



## **Consolidated Financial Statements December 31, 2009 and 2008**

**March 25, 2010**

***Epsilon Energy Ltd.  
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Concord, ON, Canada L4K 3P9***

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## MANAGEMENT'S REPORT

The consolidated financial statements of Epsilon Energy Ltd. were prepared by management within acceptable limits of materiality and are in accordance with Canadian generally accepted accounting principles. Management is responsible for ensuring that the financial and operating information presented in this annual report is consistent with that shown in the consolidated financial statements. Timely release of financial information sometimes necessitates the use of estimates when transactions affecting the current accounting period cannot be finalized until future periods. When necessary, such estimates are based on informed judgments made by management.

Management has designed and maintains an appropriate system of internal controls to provide reasonable assurance that all assets are safeguarded and financial records properly maintained to facilitate the preparation of consolidated financial statements for reporting purposes.

Deloitte & Touche LLP, an independent firm of Chartered Accountants appointed by the shareholders, has conducted an examination of the corporate and accounting records in order to express their opinion on the consolidated financial statements. The Audit Committee, consisting of three independent directors, has met with representatives of Deloitte & Touche LLP and management in order to determine if management has fulfilled its responsibilities in the preparation of the consolidated financial statements. The Board of Directors has approved the consolidated financial statements.

(signed)

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Zoran Arandjelovic  
President and Chief Executive Officer  
March 25, 2010

## AUDITORS' REPORT

To the Shareholders of  
Epsilon Energy Ltd.

We have audited the consolidated balance sheets of Epsilon Energy Ltd. as at December 31, 2009 and 2008 and the consolidated statements of operations and deficit, comprehensive loss and accumulated other comprehensive loss and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the corporation as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Calgary, Alberta  
March 19, 2010

(signed) "Deloitte & Touche LLP"  
Chartered Accountants

**EPSILON ENERGY LTD.**  
**Consolidated Balance Sheets**  
*(All amounts stated in US\$)*

	<u>December 31, 2009</u>	<u>December 31, 2008</u>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents .....	\$ 15,288,547	\$ 8,233,442
Accounts receivable .....	1,488,429	7,139,107
Notes receivable .....	-	359,401
Assets held for sale (Note 4 and Note 14) .....	100,000	-
Other current assets .....	62,382	262,979
Total current assets .....	<u>16,939,358</u>	<u>15,994,929</u>
<b>Property and equipment:</b>		
Net property and equipment (Note 4) .....	<u>66,691,074</u>	<u>84,353,485</u>
<b>Other assets:</b>		
Restricted cash (Note 5) .....	732,240	33,703,308
Other deferred charges and miscellaneous assets .....	18,504	17,842
Total other assets .....	<u>750,744</u>	<u>33,721,150</u>
<b>Total assets</b> .....	<u>\$ 84,381,176</u>	<u>\$ 134,069,564</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued liabilities .....	\$ 3,460,740	\$ 14,671,041
Line of credit (Note 5) .....	-	19,184,134
Total current liabilities .....	<u>3,460,740</u>	<u>33,855,175</u>
<b>Other liabilities:</b>		
Asset retirement obligations .....	214,393	319,763
Future income tax liabilities (Note 7) .....	-	2,600,000
Total other liabilities .....	<u>214,393</u>	<u>2,919,763</u>
<b>Total liabilities</b> .....	<u>3,675,133</u>	<u>36,774,938</u>
<b>Commitments and contingencies</b> (Note 8) .....		
<b>Related party transactions</b> (Note 10) .....		
<b>Subsequent events</b> (Note 14) .....		
<b>Shareholders' equity:</b>		
Share capital (Note 6) .....	138,272,250	138,259,259
Contributed surplus (Note 6) .....	6,098,296	5,401,361
Deficit .....	(56,787,577)	(36,558,958)
Accumulated other comprehensive loss .....	(6,876,926)	(9,807,036)
Sub total .....	<u>(63,664,503)</u>	<u>(46,365,994)</u>
Total shareholders' equity .....	<u>80,706,043</u>	<u>97,294,626</u>
<b>Total liabilities and shareholders' equity</b> .....	<u>\$ 84,381,176</u>	<u>\$ 134,069,564</u>

APPROVED ON BEHALF OF THE BOARD OF DIRECTORS
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(signed) Nick Orlando

(signed) Raymond Savoie

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

**EPSILON ENERGY LTD.**  
**Consolidated Statements of Operations and Deficit**  
*(All amounts stated in US\$)*

	<b>Years Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Revenues:</b>		
Oil and natural gas revenues .....	\$ 5,305,603	\$ 8,012,317
Natural gas gathering fees .....	133,248	287,232
Total revenues .....	5,438,851	8,299,549
<b>Operating costs and expenses:</b>		
Project operating costs.....	1,340,333	1,792,252
Impairment of unproved properties (Note 4).....	18,783,896	34,099,133
Depletion, depreciation and accretion .....	3,458,197	2,071,421
General and administrative.....	4,611,219	7,518,847
Total operating costs and expenses .....	28,193,645	45,481,653
<b>Operating loss</b> .....	<b>(22,754,794)</b>	<b>(37,182,104)</b>
<b>Other income:</b>		
Gain on sale of assets (Note 4).....	2,750,757	5,013,129
Interest and other income (expense).....	(224,582)	1,081,059
Total other income.....	2,526,175	6,094,188
<b>Net loss before income taxes</b> .....	<b>(20,228,619)</b>	<b>(31,087,916)</b>
<b>Income taxes:</b>		
Future income tax expense (Note 7).....	-	2,600,000
<b>Net loss</b> .....	<b>(20,228,619)</b>	<b>(33,687,916)</b>
<b>Deficit, beginning of year</b> .....	<b>(36,558,958)</b>	<b>(2,871,042)</b>
<b>Deficit, end of year</b> .....	<b>\$ (56,787,577)</b>	<b>\$ (36,558,958)</b>
<b>Basic and diluted loss per share</b> .....	<b>\$ (0.40)</b>	<b>\$ (0.71)</b>
<b>Weighted average number of shares outstanding</b> .....	<b>50,325,998</b>	<b>47,504,436</b>

