

**TEARLACH RESOURCES LIMITED**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**AUDITORS' REPORT**

**CONSOLIDATED BALANCE SHEETS**

**CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

## AUDITORS' REPORT

To the Shareholders of Tearlach Resources Limited

We have audited the consolidated balance sheets of Tearlach Resources Limited as at September 30, 2010 and 2009 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*DMCL*

**DALE MATHESON CARR-HILTON LABONTE LLP  
CHARTERED ACCOUNTANTS**

Vancouver, Canada  
January 25, 2011

**TEARLACH RESOURCES LIMITED**  
**CONSOLIDATED BALANCE SHEETS**

	September 30, 2010	September 30, 2009
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash and cash equivalents	\$ 6,230	\$ 25,743
GST recoverable	5,122	4,754
Prepaid expenses	7,782	-
	19,134	30,497
<b>EQUIPMENT</b> (Note 5)	-	329
<b>MINERAL PROPERTIES</b> (Note 3)	921,710	897,749
<b>OIL AND GAS PROPERTIES</b> (Note 4)	697,666	688,590
	\$ 1,638,510	\$ 1,617,165
<b>LIABILITIES AND SHAREHOLDERS' DEFICIENCY</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities	\$ 257,029	\$ 207,675
Accounts payable - secured (Note 7)	418,222	374,438
Interest payable on convertible notes	126,100	98,100
Asset retirement obligations (Note 4)	440,324	458,453
Liability for tax (Note 8)	156,779	156,291
Due to related parties (Note 9)	1,073,554	946,616
	2,472,008	2,241,573
<b>CONVERTIBLE NOTES</b> (Note 10)	245,528	195,774
	2,717,536	2,437,347
<b>SHAREHOLDERS' DEFICIENCY</b>		
<b>SHARE CAPITAL</b> (Note 11)	6,851,871	6,726,385
<b>SHARES SUBSCRIBED</b> (Note 11)	-	20,000
<b>EQUITY PORTION OF CONVERTIBLE NOTES</b> (Note 10)	97,382	97,382
<b>WARRANTS</b> (Note 11)	39,000	10,000
<b>SPECIAL WARRANTS</b> (Note 11)	4,124,926	4,146,188
<b>CONTRIBUTED SURPLUS</b> (Note 11)	875,609	875,609
<b>DEFICIT</b>	(13,067,814)	(12,695,746)
	(1,079,026)	(820,182)
	\$ 1,638,510	\$ 1,617,165

**GOING CONCERN CONTINGENCY** (Note 1)  
**CONTINGENCIES** (Note 15)  
**SUBSEQUENT EVENTS** (Notes 10 and 18)

*Approved on behalf of the Board:*

“Charles Ross”  
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*Charles Ross, Director*

“Malcolm Fraser”  
\_\_\_\_\_  
*Malcolm Fraser, Director*

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

**TEARLACH RESOURCES LIMITED**

**CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT**

	Year ended	
	September 30, 2010	September 30, 2009
<b>GENERAL AND ADMINISTRATIVE EXPENSES</b>		
Consulting fees	\$ 30,000	\$ 33,940
Consulting fees – stock based compensation (Note 11)	-	47,230
Foreign exchange gain	(17,369)	(79)
Office and general	4,716	4,053
Interest	156,582	148,900
Management fees	60,000	90,000
Management fees - stock based compensation (Note 11)	-	37,744
Professional fees	126,812	258,188
Transfer agent and filing fees	16,100	18,545
<b>LOSS BEFORE OTHER ITEMS</b>	<b>(376,841)</b>	<b>(638,521)</b>
<b>OTHER ITEMS</b>		
Gain on sale of subsidiary (Note 6)	-	17,696
<b>LOSS BEFORE INCOME TAX</b>	<b>(376,841)</b>	<b>(620,825)</b>
Current income tax	(1,003)	(2,208)
Future income tax recovery (Note 14)	5,776	7,532
<b>NET LOSS AND COMPREHENSIVE LOSS</b>	<b>(372,068)</b>	<b>(615,501)</b>
<b>DEFICIT – BEGINNING</b>	<b>(12,695,746)</b>	<b>(12,080,245)</b>
<b>DEFICIT – ENDING</b>	<b>\$ (13,067,814)</b>	<b>\$ (12,695,746)</b>
<b>BASIC AND DILUTED</b>		
<b>LOSS PER COMMON SHARE</b>	<b>\$ (0.01)</b>	<b>\$ (0.02)</b>
<b>WEIGHTED AVERAGE NUMBER OF COMMON</b>		
<b>SHARES OUTSTANDING – basic and diluted</b>	<b>42,185,762</b>	<b>35,535,351</b>

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

**TEARLACH RESOURCES LIMITED**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year ended	
	September 30, 2010	September 30, 2009
<b>CASH PROVIDED BY (USED FOR):</b>		
<b>OPERATING ACTIVITIES</b>		
Net loss for the year	\$ (372,068)	\$ (615,501)
Adjustments for items not affecting cash:		
- Amortization	329	141
- Accrued and unpaid management fees	60,000	90,000
- Accrued interest	135,150	113,284
- Accretion on convertible debenture	49,754	35,611
- Stock-based compensation	-	84,975
- Foreign exchange loss (gain)	(18,129)	5,259
- Future income tax recovery	(5,776)	(7,532)
- Gain on sale of subsidiary	-	(2,696)
	(150,740)	(296,459)
Net changes in non-cash working capital items:		
- Other current assets	-	19
- Prepaid expenses	(7,782)	-
- GST recoverable	(368)	7,573
- Liability for tax	488	(8,348)
- Accounts payable and accrued liabilities	57,146	118,186
	(101,256)	(179,029)
<b>FINANCING ACTIVITIES</b>		
Shares issued for cash	119,000	40,000
Shares subscribed	-	20,000
Warrants issued	-	10,000
Related party advances (repayment)	(11,428)	154,347
	107,572	224,347
<b>INVESTING ACTIVITIES</b>		
Mineral property acquisition and exploration costs	(23,961)	(51,218)
Proceeds from sale of subsidiary	-	15,000
Oil and gas property acquisition and development costs	(1,868)	(4,781)
	(25,829)	(40,999)
<b>CHANGE IN CASH CASH EQUIVALENTS DURING YEAR</b>	(19,513)	4,319
<b>CASH AND CASH EQUIVALENTS– BEGINNING</b>	25,743	21,424
<b>CASH AND CASH EQUIVALENTS – ENDING</b>	\$ 6,230	\$ 25,743

**SUPPLEMENTAL INFORMATION WITH RESPECT TO CASH FLOWS (Note 12)**

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

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**TEARLACH RESOURCES LIMITED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**YEAR ENDED SEPTEMBER 30, 2010**

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**NOTE 1 – NATURE OF OPERATIONS AND BASIS OF PRESENTATION**

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Tearlach Resources Limited (the “Company”) is a British Columbia, Canada incorporated company which has been primarily engaged in the acquisition, exploration and development of mineral and oil and gas properties in Canada and the United States. The Company has interests in mineral properties in Ontario, Canada and oil and gas properties in Bakersfield, California. The Company is in the process of exploring its mineral properties and developing its oil and gas properties and has not yet determined whether these properties contain reserves that are economically recoverable.

