



**Interim Unaudited Condensed Consolidated
Financial Statements for the three and nine months
ended September 30, 2011 and 2010**

November 9, 2011

Epsilon Energy Ltd.
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EPSILON ENERGY LTD.
Interim Unaudited Condensed Consolidated Balance Sheets
(All amounts stated in US\$)

	September 30, 2011	December 31, 2010 (note 5)	January 1, 2010 (note 5)
ASSETS			
Current assets			
Cash and cash equivalents	\$ 18,585,826	\$ 18,670,574	\$ 15,288,547
Accounts receivable	801,677	2,746,406	1,488,429
Assets held for sale	-	-	100,000
Restricted cash - current (Note 8)	333,680	598,036	-
Other current assets	132,543	209,079	62,382
Total current assets	<u>19,853,726</u>	<u>22,224,095</u>	<u>16,939,358</u>
Oil and gas interests			
Intangible exploration and evaluation assets (Note 6)	32,927,639	41,282,688	20,099,107
Net property and equipment (Note 7)	86,808,956	42,627,490	46,591,967
Total oil and gas interests	119,736,595	83,910,179	66,691,074
Other assets:			
Restricted cash - long-term (Note 8)	-	242,024	732,240
Other	8,010	8,010	18,504
Total other assets	<u>8,010</u>	<u>250,034</u>	<u>750,744</u>
Total assets	<u>139,598,331</u>	<u>106,384,308</u>	<u>84,381,176</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Accounts payable and accrued liabilities	1,677,753	2,196,966	3,460,740
Total current liabilities	<u>1,677,753</u>	<u>2,196,966</u>	<u>3,460,740</u>
Other liabilities			
Decommissioning liabilities (Note 9)	586,533	347,338	220,618
Deferred tax liability (Note 9)	7,767,942	-	-
Deferred farmout proceeds (Note 9)	21,612,908	21,469,603	-
Total other liabilities	<u>29,967,383</u>	<u>21,816,941</u>	<u>220,618</u>
Total liabilities	<u>31,645,136</u>	<u>24,013,907</u>	<u>3,681,358</u>
Shareholders' Equity			
Share capital (Note 10)	136,216,581	136,001,220	138,272,250
Contributed surplus (Note 10)	7,250,629	6,323,776	6,098,296
Deficit	(35,878,917)	(60,603,455)	(63,670,728)
Accumulated Foreign currency translation adjustments	364,903	648,860	-
Total shareholders' equity	<u>107,953,196</u>	<u>82,370,401</u>	<u>80,699,818</u>
Total liabilities and shareholders' equity	<u>\$ 139,598,331</u>	<u>\$ 106,384,308</u>	<u>\$ 84,381,176</u>

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

Commitments and Contingencies (Note 11)

Related party transactions (Note 13)

EPSILON ENERGY LTD.
Interim Unaudited Condensed Consolidated Statements of Earnings
(All amounts stated in US\$)

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010 (note 5)	2011	2010 (note 5)
Revenues:				
Oil & gas revenues	\$ 1,583,201	\$ 2,690,203	\$ 5,270,623	\$ 10,555,753
Total revenues	<u>1,583,201</u>	<u>2,690,203</u>	<u>5,270,623</u>	<u>10,555,753</u>
Operating costs and expenses:				
Project operating costs	1,187,440	264,430	1,735,691	1,842,195
Depletion, depreciation & amortization	1,356,192	1,130,190	2,838,526	3,935,716
Accretion (Note 9)	1,266	1,717	7,011	9,303
Impairment on exploration & evaluation asset (Note 6)	397,459	263,168	1,454,646	296,423
General and administrative	993,526	268,145	3,152,825	3,360,020
Total operating costs and expenses	<u>3,935,883</u>	<u>1,927,650</u>	<u>9,188,699</u>	<u>9,443,658</u>
Operating income/(loss)	<u>(2,352,682)</u>	<u>762,553</u>	<u>(3,918,076)</u>	<u>1,112,095</u>
Other income:				
Gain on farmout agreement (Note 7)	3,342,950	-	27,624,506	-
Other income	12,758	27,808	33,885	68,258
Total other income	<u>3,355,708</u>	<u>27,808</u>	<u>27,658,391</u>	<u>68,258</u>
Income tax expense	(984,223)	-	(984,223)	-
Net income	<u>\$ 1,987,249</u>	<u>\$ 790,361</u>	<u>\$ 24,724,538</u>	<u>\$ 1,180,353</u>
Net income per share, basic	\$ 0.04	\$ 0.02	\$ 0.50	\$ 0.02
Net income per share, diluted	\$ 0.04	\$ 0.02	\$ 0.49	\$ 0.02
Weighted average number of shares outstanding, basic	49,815,816	49,756,506	49,749,805	49,756,506
Weighted average number of shares outstanding, diluted	50,332,149	50,235,228	50,335,196	50,548,072

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

EPSILON ENERGY LTD.
Interim Unaudited Condensed Consolidated Statements of Shareholders' Equity
(All amounts stated in US\$)

	Nine months ended September 30,	
	2011	2010
		(note 5)
Share Capital:		
Balance, January 1	\$ 136,001,220	\$ 138,272,250
Exercise of stock options	398,974	688,619
Share repurchase	(183,613)	(2,741,078)
Balance, September 30	\$ 136,216,581	\$ 136,219,791
Contributed Surplus		
Balance, January 1	\$ 6,323,776	\$ 6,098,296
Buy back of shares	-	271,828
Stock options:		
<i>Amortized</i>	1,156,642	691,800
<i>Exercised</i>	(224,574)	(271,656)
<i>Forfeited</i>	(5,215)	(452,041)
Balance, September 30	\$ 7,250,629	\$ 6,338,228
Deficit		
Balance, January 1	\$ (60,603,456)	\$ (63,670,728)
Net earnings	24,724,539	1,180,353
Balance, September 30	\$ (35,878,917)	\$ (62,490,375)
Accumulated Foreign Currency Translation Adjustments		
Balance, January 1	\$ 648,860	\$ -
Foreign currency translation adjustments	(283,957)	331,293
Balance, September 30	\$ 364,903	\$ 331,293
Total Shareholders' Equity	\$ 107,953,196	\$ 80,398,937

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010 <i>(note 5)</i>	2011	2010 <i>(note 5)</i>
Cash flows from operating activities:				
Net income for the period	\$ 1,987,249	\$ 790,361	\$ 24,724,538	\$ 1,180,353
Items not involving cash:				
Depletion, depreciation and amortization	1,356,192	1,130,190	2,838,526	3,935,716
Accretion	1,266	1,717	7,011	9,303
Impairment of unproved properties	397,459	263,168	1,454,646	296,423
Stock-based compensation (recovery)	501,502	(263,192)	1,053,009	239,759
Net gain on derecognition of farmout assets	(3,342,950)	-	(27,624,506)	-
Deferred income taxes	(990,192)	-	(990,192)	-
Disposal of other assets	997	(3,133)	2,748	(3,133)
Changes in non-cash balances related to operations (Note 14)	(97,835)	(262,427)	(1,249,168)	(278,319)
Net cash provided by (used in) operating activities	(186,313)	1,656,683	216,613	5,380,102
Cash flows from investing activities:				
Additions to oil and natural gas properties (Note 14)	(3,227,116)	20,177	(7,411,505)	(6,277,255)
Additions/translation difference to other property and equipment	2,930	-	1,069	(1,809)
Proceeds from farmout agreement	6,500,000	-	6,500,000	5,000,000
Proceeds from assets sold	1,030	17,000	4,880	17,000
Changes in restricted cash - current	11,140	-	264,356	-
Changes in restricted cash - long-term	-	84,800	242,024	(115,900)
Net cash provided by (used in) investing activities	3,287,984	121,977	(399,177)	(1,377,964)
Cash flows from financing activities:				
Proceeds from options exercised	272,818	99,879	272,818	416,964
Common share buy back	(183,613)	-	(183,613)	(2,469,250)
Net cash provided by (used in) financing activities	89,205	99,879	89,205	(2,052,286)
Effect of currency rates on cash and cash equivalents				
	(99,628)	117,695	8,612	280,082
Increase (decrease) in cash and cash equivalents	3,091,248	1,996,234	(84,747)	2,229,934
Cash and cash equivalents, beginning of period	15,494,578	15,522,564	18,670,574	15,288,547
Cash and cash equivalents, end of period	\$ 18,585,826	\$ 17,518,798	\$ 18,585,826	\$ 17,518,481
Supplementary cash flow information				
Interest received	\$ 14,234	\$ 20,336	\$ 37,417	\$ 57,144
Interest paid	\$ 607	\$ 413	\$ 1,073	\$ 4,733
Income taxes paid	\$ 5,969	\$ -	\$ 5,969	\$ -
Income taxes received	\$ -	\$ -	\$ -	\$ -
Cash and cash equivalents consist of:				
Cash	\$ 1,143,996	\$ 1,769,595	\$ 1,143,996	\$ 1,769,595
Money market funds	15,645,645	15,483,941	15,645,645	15,483,941
Interest bearing short-term deposits	1,796,186	265,263	1,796,186	265,263
Cash and cash equivalents	\$ 18,585,826	\$ 17,518,799	\$ 18,585,826	\$ 17,518,799
Non-cash items:				
Increase to asset retirement obligation	\$ 133,770	\$ 31,508	\$ 238,382	\$ 16,899
Additions to oil and gas interests	\$ 19,616,861	\$ 3,965,629	\$ 143,305	\$ 4,066,966

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

EPSILON ENERGY LTD.
Interim Unaudited Condensed Consolidated Statements of Comprehensive Income
and Accumulated Foreign Currency Translation Adjustments
(All amounts stated in US\$)

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010 (note 5)	2011	2010 (note 5)
Comprehensive income:				
Net income	\$ 1,987,249	\$ 790,361	\$ 24,724,539	\$ 1,180,353
Other comprehensive income:				
Currency translation adjustments	(553,490)	202,924	(283,957)	331,293
Comprehensive income	\$ 1,433,759	\$ 993,285	\$ 24,440,582	\$ 1,511,646
Accumulated foreign currency translation adjustments:				
Balance, beginning of period	\$ 918,393	\$ 128,369	\$ 648,860	\$ -
Currency translation adjustments	(553,490)	202,924	(283,957)	331,293
Balance, end of period	\$ 364,903	\$ 331,293	\$ 364,903	\$ 331,293

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

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

1. Description of Business

Epsilon Energy Ltd. (the “Corporation” or “Epsilon”) was incorporated under the laws of the Province of Alberta on March 14, 2005. On October 24, 2007, the Corporation became a publicly traded entity on the Toronto Stock Exchange under the trading symbol “EPS”. The Corporation is engaged in the acquisition, exploration, development and production of oil and natural gas reserves in the United States, Canada, and the Federal Democratic Republic of Ethiopia (“Ethiopia”).

Epsilon is a publicly traded company, incorporated and domiciled in Canada. The address of its registered office is 150 Jardin Drive, Suite 9, Concord, ON L4K 3P9.

These interim unaudited condensed consolidated financial statements (“the interim financial statements”) were approved and authorized for issuance by the Board of Directors (“the Board”) on November 8, 2011.

2. Basis of preparation

In 2010, the accounting principles were revised to incorporate International Financial Reporting Standards (“IFRS”), and require publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. This represents Epsilon’s first application of IFRS as at and for the three and nine months ended September 30, 2011, including 2010 comparative periods. The financial statements have been prepared in accordance with IFRS 1, “First-time Adoption of International Financial Reporting Standards” and with International Accounting Standard (“IAS”) 34, “Interim Financial Reporting”, as issued by the International Accounting Standards Board (“IASB”).

