



## **Consolidated Financial Statements Unaudited**

For the Nine Months Ended  
September 30, 2009 and 2008

### **NOTICE OF NO AUDITOR REVIEW OF INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim consolidated financial statements they must be accompanied by a notice indicating that the consolidated financial statements have not been reviewed by an auditor. The accompanying unaudited interim consolidated financial statements of Solara Exploration Ltd. (the "Corporation") have been prepared by and are the responsibility of the management of the Corporation. The Corporation's independent auditor has not performed a review of these consolidated financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim consolidated financial statements by an entity's auditor.



## Consolidated Balance Sheets

(Unaudited)

	September 30, 2009	December 31, 2008
	\$	\$
<b>Assets</b>		
<b>Current assets</b>		
Cash	256,472	-
Accounts receivable	1,222,290	809,752
Due from shareholder (Note 3)	85,000	85,000
Deposits and prepaids	148,355	81,566
Commodity derivatives (Note 11)	80,583	-
	1,792,700	976,318
<b>Property, plant and equipment (Note 4)</b>	24,113,375	26,219,859
	25,906,075	27,196,177
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	1,757,751	1,923,833
Commodity derivatives (Note 11)	70,984	-
Bank debt (Note 5)	7,932,273	7,523,469
	9,761,008	9,447,302
<b>Commodity derivatives (Note 11)</b>	47,323	-
<b>Asset retirement obligations (Note 6)</b>	1,923,708	1,918,014
<b>Convertible debentures (Note 7)</b>	2,582,441	2,508,056
<b>Future income taxes (Note 8)</b>	2,370,272	2,938,516
	16,684,752	16,811,888
<b>Shareholders' equity</b>		
<b>Capital stock (Note 9)</b>	16,046,847	15,665,049
<b>Equity portion of convertible debenture (Note 7)</b>	404,808	404,808
<b>Contributed surplus (Note 10)</b>	1,617,138	1,487,968
<b>Deficit</b>	(8,847,470)	(7,173,536)
	9,221,322	10,384,289
	25,906,075	27,196,177

**Basis of presentation and future operations**  
**Commitments (Note 13)**  
**Subsequent events (Note 15)**

See accompanying notes to the financial statements.



## Consolidated Statements of Operations, Comprehensive Loss and Deficit (Unaudited)

	Three Months Ended September 30, 2009 \$	Three Months Ended September 30, 2008 \$	Nine Months Ended September 30, 2009 \$	Nine Months Ended September 30, 2008 \$
<b>Revenue</b>				
Oil and gas income	923,598	1,782,447	2,839,820	5,964,630
Royalties	(24,426)	(170,215)	(82,716)	(440,938)
Commodity derivatives (Note 11)				
Realized gains	114,603	-	198,092	-
Unrealized loss	(46,739)	-	(37,724)	-
Interest and other income	8,138	8,496	13,370	13,439
	975,174	1,620,728	2,930,842	5,537,131
<b>Expenses</b>				
Operations	377,178	495,628	1,463,089	1,410,244
General and administrative	160,676	213,462	590,857	647,138
Depletion, depreciation and accretion	742,002	859,513	2,614,533	2,750,128
Stock based compensation (Note 10)	18,739	-	42,712	80,508
Interest and accretion on convertible debentures	155,537	172,793	479,910	533,916
	1,454,132	1,741,396	5,191,101	5,421,934
<b>(Loss) Income before income taxes</b>	(478,958)	(120,668)	(2,260,259)	115,197
<b>Future income tax reduction (Note 8)</b>	140,233	33,325	586,325	(59,798)
<b>Net (loss) income and comprehensive (loss) income</b>	(338,725)	(87,343)	(1,673,934)	55,399
<b>Deficit - beginning of period</b>	(8,508,745)	(6,397,314)	(7,173,536)	(6,540,056)
<b>Deficit - end of period</b>	(8,847,470)	(6,484,657)	(8,847,470)	(6,484,657)
-				
<b>Loss per share</b>				
Basic and diluted (Note 9)	(0.01)	(0.00)	(0.05)	0.00
<b>Weighted average shares outstanding</b>				
Basic and diluted	36,722,787	34,137,864	36,722,787	34,137,864

See accompanying notes to the financial statements.



