets. Intangible assets are capitalized on the basis of the costs incurred to acquire and bring it into use.

Intangible assets are amortized on a straight-line basis over their estimated useful lives, being 5 years for software costs.

### ***(h) 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 to the Company, the total lease payments are charged to profit or loss on a straight-line basis over the period of the lease.

### ***(i) Inventories.***

Inventories are recorded at the lower of cost or 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 statement of comprehensive income.

### ***(j) 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 amortised 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

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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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 statement of comprehensive income. The primary factors that the Company considers whether a receivable is impaired is its overdue status.

### ***(k) Cash and cash equivalents.***

Cash and cash equivalents include cash in hand and cash at bank accounts and cash at highly liquid bank deposits with maturities of less than three months. Restricted balances are excluded from cash and cash equivalents for the purposes of the cash flow statement. 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.

### ***(l) 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 balance sheet date, is recognized in the balance sheet on a net basis.

### ***(m) Borrowings.***

Borrowings 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 balance sheet date.

***(n) 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.

### ***(o) Provisions for liabilities and charges.***

Provisions are recognised when the Company has a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made. Provisions are not recognized on future operating losses.

### ***(p) Decommissioning liabilities***

The Company estimates future dismantlement and site restoration costs for exploration and evaluation assets and for oil and gas properties with reference to the estimates provided from either internal or external engineers after taking into consideration the anticipated method of dismantlement and the extent of site restoration required in accordance with current legislation and industry practices. Estimated dismantlement and site restoration costs are provided for the period in which the obligation arises if a reasonable estimate of fair value can be made, based on the net present value of estimated future costs. The corresponding dismantlement and site restoration costs are capitalized as part of the carrying amount of the exploration and evaluation assets and oil and gas properties. The cost estimates are calculated annually during the life of the operation to reflect known developments, e.g. updated cost estimates and revisions to the estimated lives of operations, and are subject to formal review at regular intervals.

# Caspian Energy Inc.

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The amortization or "unwinding" of the discount applied in establishing the net present value of provisions is charged to the statement of comprehensive income in each accounting period. The amortization of the discount is shown as a financing cost, rather than as an operating cost.

Movements in the decommissioning liabilities, resulting from new development, updated cost estimates, changes to the estimated lives of operations and revisions to discount rates are capitalized within exploration and evaluation assets and oil and gas properties. These costs are then depreciated over the lives of the assets to which they relate.

### ***(q) Revenue recognition.***

Revenue is recognized when it is probable that the economic benefits associated with the transaction will flow to the Company and the amount of revenue can be measured reliably. Revenue is shown net of value-added tax, discounts and after eliminating sales within the Company. In the case of sales of goods, revenue is recorded in the period in which title to the product is transferred to the customer, normally when goods are shipped to the specified location where transfer of the risks and rewards of ownership of the goods occurs.

### ***(r) Finance income and cost.***

Finance income and costs comprise interest expense on borrowings and loans payable, deposits, interest income/ expense from unwinding of discount on site restoration provision and other financial assets and liabilities. Interest income/ interest expense is recognized using the effective interest rate method.

### ***(s) Income taxes.***

Income tax expense comprises current and deferred income tax. Income tax expense is recognized in income or loss except to the extent that it relates to items recognized directly in shareholders' equity. Income taxes have been provided for in the consolidated financial statements in accordance with Canadian and Kazakhstani legislation enacted by the balance sheet date specifically applicable to the Company. The income tax charge comprises current tax and deferred tax and is recognized in the statement of comprehensive income unless it relates to transactions that are recognized, in the same or a different period, directly in equity.

Current tax is the amount expected to be paid to or recovered from the taxation authorities in respect of taxable profits or losses for the current and prior periods. Taxable income or losses are based on estimates where the financial statements are authorized prior to the filling of the relevant tax return. Taxes, other than on income, are recorded within relevant lines in statement of comprehensive income.

Company's uncertain tax positions are reassessed by management at every balance sheet date. Liabilities are recorded for income tax positions that are determined by management as more likely than not to result in additional taxes being levied if the positions were to be challenged by the tax authorities. The assessment is based on the interpretation of tax laws that have been enacted or substantively enacted by the balance sheet date and any known court or other rulings on such issues. Liabilities for penalties, interest and taxes other than on income are recognised based on management's best estimate of the expenditure required to settle the obligations at the balance sheet date.

Deferred income tax is provided using the balance sheet liability method for temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. In accordance with the initial recognition exemption, deferred taxes are not recorded for temporary differences on initial recognition of an asset or a liability in a transaction other than a business combination if the transaction, when initially recorded, affects neither accounting nor taxable profit. Deferred tax balances are measured at tax rates enacted or substantively enacted at the balance sheet date which are expected to apply to the period when the temporary differences will be utilised. Deferred tax assets for deductible temporary differences are recorded only to the extent that it is probable that future taxable profit will be available against which the deductions can be utilised. As of each balance sheet date the timing of reversal of each

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temporary difference is accounted for in applying the appropriate effective corporate income tax rate in calculation of the deferred income tax.

### **3 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 financial statements and estimates that can cause a significant adjustment to the carrying amount of assets and liabilities within the next financial year include:

#### ***Going concern***

These 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 that 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 financial statements do not include any adjustments in the carrying values of assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used, that might result from the outcome of this uncertainty, and such adjustments may be material.

#### ***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 the Aral's related program for liquidation based on the feasibility study and engineering researches 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.

#### ***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 of Aral concluded that there were no further impairment indicators in relation to exploration and evaluation assets.



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### *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 are oil reserves (see below), discount rate (December 31, 2010 – 29.58%; January 1, 2010 – 19.78%) and forecast oil price (December 31, 2010 – USD 77; January 1, 2010 USD 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 used by management of equal validity could give rise to materially different results.

### *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.

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 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.