A summary of Epsilon’s significant accounting policies under IFRS is presented in Note 3. These policies have been retrospectively and consistently applied except where specific exemptions permitted an alternative treatment upon transition to IFRS in accordance with IFRS 1 “First-time Adoption of International Financial Reporting Standards”. Previously, the Corporation prepared its interim and annual consolidated financial statements in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”).

The interim financial statements have been prepared under the historical cost convention. The preparation of financial information in conformity with IFRS requires the use of certain accounting estimates. It also requires management to exercise its judgment in the process of applying Epsilon’s accounting policies. The key accounting estimates and judgments are explained in Note 4 below. Actual results could differ from those estimates.

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

3. Significant accounting policies

Principles of Consolidation

The Corporation's interim financial statements include the accounts of the Corporation and its wholly owned subsidiaries, Epsilon Energy USA, Inc. and Epsilon Energy International Ltd and their wholly owned subsidiaries. All material inter-company transactions have been eliminated.

Revenue recognition

Revenues from the sale of crude oil, natural gas and other petroleum products are recognized, net of royalties, when the title passes to the purchaser and collectability is assured. Revenues from crude oil and natural gas production from properties in which Epsilon has an interest together with other producers are recognized on the basis of Epsilon's net working interest in those properties.

Cash and cash equivalents

Cash and cash equivalents include cash on hand and short-term, highly liquid investments and restricted cash balances with original maturities of three months or less that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Restricted cash balances with maturity dates greater than one year are presented as a long-term asset.

Property and equipment

Property and equipment are stated at cost, less accumulated depreciation and accumulated impairment losses. They are initially recorded in the consolidated balance sheets if it's probable that they will generate future economic benefits. This includes capitalization of decommissioning and restoration costs associated with provisions for decommissioning liabilities (see "Decommissioning Liabilities") and certain development costs (see "Development costs"). Accounting for exploration costs is described separately below ("Exploration and evaluation assets"). Expenditures on renewals, improvements and transformations that extend the useful lives of the related asset are capitalized to property and equipment.

Depletion, depreciation, and amortization

Property and equipment related to oil and natural gas production activities are depleted from the moment they are available for use on a unit-of-production basis over the proved developed reserves of the field concerned, except in the case of assets whose useful life is shorter than the lifetime of the field, in which case the straight-line method is applied. License acquisition, field development and future decommissioning costs are amortized over total proved reserves of the relevant area. Where individually insignificant, unproved properties may be grouped and amortized based on factors such as the average lease term and past experience of recognizing proved reserves.

Other property and equipment are depreciated on a straight-line basis over their expected useful lives. The expected useful lives of property and equipment are reviewed on an annual basis and, if necessary, changes in useful lives are accounted for prospectively.

When tangible assets are composed of more than one significant element with different useful lives, each component is depreciated separately. The amount to be depreciated is represented by the book value reduced by the estimated net realizable value at the end of the useful life, if it is significant and can be reasonably determined.

Epsilon Energy Ltd.

Notes to the Interim Unaudited Condensed Consolidated Financial Statements

For the three and nine months ended September 30, 2011 and 2010

3. Significant accounting policies (continued)

Property and equipment (continued)

Replacement costs of identifiable components in complex assets are capitalized and depreciated over their useful lives; the residual book value of the component that has been substituted is charged to the profit and loss account. Expenditures for ordinary maintenance and repairs are expensed as incurred.

Pre-acquisition expenditures

Pre-acquisition expenditures on oil and natural gas assets are recognized as an expense in the income statement when incurred. These are costs incurred prior to obtaining legal title to the property and include legal costs to verify the legal title to the property, technical services and studies, seismic acquisition, geological and geophysical costs, and directly attributable labor, administrative and overhead costs. Once legal title is obtained, these costs are capitalized as exploration and evaluation assets.

Exploration and evaluation assets

Exploration and evaluation ("E&E") assets are initially capitalized by well, field or exploration area, as appropriate, and include payments to acquire the legal right to explore, technical services and studies, seismic acquisition, geological and geophysical costs, exploratory drilling and testing, consumed materials and directly attributable administrative and overhead costs. E&E costs are classified as intangible or tangible oil and natural gas assets according to the nature of the asset and are capitalized until the technical feasibility and commercial viability of the well or project has been established.

The technical feasibility and commercial viability of E&E assets is considered to be determinable when proven reserves are determined to exist. A review of each E&E asset is completed at least annually when impairment indicators are present, to ascertain whether proven reserves have been discovered. Upon determination of proven reserves, E&E assets attributable to those reserves are first tested for impairment and then reclassified from E&E assets to property and equipment.

Each E&E asset is reviewed for impairment whenever events or changes in circumstances indicate the carrying value may not be recoverable. When a potential impairment is indicated, an assessment of the E&E asset is performed by allocating the E&E to cash-generating units to which the exploration cost is attributed. To the extent that the capitalized expenditure is not expected to be recovered through use or disposal, it is expensed. If no future related activity is planned, the E&E costs are also expensed. E&E costs are not amortized prior to the completion of exploration and evaluation activities.

Exploration and evaluation costs expended on behalf of Epsilon under a joint operating agreement as part of the carry amount are capitalized as expenditures are made.

Development costs

Development costs are those costs incurred to obtain access to proved reserves and to provide facilities for extracting, gathering and storing oil and natural gas. Such capitalized oil and natural gas interests generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis. The carrying amount of any replaced or sold property or component is derecognized with a gain or loss recognized in the income statement. The costs of the day-to-day servicing of property and equipment are recognized in profit or loss as incurred.

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

3. Significant accounting policies (continued)

Development costs (continued)

The development costs are capitalized within property and equipment and amortized generally on a unit of production basis, as their useful life is closely related to the availability of oil and gas reserves. This method provides for residual costs at the end of each quarter to be amortized at a rate representing the ratio between the volumes extracted during the quarter and the proved developed reserves at the beginning of the quarter with consideration to the estimated future development costs necessary to bring those reserves into production. A separate depletion calculation is performed for each field or geotechnical area. Costs related to unsuccessful development wells or damaged wells are expensed immediately as losses on disposal.

Development costs expended on behalf of Epsilon under a joint operating agreement as part of the carry amount are capitalized as expenditures are made.

Impairment of assets

The carrying value of property and equipment is reviewed for impairment whenever events indicate that the carrying amounts for those assets may not be recoverable. Such indicators include changes in the Corporation's business plans, changes in commodity prices leading to unprofitable performance, and, for oil and gas properties, significant downward revisions of estimated proved reserve quantities or significant increase of the estimated development costs.

For the purpose of impairment testing, assets are grouped into smaller groups of assets that generate cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (the "cash generating unit" or "CGU"). Assets are grouped based on separately identifiable and largely independent cash flows which is typically done at the field level. If CGU's are determined to be impaired, the carrying amounts of those assets are written down to recoverable amount, which is the higher of fair value less costs to sell and value in use determined as the amount of estimated discounted future cash flows for productive assets.

The expected future cash flows used for impairment analyses are based on judgmental assessments of future production volumes, prices and costs, considering available information at the date of review and are discounted by using a pre-tax rate related to the activity involved that takes into account the market risk in the sectors where the entity operates.

For oil and natural gas properties, the expected future cash flows are estimated principally based on developed and non-developed proved reserves including, among other elements, operating costs, production taxes and the costs to be incurred for the reserves yet to be developed.

Impairments are reversed as applicable to the extent that the events or circumstances that triggered the original impairment have changed. Impairment charges and reversals are reported separately from depletion, depreciation, and amortization.

The basis for future depletion, depreciation and amortization will take into account the reduction in the value of the asset as a result of any accumulated impairment losses. When an impairment loss subsequently reverses, the carrying amount of the asset (or the cash-generating unit) is increased to the revised estimate of its recoverable amount, so that the increased carrying amount does not exceed the carrying amount that would have been determined in case no impairment loss had been recognized for the asset (or the cash-generating unit) in prior years. After such reversal, the depletion charge is adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

3. Significant accounting policies (continued)

Decommissioning liabilities

The Corporation recognizes the present value of its decommissioning 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 present value of these obligations is calculated at each period end as the present value of the expected future costs of abandonment of such property using a risk free rate, on a country by country basis.

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 a finance 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.

Deferred farmout proceeds

Exploration, evaluation and development costs incurred on behalf of Epsilon under a joint operating agreement as part of the carry amount are capitalized to an appropriate asset account or expensed to an appropriate operating cost account, with an offsetting entry to the deferred farmout proceeds. Upon reaching expenditure milestones and once the conditions for sale have been met, disposal of the property is triggered with a difference between deferred farmout proceeds and the carrying amount of the property disposed recorded as gain on disposal.

Income taxes

Income tax on profit or loss for the year comprises of current and deferred tax. Current tax is the expected tax paid or payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax paid or payable in respect of previous years.

Deferred tax is recorded using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised. The effect on deferred income tax assets and liabilities of a change in income tax rates is recognized in the period that includes the date of the enactment or substantive enactment of the change. Deferred tax assets and liabilities are presented separately except where there is a right of set-off within fiscal jurisdictions.

Leases

Agreements under which the Corporation makes payments to owners in return for the right to use an asset for a period are accounted for as leases. Leases that transfer substantially all the risks and rewards of ownership are recorded at inception as finance leases within property and equipment and debt. 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.

Joint interests

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

Epsilon Energy Ltd.

Notes to the Interim Unaudited Condensed Consolidated Financial Statements

For the three and nine months ended September 30, 2011 and 2010

3. Significant accounting policies (continued)

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.

Foreign currencies translation

Items included in the financial statements of each subsidiary are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements are presented in US dollars, which is the Corporation's functional and presentation currency.

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 at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated at foreign exchange rates prevailing at the dates the fair value was determined.

The results and financial position of subsidiaries (none of which has the currency of a hyperinflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- (a) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that statement of financial position;
- (b) income and expenses for each statement of operations and statement of comprehensive income are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and
- (c) all resulting exchange differences are recognised as a separate component of equity. On consolidation, exchange differences arising from the translation of the net investment in foreign entities are taken to shareholders' equity. When a foreign operation is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale.

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) financial assets or liabilities at fair value through profit or loss ("FVTPL"), (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 at FVTPL 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.

Epsilon Energy Ltd.

Notes to the Interim Unaudited Condensed Consolidated Financial Statements

For the three and nine months ended September 30, 2011 and 2010

3. Significant accounting policies (continued)

Financial instruments (continued)

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

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	Loans and receivables	Amortized cost
Accounts receivable.....	Loans and receivables	Amortized cost
Restricted cash.....	Loans and receivables	Amortized cost
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 does not have any Level 1, 2 or 3 disclosures.

Comprehensive income (loss)

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss) and represents the change in shareholders’ equity which results from transactions and events from sources other than the Corporation’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.

Business combinations

The acquisition method of accounting is used to account for all business combinations, including business combinations involving entities or businesses under common control, regardless of whether equity instruments or other assets are acquired. The consideration transferred for the acquisition of a subsidiary comprises the fair values of the assets transferred, the liabilities incurred and the equity interests issued.

Acquisition-related costs are expensed as incurred. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are initially measured at their fair values at the acquisition date. On an acquisition-by-acquisition basis, the Corporation recognises any non-controlling interest in the acquiree either at fair value or at the non-controlling interest’s proportionate share of the acquiree’s net identifiable assets. The excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition-date fair value of any previous equity interest in the acquiree over the fair value of the group’s share of the net identifiable assets acquired is recorded as goodwill.