## Consolidated Statements of Cash Flows (Unaudited)

	Three Months September 30, 2009 \$	Three Months September 30, 2008 \$	Nine Months September 30, 2009 \$	Nine Months September 30, 2008 \$
<b>Operating Activities</b>				
Net loss and comprehensive loss	(338,725)	(87,343)	(1,673,934)	55,399
Items not affecting cash				
Depletion, depreciation and accretion	742,002	859,513	2,614,533	2,750,128
Stock based compensation	18,739	-	42,712	80,508
Accretion on convertible debentures	24,795	24,795	74,385	74,385
Unrealized loss on commodity derivatives	46,739	-	37,724	-
Future income tax reduction	(140,233)	(33,325)	(586,325)	59,798
	353,317	763,640	509,095	3,020,218
Changes in non-cash working capital (Note 12)	(449,006)	269,048	5,589	(445,105)
	(95,689)	1,032,688	514,684	2,575,113
<b>Financing Activities</b>				
Share issue	510,000	-	510,000	-
Bank debt	(110,462)	611,857	408,804	1,987,046
Repurchase of shares	-	(37,493)	(8,150)	(112,155)
Issue costs and commissions	(50,460)	(7,000)	(50,460)	(27,143)
	349,078	567,364	860,194	1,847,748
<b>Investing Activities</b>				
Acquisitions of property and equipment	-	(1,181,821)	-	(2,364,858)
Disposition of property and equipment	-	-	490,000	-
Additions to property, plant and equipment	(247,306)	(799,543)	(957,409)	(1,678,208)
Changes in non-cash working capital (Note 12)	250,389	381,312	(650,997)	(379,795)
	3,083	(1,600,052)	(1,118,406)	(4,422,861)
<b>Decrease in cash and cash equivalents during the period</b>	256,472	-	256,472	-
<b>Cash and cash equivalents beginning of period</b>	-	-	-	-
<b>Cash and cash equivalents end of period</b>	256,472	-	256,472	-
<b>Supplemental information</b>				
Cash interest paid	72,125	85,919	343,909	380,564
Cash interest received	-	-	-	-
Cash taxes paid	-	-	-	-

See accompanying notes to the financial statements.

# **Solara Exploration Ltd.**

## **Unaudited Notes to the Consolidated Financial Statements**

### **For the nine months ended September 30, 2009 and 2008**

---

#### **Basis of Presentation and Future Operations**

Solara Exploration Ltd., (the “Corporation” or “Solara”), is involved in the exploration, development and production of petroleum and natural gas in Canada. The accounts of Solara Exploration Ltd. include the accounts of its wholly owned subsidiary Marwayne Resources Inc. which was incorporated on June 16, 2009 (see note 14).

These financial statements have been prepared on a going concern basis which presumes that the Corporation will be able to discharge its obligations and realize its assets in the normal course of business. As at September 30, 2009, the Corporation had a working capital deficiency of \$7,968,308 of which \$7,932,273 was demand bank debt on a demand revolving credit facility of \$8,000,000 (see notes 5 and 15). The Corporation had a net loss and comprehensive loss of \$1,673,934 (2008 – net income and comprehensive income of \$55,399) and cash flow from operating activities of \$514,684 (2008 - \$2,575,113 for the nine months ended September 30, 2009 and 2008 respectively).

As at September 30, 2009, the Corporation was compliant with its lender’s covenants. Management believes that they have the continued financial support of the Corporation’s lender as described in note 5 and note 15 and will have sufficient cash flow from operations in subsequent periods to satisfy its ongoing financial obligations. Consequently, management believes that the going concern assumption is appropriate for these financial statements. Should the going concern assumption not be appropriate, adjustments to the carrying amounts of the assets and liabilities, revenues and expense and the balance sheet classifications used would be necessary.

#### **1. Significant Accounting Policies**

The unaudited interim consolidated financial statements have been prepared by management in accordance with Canadian Generally Accepted Accounting Principles (“GAAP”), using the same accounting policies as those set out in note 1 to the audited financial statements for the year ended December 31, 2008, except as described in note 2 below. The unaudited interim consolidated financial statements contain disclosures that are supplemental to the Corporation’s December 31, 2008 audited financial statements. Certain disclosures, which are normally required to be included in the notes to the audited annual consolidated financial statements, have been condensed or omitted. In the opinion of management, these unaudited interim consolidated financial statements present fairly the Corporation’s financial position as at September 30, 2009 and the results of its operations for the nine months ended September 30, 2009. The unaudited interim consolidated financial statements should be read in conjunction with the Corporation’s audited financial statements and notes thereto for the year ended December 31, 2008.

