

**HILLCREST PETROLEUM LTD.**

**(formerly Hillcrest Resources Ltd.)**

**Consolidated Financial Statements**

**December 31, 2014 and 2013**

(Expressed in Canadian Dollars Unless Otherwise Stated)

# LANCASTER & DAVID

CHARTERED ACCOUNTANTS

## INDEPENDENT AUDITORS' REPORT

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To the Shareholders of Hillcrest Petroleum Ltd. (formerly Hillcrest Resources Ltd.):

We have audited the accompanying consolidated financial statements of Hillcrest Petroleum Ltd. (formerly Hillcrest Resources Ltd.), which comprise the consolidated statements of financial position as at December 31, 2014 and 2013, and the consolidated statements of comprehensive loss, changes in shareholders' equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

### *Management's Responsibility for the Consolidated Financial Statements*

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

### *Auditor's Responsibility*

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

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

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

### *Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Hillcrest Petroleum Ltd. (formerly Hillcrest Resources Ltd.) as at December 31, 2014 and 2013, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

### *Emphasis of Matter*

Without qualifying our opinion, we draw attention to Note 2 in the consolidated financial statements which describes conditions and matters that indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

/s/ Lancaster & David

CHARTERED ACCOUNTANTS

Vancouver, BC  
April 30, 2015

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**HILLCREST PETROLEUM LTD.**  
**(formerly Hillcrest Resources Ltd.)**  
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**December 31, 2014 and 2013**

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**HILLCREST PETROLEUM LTD.**  
(formerly Hillcrest Resources Ltd)  
**Consolidated Statements of Financial Position**  
(Expressed in Canadian dollars)

	December 31 2014	December 31 2013
<b>ASSETS</b>		
Current assets		
Cash	\$ 619,317	\$ 722,715
Accounts receivable	480,890	54,489
Government remittances recoverable	12,004	14,331
Prepaid expenses	249,035	4,197
Restricted Cash	2,320,201	-
Total current assets	3,681,447	795,732
Non-current assets		
Deferred financing costs	63,792	191,376
Exploration and evaluation assets (note 7)	1,417,260	1,925,952
Property and equipment (note 6)	15,333,497	1,101,525
<b>TOTAL ASSETS</b>	<b>\$ 20,495,996</b>	<b>\$ 4,014,585</b>
<b>LIABILITIES</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 3,015,457	\$ 118,194
Current portion of secured loan (note 10)	1,000,000	416,665
Current portion of decommissioning liability (note 12)	898,053	-
Unsecured loan (note 11)	45,498	-
Total current liabilities	4,959,008	534,859
Decommissioning liability (note 12)	13,418,575	51,766
Secured loan (note 10)	-	583,335
<b>Total liabilities</b>	<b>18,377,583</b>	<b>1,169,960</b>
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (note 13)	5,707,184	5,182,619
Share subscription receivable	(46,000)	-
Contributed surplus	949,834	926,289
Warrants	30,620	40,843
Accumulated other comprehensive income	(34,127)	-
Deficit	(4,489,098)	(3,305,126)
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS' EQUITY</b>	<b>\$ 20,495,996</b>	<b>\$ 4,014,585</b>

*These financial statements were approved and authorized for issue by the Board of Directors on April 29, 2015.  
They were signed on its behalf by:*

\_\_\_\_\_  
"Don Currie" Director

\_\_\_\_\_  
"Thomas Milne" Director

See accompanying notes to the consolidated financial statements

**HILLCREST PETROLEUM LTD.**  
(formerly Hillcrest Resources Ltd)  
**Consolidated Statements of Comprehensive Loss**  
**For the Years Ended December 31, 2014 and 2013**  
(Expressed in Canadian dollars)

	2014	2013
<b>Revenue</b>	<b>\$ 1,163,004</b>	<b>\$ 677,435</b>
<b>Expenses</b>		
Operating costs	\$ 495,632	\$ 147,405
Accretion	20,032	5,276
Bank charges and interest	4,666	3,539
Consulting fees ( <i>note 14</i> )	290,223	334,442
Debt issue cost	139,528	63,792
Depletion and depreciation	696,579	321,215
Filing and transfer agent fees	21,247	20,592
Investor relations and business development	121,370	100,999
Office and general	29,736	22,527
Professional fees	139,117	127,821
Rent	16,798	2,046
Stock-based compensation	11,779	121,927
Travel	65,896	34,630
Wages and benefits	28,085	-
	<b>2,080,688</b>	<b>1,306,211</b>
<b>Loss before other items</b>	<b>(917,683)</b>	<b>(628,776)</b>
<b>Other items</b>		
Interest income	79	117
Interest expense on secured loan ( <i>note 10</i> )	(170,000)	(67,432)
Interest expense on unsecured loan ( <i>note 11</i> )	(1,498)	-
Overriding royalty interest on secured loan ( <i>note 12</i> )	(44,875)	-
Acquisition costs	(15,769)	-
Loss on disposal of oil and gas properties	(38,970)	-
Loss on disposal of exploration and evaluation assets	(3,350)	-
Foreign exchange gain	8,095	11,899
<b>Net loss before other comprehensive loss for the year</b>	<b>(1,183,971)</b>	<b>\$ (684,192)</b>
<b>Other Comprehensive income (loss)</b>		
Cumulative translation adjustment	(34,127)	-
<b>Comprehensive loss for the year</b>	<b>\$ (1,218,098)</b>	<b>\$ (684,192)</b>
Basic and diluted loss per share	<b>\$ (0.03)</b>	<b>\$ (0.02)</b>
Weighted average number of common shares outstanding	<b>39,657,025</b>	<b>39,570,655</b>

See accompanying notes to the consolidated financial statements

**HILLCREST PETROLEUM LTD.**  
(formerly Hillcrest Resources Ltd)  
**Consolidated Statements of Changes in Shareholders' Equity**  
For the Years Ended December 31, 2014 and 2013  
(Expressed in Canadian dollars)

	<i>Share Capital</i>		<i>Share</i>			<i>Accumulated Other Comprehensive Income</i>		<i>Shareholders' Equity</i>
	<i>Number of Shares</i>	<i>Amount</i>	<i>Subscription Receivable</i>	<i>Contributed Surplus</i>	<i>Warrants</i>	<i>Income</i>	<i>Deficit</i>	
Balance, December 31, 2012	39,570,655	\$ 5,182,619	\$ -	\$ 722,282	\$ 98,972	\$ -	\$ (2,620,934)	\$ 3,382,939
Issued agent warrants for secured loan	-	-	-	-	23,951	-	-	23,951
Stock-based compensation	-	-	-	121,927	-	-	-	121,927
Transfer of contributed surplus on expired warrants	-	-	-	82,080	(82,080)	-	-	-
Net loss for the year	-	-	-	-	-	-	(684,192)	(684,192)
<b>Balance, December 31, 2013</b>	<b>39,570,655</b>	<b>5,182,619</b>	<b>\$ -</b>	<b>\$ 926,289</b>	<b>\$ 40,843</b>	<b>\$ -</b>	<b>\$ (3,305,126)</b>	<b>\$ 2,844,625</b>
Issued for cash pursuant to private placements	10,625,000	531,250	(46,000)	-	-	-	-	485,250
Issued for cash pursuant to the exercise of options	100,000	6,000	-	-	-	-	-	6,000
Share issuance costs and finder's fee	-	(17,811)	-	-	6,669	-	-	(11,142)
Stock-based compensation	-	-	-	11,779	-	-	-	11,779
Transfer share capital on exercise options	-	5,126	-	(5,126)	-	-	-	-
Transfer of contributed surplus on expired warrants	-	-	-	16,892	(16,892)	-	-	-
Cumulative translation adjustment	-	-	-	-	-	(34,127)	-	(34,127)
Net loss for the year	-	-	-	-	-	-	(1,183,971)	(1,183,971)
<b>Balance, December 31, 2014</b>	<b>50,295,655</b>	<b>\$ 5,707,184</b>	<b>\$ (46,000)</b>	<b>\$ 949,834</b>	<b>\$ 30,620</b>	<b>\$ (34,127)</b>	<b>\$ (4,489,097)</b>	<b>\$ 2,118,414</b>

