

TALISMAN

E N E R G Y

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

May 5, 2010

Talisman Energy Inc.
Consolidated Balance Sheets

| (millions of C\$) | March 31 2010 | December 31 2009 (restated - note 2) |
|--|------------------|---|
| Assets | | |
| Current | | |
| Cash and cash equivalents (note 14) | 1,874 | 1,690 |
| Accounts receivable | 1,148 | 1,265 |
| Inventories | 129 | 144 |
| Prepaid expenses | 37 | 9 |
| Assets of discontinued operations (note 2) | 34 | 46 |
| | 3,222 | 3,154 |
| Other assets (note 5) | 364 | 290 |
| Goodwill (note 4) | 1,177 | 1,194 |
| Property, plant and equipment | 16,538 | 17,137 |
| Assets of discontinued operations (note 2) | 1,474 | 1,843 |
| | 19,553 | 20,464 |
| Total assets | 22,775 | 23,618 |
| Liabilities | | |
| Current | | |
| Bank indebtedness | 15 | 36 |
| Accounts payable and accrued liabilities | 1,977 | 2,126 |
| Income and other taxes payable | 403 | 357 |
| Current portion of long-term debt (note 8) | 363 | 10 |
| Future income taxes | 41 | 68 |
| Liabilities of discontinued operations (note 2) | 7 | 7 |
| | 2,806 | 2,604 |
| Deferred credits | 57 | 59 |
| Asset retirement obligations (note 6) | 2,004 | 2,116 |
| Other long-term obligations (note 7) | 144 | 168 |
| Long-term debt (note 8) | 3,291 | 3,770 |
| Future income taxes | 3,489 | 3,646 |
| Liabilities of discontinued operations (note 2) | 136 | 144 |
| | 9,121 | 9,903 |
| Contingencies and commitments (note 16) | | |
| Shareholders' equity | | |
| Common shares, no par value (note 9) | | |
| Authorized: unlimited | | |
| Issued and outstanding: | | |
| March 31, 2010 - 1,018,986,947 (December 31, 2009 - 1,014,876,564) | 2,443 | 2,374 |
| Contributed surplus | 95 | 153 |
| Retained earnings | 9,402 | 9,174 |
| Accumulated other comprehensive loss | (1,092) | (590) |
| | 10,848 | 11,111 |
| Total liabilities and shareholders' equity | 22,775 | 23,618 |

See accompanying notes.

Talisman Energy Inc.
Consolidated Statements of Income and Loss

| (millions of C\$) | Three months ended March 31 | |
|---|-----------------------------|--------------------------------|
| | 2010 | 2009 (restated - note 2) |
| Revenue | | |
| Gross sales | 2,085 | 1,728 |
| Less royalties | 301 | 276 |
| Net sales | 1,784 | 1,452 |
| Other | 29 | 34 |
| Total revenue | 1,813 | 1,486 |
| Expenses | | |
| Operating | 498 | 492 |
| Transportation | 61 | 56 |
| General and administrative | 82 | 81 |
| Depreciation, depletion and amortization | 582 | 668 |
| Dry hole | 6 | 216 |
| Exploration | 96 | 68 |
| Interest on long-term debt | 41 | 45 |
| Stock-based compensation (recovery) (note 10) | (72) | 33 |
| Gain on held-for-trading financial instruments (note 11) | (97) | (73) |
| Other, net (note 12) | 113 | 16 |
| Total expenses | 1,310 | 1,602 |
| Income (loss) from continuing operations before taxes | 503 | (116) |
| Taxes | | |
| Current income tax | 235 | 142 |
| Future income tax (recovery) | (7) | (205) |
| Petroleum revenue tax | 27 | 14 |
| | 255 | (49) |
| Income (loss) from continuing operations | 248 | (67) |
| Income (loss) from discontinued operations (note 2) | (20) | 522 |
| Net income | 228 | 455 |
| | | |
| Per common share (C\$) | | |
| Income (loss) from continuing operations | 0.24 | (0.07) |
| Diluted income (loss) from continuing operations | 0.24 | (0.07) |
| Income (loss) from discontinued operations | (0.02) | 0.52 |
| Diluted income (loss) from discontinued operations | (0.02) | 0.52 |
| Net income | 0.22 | 0.45 |
| Diluted net income | 0.22 | 0.45 |
| Weighted average number of common shares outstanding (millions) | | |
| Basic | 1,017 | 1,015 |
| Diluted | 1,035 | 1,015 |

See accompanying notes.

Talisman Energy Inc.
Consolidated Statements of Comprehensive Income (Loss)

| (millions of C\$) | Three months ended March 31 | |
|---|-----------------------------|------------|
| | 2010 | 2009 |
| Net income | 228 | 455 |
| Foreign currency - translation of self-sustaining foreign operations ¹ | (147) | (179) |
| Foreign currency - translation into reporting currency | (200) | 354 |
| Transfer of accumulated foreign currency to net income (note 2) | (157) | - |
| Gains and losses on derivatives designated as cash flow hedges | | |
| Gains (losses) arising during the period ² | 9 | (9) |
| (Gains) losses recognized in net income ³ | (7) | 7 |
| | <u>2</u> | <u>(2)</u> |
| Other comprehensive income (loss) | (502) | 173 |
| Comprehensive income (loss) | (274) | 628 |

1 Includes net investment hedging gain of \$23 million (2009 - \$20 million)

2 Net of tax of \$3 million (2009 - (\$3) million)

3 Net of tax of (\$2) million (2009 - \$3 million)

See accompanying notes.