#### **2. New Accounting Pronouncements**

##### **Goodwill and intangible assets**

On January 1, 2009 the Corporation was required to adopt a new accounting standard for Goodwill and Intangible Assets, which defines the criteria for the recognition of intangible assets.

##### **Business combinations**

On January 1, 2011, the Corporation will be required to adopt a new accounting standard for Business Combinations, which harmonizes existing Canadian standards with International Financial Reporting Standards (“IFRS”). Early adoption of the new standard is permitted.

##### **Convergence with IFRS**

On January 1, 2011, the Corporation will be required to adopt IFRS. The transition from current GAAP to IFRS is a significant undertaking that may materially affect the Corporation’s reported financial position and results of operations. The International Accounting Standards Board (“IASB”) has approved amendments and exemptions to IFRS 1 in order to make it more useful to Canadian entities adopting IFRS for the first time. One such exemption relating to full cost oil and gas accounting is expected to reduce the administrative burden in the transition from the current Canadian Accounting Guideline 16 to IFRS. The amendment will permit the Corporation to apply IFRS prospectively to its full cost pool, rather than the retrospective assessment of capitalized exploration and development expenses, with the provision that an impairment test, under IFRS standards, be conducted at the transition date.

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

The Corporation is in the process of developing its IFRS conversion plan, which will include project structure and governance, resourcing and training, analysis of key differences between IFRS and GAAP, as well as a phased plan to assess accounting policies under IFRS and any potential IFRS 1 exemptions. The Corporation anticipates the completion of its project scoping, which will include a timetable for assessing the impact on data systems, internal controls over financial reporting, and business activities, before the end of 2009.

**3. Due from Shareholder**

The Corporation loaned an officer \$85,000 for the purchase of 340,000 Class A Shares of the Corporation in November, 2005. The demand loan is interest bearing at the bank prime rate plus one quarter percent and is secured by the Class A Shares purchased, and personally guaranteed. The demand loan is due for repayment on or before December 31, 2009 (see note 14).

**4. Property, Plant and Equipment**

	September 30, 2009	December 31, 2008
	\$	\$
Petroleum and natural gas properties - at cost	42,456,502	42,071,984
Office equipment and other assets – at cost	143,401	141,510
Accumulated depletion and depreciation	(18,486,528)	(15,993,635)
	<b>24,113,375</b>	<b>26,219,859</b>

As at September 30, 2009, costs of unproved properties of \$1,086,870 (2008 - \$400,000) and salvage values of \$1,177,510 (2008 - \$1,554,310) have been excluded from the depletion calculation. Future development costs of \$1,624,720 related to proved non-producing properties (2008 - \$847,000) have been included in costs subject to depletion.

General and administrative expenses for the nine months ended September 30, 2009 of \$338,942 (2008 - \$431,425) and stock based compensation expense of \$34,946 (2008 - \$NIL) directly relating to exploration and development projects were capitalized. The Corporation performed a ceiling test calculation at September 30, 2009 and determined there was no impairment of its petroleum and natural gas properties. The price forecast used in the reserve evaluation prepared by the independent engineering firm for the December 31, 2008 consolidated financial statements is outlined in the table below and is adjusted for quality differential and location. The Corporation performed a sensitivity analysis from the year end engineering reserve report to reflect the lower published prices at the end of the quarter for purposes of performing a ceiling test.

<b>Price Forecast – January 1, 2009</b>		
	<b>Oil</b>	<b>Gas</b>
	<b>CDN\$/Bbl</b>	<b>AECO C</b>
		<b>CDN\$/mmbtu</b>
2009	68.61	7.58
2010	78.94	7.94
2011	83.54	8.34
2012	90.92	8.70
2013	95.91	8.95
2014	97.84	9.14
2015	99.82	9.34
2016	101.83	9.54
2017	103.89	9.75
2018	105.99	9.95

Future prices incorporate a US/CDN exchange rate of 2009 – 0.825, 2010 – 0.85, 2011 – 0.875, 2012 – 0.925 thereafter, escalated at 2% per year thereafter.

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

---

**5. Bank Debt**

As at September 30, 2009 the Corporation has a demand revolving credit facility of \$8,000,000. The interest rate charged on advances under the credit facility is payable monthly at the bank prime rate plus 1.50%. The credit facility is secured by a \$10,000,000 fixed and floating charge debenture on the assets of the Corporation (see note 15).