See accompanying notes to the consolidated financial statements

**HILLCREST PETROLEUM LTD.**  
(formerly Hillcrest Resources Ltd)  
**Consolidated Statements of Cash Flows**

**Years Ended December 31, 2014 and 2013**

(Expressed in Canadian dollars)

	2014	2013
<b>Cash flows provided by (used in) operating activities</b>		
Net loss for the year	\$ (1,183,972)	\$ (684,192)
Adjusted for items not involving cash:		
Accretion	20,032	5,276
Amortization of debt issue costs	127,584	63,792
Depletion and depreciation	696,579	321,215
Loss on disposal of oil and gas properties	38,970	-
Loss on disposal of exploration and evaluation assets	3,350	-
Stock-based compensation	11,779	121,927
Changes in non-cash working capital:		
Accounts receivable	400,614	52,139
Government remittances recoverable	2,327	11,963
Prepaid expenses	(31,661)	(465)
Accounts payable and accrued liabilities	(213,893)	(14,925)
Interest payable on unsecured loan	-	-
	<u>(128,291)</u>	<u>(123,270)</u>
<b>Cash flows from (used in) investing activities</b>		
Cash acquired upon acquisition of Hillcrest GOM(net)	429,546	-
Sale proceeds of oil and gas properties	135,525	-
Sale proceeds of exploration and evaluation assets	359,103	653,687
Acquisition of oil and gas properties	(1,307,011)	(58,618)
Exploration and evaluation expenditures	(121,740)	(534,991)
	<u>(504,577)</u>	<u>60,078</u>
<b>Cash flows from (used in) financing activities</b>		
Deferred financing costs	-	(231,217)
Exercise of options for cash	6,000	-
Proceeds from issuance of common shares	485,250	-
Proceeds from secured loan	-	1,000,000
Proceeds from unsecured loan	50,000	-
Payment on unsecured loan	(6,000)	-
Share issuance costs	(11,142)	-
	<u>524,108</u>	<u>768,783</u>
Effect of exchange rate changes on cash	5,362	-
<b>Change in cash</b>	<b>(103,398)</b>	<b>705,591</b>
<b>Cash, beginning of the year</b>	<b>722,715</b>	<b>17,124</b>
<b>Cash, end of the year</b>	<b>\$ 619,317</b>	<b>\$ 722,715</b>
Additional Information:		
Investment in oil and gas properties expenditures included in accounts payable	\$ 50,993	\$ 847
Investment in exploration and evaluation expenditures included in accounts payable	\$ -	\$ 20,978
Interest expense on secured loan	\$ 170,000	\$ 67,432

See accompanying notes to the consolidated financial statements

**HILLCREST PETROLEUM LTD.**

(formerly Hillcrest Resources Ltd.)

Notes to Consolidated Financial Statements

December 31, 2014

(Expressed in Canadian Dollars Unless Otherwise Stated)

**1. Nature and Basis of Operations**

Hillcrest Petroleum Ltd. (formerly Hillcrest Resources Ltd.) (the “Company”) was incorporated on May 2, 2006 under the Business Corporations Act of British Columbia, and is in the business of acquiring, exploring and developing exploration interests in oil and gas projects in the United States of America. Effective March 10, 2015, the Company changed its name from Hillcrest Resources Ltd. to Hillcrest Petroleum Ltd. The Company’s registered office is suite 1700 – 3050 Post Oak Blvd, Houston, Texas 77056.

The Company is subject to several categories of risk associated with the exploration and development of oil and gas resources. Oil and gas exploration and production is a speculative business, and involves a high degree of risk. Among the factors that have a direct bearing on the Company’s prospects are uncertainties inherent in estimating oil and gas reserves, future hydrocarbon production, and cash flows, particularly with respect to wells that have not been fully tested and with wells having limited production histories; access to additional capital; changes in the price of oil and gas; availability and cost of services and equipment; and the presence of competitors with greater financial resources and capacity.

The oil and gas industry is subject, by its nature, to environmental hazards and clean-up costs. In addition, the Company’s oil and gas business makes it vulnerable to changes in prices of crude oil and natural gas. Such prices have been volatile in the past and can be expected to be volatile in the future. By definition, proved reserves are based on estimated future oil and gas prices and costs. Price declines reduce the estimated quantity of proved reserves and increase annual depletion expense (which is based on proved and probable reserves).

**2. Basis of Preparation****Statement of compliance**

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”) and the International Financial Reporting Interpretations Committee (“IFRIC”), effective for the Company’s reporting for the year ended December 31, 2014.

**Basis of measurement**

The consolidated financial statements have been prepared on a historical cost basis and are presented in Canadian dollars, which is also the Company’s functional currency.

**Going concern of operations**

These consolidated financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and the discharge of liabilities in the normal course of business for the foreseeable future. The Company incurred a net loss of \$1,183,972 during the year ended December 31, 2014 (2013 - \$684,192). The Company’s ability to meet its obligations as they fall due and to continue to operate as a going concern is dependent on the continued financial support of the creditors and the shareholders and ultimately, the attainment of profitable operations. There is no certainty that the Company will continue to produce revenue due to the inherent production risks associated with the oil and natural gas industry. In the past, the Company has relied on sales of equity securities, debt instruments and asset sales to meet its cash requirements. There can be no assurance that funding from this or other sources will be sufficient in the future to satisfy operational requirements and cash commitments. Even if the Company is able to obtain new financing, it may not be on commercially reasonable terms or terms that are acceptable to it. Failure to obtain such financing on a timely basis could cause the Company to reduce or terminate its operations. Due to the uncertainties as noted above, there is significant doubt regarding the Company’s ability to continue as a going concern. These consolidated financial statements do not include any adjustments to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

**HILLCREST PETROLEUM LTD.**

(formerly Hillcrest Resources Ltd.)

Notes to Consolidated Financial Statements

December 31, 2014

(Expressed in Canadian Dollars Unless Otherwise Stated)

**2. Basis of Preparation (continued)****Going concern of operations (continued)**

	<b>December 31, 2014</b>	December 31, 2013
Working capital (deficit)/surplus	\$ (1,277,561)	\$ 260,873
Deficit	\$ (4,489,098)	\$ (3,305,126)

**Critical judgments in applying accounting policies**

The preparation of these consolidated financial statements requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and reported amounts of expenses during the period. Actual results could differ from these estimates.

These consolidated financial statements include estimates which, by their nature, are uncertain. The impacts of such estimates are pervasive throughout the consolidated financial statements, and may require accounting adjustments based on future occurrences. Revisions to accounting estimates are recognized in the period in which the estimate is revised and future periods if the revision affects both current and future periods. These estimates are based on historical experience, current and future economic conditions and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Significant assumptions about the future and other sources of estimation uncertainty that management has made at the reporting date that could result in a material adjustment to the carrying amounts of assets and liabilities, in the event that actual results differ from assumptions made, relate to, but are not limited to, the following:

- The carrying value and the recoverability of exploration and evaluation assets and oil and gas properties;

Exploration and evaluation assets require judgment as to whether future economic benefits exist, including the existence of proven reserves and the ability to finance exploration and evaluation projects, where technical feasibility and commercial viability has not yet been determined. Amounts used for oil and gas properties impairment testing and calculations are based on estimates of future commodity prices, expected volumes, quantity of reserves and discount rate as well as future development and operating costs. These calculations require the use of estimates and assumptions which, by their nature, are subject to measurement uncertainty. Judgment is also exercised as to whether there have been indicators of impairment or impairment reversal. Indicators of impairment or impairment reversal may include, but are not limited to changes in market value of assets, estimate of future prices and costs, estimated quantity of reserves and appropriate discount rate.

- Depletion and depreciation;

The amounts recorded for depletion and depreciation of oil and natural gas properties and the amounts used in impairment testing are based on independent estimates of proved and probable reserves, well production rates, realized and forecast oil and natural gas prices, future development costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty. Accordingly, the impact on the consolidated financial statements for future periods may be material.

