Hemisphere energy corporation

# Management's Discussion and Analysis

## For the Three and Six Months Ended August 31, 2012

(Expressed in Canadian dollars)

The following discussion and analysis of the current financial position and results of operations of Hemisphere Energy Corporation ("Hemisphere" or the "Company") for the three and six months ended August 31, 2012 should be read in conjunction with the August 31, 2012 condensed interim financial statements and the related notes. These documents are available at www.sedar.com. The effective date of this report is October 29, 2012.

The information in this report is based on the unaudited condensed interim financial statements which were prepared in accordance with International Financial Reporting Standards ("IFRS") applicable to the preparation of condensed interim financial statements including IAS 34 "*Interim Financial Reporting*", as issued by the International Accounting Standards Board ("IASB").

### FORWARD-LOOKING STATEMEMENTS

This document contains "forward-looking statements" that are based on Hemisphere's current expectations, estimates, forecasts and projections. These forward-looking statements include statements regarding Hemisphere's outlook for our future operations, plans and timing for the commencement or advancement of exploration and development activities on our properties, and other expectations, intention and plans that are not historical fact. The words "estimates", "projects", "expects", "intends", "believes", "plans", or their negatives or other comparable words and phrases are intended to identify forward-looking statements. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results to differ materially from future results expressed or implied by such forward-looking statements. Many of these factors are beyond the control of Hemisphere. Consequently, all forward-looking statements made in this document are qualified by this cautionary statement and there can be no assurance that actual results or developments anticipated by Hemisphere will be realized. For the reasons set forth above, investors should not place undue reliance on such forward-looking statements. Hemisphere disclaims any intention or obligation to update or revise forward-looking information, whether as a result of new information, future events or otherwise.

### BOE CONVERSIONS

Within this document, petroleum and natural gas volumes and reserves are converted to a common unit of measure, referred to as a barrel of oil equivalent ("boe"), using a ratio of 6,000 cubic feet of natural gas to one barrel of oil. Use of the term boe may be misleading, particularly if used in isolation. The conversion ratio is based on an energy equivalent method and does not necessarily represent a value equivalency at the wellhead.

### NON-IFRS MEASUREMENTS

This document contains the terms "funds flow from operating activities" and "operating netback" that are not recognized measures under IFRS. The Company's management considers these to be key measures that demonstrate the Company's ability to generate the funds flow necessary to support future growth through capital investment and to repay debt, if any. Funds flow from operating activities represents net income or loss before depletion, depreciation and accretion, share-based payments and future income tax. Operating netback is a benchmark used in the oil and natural gas industry and represents the profit margin associated with the production and sale of oil and natural gas sales, following the deduction of royalties, operating expenses and transportation costs. These terms should not be considered an alternative to, or more meaningful than cash flow from operating activities or net income as determined in accordance with IFRS as an indicator of the Company's performance.

## BUSINESS OVERVIEW

Hemisphere produces oil from its Jenner property in southeast Alberta and liquid-rich natural gas primarily from its Trutch property in northeastern British Columbia. The Company is headquartered in Vancouver, British Columbia and is traded on the TSX Venture Exchange under the symbol "HME".

### Jenner (Southeast Alberta)

The Jenner property, operated by Hemisphere, is accessible year-round and is located east of Brooks in southeastern Alberta. Hemisphere has a working interest in approximately 12,275 net acres (4,968 ha) and has continued to build a land position in the Jenner area through crown land sales and strategic acquisitions and farm-ins.

On January 27, 2012, the Company closed a property acquisition in the Jenner area, as originally announced on December 8, 2011. The acquisition consisted of 8.5 net sections (5,380 acres) of land and operated oil production in the Jenner area directly adjacent to the Company's existing operations, with a significant portion of the land being covered with 3D seismic.

On June 19, 2012, the Company announced it entered into a seismic option and farm-in agreement to acquire 3D seismic data on or before August 15, 2012. Hemisphere will then have the option to drill a test well on or before November 15, 2012, subject to surface access, rig availability and regulatory approval. Once initial obligations are fulfilled, Hemisphere will have the option to acquire additional 3D seismic and drill additional wells to earn into a maximum of 6.5 sections of land in the Jenner area.

On September 9, 2012, the Company announced results from its summer drilling program which commenced in July 2012. The drilling program resulted in two horizontal wells that targeted the oil-bearing sandstones of the Glauconitic formation. The first well commenced production on August 1, 2012 averaging approximately 25 barrels of oil per day with a 5% water cut. The second well commenced production on August 11, 2012 averaging approximately 172 barrels of oil per day with a 6% water cut.