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## Notes to Consolidated Financial Statements

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Management's judgement is that production life of proved reserves will not exceed expiry date under subsurface use contracts (Note 1).

Proved reserve estimates of the Company as of December 31, 2010 and December 31, 2009 were based on the reports prepared by McDaniels & Associates Consultants Ltd., independent engineering consultants.

#### **4 New Accounting Pronouncements**

IFRS 9, as issued reflects the first phase of the IASB's work on the replacement of IAS 39 and applies to classification and measurement of financial assets and liabilities as defined in IAS 39. The standard is effective for annual periods beginning on or after January 1, 2013. The adoption of IFRS 9 is not expected to have a significant impact on the financial statements.

In May 2011, the IASB issued the following standards which have not yet been adopted by the Company: IFRS 10, Consolidated Financial Statements ("IFRS 10"), IFRS 11, Joint Arrangements ("IFRS 11"), IFRS 12, Disclosure of Interests in Other Entities ("IFRS 12"), IAS 27, Separate Financial Statements ("IAS 27"), IFRS 13, Fair Value Measurement ("IFRS 13") and amended IAS 28, Investments in Associates and Joint Ventures ("IAS 28"). Each of the new standards is effective for annual periods beginning on or after January 1, 2013 with early adoption permitted. The Company has not yet assessed the impact that the new and amended standards will have on its financial statements or whether to early adopt any of the new requirements.

Following is a brief summary of the new standards:

##### *IFRS 10 – Consolidated Financial Statements*

IFRS 10 requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12 Consolidation-Special Purpose Entities and parts of IAS 27 Consolidated and Separate Financial Statements.

##### *IFRS 11 – Joint Arrangements*

IFRS 11 requires a venture to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venture will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interest in joint ventures. IFRS 11 supersedes IAS 31, Interests in Joint Ventures and SIC-13, Jointly Controlled Entities, Non-Monetary Contributions by Venturers.

##### *IFRS 12 – Disclosure of Interest in Other Entities*

IFRS 12 establishes disclosure requirements for interests in other entities, such as joint arrangements, associates, special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interest in other entities.

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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### *IFRS 13 – Fair Value Measurement*

IFRS 13 is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurement and in many cases does not reflect a clear measurement basis or consistent disclosures.

## **5 Property, Plant and Equipment**

Movements in the carrying amount of property, plant and equipment were as follows:

<b>Carrying amount at January 1, 2010</b>	<b>7,057</b>
Additions	46
Disposals	(95)
Change in decommissioning liability	(66)
Depreciation charge	(1,354)
Foreign currency translation	(186)
	<hr/>
<b>Carrying amount at December 31, 2010</b>	<b>5,042</b>
Additions	-
Disposals	-
Depreciation charge	(55)
Foreign currency translation	(196)
	<hr/>
<b>Carrying amount at March 31, 2011</b>	<b>5,151</b>

## **6 Exploration and Evaluation Assets**

<b>Balance at January 1, 2010</b>	<b>30,531</b>
Additions	201
Provision for impairment	(33)
Revisions in asset retirement obligation estimates	(11)
Foreign currency translation	(1,240)
	<hr/>
<b>Balance as at December 31, 2010</b>	<b>29,448</b>
Additions	110
Provision for impairment	-
Revisions in asset retirement obligation estimates	-
Foreign currency translation	(858)
	<hr/>
<b>Balance at March 31, 2011</b>	<b>28,700</b>

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Provision for impairment in the amount CAD 33 thousand as of 31 December 2010 relates to the return of 1,909 square kilometers (55%) of the licensed area in accordance with the Exploration Contract terms.

### 7 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 March 31, 2011, December 31, 2010 and January 1, 2010 was USD 345,000, USD 339,087 and USD 320,000, respectively. 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.

As of December 31, 2010 the Company also had a security deposits for foreign personnel in the amount of approximately CAD 11 thousand (January 1, 2010: CAD 11 thousand).

### 8 Cash and Cash Equivalents

	<b>31 March, 2011</b>	<b>December 31, 2010</b>	<b>January 1, 2010</b>
Cash in USD bank account	154	238	436
Cash in KZT bank account	3	33	20
Cash in CAD bank account	619	1,063	1,020
<b>Total cash and cash equivalents</b>	<b>776</b>	<b>1,334</b>	<b>1,476</b>

# Caspian Energy Inc.

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### 9 Share Capital

#### Authorized

Unlimited number of voting common shares, without stated par value

#### Issued

	Number of shares	Amount \$
Issued and outstanding as at December 31, 2007	104,343,263	121,470,892
Warrants expired (i)	-	946,508
Rights offering (ii)	17,390,543	4,347,636
Share issue costs (iii)	-	(426,695)
	<hr/>	<hr/>
Issued and outstanding as at December 31, 2008	121,733,806	126,338,341
Issued pursuant to Convertible Debentures interest obligation (iv)	23,188,931	2,782,672
	<hr/>	<hr/>
Issued and outstanding as at December 31, 2009	144,922,737	129,121,013
Issued pursuant to Convertible Debentures interest obligation (v, vi, viii)	11,893,781	1,685,617
Issued pursuant to Private Placement (vii)	9,320,000	1,864,000
	<hr/>	<hr/>
Issued and outstanding as at December 31, 2010 and March 31, 2011	166,136,518	132,670,630

- i) On April 5, 2008, 588,270 broker warrants, with fair value of \$946,508, which entitled the holder to purchase one common share at a price of \$2.77 expired unexercised.
- ii) A Rights Offering, which closed May 28, 2008, placed 17,390,543 units at a price of \$0.25 per unit. Each unit comprised one common share in the Company and one-half of on share purchase warrant.
- iii) Share issue costs have not been tax-effected as there is no guarantee of the Company's future profitability.
- iv) On December 23, 2009, the Company issued 23,188,931 common shares and 2,318,893 share purchase warrants. The exercise prices of the common shares and share purchase warrants range from \$0.037 per share to \$0.065 per share. See note 7. These common shares were valued at the trading price at the time of issuance.
- v) On January 5, 2010, the Company issued 6,553,311 common shares and 655,322 share purchase warrants. The exercise prices of the common shares and share purchase warrants \$0.082 per share. See note 7. These common shares were valued at the trading price at the time of issuance.