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

**EPSILON ENERGY LTD.**  
**Consolidated Statements of Cash Flows**  
*(All amounts stated in US\$)*

	<b>Years Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Cash flows from operating activities:</b>		
Net loss for the year	\$ (20,228,619)	\$ (33,687,916)
Items not involving cash:		
Depletion, depreciation and accretion.....	3,458,197	2,071,421
Impairment of unproved properties.....	18,783,896	34,099,133
Stock based compensation .....	706,428	1,846,518
Gain on sale of assets .....	(2,750,757)	(5,013,129)
Future income tax expense (Note 7) .....	-	2,600,000
Changes in non-cash working capital (Note 11).....	(522,957)	(8,512,486)
Net cash used in operating activities.....	(553,812)	(6,596,459)
<b>Cash flows from investing activities:</b>		
Property and equipment .....	(35,293,288)	(47,610,971)
Proceeds from assets sold (Note 4) .....	25,563,340	6,768,025
Changes in restricted cash (Note 5) .....	32,971,068	(32,603,308)
Changes in notes receivable and other current assets .....	358,739	501,270
Net cash provided by (used in) investing activities .....	23,599,859	(72,944,984)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common shares and warrants and (issuance costs) (Note 11) .....	12,991	31,256,168
Re-purchase of common shares (Note 11) .....	-	(691,405)
Change in line of credit and notes payable (Note 5).....	(19,184,134)	19,184,134
Net cash provided by (used in) financing activities .....	(19,171,143)	49,767,896
<b>Effect of currency rates on cash and cash equivalents .....</b>	3,180,201	(9,068,611)
Increase (Decrease) in cash.....	7,055,105	(38,842,158)
Cash and cash equivalents, beginning of year .....	8,233,442	47,075,600
<b>Cash and cash equivalents, end of year.....</b>	<b>\$ 15,288,547</b>	<b>\$ 8,233,442</b>
<b>Cash and cash equivalents consist of:</b>		
Cash.....	\$ 1,096,099	\$ 5,009,389
Interest bearing short-term deposits.....	14,192,448	3,224,053
Total cash and cash equivalents .....	\$ 15,288,547	\$ 8,233,442
<b>Supplementary cash flow information:</b>		
Interest received .....	\$ 262,999	\$ 1,430,515
Interest paid.....	\$ 448,885	\$ 75,058
Income taxes paid.....	\$ -	\$ -
Income taxes received.....	\$ -	\$ -

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

**EPSILON ENERGY LTD.**  
**Consolidated Statements of Comprehensive Loss**  
**and Accumulated Other Comprehensive Loss**  
*(All amounts stated in US\$)*

	<b>Years Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Comprehensive loss:</b>		
Net loss .....	\$ (20,228,619)	\$ (33,687,916)
Other comprehensive loss:		
Currency translation adjustments .....	2,930,110	(9,068,611)
<b>Comprehensive loss</b> .....	<b>\$ (17,298,509)</b>	<b>\$ (42,756,527)</b>
 <b>Accumulated Other Comprehensive loss:</b>		
Balance, beginning of period.....	\$ (9,807,036)	\$ (738,425)
Currency translation adjustments .....	2,930,110	(9,068,611)
<b>Comprehensive loss</b> .....	<b>\$ (6,876,926)</b>	<b>\$ (9,807,036)</b>

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

**Epsilon Energy Ltd.**  
**Notes to the Consolidated Financial Statements**  
**As at December 31, 2009 and 2008**  
*(All amounts stated in US\$)*

## **1. Description of Business**

Epsilon Energy Ltd. (the “Corporation”) was incorporated under the laws of the Province of Alberta on March 14, 2005. The Corporation is engaged in the acquisition, exploration, development and production of natural gas and oil reserves. Such activities are concentrated in the following geographic areas:

- Marcellus Shale (“Pennsylvania” and “New York”) and Trenton-Black River in the United States;
- Bakken Shale (“Saskatchewan”) and Utica Shale (“Quebec”) Canada; and
- the Federal Democratic Republic of Ethiopia (“Ethiopia”)

## **2. Significant Accounting Policies**

### ***(a) Basis of Presentation***

The Corporation’s consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

All currency amounts are in U.S. dollars (“US\$”), unless stated otherwise.

In 2008 and continuing into 2010, the global credit market crisis, the volatility in the price of oil and natural gas, the recessions in the United States (“U.S.”) and Canada and the slowdown of economic growth in the rest of the world have created a substantially more volatile business environment. These conditions may limit certain of the Corporation’s planned business development activities and will continue to present risks.

### ***(b) Principles of Consolidation***

These consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries. All significant inter-company transactions have been eliminated.

### ***(c) Cash and Cash Equivalents***

Cash and cash equivalents include cash on hand and short-term, highly liquid investments with original maturities of three months or less that are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value.

### ***(d) Property and Equipment***

The Corporation follows the full cost method of accounting, whereby all costs associated with the exploration and development of oil and natural gas reserves, whether productive or unproductive, are capitalized in cost centres on a country-by-country basis. Such costs include leasehold acquisition, drilling, completion, facility, pipeline, geological and geophysical costs, rentals on non-producing leases and administrative expenses related to exploration and development activities. Gains or losses are not recognized upon disposition of oil and natural gas properties unless crediting the proceeds against accumulated costs would result in a change in the rate of depletion of 20% or more.

The accumulated costs including future development costs, less the costs of unproved properties, are depleted and amortized using the unit-of-production method based on total proved reserves as determined by independent evaluators. For purposes of the depletion and amortization calculations, net oil and natural gas reserves are converted to a common unit of measure (six thousand cubic feet of natural gas to one barrel of oil) on the basis of their relative energy content.

**Epsilon Energy Ltd.**  
**Notes to the Consolidated Financial Statements**  
**As at December 31, 2009 and 2008**  
*(All amounts stated in US\$)*

**2. Significant Accounting Policies (Cont'd)**

*(d) Property and Equipment (Cont'd)*

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

Net capitalized costs of the Corporation's oil and natural gas properties are subject to an annual Ceiling Test to ensure that capitalized costs do not exceed an estimate of future net revenues. This latter amount is the aggregate of expected undiscounted future net cash flows from proved reserves and costs of unproved properties. Future cash flows are estimated using expected future prices and costs. If the carrying amount is assessed to be not fully recoverable, the cost centre is written down to its fair value. The fair value is determined by the net present value of expected future cash flows using forecast prices from proved and probable reserves and the value of unproved properties discounted at a market adjusted interest rate. The impairment in the carrying amount of proved oil and natural gas properties would be recognized and charged to current operations.

*(e) Asset Retirement Obligations ("ARO")*

The Corporation recognizes the fair value of its ARO liabilities associated with tangible properties in the period in which the liability arises and when reasonable estimates of this fair value can be made. The fair value of this liability is calculated as the present value of the expected future costs of abandonment of such property. The liability is recorded as a long-term liability with a corresponding increase to the carrying amount of the related asset. The liability is increased each reporting period through the accretion of interest up to the future amount of the liability. The accretion is recorded as an expense in the Corporation's consolidated financial statements. The addition to the carrying amount of the asset is depleted on the same basis as the corresponding asset. Revisions to the estimated amount or timing of the obligations are reflected as increases or decreases to the recorded liability and related asset. Actual costs incurred upon settlement of the abandonment obligation are charged against the liability as incurred.

*(f) Leases*

Leases are classified as capital or operating leases. Leases which transfer substantially all of the benefits and risks of ownership of property are accounted for as capital leases. Assets acquired under capital leases are amortized over the estimated useful lives of the underlying assets. All other leases are accounted for as operating leases and the related lease payments are charged to expense as incurred.

*(g) Revenue Recognition*

Revenues from the sale of crude oil, natural gas and other petroleum products are recognized when the title passes to the purchaser and collectability is assured. Natural gas gathering fees are recognized in the production month that natural gas is delivered for sale and the natural gas gathering fee is earned.

*(h) Income Taxes*

The Corporation accounts for and measures future income tax assets and liabilities in accordance with the liability method. Under this method, future income tax assets and liabilities are recognized for estimated tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in income tax rates on future tax liabilities and assets is recognized in income in the period that includes the date of substantive enactment of the change. A valuation allowance is established to reduce income tax assets, if it is more likely than not that all or some portion of such tax assets will not be realized.