During the six months ended August 31, 2012, the Company completed significant upgrades to its main production facility by adding a new water disposal pump and a heated free-water-knockout separator for greater fluid handling capacity and reduction of operating costs.

The Company continues to evaluate the oil development opportunities on the property on an ongoing basis.

### Trutch (Northeast British Columbia)

Hemisphere has working interests varying from 30% to 100% in approximately 22,837 net acres (~9,246 ha) of the Trutch property which is located approximately 200 kilometres northwest of Fort St. John in British Columbia. Hemisphere currently has production from the unconventional liquids rich Halfway formation in Trutch and recognizes potential in the Montney and Slave Point formations. Competitors to the southeast of the Trutch area have been actively exploring and developing the prolific Tommy Lakes Halfway unconventional gas field for a number of years and have recently began using horizontal wells and multi-stage frac completions for development.

## RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED AUGUST 31, 2012

The Company reported a net loss for the three months ended August 31, 2012 of $136,556 ($0.00/share) as compared to a net loss of $75,583 ($0.00/share) for the three months ended August 31, 2011. The Company reported net income for the six months ended August 31, 2012 of $169,349 ($0.00/share) as compared to a net loss of $384,347 ($0.01/share) for the same period of the previous fiscal year.

For the three months ended August 31, 2012, the Company generated funds flow from operating activities of $823,609 ($0.02/share) as compared to a negative funds flow of $3,965 ($0.00/share) for the three months ended August 31, 2011. This represents an improvement in cash flow of $827,574.

The Company generated funds flow from operating activities of $1,892,118 ($0.04/share) for the six months ended August 31, 2012 as compared to a negative funds flow of $91,130 ($0.00/share) for the same period of the previous fiscal year which represents an improvement in cash flow of $1,983,248.

### Production

The Company's production for the three and six months ended August 31, 2012 and 2011 are as follows:

| | ***Three Months Ended August 31,*** | | ***Six Months Ended August 31,*** | |
|---|---|---|---|---|
| | ***2012*** | *2011* | ***2012*** | *2011* |
| Oil (bbl/d) | **335** | 33 | **359** | 28 |
| Natural gas (Mcf/d) | **170** | 216 | **179** | 216 |
| NGL (bbl/d) | **4** | 2 | **4** | 2 |
| **Total (boe/d)** | **367** | 71 | **393** | 66 |
| **Oil and NGL weighting** | **92%** | 49% | **92%** | 45% |

The Company's production averaged 367 boe per day ("boe/d") for the three months ended August 31, 2012 with an oil and natural gas liquids ("NGL") weighting of 92%. This represents a 417% increase in production from 71 boe/d over the same quarter in the prior fiscal year. For the six months ended August 31, 2012, production increased to 393 boe/d (92% oil and NGL weighting) from 66 boe/d (45% oil and NGL weighting) during the same period in the prior fiscal year. Increases can be attributed to the drilling of new oil wells in the Jenner area.

During the second quarter, the Company experienced some production downtime due to the shut-in of wells during drilling operations and for pool evaluation purposes. Wet weather also impacted production from one well until it was tied-in in mid-August.

## Revenue

The Company's revenue for the three and six months ended August 31, 2012 and 2011 are as follows:

| | *Three Months Ended August 31,* | | *Six Months Ended August 31,* | |
|---|---|---|---|---|
| | ***2012*** | *2011* | ***2012*** | *2011* |
| Oil | **$ 1,981,535** | $ 214,057 | **$ 4,346,621** | $ 385,767 |
| Natural gas | **30,218** | 73,661 | **60,226** | 144,246 |
| NGL | **17,387** | 9,808 | **43,955** | 23,376 |
| **Total revenue** | **$ 2,029,140** | $ 297,526 | **$ 4,450,803** | $ 553,389 |

Total revenue for the three months ended August 31, 2012 and 2011 were $2,029,140 and $297,526, respectively, which represents an increase of $1,731,614. Revenue for the three months ended August 31, 2012 consisted of $1,981,535 in oil, $30,218 in natural gas and $17,387 in NGL.