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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- vi) On April 15, 2010, the Company issued 2,271,177 common shares and 227,116 share purchase warrants, at an exercise price of \$0.218. See note 7. The common shares were valued at the trading price at the time of issue.
- vii) On May 27, 2010, the Company closed a non-brokered private placement pursuant to which it issued an aggregate of 9,320,000 common shares at a price of \$0.20 per share to raise aggregate gross proceeds of \$1,864,000.
- viii) On July 14, 2010, the Company issued 3,069,293 common shares and 306,929 share purchase warrants, at an exercise price of \$0.176. See note 7. The common shares were valued at the trading price at the time of issue.

### Warrants

On April 5, 2008, 588,270 broker warrants, with a fair value of \$946,508, which entitled the holder to purchase one common share at a price of \$2.77, expired unexercised.

8,695,272 share purchase warrants, at an exercise price of \$0.45, are outstanding at December 31, 2010. Each warrant is exercisable until the earlier of May 28, 2011 or 30 days following the receipt of a notice from the Company that the closing price of the shares for any 20 consecutive trading days exceeded \$0.75.

On December 23, 2009, the following shares purchase warrants are issued pursuant to the convertible debenture (see note 7). These warrants are exercisable until December 23, 2011:

445,030 warrants with a fair value of \$49,908 are exercisable at \$0.037 per share

995,517 with a fair value of \$109,040 are exercisable at \$0.061 per share

878,346 with a fair value of \$95,824 are exercisable at \$0.065 per share

The fair value of share purchase warrants was estimated to be \$0.11 as at the grant date using the Black-Scholes model with the following assumptions:

Risk free interest rate	
Expected life	1.69%
Expected volatility	2
Expected dividend yield	224%
	0%

On January 5, 2010, 655,322 shares purchase warrants with a fair value of \$65,008 exercisable at \$0.082 per share, were issued pursuant to the convertible debenture (see note 7). These warrants are exercisable until January 5, 2012:

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The fair value of share purchase warrants was estimated to be \$0.10 as at the grant date using the Black-Scholes model with the following assumptions:

Risk free interest rate	4.0%
Expected life	2 years
Expected volatility	210%
Expected dividend yield	0%

On April 15, 2010, pursuant to the convertible debenture (see note 7), the Company issued 227,116 share purchase warrants with a fair value of \$50,723, at an exercise price of \$0.218 per share. These warrants are exercisable until April 15, 2012.

The fair value of share purchase warrants was estimated to be \$0.22 as at the grant date using the Black-Scholes model with the following assumptions:

Risk free interest rate	4.0%
Expected life	2 years
Expected volatility	198%
Expected dividend yield	0%

On July 14, 2010, pursuant to the convertible debenture (see note 7), the Company issued 306,929 share purchase warrants with a fair value of \$35,423, at an exchange price of \$0.176 per share. These warrants are exercisable until July 14, 2012.

The fair value of share purchase warrants was estimated to be \$0.12 as at the grant date using the Black-Scholes model with the following assumptions:

Risk free interest rate	4.0%
Expected life	2 years
Expected volatility	175%
Expected dividend yield	0%

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### 10 Borrowings

	March 31, 2011	December 31, 2010	January 1, 2010
<b>Long term portion</b>			
Azden Management Limited	-	-	786
Asia credit bank	135	147	12
<b>Total long term borrowings</b>	<b>135</b>	<b>147</b>	<b>798</b>
<b>Short-term portion</b>			
Azden Management Limited (interest payable and loan payable)	3,503	3,562	-
Asia Sixth Energy Resources	959	681	-
Asia Credit Bank	3	6	239
Azden's shareholders			2,370
Ex-Im Equipments			142
<b>Total short-term borrowings</b>	<b>4,465</b>	<b>4,249</b>	<b>2,751</b>
<b>Total borrowings</b>	<b>4,600</b>	<b>4,396</b>	<b>3,549</b>

#### *Azden*

Loans from Azden to Aral are denominated in USD and from January 1, 2009 to October 25, 2010 were free of interest. Repayment terms were based on Aral's ability to generate net operating profit from crude oil sales under the Exploration Contract, excluding Well 213. On October 25, 2010 Aral entered into a new agreement with Azden to consolidate loans previously received from Azden (USD 1,500 thousand) and the loan provided by Azden's shareholder (USD 5,505 thousand) into one outstanding loan in the amount of USD 7,005 thousand with a fixed annual interest rate of 10%. The loan is payable in part or in full upon demand following the written request from Azden, provided however that Caspian consents to such repayment in writing. The final repayment date of the entire loan balance will be December 1, 2040. Loan payments are to be made free and clear and without deductions for applicable taxes, if any.

No interest payments took place in 2010 and Aral does not expect any payments of principal and interest in 2011.

The carrying amounts of borrowings from Azden approximate their fair values as of March 31, 2011 and December 31, 2010.

#### *Asia Credit Bank*

On August 24, 2009 Aral signed loan agreement with AsiaCredit Bank. The credit line amount is Tenge 90,000 thousand for 5 years with the annual interest rate of 18%. The credit line is secured by the pledge of deposits with the value of USD 217 thousand and EUR 413 thousand. During 2010 Aral received a tranche amounting to Tenge 14,123 thousand. The credit line expires and is expected to be repaid in full by 4 September 2014. The carrying amount of Aral's borrowing from Asia Credit Bank approximates its fair value as of March 31, 2011 and December 31, 2010.



