



MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of FX Energy, Inc., together with its consolidated subsidiaries (the Company), is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed by the Company's principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

As of the end of the Company's 2008 fiscal year, management conducted an assessment of the effectiveness of the Company's internal control over financial reporting based on the framework established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2008, was effective.

The Company's internal control over financial reporting includes policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the Company's consolidated financial statements.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2008, has been audited by PricewaterhouseCoopers LLP, independent registered public accounting firm, as stated in its report appearing on pages F-2 and F-3.



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors
of FX Energy, Inc. and its subsidiaries

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of comprehensive loss, of cash flows and of stockholders' equity (deficit) present fairly, in all material respects, the financial position of FX Energy, Inc. and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Salt Lake City, Utah
March 13, 2009

FX ENERGY, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
As of December 31, 2008 and 2007
(in thousands)

	2008	2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 16,588	\$ 4,262
Marketable securities	4,105	15,202
Receivables:		
Accrued oil and gas sales	1,093	1,906
Other receivables	1,720	805
Input VAT receivable	2,514	446
Inventory	211	178
Other current assets	450	365
Total current assets	26,681	23,164
Property and equipment, at cost:		
Oil and gas properties (successful efforts method):		
Proved	28,600	23,491
Unproved	2,770	2,001
Other property and equipment	6,667	5,590
Gross property and equipment	38,037	31,082
Less accumulated depreciation, depletion and amortization	(11,164)	(9,197)
Net property and equipment	26,873	21,885
Other assets:		
Certificates of deposit	406	406
Loan fees	842	914
Total other assets	1,248	1,320
Total assets	\$ 54,802	\$ 46,369

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

FX ENERGY, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
As of December 31, 2008 and 2007
(in thousands, except share data)
-Continued-

	2008	2007
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable.....	\$ 7,779	\$ 4,432
Accrued liabilities.....	4,937	3,358
Total current liabilities.....	12,716	7,790
Long-term liabilities:		
Notes payable	25,000	--
Asset retirement obligation.....	1,932	1,037
Total long-term liabilities	26,932	1,037
Total liabilities	39,648	8,827
Commitments and Contingencies (Note 6)		
Stockholders' equity:		
Preferred stock, \$0.001 par value, 5,000,000 shares authorized as of December 31, 2008 and 2007; no shares outstanding.....	--	--
Common stock, \$0.001 par value, 100,000,000 shares authorized as of December 31, 2008 and 2007; 42,202,878 and 38,196,357 shares issued and outstanding as of December 31, 2008 and 2007, respectively.....	42	38
Additional paid in capital.....	158,075	142,901
Cumulative translation adjustment	17,137	--
Accumulated other comprehensive loss.....	--	(1)
Accumulated deficit.....	(160,100)	(105,396)
Total stockholders' equity	15,154	37,542
Total liabilities and stockholders' equity	\$ 54,802	\$ 46,369

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

FX ENERGY, INC. AND SUBSIDIARIES
Consolidated Statements of Operations
For the years ended December 31, 2008, 2007 and 2006
(in thousands, except per share amounts)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Revenues:			
Oil and gas sales.....	\$ 13,494	\$ 14,903	\$ 6,533
Oilfield services	4,347	3,093	1,696
Total revenues	<u>17,841</u>	<u>17,996</u>	<u>8,229</u>
Operating costs and expenses:			
Lease operating expenses	3,441	3,538	2,647
Exploration costs	15,389	10,624	5,608
Impairment of oil and gas properties.....	14,746	2,299	3,583
Oilfield services costs	2,751	1,998	1,245
Depreciation, depletion and amortization (DD&A)	1,720	2,064	1,290
Accretion expense	84	78	53
Stock compensation	2,367	2,604	2,759
Bad debt expense	460	--	--
General and administrative costs (G&A)	7,030	7,061	5,728
Total operating costs and expenses	<u>47,988</u>	<u>30,266</u>	<u>22,913</u>
Operating loss	<u>(30,147)</u>	<u>(12,270)</u>	<u>(14,684)</u>
Other income (loss):			
Interest income (net of interest expense) and other income (expense)	(278)	433	795
Foreign exchange gain (loss).....	(24,279)	146	122
Total other income (expense).....	<u>(24,557)</u>	<u>579</u>	<u>917</u>
Net loss	<u>\$ (54,704)</u>	<u>\$ (11,691)</u>	<u>\$ (13,767)</u>
Basic and diluted net loss per common share	<u>\$ (1.35)</u>	<u>\$ (0.32)</u>	<u>\$ (0.39)</u>
Basic and diluted weighted average number of shares outstanding	<u>40,420</u>	<u>36,694</u>	<u>35,163</u>