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3. Significant accounting policies (continued)

Business combinations (continued)

If those amounts are less than the fair value of the net identifiable assets of the subsidiary acquired and the measurement of all amounts has been reviewed, the difference is recognised directly in profit or loss as a bargain purchase.

Stock-based compensation

The Corporation mainly estimates the fair value of all stock options awarded to employees and directors using the Black-Scholes option pricing model. Other models are used for options with more complex vesting criteria. Compensation expense and a corresponding increase to contributed surplus are recorded over the vesting period based on the fair value of the options granted using a graded vesting approach. 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 retained earnings (deficit). The Corporation estimates a forfeiture rate and adjusts the corresponding expense each period based on an updated forfeiture estimate.

New pronouncements adopted

September 30, 2011 is Epsilon's third reporting period under IFRS. Accounting standards effective for periods beginning on or after January 1, 2011 have been adopted as part of the transition to IFRS.

Application of new and revised International Financial Reporting Standards (IFRSs) issued but not yet effective

Epsilon has reviewed new and revised accounting pronouncements that have been issued but are not yet effective and determined that the following may have an impact on the Corporation:

As of January 1, 2015, Epsilon will be required to adopt IFRS 9 "Financial Instruments", which is the result of the first phase of the International Accounting Standards Board ("IASB") project to replace IAS 39 "Financial Instruments: Recognition and Measurement". The new standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only two classification categories: amortized cost and fair value. Portions of the standard remain in development and the full impact of the standard on Epsilon's Consolidated Financial Statements will not be known until the project is complete.

In May 2011, the IASB released the following new standards: IFRS 10, "Consolidated Financial Statements", IFRS 11, "Joint Arrangements", IFRS 12, "Disclosures of interests in other entities" and IFRS 13, "Fair Value Measurement". Each of these standards is to be adopted for fiscal years beginning January 1, 2013 with earlier adoption permitted. A brief description of each new standard follows below:

- IFRS 10, "Consolidated Financial Statements" supersedes IAS 27 "Consolidation and Separate Financial Statements" and SIC-12 "Consolidation – Special Purpose Entities". This standard provides a single model to be applied in control analysis for all investees including special purpose entities.
- IFRS 11, "Joint Arrangements" divides joint arrangements into two types, joint operations and joint ventures, each with their own accounting model. All joint arrangements are required to be reassessed on transition to IFRS 11 to determine their type to apply the appropriate accounting.
- IFRS 12, "Disclosure of Interests in Other Entities" combines in a single standard the disclosure requirements for subsidiaries, associates and joint arrangements as well as unconsolidated structured entities.
- IFRS 13, "Fair Value Measurement" defines fair value, establishes a framework for measuring fair value and sets out disclosure requirements for fair value measurements. This standard defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Epsilon is currently analysing the expected impact, if any, that the adoption of each of these standards will have on its Consolidated Financial Statements.

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4. Management's Critical Accounting Judgments and Key Sources of Estimation Uncertainty

In the application of the Corporation's accounting policies, which are described in Note 3, management is required to make judgments, estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the interim financial statements and reported amounts of revenues and expenses during the period. Accordingly, actual results may differ from estimated results.

While management believes that its estimates have been reasonable in the circumstances, the volatility in the price of oil and natural gas, the recession in Canada 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 they will continue to present future risks. To prepare these interim financial statements, management has recorded adjustments and included disclosures based on their best estimates of projected business activity and future cash flows.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Critical accounting judgments

(a) Estimation of reserves

Engineering estimates of the Corporation's oil and natural gas reserves are inherently uncertain. Proved reserves are the estimated volumes of crude oil, natural gas and gas condensates, liquids and associated substances which geological and engineering data demonstrate that can be economically producible with reasonable certainty from known reservoirs under existing economic conditions and operating methods. Although there are authoritative guidelines regarding the engineering criteria that must be met before estimated oil and natural gas reserves can be designated as "proved", the accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretation and judgment. Field reserves will only be categorized as proved when all the criteria for attribution of proved status have been met. At this stage, all booked reserves will be classified as proved undeveloped. Volumes will subsequently be reclassified from proved undeveloped to proved developed as a consequence of development activity. The first proved developed bookings will occur at the point of first oil or natural gas production. Epsilon reassesses its estimate of proved reserves periodically. The estimated proved reserves of oil and natural gas may be subject to future revision and upward and downward revision may be made to the initial booking of reserves due to production, reservoir performance, commercial factors, acquisition and divestment activity and additional reservoir development activity. In particular, changes in oil and natural gas prices could impact the amount of Epsilon's proved reserves in regards to the initial estimate and, in the case of production-sharing agreements and buy-back contracts, the share of production and reserves to which Epsilon is entitled. Accordingly, the estimated reserves could be materially different from the quantities of oil and natural gas that ultimately will be recovered. Oil and natural gas reserves have a direct impact on certain amounts reported in the consolidated financial statements. Estimated proved reserves are used in determining depletion, depreciation and amortization expenses and impairment expense. Depletion rates on oil and natural gas assets using the unit-of-production basis are determined from the ratio between the amount of hydrocarbons extracted in the quarter and proved developed reserves existing at the end of the quarter increased by the amounts extracted during the quarter.

Epsilon Energy Ltd.

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For the three and nine months ended September 30, 2011 and 2010

4. Management's Critical Accounting Judgments and Key Sources of Estimation Uncertainty (continued)

(a) Estimation of reserves (continued)

Assuming all other variables are held constant, an increase in estimated proved developed reserves for each field decreases depletion, depreciation, and amortization expense. Conversely, a decrease in estimated proved developed reserves increases depletion, depreciation, and amortization expense. In addition, estimated proved reserves are used to calculate future cash flows from oil and natural gas properties, which serve as an indicator in determining whether or not property impairment is to be carried out. The larger the volume of estimated reserves, the lower the likelihood of asset impairment.

(b) Impairments

The estimated future level of production is based on assumptions concerning: future commodity prices, lifting and development costs, field decline rates, market demand and supply, economic regulatory climates and other factors. Oil, natural gas and petroleum product prices used to quantify the expected future cash flows are estimated based on forward prices prevailing in the marketplace for the first year and management's long-term planning assumptions thereafter. The estimate of the future amount of production is based on assumptions related to the commodity future prices, lifting and development costs, market demand and other factors. The discount rate reflects the current market valuation of the time value of money and of the specific risks of the asset not reflected in the estimate of the future cash flows.

Determination as to whether and how much an asset is impaired involves management estimates on highly uncertain matters such as future commodity prices, the effects of inflation and technology improvements on operating expenses, production profiles and the outlook for global or regional market supply and demand conditions for crude oil, natural gas, commodity chemicals and refined products.

(c) Depletion, depreciation and amortization

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 deferred 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.

(d) Decommissioning liabilities

The calculation of decommissioning liabilities includes estimates of the future costs to settle the 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.

(e) Future revenues and operating costs

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.

(f) Identification of cash-generating units ("CGU's")

Management reviews the CGU determination on a periodic basis. The recoverability of property and equipment carrying values are assessed at the CGU level. Determination of what constitutes a CGU is subject to management judgments. The asset composition of a CGU can directly impact the recoverability of the assets within.

Epsilon Energy Ltd.

Notes to the Interim Unaudited Condensed Consolidated Financial Statements

For the three and nine months ended September 30, 2011 and 2010

**4. Management's Critical Accounting Judgments and Key Sources of Estimation Uncertainty
(continued)**

Key sources of estimation uncertainty

The following are the key assumptions concerning the key sources of estimation uncertainty at the end of the reporting period, that have a significant risk of causing adjustments to the carrying amounts of assets and liabilities within the next financial year.

- a) Estimates of recoverable quantities of proved and probable reserves include judgmental assumptions and the economic, geological and technical factors used to estimate reserves may change from period to period
- b) Forward price estimates of the oil and natural gas prices are used in the impairment model. Commodity prices have fluctuated widely in recent years due to global and regional factors including supply and demand fundamentals, inventory levels, weather, economic and geopolitical factors.
- c) The impairment model uses discount rate to calculate the net present value of cash flows based on weighted average cost of capital estimates. Changes in the general economic environment could result in significant changes in this estimate.
- d) Amounts recorded from joint venture partners are based on the Corporation's interpretation of underlying agreements and may 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.
- e) The provision for site restoration and abandonment is based on current legal and constructive requirements, technology, price levels and expected plans for remediation. Actual costs and cash outflows can differ from estimates because of changes in laws and regulations, public expectations, prices and discovery and analysis of site conditions and changes in clean-up technology.

The above judgments, estimates and assumptions relate primarily to unsettled transactions and events as of the date of the interim financial statements. Actual results could differ from these estimates and the differences could be material.

Impairment tests carried out at September 30, 2011 were based on the commodity price estimates as disclosed in the consolidated financial statements for the years ended December 31, 2010 and 2009. A 1% increase in the discount rate and a 5% decrease in the forward curve would not result in any additional impairment.

Epsilon Energy Ltd.

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For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS

The following discussion explains the significant differences between Epsilon's Canadian GAAP accounting policies and those applied by the Corporation under IFRS. IFRS policies have been retrospectively and consistently applied except where specific IFRS 1 optional and mandatory exemptions permitted an alternative treatment upon transition to IFRS for first-time adopters.

Canadian GAAP differs in certain respects from IFRS and comparative information as at January 1, 2010, as at and for the three and nine months ended September 30, 2010, and as at and for the twelve months ended December 31, 2010, has been restated as necessary in accordance with IFRS. Reconciliations and descriptions of the effect of the transition from Canadian GAAP to IFRS on equity and income are given below, including a description of the nature of the changes in accounting policies. As part of Epsilon's adoption of IFRS, the following elections were made under IFRS 1 "First-time Adoption of International Financial Reporting Standards" as at January 1, 2010:

- (a) IAS 21 was applied prospectively to eliminate cumulative currency translation differences by transfer to deficit.
- (b) Business combinations prior to transition date have not been restated.
- (c) Net property and equipment were recorded at historical cost using the oil and gas deemed cost exemption.

The remaining IFRS 1 exemptions were not applicable or material to the preparation of Epsilon's consolidated balance sheet at the date of transition to IFRS on January 1, 2010.

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

IFRS Adjustments

(a) Exploration and evaluation assets and expenses

Exploration and evaluation assets at January 1, 2010 were deemed to be \$20,099,107 including \$16,748,727 in the US, \$1,009,423 in Canada, \$2,340,957 in Ethiopia and the Middle East, representing the unproved properties balance under Canadian GAAP. This resulted in a reclassification of \$20,099,107 from property and equipment to exploration and evaluation assets on Epsilon's consolidated balance sheet as at January 1, 2010.

Under IFRS, joint venture partner's drilling expenditures made on behalf of Epsilon have been capitalized to the Corporation's cost pool and allocated between exploration and evaluation assets and development costs. Expenditures classified as development costs have been amortized on a unit of production basis. The exploration and evaluation assets have been tested for impairment. At September 30, 2010 and December 31, 2010, there has been no impairment of these assets. Epsilon's share of the lease operating expenses has also been recorded as an operating cost to the Corporation as these are additional payments that the joint venture partner is making on Epsilon's behalf as part of carried interest. The exploration and evaluation assets and the lease operating expenses have previously been excluded from the Corporation's financial reporting under Canadian GAAP.

As a result of the application of IFRS to the joint venture assets, Epsilon capitalized additional assets totalling \$9,066,966 and \$20,780,114 at September 30, 2010 and December 31, 2010 respectively, which were originally classified as E&E assets. The offsetting amount at September 30, 2010 of \$9,638,682 (December 31, 2010: \$21,469,603) was recorded as deferred farmout proceeds, where the balance accumulates until conditions for the disposal of the property subject to the joint operating agreement are met. As a result of the application of IFRS to the joint venture lease operating expenditures, Epsilon expensed additional \$124,662, \$571,716 and \$689,489 for the three and nine months ended September 30, 2010 and December 31, 2010, respectively, which reduced the Corporation's previously reported Canadian GAAP income by the same amount for these reporting periods.