Talisman Energy Inc.
Consolidated Statements of Changes in Shareholders' Equity

| (millions of C\$) | Three months ended March 31 | |
|--|-----------------------------|--------------|
| | 2010 | 2009 |
| Common shares (note 9) | | |
| Balance at beginning of period | 2,374 | 2,372 |
| Shares released from trust for 2008 PSU Plan (note 10) | 68 | - |
| Issued on exercise of stock options | 1 | 1 |
| Balance at end of period | <u>2,443</u> | <u>2,373</u> |
| Contributed surplus | | |
| Balance at beginning of period | 153 | 84 |
| Stock-based compensation (recovery) | (58) | 12 |
| Balance at end of period | <u>95</u> | <u>96</u> |
| Retained earnings | | |
| Balance at beginning of period | 9,174 | 8,966 |
| Net income | 228 | 455 |
| Balance at end of period | <u>9,402</u> | <u>9,421</u> |
| Accumulated other comprehensive loss | | |
| Balance at beginning of period | (590) | (272) |
| Other comprehensive income (loss) | (502) | 173 |
| Balance at end of period | <u>(1,092)</u> | <u>(99)</u> |

See accompanying notes.

Talisman Energy Inc.
Consolidated Statements of Cash Flows

| (millions of C\$) | Three months ended March 31 | |
|---|-----------------------------|----------------------------|
| | 2010 | 2009 |
| | | (restated - see note 2) |
| Operating activities | | |
| Income (loss) from continuing operations | 248 | (67) |
| Items not involving cash (note 15) | 422 | 1,219 |
| Exploration | 96 | 68 |
| | 766 | 1,220 |
| Changes in non-cash working capital | 292 | (223) |
| Cash provided by continuing operations | 1,058 | 997 |
| Cash provided by discontinued operations | 71 | 89 |
| Cash provided by operating activities | 1,129 | 1,086 |
| Investing activities | | |
| Capital expenditures | | |
| Exploration, development and other | (750) | (711) |
| Corporate acquisitions (note 3) | (189) | - |
| Property acquisitions | (25) | (28) |
| Proceeds of resource property dispositions | 107 | 33 |
| Changes in non-cash working capital | (56) | (254) |
| Discontinued operations, net of capital expenditures | 17 | 351 |
| Cash used in investing activities | (896) | (609) |
| Financing activities | | |
| Long-term debt repaid | - | (690) |
| Long-term debt issued | - | 370 |
| Common shares issued | 5 | 1 |
| Deferred credits and other | (7) | 4 |
| Changes in non-cash working capital | (2) | 1 |
| Cash used in financing activities | (4) | (314) |
| Effect of translation on foreign currency cash and cash equivalents | (38) | (16) |
| Net increase in cash and cash equivalents | 191 | 147 |
| Cash and cash equivalents net of bank indebtedness, beginning of period | 1,668 | 12 |
| Cash and cash equivalents net of bank indebtedness, end of period | 1,859 | 159 |
| Cash and cash equivalents (note 14) | 1,874 | 181 |
| Bank indebtedness | (15) | (22) |
| Cash and cash equivalents net of bank indebtedness, end of period | 1,859 | 159 |

See accompanying notes.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

The Interim Consolidated Financial Statements of Talisman Energy Inc. (“Talisman” or “the Company”) have been prepared by management in accordance with Canadian generally accepted accounting principles. Certain information and disclosures required to be included in notes to Annual Consolidated Financial Statements have been condensed or omitted. The Interim Consolidated Financial Statements should be read in conjunction with the audited Annual Consolidated Financial Statements and the notes thereto in Talisman’s Annual Report as at and for the year ended December 31, 2009.

Certain comparative information provided has been reclassified to conform to the presentation adopted in the current year.

1. Significant Accounting Policies

a) Changes in Accounting Policies

The Interim Consolidated Financial Statements have been prepared following the same accounting policies and methods of computation as the 2009 Annual Consolidated Financial Statements, except for the following:

Foreign Currency Translation

As a result of a reorganization of the Company’s operations and changes in the composition of revenue and costs, management has determined that the functional currency of both the Canadian and Norwegian self-sustaining operations is more closely linked to the US\$ than to the respective domestic currencies. Accordingly, effective January 1, 2010, these self-sustaining operations have been accounted for as US\$ functional currency entities. The impact of this change in functional currencies during the first quarter of 2010 was to increase foreign exchange losses included in income from continuing operations by \$62 million and decrease the loss from discontinued operations by \$21 million.

b) Accounting Pronouncements Adopted

Extractive Activities – Oil and Gas

In the fourth quarter of 2009, Talisman adopted prospectively the US standard *Extractive Activities – Oil and Gas* whereby yearly average commodity prices are used for purposes of calculating reserves. Previously, reserves had been calculated by reference to year-end commodity prices. Since 2009 yearly average commodity prices were higher than 2008 year-end prices, Talisman recorded an upward price revision of 77.1 million barrels of oil equivalent to its reserves in the fourth quarter of 2009 and revised its DD&A rates accordingly. Had year-end prices been used to calculate reserves, this would not have had a significant impact on the income from continuing operations in the first quarter of 2010.

c) Accounting Pronouncements Not Yet Adopted

Consolidated Financial Statements

In 2009, the CICA issued section 1601, *Consolidated Financial Statements*, which establishes standards for the preparation of consolidated financial statements that will be effective for Talisman’s 2011 reporting. The adoption of these recommendations is not expected to have a material impact on Talisman.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

Business Combinations

In 2009, the CICA issued section 1582, *Business Combinations*, which prospectively establishes principles and requirements of the acquisition method for business combinations and related disclosures that will be effective for Talisman’s 2011 reporting. The adoption of these recommendations is not expected to have a material impact on Talisman due to the adoption of IFRS discussed below.

International Financial Reporting Standards (IFRS)

In February 2008, the Accounting Standards Board confirmed that IFRS will be required for interim and annual reporting by publicly accountable enterprises effective for January 1, 2011, including 2010 comparative information. The Company has developed a changeover plan to complete the transition to IFRS by January 1, 2011 and has established a dedicated IFRS project team to address the conversion to IFRS. This team reports regularly to a steering committee, senior management and the Audit Committee. Based on work completed to date, management has determined that IFRS will have a significant impact on the Company’s accounting for PP&E and income taxes. Areas impacting accounting for PP&E include impairments, ARO, taxes and other minor adjustments. Other areas of impact include employee future benefits, share-based payments and discontinued operations.