For the six months ended August 31, 2012, total revenue was $4,450,803 as compared to $553,389 in the same period of the previous fiscal year which represents an increase of $3,897,414. Revenue for the six months ended August 31, 2012 consisted of $4,346,621 in oil, $60,226 in natural gas and $43,955 in NGL. The increases in revenue for both the three and six months ended August 31, 2012 are due to drilling and developing new wells in the Jenner area.

Average benchmark and realized prices for the three and six months ended August 31, 2012 and 2011 are as follows:

| | *Three Months Ended August 31,* | | *Six Months Ended August 31,* | |
|---|---|---|---|---|
| | ***2012*** | *2011* | ***2012*** | *2011* |
| **Benchmark prices** | | | | |
| WTI (US$/bbl)(1) | **88.13** | 92.89 | **94.78** | 98.82 |
| Exchange rate (1 US$/Cdn$) | **1.01** | 0.97 | **1.01** | 0.97 |
| WTI (C$/bbl) | **89.31** | 90.45 | **95.45** | 96.03 |
| AECO natural gas ($/Mcf)(2) | **2.13** | 3.70 | **1.97** | 3.71 |
| **Average realized prices** | | | | |
| Crude oil ($/bbl) | **64.31** | 71.56 | **65.79** | 74.96 |
| NGL ($/bbl) | **50.27** | 58.93 | **61.24** | 64.33 |
| Natural gas ($/Mcf) | **1.93** | 3.71 | **1.83** | 3.64 |
| Combined ($/boe) | **60.10** | 46.01 | **61.59** | 45.66 |

Notes:
(1) WTI represents posting prices of West Texas Intermediate Oil.
(2) Represents the AECO daily posting.

The Company's combined weighted-average realized price for the three months ended August 31, 2012 increased 31% to $60.10 as compared to $46.01 for the same quarter of the previous fiscal year. For the six months ended August 31, 2012 and 2011, the Company's combined weighted-average realized prices were $61.59 and $45.66, respectively, which represents a 35% increase. The Company's realized crude oil sales price is for the sale of heavy oil, which is subject to a heavy oil differential to West Texas Intermediate pricing, and a further quality adjustment to reflect the cost of blending our heavy oil with diluents to meet pipeline specifications.

## Operating Netback

The components of operating netback for the three and six months ended August 31, 2012 and 2011 are as follows:

| Netback | Three Months Ended August 31, 2012 | 2011 | Six Months Ended August 31, 2012 | 2011 |
|---|---|---|---|---|
| Revenue | **$ 2,029,140** | $ 297,526 | **$ 4,450,803** | $ 553,389 |
| Royalties | **436,636** | 31,144 | **876,981** | 75,431 |
| Operating costs | **346,201** | 93,177 | **786,676** | 212,526 |
| Transportation costs | **106,476** | 6,360 | **279,846** | 9,616 |
| **Operating netback** | **$ 1,139,827** | $ 166,845 | **$ 2,507,300** | $ 255,816 |
| ***Netback ($/boe)*** | | | | |
| Revenue | **$ 60.10** | $ 46.01 | **$ 61.59** | $ 45.66 |
| Royalties | **12.93** | 4.82 | **12.14** | 6.22 |
| Operating costs | **10.25** | 14.40 | **10.89** | 17.53 |
| Transportation costs | **3.15** | 0.99 | **3.87** | 0.80 |
| **Operating netback** | **$ 33.76** | $ 25.80 | **$ 34.70** | $ 21.11 |

Royalties for the three months ended August 31, 2012 were $436,636 or $12.93/boe as compared to $31,144 or $4.82/boe for the same quarter of the previous fiscal year. For the six months ended August 31, 2012 and 2011, royalties were $876,981 or $12.14/boe and $75,431 or $6.22/boe, respectively, which represents an increase of $801,550. The increases for the both the three and six months ended August 31, 2012 are attributed to the new wells acquired and drilled on the Jenner property during the period, which are subject to crown royalties as well as gross overriding royalties.

Operating costs include all costs for gathering, processing, dehydration, compression, water processing and marketing of the oil, natural gas and NGLs, as well as additional costs incurred periodically for maintenance and repairs. Operating costs for the three months ended August 31, 2012 were $346,201 or $10.25/boe as compared to $93,177 or $14.40/boe for the same quarter of the previous fiscal year which represents a decrease of $4.15/boe. Operating costs for the six months ended August 31, 2012 and 2011 were $786,676 or $10.89/boe and $212,526 or $17.53/boe, respectively, which represents a decrease of $6.65/boe.