**Going Concern**

The financial statements have been prepared on the basis of accounting principles applicable to a “going concern,” which assumes that the Company will continue its operations and will be able to realize the carrying value of its assets and discharge its liabilities in the normal course of business. The Company had a working capital deficiency of \$2,452,874 and accumulated losses of \$13,067,814 at September 30, 2010. The ability of the Company to continue as a going concern and realize the carrying value of its resource properties is dependent upon the continued financial support from related parties, the ability of the Company to raise equity financing to continue exploration and development activities or contract out further work with joint venture partners, the discovery of economically recoverable reserves, and upon future profitable operations or proceeds from disposition of resource properties. Given the operating losses accumulated in the last year, the Company’s ability to realize its assets and discharge its liabilities depends on continued support from its secured creditors, the ability to raise further funds to repay debts and to provide working capital and ultimately on generating future profitable operations. The financial statements do not reflect adjustments to the carrying values of assets, liabilities or reported results should the Company be unable to continue as a going concern.

The Company is involved in legal actions which have adversely affected its ability to raise capital. The *Claim for Expenses* action is set for trial to commence January 31, 2011. The Company believes it will, in due course, be successful in obtaining a complete dismissal of the action and will also obtain judgement on its cross complaint. Upon successful resolution of the action the Company will proceed with realizing on the Kern Front property. This will assist the Company in meeting its obligations and providing capital for future development. Resolution of the legal actions will also enable the Company to raise capital on more favourable terms.

The Company has raised flow through funds to support its exploration work on its mineral properties and intends to raised additional flow through funding to support its 2011 work program. The Company is seeking joint venture partners to assist in the financing of continued exploration and development of its properties and may also consider an outright sale of its properties provided such can be completed on terms and conditions acceptable to the Company. The Company is endeavouring to acquire revenue projects that will provide cash flow. At such time as the Company acquires a revenue project it may seek a combination of debt and equity financing to fund operating requirements.

**Principles of consolidation**

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary Tearlach Resources (California) Ltd., incorporated in California on August 14, 2006. The inactive wholly-owned subsidiary Tearlach Resources Limited (Barbados), incorporated in Barbados on January 2, 2007, was sold on March 13, 2009 to Peninsula Resources Ltd (“Peninsula”) (Refer to Notes 6 and 9). All significant inter-company transactions and balances have been eliminated upon consolidation.

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**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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**Basis of Presentation**

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) and are presented in Canadian dollars.

**Equipment and amortization**

Equipment is recorded at cost and amortization is provided using the declining balance basis at 30% per annum.

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (cont'd)**

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**Mineral properties**

The Company records its interests in mineral properties at the lower of cost or estimated recoverable value. Where specific exploration programs are planned and budgeted by management, the cost of mineral properties and related exploration expenditures are capitalized until the properties are placed into commercial production, sold, abandoned or determined by management to be impaired in value. These costs will be amortized over the estimated useful lives of the properties following the commencement of production or written off if the properties are sold or abandoned.

The costs include cash or other consideration and the assigned value of shares issued, if any, on the acquisition of mineral properties. Costs related to properties acquired under option agreements or joint ventures, whereby payments are made at the sole discretion of the Company, are recorded in the accounts at such time as the payments are made. For properties held jointly with other parties the Company only records its proportionate share of acquisition and exploration costs. The proceeds from options granted are deducted from the cost of the related property and any excess is deducted from other remaining capitalized property costs.

Capitalized costs as reported on the balance sheet represent costs incurred to date and may not reflect recoverable value. Recovery of carrying value is dependent upon future commercial success or proceeds from disposition of the mineral interests.

Management evaluates each mineral interest on a reporting period basis or as changes in events and circumstances warrant, and makes a determination based on exploration activity and results, estimated future cash flows and availability of funding as to whether costs are capitalized or charged to operations.

Mineral property interests, where future cash flows are not reasonably determinable, are evaluated for impairment based on management's intentions and determination of the extent to which future exploration programs are warranted and likely to be funded.

General exploration costs not related to specific properties and general administrative expenses are charged to operations in the year in which they are incurred.

The Company does not have any producing mineral properties and all of its efforts to date have been exploratory in nature.

**Oil and gas properties**

The Company follows the full cost method of accounting for its oil and gas operations whereby all cost related to the acquisition of petroleum and natural gas interests are capitalized. Such costs include land and lease acquisition costs, annual carrying charges of non-producing properties, geological and geophysical costs, costs of drilling and equipping productive and non-productive wells, and direct exploration salaries and related benefits.

All of the Company's oil and gas interests are held in the United States and accordingly, the Company has a single cost centre, being the United States. Certain oil and gas activities are conducted jointly with others and accordingly the accounts reflect only the Company's proportionate interest in such activities.

The Company reviews the carrying value of its oil and gas properties, which are currently unproven, annually, or when there is a significant change in events or circumstances. The estimate of net realizable value is determined by reference to the project economics, the timing of exploration work, the work programs and the exploration results achieved on the project. Where an impairment occurs a charge to earnings would be made. Once commercial production is achieved, the Company will apply a ceiling test to ensure that capitalized costs do not exceed total estimated future net revenues from the production of proved reserves less general and administrative expenses, financing costs, site restoration costs and income taxes related to future production. Any reduction in value as a result of the ceiling test will be charged to operations as additional depletion, depreciation, and amortization. The Company did not apply a ceiling test in the year ended September 30, 2010 because no proven reserves have been established on the Kern Front property. Refer to Note 4

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (cont'd)**

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**Oil and gas properties (cont'd)**

Once in commercial production, capitalized costs of proven reserves and equipment will be depleted using a unit-of-production method based upon estimated proven reserves net of royalties. Unless a significant amount of reserves is involved, proceeds received from the disposition of oil and gas properties are credited to the capitalized costs. In the event of a significant sale of reserves, a proportionate amount of cost and accumulated depletion, based upon the ratio of reserves sold to total reserves, will be removed from the capitalized costs and the resultant profit or loss is taken into income. To date, there has been no commercial production from the property and as a result no depletion has been recorded.

The recoverability of the amounts shown for oil and gas properties is dependent upon the existence of economically recoverable oil reserves, maintaining title and beneficial interest in the properties, the ability of the Company to obtain necessary financing to bring the reserves into production, and upon future profitable production or proceeds from the disposition of properties. The amounts shown as oil and gas interests represent net costs to date, less proceeds from oil sales received from development programs and impairment provisions. .

**Asset retirement obligations**

Asset retirement obligations are recognized for expected obligations related to the retirement of long-lived tangible assets that arise from the acquisition, construction, development or normal operation of such assets. A liability for an asset retirement obligation must be recognized in the period in which it is incurred and when a reasonable estimate of the fair value of the liability can be made. Furthermore, a corresponding asset retirement cost is recognized by increasing the carrying value of the related long-lived asset. The asset retirement cost is subsequently charged to operations in a rational and systematic manner over the underlying asset's useful life. The initial fair value of the asset retirement liability is accreted, by charges to operations, to its estimated future value.

**Future site restoration costs**

The Company records future site restoration costs based on estimates in accordance with current legislation and industry practices. Actual removal and site restoration expenditures are charged to the accumulated provision account as incurred.

**Stock-based compensation**

The Company follows CICA Handbook Section 3870, which establishes standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services. The standard requires that all stock-based awards be measured using a fair value method. Under the standard all awards are measured and expensed or allocated to specific asset accounts, as applicable, in the period of grant or modification. Awards granted with vesting provisions are recognized over the expected vesting period. The fair value of options and other stock-based awards issued or altered in the period, are determined using the Black-Scholes option pricing model. Upon the exercise of stock options or agents warrants, the fair value of the share based award is allocated to share capital.