## **2. Significant Accounting Policies (Cont'd)**

### ***(i) Stock Based Compensation***

The Corporation estimates the fair value of all stock options awarded to employees and directors using the Black-Scholes option pricing model. Compensation expense and a corresponding increase to contributed surplus are recorded over the vesting period based on the fair value of the options granted. When stock options are exercised for common shares, consideration paid by the stock option holders and contributed surplus associated with the stock options are recorded as share capital. If stock or stock options are repurchased, the excess of the consideration paid over the carrying amount of the stock or stock option cancelled is charged to the income statement.

### ***(j) Measurement Uncertainty***

The preparation of the consolidated financial statements under Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the year. Accordingly, actual results may differ from estimated results.

While management believes that its estimates have been reasonable, the volatility in the price of oil and natural gas, the recession in Canada and the US, and the slowdown of economic growth in the rest of the world have created a substantially more volatile business environment. These conditions will limit certain of the Corporation's previously planned business development activities and it will continue to present future risks. To prepare these consolidated financial statements, management has recorded adjustments and included disclosures based on their best estimates of projected business activity and future cash flows.

The amounts recorded for depletion, depreciation and amortization of petroleum and natural gas properties and equipment, the liability for retirement obligations and the amount recorded for future income taxes are based on estimates. The impairment test is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, estimates of reserves and the related future cash flows are subject to measurement uncertainty and the impact of differences between actual and estimated amounts on the consolidated financial statements of future periods could be material.

The calculation of asset retirement obligations includes estimates of the future costs to settle the asset retirement obligation, the timing of the settlement of the obligation and the future interest rates. The impact of differences between actual and estimated costs, timing and inflation on the consolidated financial statements of future periods could be material.

Amounts recorded from joint venture partners are based on the Corporation's interpretation of underlying agreements and may occasionally be subject to joint approval. The Corporation has recorded balances due from its joint venture partners based on costs incurred and its interpretation of allowable expenditures. Any adjustment required as a result of joint venture audits are recorded in the period of settlement with joint venture partners.

Due to the volatile nature of oil and natural gas exploration, development, and production activities, there are numerous uncertainties with respect to projecting future revenues and operating costs, which are integral components of future net income projections. These uncertainties include such items as production levels, capital expenditure levels, oil and natural gas commodity prices, reserve estimates, and lease operating costs. Actual results may vary significantly from projected amounts.

**Epsilon Energy Ltd.**  
**Notes to the Consolidated Financial Statements**  
**As at December 31, 2009 and 2008**  
*(All amounts stated in US\$)*

**2. Significant Accounting Policies (Cont'd)**

*(j) Measurement Uncertainty (Cont'd)*

Future income taxes are based on estimates as to the timing of the reversal of temporary differences and tax rates currently substantively enacted. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which were fully tradable with no vesting restrictions. This option valuation model requires the input of highly subjective assumptions including the expected stock price volatility. Because the Corporation's stock options and performance incentive warrants have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the calculated fair value, such value is subject to measurement uncertainty.

*(k) Joint Ventures*

The majority of the Corporation's oil and natural gas exploration, development and production activities are conducted jointly with others and, accordingly, these consolidated financial statements reflect only the Corporation's proportionate interest in such activities.

*(l) Earnings per Share*

Basic net income (loss) per share is calculated using the weighted average number of shares outstanding. Diluted earnings / (loss) per share is calculated using the treasury stock method. The treasury stock method assumes that any proceeds from the exercise of dilutive stock options and warrants would be used to repurchase common shares at the average market price during the period, with the incremental number of shares being included in the denominator of the diluted loss per share calculation, except when anti-dilutive.

*(m) Foreign Exchange Gains and Losses*

The Corporation translates the accounts of its Canadian parent company to US dollars by using the current rate method whereby all assets and liabilities are translated at the rates of exchange at the balance sheet dates, and revenues and expenses are translated at the average rates of exchange during the month in which they are recognized. Resulting gains or losses are included in the Consolidated Statements of Comprehensive Income (Loss) and in Shareholders' Equity as other comprehensive income (loss).

*(n) Financial Instruments*

All financial instruments are initially recognized at fair value on the balance sheet. The Corporation has classified each financial instrument into one of the following categories: (1) held-for-trading, (2) loans and receivables, (3) financial assets available-for-sale, (4) financial assets held-to-maturity, and (5) other financial liabilities. Subsequent measurement of financial instruments is based on their classification.

Financial assets and liabilities "held-for-trading" are subsequently measured at fair value with changes in those fair values recognized in net earnings. Financial assets "available-for-sale" are subsequently measured at fair value with changes in fair value recognized in other comprehensive income (loss), net of tax.

Financial assets "held-to-maturity", "loans and receivables", and "other financial liabilities" are subsequently measured at amortized cost using the effective interest method.

**Epsilon Energy Ltd.**  
**Notes to the Consolidated Financial Statements**  
**As at December 31, 2009 and 2008**  
*(All amounts stated in US\$)*

**2. Significant Accounting Policies (Cont'd)**

*(n) Financial Instruments (Cont'd)*

The Corporation's financial assets and liabilities are recorded and measured as follows:

<u>Asset or Liability</u>	<u>Category</u>	<u>Measurement</u>
Cash and cash equivalents.....	Held for trading	Fair value
Accounts receivable .....	Loans and receivables	Amortized cost
Notes receivable .....	Loans and receivables	Amortized cost
Restricted cash .....	Held for trading	Fair value
Accounts payables and accrued liabilities.	Other liabilities	Amortized cost

The Corporation classifies the fair value of financial instruments according to the following hierarchy based on the amount of observable inputs used to value the instrument.

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date. Level 2 valuations are based on inputs, including quoted forward prices for commodities, time value and volatility factors, which can be substantially observed or corroborated in the marketplace.

Level 3 – Valuations in this level are those with inputs for the asset or liability that are not based on observable market data.

The Corporation's cash and cash equivalents and restricted cash are classified as Level 1.

*(o) Comprehensive Loss*

Comprehensive loss consists of net loss and other comprehensive loss and represents the change in shareholders' equity which results from transactions and events from sources other than the Company's shareholders. These transactions and events include unrealized gains or losses on translation of the parent company Canadian dollar financial statements into the U.S. \$ functional and reporting currency.

**3. Accounting Pronouncements**

*(a) Current Year Accounting Changes*

***Goodwill and Intangible Assets***

Effective January 1, 2009, the Corporation adopted Section 3064, "Goodwill and Intangible Assets" issued by the Canadian Institute of Chartered Accountants ("CICA"). Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets subsequent to its initial recognition. This new section has no current impact on the Corporation or its Consolidated Financial Statements.

**Epsilon Energy Ltd.**  
**Notes to the Consolidated Financial Statements**  
**As at December 31, 2009 and 2008**  
*(All amounts stated in US\$)*

**3. Accounting Pronouncements (Cont'd)**

*(a) Current Year Accounting Changes (Cont'd)*

***Financial Instruments – Disclosures***

In May 2009, the CICA amended Section 3862, Financial Instruments – Disclosures, to include additional disclosure requirements about fair value measurement for financial instruments and liquidity risk disclosures. These amendments require a three level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement. These amendments are effective for the Corporation on December 31, 2009. The amendments are consistent with recent amendments to financial instrument disclosure standards in IFRS and have been included as incremental disclosure.