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### *Asia Sixth Energy Resources Limited*

On October 22, 2010 Aral signed a four sided facility agreement where Caspian Energy Ltd, Azden Management Limited act as Guarantors and Asia Sixth Energy Resources Ltd as lender. Under this agreement lender makes available a US dollar term loan facility in aggregate amount equal to the Commitment. The Facility is secured by the guarantors until the acquisition closing date which means the date upon which all conditions precedent to the acquisition have been fulfilled and closing of the acquisition has occurred pursuant to the terms of the Sale and Purchase agreement (refer to Note 1) and by a pledge of Aral's bank accounts.

As of March 31, 2011 and December 31, 2010, respectively the Company received USD 1,918 thousand and USD 1,350 thousand out of total agreed loan facility of USD 2,000 thousand, bearing a 15% annual interest rate. In accordance with the agreement, the principal and accrued interest is expected to be repaid in twelve months after first drawdown of the facility, which is November 25, 2011. If interest is not repaid on its due date, interest is accrued on the unpaid sum from the due date up to the date of actual payment at rate 7.5% higher than original rate. The carrying amount of Company's borrowing from Asia Sixth Energy Resources Ltd approximates its fair value as of March 31, 2011 and December 31, 2010.

### **11 Convertible debentures**

On March 1, 2006, the Company received US \$16 million and issued 10% per annum, convertible debentures in a like amount secured with Caspian Ltd. shares. The debentures mature on March 2, 2011 and are convertible at any time and from time to time into common shares of the Company at a conversion price of \$1.75 per share. The Company may repay the principal amount of the debentures, in whole or in part, or require conversion 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. As at December 31, 2010, the fair value of the convertible debentures approximates the carrying value of the instruments. The fair value is measured using rates that the Company currently expect to borrow which are unobservable inputs (Level 3).

On December 1, 2009, amendments to the terms of the Company's US \$16 million aggregate principal amount of secured convertible debentures due March 2, 2011 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, the Company amended the terms of the debentures to provide for the satisfaction of quarterly interest payments due thereunder as follows:

- a) 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 VWAP of the common shares on the TSX for the particular quarter in question; and;
- b) 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 also issued 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.

The foregoing proposals do not impact the payment of interest for any quarters subsequent to June 30, 2010, which will continue to remain subject to the original debenture terms providing for the debenture holders to elect to receive common shares in lieu of cash interest payments for such periods at the deemed price.

# Caspian Energy Inc.

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Certain debentures holders have requested that interest be paid in cash pertaining to the third quarter of 2010. This payment has not been made. Due to the Company's limited financial resources, management has met and continues to negotiate with debentures holders to negotiate settlement of the interest obligation through avenues other than cash payment. If management does not reach an agreeable alternative to cash payment and fails to make payment within the stipulated time frame, an event of default may occur pursuant to the debentures contract. If the delinquency is not remedied within 30 days of the default, the debentures holders then may formally notify the Company of such circumstances and demand payment of the delinquent interest to be made within ten business days. Failing payment by the Company, the debentures holders may demand that the principal and accrued interest be immediately paid and appoint a private receiver to accomplish such objective. If the private receiver wishes to dispose of the property in the Republic of Kazakhstan, ministerial assent is required. The Company has not been formally notified as to an event of default under the debentures agreement.

The debentures matured on March 2, 2011; however, no cash payments were made, nor were any shares issued to debenture holders. On April 7, 2011, the Company concluded an arrangement with its Debentures holders regarding the USD 16 million, 10% per annum, convertible debentures which matured on March 2, 2011. See note 16.

### 12 Decommissioning Liabilities

As described in Note 2, the accounting policy of the Company is to provide for estimated costs of dismantling oil and gas production facilities, including abandonment and restoration costs, based upon 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.

Movements in the asset retirement obligation for the quarter ended March 31, 2011 and the year ended December 31, 2010 are as follows:

<b>Carrying amount at January 1, 2010</b>	<b>213</b>
Revisions to costs of oil and gas properties and exploration and evaluation assets	(77)
Unwinding of the present value discount	18
Foreign currency translation	(7)
	<hr/>
<b>Carrying amount at December 31, 2010</b>	<b>147</b>
Revisions to costs of oil and gas properties and exploration and evaluation assets	-
Unwinding of the present value discount	1
Foreign currency translation	(2)
	<hr/>
<b>Carrying amount at 31 March 2011</b>	<b><u>146</u></b>

In 2010, Aral had a downward revision in the asset retirement obligation. The primary reason for revision in asset retirement obligation is due to revisions in the expected period of site restoration works following Production Contract signing for the period of 25 years.

The provision amount is determined as at the reporting date using the nominal prices effective at that date on the basis of the forecasted inflation rate for the expected period of wells operation and discount rate for the reporting dates. Uncertainties in the estimates of such costs include the potential changes in regulatory requirements, alternative

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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liquidation and restoration of disturbed land plots and level of discount and inflation rates. The provision has been discounted at a rate of 6.6% (December 31, 2010 – 6.60%) and costs have been inflated at a rate of 5.21% (December 31, 2010 – 5.21%).

### 13 General and Administrative Expenses

<i>Three months ended March 31</i>	<b>2011</b>	<b>2010</b>
Salary	314	313
Office rental	38	28
Services by third parties	40	30
Audit	-	51
Business travel	64	36
Communication expenses	4	2
Legal	27	64
Social tax	7	6
Transportation	-	8
Other expenses	43	10
<b>Total general and administrative expenses</b>	<b>537</b>	<b>548</b>

### 14 Finance Costs, Net

<i>Three months ended March 31</i>	<b>2011</b>	<b>2010</b>
Net foreign exchange loss (gain)	939	401
Interest on convertible debentures	530	591
Accretion of convertible debentures	82	86
Interest expense on loans payable	106	15
Unwinding of the present value discount: decommissioning liabilities	1	9
<b>Total finance costs, net</b>	<b>1,658</b>	<b>1,102</b>

### 15 Contingencies, Commitments 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.

# Caspian Energy Inc.

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**For the three-months ended March 31, 2011 and 2010**

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Aral's 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 December 31, 2010 no provision for potential tax liabilities had been recorded.