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

FX ENERGY, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Loss
For the years ended December 31, 2008, 2007 and 2006
(in thousands)

	2008	2007	2006
Net loss	\$ (54,704)	\$ (11,691)	\$ (13,767)
Other comprehensive income (loss)			
Foreign currency translation adjustment	13,584	--	--
Increase (decrease) in market value of marketable securities	1	71	(14)
Comprehensive loss	\$ (41,119)	\$ (11,620)	\$ (13,781)

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

FX ENERGY, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the years ended December 31, 2008, 2007 and 2006
(in thousands)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Cash flows from operating activities:			
Net loss	\$ (54,704)	\$ (11,691)	\$ (13,767)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation, depletion and amortization	1,720	2,064	1,290
Impairment of oil and gas properties	14,746	2,299	3,583
Accretion expense	84	78	53
(Gain) loss on property dispositions	(5)	--	--
Stock compensation (G&A)	2,367	2,604	2,759
Foreign exchange losses	22,306	--	--
Common stock issued for services (G&A)	498	242	517
Increase (decrease) from changes in working capital items:			
Receivables	(3,056)	(583)	1,451
Inventory	(33)	28	(110)
Other current assets	(85)	(43)	(52)
Other assets	74	(56)	(25)
Accounts payable and accrued liabilities	1,840	3,479	(995)
Asset retirement obligation	--	(2)	(7)
Net cash used in operating activities	<u>(14,248)</u>	<u>(1,581)</u>	<u>(5,303)</u>
Cash flows from investing activities:			
Additions to oil and gas properties	(21,808)	(7,517)	(7,521)
Additions to other property and equipment	(1,077)	(966)	(362)
Additions to marketable securities	(186)	(9,610)	(782)
Proceeds from maturities of marketable securities	11,284	4,941	16,800
Proceeds from sale of assets	15	--	--
Net cash provided by (used in) investing activities	<u>(11,772)</u>	<u>(13,152)</u>	<u>8,135</u>
Cash flows from financing activities:			
Payment of loan fees	--	--	(578)
Proceeds from issuance of common stock, net of offering costs	--	12,436	--
Proceeds from loan related to auction rate securities	3,354	--	--
Payments on loan related to auction rate securities	(546)	--	--
Proceeds from notes payable	25,000	--	--
Proceeds from exercise of stock options and warrants	12,313	1,915	--
Net cash provided by (used in) financing activities	<u>40,121</u>	<u>14,351</u>	<u>(578)</u>
Effect of exchange rate changes on cash	<u>(1,775)</u>	<u>--</u>	<u>--</u>
Net increase (decrease) in cash	12,326	(382)	2,254
Cash and cash equivalents at beginning of year	<u>4,262</u>	<u>4,644</u>	<u>2,390</u>
Cash and cash equivalents at end of year	<u>\$ 16,588</u>	<u>\$ 4,262</u>	<u>\$ 4,644</u>

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

FX ENERGY, INC. AND SUBSIDIARIES
Consolidated Statement of Stockholders' Equity (Deficit)
For the years ended December 31, 2008, 2007 and 2006
(in thousands)