*(b) Future Accounting Changes*

***Business Combinations***

The CICA issued Handbook Section 1582 “Business Combinations” that replaces the previous business combinations standard. Under this guidance, the purchase price used in a business combination is based on the fair value of shares exchanged at the market price at acquisition date. Under the current standard, the purchase price used is based on the market price of shares for a reasonable period before and after the date the acquisition is agreed upon and announced. In addition, the guidance generally requires all acquisition costs to be expensed. Current standards allow for the capitalization of these costs as part of the purchase price. This new Section also addresses contingent liabilities, which will be required to be recognized at fair value on acquisition, and subsequently re-measured at each reporting period until settled. Currently, standards require only contingent liabilities that are payable to be recognized. The new guidance requires negative goodwill to be recognized in earnings rather than the current standard of deducting from non-current assets in the purchase price allocation. This standard applies prospectively to business combinations on or after January 1, 2011 with earlier application permitted. The Corporation is currently assessing the impact of the standard.

***Consolidated Financial Statements and Non-controlling Interest***

The CICA issued Handbook Sections 1601 “Consolidated Financial Statements”, and 1602 “Non-controlling Interests”, which replaces existing guidance under Section 1600 “Consolidated Financial Statements”. Section 1601 establishes standards for the preparation of Consolidated Financial Statements. Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary in Consolidated Financial Statements subsequent to a business combination. These standards will be effective for the Corporation for business combinations occurring on or after January 1, 2011 with early application permitted. The Corporation is currently assessing the impact of the standard.

**Epsilon Energy Ltd.**  
**Notes to the Consolidated Financial Statements**  
**As at December 31, 2009 and 2008**  
*(All amounts stated in US\$)*

**4. Property and Equipment**

	<u>Gross Cost</u>	<u>Accumulated Depletion, Depreciation &amp; Impairment</u>	<u>Net Book Value</u>
<b>As at December 31, 2009:</b>			
Oil and natural gas properties			
United States.....	\$ 67,483,813	\$ 6,746,650	\$ 60,737,163
Canada.....	3,312,075	1,390	3,310,685
Yemen.....	50,413,720	50,413,720	-
Ethiopia.....	2,094,037	-	2,094,037
Oman.....	929,127	929,127	-
Other.....	268,196	21,276	246,920
Total oil and natural gas properties.....	<u>\$ 124,500,968</u>	<u>\$ 58,112,163</u>	<u>\$ 66,388,805</u>
Other property and equipment.....	583,591	281,322	302,269
Grand total.....	<u>\$ 125,084,559</u>	<u>\$ 58,393,485</u>	<u>\$ 66,691,074</u>
		<b>Accumulated Depletion, Depreciation &amp; Impairment</b>	<b>Net Book Value</b>
	<b>Gross Cost</b>		
<b>As at December 31, 2008:</b>			
Oil and natural gas properties.....			
United States.....	\$ 71,295,961	\$ 3,419,849	\$ 67,876,112
Canada.....	600,451	-	600,451
Yemen.....	47,316,330	34,071,330	13,245,000
Ethiopia.....	1,851,114	-	1,851,114
Oman.....	280,577	27,803	252,774
Other.....	170,141	-	170,141
Total oil and natural gas properties.....	<u>\$ 121,514,574</u>	<u>\$ 37,518,982</u>	<u>\$ 83,995,592</u>
Other property and equipment.....	495,746	137,853	357,893
Grand total.....	<u>\$ 122,010,320</u>	<u>\$ 37,656,835</u>	<u>\$ 84,353,485</u>

Costs excluded from the depletion calculation include \$7,369,526 (2008: \$11,181,674) in the United States and \$1,009,423 (2008: \$0) in Canada. Costs in Ethiopia are in the pre-production stage and have not been depleted and recoverability is dependent upon achieving commercial production and profitability.

***Capitalized General and Administrative Costs (“G&A”)***

Capitalized G&A costs consist of wages, travel and other G&A costs directly associated with specific capital projects. Capitalized G&A costs for each country cost center for the years ended December 31, 2009 and 2008, respectively, were as follows:

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**4. Property and Equipment (Cont'd)**

*Capitalized General and Administrative Costs ("G&A") (Cont'd)*

	Year Ended December 31,	
	2009	2008
<b>Capitalized G&amp;A Costs:</b>		
United States .....	\$ 675,609	\$ 458,244
Canada.....	12,950	45,796
Yemen .....	80,716	556,451
Oman .....	401,847	86,834
Ethiopia .....	86,943	56,305
Other.....	61,724	123,891
Total .....	\$ 1,319,789	\$ 1,327,521

*Sale of Oil and Natural Gas Property Interests*

West Virginia:

On June 16, 2009 the Corporation sold all of its oil and natural gas properties in West Virginia to an unrelated third party for a net amount of \$12,932,272 and recognized a loss of \$7,142,665 (net of tax of \$2,600,000). During 2008, the Corporation divested itself of non-core unproved properties located in West Virginia and Ohio for \$6,839,761 and recognized a gain of \$5,013,129.

Pennsylvania:

On October 16, 2009 the Corporation sold non-core acres located in eastern Pennsylvania to an unrelated third party for \$12,631,068 and recognized a gain of \$9,893,422.

*Unproved Property Impairment*

Yemen

During 2009, the Corporation recorded an unproved property impairment of \$17,861,297 pertaining to Block 41 in Yemen to write down the properties to the estimated fair value of \$100,000. See Note 14, Subsequent Events – “Sale of Epsilon Yemen”. Included in this amount is \$5,138,563 due from Oil and Gas Mine Company (“OGMC”), a non-operated joint interest owner in Block 41 in Yemen. At December 31, 2008, the Corporation had recorded an unproved property impairment of \$34,071,330 covering its interests on Block 41 in Yemen.

Oman

In 2009, the Corporation notified the Ministry of Oil and Gas, Sultanate of Oman, that the Corporation was withdrawing from previously signed Exploration and Production Sharing Agreement (“EPSA”) covering Block 55 in Oman where it was the official operator. As a result, during 2009, the Corporation recorded an unproved property impairment of \$922,599 pertaining to Oman.

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**4. Property and Equipment (Cont'd)**

*Unproved Property Impairment (Cont'd)*

The Reserve Report for Canada and the United States was prepared by utilizing the following forecasted benchmark oil and gas prices:

	<b>Commodity Pricing</b>	
	<b>Gas (\$/Mmbtu)</b>	<b>Oil (\$/Bbl)</b>
2010 .....	\$ 6.05	\$ 80.00
2011 .....	\$ 6.90	\$ 83.60
2012 .....	\$ 7.30	\$ 87.40
2013 .....	\$ 7.70	\$ 91.30
2014 .....	\$ 8.15	\$ 95.30
Thereafter .....	2% escalation	2% escalation

**5. Line of Credit and Letter of Credit**

*Lines of Credit*

*Northwestern Bank, Traverse City, Michigan*

At December 31, 2008, the Corporation had a USD\$11,000,000 credit line in place, secured by a lien on the Corporation's New York assets in the amount of \$10,000,000 and a \$1,000,000 minimum deposit at Northwestern Bank. Terms of the credit line included an interest rate of prime less 1/4 percent. As at December 31, 2008, the Corporation had an outstanding amount of \$9,204,500 under the terms of this credit line, leaving \$1,795,500 of available unused credit.