The areas impacted by IFRS discussed above should not be regarded as a comprehensive list of changes that will result from the transition to IFRS. Talisman continues to monitor the development of standards, which are expected to change prior to 2011.

The impact of IFRS on the Consolidated Financial Statements is not quantifiable at this time.

2. Discontinued Operations

The assets and liabilities related to discontinued operations have been reclassified as assets or liabilities of discontinued operations on the Consolidated Balance Sheets. Operating results related to these assets and liabilities have been included in net income from discontinued operations on the Consolidated Statements of Income. Comparative period balances have been restated.

| | Three months ended March 31 | | | | | | | | | |
|---|-----------------------------|-------------|----------|------------|-------------|------------|------------|-----------|-------------|------------|
| | North America | | UK | | Scandinavia | | Other | | Total | |
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Revenue | | | | | | | | | | |
| Gross sales | 102 | 155 | - | - | - | - | 7 | 19 | 109 | 174 |
| Royalties | 12 | 28 | - | - | - | - | 1 | (2) | 13 | 26 |
| Revenue, net of royalties | 90 | 127 | - | - | - | - | 6 | 21 | 96 | 148 |
| Expenses | | | | | | | | | | |
| Operating, marketing and general | 21 | 40 | - | - | - | - | 4 | (1) | 25 | 39 |
| Dry hole | - | 29 | - | - | - | - | - | 2 | - | 31 |
| Depreciation, depletion and amortization | 42 | 74 | - | - | - | - | - | 4 | 42 | 78 |
| Income (loss) from discontinued operations before income taxes | 27 | (16) | - | - | - | - | 2 | 16 | 29 | - |
| Taxes | 7 | (4) | - | - | - | (1) | 3 | 2 | 10 | (3) |
| Gain (loss) on disposition, net of tax | (34) | 57 | - | 471 | - | (9) | (5) | - | (39) | 519 |
| Income (loss) from discontinued operations | (14) | 45 | - | 471 | - | (8) | (6) | 14 | (20) | 522 |

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

| | As at March 31, 2010 and December 31, 2009 | | | | | | | | | |
|------------------------------------|--|-------|------|------|-------------|------|-------|------|-------|-------|
| | North America | | UK | | Scandinavia | | Other | | Total | |
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Assets | | | | | | | | | | |
| Current assets | 34 | 28 | - | - | - | - | - | 18 | 34 | 46 |
| Property, plant and equipment, net | 1,431 | 1,777 | - | - | - | - | - | 19 | 1,431 | 1,796 |
| Goodwill | 43 | 44 | - | - | - | - | - | 3 | 43 | 47 |
| Total assets | 1,508 | 1,849 | | | | - | - | 40 | 1,508 | 1,889 |
| Liabilities | | | | | | | | | | |
| Current liabilities | 7 | 7 | - | - | - | - | - | - | 7 | 7 |
| Asset retirement obligations | 63 | 66 | - | - | - | - | - | 1 | 63 | 67 |
| Future income taxes | 73 | 72 | - | - | - | - | - | 5 | 73 | 77 |
| Total liabilities | 143 | 145 | - | - | - | - | - | 6 | 143 | 151 |

North America

Talisman has classified assets of \$1.5 billion from the 2010 North America disposition program as held for sale and has recorded an after tax loss of \$34 million in the first quarter of 2010. The net investment in the Company’s Canadian self-sustaining operations has been reduced as a result of these asset dispositions and, accordingly, \$157 million of exchange gains previously accumulated in other comprehensive income have been included in the carrying value of these assets. These transactions are expected to close by mid year.

In 2009, Talisman completed the sale of oil and gas producing assets in Western Canada for proceeds of \$90 million, comprising cash and non-cash consideration, resulting in a gain of \$57 million, net of tax of \$19 million.

UK

In 2009, Talisman completed the sale of its assets in the Netherlands for proceeds of \$596 million, resulting in a gain of \$471 million, net of tax of \$nil.

Scandinavia

In 2009, Talisman recorded an after tax writedown of \$9 million in respect of the sale of a 10% share in the Yme field offshore development and three exploration licences.

Other

In 2010, Talisman completed the sale of assets in Tunisia for proceeds of \$23 million, resulting in a loss of \$5 million, net of tax of \$nil.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

3. Acquisition

In January 2010, Talisman acquired 100% of the share capital of Hess (Indonesia-Jambi Merang) Limited, a company which owns a 25% interest in the Jambi Merang Petroleum Sharing Contract, for consideration of \$189 million in cash. This acquisition, which facilitates Talisman’s strategy to increase its presence in Indonesia, was accounted for using the purchase method and the preliminary allocation of the purchase price to the assets and liabilities acquired is as follows:

| Fair value of net assets acquired | Southeast Asia |
|--|-----------------------|
| Property, plant and equipment | 177 |
| Goodwill | 36 |
| Working capital | 12 |
| Future income tax | (36) |
| | 189 |

4. Goodwill

Changes in the carrying amount of the Company’s goodwill are as follows:

| | Three months ended March 31, 2010 | Year ended December 31, 2009 |
|------------------------------|--|---------------------------------|
| Opening balance | 1,194 | 1,206 |
| Acquired (note 3) | 36 | - |
| Foreign currency translation | (53) | (12) |
| Closing balance ¹ | 1,177 | 1,194 |

¹ At March 31, 2010 \$43 million (December 31, 2009 - \$47 million; January 1, 2009 - \$155 million) has been reclassified to assets of discontinued operations.

Goodwill has no tax basis.