	Preferred Stock	Common Stock		Deferred Compensation	Additional Paid in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity (Deficit)
		Shares Issued	Par Value \$0.001 Per Share					
Balance as of December 31, 2005	--	35,097	\$ 35	\$ (2,975)	\$ 125,216	\$ (58)	\$ (79,938)	\$ 42,280
Common stock issued for services and other	--	464	1	--	706	--	--	707
Elimination of deferred compensation upon adoption of SFAS No. 123R	--	--	--	2,975	(2,975)	--	--	--
Stock compensation	--	--	--	--	2,759	--	--	2,759
Other comprehensive loss	--	--	--	--	--	(14)	--	(14)
Net loss for year	--	--	--	--	--	--	(13,767)	(13,767)
Balance as of December 31, 2006	--	35,561	\$ 36	\$ --	\$ 125,706	\$ (72)	\$ (93,705)	\$ 31,965
Common stock issued for services and other	--	463	--	--	242	--	--	242
Exercise of stock options and warrants	--	672	1	--	1,915	--	--	1,916
Issuance of common stock	--	1,500	1	--	12,434	--	--	12,435
Stock compensation	--	--	--	--	2,604	--	--	2,604
Other comprehensive income	--	--	--	--	--	71	--	71
Net loss for year	--	--	--	--	--	--	(11,691)	(11,691)
Balance as of December 31, 2007	--	38,196	\$ 38	\$ --	\$ 142,901	\$ (1)	\$ (105,396)	\$ 37,542
Common stock issued for services and other	--	488	--	--	498	--	--	498
Exercise of stock options and warrants	--	3,519	4	--	12,309	--	--	12,313
Stock compensation	--	--	--	--	2,367	--	--	2,367
Cumulative translation adjustment due to change in functional currency at October 1, 2008	--	--	--	--	--	3,553	--	3,553
Other comprehensive income	--	--	--	--	--	13,585	--	13,585
Net loss for year	--	--	--	--	--	--	(54,704)	(54,704)
Balance as of December 31, 2008	--	42,203	\$ 42	\$ --	\$ 158,075	\$ 17,137	\$ (160,100)	\$ 15,154

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

FX ENERGY, INC. AND SUBSIDIARIES
Notes to the Consolidated Financial Statements

Note 1: Summary of Significant Accounting Policies

Organization

FX Energy, Inc., a Nevada corporation, and its subsidiaries (collectively referred to hereinafter as the “Company”), is an independent energy company with activities concentrated within the upstream oil and gas industry. In Poland, the Company has projects involving the exploration and exploitation of oil and gas prospects in partnership with the Polish Oil and Gas Company (“POGC”), other industry partners and for its own account. In the United States, the Company explores for and produces oil from fields in Montana and Nevada and has an oilfield services company in northern Montana that performs contract drilling and well servicing operations.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries and the Company’s undivided interests in Poland. All significant inter-company accounts and transactions have been eliminated in consolidation. At December 31, 2008, the Company owned 100% of the voting common stock or other equity securities of its subsidiaries.

Cash and Cash Equivalents and Marketable Securities

The Company considers all highly-liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. The Company determines the appropriate classification of its investments in cash and cash equivalents and marketable securities at the time of purchase and reevaluates such designation at each balance sheet date.

Fair Value of Financial Instruments

The carrying amounts of our financial instruments, including cash and cash equivalents, marketable securities, accounts receivable, accounts payable and accrued liabilities, approximate fair value because of their generally short maturities.

Concentration of Credit Risk

Excluding the receivable for Input VAT, which is due from the State Treasury Office of Poland, the majority of the Company’s receivables are within the oil and gas industry, primarily from the purchasers of its oil and gas, fees generated from oilfield services and its industry partners. Substantially all of the Company’s domestic receivables are with Cenex, a regional refiner and marketer, and substantially all of the Company’s Polish receivables are with the Polish Oil and Gas Company or one of its affiliates. The receivables are not collateralized. To date, the Company has experienced minimal bad debts, and has no allowance for doubtful accounts at December 31, 2008 and 2007. The majority of the Company’s cash and cash equivalents are held by four financial institutions in Utah, Montana, New York and Poland. The Company’s marketable securities are held by one financial institution in Utah.

Derivative Instruments

Statement of Financial Accounting Standards No. 133, “Accounting for Derivative Instruments and Hedging Activities” (“SFAS No. 133”), requires derivative instruments to be recognized as either assets or liabilities in the balance sheet at fair value. The accounting for changes in the fair value of derivative instruments depends on their intended use and resulting hedge designation. For derivative instruments designated as hedges, the changes in fair value are recorded in the balance sheet as a component of accumulated other comprehensive income. Changes in the fair value of derivative instruments not designated as hedges are recorded in the Consolidated Statements of Operations, generally as a component of interest and other income (expense). At December 31, 2008 and 2007, the Company had no derivative instruments designated as hedges.

Inventory

Inventory consists primarily of tubular goods and production related equipment and is valued at the lower of average cost or market.