On October 16, 2009, the Corporation paid the outstanding balance of \$7,500,000 with regards to its line of credit at Northwestern Bank in full and closed the facility.

*TD Bank, Toronto, Canada*

At December 31, 2008, the Corporation had a USD\$15,000,000 credit line in place, secured by Canadian dollar equivalent of 115% of the borrowed amount. At December 31, 2008, the amount of restricted cash and cash equivalents by TD Bank was based on full utilization of the credit line coupled with a reserve for currency fluctuations. Terms of the credit line include an interest rate of prime plus 0.5%. As at December 31, 2008, the Corporation had an outstanding amount of \$9,979,634 under the terms of this credit line, leaving \$5,020,366 of available unused credit.

In 2009, the Corporation paid its line of credit at TD Bank in full and closed the facility.

*Letters of Credit*

*Yemen*

Under terms of the Block 41 PSA, as operator the Corporation must post a letter of credit in favor of the Ministry of Minerals covering the gross amount of expected expenditures during each calendar year. During 2008, the Corporation initially posted a \$16,000,000 letter of credit secured by \$17,600,000 of restricted cash deposits at TD Bank. The letter of credit was subsequently reduced as documented details pertaining to the work program on Block 41 were presented to the Ministry of Minerals by the Corporation. At December 31, 2009, the balance of that letter of credit had been reduced to \$312,000, which was secured by restricted cash of \$378,233.

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**5. Line of Credit and Letter of Credit (Cont'd)**

*Ethiopia*

As of December 31, 2009, under terms of the Ethiopia PSA, the Corporation has provided an additional amount of \$289,007 to TD Bank which is held as restricted cash, to be used against a letter of credit in favor of Ministry of Mines and Energy for \$150,000. The Corporation is currently negotiating terms of the letter of credit. As of December 31, 2008 there was no letter of credit outstanding in relation to Ethiopia PSA.

*Restricted Cash*

At December 31, 2009 and 2008, the Corporation's restricted cash balances consisted of the following:

	<b>At December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Restricted Cash:</b>		
Northwestern Bank – loan facility.....	\$ -	\$ 1,000,000
Northwestern Bank – letter of credit .....	65,000	-
TD Bank – loan facility .....	-	21,328,244
TD Bank – Yemen letter of credit .....	378,233	11,375,064
TD Bank – Ethiopia letter of credit and other ...	289,007	-
Total.....	<u>\$ 732,240</u>	<u>\$ 33,703,308</u>

**6. Shareholders' Equity**

*(a) Authorized shares*

The Corporation is authorized to issue an unlimited number of Common Shares with no par value and an unlimited number of Preferred Shares with no par value.

*(b) Issued*

The following table summarizes the components of share capital for the years ended December 31, 2009 and 2008 respectively:

	<b>Number of Shares Issued</b>	<b>Amount</b>
<b>Balance at December 31, 2007</b> .....	45,698,323	\$ 109,725,936
Warrants exercised .....	17,000	42,500
Warrants exercised .....	-	11,269
Shares issued for Bought Deal .....	5,600,000	33,442,500
Issuance costs for Bought Deal .....	-	(2,228,832)
Repurchase of Common Shares.....	(1,000,000)	(2,734,114)
<b>Balance at December 31, 2008</b> .....	50,315,323	138,259,259
Issuance costs for Bought Deal .....	-	(280)
Exercise of Stock Options .....	10,675	13,271
<b>Balance at December 31, 2009</b> .....	<u>50,325,998</u>	<u>\$138,272,250</u>

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**6. Shareholders' Equity (Cont'd)**

*(c) Stock Options*

The following table summarizes stock option activity for the years ended December 31, 2009 and 2008 respectively (exercise price in Canadian dollars):

	<b>As at December 31, 2009</b>		<b>As at December 31, 2008</b>	
	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
<b>Stock Options Outstanding:</b>				
Beginning of year .....	3,317,449	\$ 2.60	2,565,632	\$ 2.31
Granted.....	360,000	\$ 2.41	977,817	\$ 3.78
Exercised.....	(10,675)	\$ 0.85	-	-
Forfeited.....	(649,047)	\$ 3.72	(226,000)	\$ 4.33
End of period.....	<u>3,017,727</u>	<u>\$ 2.35</u>	<u>3,317,449</u>	<u>\$ 2.60</u>
Exercisable at year-end .....	<u>2,117,127</u>	<u>\$ 1.81</u>	<u>1,836,166</u>	<u>\$ 1.81</u>

The following table summarizes information about stock options outstanding at December 31, 2009 and 2008 respectively (exercise price in Canadian dollars):

<b>Exercise Price</b>	<b>Number of Options Outstanding</b>	<b>Number of Options Exercisable</b>	<b>Black-Scholes Option Pricing Model Valuation</b>	<b>Weighted Average Remaining Contractual Life (in years)</b>
<b>As at December 31, 2009:</b>				
\$ 0.85	240,595	240,595	\$ 108,339	3.95
\$ 1.00	856,000	856,000	557,768	5.88
\$ 1.34	100,000	-	17,350	2.67
\$ 1.45	80,000	-	28,647	9.61
\$ 1.97	50,000	25,000	30,978	2.81
\$ 2.00	340,000	340,000	335,403	1.84
\$ 2.50	413,632	410,032	784,540	7.48
\$ 4.00	825,000	223,000	1,474,514	8.34
\$ 5.60	50,000	10,000	126,924	8.63
\$ 6.10	62,500	12,500	340,177	8.45
Total	<u>3,017,727</u>	<u>2,117,127</u>	<u>\$ 3,804,640</u>	<u>6.20</u>
<b>As at December 31, 2008:</b>				
\$ 0.85	315,317	-	\$ 29,206	4.95
\$ 1.00	856,000	856,000	557,768	6.88
\$ 2.00	347,500	314,167	320,576	2.94
\$ 2.50	621,132	547,999	896,742	6.84
\$ 4.00	865,000	118,000	1,003,418	9.10
\$ 5.34	100,000	-	65,301	9.67
\$ 5.60	50,000	-	42,850	9.63
\$ 6.10	162,500	-	220,181	9.45
Total	<u>3,317,449</u>	<u>1,836,166</u>	<u>\$ 3,136,042</u>	<u>7.11</u>

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**6. Shareholders' Equity (Cont'd)**

The fair value of options granted during the year ended December 31, 2009 was \$0.85 (December 31, 2008 – \$2.65), calculated using a risk free rate of 4.3%, dividend yield of 0%, volatility factor of 84%, and expected life of 3 years. The value of the options was recorded as stock based compensation expense, with an offsetting amount to contributed surplus based on the vesting terms.