**Changes in tax legislation in 2010.** According to the new tax legislation approved by the Parliament in the fourth quarter 2008 and subsequently signed by the President in December 2008, starting from January 1, 2009 stability of the subsurface use contracts tax regimes was cancelled, except for valid production sharing agreements and subsurface use contracts ratified by the Kazakhstan Parliament. As a result, starting from January 1, 2009 the Company is subject to the New Tax Code.

The Kazakhstan Government introduced significant amendments to the Tax Code effective from January 1, 2009. The following key changes were made: replacement of the royalty by the mineral production tax; change in the methodology of calculation of rent tax on oil exports; change in the methodology of excess profit tax calculations; reduction of the VAT to 12%; reduction of the corporate income tax rates: from 30% to 20% starting January 1, 2009, from 20% to 17.5% in 2010, and 15% in 2011; introduction of fixed rate of social tax of 11%; increase of property tax rate from 1% to 1.5% in respect of the tax base represented exclusively by immovable property, and other changes.

Further, on November 17, 2009, the President of the Republic of Kazakhstan approved new changes and amendments to the Tax Code. The key amendment was to keep corporate income tax rate at 20% until January 1, 2013, and to apply the rate of 17.5% in 2013 and 15% onwards.

On November 26, 2010, the President of the Republic of Kazakhstan signed the "Law on amendments and addenda to some legislative acts of the Republic of Kazakhstan on issues of taxation", according to which the corporate income tax rate was fixed at 20% without changes in rates in subsequent years.

**Transfer pricing.** On July 5, 2008, the new law on transfer pricing was introduced, which is effective from 1 January 2009. This new law replaced 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 2010 as it is considered to be in accordance with new transfer pricing legislation. The management of Aral 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, related to the new law on transfer pricing, the management of Aral 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 by Aral in these financial statements.

**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, management of Aral 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 1,772 thousand may be imposed relating to 2005 – 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 from 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

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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### For the three-months ended March 31, 2011 and 2010

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Export Quota for transportation by rail. Should the government authorities determine that Export Quotas received by Aral were still in violation of Exploration Contract terms, Aral may be imposed to fines and penalties which cannot be estimated reliably, and/or termination of the Exploration Contract. During 2010 and previous years the Aral's export sales related to the crude oil extracted only at the East Zhagabulak. According to Production Contract Aral is obliged to sell 20% of produced crude oil on domestic market. Aral did not follow this condition of the Production Contract in 2010.

**Minimum Working Program.** During 2009 Aral signed an addendum to the Exploration Contract, which among other changes to the Exploration Contract (see Note 1) stipulated USD 21,400 thousand Work Program commitments for 2009 and USD 50,400 thousand for the remaining three years with drilling of the an additional 8 wells till December 29, 2012. However, as of December 31, 2009 Aral's actual expenditures were significantly less than the amounts committed to 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 USD 24,482 thousand, drilling of additional 4 wells, and an increase in total Work Program commitments to USD 56,794 thousand for subsequent three years.

During 2010 Aral had commitments under its Work Program for the amount of USD 24,482 thousand, however the accrual expenditures in respect to the capital investments were less than committed. Aral communicated with the government authorities and expects an addendum to the Exploration Contract to be signed by the end of June 2011 that accepts the shortfalls with the following conditions; increase in Work Program commitments of USD 13,950 thousand, drilling of additional 2 wells, and increase in total Work Program commitments for 2011-2012.

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.

**Social and training commitments.** 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 Dollars 100,000. Management believes that Aral was not subject to this requirement in 2010 as the Contract was signed in the middle of 2010 only.

0.1% of Aral's annual extraction cost should be allocated for professional training of the Kazakhstani staff engaged in the works to be executed under the Production Contract. The management believes that as Aral has signed Production Contract in the middle of 2010 and Annual Program was not yet developed and approved with the relevant government authorities, no training obligations arise in 2010.

**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. The management of Aral 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 modern technology in meeting more stringent standards.

**Restoration.** Under the terms of the Exploration Contract, Aral should 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 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 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. The drilling contractor has made a claim for significant compensation in excess of what the Aral believes is correct and accrued (see Note \_\_). Aral considers the contractor to be responsible for the failure. The matter is currently under negotiation and the amount of possible cash outflows, if any, are not yet determinable.

**Gas utilization.** On 3 October 2008 a final "Gas utilization program" was approved and agreed with the Ministry. According to the Program Aral was obliged to install all required equipment by the end of 2009, otherwise gas flared during the period from 3 October 2008 till 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 capital expenditure commitments are equal

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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### For the three-months ended March 31, 2011 and 2010

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to CAD 12,238 thousand. On July 2, 2009 Aral conducted a meeting with the Ministry regarding the fulfillment of the Program. As a result of this meeting, Aral was allowed to postpone the installation of the required equipment till June 30, 2011. As of December 31, 2010 Aral only had a contract signed with the subcontractor for the development of the technical specifications of the gas flaring project and, accordingly, ceased production in 2011 till further resolution.

**Capital commitments.** As at March 31, 2011 Aral had no purchase commitments related to the purchase of equipment for oil and gas properties.

**Insurance policies.** Aral holds insurance policies in relation to the following risks:

- Insurance of civil responsibility of employer for causing damage to life and health of employee during his/her work duties;
- Insurance of civil responsibility of employer for causing damage to environment;
- Insurance of civil responsibility of owners of vehicles;
- Insurance of civil responsibility of owners of properties, operations of which can cause damage to third parties.