Oil and Gas Properties

The Company follows the successful efforts method of accounting for its oil and gas operations. Under this method of accounting, all property acquisition costs and costs of exploratory and development wells are capitalized when incurred, pending determination of whether an individual well has found proved reserves. If it is determined that an exploratory well has not found proved reserves, or if the determination that proved reserves have been found cannot be made within one year, or if the Company is not making sufficient progress assessing the reserves and the economic and operating viability of the project, the costs of the well are expensed. The costs of development wells are capitalized whether productive or nonproductive. Geological and geophysical costs on exploratory prospects and the costs of carrying and retaining unproved properties are expensed as incurred. An impairment allowance is provided to the extent that capitalized costs of unproved properties, on a property-by-property basis, are not considered to be realizable. Depletion, depreciation and amortization (“DD&A”) of capitalized costs of proved oil and gas properties is provided on a field-by-field basis using the units-of-production method. The computation of DD&A takes into consideration the anticipated proceeds from equipment salvage. An impairment loss is recorded if the net capitalized costs of proved oil and gas properties exceed the aggregate undiscounted future net revenues determined on a field-by-field basis. The impairment loss recognized equals the excess of net capitalized costs over the related fair value determined on a property-by-property basis. Gains and losses are recognized on sales of entire interests in proved and unproved properties. Sales of partial interests are generally treated as a recovery of costs and any resulting gain or loss is recorded as other income.

Low year-end oil prices resulted in a negative revision to our oil reserves and their estimated future net revenues in the United States for 2008. As a result of the negative revisions, the net book value of the Company’s domestic oil properties was greater than their estimated future net revenues at December 31, 2008. According to the provisions of Statement of Financial Accounting Standards No. 144 (“SFAS No. 144”), Accounting for the Impairment and Disposal of Long-Lived Assets, the Company recorded an impairment of capitalized costs in the amount of \$3,773,614 in 2008. The impairment amount was calculated by reducing the net capitalized costs of the U.S. oil properties to their fair value at year-end. The fair value of the properties was equal to their remaining estimated discounted future net cash flows.

During 2008, the Company impaired the costs of the Grundy-1 and Sroda-6 wells. According to the provisions of FASB Staff Position No. 19-1, “Accounting for Suspended Well Costs” (“FSP No. 19-1”) capitalized costs of exploratory wells are required to be expensed if the enterprise is not making sufficient progress assessing the reserves and economic viability of the project. Under current economic conditions, the Company does not have firm plans to further develop these two wells. Accordingly, the Company has recorded an impairment charge of \$7,219,871 associated with the Grundy-1 well and \$3,752,122 associated with the Sroda-6 well in 2008.

The Wilga well in Poland began to experience significant water encroachment from one of its three productive zones during the fourth quarter of 2007, and production engineering data suggested that the well might experience a decline in oil and gas production over the course of the succeeding 12-18 months as a result. As a consequence of the water encroachment, the proved reserves at Wilga were reduced at year-end 2007. According to the provisions of SFAS No. 144, the Company recorded an impairment of capitalized costs in the amount of \$2,299,534 in 2007. The impairment amount was calculated by reducing the net capitalized costs of the well to its fair value at year-end. The fair value of the well was equal to its remaining estimated discounted future net cash flows.

The following table reflects the net changes in capitalized exploratory well costs, which are capitalized pending the determination of proved reserves, during 2008, 2007 and 2006.

	December 31,		
	2008	2007	2006
	(In thousands)		
Beginning balance at January 1	\$ 669	\$ 2,386	\$ 3,435
Additions to capitalized exploratory well costs pending the determination of proved reserves	2,390	669	2,386
Reclassifications to wells, facilities and equipment based on the determination of proved reserves	--	(2,386)	--
Capitalized exploratory well costs charged to expense	(669)	--	(3,435)
Ending balance at December 31	<u>\$ 2,390</u>	<u>\$ 669</u>	<u>\$ 2,386</u>

The 2008 balance includes drilling costs incurred for the Kromolice-2 well in Poland, which was drilling at the end of the year. The 2007 balance includes equipment costs incurred for the Grundy well in Poland, which began drilling in early 2008. The provisions of FSP No. 19-1 required the costs associated with this well, which included approximately \$669,000 at year-end December 31, 2007, to be impaired at December 31, 2008. The 2006 balance includes costs associated with the Winna Gora and Roszkow wells in Poland, which were in process at year end. Both wells were completed in 2007 as successful gas wells. As a result of its focus in the Sroda area, the Company determined in 2006 to delay assessing the reserves and the economic and operating viability of its Rusocin well in Poland. Pursuant to FSP No. 19-1, costs associated with this well, approximately \$3.4 million, were impaired at December 31, 2006.