5. Other Assets

| | March 31, 2010 | December 31, 2009 |
|--|-----------------------|-------------------|
| Accrued pension asset | 26 | 29 |
| Fair value of derivative contracts (note 11) | 78 | 42 |
| Investments | 34 | 36 |
| Future tax assets | 150 | 120 |
| Note receivable | 44 | 43 |
| Asset retirement sinking fund | 26 | 15 |
| Other | 6 | 5 |
| | 364 | 290 |

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

6. Asset Retirement Obligations (ARO)

Changes in carrying amounts of the Company’s ARO associated with its property, plant and equipment are as follows:

| | Three months ended March 31, 2010 | Year ended December 31, 2009 |
|--|--------------------------------------|---------------------------------|
| ARO liability, beginning of period | 2,146 | 1,907 |
| Liabilities incurred during period | - | 50 |
| Liabilities settled during period | - | (50) |
| Accretion expense | 33 | 117 |
| Revisions in estimated future cash flows | 2 | 218 |
| Foreign currency translation | (148) | (96) |
| ARO liability, end of period ^{1, 2} | 2,033 | 2,146 |

1 Included in March 31, 2010 and December 31, 2009 liabilities are \$29 million and \$30 million respectively of short-term reclamation costs recorded in accounts payable on the balance sheet for a net long-term ARO liability of \$2,004 million and \$2,116 million respectively.

2 At March 31, 2010, \$63 million (December 31, 2009 - \$67 million; January 1, 2009 - \$123 million) has been reclassified to liabilities of discontinued operations.

7. Other Long-Term Obligations

| | March 31, 2010 | December 31, 2009 |
|---|----------------|-------------------|
| Accrued pension and other post-employment benefits liability | 29 | 28 |
| Fair value of derivative contracts (note 11) | - | 7 |
| Discounted obligations on capital leases ¹ | 86 | 94 |
| Long-term portion of stock-based compensation liability (note 10) | 14 | 27 |
| Other | 15 | 12 |
| | 144 | 168 |

1 Of the total discounted liability of \$104 million (December 31, 2009 - \$113 million), \$18 million (December 31, 2009 - \$19 million) is included in accounts payable and accrued liabilities.

8. Long-Term Debt

| | March 31, 2010 | December 31, 2009 |
|--|----------------|-------------------|
| Tanggung project financing | 102 | 106 |
| Debentures and notes (unsecured): | | |
| US\$ denominated (US\$2,810 million, 2009 - US\$2,810 million) | 2,854 | 2,941 |
| C\$ denominated | 350 | 350 |
| UK£ denominated (UK£250 million) | 386 | 423 |
| Gross debt | 3,692 | 3,820 |
| Prepaid financing costs | (38) | (40) |
| | 3,654 | 3,780 |
| Less: current portion | (363) | (10) |
| | 3,291 | 3,770 |

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

9. Share Capital

Talisman’s authorized share capital consists of an unlimited number of common shares without nominal or par value and first and second preferred shares. No preferred shares have been issued.

| Continuity of common shares | Three months ended March 31, 2010 | | Year ended December 31, 2009 | |
|---|--------------------------------------|--------|---------------------------------|--------|
| | Shares | Amount | Shares | Amount |
| Balance, beginning of period | 1,014,876,564 | 2,374 | 1,014,708,249 | 2,372 |
| Issued on exercise of options | 48,383 | 1 | 168,315 | 2 |
| Shares released from trust for 2008 PSU Plan (note 10) | 4,062,000 | 68 | - | - |
| Balance, end of period | 1,018,986,947 | 2,443 | 1,014,876,564 | 2,374 |

Following the vesting of the 2008 Performance Share Units (PSUs) on January 31, 2010, the 4,062,000 shares held in trust were used to settle the majority of the Company’s obligation and, accordingly, were added back to the total issued and outstanding common shares.

Subsequent to March 31, 2010, 46,875 stock options were exercised for shares.

In November 2009, the Company renewed its normal course issuer bid (NCIB) with the Toronto Stock Exchange (TSX). Pursuant to the NCIB, the Company may repurchase up to 50,945,743 of its common shares (representing 5% of the common shares outstanding at November 18, 2009) during the 12 month period commencing December 2, 2009 and ending December 1, 2010.

10. Stock-Based Compensation

Stock Option Plans

Talisman has stock option plans in place that allow for the granting of options to employees and directors. All options issued by the Company permit the holder to purchase one common share of the Company at the stated exercise price or to receive a cash payment equal to the appreciated value of the stock option.

| Continuity of stock options | Three months ended March 31, 2010 | | Year ended December 31, 2009 | |
|----------------------------------|--------------------------------------|---|---------------------------------|---|
| | Number of Options | Weighted-average exercise price (\$) | Number of Options | Weighted-average exercise price (\$) |
| Outstanding, beginning of period | 69,489,526 | 15.22 | 64,877,521 | 15.14 |
| Granted | 171,985 | 18.22 | 12,023,390 | 13.37 |
| Exercised for common shares | (48,383) | 6.85 | (168,315) | 5.87 |
| Exercised for cash payment | (1,692,312) | 10.14 | (4,887,191) | 9.00 |
| Cancelled/forfeited | (261,815) | 16.99 | (2,355,879) | 17.03 |
| Outstanding, end of period | 67,659,001 | 15.36 | 69,489,526 | 15.22 |
| Exercisable, end of period | 36,131,052 | 13.52 | 33,825,777 | 13.28 |

The mark-to-market liability for the stock option plans at March 31, 2010 was \$176 million (December 31, 2009 - \$268 million).