#### 16 Events after the Reporting Date

On April 7, 2011, the Company concluded an arrangement with its Debentures holders regarding the USD 16 million, 10% 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 plus accrued interest into common shares of the Company at a price of \$0.19 per common share (this aggregates \$9,790,753 convertible to 49,777,218 common shares)
- Amend the existing Debentures to an amount of \$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
- Interest remains at 10% per annum, payable in cash quarterly, or at the election of the holders in stock at a 5% discount to 20 day Volume Weighted Average Price (VWAP) plus ½ share purchase warrant (2 year life) at a 30% premium to VWAP.

#### 17 Explanation of Transition to IFRS

As stated in note 2 (a), these are the Company's first financial statements prepared in accordance with IFRS. The Company has adopted IFRS effective January 1, 2011. The Company's financial statements for the year ending December 31, 2011 will be the first annual financial statements that comply with IFRS. Accordingly, the Company will make an unreserved statement of compliance with IFRS beginning with its 2011 annual financial statements. The Company's transition date is January 1, 2010 (the "transition date") and the Company has prepared its opening IFRS balance sheet at that date.

The accounting policies set out in note 3 have been applied in preparing the financial statements for the period ended March 31, 2011, the comparative information presented in these financial statements for the period ended March 31, 2010 and December 31, 2010 and the preparation of an opening IFRS balance sheet at January 1, 2010. The Company will ultimately prepare its opening balance sheet and financial statements for 2010 and 2011 by applying existing IFRS effective as at December 31, 2011. Accordingly, the opening balance sheet and financial statements for 2010 and 2011 may differ from these financial statements.

In preparing its opening IFRS balance sheet, the Company has adjusted amounts reported previously in financial statements prepared in accordance with Previous GAAP. An explanation of how the transition from Previous GAAP to

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

For the three-months ended March 31, 2011 and 2010

IFRS has affected the Company's financial position, financial performance and cash flows is set out in the following tables and the notes that accompany the tables.

### a) Reconciliation of equity from Canadian GAAP to IFRS

i) At the date of IFRS transition – January 1, 2010:

#### Caspian Energy Inc.

#### Balance Sheet

(unaudited)

As at (Cdn \$ thousands)	Notes	Previous GAAP December 31, 2009	IFRS adjustments	IFRS January 1, 2010
<b>ASSETS</b>				
Current Assets				
Cash and cash equivalents		\$ 1,476	\$ -	\$ 1,476
Accounts receivable and prepaids		773	-	773
VAT receivable		79	-	79
Inventory	<i>b</i>	579	1,899	2,478
		<b>2,907</b>		4,806
Restricted cash		347	-	347
Exploration and evaluation	<i>a</i>	-	30,531	30,531
Property and equipment	<i>a,b,c</i>	73,841	(66,784)	7,057
		<b>\$ 77,095</b>		<b>\$ 42,741</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
Current Liabilities				
Accounts payable and accrued liabilities	<i>d</i>	\$ 4,762	\$ (460)	4,302
Convertible debentures		-	-	-
Loans payable	<i>d</i>	-	2,751	2,751
		<b>4,762</b>		7,053
Loans payable	<i>d</i>	3,156	(2,358)	798
Convertible debentures		21,814	-	21,814
Decommissioning provision	<i>e</i>	259	(46)	213
		<b>29,991</b>		<b>29,878</b>
Shareholders' Equity				
Share capital		129,121	-	129,121
Warrants		255	-	255
Contributed surplus	<i>f</i>	15,361	(1,483)	13,878
Accumulated other comprehensive income		-		-
Deficit	<i>a,b,c, d, e</i>	(97,635)	(32,756)	(130,391)
		<b>47,102</b>		<b>12,863</b>
		<b>\$ 77,093</b>		<b>\$ 42,741</b>

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

For the three-months ended March 31, 2011 and 2010

ii) As at March 31, 2010:

### Caspian Energy Inc.

#### Balance Sheet

(unaudited)

As at (Cdn \$ thousands)	Notes	Previous GAAP March 31, 2010	IFRS adjustments	IFRS March 31, 2010
<b>ASSETS</b>				
Current Assets				
Cash and cash equivalents		\$ 765	\$ -	\$ 765
Accounts receivable and prepaids		519	-	519
VAT receivable		112	-	112
Inventory	<i>c</i>	564	1,858	2,422
		<b>1,960</b>		<b>3,818</b>
Restricted cash		356	-	356
Exploration and evaluation	<i>a</i>	-	30,118	30,118
Property and equipment	<i>a, b, c</i>	73,110	(66,449)	6,661
		<b>\$ 75,426</b>		<b>\$ 40,953</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
Current Liabilities				
Accounts payable and accrued liabilities		\$ 4,568	\$ 72	4,400
Convertible debentures		-	-	-
Loans payable	<i>d</i>	-	-	2,564
		<b>4,568</b>		<b>6,964</b>
Loans payable	<i>d</i>	3,088	-	764
Convertible debentures		21,010	-	21,010
Decommissioning provision	<i>e</i>	263	(46)	217
		<b>28,929</b>		<b>28,955</b>
Shareholders' Equity				
Share capital		129,842	-	129,842
Warrants		320	-	320
Contributed surplus	<i>f</i>	15,361	(1,483)	13,878
Accumulated other comprehensive income	<i>g</i>	-	400	400
Deficit	<i>a, b, c, d, e</i>	(99,024)	(33,418)	(132,442)
		<b>46,499</b>		<b>11,998</b>
		<b>\$ 75,428</b>		<b>\$ 40,953</b>



# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

For the three-months ended March 31, 2011 and 2010

iii) As at December 31, 2010:

### Caspian Energy Inc.

#### Balance Sheet

(unaudited)