**HILLCREST PETROLEUM LTD.**

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Notes to Consolidated Financial Statements

December 31, 2014

(Expressed in Canadian Dollars Unless Otherwise Stated)

**2. Basis of Preparation (continued)**

- Petroleum and natural gas reserves;

The Company's reserves are evaluated and reported on by independent reserve engineers. Reserve estimates have a material impact on depletion expense, testing for impairment, and decommissioning liabilities, all of which could possibly have a material impact on the consolidated financial statements. The estimation of economically recoverable oil and natural gas reserves is also based on a number of variable factors and assumptions, including historical production, production rates and declines, timing and amount of capital expenditures, marketability, future commodity prices, royalty rates and production costs. Management reviews information as it becomes available and makes changes to its estimations where necessary. Such changes may result in a material impact on the consolidated financial statements.

Significant judgements include the determination of the Company's cash generating units ("CGUs"), which require management to make judgements as to which oil and gas properties can be aggregated into a CGU. The Company's oil and gas assets are aggregated into CGUs for the purpose of calculating impairment and depletion. Factors considered by management include, but are not limited to, the product produced (i.e. oil versus gas), the common infrastructure shared by individual properties, proximity of properties to each other, and planned development activities.

- Decommissioning liabilities:

Amounts recorded for decommissioning obligations and the related accretion expense requires the use of estimates with respect to the amount and timing of decommissioning expenditures. Other provisions are recognised in the period when it becomes probable that there will be a future cash outflow.

- Other provisions:

The consolidated financial statements include accruals and provisions based on management's interpretation of the terms of existing terms and commitments. Best available information is used to determine the accruals at each period end. The Company is at varying stages of negotiations with certain partners to settle differences in opinion of the obligations of each party under existing agreements. The accruals made by management in this regard may be significantly different from those determined by the Company's partners or amounts agreed to as a result of negotiations. The effect on the consolidated financial statements resulting from such adjustments, if any, may be material and will be reflected prospectively.

- The inputs used in the accounting for share-based payments:

Compensation costs recognised for share-based compensation plans are subject to the estimation of what the ultimate payout will be using pricing models such as the Black-Scholes model which is based on significant assumptions such as volatility, dividend yield and expected term.

- Income taxes:

Tax interpretations, regulations and legislation in the jurisdictions in which the Company operates are subject to change. Therefore, income taxes are subject to measurement uncertainty. Deferred income tax assets are assessed by management at the end of the reporting period to determine the likelihood that they will be realised from future taxable earnings. The Company has yet to record any deferred tax assets or liabilities.

**HILLCREST PETROLEUM LTD.**

(formerly Hillcrest Resources Ltd.)

Notes to Consolidated Financial Statements

December 31, 2014

(Expressed in Canadian Dollars Unless Otherwise Stated)

**3. Significant Accounting Policies****Principles of consolidation**

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Hillcrest Exploration Inc., Hillcrest Resources (Arizona) Ltd. and Hillcrest GOM Inc. (formerly Gulfsands Petroleum USA Inc.) ("HGOM"), including HGOM's wholly-owned subsidiary Darcy Energy LLC. All intercompany balances and transactions have been eliminated.

**Foreign currency translation****(i) Functional and presentation currency**

The financial results of foreign operations that have a functional currency different from the presentation currency are translated into the presentation currency. Income and expenditure transactions of foreign operations are translated at the average rate of exchange for the month except for significant individual transactions which are translated at the rate of exchange in effect at the transaction date. All assets and liabilities, including fair value adjustments and goodwill arising on acquisition, are translated at the rate of exchange ruling at the

**3. Significant Accounting Policies (continued)**

reporting date. Differences arising on translation from the transition date are recognized as other comprehensive income.

When the settlement of a monetary item receivable from or payable to a foreign operation is neither planned nor likely in the foreseeable future, foreign exchange gains and losses arising from such a monetary item are considered to form part of the net investment in a foreign operation and are recognized in other comprehensive income. On disposal of part or all of the operations, the proportionate share of the related cumulative gains and losses previously recognized in the comprehensive income are included in determining the profit or loss on disposal of that operation. The consolidated financial statements are presented in Canadian dollars, which is the Company's functional and presentation currency, while the US dollar is the functional currency of the Company's subsidiaries.

**(ii) Transactions and balances**

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions, and from the translation of monetary assets and liabilities denominated in foreign currencies, are recognised in net loss, except for the Company's net investment in its foreign subsidiaries which are recognised in other comprehensive income.

**Cash and cash equivalents**

- a. Cash equivalents consist of highly liquid investments, which are readily convertible into cash and generally have maturities of three months or less when acquired. As of December 31, 2014 and 2013, there were no cash equivalents.
- b. Restricted cash consists of a security deposits for the Company's decommissioning liability. As of December 31, 2014, the security deposits balance was \$2,320,201 (US\$2,000,000) (2013 - \$ nil).

**HILLCREST PETROLEUM LTD.**

(formerly Hillcrest Resources Ltd.)

Notes to Consolidated Financial Statements

December 31, 2014

(Expressed in Canadian Dollars Unless Otherwise Stated)

**3. Significant Accounting Policies (continued)****Exploration and evaluation**

Exploration and evaluation (“E&E”) costs are capitalized for projects after the Company has acquired the legal right to explore but prior to their technical feasibility and commercial viability being confirmed, generally determined as the establishment of proved or probable reserves. These costs may include costs of license acquisition, technical services and studies, seismic acquisition, exploration drilling and testing, directly attributable overhead and administration expenses, including remuneration of production personnel and supervisory management, the projected costs of retiring the assets, and any activities in relation to evaluating the technical feasibility and commercial viability of extracting mineral resources.

Once technical feasibility and commercial viability are confirmed the E&E asset is then reclassified to property and equipment and tested for impairment. For purposes of impairment testing, E&E assets are allocated to the appropriate cash-generating units based on geographic proximity. Expired lease costs are expensed as part of depletion and depreciation expense as they occur and costs incurred prior to the legal right to explore are charged to net income (loss).

**Property and equipment****(i) Cost and valuation**

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

Equipment includes computer equipment which is recorded at cost on initial acquisition. Cost includes the purchase price and the directly attributable costs of acquisition required to bring an asset to the location and condition necessary for the asset to be capable of operating in the manner intended by management. Subsequent expenditure relating to an item of equipment is capitalized when it is probable that future economic benefits from the use of the assets will be increased. All other subsequent expenditure is recognized as repairs and maintenance expenses during the period in which they are incurred.

**(ii) Depletion and depreciation**

The provision for depletion for oil and natural gas assets is calculated based on each asset’s production for the period divided by the Company’s estimated total proved and probable oil and natural gas reserve volumes before royalties for that asset, taking into account estimated future development costs. Production and reserves of natural gas and associated liquids are converted at the energy equivalent ratio of six thousand cubic feet of natural gas to one barrel of oil. Changes in estimates used in prior periods, such as proven and probable reserves, that affect the unit-of-production calculations do not give rise to prior period adjustments and are dealt with on a prospective basis.

Equipment is depreciated on a declining balance basis over the estimated useful life of the asset at the rate of 33% to 55% per annum. Where components of an asset have a different useful life and cost that is significant to the total cost of the asset, depreciation is calculated on each separate component. Depreciation methods, useful lives and residual values are reviewed at the end of each reporting date, and adjusted if appropriate.

**HILLCREST PETROLEUM LTD.**

(formerly Hillcrest Resources Ltd.)

Notes to Consolidated Financial Statements

December 31, 2014

(Expressed in Canadian Dollars Unless Otherwise Stated)

**3. Significant Accounting Policies (continued)****Impairment of non-financial assets**

At each reporting period the carrying amounts of the Company's non-financial assets, other than exploration and evaluation assets, are reviewed for indicators of impairment. If indicators exist, the recoverable amount of the asset is estimated. Exploration and evaluation assets are assessed for impairment when they are reclassified to property and equipment and if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

For purposes of assessing impairment, exploration and evaluation assets and property and equipment are grouped into cash generating units ("CGU") defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows of other assets or groups of assets. The Company has used geographical proximity, geological similarities, analysis of shared infrastructure, commodity type, assessment of exposure to market risks and materiality to define its CGUs.

If the carrying amount exceeds the recoverable amount, the asset or CGU is recorded at its recoverable amount with the reduction recognized in net income (loss) in depletion and depreciation expense. The recoverable amount is the greater of the value in use or fair value less costs to sell. Fair value is the amount the asset could be sold for in an arm's length transaction. The value in use is the present value of the estimated future cash flows of the asset from its continued use. The fair value less costs to sell considers the continued development of a property and market transactions in a valuation model. The Company uses the present value of the cash generating unit's estimated future cash flows from both proved and probable reserves in its fair value model. These calculations are corroborated by valuation multiples, quoted share prices for publicly traded entities or other available fair value indicators.