The increase in operating expenses for the period is attributed to a scheduled maintenance turnaround for facilities in the Jenner area, which occurs approximately every three years. The decrease in operating costs per boe is due to the increased production in the Jenner area which has more than offset the increase in operating costs for the period.

Operating netback for the three months ended August 31, 2012 was $1,139,827 or $33.76/boe which is an increase of $972,982 or $7.96/boe from $166,845 or $25.80/boe in the same quarter of the previous fiscal year. For the six months ended August 31, 2012, the operating netback increased by $2,251,485 or $13.59/boe to $2,507,300 or $34.70/boe from $255,816 or $21.11/boe for the same period of the prior fiscal year. The increase in operating netback is attributed to having higher revenue per boe due to the higher oil and liquids weighting as well as the lower operating costs per boe.

### Depletion and Depreciation

| | Three Months Ended August 31, | | Six Months Ended August 31, | |
|---|---|---|---|---|
| | ***2012*** | *2011* | ***2012*** | *2011* |
| Depletion expense | **$ 715,887** | $ 53,454 | **$ 1,428,158** | $ 106,970 |
| Depreciation expense | **1,513** | 1,194 | **3,145** | 2,388 |
| **Total** | **$ 717,400** | $ 54,648 | **$ 1,431,303** | $ 109,358 |
| **$ per boe** | **$ 21.25** | $ 8.47 | **$ 19.81** | $ 9.05 |

Depletion and depreciation expense for the three months ended August 31, 2012 and 2011 were $717,400 or $21.25/boe and $54,648 or $8.47/boe, respectively, which represents an increase of $662,752 or $12.77/boe. For the six months ended August 31, 2012, depletion and depreciation increased by $1,321,945 or $10.76/boe to $1,431,303 or $19.81/boe from $109,358 or $9.05/boe for the same period of the previous fiscal year.

The depletion rate is calculated on proved and probable oil and natural gas reserves, taking into account the future development costs to produce the reserves. The increase in depletion is relative to the Company's acquisitions of property and development of producing wells in the past twelve months. For the three and six months ended August 31, 2012, depreciation was recorded for the Company's fixed assets in the amount of $1,513 and $3,145, respectively.

### Capital Expenditures

| | Three Months Ended August 31, | | Six Months Ended August 31, | |
|---|---|---|---|---|
| | ***2012*** | *2011* | ***2012*** | *2011* |
| Land and lease | **$ 4,256** | $ 7,264 | **$ 18,752** | $ 9,014 |
| Geological and geophysical | **41,752** | 125,000 | **90,920** | 130,106 |
| Drilling and completions | **1,634,516** | 1,270,754 | **2,517,912** | 1,293,771 |
| Investment in facilities | **1,222,376** | 246,339 | **3,105,439** | 270,774 |
| Development capital | **2,902,900** | 1,649,356 | **5,733,022** | 1,703,664 |
| Property acquisitions | **191,644** | 16,421 | **191,644** | 1,170,607 |
| **Total capital expenditures** | **$ 3,094,543** | $ 1,665,777 | **$ 5,924,666** | $ 2,874,271 |

For the three and six months ended August 31, 2012, capital expenditures on development capital totaled $2.9 million and $5.7 million, respectively. This development capital includes $2.5 million spent in the six months ended August 31, 2012 on drilling and completing three horizontal wells on the Jenner property as well as $3.1 million spent in building infrastructure in the Company's core Jenner area. This infrastructure included, pipelines for the new wells, upgrades to Jenner's main production facility by adding a new water disposal pump and a heated free-water-knockout separator for greater fluid handling capacity and reduction of operating costs.

### Share-Based Payments

Share-based payments for the three months ended August 31, 2012 and 2011 were $238,469 and $15,515, respectively, which represents an increase of $222,954. For the six months ended August 31, 2012, share-based payments increased by $101,084 to $282,872 from $181,788 in the same period of the previous fiscal year. The increase is due to the granting of additional incentive stock options to consultants and employees during the period.

### General and Administrative

General and administrative expenses, before other items, for the three months ended August 31, 2012 was $315,545 as compared to $168,998 for the same quarter of the prior fiscal year which represents an increase of $146,547. For the six months ended August 31, 2012, general and administrative expenses increased by $270,814 to $611,942 from $341,128 in the same period of the previous fiscal year.

The increase in general and administrative expenses can be attributed to the increase of wages and benefits, investor-related expenses and office rent and expenses. Wages and benefits increased due to the addition of new technical and office staff. Investor-related expenses increased as a result of the Company's engagement in investor relations services. Office rent and expenses increased as a result of the relocation of the Company's office and the addition of new personnel.