Subsequent to March 31, 2010, 18,900 stock options were exercised for cash, 46,875 were exercised for shares, 7,073,210 were granted and 185,346 were cancelled, with 74,481,090 outstanding at April 30, 2010.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

Cash Unit Plans

In addition to the Company’s stock option plans, various subsidiaries of the Company issue stock appreciation rights under the cash unit plans. Cash units are similar to stock options except that the holder does not have a right to purchase the underlying share of the Company.

| Continuity of cash units | Three months ended March 31, 2010 | | Year ended December 31, 2009 | |
|----------------------------------|--------------------------------------|---|---------------------------------|---|
| | Number of units | Weighted-average exercise price (\$) | Number of units | Weighted-average exercise price (\$) |
| Outstanding, beginning of period | 10,078,102 | 16.42 | 9,723,082 | 16.52 |
| Granted | 6,470 | 18.09 | 1,403,650 | 13.23 |
| Exercised | (149,432) | 10.97 | (732,565) | 9.72 |
| Cancelled/forfeited | (21,610) | 15.56 | (316,065) | 18.94 |
| Outstanding, end of period | 9,913,530 | 16.49 | 10,078,102 | 16.42 |
| Exercisable, end of period | 4,789,810 | 15.29 | 4,806,867 | 15.09 |

The mark-to-market liability for the cash unit plan at March 31, 2010 was \$17 million (December 31, 2009 - \$28 million).

Subsequent to March 31, 2010, 16,880 cash units were exercised, 931,210 were granted and 560 were cancelled, with 10,827,300 outstanding at April 30, 2010.

Long-Term PSU Plan

In 2009, the Company implemented a long-term PSU plan that allows for the granting of PSUs to employees and vesting to varying degrees (0–150%) subject to predetermined performance measures being achieved. Each PSU represents the right, subject to performance, to receive one common share of the Company.

| Continuity of long-term PSU plan | Three months ended March 31, 2010 | Year ended December 31, 2009 |
|----------------------------------|--------------------------------------|---------------------------------|
| | Number of units | Number of units |
| Outstanding, beginning of period | 5,520,158 | - |
| Granted | 77,039 | 5,791,165 |
| Cancelled/forfeited | (515,070) | (271,007) |
| Outstanding, end of period | 5,082,127 | 5,520,158 |

During the three months ended March 31, 2010, the Company recorded stock-based compensation of \$5 million (2009 - \$nil) relating to its long-term PSU plan, with a corresponding increase in contributed surplus.

The Company may purchase shares on the open market to satisfy its obligation to deliver common shares to settle long-term PSUs. 480,000 shares were purchased in April 2010 for \$8 million.

Subsequent to March 31, 2010, 3,241,777 long-term PSUs were granted and 88,501 were cancelled, with 8,235,403 outstanding at April 30, 2010.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

2008 PSU Plan

In 2008, Talisman implemented a PSU plan pursuant to which 4,158,860 PSUs were granted. These PSUs vested on January 31, 2010 subject to predetermined performance measures being achieved. Based on the Company’s performance relative to these predetermined performance measures, the Board of Directors approved the vesting of 90% of the PSUs granted.

To satisfy the Company’s obligation to deliver common shares to settle the PSUs, the Company established a trust that purchased 4,062,000 common shares on the open market for \$68 million. For accounting purposes, the cost of the purchase of the common shares held in trust was accounted for as a reduction in outstanding common shares and the trust was consolidated in accordance with Accounting Guideline 15 since it met the definition of a variable interest entity and the Company was the primary beneficiary of the trust. These shares were held in trust until the PSUs vested. The Company was not exposed to fluctuations in the stock price in respect of the shares held in trust.

During the three months ended March 31, 2010, the Company recorded stock-based compensation recovery of \$1 million (2009 – \$12 million expense) relating to its 2008 PSU plan, with a corresponding change in contributed surplus.

Deferred Share Unit (DSU) Plan

Talisman issues DSUs to directors in lieu of cash compensation. Each DSU represents the right to receive a cash payment on retirement equal to the market value of the Company’s shares at the time of surrender. Dividends are credited as additional DSUs when paid. At March 31, 2010, there were 418,795 DSUs outstanding (December 31, 2009 – 396,550) and the mark-to-market liability was \$7 million (December 31, 2009 – \$8 million). Expense related to the DSUs is recognized in general and administrative expense on the Consolidated Statements of Income.

Restricted Share Unit (RSU) Plan

Talisman has a RSU plan that grants RSUs to eligible employees. All RSUs issued by the Company permit the holder to receive a cash payment equal to the market value of the stock. Typically, RSUs granted under the plan are paid three years after the grant date. At March 31, 2010, there were 344,688 RSUs outstanding, including dividend equivalent RSUs (December 31, 2009 – 342,730) and the mark-to-market liability was \$3 million (December 31, 2009 – \$3 million).

Stock-Based Compensation (Recovery)

For the three months ended March 31, 2010, the Company recorded a stock-based compensation recovery of \$72 million (2009 – \$33 million expense) in respect of the plans described above as follows: stock options - \$68 million recovery, cash units - \$8 million recovery, 2008 PSUs - \$1 million recovery, long-term PSUs - \$5 million expense and RSUs - \$nil. The stock-based compensation recovery includes a cash payment of \$19 million (2009 - \$5 million) to employees in settlement of fully accrued stock-based compensation liabilities for options and cash units exercised in the period.

Of the combined mark-to-market liability for the stock option, cash unit, DSU and RSU plans of \$204 million (December 31, 2009 - \$307 million), \$190 million (December 31, 2009 - \$280 million) is included in accounts payable and accrued liabilities and \$14 million (December 31, 2009 - \$27 million) is included in other long-term obligations.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

11. Financial Instruments and Risk Management

Talisman’s financial assets and liabilities at March 31, 2010 comprised cash and cash equivalents, accounts receivable, note receivable, investments, bank indebtedness, accounts payable and accrued liabilities, long-term debt, discounted obligations under capital leases and risk management assets and liabilities arising from the use of derivative financial instruments.

Fair value of Financial Assets and Liabilities

The fair value of debentures and notes is based on market quotations, which reflect the discounted present value of the principal and interest payments using the effective yield for instruments having the same term and risk characteristics. The fair value of Talisman’s long-term debt at March 31, 2010 was \$4 billion, while the carrying value was \$3.7 billion. The fair values of all other financial assets and liabilities approximate their carrying values.