Impairments are reversed in subsequent periods when there has been an increase in the recoverable amount of a previously impaired asset or CGU and these reversals are recognized in net income (loss). The recovery is limited to the original carrying amount less depletion and depreciation that would have been recorded had the asset not been impaired.

**Impairment of financial assets**

At each reporting date, the Company assesses whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after initial recognition of the asset and that event has an impact on the estimated future cash flows of the financial asset or group of financial assets.

**Decommissioning and restoration costs**

Decommissioning and restoration costs will be incurred by the Company at the end of the operating life of certain of the Company's assets. The ultimate decommissioning and restoration costs are uncertain and cost estimates can vary in response to many factors including changes to relevant legal and regulatory requirements, the emergence of new restoration techniques or experience at other production sites. The expected timing and amount of expenditure can also change, for example in response to changes in reserves or changes in laws and regulations or their interpretation. In determining the amount of the provision, assumptions and estimates are required in relation to discount rates. As a result, there could be significant adjustments to the provisions established which would affect future financial results.

As at December 31, 2014, the Company has accrued \$14,316,628 asset retirement obligations (2013 - \$51,766) related to its oil and gas and mineral exploration properties.

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**3. Significant Accounting Policies (continued)****Provisions**

A provision is recognised if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax “risk-free” rate that reflects current market assessments of the time value of money and the risks specific to the liability. Provisions are not recognised for future operating losses.

**Financial instruments****(i) Non-derivative financial assets**

All financial instruments are classified into one of five categories: financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables, available-for-sale financial assets or other financial liabilities. All financial instruments and derivatives are measured in the statement of financial position at fair value, except for loans and receivables, held-to-maturity investments and other financial liabilities, which are measured at amortized cost. Subsequent measurement and changes in fair value will depend on their initial classification. Financial assets at fair value through profit or loss are measured at fair value and changes in fair value are recognized in net income (loss).

Available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the instrument is derecognized or impaired. Held-to-maturity investments, loans and receivables, and other financial liabilities are initially measured at fair value and subsequently measured at amortized cost. Amortization of premiums or discounts and losses due to impairment are included in current year net income (loss).

The Company has classified its cash and restricted cash as a financial asset at fair value through profit or loss, and accounts receivable as loans and receivables.

The Company derecognizes a financial asset when its contractual obligations to the cash flows from the asset are discharged or cancelled or expire.

**(ii) Non-derivative financial liabilities**

The Company initially recognizes debt securities issued and subordinated liabilities on the date that they are originated. All other financial liabilities (including liabilities designated at fair value through profit or loss) are recognized initially on the trade date at which the Company becomes a party to the contractual provisions of the instrument.

The Company classifies the non-derivative financial liabilities to the following categories: loans and borrowings, bank overdrafts, and trade and other payables. Such financial liabilities are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition these financial liabilities are measured at amortized cost using the effective interest method.

Accounts payable and accrued liabilities, secured loan and unsecured loan, are classified as other financial liabilities. Transaction costs incurred upon the issuance of debt instruments or modification of a financial liability are deducted from the financial liability and are amortized using the effective interest method over the expected life of the related liability.

The Company derecognizes a financial liability when its contractual obligations are discharged or cancelled or expire.

**(iii) Offsetting of financial assets and liabilities**

Financial assets and financial liabilities are offset and the net amount reported in the consolidated statement of financial position if, and only if, there is a currently enforceable legal right to offset the recognized amounts and there is an intention to settle on a net basis, or to realize the assets and settle the liabilities simultaneously.

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**3. Significant Accounting Policies (continued)****Joint operations**

Oil and natural gas operations are conducted jointly with external parties and, accordingly, these consolidated financial statements reflect only the Company's proportionate interest in such activities.

**Revenue recognition**

Revenue from the sale of oil and natural gas is recorded when the significant risks and rewards of ownership of the product is transferred to the buyer, which is usually when legal title passes to the external party, and is based on volumes delivered to customers at contractual delivery points and rates. Delivery is generally at the time the petroleum enters the tank and when natural gas enters the pipeline. The costs associated with the delivery, including operating and maintenance costs, transportation and production-based royalty expenses, are recognized during the same period in which the related revenue is earned and recorded. Revenue is measured net of royalties, discounts and customs duties.

**Share-based payments**

The grant date fair value of share-based payment awards granted to employees is recognized as an employee expense, with a corresponding increase in equity, over the period that the employees unconditionally become entitled to the awards. The amount recognized as an expense is adjusted to reflect the number of awards for which the related service and non-market vesting conditions are expected to be met, such that the amount ultimately recognized as an expense is based on the number of awards that do meet the related service and non-market performance conditions at the vesting date. For share-based payment awards with non-vesting conditions, the grant date fair value of the share-based payment is measured to reflect such conditions and there is no true-up for differences between expected and actual outcomes.

Where equity instruments are granted to parties other than employees, they are recorded by reference to the fair value of the services received. If the fair value of the services received cannot be reliably estimated, the Company measures the services received by reference to the fair value of the equity instruments granted, measured at the date the counterparty renders service.

All equity-settled share-based payments are reflected in contributed surplus, until exercised. Upon exercise, shares are issued from treasury and the amount reflected in contributed surplus is credit to share capital, adjusted for any consideration paid.

**Taxes**

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to a business combination, or items recognized directly in equity or in other comprehensive income.

**i) Current income tax**

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

**ii) Deferred income tax**

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is not recognized for the following temporary differences:

- liabilities arising from initial recognition of goodwill for which amortization is not deductible for tax purposes;
- liabilities arising from the initial recognition of an asset/liability other than in a business combination which, at the time of the transaction, does not affect either the accounting or the taxable profit; and
- liabilities arising from undistributed profits from investments where the entity is able to control the timing of the reversal of the difference and it is probable that the reversal will not occur in the foreseeable future.

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**3. Significant Accounting Policies (continued)****Taxes (continued)**

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

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

## iii) Sales tax

Revenues, expenses and assets are recognized net of the amount of sales tax except:

- Where the sales tax incurred on a purchase of assets or services is not recoverable from the taxation authority, in which case, the sales tax is recognized as part of the cost of acquisition of the asset or as part of the expense item as applicable
- Receivables and payables that are stated with the amount of sales tax included. The net amount of sales tax recoverable from, or payable to, the taxation authority is included as part of receivables or payables in the statement of financial position.

**Basic and diluted earnings (loss) per share**

Earnings (loss) per share are calculated using the weighted-average number of common shares outstanding during the year. In calculating diluted earnings (loss) per share, the Company considers the potential exercise of outstanding share purchase options and warrants to the extent each option, warrant or contingent issuance was dilutive. Potentially dilutive securities were excluded in the computation of diluted loss per share as their inclusion would be anti-dilutive.

**Standards, amendments and interpretations not yet effective**

The following standards and amendments to existing standards have been published and are mandatory for the Company's annual accounting periods beginning January 1, 2015 or later periods:

*Share-based payment (IFRS 2)*

IFRS 2 is amended to clarify the definition of vesting conditions. This accounting policy applies to share-based payment transactions for which the grant date is on or after July 1, 2014.

*Business combinations (IFRS 3)*

IFRS 3 is amended to provide clarification related to (i) contingent consideration in a business combination and (ii) scope exception for joint arrangements. These amendments are effective for fiscal years beginning on or after July 1, 2014.

*Operating segments (IFRS 8)*

IFRS 8 is amended to require (i) disclosure of judgements made by management in aggregating segments, and (ii) a reconciliation of segment assets to the entity's assets when segment assets are reported. These amendments are effective for fiscal years beginning on or after July 1, 2014.

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**3. Significant Accounting Policies (continued)****Standards, amendments and interpretations not yet effective (continued)***Financial instruments (IFRS 9)*

IFRS 9 replaces IAS 39 “Financial Instruments: Recognition and Measurement”, which eliminates the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classifications: amortized cost and fair value. In November 2013, the IASB amended IFRS 9 to include the new general hedge accounting model which remains optional, allows more opportunities to apply hedge accounting, and will be effective on January 1, 2018 and applied retroactively to each period presented.