### Finance Income and Expense

| | Three Months Ended August 31, | | Six Months Ended August 31, | |
|---|---|---|---|---|
| | ***2012*** | *2011* | ***2012*** | *2011* |
| **Finance income:** | | | | |
| Interest income | **$ (90)** | $ - | **$ (90)** | $ (843) |
| **Finance expense:** | | | | |
| Interest expense | **762** | 1,811 | **3,330** | 6,661 |
| Accretion of provision | **4,297** | 1,456 | **8,594** | 2,071 |
| | **5,058** | 3,267 | **11,923** | 8,732 |
| **Net finance expense** | **$ 4,968** | $ 3,267 | **$ 11,833** | $ 7,889 |

Net finance expenses for the three months ended August 31, 2012 and 2011 were $4,968 and $3,267, respectively, representing an increase of $1,701. For the six months ended August 31, 2012, net finance expense was $11,833 which represents an increase of $3,944 from $7,889 for the same period of the previous fiscal year.

The changes in net finance expense for the three and six months ended August 31, 2012 can be attributed to the increase in accretion expense from the addition of new wells, which is partially offset by a reduction in interest expense. The reduction in interest expense was due to the higher amount of part XII.6 tax realized in the prior year from the look-back flow through expenditures.

## SELECTED ANNUAL INFORMATION

The following are highlights of financial data on the Company for the most recently completed three fiscal years:

| | Fiscal Year Ended February 29, 2012 (IFRS) | February 28, 2011 (IFRS) | February 28, 2010 (GAAP) |
|---|---|---|---|
| Income (Loss) before Income Tax | $ (451,879) | $ (1,486,455) | $ (675,652) |
| Net Income (Loss) | 942,665 | (1,486,455) | (614,707) |
| Income (Loss) Per Share | 0.03 | (0.07) | (0.05) |
| Total Assets | 18,914,071 | 3,248,901 | 2,074,329 |
| Total Liabilities | 1,456,802 | 316,978 | 359,171 |
| Working Capital | 2,363,944 | 1,729,423 | 559,483 |
| Capitalized acquisition, exploration and development costs | 13,075,574 | 535,013 | 564,222 |
| Share-based payments | 1,089,738 | 423,932 | 149,311 |
| Shares issued for cash, net of issue costs | 12,457,943 | 2,212,542 | 1,303,751 |
| General and administration costs | 977,461 | 574,689 | 733,361 |

## SUMMARY OF QUARTERLY RESULTS

| | 31-Aug-12 Q2 IFRS | 31-May-12 Q1 IFRS | 29-Feb-12 Q4 IFRS | 30-Nov-11 Q3 IFRS | 31-Aug-11 Q2 IFRS | 31-May-11 Q1 IFRS | 28-Feb-11 Q4 GAAP | 30-Nov-10 Q3 GAAP | 31-Aug-10 Q2 GAAP |
|---|---|---|---|---|---|---|---|---|---|
| Total revenue | 2,029,230 | 2,421,663 | 2,763,564 | 1,273,677 | 297,526 | 256,706 | 87,093 | 71,040 | 81,479 |
| Income (loss) before other items | (131,587) | 312,770 | (667,254) | 597,456 | (72,317) | (304,141) | (309,654) | (287,882) | (193,338) |
| Basic income (loss) per share | (0.00) | 0.01 | (0.02) | 0.02 | (0.00) | (0.01) | (0.02) | (0.01) | (0.01) |
| Diluted income (loss) per share | (0.00) | 0.01 | (0.02) | 0.02 | (0.00) | (0.01) | (0.02) | (0.01) | (0.01) |
| Net income (loss) | (136,556) | 305,905 | 730,504 | 596,509 | (75,583) | (308,764) | (529,637) | (284,817) | (196,697) |
| Basic income (loss) per share | (0.00) | 0.01 | 0.02 | 0.02 | (0.00) | (0.01) | (0.03) | (0.01) | (0.01) |
| Diluted income (loss) per share | (0.00) | 0.01 | 0.02 | 0.02 | (0.00) | (0.01) | (0.03) | (0.01) | (0.01) |

The figures for the quarters of the current and previous fiscal years are presented with the application of IFRS. Figures for the prior periods are all stated in accordance with previous GAAP.