**Loss per share**

Basic loss per share is calculated by dividing the loss for the year by the weighted average number of shares outstanding during the year. Diluted loss per share is calculated using the treasury stock method. Under the treasury stock method, the weighted average number of shares outstanding used in the calculation of diluted loss per share assumes that the deemed proceeds received from the exercise of stock options, share purchase warrants and their equivalents would be used to repurchase common shares of the Company at the average market price during the year. Existing stock options and share purchase warrants have not been included in the computation of diluted loss per share as to do so would be anti-dilutive. Accordingly, basic and diluted loss per share are the same.

**Share Issue Costs**

Share issue costs incurred on the issue of the Company's shares are charged directly to share capital.

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (cont'd)**

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**Flow-through shares**

The resource expenditure deductions for income tax purposes related to exploration activities funded by flow-through share arrangements are renounced to investors in accordance with Canadian tax legislation. Under the recommendations of the Emerging Issues Committee (EIC 146 of the CICA), future income tax liabilities resulting from the renunciation of qualified mineral expenditures by the Company is recorded as a reduction in share capital. Any corresponding realization of future income tax benefits resulting from the utilization of prior year losses available to the Company not previously recorded, as the Company did not meet the criteria for recognition, will be reflected as part of the Company's operating results as a recovery of future income taxes in the same period of filing the renunciations with the Canada Revenue Agency.

**Use of estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant areas requiring the use of management estimates relate to the determination of impairment of oil and gas properties and mineral properties, useful lives for depreciation and amortization, determination of liability for taxes as a result of flow-through renunciation reversals, asset retirement obligation, and determination of fair value for stock based transactions. Financial results as determined by actual events could differ from those estimates.

**Foreign currency translation**

The financial statements of the Company's integrated foreign subsidiaries are translated into Canadian dollar equivalents using the temporal method whereby all monetary assets and liabilities are translated at the rate of exchange at the balance sheet date. Non-monetary assets and liabilities are translated at exchange rates prevailing at the transaction date. Income and expenses are translated at rates which approximate those in effect on transaction dates. Gains and losses arising from translation of foreign currency monetary assets and liabilities at each period end are included in earnings. Transaction amounts denominated in foreign currencies are translated into their Canadian dollar equivalents at exchange rates prevailing at the transaction date. Gains and losses arising from translation of foreign currency monetary assets and liabilities and transactions are included in earnings.

**Income taxes**

Income taxes are accounted for using the liability method, which requires the recognition of taxes payable or refundable for the current period and future tax liabilities and assets for future tax consequences of events that have been recognized in the Company's financial statements or tax returns. The measurement of current and future tax liabilities and assets is based on provisions of enacted tax laws and the effects of future changes in tax laws or rates. The measurement of future tax assets is reduced, if necessary, by a valuation allowance, where, based on available evidence, the probability of realization of the future tax asset does not meet a more likely than not criterion. The Company has not recognized potential future benefit amounts as the criteria for recognition under GAAP have not been met.

**Comprehensive Income**

CICA Handbook Section 1530 establishes standards for the reporting and presenting of comprehensive income which is defined as the change in equity from transaction and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income that are excluded from net loss. At September 30, 2010 and 2009 the Company had no items that caused other comprehensive loss to be different than net loss.

**Financial instruments**

Handbook Sections 3862 and 3863 replace Handbook Section 3861, Financial Instruments – Disclosure and Presentation, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. The Company has included disclosures recommended by the new Handbook sections in Note 16 to these financial statements

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (cont'd)**

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In June 2009, the CICA amended Handbook Section 3862, Financial Instruments – Disclosures to require disclosure about the inputs used in making fair value measurements, including their classification within a hierarchy that prioritizes their significance. The three levels of the fair value hierarchy are:

Level 1 - Unadjusted quoted prices in active markets for identical assets or liabilities;

Level 2 - Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly; and

Level 3 - Inputs that are not based on observable market data.

The Company's financial instruments consist of cash and cash equivalents, other receivable, accounts payable, convertible notes and amounts due to related parties. The value of the Company's arm's length short term financial instruments is estimated by management to approximate their carrying values due to their immediate or short-term maturity. The fair value of advances due to related parties has not been determined as comparable arms-length interest, security and risk information is not determinable. The fair value of the convertible notes may be impacted by changes in market yields, but management estimates that the fair value approximates carrying value.

Cash and cash equivalents is classified as trading; accounts payable, convertible notes and amounts due to related parties are classified as other financial liabilities.

Net Smelter Royalties ("NSR") are a form of derivative financial instrument. The fair value of the Company's right to purchase the NSR is not determinable at the current stage of the Company's exploration program. No value has been assigned by management. The Company does not engage in any form of derivative or hedging instruments.

**Credit risk and the fair value of financial assets and financial liabilities**

On January 20, 2009, the Emerging Issues Committee ("EIC") of the Canadian Accounting Standards Board ("AcSB") issued EIC Abstract 173, Credit Risk and Fair Value of Financial Assets and Financial Liabilities ("EIC 173"), which establishes that an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and financial liabilities, including derivative instruments. EIC 173 should be applied retrospectively without restatement of prior years to all financial assets and liabilities measured at fair value in interim and annual financial statements for periods ending on or after January 20, 2009. Adoption of this EIC did not have a significant impact on the Company's financial statements.

**New Accounting Standards Not Yet Adopted**

**International Financial Reporting Standards (IFRS)**

In January 2006, the AcSB adopted a strategic plan for the direction of accounting standards in Canada. Accounting standards for public companies in Canada are expected to converge with International Financial Reporting Standards ("IFRS") over a transition period for fiscal periods beginning on or after January 1, 2011.

The Company has begun to assess its requirements and first time adoption methodologies, including its internal training and resource needs and first time adoption implications.

Management prepared a component evaluation of its existing financial statement line items, comparing Canadian GAAP to the corresponding IFRS guidelines, and has identified a number of differences. Many of the differences identified are not expected to have a material impact on the reported results and financial position. Management is working towards policy choices by the third quarter of 2011.

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (cont’d)**

**Business Combination, Non-Controlling Interest, and Consolidation**

In January 2009, the CICA issued Handbook Sections 1582, Business Combination (“Section 1582”); 1601, Consolidated Financial Statements (“Section 1601”); and 1602, Non-controlling Interests (“Section 1602”), which replace CICA Handbook Sections 1581, Business Combinations, and 1600, Consolidated Financial Statements. Section 1582 establishes standards for the accounting for business combinations that are equivalent to the business combination accounting standard under IFRS. Section 1582 is applicable for the Company’s business combinations and acquisition dates on or after January 1, 2011. Early adoption of this section is permitted. Section 1601 is applicable for the Company’s interim and annual financial statements for its fiscal year beginning January 1, 2011. Early adoption of this section is permitted. If the Company chooses to adopt any one of these sections, the other sections must also be adopted at the same time. The adoption of this standard is not expected to have a material impact on the Company’s financial statements.

**Comparative figures**

Certain of the comparative figures have been reclassified to conform to the current year's presentation.