*Property, plant and equipment (IFRS 16) and intangible assets (IFRS 38)*

IFRS 16 and 38 are amended to classify how gross carrying amount and accumulated depreciation are treated where an entity uses the revaluation model. These amendments are effective for fiscal years beginning on or after July 1, 2014.

*Related party transactions (IFRS 24)*

IFRS 24 is amended to (i) revise definition of “related party” to include an entity that provides key management personnel services to the reporting entity or its parent, and (ii) clarify related party disclosure requirements. These amendments are effective for fiscal years beginning on or after July 1, 2014.

Management anticipates that the above standards will be adopted in the Company’s financial statements for the period beginning January 1, 2015 or later, and currently evaluating the impact of the adoption of these standards.

**4. Capital Management**

The Company manages its capital structure and makes adjustments to it, based on the funds available to the Company, in order to support the acquisition, exploration and development of oil and gas properties. The Board of Directors does not establish quantitative return on capital criteria for management, but rather relies on the expertise of the Company’s management to sustain future development of the business.

The Company is primarily dependent on external financing to fund its activities. In order to carry out the planned exploration and development and pay for administrative costs, the Company will spend its existing working capital and raise additional funds as needed using best efforts. The Company will continue to assess new properties and seek to acquire an interest in additional properties if it feels there is sufficient economic potential and if it has adequate available or committed financial resources to complete such acquisitions.

Management reviews its capital management approach on an ongoing basis and believes that this approach, given the size of the Company, is reasonable.

There were no changes in the Company’s approach to capital management during the year ended December 31, 2014. The Company is not subject to externally imposed capital requirements.

**5. Risk Factors**

The Company’s risk exposures and the impact on the Company’s financial instruments are summarized below:

**Credit risk**

The Company’s credit risk is primarily attributable to cash and accounts receivable. The Company’s maximum exposure to credit risk at the end of the reporting period is the carrying value of these assets. Substantially all of the Company’s customers are in the oil and natural gas industry and are subject to normal industry credit risks. The Company has minimal collection risk related to these receivables and expects to collect the outstanding receivables in the normal course of operations. At December 31, 2014, the maximum credit exposure is the carrying amount of the accounts receivable of \$480,890 (2013 - \$54,489). The Company has no significant concentration of credit risk arising from operations. Cash and cash equivalents are held with reputable financial institutions, from which management believes the risk of loss to be remote.

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**5. Risk Factors (continued)****Liquidity risk**

The Company's approach to managing liquidity risk is to ensure that it will have sufficient liquidity to meet liabilities when due. As at December 31, 2014, the Company had current assets of \$3,681,447 (2013 - \$795,732) to settle current liabilities of \$4,959,008 (2013 - \$534,859).

**Market risk**

Market risk is the risk of loss that may arise from changes in market factor such as interest rates, foreign exchange rates, and commodity and equity prices.

**Interest rate risk**

The Company has cash balances and secured loan bears interest. The Company's current policy is to invest excess cash in investment-grade short-term certificates of deposits issued by its banking institutions. The Company periodically monitors the investments it makes and is satisfied with the credit ratings of its banks.

**Foreign currency risk**

Foreign currency exchange rate risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in foreign exchange rates. The Company operates in Canada and the United States. All of the Company's oil and natural gas sales are denominated in United States dollars.

The Company was exposed to the following foreign currency risk:

	<b>December 31, 2014</b>	December 31, 2013
Expressed in foreign currencies	<b>US\$</b>	US\$
Cash	\$ 485,732	\$ 290,064
Accounts receivable	359,639	51,230
Restricted cash	2,000,000	-
Accounts payable and accrued liabilities	(2,379,703)	(31,784)
	<b>\$ 465,668</b>	<b>\$ 309,510</b>

The following foreign exchange rates applied for the years ended December 31:

	<b>December 31, 2014</b>	December 31, 2013
Year-to-date average USD to CAD	<b>1.1046</b>	1.0300
As at	<b>1.1601</b>	1.0636

The Company has performed a sensitivity analysis on its foreign currency denominated financial instruments. Based on the Company's foreign currency exposure noted above and assuming that all other variables remain constant, a 10% appreciation of the US dollar against the Canadian dollar would result in the increase of net gain of \$46,567 at December 31, 2014 (2013 - increase of net gain of \$30,951). For a 10% depreciation of the above foreign currencies against the Canadian dollar, assuming all other variables remain constant, there would be an equal and opposite impact on net loss.

**Price risk**

The Company is exposed to price risk with respect to commodity and equity prices. Equity price risk is defined as the potential adverse impact on the Company's earnings due to movements in individual equity prices or general movements in the level of the stock market. Commodity price risk is defined as the potential adverse impact on earnings and economic value due to commodity price movements and volatilities. Commodity prices for oil and natural gas are impacted by not only the relationship between the Canadian and US dollar, but also world economic events that dictate the levels of supply and demand. The Company closely monitors commodity prices of natural resources, individual equity movements, and the stock market to determine the appropriate course of action to be taken by the Company.

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**5. Risk Factors (continued)****Financial Instruments**

The Company's financial instruments that are measured at fair value on a recurring basis in periods subsequent to initial recognition and the fair value hierarchy used to measure them are presented in the table below. The Company classifies its other financial assets and other financial liabilities measured at fair value using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

The fair value hierarchy has the following levels:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

Level 3: Inputs for the asset or liability that is not based on observable market data (unobservable inputs).

Cash is measured at Level 1 of the fair value hierarchy.

**6. Property and Equipment**

	<b>Computer</b>	<b>Oil and Gas</b>	
	<b>\$</b>	<b>Interests</b>	<b>Total</b>
		<b>\$</b>	<b>\$</b>
<b>Cost</b>			
Balance at December 31, 2012	13,520	1,648,084	1,661,604
Additions	-	46,584	46,584
Balance at December 31, 2013	13,520	1,694,668	1,708,188
Additions	4,821	15,115,985	15,120,806
Disposals	-	(235,925)	(235,925)
Balance at December 31, 2014	18,341	16,574,728	16,593,069
<b>Accumulated depletion, depreciation and impairment</b>			
Balance at December 31, 2012	12,763	272,685	285,448
Depletion and depreciation for the year	392	320,823	321,215
Balance at December 31, 2013	13,155	593,508	606,663
Depletion and depreciation for the year	188	696,391	696,579
Disposals	-	(43,670)	(43,670)
Balance at December 31, 2014	13,343	1,246,229	1,259,572
<b>Carrying amounts</b>			
Balance at December 31, 2013	365	1,101,160	1,101,525
Balance at December 31, 2014	4,998	15,328,499	15,333,497

**Hartburg Project, Newton County, Texas**

By agreement dated December 8, 2009, the Company entered into an Assignment and Assumption Agreement for the assignment of a 60% working interest in certain land leases known as the Hartburg Project in Newton County, Texas. In consideration the Company paid a lump sum of \$117,040 (US\$111,266). The Company is responsible for their proportionate share of all future costs of the development of the property.

On March 27, 2009, Barry Lasker ("Lasker") and Delta Oil and Gas, Inc. ("Delta") entered into an exploration agreement (the "Exploration Agreement"). Pursuant to the terms of the Exploration Agreement, Lasker agreed

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**6. Property and Equipment (continued)****Hartburg Project, Newton County, Texas (continued)**

to identify and secure leases which would subsequently be assigned to Delta and pursuant to the terms of such agreement, Delta agreed to pay 100% of the lease acquisition costs and operating costs of up to three wells. In exchange for Lasker's performance under the Exploration Agreement, Lasker obtained a 10% carried interest in the first target well, Donner #1, and a 20% carried interest in the second and third target wells, Prospect 1 (Donner #2) and Prospect 2 (Donner #4), respectively, until payout in each of the wells. Upon payout, Lasker's carried interest converted to a 50% working interest in Donner #1 and a 40% working interest in each of Prospect 1 and Prospect 2.

On December 30, 2010, Delta entered into an agreement (the "HRI Assignment") with the Company to assign 60% of all of Delta's right, title and interest in and to the Exploration Agreement.