As at December 31, 2010, the Corporation's exploration and evaluation assets were \$41,282,688 including \$35,325,005 in the US, \$3,569,122 in Canada and \$2,388,561 in Ethiopia. The exploration and evaluation assets in the Middle East in the amount of \$246,920 were written off during the twelve months ended December 31, 2010.

Under Canadian GAAP, exploration and evaluation costs were capitalized as property and equipment in accordance with the CICA's full cost accounting guidelines. Under IFRS, Epsilon capitalizes these costs initially as exploration and evaluation assets. Once technical feasibility and commercial viability of the area has been determined, the capitalized costs are transferred from exploration and evaluation assets to property and equipment. Under IFRS, unrecoverable exploration and evaluation costs associated with an area and costs incurred prior to obtaining the legal rights to explore are expensed.

During the three and nine months ended September 30, 2010, and twelve months ended December 31, 2010, Epsilon transferred \$nil of capitalized exploration and evaluation costs to property and equipment. During the same periods Epsilon expensed \$63,422, \$328,004 and \$328,004 of previously capitalized pre-acquisition costs and \$24,769, \$51,769 and \$51,769 previously capitalized salaries incurred prior to obtaining legal title to explore. The application of IFRS to exploration and evaluation costs resulted in a decrease of \$89,435, \$379,773 and \$379,773 to Epsilon's Canadian GAAP net earnings for the three and nine months ended September 30, 2010 and December 31, 2010, respectively.

As at the date of transition, the Corporation tested all of its CGUs for impairment. The recoverable amount of each CGU was estimated based on the higher of the value in use and the fair value less costs to sell. The fair value less costs to sell was determined using discounted proved forecasted cash flows, with escalating prices and future development costs, as obtained from the Corporation's reserve report. Based on the above assessment, there were no adjustments to the carrying amounts of exploration and evaluation assets at January 1, 2010.

Epsilon Energy Ltd.

Notes to the Interim Unaudited Condensed Consolidated Financial Statements

For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

(b) Depletion, depreciation and amortization (“DD&A”)

Net development costs at January 1, 2010 were deemed to be \$46,591,967, representing the full cost pool balance under Canadian GAAP. Consistent with Canadian GAAP, these costs are capitalized as property and equipment under IFRS. Under Canadian GAAP, development costs, whose life is equal to the lifetime of the field, were depleted using the unit-of-production method calculated at the established area level consistent with IFRS, with \$nil effect on the DD&A expense and net earnings for the twelve months ended December 31, 2010.

The development costs whose useful life is shorter than the lifetime of the field were depreciated using a straight – line basis over the remaining useful life of the assets. The application of IFRS to development costs resulted in an increase of \$20,695, \$113,510 and \$110,972 to Epsilon’s Canadian GAAP net earnings for the three and nine months ended September 30, 2010 and December 31, 2010, respectively.

The IFRS 1 exemption permitted the Corporation to allocate development costs to the area level using proved reserves values for each cash generating unit as at January 1, 2010.

(c) Asset retirement obligation (“ARO”)

Under Canadian GAAP, the asset retirement obligation was measured as the estimated fair value of the decommissioning liabilities expected to be incurred. Liabilities were not remeasured to reflect period end discount rates.

Under IFRS, the decommissioning liability is measured as the best estimate of the expenditure to be incurred and requires that the decommissioning liability be remeasured using the period-end risk free discount rate.

Epsilon was required to remeasure its asset retirement obligation upon transition to IFRS and recognize the difference in retained earnings. The application of this exemption resulted in a \$6,225 increase to the asset retirement obligation on Epsilon’s consolidated balance sheet as at January 1, 2010, and an after-tax offset to retained earnings of \$6,225. Subsequent IFRS remeasurements of the obligation are recorded through property and equipment with an offsetting adjustment to the asset retirement obligation. As at September 30, 2010 and December 31, 2010, Epsilon's asset retirement obligation increased by \$66,530 and \$98,227, respectively, which primarily reflects the remeasurement of the obligation using Epsilon's risk free discount rate of 3.52 percent as at September 30, 2010 and 3.56 percent at December 31, 2010. The increase to asset retirement accretion at September 30, 2010 and December 31, 2010 was immaterial.

(d) Foreign currency translation adjustment

As permitted by IFRS 1, the Corporation elected to apply the exemption to set the cumulative foreign currency translation adjustment to zero upon transition to IFRS. Accordingly, \$6,876,926 was recognized as an adjustment to deficit on January 1, 2010. The reclassification had no impact on total shareholders’ equity as at January 1, 2010. As a result of the election, the accounts of the Corporation have not been retrospectively restated using IFRS foreign currency principles.

The IFRS adjustments discussed above are recorded in the Corporation’s functional currency and are subject to translation for presentation purposes. The associated foreign currency impacts are reported in accumulated other comprehensive income.

Epsilon Energy Ltd.
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5. Reconciliation from Canadian GAAP to IFRS (continued)

IFRS Opening Consolidated Balance Sheet as at January 1, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
ASSETS						
Current assets:						
Cash and cash equivalents	\$ 15,288,547	-	-	-	-	\$ 15,288,547
Accounts receivable	1,488,429	-	-	-	-	1,488,429
Assets held for sale	100,000	-	-	-	-	100,000
Other current assets	62,382	-	-	-	-	62,382
TOTAL CURRENT ASSETS	16,939,358	-	-	-	-	16,939,358
Oil and gas interests:						
Intangible exploration and evaluation assets (Note 6)	-	20,099,107	-	-	-	20,099,107
Net property and equipment (Note 7)	66,691,074	(20,099,107)	-	-	-	46,591,967
Total oil and gas interests	66,691,074	-	-	-	-	66,691,074
Other assets:						
Restricted cash (Note 8)	732,240	-	-	-	-	732,240
Other deferred charges and miscellaneous assets	18,504	-	-	-	-	18,504
Total other assets	750,744	-	-	-	-	750,744
Total assets	84,381,176	-	-	-	-	84,381,176
LIABILITIES AND SHAREHOLDERS' EQUITY						
Current liabilities:						
Accounts payable and accrued liabilities	3,460,740	-	-	-	-	3,460,740
Total current liabilities	3,460,740	-	-	-	-	3,460,740
Other liabilities:						
Asset retirement obligations (Note 9)	214,393	-	-	6,225	-	220,618
Total liabilities	3,675,133	-	-	6,225	-	3,681,358
Shareholders' equity:						
Share capital (Note 10)	138,272,250	-	-	-	-	138,272,250
Contributed surplus (Note 10)	6,098,296	-	-	-	-	6,098,296
Deficit	(56,787,577)	-	-	(6,225)	(6,876,926)	(63,670,728)
Accumulated other comprehensive loss	(6,876,926)	-	-	-	6,876,926	-
Sub total	80,706,043	-	-	(6,225)	-	80,699,818
Total shareholders' equity	80,706,043	-	-	(6,225)	-	80,699,818
LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 84,381,176	-	-	-	-	\$ 84,381,176

Epsilon Energy Ltd.
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5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Balance Sheet as at September 30, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
ASSETS						
Current assets:						
Cash and cash equivalents	\$ 17,518,799	-	-	-	-	\$ 17,518,799
Accounts receivable	2,152,092	-	-	-	-	2,152,092
Assets held for sale	-	-	-	-	-	-
Other current assets	168,873	-	-	-	-	168,873
TOTAL CURRENT ASSETS	19,839,764	-	-	-	-	19,839,764
Oil and gas interests:						
Intangible exploration and evaluation assets	-	41,292,182	-	-	-	41,292,182
Net property and equipment	62,325,740	(32,604,989)	113,510	54,540	-	29,888,800
Total oil and gas interests	62,325,740	8,687,193	113,510	54,540	-	71,180,982
Other assets:						
Restricted cash	848,140	-	-	-	-	848,140
Other deferred charges and miscellaneous assets	8,010	-	-	-	-	8,010
Total other assets	856,150	-	-	-	-	856,150
Total assets	83,021,654	8,687,193	113,510	54,540	-	91,876,896
LIABILITIES AND SHAREHOLDERS' EQUITY						
Current liabilities:						
Accounts payable and accrued liabilities	1,601,759	-	-	-	-	1,601,759
Total current liabilities	1,601,759	-	-	-	-	1,601,759
Other liabilities:						
Asset retirement obligations	170,989	-	-	66,529	-	237,518
Deferred farmout proceeds	-	9,638,682	-	-	-	9,638,682
Total other liabilities	170,989	9,638,682	-	66,529	-	9,876,200
Total liabilities	1,772,748	9,638,682	-	66,529	-	11,477,959
Shareholders' equity:						
Share capital	136,219,791	-	-	-	-	136,219,791
Contributed surplus	6,338,228	-	-	-	-	6,338,228
Deficit	(54,763,480)	(951,489)	113,510	(11,989)	(6,876,926)	(62,490,375)
Accumulated other comprehensive loss	(6,545,633)	-	-	-	6,876,926	331,293
Sub total	81,248,906	(951,489)	113,510	(11,989)	-	80,398,937
Total shareholders' equity	81,248,906	(951,489)	113,510	(11,989)	-	80,398,937
LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 83,021,654	8,687,193	113,510	54,540	-	\$ 91,876,896

Epsilon Energy Ltd.
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5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Balance Sheet as at December 31, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
ASSETS						
Current assets:						
Cash and cash equivalents	\$ 18,670,574	-	-	-	-	\$ 18,670,574
Accounts receivable	2,746,406	-	-	-	-	2,746,406
Restricted cash - current	-	-	-	-	-	598,036
Other current assets	209,079	-	-	-	-	209,079
TOTAL CURRENT ASSETS	21,626,059	-	-	-	-	22,224,095
Oil and gas interests:						
Intangible exploration and evaluation assets (Note 6)	-	41,282,688	-	-	-	41,282,688
Net property and equipment (Note 7)	63,308,624	(20,880,585)	109,213	90,239	-	42,627,491
Total oil and gas interests	63,308,624	20,402,103	109,213	90,239	-	83,910,179
Other assets:						
Restricted cash (Note 8)	840,060	-	-	-	-	242,024
Other deferred charges and miscellaneous assets	8,010	-	-	-	-	8,010
Total other assets	848,070	-	-	-	-	250,034
Total assets	85,782,753	20,402,103	109,213	90,239	-	106,384,308
LIABILITIES AND SHAREHOLDERS' EQUITY						
Current liabilities:						
Accounts payable and accrued liabilities	2,196,966	-	-	-	-	2,196,966
Total current liabilities	2,196,966	-	-	-	-	2,196,966
Other liabilities:						
Asset retirement obligations (Note 9)	249,111	-	-	98,227	-	347,338
Deferred farmout proceeds (Note 5 (a))	-	21,469,603	-	-	-	21,469,603
	249,111	21,469,603	-	98,227	-	21,816,941
Total liabilities	2,446,077	21,469,603	-	98,227	-	24,013,907
Shareholders' equity:						
Share capital (Note 10)	136,001,220	-	-	-	-	136,001,220
Contributed surplus (Note 10)	6,323,776	-	-	-	-	6,323,776
Deficit	(52,760,254)	(1,067,500)	109,213	(7,988)	(6,876,926)	(60,603,455)
Accumulated other comprehensive loss	(6,228,066)	-	-	-	6,876,926	648,860
Sub total	83,336,676	(1,067,500)	109,213	(7,988)	-	82,370,401
Total shareholders' equity	83,336,676	(1,067,500)	109,213	(7,988)	-	82,370,401
LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 85,782,753	(1,067,500)	109,213	90,239	-	\$ 106,384,308