**NOTE 3 – MINERAL PROPERTIES**

In October 2005 the Company completed the acquisition of 100% ownership of 23 mineral claims on the Foy and Hess Offset Dykes on the North Range of the Sudbury Basin region of Ontario.

During the year ended September 30, 2008 the Company dropped 14 claims based on geological evaluation. In addition one claim was dropped due to an administrative error. The claim was reacquired on January 23, 2009 for \$2,000 cash and 75,000 shares. The shares were delivered by a director of the Company. The Company recorded an amount due to the director of \$3,750 representing the value of the 75,000 shares. Refer to Note 9.

In December 2008, two additional claims were relinquished. One of these claims was re-staked in December 2008. The Company staked three additional claims in June 2009 bringing total claims to 11.

The Company incurred property acquisition costs of \$nil (2009 - \$12,768) and exploration costs of \$13,961 (2009 - \$32,200) and paid advance royalties of \$10,000 (2009 - \$10,000) during the year ended September 30, 2010 with respect to the Foy Hess Property. The claims remain subject to a 2% NSR and annual advance royalty payments of \$10,000 per year.

The following costs have been incurred on the Foy Hess Property:

	Acquisition	Deferred Exploration Costs	Advance Royalties	Total
Balance at September 30, 2008	\$ 382,857	\$ 439,924	\$ 20,000	\$ 842,781
Additions	12,768	32,200	10,000	54,968
Balance at September 30, 2009	395,625	472,124	30,000	897,749
Additions	-	13,961	10,000	23,961
Balance at September 30, 2010	\$ 395,625	\$ 486,085	\$ 40,000	\$ 921,710

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 3 – MINERAL PROPERTIES – (cont’d)**

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The details of exploration costs on the Foy Hess Property are as follows:

	September 30, 2010	September 30, 2009
Balance beginning	\$ 472,124	\$ 439,924
Geological exploration	11,756	30,286
Assays	2,205	1,914
Balance ending	\$ 486,085	\$ 472,124

**NOTE 4– OIL AND GAS PROPERTIES**

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**Kern Front Field**

The following costs have been incurred on the Kern Front Field Property:

	Carrying Value
September 30, 2008	\$ 677,710
Additions	10,880
September 30, 2009	688,590
Additions	9,076
September 30, 2010	\$ 697,666

On April 21, 2006, as amended May 30, 2006 and November 14, 2006, the Company entered into an agreement (the “Kern Agreement”) with Western States International, Inc. (“WSI”) and Gas & Oil Technologies, Inc. (“G&O”), both of Monrovia, California and their principal shareholders (the “Vendors”) to purchase a 60% working interest in an oil and gas property known as the Kern Front Field (the “Property”) in consideration for \$1 in cash and the issuance of 7,500,000 common shares of the Company with a fair value of \$0.1575 per share totalling \$1,181,250 (the “Vend-In Shares”) and 30,000,000 special warrants with a fair value of \$0.1575 per special warrant totalling \$4,725,000 (the “Special Warrants”), each of which may be converted into one common share of the Company at no additional cost, subject to certain limitations if as a result of such conversion the special warrant holder would own 10% or more of the shares of the Company, for a total fair value of \$5,906,251. Closing of the Kern Agreement was completed on December 12, 2006. The Company incurred an additional \$2,849 in other acquisition costs.

The Vend-In Shares and the Special Warrants shall be issuable as fully paid and non-assessable. The 30,000,000 Special Warrants and 3,394,790 of the 7,500,000 Vend-In Shares are subject to a TSX Venture Exchange Tier 2 value security escrow agreement to be released over 36 months subject to the following schedule:

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 4 – OIL AND GAS PROPERTIES (Cont'd)**

Release Date	% of Balance Released	Vend-In Shares		Special Warrants	
		Total Released	Balance In Escrow	Total Released	Balance In Escrow
Opening Balance			3,394,790		30,000,000
December 12, 2006	1/10	339,479	3,055,311	3,000,000	27,000,000
June 12, 2007	1/6	509,219	2,546,093	4,500,000	22,500,000
December 12, 2007	1/5	509,219	2,036,874	4,500,000	18,000,000
June 12, 2008	1/4	509,219	1,527,656	4,500,000	13,500,000
December 12, 2008	1/3	509,219	1,018,437	4,500,000	9,000,000
June 12, 2009	1/2	509,219	509,219	4,500,000	4,500,000
December 12, 2009	1	509,219	-	4,500,000	-

During the year ended September 30, 2010 the Company incurred development costs of \$9,076 (2009 - \$10,880) with respect to the Kern Front Field Property.

In accordance with CICA Handbook Section 3110, *Asset Retirement Obligations*, the asset retirement obligation was estimated by management based on the Company's working interest in its wells, estimated costs to remediate, reclaim and abandon the wells and estimated timing of the costs to be incurred. The Company estimated the total asset retirement obligation to be \$440,324 (US\$427,582) at September 30, 2010 (2009: \$458,453) (US\$427,582)). The Kern Front Field had no proven or probable reserves as of September 30, 2010 and 2009; accordingly management classified the entire undiscounted liability as current at September 30, 2010 and 2009.

**Judkins Lease Termination**

The Company was advised by WSI, which sold the Company its interest in the Kern Front Field Property in December, 2006, that as a result of litigation commenced by third parties, the Superior Court of the State of California has awarded judgment against WSI terminating its rights over a portion of the Property known as the "Judkins Lease". This lease comprised 320 acres and 23 wells of the total 759 acres and 142 wells on the Property. In its Judgment, the Court ordered that the Judkins Lease was terminated effective December 2003 and that a subsequent lease purportedly granted in favour of WSI was not valid. The Company has concluded that, since the date of termination predates the purported date of sale by almost three years, the Company is not obligated for any development costs incurred on the Judkins Lease. The Company recorded a full impairment in relation to the Judkins Lease in the year ended September 30, 2007; accordingly no further impairment was recorded in the year ended September 30, 2008. Consequently the Company recorded a net gain of \$159,151 representing the write-off of a development cost liability of \$235,408 and a loan loss in the amount of \$76,257 for doubtful recovery of amounts advanced on the property in 2008. The Company commenced an action in the British Columbia Supreme Court against WSI and an affiliated company seeking damages for breach of contract and other things, arising from this and other matters. The Company has obtained a default judgement in the amount of \$18,043,692 against WSI and G&O with costs to be assessed. Refer to Note 15.

**Impairment**

At September 30, 2007 the Kern Front Field Property had no proven reserves. The Company estimated the net realizable value of the Kern Front Field property to be \$650,000 at September 30, 2007. The Company has estimated the net realizable value of the remaining leases at September 30, 2010, 2009 and 2008 to be greater than the carrying value. Accordingly no further impairment was recorded in the years ended September 30, 2010, 2009 and 2008.

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 5 – EQUIPMENT**

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	Cost	Accumulated Amortization	September 30, 2010 Net Book Value	
Computer Hardware	\$ 3,963	\$ 3,963	\$	-

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	Cost	Accumulated Amortization	September 30, 2009 Net Book Value	
Computer Hardware	\$ 3,963	\$ 3,634	\$	329

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**NOTE 6 – SALE OF SUBSIDIARY**

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On March 13, 2009 the Company sold its inactive subsidiary Tearlach Resources Limited (Barbados) to Peninsula for cash consideration of \$15,000 (Note 9).