As at (Cdn \$ thousands)	Notes	Previous GAAP December 31, 2010	IFRS adjustments	IFRS December 31, 2010
<b>ASSETS</b>				
Current Assets				
Cash and cash equivalents		\$ 1,334	\$ -	\$ 1,334
Accounts receivable and prepaids		425	-	425
VAT receivable		144	-	144
Inventory	<i>b</i>	524	204	728
		<b>2,427</b>		2,631
Restricted cash		350	-	350
Exploration and evaluation	<i>a</i>	-	29,448	29,448
Property and equipment	<i>a, b, c</i>	66,671	(61,269)	5,402
		<b>\$ 69,448</b>		<b>\$ 37,831</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
Current Liabilities				
Accounts payable and accrued liabilities		\$ 4,373	\$ (279)	4,094
Convertible debentures		21,621	-	21,621
Loans payable	<i>d</i>	750	3,499	4,249
		<b>26,744</b>		29,964
Loans payable	<i>d</i>	3,493	(3,346)	147
Convertible debentures		-	-	-
Decommissioning provision	<i>e</i>	56	90	146
		<b>30,293</b>		<b>30,257</b>
Shareholders' Equity				
Share capital		132,671	-	132,671
Warrants		406	-	406
Contributed surplus	<i>f</i>	15,891	(1,484)	14,407
Accumulated other comprehensive income		-	992	992
Deficit	<i>a, b, c, d, e</i>	(109,813)	(31,089)	(140,902)
		<b>39,155</b>		<b>7,574</b>
		<b>\$ 69,448</b>		<b>\$ 37,831</b>

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

For the three-months ended March 31, 2011 and 2010

### Reconciliation of total comprehensive income for the three months ended March 31, 2010

Caspian Energy Inc.

Statements of Income and Comprehensive Income

(unaudited)

(Cdn\$ thousands)	Note	Three Months Ended March 31, 2010		
		Previous GAAP	Effect of transtion to IFRS	IFRS
Revenues		\$ 492	\$ -	\$ 492
<b>Expenses</b>				
General and administrative		548	\$ -	548
Accretion of convertible debentures	<i>h</i>	86	\$ (86)	-
Interest	<i>h</i>	591	\$ (591)	-
Operating Expenses		380	\$ -	380
Transportation		252	\$ -	252
Stock Based Compensation		-	\$ -	-
Foreign exchange loss	<i>h</i>	(785)	\$ 785	-
Depletion and depreciation	<i>c</i>	794	\$ (533)	261
		1,866		1,441
<b>Operating income before finance expense and income taxes</b>		(1,374)		(949)
Other Income				
Finance expense	<i>h</i>	15	1,087	1,102
<b>Income before income taxes</b>		(1,389)		(2,051)
<b>INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)</b>		(1,389)		(2,051)
<b>Income per share \$</b>				
Basic & Diluted		(0.01)		(0.01)

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

For the three-months ended March 31, 2011 and 2010

### Reconciliation of total comprehensive income for the year ended December 31, 2010

Caspian Energy Inc.

Statements of Income and Comprehensive Income

(unaudited)

<i>(Cdn\$ thousands)</i>	<i>Note</i>	Year Ended December 31, 2010		
		Previous GAAP	Effect of transtion to IFRS	IFRS
Revenues		\$ 3,428	\$ -	\$ 3,428
<b>Expenses</b>				
General and administrative		2,694	\$ -	2,694
Accretion of convertible debentures	<i>h</i>	525	\$ (525)	-
Interest	<i>h</i>	2,121	\$ (2,121)	-
Operating Expesnse		1,744	\$ -	1,744
Transportation		1,346	\$ -	1,346
Stock Based Compensation		529	\$ -	529
Foreign exchange loss	<i>h</i>	191	\$ (191)	-
Depletion and depreciation	<i>c</i>	6,360	\$ (5,006)	1,354
E&E Expense	<i>a</i>	-	\$ 33	33
Geological and geophysical expenses related to oil and gas properties	<i>b</i>	-	\$ 6	6
		15,510		7,706
<b>Operating income before finance expense and income taxes</b>		(12,082)		(4,278)
Other Income	<i>b</i>	95	1,395	1,490
Finance expense	<i>h</i>	-	3,857	3,857
<b>Income before income taxes</b>		(12,177)		(9,625)
Income Taxes		-	876	876
<b>INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)</b>		(12,177)		(10,501)
<b>Income per share \$</b>				
Basic & Diluted		(0.08)		(0.06)

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

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**For the three-months ended March 31, 2011 and 2010**

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### *Transition elections*

IFRS 1 allows first-time adopters certain exemptions from the general requirement to apply IFRS as effective for December 2011 year ends retrospectively. The Company has taken the following exemptions:

- i) IFRS 3 *Business Combinations* has not been applied to acquisitions of subsidiaries or of interests in associates and joint ventures that occurred before January 1, 2010, the Company's date of transition.
- ii) IFRS 2 *Share-based Payment* has not been applied to any equity instruments that were granted on or before November 7, 2002, nor has it been applied to equity instruments granted after November 7, 2002 that vested before January 1, 2010.
- iii) The Company has elected to apply the exemption, as allowed under IFRS 1, and deemed the cumulative translation differences for all foreign operations to be zero at the date of transition to IFRS. Any gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of transition to IFRSs and shall include later translation differences.

### *Footnotes to reconciliations:*

#### **a) Exploration and evaluation ("E&E") assets**

Under IFRS, capitalized E&E expenditures are required to be classified separately on the balance sheet. Under Canadian GAAP, these costs were included within property, plant and equipment. E&E assets will not be depleted, and will be assessed for impairment when indicators of impairment exist. The Company reclassified \$30,531 from property, plant and equipment to E&E as at January 1, 2010 (March 31, 2010 - \$30,118; December 31, 2010 - \$29,448).

In the fourth quarter of 2010, an impairment charge of \$33 was recorded relating to Aral surrendering 55% (1,909.1 square km) of the North Block territory pursuant to Amendment No. 5 of the Exploration Contract.

#### **b) Property, plant and equipment**

Under Previous GAAP, the Company followed the full-cost method of accounting for oil and gas assets. Under IFRS, the Company has elected not to capitalize certain costs which were capitalized under Previous GAAP. As a result, an adjustment was made to reduce property, plant and equipment by \$5,860 as at January 1, 2010 with a corresponding increase in deficit.