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Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Statement of Earnings and Deficit for the Three Months Ended September 30, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E	DD&A	ARO	Foreign currency translation adjustment	
		Note 5 (a)	Note 5 (b)	Note 5 (c)	Note 5 (d)	
Revenues:						
Oil & gas revenues	\$ 2,690,203	-	-	-	-	\$ 2,690,203
Total revenues	2,690,203	-	-	-	-	2,690,203
Operating costs and expenses:						
Project operating costs	75,103	124,662	-	-	-	199,765
Impairment of unproved properties	263,168	-	-	-	-	263,168
Depletion, depreciation and amortization	1,150,885	-	(20,695)	-	-	1,130,190
Exploration & Evaluation	-	64,665	-	-	-	64,665
Asset retirement accretion	2,035	-	-	(318)	-	1,717
General and administrative	243,376	24,769	-	-	-	268,145
Total operating costs and expenses	1,734,567	214,097	(20,695)	(318)	-	1,927,650
Operating income	955,636	(214,097)	20,695	318	-	762,553
Other income:						
Other income	27,808	-	-	-	-	27,808
Total other income	27,808	-	-	-	-	27,808
Net income	\$ 983,444	(214,097)	20,695	318	-	\$ 790,361
Deficit, beginning of period	\$ (55,746,924)	(95,472)	61,598	(12,543)	(6,876,926)	\$ (62,670,267)
Deficit, end of period	\$ (54,763,480)	(214,097)	20,695	(12,225)	(6,876,926)	\$ (61,879,906)
Weighted average number of shares outstanding, basic	49,756,506	-	-	-	-	49,756,506
Weighted average number of shares outstanding, diluted	50,235,228	-	-	-	-	50,235,228
Net income (loss) per share, basic	\$ 0.02	-	-	-	-	\$ 0.02
Net income (loss) per share, diluted	\$ 0.02	-	-	-	-	\$ 0.02

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Statement of Earnings and Deficit for the Nine Months Ended September 30, 2010

	IFRS Adjustments					IFRS
	Previous GAAP					
		E&E	DD&A	ARO	Foreign currency translation adjustment	
		Note 5 (a)	Note 5 (b)	Note 5 (c)	Note 5 (d)	
Revenues:						
Oil & gas revenues	\$ 10,555,753	-	-	-	-	\$ 10,555,753
Total revenues	10,555,753	-	-	-	-	10,555,753
Operating costs and expenses:						
Project operating costs	942,475	571,716	-	-	-	1,514,191
Impairment of unproved properties	296,423	-	-	-	-	296,423
Depletion, depreciation and amortization	4,049,226	-	(113,510)	-	-	3,935,716
Exploration & evaluation	-	328,004	-	-	-	328,004
Asset retirement accretion	3,539	-	-	5,764	-	9,303
General and administrative	3,308,251	51,769	-	-	-	3,360,020
Total operating costs and expenses	8,599,914	951,489	(113,510)	5,764	-	9,443,658
Operating income	1,955,839	(951,489)	113,510	(5,764)	-	1,112,095
Other income:						
Other income	68,258	-	-	-	-	68,258
Total other income	68,258	-	-	-	-	68,258
Net income	\$ 2,024,097	(951,489)	113,510	(5,764)	-	\$ 1,180,353
Deficit, beginning of period	\$ (56,787,577)	-	-	(6,225)	(6,876,926)	\$ (63,670,728)
Deficit, end of period	\$ (54,763,480)	(951,489)	113,510	(11,989)	(6,876,926)	\$ (62,490,375)
Weighted average number of shares outstanding, basic						
	49,756,506	-	-	-	-	49,756,506
Weighted average number of shares outstanding, diluted						
	50,548,072	-	-	-	-	50,548,072
Net income (loss) per share, basic	\$ 0.04	-	-	-	-	\$ 0.02
Net income (loss) per share, diluted	\$ 0.04	-	-	-	-	\$ 0.02

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Statement of Earnings for the Twelve Months Ended December 31, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
Revenues:						
Oil & gas revenues	\$ 14,753,440	-	-	-	-	\$ 14,753,440
Total revenues	14,753,440	-	-	-	-	14,753,440
Operating costs and expenses:						
Project operating costs	1,485,215	689,489	-	-	-	2,174,704
Impairment of unproved properties	296,423	-	-	-	-	296,423
Depletion, depreciation and amortization	4,849,615	-	(110,972)	-	-	4,738,643
Exploration and evaluation	-	328,003	-	-	-	328,003
Asset retirement accretion	70,555	-	-	1,761	-	72,316
General and administrative	4,077,536	51,769	-	-	-	4,129,305
Total operating costs and expenses	10,779,344	1,069,261	(110,972)	1,761	-	11,739,394
Operating income	3,974,096	(1,069,261)	110,972	(1,761)	-	3,014,046
Other income:						
(Loss) on sale of assets	(34,513)	-	-	-	-	(34,513)
Other income	87,740	-	-	-	-	87,740
Total other income	53,227	-	-	-	-	53,227
Net income	\$ 4,027,323	(1,069,261)	110,972	(1,761)	-	\$ 3,067,273
Deficit, beginning of period	\$ (56,787,577)	-	-	(6,225)	(6,876,926)	\$ (63,670,728)
Deficit, end of period	\$ (52,760,254)	(1,069,261)	110,972	(7,986)	(6,876,926)	\$ (60,603,455)
Weighted average number of shares outstanding, basic	49,953,148	-	-	-	-	49,953,148
Weighted average number of shares outstanding, diluted	51,177,139	-	-	-	-	51,177,139
Net income (loss) per share, basic	\$ 0.08	-	-	-	-	\$ 0.06
Net income (loss) per share, diluted	\$ 0.08	-	-	-	-	\$ 0.06

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Cash Flows for the three months ended September 30, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
Cash flows from operating activities:						
Net income for the quarter	\$ 983,444	(214,097)	20,695	318	-	\$ 790,361
Items not affecting cash:						
Depletion, depreciation and amortization	1,150,885	-	(20,695)	-	-	1,130,190
Asset retirement accretion	2,035	-	-	(318)	-	1,717
Impairment of unproved properties	263,168	-	-	-	-	263,168
Loss on sale of assets	(3,133)	-	-	-	-	(3,133)
Stock-based compensation	(263,192)	-	-	-	-	(263,192)
Changes in non-cash balances related to operations	(262,427)	-	-	-	-	(262,427)
Net cash provided by operating activities	1,870,779	(214,097)	-	-	-	1,656,683
Cash flows from investing activities:						
Additions to oil and natural gas properties	(193,919)	214,097	-	-	-	20,177
Additions to other property and equipment	-	-	-	-	-	-
Proceeds from the farmout agreement	-	-	-	-	-	-
Proceeds from assets sold	17,000	-	-	-	-	17,000
Changes in restricted cash	84,800	-	-	-	-	84,800
Proceeds from assets held for sale	-	-	-	-	-	-
Net cash (used in) investing activities	(92,119)	214,097	-	-	-	121,977
Cash flows from financing activities:						
Proceeds from options exercised	99,879	-	-	-	-	99,879
Common share buy back	-	-	-	-	-	-
Net cash (used in) financing activities	99,879	-	-	-	-	99,879
Effect of currency rates on cash and cash equivalents	117,695	-	-	-	-	117,695
Increase in cash and cash equivalents	1,996,234	-	-	-	-	1,996,234
Cash and cash equivalents, beginning of period	15,522,564	-	-	-	-	15,522,564
Cash and cash equivalents, end of period	\$ 17,518,798	-	-	-	-	\$ 17,518,798
Cash and cash equivalents consist of:						
Cash	\$ 1,769,595	-	-	-	-	\$ 1,769,595
Money market funds	15,483,941	-	-	-	-	15,483,941
Interest bearing short-term deposits	265,263	-	-	-	-	265,263
Cash and cash equivalents	\$ 17,518,799	-	-	-	-	\$ 17,518,799
Non-cash transactions:						
Increase to asset retirement obligation						\$ 31,508
Additions to oil and natural gas interests						\$ 3,965,629

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Cash Flows for the nine months ended September 30, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E	DD&A	ARO	Foreign currency translation adjustment	
		Note 5 (a)	Note 5 (b)	Note 5 (c)	Note 5 (d)	
Cash flows from operating activities:						
Net income for the year	\$ 2,024,097	(951,489)	113,510	(5,764)	-	\$ 1,180,353
Items not affecting cash:						
Depletion, depreciation and amortization	4,049,226	-	(113,510)	-	-	3,935,716
Asset retirement accretion	3,539	-	-	5,764	-	9,303
Impairment of unproved properties	296,423	-	-	-	-	296,423
Loss on sale of assets	(3,133)	-	-	-	-	(3,133)
Stock-based compensation	239,759	-	-	-	-	239,759
Changes in non-cash balances related to operations	(278,319)	-	-	-	-	(278,319)
Net cash provided by operating activities	6,331,591	(951,489)	-	-	-	5,380,102
Cash flows from investing activities:						
Additions to oil and natural gas properties	(7,228,744)	951,489	-	-	-	(6,277,255)
Additions to other property and equipment	(1,809)	-	-	-	-	(1,809)
Proceeds from the farmout agreement	5,000,000	-	-	-	-	5,000,000
Proceeds from assets sold	17,000	-	-	-	-	17,000
Changes in restricted cash	(115,900)	-	-	-	-	(115,900)
Proceeds from assets held for sale	-	-	-	-	-	-
Net cash (used in) investing activities	(2,329,453)	951,489	-	-	-	(1,377,964)
Cash flows from financing activities:						
Proceeds from options exercised	416,964	-	-	-	-	416,964
Common share buy back	(2,469,250)	-	-	-	-	(2,469,250)
Net cash (used in) financing activities	(2,052,286)	-	-	-	-	(2,052,286)
Effect of currency rates on cash and cash equivalents	280,082	-	-	-	-	280,082
Increase in cash and cash equivalents	2,229,934	-	-	-	-	2,229,934
Cash and cash equivalents, beginning of period	15,288,547	-	-	-	-	15,288,547
Cash and cash equivalents, end of period	\$ 17,518,481	-	-	-	-	\$ 17,518,481
Cash and cash equivalents consist of:						
Cash	\$ 1,769,595	-	-	-	-	\$ 1,769,595
Money market funds	15,483,941	-	-	-	-	15,483,941
Interest bearing short-term deposits	265,263	-	-	-	-	265,263
Cash and cash equivalents	\$ 17,518,799	-	-	-	-	\$ 17,518,799
Non-cash transactions:						
Increase to asset retirement obligation						\$ 16,899
Additions to oil and natural gas interests						\$ 4,066,966