Other Property and Equipment

Other property and equipment, including oilfield servicing equipment, is stated at cost. Depreciation of other property and equipment is calculated using the straight-line method over the estimated useful lives (ranging from 3 to 40 years) of the respective assets. The costs of normal maintenance and repairs are charged to expense as incurred. Material expenditures that increase the life of an asset are capitalized and depreciated over the estimated remaining useful life of the asset. The cost of other property and equipment sold, or otherwise disposed of, and the related accumulated depreciation are removed from the accounts and any gain or loss is reflected in current operations.

The historical cost of other property and equipment, presented on a gross basis with accumulated depreciation, is summarized as follows:

	December 31,		Estimated Useful Life (in years)
	2008	2007	
	(In thousands)		
Other property and equipment:			
Drilling rigs	\$ 5,101	\$ 4,180	6
Other vehicles	309	320	5
Building	108	108	40
Office equipment and furniture	1,149	982	3 to 6
Total cost	<u>6,667</u>	<u>5,590</u>	
Accumulated depreciation	(4,663)	(4,250)	
Net other property and equipment	<u>\$ 2,004</u>	<u>\$ 1,340</u>	

Supplemental Disclosure of Cash Flow Information

Noncash investing and financing transactions not reflected in the consolidated statements of cash flows include the following:

	Year Ended December 31,		
	2008	2007	2006
	(In thousands)		
Noncash investing transactions:			
Additions to properties included in current liabilities	\$ 1,927	\$ 428	\$ 2,359
	Year Ended December 31,		
	2008	2007	2006
	(In thousands)		
Cash paid for interest and income taxes:			
Cash paid during the year for interest.....	\$ 418	\$ 125	\$ --
Cash paid during the year for income taxes	--	--	--

Cash paid for interest in 2008 includes \$188,715 in commitment fees on the Company's Senior Facility Agreement. Cash paid for interest in 2007 includes \$119,040 in commitment fees paid on the Company's Senior Facility Agreement.

Revenue Recognition

Revenues associated with oil and gas sales are recorded when title passes, which is upon delivery to the pipeline or purchaser, and are net of royalties. Oilfield service revenues are recognized when the related service is performed.

Stock-Based Compensation

The Company maintains several share-based incentive plans. Under these plans, the Company may issue options or restricted stock awards. Options are granted at an option price equal to the market value of the stock at the date of grant, have terms ranging from five to seven years and vest in three equal annual installments. Restricted stock awards have similar terms and vesting requirements.

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R, "Share-Based Payment" ("SFAS No. 123R"). Under SFAS No. 123R, share-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as expense over the employee's requisite service period. The Company adopted SFAS No. 123R using the modified prospective transition method. Upon adoption, deferred compensation of \$2,975,157 was eliminated against additional paid-in capital. Under this method, prior periods are not revised for comparative purposes. The provisions of SFAS No. 123R apply to new awards and to awards that are outstanding on the effective date that are subsequently modified or cancelled. Compensation expense for unvested awards at the effective date will be recognized over the remaining requisite service period using the compensation cost calculated for pro forma disclosure purposes under SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123").

Income Taxes

Deferred income taxes are provided for the differences between the tax bases of assets or liabilities and their reported amounts in the consolidated financial statements. Such differences may result in taxable or deductible amounts in future years when the asset or liability is recovered or settled, respectively.

The Company adopted the provisions of Financial Accounting Standards Board (“FASB”) Interpretation No. 48, “Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109,” (“FIN 48”), effective January 1, 2007. The Company did not have any unrecognized tax benefits, and there was no effect on its financial condition or results of operations as a result of implementing FIN 48. The Company did not have any unrecognized tax benefits at December 31, 2008. The Company is subject to audit by the IRS and various states for the prior three years. The Company does not believe there will be any material changes in its unrecognized tax positions over the next 12 months. The Company’s policy is that it recognizes interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. As of the date of adoption of FIN 48, the Company did not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any tax-related interest expense recognized during the year ended December 31, 2008.