The effect of the Exploration Agreement and the HRI Assignment was to create the following net revenue interests to the Company in Donner #1, Donner #2, and Donner #4:

Donner #1

Before payout	48%
After payout	22.5%

Donner #2 and Donner #4

Before payout	48%
After payout	27%

During March 2014, the Donner 4 well was completed and placed into production. This well is part of the Hartburg Project and is located 500 feet southwest of the Company's Donner #1 well.

On February 24, 2014, the Company commenced drilling of the Brown 1 well in the Hartburg project. The well was completed and placed into production on April 9, 2014.

**Livingston Property, Polk County, Texas**

By agreement dated November 1, 2009, the Company entered into an Assignment of Oil and Gas Lease and Bill of Sale for the assignment of a 30% working interest and a 22.5% net revenue interest in certain oil and gas leases known as the Livingston property in Polk County, Texas. In consideration the Company paid a lump sum of \$96,120 (US\$90,000). The Company is responsible for their proportionate share of all future costs of the development of the property.

On June 1, 2014, the Company agreed to sell the property for \$135,525 (US\$125,000) to NADSOILCO LLC. The net carrying value of the property at June 1, 2014, was \$174,495, resulting in a loss on sale of \$38,970.

**Tulla Property, Teton and Pondera County, Texas**

On November 1, 2011 the Company entered into a purchase and sale agreement with Washington-based Longshot Oil LLC, with respect to the acquisition by the Company from Longshot of certain oil and gas properties in Pondera county, Montana. Pursuant to the terms of the purchase and sale agreement, the Company acquired Longshot's legal and beneficial right, title and interest in and to certain oil and gas properties in Pondera county, Montana, including all oil and gas leases, all geological and geophysical data (including all seismic data) and copies of all records with respect to such oil and gas properties. As consideration for the acquisition of the properties, the Company paid Longshot \$350,000 in cash. During August 2012, the Company sold the property for its net book value to Bakken Oil Holdings LLC. ("Bakken"), and Bakken forgave the remaining amount owing on the Woodrow Montana Project (Note 7).

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**6. Property and Equipment (continued)****Gulf of Mexico Properties**

On December 19, 2014, the Company completed the purchase of Gulfsands Petroleum USA Inc. ("GPUSA"), which was subsequently renamed Hillcrest GOM Inc. ("HGOM"), and is now a wholly owned subsidiary of the Company. HGOM holds a portfolio of non-operated oil and gas properties, which are located in the Gulf of Mexico, within the shallow water "shelf" region offshore Louisiana. These comprise 10 leases containing 5 producing fields. Working interests in these leases range from approximately 4% to 26%. With the acquisition, the Company assumed its share of the forward decommissioning liability for the facilities and wells. The decommissioning liability is a mix of relatively near term to longer term obligations that largely occur at the end of productive field life (Note 12).

**7. Exploration and Evaluation Assets**

	<b>Total</b>
	<b>\$</b>
Balance at December 31, 2012	2,023,670
Additions	555,969
Sales proceeds	(653,687)
Balance at December 31, 2013	1,925,952
Reclassified to oil & gas properties	(979,862)
Additions	833,622
Sales proceeds	(359,102)
Loss on disposal	(3,350)
Balance at December 31, 2014	1,417,260

**Montana Project with Longshot Oil, LLC – Muddy Creek**

On September 26, 2011, the Company entered into a purchase and sale agreement with Longshot Oil, LLC, a private company with common management and shareholders with Bakken Oil Holdings, with the acquisition of certain oil and gas properties in Teton County, Montana. The Company will issue 1,000,000 common shares of the Company at a fair value of \$0.25 per share and pay \$400,000 in cash.

On September 2, 2013, the Company entered into a Letter of Intent with Nelan Advisors Corporation ("Nelan") pursuant to which Nelan has the right to farm in to a 50% working interest in the Company's oil and gas interests and related rights to the oil and gas leases in Montana. Pursuant to the Letter of Intent, the Company received an aggregate of US\$400,000 as consideration for the farm in. A non-refundable deposit of \$52,460 (US\$50,000) was received on September 4, 2013. On October 15, 2013, the Company signed a purchase and sale agreement with Nelan Advisors Corporation, at which time a further \$51,770 (US\$50,000) was paid to the Company. Remaining cash due to the Company was received in three installments at 60 day intervals following the signing of the Definitive Agreement. \$106,082 (US\$100,000) was received on December 16, 2013, \$110,170 (US\$100,000) was received on February 21, 2014, and \$109,770 (US\$100,000) was received on April 15, 2014. During the year ended December 31, 2014, the Company recognized a gain on sale of working interest of \$84,546.

Costs as at December 31, 2014 were \$345,706 (2013 - \$481,100).

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**7. Exploration and Evaluation Assets (continued)****Montana Project with Bakken Oil Holdings LLC - Woodrow**

On November 30, 2011 the Company entered into a purchase and sale agreement with Bakken Oil Holdings, LLC to acquire certain oil and gas properties in Teton and Pondera Counties, Montana comprising approximately 12,333 acres. As consideration, the Company will issue 4,000,000 warrants exercisable at \$0.20 per share for a period of 24 months and pay \$1,000,000 in cash. During August 2012, the Company signed an agreement, whereby Bakken forgave the remaining amount owing in return for the Tulla property. The agreement also cancelled the requirement for the Company to issue 4,000,000 warrants at a price of \$0.20 per share.

On August 14, 2013, the Company signed a definitive agreement with West Bakken Holdings Ltd giving them the right to farm in to the working interest of the Company. The agreement, when completed, includes 50% in the oil and gas interests, and properties and related rights and interests to the oil and gas leases in Montana, comprising 12,333 gross acres in Teton county. Pursuant to the agreement, the Company will receive a total of US\$550,000 as consideration for the farm in. A non-refundable deposit of \$52,550 (US\$50,000) was received on July 3, 2013, \$129,238 (US\$125,000) was received on August 16, 2013, and \$129,175 (US\$125,000) was received on October 16, 2013 and \$132,413 (US\$125,000) was received on December 11, 2013. The final \$139,163 (US\$125,000) was received on February 21, 2014. During the year ended December 31, 2014, the Company recognized a loss on sale of working interest of \$87,897.

The costs as at December 31, 2014 were \$670,434 (2013 - \$897,493).

**Donner Prospect – 78 acres, Newton County**

On August 1, 2013, Bazmo Exploration Inc., (“Bazmo”) and the Company entered into an exploration agreement (the “Exploration Agreement”) for US\$92,746. Pursuant to the terms of the Exploration Agreement, Bazmo agreed to identify and secure leases which would subsequently be assigned to the Company and pursuant to the terms of such agreement, the Company agreed to pay 100% of the lease acquisition costs and operating costs of all wells drilled. In exchange for Bazmo’s performance under the Exploration Agreement, Bazmo obtained a 10% carried interest in all target wells, until payout in each of the wells. Upon payout, Bazmo’s carried interest will convert to a 50% working interest in all target wells. The costs as at December 31, 2014 were \$401,120 (2013 - \$297,272).

**8. Acquisition**

On December 19, 2014, the Company completed a Share Purchase Agreement (the “SPA”) to acquire all of the issued and outstanding common shares of Hillcrest GOM Inc., (formerly Gulfsands Petroleum USA) in consideration of \$58,195 (US\$50,000). HGOM holds a portfolio of non-operated oil and gas properties, which are located in the Gulf of Mexico, within the shallow water "shelf" region offshore Louisiana.

The acquisition has been accounted for as a business combination, with the Company being the acquirer for accounting purposes. The assets acquired and liabilities assumed from HGOM are as follows:

Cash	487,741
Restricted cash	2,321,601
Accounts receivable	827,015
Prepaid expenses	213,177
Oil and gas properties	13,325,092
Equipment	4,824
Accounts payable and accrued liabilities	(3,040,683)
Abandonment reserve	(14,206,168)
<b>Net assets acquired</b>	<b>\$ 67,401</b>

The difference between the purchase consideration and book values of HGOM’s net assets has been assigned to oil and gas properties. In connection with the acquisition, the Company incurred acquisition-related costs of \$15,769, which have been expensed and included in net loss.