**(d) Contributed Surplus**

The following table summarizes contributed surplus for the years ended December 31, 2009 and 2008 respectively:

	<b>Year Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Contributed surplus:</b>		
Balance, beginning of year .....	\$ 5,401,361	\$ 1,512,133
Valuation of re-purchase of Common Shares .....	-	2,042,710
Stock options amortized, granted and exercised .....	696,935	1,846,518
Balance, end of year .....	<u>\$ 6,098,296</u>	<u>\$ 5,401,361</u>

**Escrowed Shares**

7,352,988 Common Shares held by certain insiders of the Corporation (the “Escrowed Shares”) were held in escrow by Computershare Trust Company of Canada, the escrow agent (the “Escrow Agreement”). Terms of the Escrow Agreement included the release of one-fourth of the Escrowed Shares upon completion of the Corporation’s Initial Public Offering (“IPO”) on October 24, 2007, one-third of the remaining Escrowed Shares six months after the IPO, one-half of the remaining Escrowed Shares twelve months after the IPO, and all remaining Escrowed Shares eighteen months after the IPO. All Escrowed Shares were released effective May 24, 2009.

**7. Income Taxes**

	<b>Year Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Provision for Income Taxes:</b>		
Net loss before income taxes .....	\$ (20,228,619)	\$ (31,087,916)
Future income tax recovery based on statutory rate .....	(5,866,300)	(9,170,935)
Stock based compensation .....	204,864	618,584
International operations .....	5,839,432	7,433,320
Other non-deductible losses .....	-	973,780
Other .....	563,367	500,259
Change in valuation allowance .....	(741,363)	2,244,992
Income tax provision .....	<u>\$ -</u>	<u>\$ 2,600,000</u>

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**7. Income Taxes (Cont'd)**

**(a) Future Tax Balances**

The tax effects of temporary differences and losses that give rise to future income tax assets and liabilities for the years ended December 31, 2009 and 2008, respectively, are comprised of the following amounts:

	<b>Year Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Future Income Tax:</b>		
Share issue costs.....	\$ 1,030,146	\$ 1,758,720
Non-capital losses .....	10,132,280	3,229,863
Temporary difference for property and equipment.....	(2,400,054)	(5,623,493)
Valuation allowance.....	(8,762,372)	(1,965,090)
Future income tax liability .....	<u>\$ -</u>	<u>\$ 2,600,000</u>

A future income tax asset of \$7,565,033 was not recorded on the property and equipment disposition in Note 4.

**(b) Tax Loss Carry-forwards**

As at December 31, 2009, the Corporation had \$4,607,578 of non-capital losses in Canada and \$22,003,275 of non-capital losses in the United States, which under certain circumstances may be used to reduce taxable income of future years. These losses expire as follows:

<b>Year of Expiration:</b>	<b>Canada</b>	<b>United States</b>	<b>Total</b>
	<u>          </u>	<u>          </u>	<u>          </u>
2015 .....	\$ 37,106	\$ -	\$ 37,106
2025 .....	-	183,300	183,300
2026 .....	-	16,746	16,746
2027 .....	69,170	4,189,528	4,258,698
2028 .....	1,441,261	2,650,028	4,091,289
2029 .....	3,060,041	14,963,673	18,023,714
Total.....	<u>\$ 4,607,578</u>	<u>\$ 22,003,275</u>	<u>\$ 26,610,853</u>

**8. Commitments and Contingencies**

***Yemen***

In accordance with the Farm-in Agreement with OGMC dated September 10, 2007 covering the Corporation's acquisition of a 57.14% paying interest in the Block 41 Production Sharing Agreement from OGMC, the Corporation was obligated to pay OGMC \$3,000,000 upon a Declaration of Commerciality. The \$3,000,000 payment would only be incurred in the event the Corporation made a commercial oil or natural gas discovery on Block 41 and the Ministry of Minerals granted a license to commercially produce such discovery. Due to the unlikely contingent nature of this item, it was not reflected in the Corporation's Balance Sheet at December 31, 2009 and 2008 respectively.

The Corporation has withdrawn from Yemen and is currently negotiating final settlements with contractors. Management is of the opinion that no additional accrual or disclosure is required for any possible settlements.

## **8. Commitments and Contingencies (Cont'd)**

### ***Oman – Block 55 Exploration and Production Sharing Agreement (“EPSA”)***

On January 26, 2009, the Corporation was awarded a 100% operated working interest in Block 55, an onshore oil and natural gas concession in Oman, in return for a \$25.5 million work commitment over three years and sharing in commercial production, if any, over a 20 year contractual term.

In an effort to conserve its capital, during 2009, the Corporation did not pay any up-front costs for Block 55 to the government of Oman. In November 2009, the Corporation notified the Ministry of Oil and Gas, Sultanate of Oman, that the Corporation was withdrawing from previously signed Exploration and Production Sharing Agreement (“EPSA”) covering Block 55 in Oman where it was the official operator. The Corporation has reversed a capital accrual of \$2,250,000 in up-front costs pertaining to Block 55 in Oman and is of the opinion that no additional accrual or disclosure for exit costs is required.

### ***Saskatchewan - Bakken Shale Drilling Commitment***

The Corporation entered into an agreement with an unrelated privately held Canadian company on August 28, 2008, whereby the Corporation agreed to pay 100% of the costs to drill a minimum of two horizontal wells in the Bakken shale in order to earn a 50% working interest in acreage controlled by the unrelated private company. During 2009, the Corporation paid \$2,213,680 (CDN\$2,403,300) for the cost to drill the first of the two aforementioned earning wells. The second well obligation of \$2,400,000 will be partially substituted for a 3D seismic program, which is expected to cost \$1,200,000. The remaining balance after completion of the 3D seismic program will be committed to the next well that is expected to be drilled in late 2010.

### ***New York – Trenton-Black River Well Units***

During 2006, the Department of Environmental Conservation (“DEC”) classified the Corporation’s interest in several wells drilled prior to a statute change as an integrated non-participating owner. As a result, the Corporation was charged a non-consent penalty (300% of 100% of the total drilling and completion costs ) on its pro-rata share of costs to drill and complete various wells by Fortuna Energy Inc., the operator. The Corporation believes its interest in the subject wells should have been classified as an integrated participating owner upon payment of its pro-rata share of costs, effectively negating the non-consent penalty the operator could charge prior to disbursing the Corporation’s pro-rata share of profits. The Corporation formally appealed the DEC’s ruling, and, if successful, will require the non-consent penalty withheld by the operator to be disbursed to the Corporation. As a result, there is no anticipated effect on the Corporation’s established working interest. As a non-operator, the Corporation is not liable to make any non-consent payments.

Due to this contingency, there were no amounts initially recorded on the Corporation’s consolidated financial statements prior to payout. In the case where payout has occurred, the Corporation recorded its share of costs and revenues on a prospective basis beginning with the month that each well had been determined to have achieved payout. As at December 31, 2009, the Corporation was classified as an integrated non-participating owner in 7 gross (0.10 net) wells, including 3 gross (0.06 net) for which the non-consent penalty had been paid out. As of December 31, 2009, the Corporation had received a favorable decision on its F Andrews well appeal from the NY DEC commissioner. The decision was not appealed by Fortuna Energy Inc. and the Corporation is currently awaiting final settlement numbers. This decision will result in reimbursement of the non-consent penalty charged to the Corporation for that well. There has been no decision issued for the remaining wells that the Corporation has appealed.