## SHARE CAPITAL AND FINANCING ACTIVITIES

During the six months ended August 31, 2012, the Company issued 42,853 common shares from the exercise of common share purchase warrants and stock options, following which, the Company's total common shares outstanding increased to 50,417,554.

The Company received $22,712 through the exercise of 37,853 common share purchase warrants and $1,250 through the exercise of 5,000 stock options during the six months ended August 31, 2012.

Details of the Company's stock options for the six months ended August 31, 2012 are as follows:

| | | | Changes in the Period | | | | |
|---|---|---|---|---|---|---|---|
| Exercise Price | Expiry Date | Balance Outstanding February 29, 2012 | Granted | Exercised | Expired/ Cancelled | **Balance Outstanding August 31, 2012** | **Balance Exercisable August 31, 2012** |
| $ 0.27 | 28-Sep-14 | 445,000 | - | - | - | 445,000 | 445,000 |
| $ 0.25 | 8-Mar-15 | 490,000 | - | (5,000) | - | 485,000 | 485,000 |
| $ 0.26 | 30-Sep-15 | 520,000 | - | - | - | 520,000 | 520,000 |
| $ 0.30 | 23-Dec-15 | 425,000 | - | - | - | 425,000 | 425,000 |
| $ 0.30 | 27-Jan-16 | 200,000 | - | - | - | 200,000 | 200,000 |
| $ 0.38 | 9-Feb-16 | 50,000 | - | - | - | 50,000 | 50,000 |
| $ 0.40 | 26-May-16 | 520,000 | - | - | - | 520,000 | 520,000 |
| $ 0.48 | 5-Jul-16 | 50,000 | - | - | - | 50,000 | 50,000 |
| $ 0.70 | 8-Feb-17 | 1,550,000 | - | - | - | 1,550,000 | 1,425,000 |
| $ 0.65 | 24-Apr-17 | - | 75,000 | - | - | 75,000 | 75,000 |
| $ 0.61 | 5-Jul-17 | - | 425,000 | - | - | 425,000 | 425,000 |
| | | 4,250,000 | 500,000 | (5,000) | - | 4,745,000 | 4,620,000 |
| **Weighted-average exercise price** | | **$ 0.45** | **$ 0.62** | **$ 0.25** | **$ -** | **$ 0.47** | **$ 0.47** |

During the six months ended August 31, 2012, the Company recognized $282,872 in share-based payment expense from the issuance of 500,000 options to consultants and employees of the Company. This represents an increase of $101,084 as compared to $181,788 for the six months ended August 31, 2011. The fair value was determined using the Black-Scholes option pricing model with the following weighted-average assumptions:

| | ***August 31, 2012*** | *August 31, 2011* |
|---|---|---|
| Expected life (years) | **3.75** | 5.00 |
| Interest rate | **1.36%** | 1.72% |
| Volatility (weekly) | **140.23%** | 143.47% |
| Dividend yield | **0.00%** | 0.00% |

The weighted-average grant date fair value for stock options granted during the six months ended August 31, 2012 was $0.62 as compared to $0.42 for the six months ended August 31, 2011. The forfeiture rate has been estimated at 0% (August 31, 2011 – 0%).

Included in share-based payments were 250,000 stock options granted to a company performing investor relations services (August 31, 2011 - 30,000). These options were granted on February 8, 2012, have an exercise price of $0.70 per share and expire on February 8, 2017. The options vest 25% at each three-month interval from the grant date. The total number of options that remain unvested at August 31, 2012 is 125,000 (August 31, 2011 – nil).

Option pricing models require the input of highly subjective assumptions including the expected price volatility. Changes in the subjective input assumptions can materially affect the fair value estimate.

Details of the Company's share purchase warrants as at August 31, 2012 are as follows:

| Exercise Price | Expiry Date | Balance Outstanding & Exercisable February 29, 2012 | Issued | Exercised | Expired/ Canceled | Balance Outstanding & Exercisable **August 31, 2012** |
|---|---|---|---|---|---|---|
| $0.60 | 29-Oct-12 | 2,108,872 | - | (37,853) | - | 2,071,019 |
| $0.80 | 10-Nov-12 | 132,650 | - | - | - | 132,650 |
| $0.95 | 27-Jan-14 | 6,161,578 | - | - | - | 6,161,578 |
| $0.95 | 27-Jan-14 | 86,256 | - | - | - | 86,256 |
| $0.70 | 27-Jan-14 | 862,620 | - | - | - | 862,620 |
| | | 9,351,976 | - | (37,853) | - | 9,314,123 |
| **Weighted-average exercise price** | | **$ 0.85** | **$ -** | **$ 0.60** | **$ -** | **$ 0.84** |

| | ***August 31, 2012*** | *October 29, 2012** |
|---|---|---|
| **Fully Diluted Share Capital** | | |
| Common shares issued and outstanding | **50,417,554** | 52,131,748 |
| Share purchase warrants | **9,314,123** | 7,243,104 |
| Stock options | **4,745,000** | 4,745,000 |
| **Total Fully Diluted** | **64,476,677** | 64,119,852 |