The Company recorded a gain of \$17,696 on the sale as follows:

Cash consideration received		\$ 15,000
Book value of assets disposed		
Prepaid expenses	\$ 4,401	
Less liabilities disposed		
Current liabilities	<u>7,097</u>	
Less net assets disposed		<u>(2,696)</u>
Gain on disposal		<u>\$ 17,696</u>

**NOTE 7 – ACCOUNTS PAYABLE - SECURED**

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At September 30, 2010 the Company had \$418,222 (2009 - \$374,438) in accounts payable which are secured with a second general charge over the Company's assets which ranks *pari passu* with secured amounts owing to related parties. Refer to Note 9.

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 8 – LIABILITY FOR TAX**

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Liability for tax is comprised of the following:

	September 30, 2010	September 30, 2009
i. Accrued Part XII.6 tax liability	\$ 882	\$ 394
ii. Flow-through share indemnification liabilities	155,897	155,897
	\$ 156,779	\$ 156,291

The Company recorded Part XII.6 tax of \$184 in relation to flow through amounts renounced effective December 31, 2008 and spent after January 1, 2009. The Company recorded Part XII.6 tax of \$488 in relation to flow through amounts renounced effective December 31, 2009 and spent after January 1, 2010.

**Flow-through Indemnification Liability:**

At September 30, 2004, the Company recorded renunciation reversals of \$199,899 as a result of flow-through funding raised in 2003 that had not been spent within the required deadlines. During the year ended September 30, 2010 the Company accrued interest of \$nil (2009 – \$15,897) related to flow-through indemnification liabilities. The Company estimates that \$155,897 - comprised of tax and interest expense - is due to investors who participated in the flow-through financing pursuant to the indemnity provisions of the private placement offering.

**NOTE 9 - RELATED PARTY TRANSACTIONS**

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During the year ended September 30, 2010 the Company entered into the following transactions with related parties:

- a) The Company incurred management fees of \$60,000 to a company controlled by a director.
- b) Loans totaling net \$2,500 were received from a company controlled by a director. As of September 30, 2010 the loan balance was \$422,678. The loans bear interest at 12% per annum. The Company accrued interest of \$47,223 in relation to these loans.
- c) Expenses totaling \$5,804 were paid by a director. Interest of \$2,821 was accrued on total amounts owing to the director for expenses.

During the year ended September 30, 2009 the Company entered into the following transactions with related parties:

- d) The Company incurred management fees of \$90,000 to a director and to a company controlled by a director.
- e) Loans totaling \$153,507 were received from a company controlled by a director. The loans bear interest at 12% per annum. The Company accrued interest of \$41,924 in relation to the total balance of loans owed to this company.
- f) Expenses totaling \$792 were paid by a director. Interest of \$2,481 was accrued on total amounts owing to the director for expenses.
- g) On March 13, 2009 the Company sold its subsidiary Tearlach Resources Limited (Barbados) to Peninsula, a company with directors in common. (Refer to Note 6)
- h) On January 23, 2009 75,000 shares were delivered from his personal holdings by a director of the Company for mineral property acquisition costs. The Company recorded an amount due to the director of \$3,750 representing the fair value of the 75,000 shares. (Refer to Note 3)

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 9 - RELATED PARTY TRANSACTIONS (Cont'd)**

All related party transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties. Unless otherwise noted related party amounts are unsecured, bear no interest and have no fixed terms of repayment.

Amounts owing to related party as at September 30, 2010 and 2009 were as follows:

	September 30, 2010	September 30, 2009
i. Director and companies controlled by the director for management fees, loans and expenses. Secured by a second general charge over the Company's assets which ranks <i>pari passu</i> with secured accounts payable. Refer to Note 7.	\$ 865,932	\$ 743,534
ii. Director for management fees and expenses	194,875	193,900
iii. Companies with directors in common	12,747	9,182
	<u>\$ 1,073,554</u>	<u>\$ 946,616</u>

**NOTE 10 - CONVERTIBLE NOTES**

Effective as of March 30, 2006 (the "Effective Date") the Company completed a private placement of 9,166,665 units at a price of \$0.06 per Unit for total net proceeds of \$550,000. Each Unit is comprised of one secured convertible note and one detachable share purchase warrant. Each Warrant entitles the holder to purchase one additional common share of the Company for a period of two years at \$0.10 per share. The Convertible Notes are issued in series, and are each alike (except as to amount and holder). The outstanding principal and interest owing under the Convertible Notes are convertible into common shares of the Company at the option of the lender for a period of five years from the Effective Date at a price per share of \$0.06 if converted in the first or second year after March 30, 2006 on or before March 30, 2008, \$0.07 if converted during the third year thereafter on or before March 30, 2009, \$0.08 if converted in the fourth year thereafter on or before March 30, 2010 and \$0.09 if converted in the fifth year thereafter on or before March 30, 2011.

The Convertible Notes bear interest from the Effective Date at a rate of 10% per annum (calculated semi-annually in arrears) and will mature five years from the Effective Date or on the earlier occurrence of an event of default. The Convertible Notes are secured by a first charge over the assets of the Company.

The Company classified the Notes into debt and equity components based on their relative fair values. The debt component of \$213,736 was calculated as the present value of the required interest and principal payment that would have been applicable to non-convertible debt. An amount of \$191,285 representing the estimated value of the right of conversion, was included in shareholders' equity as the equity component of convertible notes and an amount of \$145,060 representing the estimated value of the warrants was included in shareholders' equity as warrants.

Since the Effective Date, a total of \$269,999 of the Convertible Notes and \$16,503 in accrued interest were converted by the Note holders to shares of the Company at a conversion price of \$0.06 per share for total 4,775,041 common shares and the book value of convertible notes of \$114,328, equity component of convertible notes of \$93,903; and accrued interest of \$16,502 were transferred to share capital for increase in share capital of \$224,733.

During the year ended September 30, 2010 the Company recorded interest expense of \$28,000 (2009 - \$27,985) on the Notes. An additional \$49,755 (2009 - \$35,611) was recorded as interest expense and accreted back to the carrying value of the Notes.

Subsequent to the year ended September 30, 2010, all holders of the Convertible Notes agreed to extend the maturity date to March 30, 2012 with the conversion price remaining at \$0.09 per share.

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 11 - SHARE CAPITAL**

Authorized:		Shares	Amount
100,000,000 common shares without par value			
100,000,000 preferred shares without par value			
<hr/>			
Common shares issued:			
Balance at September 30, 2008		34,432,844	\$ 6,651,392
Issued for cash by private placement at \$0.05 per unit (net of warrants)		1,000,000	40,000
Renunciation of flow-through shares		-	(7,532)
Issued for exercise of special warrants at \$0.1575 per share		270,000	42,525
<hr/>			
Balance at September 30, 2009		35,702,844	6,726,385
Issued for exercise of special warrants at \$0.1575 per share		135,000	21,262
Renunciation of flow-through shares		-	(5,776)
Issued for cash by private placement at \$0.02 per unit (net of fees)		7,250,000	110,000
<hr/>			
Balance at September 30, 2010		43,087,844	\$ 6,851,871

Significant share transactions were as follows:

- a) In October 2008 the Company closed a private placement of 1,000,000 units comprised of 500,000 flow-through units and 500,000 non-flow-through units at \$0.05 per unit for gross proceeds of \$50,000. Each unit is comprised of one common share and one share purchase warrant entitling the holder to purchase one additional common share from the Company at \$0.10 for two years. The warrants were determined to have a fair value of \$0.01 each for a total of \$10,000. As at September 30, 2009 \$25,000 of the flow-through funds received were expended on qualifying exploration expenditures. The Company renounced flow-through expenditures of \$25,000 on December 31, 2008, and recorded a recovery of future income taxes of \$7,532 related to the tax benefits renounced.
- b) On December 23, 2008, the Company issued 135,000 common shares upon the exercise of 135,000 special warrants. An amount of \$21,263 (\$0.1575 per share) which was previously recorded as special warrants was reallocated to share capital upon exercise of the special warrants.
- c) On August 13, 2009, the Company issued 135,000 common shares upon the exercise of 135,000 special warrants. An amount of \$21,263 (\$0.1575 per share) which was previously recorded as special warrants was reallocated to share capital upon exercise of the special warrants.
- d) On November 12, 2009 the Company closed a non-brokered private placement of 6,250,000 Non-Flow-through Units and 1,000,000 Flow-through units at a price of \$0.02 per Unit for gross proceeds of \$145,000, of which \$20,000 had been received by September 30, 2009. A finders' fee of \$6,000 was paid representing a 10% cash commission on subscription proceeds from four placees introduced to the placement by the finder.

Each Non Flow-through Unit consists of one common share of the Company and one common share purchase warrant. Each warrant entitles the holder to purchase one share at a price of \$0.05 for a period expiring one year from the date of issuance and at a price of \$0.10 for the second through fifth years from the date of issuance.

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 11 - SHARE CAPITAL (cont'd)**

Each Flow-through Unit consists of one Flow-through Share of the Company and one Flow-through Warrant. Each Flow-Through Warrant will entitle the holder thereof to purchase one Flow-through Share at a price of \$0.05 for a period expiring one year from the date of issuance and at a price of \$0.10 for the second through fifth years from the date of issuance.

The warrants were determined to have a fair value of \$0.004 each for a total value of \$29,000. The Company renounced flow-through expenditures of \$20,000 on December 31, 2009, and recorded a recovery of future income taxes of \$5,776 related to the tax benefits renounced. As at September 30, 2010 \$13,961 of the flow-through funds was spent on qualifying exploration expenditures. The balance of \$6,039 was spent subsequent to September 30, 2010.

- e) On December 15, 2009, the Company issued 135,000 common shares upon the exercise of 135,000 special warrants. An amount of \$21,262 (\$0.1575 per share) which was previously recorded as special warrants was reallocated to share capital upon exercise of the special warrants.

**Stock Option Plan**

During December 2006 the TSX Venture Exchange (“Exchange”) approved a stock option plan (the ‘2006 Plan’). Any options granted under the 2006 Plan vest according to the terms deemed appropriate by the directors of the Company and that are in compliance with Exchange policy, or, upon Exchange approval, will vest immediately in the event of a change of control of the Company or takeover bid.

The number of common shares allowed under the Plan, together with all of the Company’s other previously established or proposed share compensation arrangements, may not exceed 20% of the total number of issued and outstanding common shares of the Company. The maximum number of common shares which may be issued pursuant to options granted is 4,963,894 or such additional amounts as may be approved from time to time by shareholders of the Company. At the Company’s annual general meeting on June 26, 2008 the shareholders approved an increase in the number of options which may be granted to 6,135,307. The Company has not applied for Exchange approval for this increase.

**Stock Options**

The Company had outstanding incentive stock options to directors, employees and consultants entitling the holders to purchase an aggregate of common shares as follows:

September 30, 2010								
		Outstanding			Vested and exercisable			
Issue Date	Expiry Date	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Life in Years	Number of Shares	Exercise Price Per Share	Weighted Average Life in Years	Weighted Average Life in Years
October 1, 2005	October 1, 2010	85,000	\$ 0.20	0.00	85,000	\$ 0.20	0.00	0.00
January 2, 2006	January 2, 2011	100,000	0.20	0.26	100,000	0.20	0.26	0.26
December 1, 2006	December 1, 2011	15,000	0.50	1.17	15,000	0.50	1.17	1.17
December 12, 2007	December 12, 2012	2,305,950	0.10	2.20	2,305,950	0.10	2.20	2.20
		2,505,950	\$ 0.11	1.92	2,505,950	\$ 0.11	1.92	1.92

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 11 - SHARE CAPITAL (cont'd)**

		September 30, 2009					
		Outstanding			Vested and exercisable		
Issue Date	Expiry Date	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Life in Years	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Life in Years
October 1, 2005	October 1, 2010	85,000	\$ 0.20	1.00	85,000	\$ 0.20	1.00
January 2, 2006	January 2, 2011	100,000	0.20	1.26	100,000	0.20	1.26
December 1, 2006	December 1, 2011	15,000	0.50	2.17	15,000	0.50	2.17
December 13, 2006	December 13, 2011	480,000	0.50	2.20	480,000	0.50	2.20
December 12, 2007	December 12, 2012	2,305,950	0.10	3.20	2,305,950	0.10	3.20
January 24, 2008	January 24, 2013	100,000	0.10	3.32	100,000	0.10	3.32
		3,085,950	\$ 0.17	2.92	3,085,950	\$ 0.17	2.92

A summary of the Company's stock options and changes during the year are presented below:

	Year ended September 30, 2010			Year ended September 30, 2009		
	Number of Common Shares	Weighted Average Exercise Price per Share	Weighted Average Life in Years	Number of Common Shares	Weighted Average Exercise Price per Share	Weighted Average Life in Years
Balance beginning	3,085,950	\$ 0.17	2.92	4,142,000	\$ 0.18	3.09
Granted	-	-	-	-	-	-
Exercised	-	-	-	-	-	-
Expired/cancelled	(580,000)	0.3	-	(1,056,050)	0.20	-
Balance ending	2,505,950	\$ 0.11	1.92	3,085,950	\$ 0.17	2.92

On December 1, 2006, the Company granted 15,000, 5-year options exercisable at \$0.50 per common share to a consultant. The total fair value of \$6,142 was estimated using the Black-Scholes option pricing model assuming an expected life of five years, a risk-free interest rate of 3.8% and an expected volatility of 126%. The stock options vest as follows: 20% upon grant of the options and a further 13.33% each quarter over the following 18 months. A consulting fee expense of \$614 was recorded representing the fair value of the options which vested during the year ended September 30, 2009

On December 13, 2006, the Company granted 480,000 5-year options exercisable at \$0.50 per common share to three consultants. The total fair value of \$196,631 was estimated using the Black-Scholes option pricing model assuming an expected life of five years, a risk-free interest rate of 3.86% and an expected volatility of 126%. The stock options vest as follows: 20% upon grant of the options and a further 13.33% each quarter over the following 18 months. A consulting fee expense of \$19,663 (2008 - \$78,652) was recorded representing the fair value of the options which vested during the year ended September 30, 2009. The options were cancelled in the year ended September 30, 2010 upon termination of services by the consultants.

On December 12, 2007, the Company granted 2,405,950 5-year options exercisable at \$0.10 per common share to four directors, three consultants, an employee and an investor relations specialist. The total fair value of \$191,726 was estimated using the Black-Scholes option pricing model assuming an expected life of five years, a risk-free interest rate of 3.87% and an expected volatility of 109%. The stock options vest as follows: 16.67% upon grant of the options and a further 16.67% each quarter over the following 18 months. 100,000 of these options were cancelled in January 2008 upon the resignation of the Company's investor relations consultant. A management fee expense of \$37,744 (2008 - \$75,488); a consulting fee expense of \$23,508 (2008 - \$47,016); and an investor relations expense of \$nil (2008 - \$1,328) were recorded representing the fair value of the options which vested during the year ended September 30, 2009.