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**8. Commitments and Contingencies (Cont'd)**

***Ethiopia***

On May 14, 2009, the Corporation announced that it had signed a Production Sharing Agreement (“PSA”) with the Ministry of Mines and Energy in Democratic Republic of Ethiopia. Terms of the PSA include an initial three-year exploration period that includes a minimum financial commitment of \$3,000,000 to drill one exploratory well and to acquire a minimum of 200 kilometers of 2D seismic. In the event the Corporation makes a commercial discovery, the initial percentage split of profit oil and/or gas will be 80% for the Corporation and 20% for the Ministry. Through December 31, 2009, the Corporation had incurred \$2,094,038 under the terms of this agreement.

The Corporation’s future commitments are summarized in the following table:

	<b>Payments Due by Period</b>			
	<b>Total</b>	<b>Less than 1 Year</b>	<b>1 – 3 Years</b>	<b>4 Years and After</b>
<b>Future Commitments:</b>				
Accounts payable and accrued liabilities	\$ 3,460,740	\$ 3,449,527	\$ 11,213	\$ -
Operating leases .....	1,326,658	522,164	728,329	76,165
Purchase obligations <sup>(1)</sup> ....	2,733,000	2,733,000	-	-
Other long-term obligations <sup>(2)</sup> .....	3,318,690	-	3,318,690	-
Total .....	<u>\$ 10,839,088</u>	<u>\$6,704,691</u>	<u>\$ 4,058,232</u>	<u>\$ 76,165</u>

Notes:

(1) Saskatchewan - Bakken Shale Drilling Commitment and 3-D Seismic payment due March 2010.

(2) Estimated remaining costs pertaining to the Production Sharing Agreement in Ethiopia.

**9. Financial Instruments**

***Risk Management***

The Corporation is exposed to the following risks related to financial assets and liabilities:

***Liquidity Risk***

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they become due. Liquidity describes a Corporation’s ability to access cash. Companies operating in the upstream oil and natural gas industry require sufficient cash in order to fund capital programs necessary to explore, develop and produce oil and natural gas, and to repay debt. The Corporation actively monitors its cash requirements to ensure it has sufficient available funds to meet current and foreseeable financial requirements at a reasonable cost. The Corporation prepares annual capital expenditure budgets, which are regularly monitored and updated as warranted. The Corporation also utilizes authorizations for expenditures to further manage capital expenditures.

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**9. Financial Instruments (Cont'd)**

At December 31, 2009, the Corporation had a working capital surplus of \$13,478,618. The Corporation has commitments under existing agreements as described in Note 8, Commitments and Contingencies. Given the Corporation's working capital position and its outlook on future capital requirements, management assesses liquidity risk to be low.

***Commodity Price Risk***

The Corporation sells its current oil and natural gas production primarily at market rates and occasionally via forward fixed price physical delivery sale contracts. Fluctuations in oil and natural gas prices can materially impact the current and future profitability of the Corporation.

As of December 31, 2009, the Corporation had two outstanding physical delivery forward sales contracts with natural gas buyers. First contract commenced on November 1, 2009 for natural gas sale of approximately 3 MMcf per day at a fixed price of \$5.15 per Mcf. The second contract, which was signed on December 15, 2009, effective January 1, 2010 calls for natural gas sale of approximately 3 MMcf per day at a fixed price of \$5.50 per Mcf. Both contracts were for periods of six months.

As the contracts are physical delivery contracts and the Corporation has enough production to fulfill its commitment, the contracts are not treated as financial derivatives.

***Interest Rate Risk***

The Corporation maintains its short-term deposits in instruments that are redeemable within three months without penalty, and thereby has limited exposure to short term interest rate fluctuations. The Corporation does not utilize any interest rate based derivatives. The Corporation analyzes interest rate risk by calculating the effect of percent changes in the interest earned on its cash, cash equivalents and restricted cash. At December 31, 2009, the Corporation had no debt.

***Foreign Currency Risk***

The Corporation is exposed to risks arising from fluctuations in foreign currency exchange rates, primarily between Canadian and U.S. dollars. The Corporation does not utilize any foreign currency based derivatives. In order to manage this risk and to defer the realization of any resulting currency loss from converting Canadian dollars to US dollars, the Corporation retains cash balances in both US and Canadian dollars.

The Corporation regularly analyzes foreign currency risk between Canadian dollars and US dollars by calculating the effect of percent changes in the foreign currency exchange rates against period end cash, cash equivalents and restricted cash balances. For example, applying a 5% plus or minus change in the year end conversion rate (1.0491) of Canadian to US dollars against the Corporation's Canadian denominated cash, cash equivalents and restricted cash balances of \$11,680,540 at December 31, 2009 would have affected the value of such balances by approximately \$584,000. Substantially all of the Corporation's business operations are conducted in either US dollars or Canadian dollars and there are no significant outstanding foreign currency accounts receivable or accounts payable balances.

***Credit Risk***

Credit risk arises from the possibility that the entities which the Corporation has receivables from or has invested in may experience difficulties and be unable to fulfill their obligations. The Corporation mitigates this risk of credit loss by taking a security interest in underlying assets of the investment. Accounts receivable are assessed on a regular basis by management to ensure the credit worthiness of debtors and the ultimate collection thereof. The Corporation's accounts receivable balances consist of

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**9. Financial Instruments (Cont'd)**  
*Credit Risk (Cont'd)*

receivables pertaining to its natural gas and oil production in Pennsylvania and New York from one marketer and for pro-rata share of costs of operations from its joint interest partners in New York. The Corporation's maximum credit exposure is approximately two months of oil and natural gas production for revenue receivables. The Corporation has the right to offset the amount owed by its joint interest partners against any revenue it disburses to them. As at December 31, 2009 and 2008, there were no provisions for doubtful accounts pertaining to accounts receivable balances for its oil and natural gas revenues or its joint interest partners. The maximum credit risk that the Corporation is exposed to is the current carrying value of its accounts receivable and cash and cash equivalent balances.

The Corporation considers any amounts greater than 90 days to be overdue. An aging of accounts receivable at December 31, 2009 is:

Current .....	\$	1,244,500
31 – 60 days .....	\$	160,216
61 – 90 days .....	\$	80,795
Over 90 days .....	\$	2,918
Total accounts receivable.....	\$	1,488,429

***Fair Value***

The Corporation's carrying value of cash and cash equivalents, accounts receivable, restricted cash, and accounts payable and accrued liabilities approximates their fair value due to the immediate or short-term maturity of these instruments.