The amount of the credit facility is subject to a borrowing base test performed on a periodic basis by the lender, based primarily on reserves and using commodity prices estimated by the lender, as well as other factors. A decrease in the borrowing base could result in a reduction to the credit facility.

**6. Asset Retirement Obligations**

	September 30, 2009 \$	December 31, 2008 \$
Balance – beginning of period	1,918,014	1,379,141
Acquired	-	702,557
Revisions	(115,946)	(374,901)
Incurred	-	56,003
Accretion expense	121,640	155,214
Balance – end of period	1,923,708	1,918,014

The total future asset retirement obligation was estimated by management based on the Corporation's net ownership interest in the wells and facilities, estimated costs to reclaim and abandon the wells and facilities, and the estimated timing of the costs to be incurred in future periods. The expected cost of site reclamations was estimated by the Corporation's management using the Alberta Energy Utilities Board guidelines for certain areas and actual well abandonment costs for these areas in Alberta. Note that all of the Corporation's assets are located in Alberta.

As at September 30, 2009, the undiscounted cash flow of the asset retirement obligation was \$2,582,315 (2008 – \$2,443,331). The Corporation expects the obligation to occur on average over 6 years and will be funded from general corporate resources at the time of abandonment. The present value of the obligation has been calculated using a discounted credit adjusted risk free rate of 9.00%, and an annual inflation rate of 2.5%.

**7. Convertible Debentures**

In July, 2006, the Corporation raised \$2,756,000 through the issue of 8.5% fixed rate unsecured subordinated convertible debentures which mature on July 7, 2011. Each \$1,000 debenture is convertible at any time prior to July 7, 2011 (debenture expiry date) into 667 Class A Shares at a price of a \$1.50 per share. The debentures are redeemable at the option of the Corporation at any time after July 6, 2007 at \$1,050 per debenture provided that the average trading price of the Class A Shares exceed a \$1.80 for 20 consecutive trading days prior to the notice date.

The fair value of the conversion feature, calculated using the effective interest method, was estimated to be \$404,808, has been classified as equity. The debt component is classified as a liability and recorded as the present value of the obligation to make future interest payments in cash. The convertible debentures are subordinated to the fixed and floating debenture in favor of the Corporation's lender (see note 5).

The carrying value of the convertible debenture debt component is accreted to the original face value of the instruments over their useful life. Accretion expense of \$74,385 has been recorded during the nine months ended September 30, 2009 (2008 - \$74,385).

**8. Income Taxes**

The provision for income taxes is different from the amount computed by applying the combined Canadian Federal and Provincial tax rates to the loss before income taxes. The principal reasons for the difference are as follows:

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

	<b>Nine Months Ended September 30, 2009</b>	Nine Months Ended September 30, 2008
	\$	\$
Corporate income tax rate	29.0%	29.5%
Income (loss) before income taxes	(2,260,259)	115,197
Expected income tax (reduction)	(655,475)	33,983
Add		
Stock based compensation	12,386	23,750
Change in prior year estimate	31,488	-
Other	25,276	2,065
Income tax (reduction) expense	(586,325)	59,798

The net future income tax liability is composed of temporary differences and the following table shows the tax-effected amounts of those items.

	<b>Nine Months Ended September 30, 2009</b>	Year Ended December 31, 2008
	\$	\$
Property, plant and equipment	(3,671,375)	(4,087,607)
Non-capital losses	519,388	411,480
Share issue costs	281,551	258,107
Asset retirement obligations	500,164	479,504
Future income tax liability	(2,370,272)	(2,938,516)

As at September 30, 2009 the Corporation had non-capital losses of approximately \$1,997,646 that will expire in the years 2016 to 2019.

**9. Capital Stock**

**a) Authorized and Issued**

Unlimited number of Class A Shares with no par value  
 Unlimited number of Class B Shares with no par value  
 Unlimited number of preferred shares with no par value, of which none have been issued.

The Corporation may issue an unlimited number of Class A Shares and Class B Shares both of which are voting shares. The Class B Shares are convertible at the option of the Corporation, at any time after September 30, 2009, into Class A Shares on the basis of \$10.00 for each Class B Share, divided by the greater of \$1.00 or the market price of Class A Shares at the time of conversion. Any Class B Shares not converted by December 31, 2010 will automatically be converted pursuant to the same conversion formula.