*Subsequent to August 31, 2012, 1,714,194 share purchase warrants were exercised at a price of $0.60 which resulted in total proceeds of $1,028,516.

## CAPITAL MANAGEMENT

The Company manages its capital with the following objectives:

- To ensure sufficient financial flexibility to achieve the Company's ongoing business objectives including the replacement of production, funding of future growth opportunities, and pursuit of accretive acquisitions; and

- To maximize shareholder return through enhancing the share value.

The Company monitors its capital structure and makes adjustments according to market conditions in an effort to meet its objectives given the current outlook of the business and industry in general. The capital structure of the Company is composed of working capital, share capital, and the undrawn component of the bank credit facility. The Company may manage its capital structure by issuing new shares, repurchasing outstanding shares, obtaining additional financing from the Company's credit facility, issuing new debt instruments, other financial or equity-based instruments, adjusting capital spending, or disposing of assets. The capital structure is reviewed on an ongoing basis.

The Company's capital structure as at August 31, 2012 and August 31, 2011 are as follows:

| | August 31, 2012 | August 31, 2011 |
|---|---|---|
| Current assets | $ 1,514,054 | $ 2,472,605 |
| Current liabilities | 3,158,694 | 516,589 |
| Working capital surplus/(deficit) | (1,644,640) | 1,956,016 |
| Share capital | 36,743,445 | 27,572,168 |
| Undrawn component of bank credit facility | 4,600,000 | - |
| **Total capital** | $ 39,698,805 | $ 29,528,184 |

The Company has total credit facilities of $5,500,000 (August 31, 2011 - $nil). The credit facilities are comprised of a revolving operating demand loan of $4,000,000 and a non-revolving acquisition and development demand loan of $1,500,000. As at August 31, 2012, the Company has drawn $900,000 (August 31, 2011 - $nil) on these credit facilities. The Company's next borrowing base review is scheduled to occur on or before November 1, 2012.

## RELATED PARTY TRANSACTIONS

These transactions are in the ordinary course of business and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties. The following represents transactions entered into for the six months ended August 31, 2012:

(a) Management fees of $20,000 (August 31, 2011 - $50,000) were charged by directors and officers of the Company, and

(b) Compensation of key management personnel compensation, consisting of officers, were awarded in the following denominations:

| | August 31, 2012 | August 31, 2011 |
|---|---|---|
| Salaries and wages | $ 218,750 | $ 81,250 |
| Share-based payments | $ 196,387 | $ 94,328 |

During the three and six months ended August 31, 2012 and 2011, no long-term benefits were paid to related parties.

## CORPORATE INTERNAL CONTROLS

Management has evaluated the effectiveness of the Company's disclosure controls and procedures as at August 31, 2012 and has concluded, based on its evaluation, that these controls and procedures provide reasonable assurance that material information relating to the Company is made known to management and reported, as required. Management is also responsible for the design of internal controls over financial reporting in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS. Management believes the design to be sufficient and appropriate to provide such reasonable assurance.

## OFF-BALANCE SHEET ARRANGEMENTS

The Company has not entered into any off-balance sheet transactions.

## PROPOSED TRANSACTIONS

As of the effective date, there are no outstanding proposed transactions.

## CRITICAL ACCOUNTING ESTIMATES

The Company's significant accounting policies are set out in Notes 2 and 3 to the condensed interim financial statements for the period ended August 31, 2012 and the audited annual financial statements for the year ended February 29, 2012. The policies have been consistently followed in the preparation of the interim financial statements. There have been no changes to the Company's accounting policies since these condensed interim financial statements were issued.

The preparation of financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that may affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the year in which the estimates are revised and in any future years affected.