**10. Related Party Transactions**

The Corporation reports its related party transactions on an exchange amount basis in equivalent US dollars. A summary of such transactions follows:

***Executive Chairman***

The Corporation utilizes administrative services provided by 706147 Ontario, Inc., a company owned by the Executive Chairman's spouse. In addition, the Corporation utilizes consultation services provided by Capital Z Corporation, a company owned by the Executive Chairman and the Corporation shares office space with Capital Z Corporation at no charge. Related party transactions with the Corporation's Executive Chairman were conducted in Canadian dollars and the exchange rate differences were immaterial. A summary of related party transactions and outstanding balances between the Corporation and its Executive Chairman follows:

	<b>Year Ended</b>	
	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
706147 Ontario, Inc.....	\$ 48,618	\$ 60,592
Capital Z Corporation.....	\$ 2,181	\$ -
Accounts Payable and Accounts Receivable.....	\$ -	\$ -

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**10. Related Party Transactions (Cont'd)**

*Director and former President and CEO*

Austin Exploration LLC, a company owned by a Director who was also the former President and CEO of the Corporation, was also a participant in the Corporation's Empire project. Western Land Services Inc., a company owned by the same person, provides oil and natural gas lease brokerage services to the Corporation in accordance with a Project Services Agreement between Western Land Services and the Corporation. Under terms of the Project Services Agreement, Western Land Services agreed to provide services to the Corporation at its lowest corporate rates less 10%. Substantially all of the service amounts provided by Western Land Services are capitalized with oil and natural gas properties. Related party transactions with the Director and former President and CEO were conducted in US dollars. A summary of related party transactions and outstanding balances between the Corporation and its Director who was also the former President and CEO follows.

	<b>Year Ended</b>	
	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Austin Exploration LLC:</b>		
Accounts receivable .....	\$ 36,819	\$ 109,652
Joint venture costs .....	\$ 408,873	\$ 2,654,594
Joint venture revenues .....	\$ 563,835	\$ 902,291
Accounts payable .....	\$ -	\$ 75,115
<b>Western Land Services:</b>		
Lease brokerage services .....	\$ 440,092	\$ 1,902,049
Accounts payable .....	\$ 86,320	\$ 138,819

**11. Supplementary Cash Flow Information**

Non-cash changes to the *Changes in Non-cash Balances Related to Operations* component of cash flows used in operations and investing for the years ended December 31, 2009 and 2008, respectively, were comprised of the following:

	<b>Year Ended</b>	
	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Changes in Non-Cash Balances:</b>		
Accounts receivable .....	\$ 5,650,678	\$ (6,564,201)
Notes Receivable .....	359,401	(359,401)
Other current assets .....	(662)	72,449
Accounts payable, accrued and other liabilities .....	(6,532,374)	(1,661,333)
Total changes to non-cash balances related to operations .....	<u>\$ (522,957)</u>	<u>\$ (8,512,486)</u>

**Epsilon Energy Ltd.**  
**Notes to the Consolidated Financial Statements**  
**As at December 31, 2009 and 2008**  
*(All amounts stated in US\$)*

**11. Supplementary Cash Flow Information (Cont'd)**

Changes to the *Proceeds from Issuance of Common Shares and Warrants, Net of Issuance Costs* component of cash provided by financing activities for the years ended December 31, 2008 and 2007, respectively, were comprised of the following:

	<b>Year Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Issuance of Common Shares and warrants:</b>		
Share Capital, beginning of year .....	\$ 138,259,259	\$ 109,725,936
Cash based changes:		
Cash proceeds from the issuance of Common Shares and warrants, net of issuance costs .....	8,245	31,256,168
Re-purchase of Common Shares .....	-	(691,404)
Non-cash changes:		
Valuation of re-purchased Common Shares .....	-	(2,042,710)
Warrants amortized / issued .....	4,746	11,269
Share Capital, end of year .....	<u>\$ 138,272,250</u>	<u>\$ 138,259,259</u>

**12. Reportable Geographical Segments**

As at December 31, 2009, the Corporation's operations by geographical area included the United States, Canada, Yemen, Ethiopia, and Oman. See Note 4 "*Property and Equipment*". Summarized reportable geographical segment data follows:

<b>Reportable Segments:</b>	<b>Year Ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
United States:		
Revenues .....	\$ 5,420,610	\$ 8,299,549
Operating costs .....	1,329,455	1,792,252
Capital expenditures .....	20,441,085	34,484,428
Canada:		
Revenues .....	18,241	-
Operating costs .....	10,878	-
Capital expenditures .....	2,711,624	534,638
Yemen:		
Revenues .....	-	-
Operating costs .....	-	-
Capital expenditures .....	2,785,391	15,125,972
Ethiopia:		
Revenues .....	-	-
Operating costs .....	-	-
Capital expenditures .....	242,924	1,851,114
Other International:		
Revenues .....	-	-
Operating costs .....	-	-
Capital expenditures .....	746,604	450,718
<b>Total Reportable Segments:</b>		
<b>Revenues .....</b>	<b>5,438,851</b>	<b>8,299,549</b>
<b>Operating costs .....</b>	<b>1,340,333</b>	<b>1,792,252</b>
<b>Capital expenditures .....</b>	<b>26,927,628</b>	<b>52,446,870</b>

**Epsilon Energy Ltd.**  
**Notes to the Consolidated Financial Statements**  
**As at December 31, 2009 and 2008**  
*(All amounts stated in US\$)*

**13. Capital Disclosures**

The Corporation as at December 31, 2009 defines its capital as follows:

- Cash
- Restricted cash, net of utilized letters of credit
- Shareholders' equity

The amounts included in the Corporation's capital are as follows:

	<b>As at December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Capital:</b>		
Cash and short-term investments .....	\$ 15,288,547	\$ 8,233,442
Restricted cash, net of utilized lines of credit .	\$ 732,240	\$ 14,519,174
Unused NW Bank loan facility .....	\$ -	\$ 1,795,500
Shareholders' equity	\$ 80,706,043	\$ 97,294,626

The Corporation's strategy is designed and formulated to maintain a flexible capital structure to allow the Corporation the ability to respond to changes in economic conditions, additional capital requirements, and the risk characteristics of the underlying assets of the Corporation. The Corporation considers the cash flows from the underlying assets and future capital needs when assessing the need for additional capital, if any. Depending on future liquidity requirements, the Corporation may invest its excess cash in short or long-term financial instruments.

**14. Subsequent Events**

***Sale of Epsilon Yemen***

At December 31, 2009 the Corporation's business strategy involved focusing and targeting development of natural gas and oil properties within the United States and Canada. On February 2, 2010, Epsilon Energy International Ltd., the sole shareholder of Epsilon Yemen and a wholly-owned subsidiary of the Corporation, sold Epsilon Yemen to an unrelated third party purchaser for US\$100,000, pending government of Yemen approval. Pursuant to the agreement the purchaser shall receive 100% of the shares of Epsilon Yemen including all outstanding assets and liabilities as of the closing date. The agreement calls for the Corporation to receive 20% of proceeds from any subsequent sale of all or any part of the included 57.14% working interest in Block 41 or, in the event that commerciality is declared, 25% of the cost recovery pool monies received from the government of Yemen, in either case, the total amount not to exceed US\$5,000,000. There can be no assurance that government approval will be obtained.

***Farmout Agreement with Chesapeake***

On February 3, 2010, the Corporation closed a Farmout Agreement with Chesapeake Energy Corporation ("Chesapeake"). At closing Chesapeake paid to the joint venture approximately \$5 million in cash and will earn a 50% interest in the Corporation's upstream Marcellus Shale assets by paying a further \$95 million over time by carrying the first \$95-million of the Corporation's 50-per-cent share of leasehold, drilling, completing, equipping and gathering costs attributable to the prospect.

**15. Comparative Information**

Certain comparative figures have been reclassified from financial statements previously presented to conform to the current presentation.