On February 28, 2009 the Corporation recorded the renouncement of expenditures relating to the flow through shares issued in December 2008. The cumulative tax effect adjustment relating to the flow through shares was \$31,200.

On July 31, 2009, the Corporation completed a non-brokered private placement of 5.1 million units for aggregate proceeds of \$510,000 in the private placement. Each Unit was priced at \$0.10 and comprised of two flow-through Class A Shares priced at \$0.05 per share and one purchase warrant to acquire one (1) flow-through Class A Share of the Corporation. Each warrant will be exercisable for one flow-through Class A Share of the Corporation at a price of \$0.10 per share until March 31, 2010. The fair value of the Class A Share purchase warrants is extended at the grant date using the Black-Scholes pricing model and has been credited to warrants within shareholders' equity. The assumptions used in the calculation are noted below:

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

Risk –free rate	2.49%
Expected life	8 months
Expected volatility	117%
Fair value per warrant	\$0.0084

	Nine Months ended September 30, 2009		Year ended December 31, 2008	
	Number of Shares	Amount \$	Number of Shares	Amount \$
<b>Class A Shares</b>				
Balance – opening	24,620,937	13,385,075	25,324,192	13,935,414
Issued – flow through shares	10,200,000	465,000	600,000	120,000
Issued – warrants	-	45,000	-	-
Share purchase financing	-	-	-	(15,557)
Repurchase of shares	(110,000)	(59,662)	(1,303,255)	(654,782)
Balance – closing	34,710,937	13,835,413	24,620,937	13,385,075
<b>Class B Shares</b>				
Balance – opening	986,700	9,867,000	1,044,000	10,440,000
Repurchase of shares	-	-	(57,300)	(573,000)
Balance – closing	986,700,	9,867,000	986,700	9,867,000
Cumulative tax effect adjustment relating to the following				
Flow – through shares	-	(5,528,657)	-	(5,497,457)
Share issue costs	-	(2,126,909)	-	(2,089,569)
	-	(7,655,566)	-	(7,587,026)
Balance - closing	35,697,637	16,046,847	25,607,637	15,665,049

**b) Stock Options**

The Corporation has a stock option plan under which it may grant options to directors, officers, employees, consultants and certain service providers. Stock options are granted at the discretion of the Board of Directors and subject to the applicable regulations, vest over two years and expire five years after the date of grant. The following table summarizes the status of the stock option plan as at September 30, 2009, and December 31, 2008.

	Number of Stock Options	Weighted Average Exercise Price (\$/share)
Outstanding, December 31, 2007	1,486,661	0.42
Granted	1,190,000	0.30
Forfeited	(325,000)	0.33
Outstanding, December 31, 2008	2,351,661	0.37
Granted	1,090,000	0.10
Forfeited	(75,000)	0.49
Outstanding, September 30, 2009	3,366,661	0.28
Exercisable, September 30, 2009	2,301,661	0.33

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

The following table summarizes stock options outstanding at September 30, 2009.

Weighted Average Exercise Price (\$/Share)	Number of Stock Options Outstanding	Weighted Average Remaining Contractual Life (years)	Number of Stock Options Exercisable
0.35	1,111,661	1.25	1,111,661
0.95	150,000	2.00	150,000
0.30	775,000	3.25	516,667
0.30	185,000	3.75	123,333
0.30	55,000	4.00	36,667
0.10	1,090,000	5.00	363,333
0.37	3,366,661	3.14	2,301,661

**c) Normal Course Issuer Bid**

Under the normal course issuer bid, the Corporation received approval commencing May 6, 2009 to purchase up to 5% of its outstanding Class A Shares until May 5, 2010. During the nine months ended September 30, 2009 the Corporation repurchased and cancelled 110,000 Class A Shares (2008 – 322,755) at a net cost of \$8,150 (2008 - \$178,792) The average carrying value of the Class A Shares repurchased of \$59,662 (2008 - \$94,983) was charged to share capital with the difference of \$51,512 (2008 - \$48,306) included in contributed surplus.

Under the normal course issuer bid, the Corporation received approval commencing May 6, 2009 to purchase up to 5% of its outstanding Class B Shares until May 6, 2010. During the nine months ended September 30, 2009 the Corporation repurchased and cancelled NIL Class B Shares (2008– 21,200) at a net cost of \$NIL (2008 - \$31,080). The average carrying value of the Class B Shares repurchased of \$NIL (2008 - \$208,907) was charged to share capital with the difference of \$NIL (2008 - \$140,920) included in contributed surplus.