Talisman’s processes for estimating and classifying the fair value of financial instruments are consistent with those in place at December 31, 2009. The following table presents the Company’s material assets and liabilities measured at fair value for each hierarchy level as at March 31, 2010:

| | Fair value measurements using | | | Total fair value |
|----------------------|-------------------------------|----------------|----------------|------------------|
| | Level 1 inputs | Level 2 inputs | Level 3 inputs | |
| Assets | | | | |
| Interest rate swaps | - | 33 | - | 33 |
| Cross currency swaps | - | 39 | - | 39 |
| Commodity swaps | - | 7 | - | 7 |
| Commodity collars | - | 83 | - | 83 |
| Note receivable | - | - | 44 | 44 |
| | - | 162 | 44 | 206 |
| Liabilities | | | | |
| Commodity swaps | - | 1 | - | 1 |
| Commodity collars | - | 222 | - | 222 |
| | - | 223 | - | 223 |

The following table sets forth a reconciliation of changes in the fair value of the assets classified as Level 3 in the fair value hierarchy:

| | Three months ended March 31, 2010 | Three months ended March 31, 2009 |
|--------------------------------|--------------------------------------|--------------------------------------|
| Balance at beginning of period | 43 | 31 |
| Realized and unrealized gains | 1 | 2 |
| Balance at end of period | 44 | 33 |

Unobservable inputs utilized to determine the fair value of the note receivable include the volatility of the counterparty’s common shares.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

Risk Management Assets and Liabilities

| Derivative instrument | Balance sheet caption | March 31, 2010 | December 31, 2009 |
|-----------------------------|--|----------------|-------------------|
| Assets | | | |
| Interest rate swaps | Accounts receivable | 13 | 13 |
| Interest rate swaps | Other assets | 20 | 14 |
| Cross currency swaps | Other assets | 39 | 28 |
| Commodity contracts | Accounts receivable | 71 | 17 |
| Commodity contracts | Other assets | 19 | - |
| Risk management assets | | 162 | 72 |
| Liabilities | | | |
| Cross currency swaps | Accounts payable and accrued liabilities | - | 1 |
| Commodity contracts | Accounts payable and accrued liabilities | 223 | 275 |
| Commodity contracts | Other long-term obligations | - | 7 |
| Risk management liabilities | | 223 | 283 |

For the three months ended March 31, 2010, the Company recorded a gain on held-for-trading financial instruments of \$97 million (2008 – \$73 million).

Currency Risk

In respect of financial instruments existing at March 31, 2010, a 1% strengthening of the US\$ against the other currencies to which the Company is exposed (Canadian dollar, British pound and Norwegian kroner), with all other variables assumed constant, would have resulted in an increase of \$4 million in net income and a decrease of \$9 million in other comprehensive income for the three month period ended March 31, 2010. A similar weakening of the US\$ would have had the opposite effect.

Interest Rate Risk

In respect of financial instruments existing at March 31, 2010, a 1% increase in interest rates would have resulted in a \$8 million decrease in net income, principally related to the fair value of the interest rate swap, for the three month period ended March 31, 2010. A similar decrease in interest rates would have had the opposite effect.

Credit Risk

A significant proportion of Talisman’s accounts receivable balance is with customers in the oil and gas industry and is subject to normal industry credit risks. At March 31, 2010, approximately 89% of the Company’s trade accounts receivable were current. Talisman had no customers with individually significant outstanding balances at March 31, 2010. Concentration of credit risk is mitigated by having a broad domestic and international customer base. The maximum credit exposure associated with accounts receivable is the carrying value.

Liquidity Risk

The majority of the Company’s debt matures subsequent to 2011, with \$13 million maturing in 2010 and \$350 million in 2011.

At March 31, 2010, the Company had not drawn against its available \$2.8 billion of bank lines of credit, which are all fully committed through 2012. These maturity dates may be extended from time to time by agreement between the Company and the respective lenders.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

The Company may hedge a portion of its future production to protect cash flows to allow it to meet its strategic objectives.

Commodity Price Risk

The Company had the following commodity price derivative contracts outstanding at March 31, 2010:

| Fixed price swaps | Term | mcf/d | C\$/mcf | Fair value |
|-------------------|--------------|--------|---------|------------|
| ICE index | Apr-Sep 2010 | 20,638 | 5.45 | 2 |
| ICE index | Oct-Dec 2010 | 17,824 | 6.41 | 1 |
| ICE index | Jan-Mar 2011 | 17,824 | 6.41 | (1) |
| ICE index | Apr-Jun 2011 | 16,886 | 5.84 | - |
| | | | | <u>2</u> |

| Fixed price swaps | Term | mcf/d | US\$/mcf | Fair value |
|-------------------|--------------|--------|----------|------------|
| NYMEX index | Jan-Dec 2011 | 23,734 | 6.12 | <u>4</u> |

| Two-way collars | Term | bbls/d | Floor/ceiling US\$/bbl | Fair value |
|-----------------------|--------------|--------|---------------------------|--------------|
| Dated Brent oil index | Apr-Dec 2010 | 28,000 | 52.57/80.14 | (65) |
| Dated Brent oil index | Apr-Dec 2010 | 25,000 | 71.72/90.00 | (9) |
| WTI | Apr-Dec 2010 | 22,000 | 50.20/60.87 | (148) |
| | | | | <u>(222)</u> |

| Two-way collars | Term | mcf/d | Floor/ceiling C\$/mcf | Fair value |
|-----------------|--------------|--------|--------------------------|------------|
| AECO index | Apr-Jun 2010 | 94,820 | 5.82/7.17 | 16 |
| AECO index | Apr-Dec 2010 | 47,410 | 5.78/7.39 | 23 |
| | | | | <u>39</u> |

| Two-way collars | Term | mcf/d | Floor/ceiling US\$/mcf | Fair value |
|-----------------|--------------|--------|---------------------------|------------|
| NYMEX index | Jul-Dec 2010 | 95,000 | 5.90/7.03 | 23 |
| NYMEX index | Jan-Jun 2011 | 95,000 | 5.27/6.66 | 4 |
| NYMEX index | Jan-Dec 2011 | 71,200 | 6.14/6.59 | 17 |
| | | | | <u>44</u> |