In addition, under Previous GAAP, replacement parts and certain supplies related to oil and gas activities were classified within property, plant and equipment. Under IFRS, the Company has reclassified \$1,899 from property, plant and equipment to inventory as at January 1, 2010 (March 31, 2010 - \$1,858; December 31, 2010 - \$204).

The recognition and measurement of impairment differs under IFRS from Previous GAAP. IFRS requires an asset impairment test to be conducted on the transition date and subsequently when indicators of impairment are present. Under Previous GAAP, impairment of long-lived assets is assessed on the basis of an asset's estimated undiscounted future cash flows compared with the asset's carrying amount and if impairment is indicated, discounted cash flows are prepared to quantify the amount of impairment.

# Caspian Energy Inc.

## Notes to Consolidated Financial Statements

(Unaudited)

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IFRS requires the impairment test to occur at the asset level or the CGU level when long-lived assets exist that do not generate independent cash inflows. The carrying amount of the asset or CGU is compared to its recoverable amount which is the higher of the value-in-use or the fair value of the assets less the costs to sell it.

The Company performed an assessment of impairment for all property, plant and equipment at the date of transition. Based on the results of the testing, the Company determined that the carrying value of property, plant and equipment exceeded the recoverable amount of property, plant and equipment (based on a value in use calculation) at January 1, 2010. As such, an impairment charge of \$16,667 was recorded with a corresponding increase in deficit. No additional impairments were required as at March 31, 2010 or December 31, 2010.

Under Canadian GAAP, proceeds from dispositions of assets were deducted from the full cost pool without recognition of a gain or loss unless the deduction resulted in a change to the country cost centre depletion rate of 20 percent or greater, in which case a gain or loss was recorded.

Under IFRS, gains or losses are recorded on dispositions and are calculated as the difference between the proceeds and the net book value of the asset disposed. For the year ended December 31, 2010, Caspian recognized a \$1,395 net loss on dispositions under IFRS compared to Canadian GAAP results. The net loss arose due to the dispositions of inventory in ARAL.

### **c) Depletion expense**

As a result of the changes to the carrying amount of property plant and equipment noted in (b) above, depletion expense decreased as compared to its calculation under Previous GAAP. March 31, 2010 depletion was lower by \$533 and for the year December 31, 2010, depletion was reduced by \$5,006.

Accretion expense of \$9 for the period ended March 31, 2010 (\$18 for the year ended December 31, 2010) has been reclassified to Finance Expense under IFRS.

### **d) Loans payable**

Under Previous GAAP, certain loan payable balances were classified as non-current liabilities and certain current loan amounts were included within accounts payable and accrued liabilities. Under IFRS, \$2,751 has been reclassified from non-current liabilities to current portion of loans payable and \$460 has been reclassified from accounts payable and accrued liabilities to current portion of loans payable. The total amount of loans payable under IFRS is unchanged from the balance recorded under Previous GAAP.

### **e) Decommissioning provision**

Under Canadian GAAP decommissioning liabilities (previously referred to as 'asset retirement obligations') were discounted at a credit adjusted risk free rate. Under IFRS the estimated cash flow to abandon and remediate oil and gas assets has been risk adjusted and the provision is discounted at a risk free rate. In addition, as described in (g) below) under Previous GAAP, decommissioning liabilities related to foreign operations were translated at historical discount rates, whereas under IFRS, these amounts are translated at the rate in effect on the balance sheet date. The net impact of these differences as at January 1, 2010 was a decrease of \$46 to the decommissioning liability balance (March 31, 2010 – decrease of \$46; December 31, 2010 – increase of \$91).

### **f) Convertible debentures equity component**

Under Previous GAAP, the portion of initial value associated with the conversion feature of a convertible debenture was classified as a separate component of equity. Due to certain conversion features in the Company's convertible debentures,

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IFRS requires the conversion feature of convertible debentures to be classified as a financial instrument on transition and marked-to-market each reporting period. Since the conversion feature of the debentures outstanding on January 1, 2010 was sufficiently out-of-the-money, the fair value of this feature was determined to be nil. As a result, the Canadian GAAP balance of the equity component of convertible debentures at January 1, 2010 of \$1,483 (included within contributed surplus under Previous GAAP), has been reclassified to deficit as at January 1, 2010.

### **g) Functional currency of foreign operations**

Under Previous GAAP, the Company accounted for its interest in Aral as an integrated foreign operation. Therefore, monetary items were translated at period end rates and non-monetary items were translated at historical rates with all foreign currency gains and losses recognized in profit or loss. IFRS requires that the functional currency of each foreign operation of the Company be determined separately and all monetary and non-monetary items translated at period end rates with all foreign currency gains and losses recognized in accumulated other comprehensive income in equity.

Under IFRS, it was determined that Aral's functional currency was Tenge. In accordance with IFRS 1 optional exemptions, the Company elected to transfer the accumulated other comprehensive income balances at January 1, 2010 directly to deficit. For subsequent periods, accumulated comprehensive income is shown as a separate component of equity under IFRS. Translation of Aral balances as at March 31, 2010 and for the three-month period then ended resulted in the recognition of accumulated other comprehensive income of \$400 (December 31, 2010 - \$992).

The change in functional currency for Aral also resulted in changes to the foreign currency gain / loss recorded in the Company's financial statements. For the period ended March 31, 2010, an additional foreign currency loss of \$1,175 was recorded (Year ended December 31, 2010 – additional loss of \$951).

### **h) Finance expenses**

Under IFRS, foreign currency losses (gains), interest expense, and accretion on convertible debentures and the unwinding of the discount on decommissioning liabilities are included as finance expenses. These individual amounts for Previous GAAP have been reclassified for IFRS.

### **i) Adjustments to the statement of cash flows**

The transition from Previous GAAP to IFRS had no significant impact on cash flows generated by the Company.