**d) Per Share Information**

The weighted average number of Class A Shares (after conversion of the Class B Shares) outstanding as at September 30, 2009, for basic and diluted was 36,722,787 Class A Shares (2008 – 34,137,864 basic and diluted). Due to net losses realized for the periods ended September 30, 2009 and 2008, the inclusion of stock options is anti-dilutive.

**10. Contributed Surplus**

Stock based compensation expense was calculated using the Black-Scholes Option Pricing Model, using a risk free interest rate between 3.62% and 2.49% (2008 – 3.62%), expected life of five years, expected average volatility factor of 117% (2008 – 117%) and no dividends. The convertible debentures are convertible into Class A Shares of the Corporation at a price of \$1.50 (2008 – \$1.50).

	Nine Months ended September 30, 2009	Year ended December 31, 2008
	\$	\$
Balance – beginning of year	1,487,968	323,016
Stock based compensation expense	42,712	98,722
Stock based compensation capitalized	34,946	94,944
Shares purchased for cancellation	51,512	971,286
Balance – end of period	1,617,138	1,487,968

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

---

**11. Financial Risk Management**

**Overview**

Solara has exposure to the following risks from its use of financial instruments:

- Credit risk
- Liquidity risk
- Market risk

This note presents information about Solara's exposure to each of the above risks, the Corporation's objectives, policies and processes for measuring and managing risk, and the Corporation's management of capital. Further quantitative disclosures are included throughout these financial statements. The Board of Directors has overall responsibility for the establishment and oversight of the Corporation's risk management framework. The Board is in the process of implementing risk management policies. Solara's risk management policies will be designed to identify and analyze the risks faced by the Corporation, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Corporation's activities.

**Credit Risk**

Credit risk is the risk of financial loss to the Corporation if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from Solara's accounts receivables from joint interest partners and petroleum and natural gas marketers. As at September 30, 2009, Solara's accounts receivables consisted of \$432,923 from joint interest partners, and \$315,101 of receivables from petroleum and natural gas marketers. Receivables from petroleum and natural gas marketers are normally collected on the 25th day of the month following production. Solara's policy to mitigate credit risk associated with these balances is to establish marketing relationships with established purchasers. The Corporation historically has not experienced any collection issues with its petroleum and natural gas marketers, and currently has no such collection issues. Joint interest receivables are typically collected within one to three months of the joint interest bill being issued to the partner. Solara attempts to mitigate the risk from joint interest receivables by obtaining partner approval of significant capital expenditures prior to expenditure. However, the receivables are from participants in the petroleum and natural gas sector, and collection of the outstanding balances is dependent on industry factors, such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. In addition, further risk exists with joint interest partners as disagreements occasionally arise that increases the potential for non-collection. Solara does not typically obtain collateral from petroleum and natural gas marketers or joint interest partners; however, Solara does have the ability to withhold production from joint interest partners in the event of non-payment, to take its share of production in kind and cash call partners for their share of capital expenditures. The carrying amount of accounts receivable represents the maximum credit exposure. Solara did not have an allowance for doubtful accounts as at September 30, 2009 and did not provide for any doubtful accounts, nor was it required to write-off any receivables during the nine months ended September 30, 2009.

As at September 30, 2009 and December 31, 2008, Solara considers its trade receivables to be aged as follows:

	<b>September 30, 2009</b>	December 31, 2008
	\$	\$
Due (less than 90 days)	<b>1,002,864</b>	674,878
Past due (91 - 150 days)	<b>219,426</b>	134,874
	<b>1,222,290</b>	809,752

As of November 24, 2009, the Corporation had collected \$68,671 of the past due trade receivables. The remaining \$150,755 relates to prior period gross overriding royalties and joint interest billings. Solara is currently working with these accounts to resolve payment of the outstanding amounts. The Corporation has the right of offset with respect to approximately \$42,000 of the remaining amount.

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

---

**Liquidity Risk**

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they are due. Solara's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking harm to the Corporation's reputation. Solara prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. Further, the Corporation utilizes authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures. To facilitate the capital expenditure program, Solara has a revolving reserves based credit facility, as outlined in note 5, which is reviewed at least annually by its lender.