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 11 - SHARE CAPITAL (cont'd)**

On January 24, 2008, the Company granted 100,000 5-year options exercisable at \$0.10 per common share to a consultant of the Company. The total fair value of \$6,890 was estimated using the Black-Scholes option pricing model assuming an expected life of five years, a risk-free interest rate of 3.86% and an expected volatility of 133%. The stock options vest as follows: 25% upon grant of the options and a further 12.5% each quarter over the following 18 months. During the year ended September 30, 2010, the Company recorded consulting expense of \$Nil (2009 - \$3,445) representing the fair value of the options which vested during the year. The options were cancelled during the year ended September 30, 2010 upon termination of services by the consultant.

The weighted average grant date fair value of options outstanding at September 30, 2010 was \$0.11 (2009 - \$0.13) as follows:

September 30, 2010			September 30, 2009		
Grant Date	Number of Shares Granted	Weighted Average Fair Value per Share	Grant Date	Number of Shares Granted	Weighted Average Fair Value per Share
December 12, 2007	2,305,950	\$ 0.08	December 12, 2007	2,305,950	\$ 0.08
January 24, 2008	-	-	January 24, 2008	100,000	0.07
December 1, 2006	15,000	0.41	December 1, 2006	15,000	0.41
December 13, 2006	-	-	December 13, 2006	480,000	0.41
October 1, 2005	85,000	0.06	October 1, 2005	85,000	0.06
January 2, 2006	100,000	0.04	January 2, 2006	100,000	0.04
	2,505,950	\$ 0.11		3,085,950	\$ 0.13

**Warrants**

The Company had outstanding warrants entitling the holders to purchase an aggregate of common shares as follows:

Date Issued	Exercise Price Per Share	Expiry Date	September 30, 2010		September 30, 2009		
			Number of Shares	Weighted Average Life in Years	Number of Shares	Weighted average exercise price	Weighted Average Life in Years
October 15, 2008	\$ 0.10	October 15, 2010	1,000,000	0.04	1,000,000	\$ 0.10	1.04
November 12, 2009	\$ 0.10	November 12, 2014	7,250,000	4.12			
			8,250,000	3.63	1,000,000		1.04

A summary of the Company's warrants and changes during the periods is presented below:

	Year ended September 30, 2010			Year ended September 30, 2009		
	Number of Warrants	Weighted Average Exercise Price per Share	Weighted Average Life in Years	Number of Warrants	Weighted Average Exercise Price per Warrant	Weighted Average Life in Years
Balance, beginning	1,000,000	\$ 0.10	1.04	-	\$ -	-
Granted	7,250,000	0.10	5.00	1,000,000	0.10	2.00
Exercised	-	-	-	-	-	-
Expired/Cancelled	-	-	-	-	-	-
Balance, ending	8,250,000	\$ 0.10	3.63	1,000,000	\$ 0.10	1.04

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 11 - SHARE CAPITAL (cont'd)**

**Special Warrants**

During the year ended September 30, 2007 the Company issued 30,000,000 special warrants with a fair value of \$0.1575 per special warrant for a total fair value of \$4,725,000. Each special warrant may be converted into one common share of the Company at no additional cost, subject to certain limitations if as a result of such conversion the special warrant holder would own 10% or more of the shares of the Company.

A summary of the Company's special warrants and changes for the period is presented below:

	Year ended September 30, 2010	Year ended September 30, 2009
Balance beginning	26,325,000	26,595,000
Exercised	(135,000)	(270,000)
Balance ending	26,190,000	26,325,000

The Special Warrants are to be released over 36 months (Note 4). A summary of the Company's special warrants held in escrow and changes for the period is presented below:

	Year ended September 30, 2010	Year ended September 30, 2009
Balance in escrow - beginning	4,500,000	13,500,000
Placed in escrow	-	-
Released from escrow	(4,500,000)	(9,000,000)
Balance in escrow - ending	-	4,500,000

**Contributed Surplus**

A summary of contributed surplus is as follows:

	Year ended September 30, 2010	Year ended September 30, 2009
Balance, beginning	\$ 875,609	\$ 790,634
Stock-based compensation	-	84,975
Balance, ending	\$ 875,609	\$ 875,609

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 12 – SUPPLEMENTAL INFORMATION WITH RESPECT TO CASH FLOWS**

	September 30, 2010	September 30, 2009
	\$	\$
Cash paid for interest	-	-
Cash paid for income taxes	-	8,532
Shares issued for exercise of special warrants	21,262	42,525
Oil and gas development costs included in liability for development costs	7,208	6,099
Cash and cash equivalents consists of:		
Cash	439	19,960
Guaranteed Investment Certificate	5,791	5,783
	6,230	25,743

**NOTE 13 – SEGMENTED INFORMATION**

The Company's assets are located in the following geographic locations:

	September 30, 2010	September 30, 2009
Canada	\$ 940,843	\$ 928,575
USA	697,667	688,590
	\$ 1,638,510	\$ 1,617,165

The Company's net loss from operations in the year ending September 31, 2010 and 2009 were incurred as follows:

	Year ended September 30, 2010	Year ended September 30, 2009
Canada	\$ (281,310)	\$ (554,078)
USA	(90,758)	(61,423)
	\$ (372,068)	\$ (615,501)

**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

**NOTE 14 – FUTURE INCOME TAX**

The actual income tax provisions differ from the expected amounts calculated by applying the Canadian combined federal and provincial corporate statutory income tax rates to the Company's loss before income taxes. The components of these differences are as follows:

	2010	2009
Loss before income taxes	\$ (376,841)	\$ (620,825)
Corporate statutory tax rate	28.88%	30.13%
Expected tax expense (recovery)	(108,813)	(187,024)
Increase (decrease) resulting from:		
Change in corporate tax rate	(4,531)	36,255
Other	(42,786)	-
Difference in tax rates in foreign jurisdiction	(9,646)	(10,950)
Unrecognized items for tax purposes	14,367	33,603
Expiry of non-capital losses carried forward	94,691	42,489
Change in future tax asset valuation allowance	(22,820)	100,065
Effect of change in foreign exchange rates	73,762	(21,970)
Future income tax provision (recovery)	<u>\$ (5,776)</u>	<u>\$ (7,532)</u>

The Company's tax-effected future income tax assets and liabilities are made up as follows:

	2010	2009
Future income tax assets (liabilities)		
Non-capital losses carried forward	\$ 2,746,898	\$ 2,809,580
Capital losses carried forward	86,636	43,850
Resource property tax pools in excess of carrying value of properties	40,117	45,117
Equipment	869	787
	<u>2,876,514</u>	<u>2,899,334</u>
Valuation allowance		
Valuation allowance opening	(2,899,334)	(2,799,269)
Change in valuation allowance	22,820	(100,065)
Valuation allowance, closing	<u>(2,876,514)</u>	<u>(2,899,334)</u>
Net future tax asset (liability)	<u>\$ -</u>	<u>\$ -</u>

The Company renounced flow-through expenditures of \$25,000 on December 31, 2008, and recorded a recovery of income taxes of \$7,532 related to the tax benefits renounced. As at September 30, 2009 all of the flow-through funds received were expended on qualifying exploration expenditures.