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Cash Flows for the twelve months ended December 31, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
Cash flows from operating activities:						
Net income for the year	\$ 4,027,323	(1,069,261)	110,972	(1,761)	-	\$ 3,067,274
Items not affecting cash:						
Depletion, depreciation and amortization	4,847,856	-	(110,972)	-	-	4,736,884
Asset retirement accretion	72,314	-	-	1,761	-	74,075
Impairment of unproved properties	296,423	-	-	-	-	296,423
Loss on sale of assets	34,513	-	-	-	-	34,513
Stock-based compensation	262,983	-	-	-	-	262,983
Changes in non-cash balances related to operations	(394,179)	-	-	-	-	(394,179)
Net cash provided by operating activities	9,147,233	(1,069,261)	-	-	-	8,077,973
Cash flows from investing activities:						
Additions to oil and natural gas properties	(8,908,993)	1,069,261	-	-	-	(7,839,733)
Additions to other property and equipment	(5,423)	-	-	-	-	(5,423)
Proceeds from the farmout agreement	5,000,000	-	-	-	-	5,000,000
Proceeds from assets sold	26,700	-	-	-	-	26,700
Changes in restricted cash	(107,820)	-	-	-	-	(107,820)
Proceeds from assets held for sale	100,000	-	-	-	-	100,000
Net cash (used in) investing activities	(3,895,536)	1,069,261	-	-	-	(2,826,276)
Cash flows from financing activities:						
Proceeds from options exercised	488,119	-	-	-	-	488,119
Common share buy back	(2,796,654)	-	-	-	-	(2,796,654)
Net cash (used in) financing activities	(2,308,535)	-	-	-	-	(2,308,535)
Effect of currency rates on cash and cash equivalents	438,865	-	-	-	-	438,865
Increase in cash and cash equivalents	3,382,027	-	-	-	-	3,382,027
Cash and cash equivalents, beginning of period	15,288,547	-	-	-	-	15,288,547
Cash and cash equivalents, end of period	\$ 18,670,574	-	-	-	-	\$ 18,670,574
Cash and cash equivalents consist of:						
Cash	\$ 4,264,286	-	-	-	-	\$ 4,264,286
Money market funds	14,406,288	-	-	-	-	14,406,288
Cash and cash equivalents	\$ 18,670,574	-	-	-	-	\$ 18,670,574
Non-cash transactions:						
Increase to asset retirement obligation						\$ 90,239
Additions to oil and natural gas interests						\$ 14,157,626

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Comprehensive Income and Accumulated Other Comprehensive Income for the three months ended September 30, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment	
					Note 5 (d)	
Comprehensive income:						
Net Income	\$ 983,444	(214,097)	20,695	318	-	\$ 790,361
Other comprehensive income:						
Currency translation adjustments	202,924	-	-	-	-	202,924
Comprehensive income	\$ 1,186,368	(214,097)	20,695	318	-	\$ 993,285
Accumulated other comprehensive income:						
Balance, beginning of period	\$ (6,748,557)	-	-	-	6,876,926	\$ 128,369
Currency translation adjustments	202,924	-	-	-	-	202,924
Balance, end of period	\$ (6,545,633)	-	-	-	6,876,926	\$ 331,293

Consolidated Comprehensive Income and Accumulated Other Comprehensive Income for the nine months ended September 30, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment	
					Note 5 (d)	
Comprehensive income:						
Net Income	\$ 2,024,097	(951,489)	113,510	(5,764)	-	\$ 1,180,353
Other comprehensive income:						
Currency translation adjustments	331,293	-	-	-	-	331,293
Comprehensive income	\$ 2,355,390	(951,489)	113,510	(5,764)	-	\$ 1,511,646
Accumulated other comprehensive income:						
Balance, beginning of period	\$ (6,876,926)	-	-	-	6,876,926	\$ -
Currency translation adjustments	331,293	-	-	-	-	331,293
Balance, end of period	\$ (6,545,633)	-	-	-	6,876,926	\$ 331,293

Epsilon Energy Ltd.

Notes to the Interim Unaudited Condensed Consolidated Financial Statements

For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Comprehensive Income and Accumulated Other Comprehensive Income for the twelve months ended December 31, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E	DD&A	ARO	Foreign currency translation adjustment	
		Note 5 (a)	Note 5 (b)	Note 5 (c)	Note 5 (d)	
Comprehensive income:						
Net Income	\$ 4,027,323	(1,069,261)	110,972	(1,761)	-	\$ 3,067,273
Other comprehensive income:						
Currency translation adjustments	648,860	-	-	-	-	648,860
Comprehensive income	\$ 4,676,183	(1,069,261)	110,972	(1,761)	-	\$ 3,716,133
Accumulated other comprehensive income:						
Balance, beginning of period	\$ (6,876,926)	-	-	-	6,876,926	\$ -
Currency translation adjustments	648,860	-	-	-	-	648,860
Balance, end of period	\$ (6,228,066)	-	-	-	6,876,926	\$ 648,860

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Statement of Changes in Shareholders' Equity as at January 1, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
Share capital:						
Balance, beginning of period	\$ 138,272,250	-	-	-	-	\$ 138,272,250
Exercise of stock options	-	-	-	-	-	-
Balance, end of period	<u>\$138,272,250</u>	-	-	-	-	<u>\$138,272,250</u>
Contributed surplus:						
Balance, beginning of period	\$ 6,098,296	-	-	-	-	\$ 6,098,296
Stock options amortized, granted, exercised & forfeited	-	-	-	-	-	-
Balance, end of period	<u>\$ 6,098,296</u>	-	-	-	-	<u>\$ 6,098,296</u>
Deficit						
Balance, beginning of period	\$ (56,787,577)	-	-	(6,225)	(6,876,926)	\$ (63,670,728)
Net Earnings	-	-	-	-	-	-
Balance, end of period	<u>\$ (56,787,577)</u>	-	-	<u>(6,225)</u>	<u>(6,876,926)</u>	<u>\$ (63,670,728)</u>
Accumulated other comprehensive income:						
Balance, beginning of period	\$ (6,876,926)	-	-	-	6,876,926	\$ -
Currency translation adjustments	-	-	-	-	-	-
Balance, end of period	<u>\$ (6,876,926)</u>	-	-	-	<u>6,876,926</u>	<u>\$ -</u>

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Statement of Changes in Shareholders' Equity for the nine months ended September 30, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
Share capital:						
Balance, beginning of period	\$ 138,272,250	-	-	-	-	\$ 138,272,250
Exercise of stock options, share repurchase	(2,052,459)	-	-	-	-	(2,052,459)
Balance, end of period	\$ 136,219,791	-	-	-	-	\$ 136,219,791
Contributed surplus:						
Balance, beginning of period	\$ 6,098,296	-	-	-	-	\$ 6,098,296
Stock options amortized, granted, exercised & forfeited	239,932	-	-	-	-	239,932
Balance, end of period	\$ 6,338,228	-	-	-	-	\$ 6,338,228
Deficit						
Balance, beginning of period	\$ (56,787,577)	-	-	(6,225)	(6,876,926)	\$ (63,670,728)
Net Earnings	2,024,097	(951,489)	113,510	(5,764)	-	1,180,353
Balance, end of period	\$ (54,763,480)	(951,489)	113,510	(11,989)	(6,876,926)	\$ (62,490,375)
Accumulated other comprehensive income:						
Balance, beginning of period	\$ (6,876,926)	-	-	-	6,876,926	-
Currency translation adjustments	331,293	-	-	-	-	331,293
Balance, end of period	\$ (6,545,633)	-	-	-	6,876,926	\$ 331,293

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

5. Reconciliation from Canadian GAAP to IFRS (continued)

Consolidated Statement of Changes in Shareholders' Equity for the twelve months ended December 31, 2010

	IFRS Adjustments					IFRS
	Previous GAAP	E&E Note 5 (a)	DD&A Note 5 (b)	ARO Note 5 (c)	Foreign currency translation adjustment Note 5 (d)	
Share capital:						
Balance, beginning of period	\$ 138,272,250	-	-	-	-	\$ 138,272,250
Exercise of stock options, share repurchase	(2,271,030)	-	-	-	-	(2,271,030)
Balance, end of period	\$ 136,001,220	-	-	-	-	\$ 136,001,220
Contributed surplus:						
Balance, beginning of period	\$ 6,098,296	-	-	-	-	\$ 6,098,296
Stock options amortized, granted, exercised & forfeited	225,480	-	-	-	-	225,480
Balance, end of period	\$ 6,323,776	-	-	-	-	\$ 6,323,776
Deficit						
Balance, beginning of period	\$ (56,787,577)	-	-	-	-	\$ (56,787,577)
Net Earnings	4,027,323	(1,069,261)	110,972	(7,986)	(6,876,926)	(3,815,878)
Balance, end of period	\$ (52,760,254)	(1,069,261)	110,972	(7,986)	(6,876,926)	\$ (60,603,455)
Accumulated other comprehensive income:						
Balance, beginning of period	\$ (6,876,926)	-	-	-	6,876,926	-
Currency translation adjustments	648,860	-	-	-	-	648,860
Balance, end of period	\$ (6,228,066)	-	-	-	6,876,926	\$ 648,860

Epsilon Energy Ltd.
Notes to the Interim Unaudited Condensed Consolidated Financial Statements
For the three and nine months ended September 30, 2011 and 2010

6. Intangible exploration and evaluation assets

The following table summarizes the Corporation's intangible exploration and evaluation assets as at September 30, 2011 and December 31, 2010:

	\$
Balance, January 1, 2010	20,099,107
Additions	5,403,467
Additions - Chesapeake	15,780,114
Impairments	-
Transfers to P&E	-
Balance, December 31, 2010	41,282,688
Balance, January 1, 2011	41,282,688
Additions	10,129,641
Additions - Chesapeake	10,707,099
Impairments	(1,454,646)
Transfers to P&E	(9,295,392)
Transfers to P&E - Chesapeake	(18,441,752)
Balance, September 30, 2011	32,927,639

Impairments to E&E consist of \$1,192,376 for undeveloped property costs in Ohio, and \$253,818 unproved exploratory well costs in Saskatchewan as of September 30, 2011.

	September 30, 2011	December 31, 2010	January 1, 2010
Intangible exploration and evaluation assets			
United States	28,337,515	35,325,005	16,748,727
Canada	1,989,824	3,569,122	1,009,423
Ethiopia	2,600,300	2,388,561	2,094,037
Other	-	-	246,920
Total	\$ 32,927,639	\$ 41,282,688	\$ 20,099,107

As a result of the Corporation's recent New York asset reallocation, a reclass of \$170,408 was made from property & equipment, back to exploration & evaluation based on carrying values. The amount represents Epsilon's remaining 50% net book value of the proved and depleting New York assets that were exchanged for an additional and remaining 50% in existing unproved assets. As of September 30, 2011, the corporation owns 100% interest in all its unproved properties in New York.

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7. Property and Equipment

The following table summarizes the Corporation's oil and natural gas property and other equipment as at September 30, 2011 and December 31, 2010:

	\$
Cost	
Balance, January 1, 2010	46,591,967
Additions	1,148,428
Disposals	(16,627)
Transfers from E&E	-
Balance, December 31, 2010	47,723,768
Balance, January 1, 2011	47,723,768
Additions	545,101
Additions - Chesapeake	33,862,736
Disposals	-
Disposals - Chesapeake	(15,117,360)
Transfers from E&E	9,295,392
Transfers from E&E - Chesapeake	18,441,752
Balance, September 30, 2011	94,751,389
Depletion, amortization and impairments	
Balance, January 1, 2010	-
Depletion and depreciation for the period	4,738,643
Impairment	296,423
Disposals	61,212
Balance, December 31, 2010	5,096,278
Balance, January 1, 2011	5,096,278
Depletion and depreciation for the period	2,838,527
Impairment	-
Disposals	7,628
Balance, September 30, 2011	7,942,432
Carrying amounts	
At January 1, 2010	46,591,967
At December 31, 2010	42,627,490
At September 30, 2011	86,808,956

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7. Property and Equipment (continued)

Chesapeake Joint Venture Assets

Below is a table that summarizes the total assets subject to the Corporation's joint venture agreements with Chesapeake as at September 30, 2011:

	E&E	P&E	Total
Additions	\$ 8,045,461	\$ 52,304,488	\$ 60,349,949
Disposals	-	(15,117,360)	(15,117,360)
Balance, September 30, 2011	\$ 8,045,461	\$ 37,187,128	\$ 45,232,588

During period ended June 30, 2011, Chesapeake, Epsilon's joint venture partner in Pennsylvania, fulfilled its first earning period carry obligation benchmark by spending \$50.0 million in development costs on Epsilon's behalf in accordance to the executed Farmout Agreement. Epsilon derecognized 25% of its assets pertaining to the Farmout Agreement assignable to Chesapeake in the amount of \$13,884,444, and recognized a gain on disposal of the assets for \$36,115,556, net of \$8,758,135 in deferred taxes.