**Market Risk**

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices and interest rates, will affect the Corporation's net earnings or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Corporation may from time to time utilize both financial derivatives and physical delivery sales contracts to manage market risks.

**(a) Foreign Currency Exchange Rate Risk**

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. Although substantially all of Solara's oil and natural gas sales are denominated in Canadian dollars, the underlying market prices in Canada for oil and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. The Corporation had no forward exchange rate contracts in place as at or during the year ended December 31, 2008 and the period ended September 30, 2009.

**(b) Commodity Price Risk**

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for oil and natural gas are impacted by not only the relationship between the Canadian and United States dollar, as outlined above, but also world economic events that dictate the levels of supply and demand.

The Corporation has entered into a commodity price contract with its lender which provides for a minimum price of \$5.21 per gigajoule (GJ) on 350 GJs per day for the period commencing on April 1, 2009 until December 31, 2009, and a ceiling price of \$7.50 per GJ commencing on January 1, 2010 and ending March 31, 2011. The Corporation has entered into a second commodity price contract with its lender which provides for a minimum price of \$5.00 per GJ on 200 GJs per day for the period commencing on April 1, 2009 until December 31, 2009, and a ceiling price of \$6.675 per GJ commencing on January 1, 2010 and ending March 31, 2011.

**Realized Commodity Derivative Gain**

The realized commodity derivative gain of \$198,092 for the nine months ended September 30, 2009 (nine months ended September 30, 2008 – NIL) relates to the cash settlement of derivative instruments.

**Unrealized Commodity Derivative Gain (loss)**

The unrealized commodity derivative loss of \$37,724 for the nine months ended September 30, 2009 (nine months ended September 30, 2008 – NIL) represents the change in fair value of the Corporation's financial risk management agreements.

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

	September 30, 2009	December 31, 2008
	\$	\$
Balance, beginning of period	-	-
Change in fair value of derivative instrument contracts	(37,724)	-
Balance, end of period	(37,724)	-

The fair value of commodity derivatives as at September 30, 2009 is comprised of the following commodity price risk management agreements.

**Commodity Derivative Agreements**

Term	Contract	Volume (GJ)	Fixed Price (\$/GJ)	Fair value as at September 30, 2009 (\$/CDN)
Apr 09 to Dec 09	Swap	6,200	5.00	26,045
Apr 09 to Dec 09	Swap	10,850	5.21	54,538
Jan 10 to Mar 11	Call	6,200	6.675	(54,601)
Jan 10 to Mar 11	Call	10,850	7.50	(63,706)
<b>Total CAN</b>				<b>(37,724)</b>

**(c) Interest Rate Risk**

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Corporation is exposed to interest rate fluctuations on its bank debt, which bears a floating rate of interest. At September 30, 2009, if interest rates had been 1% lower with all other variables held constant, the after tax net loss for the period would have been \$42,557 lower (2008 after tax net income - \$36,476 higher), due to lower interest expense. An equal and opposite impact would have occurred to the net loss had interest rates been 1% higher. The Corporation had no interest rate swap in place as at or during the nine months ended September 30, 2009.

**Capital Management**

General adverse economic conditions globally, including the possibility of a recession in Canada and a worldwide economic slowdown, recent disruptions to the credit and financial markets in Canada and worldwide and local economic turmoil may adversely affect the value of the Corporation's business and value of its securities.

The Corporation's policy is to maintain a sufficient capital base to sustain the future development of the business and to maintain investor, creditor and market confidence. The Corporation manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying petroleum and natural gas assets. The Corporation considers its capital structure to include shareholders' equity and bank debt. In order to maintain or adjust the capital structure, the Corporation may, from time to time, issue shares and adjust its capital spending to manage current and projected debt levels. The Corporation monitors capital based on the ratio of bank debt to funds from operations for the most recent 12 month period. Funds from operations is calculated based on cash provided by operating activities before changes in non-cash working capital and expenditures on asset retirement obligations. The Corporation's strategy is to endeavor to maintain a ratio of bank debt to annual funds from operations of approximately 2.5 to 1 or lower. This ratio may increase at certain times as a result of acquisitions and/or large capital projects. As at September 30, 2009, the Corporation's ratio of net debt to annual funds from operations was approximately 11.7 to 1. The Corporation anticipates that the ratio will exceed the target range by a significant margin throughout 2009 due to reduced funds from operations affected by materially lower commodity prices relative to 2008. The Corporation's share capital is not subject to external restrictions; however, the bank debt facility is based on

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

petroleum and natural gas reserves (see note 5), and contains certain financial covenants. The Corporation has not paid or declared any dividends since the date of incorporation, nor are any contemplated in the foreseeable future. Management is reviewing all of its field operating and general and administrative expenses and has deferred all major capital projects until such time that funds from operations warrant capital investments. Our corporate emphasis is on trade debt reduction and retiring a portion of the bank line of credit for the balance of 2009.