In respect of outstanding financial instruments and assuming forward commodity prices in existence at March 31, 2010, an increase of US\$1/bbl in the price of oil and \$0.10/mcf in the price of natural gas would have reduced the net fair value of commodity derivatives thereby resulting in a decrease in net income of approximately \$15 million for the three month period ended March 31, 2010. A similar decrease in commodity prices would result in an increase in net income of approximately \$17 million for the three month period ended March 31, 2010.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

Physical Commodity Contracts

The Company enters into fixed price sales contracts for the physical delivery of commodities. These contracts are in the regular course of business and are intended to be settled by delivering the product. As such, the fair value of these contracts is not recognized in the Consolidated Financial Statements and future revenues are recognized in net income as earned over the term of the contract. The Company anticipates having sufficient future production to meet these fixed price sales contract commitments. The Company had the following physical commodity contracts outstanding at March 31, 2010:

| Contract | Term | Average volume | Average price or floor/ceiling |
|--------------------------|-------------------|-----------------------|---------------------------------------|
| AECO natural gas swaps | Apr-Dec 2010 | 14,223 mcf/d | C\$6.33/mcf |
| AECO natural gas collars | Apr-Dec 2010 | 175,417 mcf/d | C\$6.33/7.55/mcf |
| AECO natural gas swaps | Apr 2010-Dec 2011 | 3,671 mcf/d | C\$3.02/mcf |

12. Other Expenses, Net

| | Three months ended March 31, 2010 | Three months ended March 31, 2009 |
|------------------------------------|--|--------------------------------------|
| Foreign exchange (gains) losses | 51 | (3) |
| Net (gain) loss on asset disposals | (51) | 8 |
| Property impairments | 91 | - |
| Other | 22 | 11 |
| | 113 | 16 |

During the quarter, the Company wrote-off exploration acquisition costs in Scandinavia and Rest of the World of \$66 million and \$25 million respectively.

13. Employee Benefits

The Company’s net pension benefit plan expense is as follows:

| | Three months ended March 31, 2010 | Three months ended March 31, 2009 |
|---|--|--------------------------------------|
| Current service cost - defined benefit | 6 | 4 |
| Current service cost - defined contribution | 3 | 3 |
| Interest cost | 5 | 5 |
| Expected return on plan assets | (3) | (2) |
| | 11 | 10 |

14. Cash and Cash Equivalents

Of the cash and cash equivalents balance of \$1.9 billion, arising largely from the disposition of assets during 2009, \$149 million has been invested in bank deposits and the remainder in highly rated marketable securities with maturities of less than three months.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(tabular amounts in millions of Canadian dollars (“\$”) except as noted)

15. Selected Cash Flow Information

| | Three months ended March 31, 2010 | Three months ended March 31, 2009 |
|---|--------------------------------------|--------------------------------------|
| Items not involving cash: | | |
| Depreciation, depletion and amortization | 582 | 668 |
| Dry hole | 6 | 216 |
| Net (gain) loss on asset disposals | (51) | 8 |
| Property impairments | 91 | - |
| Stock-based compensation expense (recovery) | (88) | 28 |
| Future taxes and deferred petroleum revenue tax (recovery) | (17) | (205) |
| Mark-to-market change of held-for-trading financial instruments | (151) | 507 |
| Other | 50 | (3) |
| | 422 | 1,219 |
| Interest paid | 37 | 51 |
| Income taxes paid | 176 | 370 |

16. Contingencies and Commitments

Contingencies

From time to time, Talisman is the subject of litigation arising out of the Company’s operations. Damages claimed under such litigation, including the litigation discussed below may be material or may be indeterminate and the outcome of such litigation may materially impact the Company’s financial condition or results of operations. While Talisman assesses the merits of each lawsuit and defends itself accordingly, the Company may be required to incur significant expenses or devote significant resources to defending itself against such litigation. These claims are not currently expected to have a material impact on the Company’s financial position.

In September 2006, the United States District Court for the Southern District of New York (the “Court”) granted Talisman’s Motion for Summary Judgment, dismissing the lawsuit brought against Talisman by the Presbyterian Church of Sudan and others under the Alien Tort Claims Act. The lawsuit alleged that the Company conspired with, or aided and abetted, the Government of Sudan to commit violations of international law in connection with the Company’s now disposed of interest in oil operations in Sudan. The plaintiffs have twice attempted to certify the lawsuit as a class action. In March 2005 and in September 2005, the Court rejected the plaintiffs’ effort to certify two different classes (or groups) of plaintiffs. In October 2009, the Second Circuit Court of Appeals dismissed the plaintiff’s appeal of the Court’s decision granting Talisman’s Motion for Summary Judgment, denying class certification and refusing to consider the plaintiff’s proposed third amended complaint. On April 15, 2010, the plaintiffs filed a Petition for Writ of Certiorari seeking review by the United States Supreme Court of the Second Circuit Court of Appeals’ decision dismissing the plaintiffs’ appeal. Talisman believes the lawsuit is entirely without merit.

Commitments

There were no material changes in the Company’s commitments between January 1 and March 31, 2010.

17. Subsequent Event

In April 2010, Talisman entered into an agreement to acquire 37,000 net acres of land in the Eagle Ford shale play in Texas for approximately US\$360 million.