During period ended September 30, 2011, Chesapeake, Statoil and Epsilon executed an Interim Gas Gathering Systems agreement, where the Corporation sold an additional 15% interest in its existing gathering system. In the original Farmout Agreement, 50% of these assets were already assignable to Chesapeake, upon fulfilling the carry obligations. As part of the terms of the new agreement, Epsilon received \$5.0 million to apply against the Farmout Agreement carry on the original 50% interest, and \$1.5 million as consideration for the additional 15% interest. The Corporation recognized a net gain on disposal on 15% of the gathering system assets for \$267,084.

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 three and nine months ended September 30, 2011 and 2010, December 31, 2010 and on transition date were as follows:

	Three months ended		Nine months ended		December 31,
	September 30,		September 30,		
	2011	2010	2011	2010	2010
Capitalized G&A Costs:					
United States	\$ 102,860	\$ 116,901	\$ 314,115	\$ 381,309	\$ 456,031
Canada	20,692	20,381	64,401	37,677	44,250
Ethiopia	12,815	20,774	47,472	34,916	53,239
Other	-	-	-	17,117	17,117
Total	\$ 136,367	\$ 158,056	\$ 425,988	\$ 471,019	\$ 570,637

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8. Restricted Cash

Restricted Cash:	September 30, 2011	December 31, 2010	January 1, 2010
Current portion:			
Amegy Bank - letter of credits	\$ 140,000	\$ 200,000	\$ -
TD Bank – Yemen letter of credit	-	398,036	-
TD Bank – Ethiopia letter of credit	193,680	-	-
	<u>\$ 333,680</u>	<u>\$ 598,036</u>	<u>\$ -</u>
Long-term portion:			
Northwestern Bank	\$ -	\$ -	\$ 65,000
TD Bank – Yemen letter of credit	-	-	378,233
Amegy Bank - letter of credit	-	40,000	-
TD Bank – Ethiopia letter of credit	-	202,024	289,007
	<u>\$ -</u>	<u>\$ 242,024</u>	<u>\$ 732,240</u>

9. Other Liabilities

Decommissioning Liabilities

	September 30, 2011	December 31, 2010	January 1, 2010
Balance, beginning	\$ 347,338	\$ 220,618	\$ 319,762
Liabilities incurred	10,094	-	-
Liabilities acquired	96,911	111,775	32,274
Change in estimates	125,179	(57,369)	(143,261)
Accretion expense	7,011	72,314	11,843
Balance, end	<u>\$ 586,533</u>	<u>\$ 347,338</u>	<u>\$ 220,618</u>

Deferred Tax Liability

As a result of the Corporation's gain on the farmout transaction with Chesapeake, a deferred tax liability was recorded to reflect the taxable temporary difference. As at September 30, 2011, there is a \$nil (December 31, 2010 – (\$5.7) million) valuation allowance on deductible temporary differences.

Deferred Farmout Proceeds

The table below summarizes the development and operating costs incurred on behalf of Epsilon under its joint operating agreement with Chesapeake as of September 30, 2011:

	<u>\$</u>
Cash consideration	5,000,000
Post close adjustment	1,981,051
Capital costs spent	13,799,063
Operating costs spent	689,489
Balance, December 31, 2010	<u>21,469,603</u>
Balance, January 1, 2011	21,469,603
Cash consideration	5,000,000
Capital costs spent	44,569,835
Operating costs spent	573,470
Less: First Chesapeake Carry Milestone	<u>(50,000,000)</u>
Balance, September 30, 2011	<u>21,612,908</u>

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10. 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 nine months ended September 30, 2011 and year ended December 31, 2010, respectively:

	<u>Number of Shares Issued</u>	<u>Amount</u>
Balance at December 31, 2009	50,325,998	\$ 138,272,250
Exercise of stock options	515,254	797,452
Buy back of shares	<u>(1,125,000)</u>	<u>(3,068,482)</u>
Balance at December 31, 2010, and June 30, 2011	<u>49,716,252</u>	<u>\$ 136,001,220</u>
Exercise of stock options	130,000	398,974
Buy back of shares	<u>(64,300)</u>	<u>(183,613)</u>
Balance at September 30, 2011	<u>49,781,952</u>	<u>\$ 136,216,581</u>

(c) Stock Options

The following table summarizes stock option activity for the nine months ended September 30, 2011 and the year ended December 31, 2010 (exercise price in Canadian dollar):

	<u>As at September 30, 2011</u>		<u>As at December 31, 2010</u>	
	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>
Stock Options Outstanding:				
Balance at beginning of period	1,920,491	\$ 2.43	3,017,727	\$ 2.35
Granted	821,740	\$ 3.58	700,000	\$ 2.84
Exercised	(130,000)	\$ 2.00	(515,254)	\$ 0.96
Forfeited	(135,000)	\$ 2.70	(1,281,982)	\$ 3.05
Balance at period-end	<u>2,477,231</u>	<u>\$ 2.82</u>	<u>1,920,491</u>	<u>\$ 2.43</u>
Exercisable at period-end	<u>1,307,431</u>	<u>\$ 2.20</u>	<u>1,168,991</u>	<u>\$ 2.03</u>

The average share price during the nine months ended September 30, 2011 was \$3.56 (December 31, 2010: \$2.92).

The following table summarizes information about stock options outstanding at September 30, 2011 and December 31, 2010 (exercise price in Canadian dollars):

Epsilon Energy Ltd.

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10. Shareholders' Equity (continued)

<u>Exercise Price</u>	<u>Number of Options Outstanding</u>	<u>Number of Options Exercisable</u>	<u>Option Pricing Model Valuations</u>	<u>Weighted Average Remaining Contractual Life (in years)</u>
As at September 30, 2011:				
\$ 0.85	10,675	10,675	\$ 24,667	2.20
\$ 1.00	481,000	481,000	310,790	4.13
\$ 1.34	100,000	100,000	57,832	0.92
\$ 1.45	65,000	65,000	63,621	7.87
\$ 2.00	10,000	10,000	145,740	0.02
\$ 2.50	227,316	226,116	785,686	5.73
\$ 2.80	75,000	-	6,014	2.22
\$ 3.04	250,000	50,000	283,022	8.32
\$ 3.35	100,000	50,000	179,339	2.28
\$ 3.61	711,740	46,740	661,636	9.62
\$ 4.00	436,500	261,900	977,813	6.33
\$ 6.10	10,000	6,000	55,857	6.70
Total	<u>2,477,231</u>	<u>1,307,431</u>	<u>\$ 3,552,017</u>	<u>6.45</u>

<u>Exercise Price</u>	<u>Number of Options Outstanding</u>	<u>Number of Options Exercisable</u>	<u>Option Pricing Model Valuations</u>	<u>Weighted Average Remaining Contractual Life (in years)</u>
As at December 31, 2010:				
\$ 0.85	10,675	10,675	\$ 24,667	2.95
\$ 1.00	481,000	481,000	310,790	4.88
\$ 1.34	100,000	50,000	57,831	1.67
\$ 1.45	65,000	32,500	63,620	8.61
\$ 2.00	140,000	140,000	145,740	0.58
\$ 2.42	75,000	-	29,642	2.55
\$ 2.50	227,316	224,916	785,686	6.48
\$ 2.80	75,000	-	6,013	2.96
\$ 2.93	50,000	-	49,013	4.17
\$ 3.04	250,000	-	283,022	9.07
\$ 4.00	436,500	225,900	977,813	7.07
\$ 6.10	10,000	4,000	55,857	7.45
Total	<u>1,920,491</u>	<u>1,168,991</u>	<u>\$ 2,789,694</u>	<u>5.05</u>

Epsilon Energy Ltd.
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10. Shareholders' Equity (continued)

(c) Stock Options (continued)

The weighted average fair value of options granted during the nine months ended September 30, 2011 was \$3.58 (September 2010: \$2.84) per option calculated using a risk-free rate of 4.3%, dividend yield of 0%, historical volatility factor of 100%, and expected life ranging from .1 to 9.6 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.

On May 12, 2011, the Corporation awarded 46,740 to directors and 675,000 options to employees in accordance with Epsilon's Stock Option Plan. These stock options are exercisable at the closing price of \$3.61 on May 12, 2011. The directors' options will vest immediately. The employees' options will vest only after the common shares trade at or above \$8.00 per share on the Toronto Stock Exchange for a period of 20 consecutive trading days at any time in the 36 months from the date of grant of the options.

As of September 30, the May 12, 2011 option grants were re-valued under the Trinomial Hull White pricing model, creating an additional expense of \$39K for the period. The Hull White model handles performance and market based vesting criteria more appropriately than the Black Scholes model.

(d) Contributed Surplus

The following table summarizes contributed surplus for the nine months ended September 30, 2011, the year ended December 31, 2010 and on transition date:

	<u>September 30, 2011</u>	<u>December 31, 2010</u>	<u>January 1, 2010</u>
Contributed surplus:			
Balance, beginning of period	\$ 6,323,776	\$ 6,098,296	\$ 5,401,361
Buy back of shares	-	271,828	
Stock options:			
<i>Amortized</i>	1,156,642	911,914	1,108,699
<i>Exercised</i>	(224,574)	(309,332)	(4,746)
<i>Forfeited</i>	(5,215)	(648,930)	(407,018)
Balance, end of period	<u>\$ 7,250,629</u>	<u>\$ 6,323,776</u>	<u>\$ 6,098,296</u>

11. Commitments and Contingencies

Yemen

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.

Oman

The Corporation has withdrawn from Oman, and is of the opinion that no additional accrual or disclosure for exit costs is required.

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 Talisman Energy Inc. (formerly 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.

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11. Commitments and Contingencies (continued)

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 September 30, 2011, the Corporation was classified as an integrated non-participating owner in 1 gross (0.03 net) wells. In 2011, the Corporation received a favorable decision on its Drumm well appeal from the NY DEC commissioner. The decision was not appealed by Talisman Energy Inc. (formerly 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. All remaining previously mentioned wells have been assigned to the Corporation's former partners.

Mississippi

On October 1, 2010, the Corporation signed Participation Agreement (the "Agreement") with a large US-based private land owner ("land owner") to explore for and produce oil and gas. Under the principal terms of the Agreement, Epsilon is committed to drill a minimum of two horizontal wells within one year from the effective date of the agreement at an estimated cost of \$10.0 million and, in turn, Epsilon will earn 60% of the land owner's available mineral interests in the approximate 15,800 gross/13,600 net acres it owns or controls. Should the Corporation fail to drill the two wells within the time period specified, the Corporation will pay a sum of \$1.0 million within ten days after the end of the time period. On November 1, 2010, the Corporation entered into a joint venture agreement with Rockefeller Hughes (USA), LLC ("RHC"), a party related by common directorship, pursuant to which the Corporation agreed to assign 9% of its 60% working interest in the land owner's available mineral interests to RHC. Since Epsilon and RHC are carrying the cost of the first two wells, the Epsilon's proportionate share of the commitment has become \$8.5 million. As of September 30, 2011, Epsilon spent \$4,933,921 on the first well of its two well commitment.