**Fair Value of Financial Instruments**

Solara's financial instruments as at September 30, 2009 and the year ended December 31, 2008 include accounts receivable, an amount due from shareholder, accounts payable and accrued liabilities, bank debt and convertible debenture. The fair value of these amounts, excluding bank debt, approximate their carrying amounts due to their short terms to maturity. Bank debt is payable on demand and bears interest at a floating market rate, and accordingly, the fair market value approximates the carrying amount.

**12. Cash Flow Information**

Changes in non-cash working capital were as follows:

	2009	2008
Nine Months Ended September 30,	\$	\$
<b>Changes in non-cash working capital balances</b>		
Accounts receivable	(412,538)	(351,761)
Advances and prepaids	(66,789)	17,286
Accounts payable and accrued liabilities	(166,081)	(490,425)
	<b>(645,408)</b>	<b>(824,900)</b>

	2009	2008
Nine Months Ended September 30,	\$	\$
<b>Changes in non-cash working capital relates to</b>		
Operating	5,589	(445,105)
Investing	(650,997)	(379,795)
	<b>(645,408)</b>	<b>(824,900)</b>

**13. Commitments**

- a) The Corporation is committed to office lease payments totalling \$132,429 to March 1, 2011 based on current operating costs. These obligations are as follows.

	\$
2009	23,370
2010	93,479
2011	15,580

**Solara Exploration Ltd.**  
**Unaudited Notes to the Consolidated Financial Statements**  
**For the nine months ended September 30, 2009 and 2008**

---

**14. Related Party Transactions**

The President, CEO, and a director of the Corporation is a major shareholder of a private Alberta company that provides management consulting services to the Corporation. During the nine months ended September 30, 2009 the Corporation paid a total of \$156,800 for various fees (2008 - \$47,500). The Corporation has provided a demand loan in the amount of \$85,000 to purchase 340,000 Class A Shares of the Corporation to the President and CEO in November, 2005. The loan is secured by the Class A Shares and a demand promissory note bearing interest at bank prime plus one quarter of one percent. The note is due on or before December 31, 2009 (see note 3).

The Corporate Secretary of the Corporation is counsel with a law firm that provides legal services to the Corporation. During the nine months ended September 30, 2009, the Corporation paid a total of \$83,328 (2008 - \$79,834) for such services.

For the nine months ended September 30, 2009, consulting services were provided by a company controlled by the Vice President, Engineering and Operations of the Corporation for \$110,000 (2008 -\$45,500). These transactions have been recorded at the exchange amount of the consideration which is the amount agreed upon between the parties.

For the nine months ended September 30, 2009, consulting services were provided by a company controlled by the Vice President, Exploration of the Corporation for \$23,125 (2008 -NIL). These transactions have been recorded at the exchange amount of the consideration which is the amount agreed upon between the parties.

In June, 2009 the Corporation entered into a Farmout, Option and Conveyance Agreement with the Marwayne Production Limited Partnership ("LP") which provides for the farmout and option by the Corporation of certain interests in an oil project located in eastern Alberta. The General Partner of the LP is Marwayne Resources Inc., a wholly owned subsidiary of the Corporation. The Corporation will undertake the drilling of three wells on the farmout lands on behalf of the General Partner and the LP. In addition, the LP has purchased and equalized the LP with the Corporation in producing properties situated on the farmout and option lands for \$490,000 so that the interest of the LP is uniform with the interests of the Corporation in the farmout lands after completion of the three well drilling program. Pursuant to the agreement, the LP will initially spend up to \$1,300,000 on the project.

**15. Subsequent Events**

On November 20, 2009 the Corporation's major lender reviewed its credit facility and renewed the facility for \$8,000,000 at a rate equal to the prime rate plus 1.5% per annum. The next scheduled review will be in May, 2010.