18. Segmented Information

| (millions of CS) | North America ¹ | | UK | | Scandinavia | | Southeast Asia ² | | Other ³ | | Total | |
|--|----------------------------|--------|-------|-------|-------------|-------|-----------------------------|-------|--------------------|-------|--------|--------|
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Revenue | | | | | | | | | | | | |
| Gross sales | 474 | 429 | 606 | 529 | 372 | 242 | 568 | 390 | 65 | 138 | 2,085 | 1,728 |
| Royalties | 67 | 61 | 2 | 1 | - | - | 194 | 145 | 38 | 69 | 301 | 276 |
| Net sales | 407 | 368 | 604 | 528 | 372 | 242 | 374 | 245 | 27 | 69 | 1,784 | 1,452 |
| Other | 23 | 26 | 5 | 7 | 1 | 1 | - | - | - | - | 29 | 34 |
| Total revenue | 430 | 394 | 609 | 535 | 373 | 243 | 374 | 245 | 27 | 69 | 1,813 | 1,486 |
| Segmented expenses | | | | | | | | | | | | |
| Operating | 111 | 121 | 233 | 211 | 86 | 74 | 63 | 68 | 5 | 18 | 498 | 492 |
| Transportation | 19 | 12 | 10 | 13 | 16 | 12 | 14 | 17 | 2 | 2 | 61 | 56 |
| DD&A | 195 | 206 | 161 | 236 | 145 | 103 | 76 | 109 | 5 | 14 | 582 | 668 |
| Dry hole | 1 | 100 | - | 31 | (1) | 28 | (8) | 51 | 14 | 6 | 6 | 216 |
| Exploration | 32 | 22 | 5 | 2 | 11 | 6 | 24 | 15 | 24 | 23 | 96 | 68 |
| Other | (19) | 4 | (2) | 4 | 66 | 1 | 10 | (2) | 7 | 12 | 62 | 19 |
| Total segmented expenses | 339 | 465 | 407 | 497 | 323 | 224 | 179 | 258 | 57 | 75 | 1,305 | 1,519 |
| Segmented income (loss) before taxes | 91 | (71) | 202 | 38 | 50 | 19 | 195 | (13) | (30) | (6) | 508 | (33) |
| Non-segmented expenses | | | | | | | | | | | | |
| General and administrative | | | | | | | | | | | 82 | 81 |
| Interest on long-term debt | | | | | | | | | | | 41 | 45 |
| Stock-based compensation (recovery) | | | | | | | | | | | (72) | 33 |
| Currency translation | | | | | | | | | | | 51 | (3) |
| Gain on held-for-trading financial instruments | | | | | | | | | | | (97) | (73) |
| Total non-segmented expenses | | | | | | | | | | | 5 | 83 |
| Income (loss) from continuing operations before taxes | | | | | | | | | | | 503 | (116) |
| Capital expenditure | | | | | | | | | | | | |
| Exploration | 122 | 81 | 6 | 46 | 13 | 59 | 45 | 81 | 59 | 63 | 245 | 330 |
| Development | 156 | (4) | 110 | 131 | 163 | 115 | 42 | 196 | 20 | 1 | 491 | 439 |
| Midstream | (1) | 35 | - | - | - | - | - | - | - | - | (1) | 35 |
| Exploration and development | 277 | 112 | 116 | 177 | 176 | 174 | 87 | 277 | 79 | 64 | 735 | 804 |
| Property acquisitions | | | | | | | | | | | 222 | 66 |
| Proceeds on dispositions | | | | | | | | | | | (143) | (71) |
| Other non-segmented | | | | | | | | | | | 10 | 10 |
| Net capital expenditures⁴ | | | | | | | | | | | 824 | 809 |
| Property, plant and equipment | 6,665 | 6,861 | 4,120 | 4,549 | 1,951 | 2,040 | 2,960 | 2,864 | 842 | 823 | 16,538 | 17,137 |
| Goodwill | 164 | 167 | 263 | 289 | 608 | 628 | 142 | 110 | - | - | 1,177 | 1,194 |
| Other | 2,242 | 1,252 | 307 | 386 | 207 | 226 | 501 | 427 | 106 | 156 | 3,363 | 2,447 |
| Discontinued operations | 1,508 | 1,850 | - | - | - | - | - | - | - | 39 | 1,508 | 1,889 |
| Segmented assets | 10,579 | 10,130 | 4,690 | 5,224 | 2,766 | 2,894 | 3,603 | 3,401 | 948 | 1,018 | 22,586 | 22,667 |
| Non-segmented assets | | | | | | | | | | | 189 | 951 |
| Total assets | | | | | | | | | | | 22,775 | 23,618 |

| 1. North America | | 2010 | 2009 | 2. Southeast Asia | | 2010 | 2009 |
|--------------------------------------|--|-------|-------|--------------------------------------|--|-------|-------|
| Canada | | 374 | 359 | Indonesia | | 215 | 138 |
| US | | 56 | 35 | Malaysia | | 119 | 67 |
| Total revenue | | 430 | 394 | Vietnam | | 16 | 29 |
| Canada | | 5,465 | 5,699 | Australia | | 24 | 11 |
| US | | 1,200 | 1,162 | Total revenue | | 374 | 245 |
| Property, plant and equipment | | 6,665 | 6,861 | Indonesia | | 1,052 | 1,243 |
| | | | | Malaysia | | 1,122 | 1,171 |
| | | | | Vietnam | | 263 | 241 |
| | | | | Papua New Guinea | | 328 | - |
| | | | | Australia | | 195 | 209 |
| | | | | Property, plant and equipment | | 2,960 | 2,864 |
| | | | | 3. Other | | | |
| | | | | Algeria | | 27 | 69 |
| | | | | Total revenue | | 27 | 69 |
| | | | | Algeria | | 201 | 193 |
| | | | | Other | | 641 | 630 |
| | | | | Property, plant and equipment | | 842 | 823 |

4 Excluding corporate acquisitions