Significant areas requiring the use of estimates include the collectability of accounts receivable, the recoverability of petroleum and natural gas interest costs, the fair value of financial instruments, balance of accrued liabilities, determination of decommissioning and environmental obligations, the rates of depletion and accretion of petroleum and natural gas interests, assumptions used in the calculation of fair value of stock-based compensation and finder's warrants, and the valuation allowance for future income tax assets. While management believes that these estimates are reasonable, actual results could differ from those estimates and could impact future results of operations and cash flows.

Reserve estimates impact a number of the areas referred to above, in particular the valuation of petroleum and natural gas interests, determination of decommissioning and environmental obligation, and the calculation of depletion.

## FINANCIAL INSTRUMENTS

Fair value estimates of financial instruments are made at a specific point in time, based on relevant information about financial markets and specific financial instruments. As these estimates are subjective in nature, involving uncertainties and matters of significant judgment, they may be subject to future adjustment. Changes in assumptions can significantly affect estimated fair values. At August 31, 2012, the Company's financial instruments include cash and cash equivalent, accounts receivable, reclamation deposits, and accounts payable and accrued liabilities.

The fair values of accounts receivable, and accounts payable and accrued liabilities approximate their carrying values due to the short-term maturity of these financial instruments. The fair value of the reclamation deposits also approximates its carrying value.

## FINANCIAL RISKS

The Company's activities expose it to a variety of financial risks that arise as a result of its exploration, development, production and financing activities such as, credit risk, liquidity risk and market risk. The following provides information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk.

### Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its payment obligations. This risk arises principally from the Company's receivables from joint venture partners and oil and natural gas marketers, and from its cash and cash equivalent balance and reclamation deposits. The credit risk associated with cash, cash equivalent, and reclamation deposits is minimized substantially by ensuring these financial assets are placed with major financial institutions with strong investment-grade ratings by a primary ratings agency. The Company does not anticipate any default.

### Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they become due. The Company's approach to managing liquidity risk is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when they become due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company.

The Company has a cash and cash equivalent balance at August 31, 2012 of $525,751 (February 29, 2012 - $2,183,898) and accounts receivable of $912,845 (February 29, 2012 - $1,252,385). At August 31, 2012, the Company had accounts payable and accrued liabilities of $2,258,694 (February 29, 2012 - $1,098,373) and a negative working capital of $1,644,640 (February 29, 2012 - $2,363,945). All of the Company's financial liabilities have contractual maturities of less than 90 days.

### 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 value of the financial instruments. Market risk comprises three types of risk: interest rate risk, foreign currency risk, and other price risk.

*Interest rate risk*

The Company's cash and cash equivalent is held in bank accounts and due to the short-term nature of these financial instruments, fluctuations in market interest rates do not have an impact on the fair value as at August 31, 2012. The Company manages interest rate risk by maintaining an investment policy that focuses on the preservation of capital and liquidity.

*Foreign currency risk*

The Company is not exposed to significant foreign currency risk.

*Other price risk*

Other price risk is the risk that the fair or future cash flows of a financial instrument will fluctuate due to changes in market prices, other than those arising from interest rate risk or foreign currency risk. The Company is not exposed to significant other price risk.

## BUSINESS RISK

Oil and gas exploration and development involves a high degree of risk whereby many properties are ultimately not developed to a producing stage. There can be no assurance that the Company's future exploration and development activities will result in discoveries of commercial bodies of oil and gas. Whether an oil and gas property will be commercially viable depends on a number of factors including the particular attributes of the reserve and its proximity to infrastructure, as well as commodity prices and government regulations, including regulations relating to prices, taxes, royalties, land tenure, land use, and environmental protection. The exact effect of these factors cannot be accurately predicted, and the combination of these factors may result in an oil and gas property not being profitable.

## LIST OF DIRECTORS AND OFFICERS

Charles O'Sullivan, B.Sc., Director and Chairman
Don Simmons, B.Sc., P. Geol., Director, President and CEO
Dorlyn Evancic, CGA, Chief Financial Officer
Ian Duncan, B.Sc., P. Eng., Vice President of Engineering
Andrew Arthur, M.Sc., P. Geol., Vice President of Exploration
Frank Borowicz, QC, CA (Hon), Director
Gregg Vernon, B.Sc., P. Eng., Director
Greg Sadler, P. Eng., Director
Bruce McIntyre, P. Geol., Director

## ADDITIONAL INFORMATION

Additional information relating to Hemisphere, including the Company's condensed interim financial statements and accompanying notes can be found on SEDAR at www.sedar.com.