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**9. Accounts payable and accrued liabilities**

Included in accounts payable and accrued liabilities are:

- a. Civil penalties of \$382,833 (US\$330,000) – The Office of Natural Resource Revenue (ONRR) assessed a civil penalty for failure to timely file corrections to monthly reports for plant products sold during the period 2007-2008. Subsequent to the year ended December 31, 2014, the Company entered into an Installment Agreement with ONRR for payment of the remaining balance (Note 18).
- b. Provision for repair of an oil rig of \$1,450,125 (US\$1,250,000) – The Company has accrued US\$1,250,000 for costs and expenses related to the operation of certain properties which the operator has billed but are disputed by the Company and the other partners. The Company is currently in settlement discussions with the operator to resolve the disputed charges.

**10. Secured Loan**

On July 19, 2013, the Company closed its initial draw of \$1,000,000 (the “Initial Draw”) pursuant to a senior secured loan facility of up to \$2,000,000 arranged with Ascendant Securities Inc. (“ASI”) on behalf of a group of clients of ASI (the “Lenders”). An additional \$1,000,000 may be drawn at the option of the Company subject to the terms and conditions of a trust indenture between the Company and ASI. In connection with the Initial Draw, the Company has issued senior secured debentures of the Company (the “Debentures”) in an aggregate principal amount of \$1,000,000. The Debentures will bear interest at a rate of 15% per annum, compounded monthly. The principal amount of the Debentures evidencing the Initial Draw will mature on July 18, 2015. As part of the consideration for the Loan Facility, the Lenders received an aggregate 6% overriding royalty interest in the Company’s proceeds from all oil, gas and other hydrocarbons produced from any new wells developed on the Company’s Donner Properties using any portion of the proceeds from the Initial Draw. The Company has paid ASI a cash agent’s fee of \$60,000, the first installment of an annual monitoring fee of \$25,000 and a 2% overriding royalty interest on the Company’s proceeds from all oil, gas and other hydrocarbons produced from any well, for acting as collateral agent. The Company also issued an aggregate of 1,200,000 Agent Warrants. The Agent Warrants entitle the holder thereof to purchase up to 1,200,000 common shares of the Company at a price of \$0.10 per share until July 18, 2015.

On September 9, 2014, the Company amended the senior secured loan terms such that if the principle payments were not paid, then the Company would pay \$4,000 plus 15% interest on the outstanding principle, and the overriding royalty interest will be increased to 10% of the net revenue interest received by the Company on its Brown #1 and Donner #4 wells. The Company will also forward the revenue received from Brown #1 and Donner #4 less Joint Interest Billing on these wells on the 19<sup>th</sup> of each month until the Company has paid all past outstanding principle payments. These latter payments will be considered as part payment of the principle amount due. During the year ended December 31, 2014, the Company incurred interest expense of \$170,000 (2013 - \$67,432) and overriding royalty interest of \$44,875 (2013 - \$nil).

**11. Unsecured Loan**

On September 8, 2014, the Company obtained an unsecured loan of \$50,000. The loan carries an interest rate of 10% per annum and payable on maturity. The Company shall pay \$3,000 per month commencing on October 8, 2014 and on the 8<sup>th</sup> day of each month thereafter. The Company may renew the loan agreement for an additional three years period.

The table below reflects the change in the unsecured loan during the years ended December 31, 2014 and 2013:

	<b>December 31, 2014</b>	<b>December 31, 2013</b>
Balance, beginning of the year	\$ -	\$ -
Loan received	50,000	-
Payout	(6,000)	-
Interest accrued	1,498	-
Balance, end of the year	<u>\$ 45,498</u>	<u>\$ -</u>

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**12. Decommissioning Liability**

The decommissioning liability for the Gulf of Mexico properties relates to the expected present value of costs of plugging and abandoning the exploration and development assets held by Hillcrest GOM Inc. (formerly Gulfsands Petroleum USA, Inc.) and Darcy Energy LLC. The provision for decommissioning is estimated after taking account of inflation, years to abandonment and an appropriate discount rate. At December 31, 2014, the oil and gas properties had estimated abandonment dates between 2015 and 2025.

Actual decommissioning costs will ultimately depend upon future market prices for the decommissioning work required, which will reflect market conditions at the relevant time. Furthermore, the timing of decommissioning is likely to depend on when the fields cease to produce at economically viable rates. This in turn will depend upon future oil and gas prices, which are inherently uncertain. The actual amounts paid for decommissioning may ultimately vary significantly from the provision at December 31, 2014, requiring potentially material adjustments to the carrying value of the obligations.

The movement in the provision for the decommissioning liability was as follows:

	Hartburg Project, Texas	Gulf of Mexico Properties	Total
Balance, beginning of year	\$ 51,766	\$ -	\$ 51,766
Additions	47,256	-	47,256
Assumed upon acquisition of Hillcrest GOM Inc.	-	14,197,579	14,197,579
Accretion	5,244	14,783	20,027
Balance, end of the year	\$ 104,266	\$ 14,212,362	\$ 14,316,628
Current portion	\$ -	\$ 898,053	\$ 898,053
Non-current portion	104,266	13,314,309	13,418,575
	\$ 104,266	\$ 14,212,362	\$ 14,316,628

The total undiscounted amount of estimated cash flows required to settle the provision for decommissioning liability for the Hartburg Project and the Gulf of Mexico Properties is \$145,200 (US\$125,162) and \$14,544,877 (US\$12,537,606), respectively, as at December 31, 2014. The provision has been estimated using risk-free discount rates ranging from 3% to 12%, and inflation rates ranging from 2.0% to 2.5%.

**13. Share Capital**

Authorized:

Unlimited number of common shares without par value

Issued and outstanding:

Year Ended December 31, 2014

**Issued for Cash**

On July 25, 2014, the Company issued 100,000 common shares pursuant to the exercise of 100,000 options at \$0.06 per share for total proceeds of \$6,000.

On December 30, 2014, the Company closed a non-brokered private placement and issued 10,625,000 common shares at \$0.05 per unit for aggregate gross proceeds of \$531,250. Each unit consists of one common share and one-half of one common share purchase warrant, with each full warrant being exercisable to acquire one common share at \$0.08 per share until December 30, 2016. The Company also paid a finders' fee of \$8,000 and issued 160,000 Agent's warrants. The Agent's warrants have an exercise price of \$0.08 per share and are exercisable until December 30, 2015. The Agent's warrants were valued at \$6,669 using the Black Scholes option pricing model with weighted average assumptions of an expected life of one year, dividend yield of 0%, expected volatility of 126%, and risk-free rate of return of 1.02%.

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**13. Share Capital (continued)**

*Year Ended December 31, 2013*

During the year ended December 31, 2013, the Company did not issue any common shares.

**Share Purchase Warrants**

During the year ended December 31, 2014, the Company extended the expiring date of 853,111 share purchase warrants to February 28, 2015, each warrant is exercisable for one common share at \$0.12 per share. Subsequent to the year end the expiry date was extended to February 28, 2016. The Company also issued 5,312,500 share purchase warrants pursuant to private placements. Each warrant is exercisable for one common share at \$0.08 per share expiring on December 30, 2016. The following table summarises share purchase warrant transactions:

	<b>December 31, 2014</b>		December 31, 2013	
	<b>Number of Warrants</b>	<b>Weighted Average Exercise Price</b>	Number of Warrants	Weighted Average Exercise Price
Balance, beginning of year	853,111	\$ 0.12	853,111	\$ 0.12
Issued	5,312,500	0.08	-	-
Exercised	-	-	-	-
Expired	-	-	-	-
Balance, end of year	<b>6,165,611</b>	<b>\$ 0.09</b>	853,111	\$ 0.12

**Agent's Warrants**

On July 19, 2013, the Company issued senior secured debentures of the Company in an aggregate principal amount of \$1,000,000. The Company also issued an aggregate of 1,200,000 Agent's warrants which entitle the holder to purchase up to 1,200,000 common shares of the Company at a price of \$0.10 per share until July 18, 2015. Refer to Note 10.

On February 28, 2014, 111,600 Agent's warrants expired in full.

On December 30, 2014, the Company issued 160,000 Agent's warrants with an exercise price of \$0.08 per share and exercisable until December 30, 2015, pursuant to a non-brokered private placement.