The second well of the two well commitment was not drilled by August 31, 2011, so the Corporation incurred a penalty fee of \$1.0 million, which was paid in October. Also, on September 29, 2011, Rockefeller Hughes (USA), LLC revoked its working interest back to the Corporation, in exchange for relief of July, August and September's joint interest billings. Epsilon is actively looking for a joint venture partner to continue operations in this area.

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 (the "Ministry"). Terms of the PSA comprise of an initial three-year exploration period that includes a commitment to drill one exploratory well and to acquire a minimum of 200 kilometers of 2D seismic. The Corporation is also committed to make three annual payments \$40,000 each for training and community development, three annual payments of \$82,500 for land rentals and a work commitment of \$3,000,000 to be spent by the end of the PSA term.

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. To September 30, 2011, the Corporation had incurred \$2,600,300 (2010: \$2,388,561) under the terms of this agreement, mainly for a high resolution airborne gravity and magnetic survey.

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11. Commitments and Contingencies (continued)

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

	Payments Due by Period		
	Total	Less than 1 Year	1 – 3 Years
Future Commitments:			
Accounts payable and accrued liabilities	\$ 1,677,753	\$ 1,677,753	\$ -
Operating leases	174,661	77,627	97,034
Other obligations - Ethiopia	399,700	399,700	-
Total future commitments	\$ 2,252,114	\$ 2,155,080	\$ 97,034

The Corporation enters into commitments for capital expenditures in advance of the expenditures being made. At a given point in time, it is estimated that the Company has committed to capital expenditures equal to approximately one quarter of its capital budget by means of giving the necessary authorizations to incur the expenditures in a future period. This commitment has not been included in the commitment table above as it is of a routine nature and is part of normal course of operations for active oil and gas companies.

Litigation

The Corporation is involved in litigation and claims arising in the normal course of operations. Management is of the opinion that any pending litigation is remote, without merit and would not have a material adverse impact on the Corporation's financial position or results of operations.

12. 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.

At September 30, 2011, the Corporation had a working capital surplus of \$18,175,974 (December 31, 2010 - \$20,269,153). The Corporation has commitments under existing agreements as described in Note 11, 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. Fluctuations in oil and natural gas prices can materially impact the current and future profitability of the Corporation.

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12. Financial Instruments (continued)

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 September 30, 2011 and December 31, 2010, 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 period end conversion rate (.96840) of Canadian to US dollars against the Corporation's Canadian denominated cash, cash equivalents and restricted cash balances of \$18,919,506 at September 30, 2011 would have affected the value of such balances by approximately +/- \$945,975. 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 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 September 30, 2011 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 September 30, 2011, December 31, 2010 and on transition date is:

	September 30, 2011	December 31, 2010	January 1, 2010
Current	\$ 800,679	\$ 1,654,132	\$ 1,244,500
31 - 60 days	-	544,954	160,216
61 - 90 days	-	70,577	80,795
Over 90 days	998	476,743	2,918
Total accounts receivable	<u>\$ 801,677</u>	<u>\$ 2,746,406</u>	<u>\$ 1,488,429</u>

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12. Financial Instruments (continued)

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.

13. 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. 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. The Executive Chairman is the Chairman and CEO of Rockefeller Hughes, a company that rents office space from the Corporation. The following G&A transactions arose in the normal course of business and have been accounted for at the exchange amount being the amount agreed to by the related parties, which approximates the arms length equivalent value:

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
706147 Ontario, Inc.	\$ 10,867	\$ 10,389	\$ 32,960	\$ 31,061
Capital Z Corporation	20,039	2,180	39,494	39,375
Rockefeller Hughes	(4,800)	(3,200)	(14,400)	(12,800)

The following balances are included in accounts payable and accrued liabilities and are unsecured, non-interest bearing and due on demand:

	Nine months September 30, 2011	December 31, 2010	January 1, 2010
706147 Ontario, Inc.	\$ 3,933	\$ 56	\$ 48,618
Capital Z Corporation	4,094	735	2,181

The following balances are included in accounts receivable and are unsecured, non-interest bearing and due on demand:

	Nine months September 30, 2011	December 31, 2010	January 1, 2010
Rockefeller Hughes	\$ -	\$ -	\$ -

On September 29, 2011, Rockefeller Hughes revoked its 15% working interest back to the Corporation, in exchange for relief of July, August and September's joint interest billings of \$448,984.

Epsilon Energy Ltd.**Notes to the Interim Unaudited Condensed Consolidated Financial Statements***For the three and nine months ended September 30, 2011 and 2010***13. Related Party Transactions (continued)****Director**

On February 7, 2007, the Corporation obtained a 25% undivided participating interest in Gastem Inc.'s undeveloped oil and natural gas interests covering approximately 1,184,000 acres (249,000 net) in the St. Lawrence Lowlands and in the Gaspé Peninsula of Quebec. Under terms of the agreement, the Corporation may elect to participate on a well-by-well basis with a 25% working interest in any current or future oil and natural gas property Gastem Inc. may acquire in Quebec. In return, the Corporation granted Gastem Inc. the right to participate for 25% of the Corporation's interest in certain future wells to be drilled in the Corporation's Amber Bank project in West Virginia by spending up to \$1.05 million. The Corporation's carrying value of the portion of its Amber Bank project's leasehold attributable to Gastem Inc.'s participation was nominal. The agreement was consummated with the expectation that Raymond Savoie, Gastem Inc.'s President, would become a director of the Corporation. Mr. Savoie became a director of the Corporation on July 16, 2007. On June 16, 2009, the Corporation, along with Gastem Inc., sold all of its oil and natural gas property interests in West Virginia to an unrelated third party for a gross amount of \$14,000,000 (\$779,802 net to Gastem Inc.). A summary of Gastem's joint venture share of related party transactions between the Corporation and Gastem Inc. follows:

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Gastem Inc.				
Joint venture costs	\$ (70,169)	\$ 16,672	\$ (11,954)	\$ 92,709
	Nine months September 30, 2011	December 31, 2010	January 1, 2010	
Accounts payable	\$ 24,997	\$ 151,059	\$ 296,678	

Cash remuneration of key management personnel of the Corporation, which includes officers and other key personnel, is set out below in aggregate:

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Salaries and wages	\$ 235,429	\$ 266,534	\$ 758,034	\$ 631,753
Short-term benefits	1,625	1,505	5,418	5,016
Total compensation	\$ 237,054	\$ 268,039	\$ 763,452	\$ 636,769

These transactions arose in the normal course of business and have been accounted for at the exchange amount being the amount agreed to by the related parties, which approximates the arms length equivalent. The balances are unsecured, non-interest bearing and due on demand.

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14. Supplementary Cash Flow Information

Non-cash changes to the *Changes in Non-cash Balances Related to Operations* component of cash flows provided by/used in operations for the three and nine months ended September 30, 2011 and 2010, December 31, 2010, respectively, were comprised of the following:

	Three months ended		Nine months ended		December 31,
	September 30,		September 30,		
	2011	2010	2011	2010	2010
Changes in non-cash balances:					
Other current assets	\$ (13,432)	\$ (113,303)	\$ 76,536	\$ (95,997)	\$ (146,697)
Other	-	-	-	-	10,494
Accounts payable and accrued liabilities	(84,403)	(149,124)	(1,325,704)	(182,323)	(257,976)
Total changes to non-cash balances	\$ (97,835)	\$ (262,427)	\$ (1,249,168)	\$ (278,319)	\$ (394,179)

Non-cash charges relating to the *Property and equipment* component of cash used in investing activities for the three and nine months ended September 30, 2011 and 2010, December 31, 2010, respectively, were comprised of the following:

	Three months ended		Nine months ended		December 31,
	September 30,		September 30,		
	2011	2010	2011	2010	2010
Additions to Oil and Natural Gas Properties:					
Change in gross property for the period	\$ (2,894,959)	\$ (530,917)	\$ (10,066,706)	\$ (4,004,788)	\$ (5,750,117)
Non-cash changes:					
Accounts receivable	103,948	780,635	1,944,729	(563,663)	(1,257,977)
Notes receivable	724,029	-	-	-	-
Asset retirement obligations	132,504	29,792	178,484	17,576	(35,023)
Accounts payable and accrued liabilities	(1,746,499)	(174,105)	239,419	(1,676,658)	(1,006,611)
Currency translation effect	453,861	(85,228)	292,569	(51,212)	209,995
Total changes to Oil and Gas Properties	\$ (3,227,116)	\$ 20,178	\$ (7,411,505)	\$ (6,278,745)	\$ (7,839,733)

Epsilon Energy Ltd.**Notes to the Interim Unaudited Condensed Consolidated Financial Statements***For the three and nine months ended September 30, 2011 and 2010***14. Supplementary Cash Flow Information (continued)**

Changes to the *Proceeds from Issuance of Common Shares and Warrants, Net of Issuance Costs* component of cash provided by financing activities for the three and nine months ended September 30, 2011 and 2010, December 31, 2010, respectively, were comprised of the following:

	Three months ended		Nine months ended		December 31,
	September 30,		September 30,		
	2011	2010	2011	2010	
Share capital, beginning of period	\$ 136,001,220	\$ 136,055,330	\$ 136,001,220	\$ 138,272,250	\$ 138,272,250
Cash-based changes:					
Options exercised, cash portion	272,818	99,879	272,818	416,964	488,119
Buy back of shares	(183,613)	-	(183,613)	(2,469,250)	(2,796,654)
Non-cash changes:					
Stock options exercised	126,156	64,583	126,156	271,656	309,333
Buy back of shares	-	-	-	(271,828)	(271,828)
Share capital, end of period	<u>\$ 136,216,581</u>	<u>\$ 136,219,791</u>	<u>\$ 136,216,581</u>	<u>\$ 136,219,791</u>	<u>\$ 136,001,220</u>

Epsilon Energy Ltd.**Notes to the Interim Unaudited Condensed Consolidated Financial Statements***For the three and nine months ended September 30, 2011 and 2010***15. Reportable Geographical Segments**

As at September 30, 2011, the Corporation's operations by geographical area included the United States, Canada, and Ethiopia. Summarized reportable geographical segment data follows:

Reportable Segments:	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
United States:				
Revenues	\$ 1,465,644	\$ 2,684,771	\$ 4,961,906	\$ 10,532,514
Operating costs	1,128,658	262,078	1,573,036	1,838,298
Capital expenditures	14,361,658	4,598,871	20,011,572	11,951,374
Canada:				
Revenues	117,556	5,432	308,717	23,238
Operating costs	58,782	2,350	162,655	3,894
Capital expenditures	728,811	113,753	2,923,939	1,509,111
Ethiopia:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	12,815	77,572	211,739	257,376
Other International:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	-	876	-	16,247
Total Reportable Segments				
Revenues	\$ 1,583,200	\$ 2,690,203	\$ 5,270,623	\$ 10,555,752
Operating costs	\$ 1,187,440	\$ 264,428	\$ 1,735,691	\$ 1,842,192
Capital expenditures	\$ 15,103,283	\$ 4,789,320	\$ 23,147,250	\$ 13,734,108

The numbers above exclude asset sales and impairments.

Epsilon Energy Ltd.

Notes to the Interim Unaudited Condensed Consolidated Financial Statements

For the three and nine months ended September 30, 2011 and 2010

16. Capital Disclosures

The Corporation as at September 30, 2011 defines its capital as follows:

- Debt
- Shareholders' equity

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

	<u>September 30, 2011</u>	<u>December 31, 2010</u>	<u>January 1, 2010</u>
Capital:			
Debt	\$ -	\$ -	\$ -
Shareholders' equity	\$ 107,953,196	\$ 82,370,401	\$ 80,669,818

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.