The Company renounced flow-through expenditures of \$20,000 on December 31, 2009, and recorded a recovery of income taxes of \$5,776 related to the tax benefits renounced. As at September 30, 2010 \$13,961 of the flow-through funds received were expended on qualifying exploration expenditures. The balance of \$6,039 was spent subsequent to September 30, 2010.

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 14 – FUTURE INCOME TAX (Cont'd)**

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The Company has Canadian non-capital loss carry forwards of approximately \$2,277,089 (2009 - \$2,319,144) and US net operating loss carry forwards of approximately US\$5,385,616 (2009 – \$5,263,984) which can be applied to reduce future taxable income in Canada and the US respectively, and expiring as follows:

Year of Expiry	Canada (Cdn\$)	United States (US \$)
2014	303,365	-
2015	216,705	-
2026	387,045	-
2027	358,766	5,155,381
2028	377,911	-
2029	395,293	108,603
2030	238,044	121,632
	\$ 2,277,089	\$ 5,385,616

In addition, the Company has Canadian exploration and development expenditures of approximately \$1,082,177 (2009 - \$1,078,217) and capital loss carry-forwards of approximately \$693,091 which may be available to reduce future taxable income. Both the exploration and development expenditures and the capital losses can be carried forward indefinitely.

The Company's California subsidiary has United States resource pools of US\$697,056 (2009 - US\$689,211) which can be carried forward indefinitely and which may be available to reduce future taxable income.

Due to the uncertainty of realization of these loss carry-forwards and resource tax pools, the benefit is not reflected in the financial statements as the Company has provided a full valuation allowance for the future tax assets resulting from these items.

**NOTE 15 – CONTINGENCIES**

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The Company recognizes liabilities for contingencies when it is probable that liabilities may be incurred and where such liabilities can be reasonably estimated. Legal proceedings in which the Company is involved are summarized below.

**Tearlach vs WSI**

On December 11, 2008 the Company commenced legal proceedings in the Supreme Court of British Columbia against WSI and G&O of Monrovia, California (the "Defendants"), alleging numerous breaches in a contract between the Company and the Defendants which contract was entered into April 21, 2006. The contract and resulting breaches relate to the Company's purchase of oil and gas properties located in Bakersfield, California, USA from the Defendants as Vendors of the properties. In documents filed in the Action, the Company alleges that, among other things, the Defendants and their representatives have engaged in intentional, fraudulent and deceitful material misrepresentations and concealment of facts and other conduct which justifies an award for exemplary, aggravated and punitive damages, in addition to general and special damages. The Company has obtained a default judgement in the amount of \$18,043,692 against WSI and G&O with costs to be assessed (Note 4).

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 15 – CONTINGENCIES (Cont'd)**

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**Claim for expenses**

WSI and G&O (also known as United Pacific Energy Corporation ) of Monrovia, California has demanded that the Company pay certain expenses which it claims are payable pursuant to the contract entered into April 21, 2006. UPEC/WSI has not commenced legal action in relation to this claim. The Company believes this claim is without foundation or merit in that the majority of expenses claimed were incurred on the Judkins Lease, which by Court Order has been declared to have terminated prior to the date WSI purportedly sold the Company an interest in this lease and therefore was not owned by either party at all material times when these expenses were allegedly incurred. Refer to Note 4.

WSI, G&O and UPEC filed an action against the Company, Tearlach California and two of its directors and officers. The suit alleges causes of action for fraud, breach of contract and declaratory relief in connection with claims for expenses and other matters related to contracts between the parties. The Company, Tearlach California and the directors have filed a defence in the action and have also filed a cross complaint against the plaintiffs and three associated individuals alleging causes of action for breach of contract, fraud and related torts seeking unspecified damages as against the cross defendants. The Company believes it will, in due course, be successful in obtaining a complete dismissal of the action and will also obtain judgement on the cross complaint. The action is set for trial to commence January 31, 2011.

**Settlement bonus**

The Company has agreed to pay a minimum bonus of \$100,000 to legal counsel upon successful settlement of outstanding legal disputes with WSI and related parties.

The Company has not recorded a liability in relation to the foregoing matters as the amount and likelihood of loss, if any, cannot be determined at this time.

**NOTE 16 - RISK MANAGEMENT**

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**Management of Industry Risk**

The Company is engaged primarily in mineral exploration and oil and gas development and manages related industry risk issues directly. The Company may be at risk for environmental issues and fluctuations in commodity pricing. Management is not aware of and does not anticipate any significant environmental remediation costs or liabilities in respect of its current operations.

**Management of Financial Risk**

The Company's financial instruments are exposed to certain financial risks, which include credit risk, liquidity risk, and market risk.

*Credit Risk*

Credit risk is the risk that one party to a financial instrument will fail to fulfil an obligation causing the other party to incur a financial loss. The Company is exposed to credit risks arising from its cash holdings and, GST recoverable. The Company manages credit risk by placing cash with major Canadian financial institutions. GST recoverable is due from the Federal Government of Canada. Management believes that credit risk related to this amount is nominal.

*Liquidity risk*

Liquidity risk is the risk that the Company will not have sufficient funds to meet its financial obligations when they are due. To manage liquidity risk, the Company reviews additional sources of capital and replacement debt structures to continue its operations and discharge its commitments as they become due.

*Market risk*

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and price risk.

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**TEARLACH RESOURCES LIMITED.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2010**

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**NOTE 16 - RISK MANAGEMENT (Cont'd)**

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*Currency risk*

Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Company's functional currency is the Canadian dollar. There is moderate currency risk to the Company as its oil and gas property interests are located in the United States.

The Company manages its exposure to these risks by monitoring its financial instruments, if any, dominated in US dollars. The Company does not engage in any form of derivative or hedging instruments to reduce its foreign currency risk.

*Interest rate risk*

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company is not exposed to significant interest rate risk.

*Commodity price risk*

The ability of the Company to develop its oil and gas properties is directly related to the market price of oil and gas. The Company closely monitors the price of oil and gas to determine appropriate action to be taken by the Company.

*Financial instruments fair values*

The fair value of cash and cash equivalents is measured using level 1 of the fair value hierarchy. The fair values of GST recoverable and accounts payable and accrued liabilities approximate their carrying values due to the short term or demand nature of these instruments. It is management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments.

**NOTE 17 - CAPITAL MANAGEMENT**

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The Company manages its cash, loans from related parties and common shares as capital. The Company's objective when managing capital is to safeguard the Company's ability to continue as a going concern in order to pursue the development of its properties and to maintain a flexible capital structure which optimizes the cost of capital at an acceptable risk.

The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust the capital structure, the Company may attempt to issue new shares, issue new debt, or acquire or dispose of assets. In order to maximize ongoing development efforts, the Company does not pay out dividends.

The Company expects it will need to raise capital to continue operations through its next fiscal year. There were no changes in the Company's approach to capital management during the year ended September 30, 2010. The Company is not subject to externally imposed capital requirements.

**NOTE 18 – SUBSEQUENT EVENTS**

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- a) Subsequent to the year ended September 30, 2010, the Company received an additional advance of \$13,000 from a company controlled by a director.
- b) Subsequent to the year ended September 30, 2010, 185,000 options expired unexercised.