The following table summarises Agent's warrant transactions:

	<b>December 31, 2014</b>		December 31, 2013	
	<b>Number of Agent's Warrants</b>	<b>Weighted Average Exercise Price</b>	Number of Warrants	Weighted Average Exercise Price
Balance, beginning of year	1,311,600	\$ 0.11	547,667	\$ 0.20
Issued	160,000	0.08	1,200,000	0.10
Expired	(111,600)	0.18	(436,067)	0.20
Balance, end of year	<b>1,360,000</b>	<b>\$ 0.10</b>	1,311,600	\$ 0.11

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**13. Share Capital (continued)****Stock Options**

Effective November 4, 2010, the Company adopted a stock option plan to grant stock options to its directors, officers, employees and consultants. Subjective to the requirement of the TSX Venture Exchange (the "Exchange"), the aggregate number of securities reserved for issuance under the plan, at any point in time, will be 10% of the number of common shares of the Company issued and outstanding at the time the option is granted (on a diluted basis), less any common share reserved for issuance under share options granted under share compensation arrangements other than the plan. The exercise price of option grants will be determined by the Board of Directors, but will not be less than the closing market price of the common shares on the Exchange less allowable discounts at the time of grant. All options granted under the plan will expire not later than the date that is five years from the date that such options are granted.

On September 9, 2013, the Company granted 1,750,000 stock options to officers, directors and consultants of the Company. The stock options are exercisable for a period of 5 years from the date of listing on the TSX Venture Exchange ("Listing") at an exercise price of \$0.06 per common share. The stock options granted vested immediately. Total stock-based compensation expense of \$82,446 has been charged to operations. The weighted average fair value of the options granted was \$0.05 per option.

On November 26, 2013, the Company granted 600,000 stock options to officers, directors and consultants of the Company. The stock options are exercisable for a period of 5 years from the date of listing on the TSX Venture Exchange ("Listing") at an exercise price of \$0.06 per common share. The stock options granted vested immediately. Total stock-based compensation expense of \$30,756 has been charged to operations. The weighted average fair value of the options granted was \$0.05 per option.

On November 26, 2013, the Company granted 400,000 stock options to a consultant for investor relations. The stock options are exercisable for a period of 5 years from the date of listing on the TSX Venture Exchange ("Listing") at an exercise price of \$0.06 per common share. The stock options granted have a vesting period of 25% that vest over the next 12 months at three month intervals. Total stock-based compensation expense of \$11,779 has been charged to operations for the year ended December 31, 2014 (2013 - \$8,725). The weighted average fair value of the options granted was \$0.05 per option.

The fair value of the option granted was estimated on the date of grant using the Black-Scholes option pricing model with the following weight average assumptions:

	<u>December 31, 2014</u>	<u>December 31, 2013</u>
Dividend yield	Nil	Nil
Expected volatility	125 to 128%	128 to 130%
Risk-free rate of return	1.46 to 1.63%	1.71 to 2.12%
Expected life of options	4 – 5 years	5 years

	<b>Number of</b>	<b>Weighted</b>	<b>Number of</b>	<b>Weighted</b>
	<b>Stock Options</b>	<b>Average</b>	<b>Stock Options</b>	<b>Average</b>
		<b>Exercise Price</b>		<b>Exercise Price</b>
Outstanding, beginning of year	4,600,000	\$ 0.12	2,825,000	\$ 0.21
Granted	-	-	2,750,000	0.06
Cancelled	(1,550,000)	(0.15)	-	-
Exercised	(100,000)	(0.06)	-	-
Expired	-	-	(975,000)	(0.22)
Outstanding, end of year	<b>2,950,000</b>	<b>\$ 0.11</b>	4,600,000	\$ 0.12
Exercisable, end of year	<b>2,950,000</b>	<b>\$ 0.11</b>	4,300,000	\$ 0.13

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**13. Share Capital (continued)****Stock Options (continued)**

The 2,950,000 stock options outstanding at December 31, 2014 expire as follows:

<b>Number of shares</b>	<b>Exercise Price /Share</b>	<b>Expiry date</b>
650,000	\$ 0.20	March 22, 2016
250,000	\$ 0.25	September 26, 2016
1,550,000	\$ 0.06	September 9, 2018
500,000	\$ 0.06	November 26, 2018
<b>2,950,000</b>		

The weighted average remaining contractual life of these outstanding options is 3.23 years. The weighted average grant date fair value of these options are \$0.11 per option.

**14. Related Party Transactions**

Related party transactions are with directors and a company controlled by a director and officer of the Company.

The following summarizes the Company's related party transactions during the years ended December 31, 2014, and 2013:

	<b><u>2014</u></b>	<b><u>2013</u></b>
Consulting fees to the Chief Executive Officer of the Company	<b>\$ 90,000</b>	\$ 90,000
Consulting and accounting fees to companies controlled by the Chief Financial Officer of the Company	<b>\$ 78,000</b>	\$ 73,500
Consulting Fees to Directors of the Company	<b>\$ 72,056</b>	\$ 54,085
Salaries paid to an Officer	<b>\$ 11,618</b>	\$ nil

As at December 31, 2014, the Company owed \$10,618 (2013 - \$10,131) to the Chief Executive Officer which is included in accounts payable and accrued liabilities. Stock-based compensation of \$nil was recognised during the year ended December 31, 2014 (2013 - \$68,117), related to stock options granted to directors and officers.

These transactions are in the normal course of operations and are measured at the exchange amount of consideration established and agreed to by the related parties.

**15. Geographical Segmented Information**

The Company is engaged in one business activity, being the acquisition, exploration, development and production of oil and gas reserves. The two geographical segments are Canada and United States. All non-current assets, revenue and operating costs are held solely in the United States segment.

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**16. Commitments**

The Company entered into a rental agreement on June 3, 2013, with a term of 50 months, terminating on July 31, 2017. The base rent payable under the lease is as follows:

Period	Annual Base Rent (USD) \$
January 1, 2015 to July 31, 2015	US\$ 55,545
August 1, 2015 to July 31, 2016	98,105
August 1, 2016 to July 31, 2017	101,031
	<u>US\$ 386,812</u>

In addition to the above base rent, the Company's share of the operating costs for calendar year 2015 is US\$5,306 per month.

**17. Income Taxes**

The Company has accumulated non-capital losses for tax purposes of approximately \$46,384,000 (2013–\$1,169,000), which begin to expire commencing in 2024.

Future income tax assets and liabilities are recognized for temporary differences between the carrying amounts of the balance sheet items and their corresponding tax values as well as for the benefit of losses available to be carried forward to future years for tax purposes that are more likely than not to be realized.

The reconciliation of income tax benefit computed at statutory rates to the reported income tax benefit is as follows:

	<u>2014</u>	<u>2013</u>
Income (loss) before income taxes	\$ 1,184,000	\$ 684,000
Statutory income tax rate	26.00%	25.74%
Expected income tax recovery (expense)	\$ 308,000	\$ 176,000
Non-deductible items	(197,000)	(106,000)
Change in tax rates	-	14,000
Difference in tax rates between foreign jurisdictions	5,000	-
Change in valuation allowance	(116,000)	(84,000)
Income tax recovery (expense)	<u>\$ -</u>	<u>\$ -</u>

Significant components of the Company's future tax assets and liabilities, after applying substantially enacted corporate income tax rates, are as follows:

	<u>2014</u>	<u>2013</u>
Future income tax assets:		
Non-capital losses	\$ 12,060,000	\$ 304,000
Property and equipment	(1,465,000)	(508,000)
Share issue costs	132,000	163,000
	<u>(10,727,000)</u>	<u>(41,000)</u>
Valuation allowance for future income tax assets	10,727,000	41,000
	<u>\$ -</u>	<u>\$ -</u>

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**18. Subsequent Events**

- a. On February 12, 2015, the Company entered into an Installment Agreement with the United States Department of the Interior and through the Office of Natural Resources Revenue (ONRR) in connection with civil penalties (Note 9(a)). The Company agreed to pay the balance of civil penalties of US\$313,176 in 60 monthly installments of US\$5,220 beginning on March 12, 2015. The first and second installments have been made and subsequent installment payments will be due on the 12th of each month until the 60th installment of US\$5,220 is paid on February 12, 2020.
- b. On February 18, 2015, the Company extended the expiry date of 853,111 warrants from February 28, 2015 to February 28, 2016.
- c. Effective March 10, 2015, the Company changed its name to Hillcrest Petroleum Ltd.