New Accounting Standards

In December 2007, the FASB issued SFAS No. 160, “Non-controlling Interests in Consolidated Financial Statements – an amendment of ARB No. 51” (SFAS No. 160). This statement improves the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements. SFAS No. 160 affects those entities that have an outstanding non-controlling interest in one or more subsidiaries or that deconsolidate a subsidiary. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Early adoption is prohibited. The adoption of this statement is not expected to have any effect on the Company's financial statements.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133” (SFAS No. 161). This statement is intended to improve transparency in financial reporting by requiring enhanced disclosures of an entity’s derivative instruments and hedging activities and their effects on the entity’s financial position, financial performance, and cash flows. SFAS No. 161 applies to all derivative instruments within the scope of SFAS 133, “Accounting for Derivative Instruments and Hedging Activities” (SFAS No. 133) as well as related hedged items, bifurcated derivatives, and non-derivative instruments that are designated and qualify as hedging instruments. SFAS No. 161 is effective prospectively for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of this statement is not expected to have a material effect on the Company's financial statements.

In October 2008, FASB issued FSP FAS 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active,” to clarify guidance on determining the fair value of a financial asset under SFAS No. 157 in a market that is not active. FSP FAS 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The adoption of this statement was effective October 1, 2008 and did not have a material impact on our financial position or results of operations.

In December 2008, the SEC issued a final rule, Modernization of Oil and Gas Reporting which is effective January 1, 2010 for reporting 2009 reserve information. The new disclosure requirements permit the use of new technologies to determine proved reserves if those technologies have been demonstrated empirically to lead to reliable conclusions about reserve volumes. The new disclosure requirements also require companies to include nontraditional resources such as oil sands, shale, coalbeds or other nonrenewable natural resources in reserves if they are intended to be upgraded to synthetic oil and gas. Currently the SEC requires that reserve volumes are determined using prices on the last day of the reporting period; however, the new disclosure requirements provide for reporting oil and gas reserves using an average price based upon the prior twelve month period rather than year-end prices. The new requirements also will allow companies to disclose their probable and possible reserves to investors. The new disclosure requirements also require companies to report the independence and qualifications of a reserves preparer or auditor. The Company will adopt the provisions of the final rule in connection with our December 31, 2009 Form 10-K filing. The Company is currently evaluating the impact of the final rule.

The Company has reviewed all other recently issued, but not yet adopted, accounting standards in order to determine their effects, if any, on its consolidated results of operations, financial position and cash flows. Based on that review, the Company believes that none of these pronouncements will have a significant effect on current or future earnings or operations.

Foreign Operations

Effective October 1, 2008, the Company changed the functional currency of its Polish subsidiary from the U.S. dollar to the Polish zloty. During the fourth quarter of 2008, for the first time, the Company entered into forward zloty purchase contracts. In early 2009, the Company entered into construction and revenue agreements that would recognize the results of increasingly significant levels of production and corresponding revenues in Polish zloty. In recognition of these economic events combined with the resulting increases in future zloty revenues and expenditures of the Polish entity, the Company determined that it was appropriate to change the functional currency of FX Energy Poland to the Polish zloty.

Financial Accounting Statement No. 52 “Foreign Currency Translation,” requires the assets, liabilities, and results of operations of a foreign operation to be measured using the functional currency of that foreign operation. Because FX Energy Poland's functional currency is now the Polish zloty, translation adjustments will result from the process of translating its financial statements into the U.S. dollar reporting currency. Translation adjustments will not be included in determining net income but shall be reported separately and accumulated in other comprehensive income. The accounting basis of the assets and liabilities affected by the change are adjusted to reflect the difference between the exchange rate when the asset or liability arose and the exchange rate on the date of the change. Upon the change in functional currency, the Company recorded a cumulative translation adjustment (“CTA”) of approximately \$3.3 million, which is shown in the consolidated statement of stockholders' equity (deficit). Because of the change in exchange rates between reporting periods and changes in certain account balances, the CTA will change from period to period. At December 31, 2008, the CTA was approximately \$17.1 million reflecting the impact of exchange rate fluctuations.

The change in functional currency will also affect the amounts the Company reports for its Polish assets, liabilities, revenues and expenses from those that would be reported had it maintained the U.S. dollar as the functional currency for its Polish operations. The differences will depend on changes in period-average and period-end exchange rates. During the fourth quarter of 2008, the Company recorded foreign currency transaction losses of approximately \$24.3 million, principally attributable to increases in the amount of Polish zlotys necessary to satisfy outstanding intercompany dollar-denominated loans and unpaid interest to FX Energy, Inc. Future transaction gains or losses may be significant given the amount of intercompany loans and the volatility of the exchange rate.

The change in functional currency will have no impact on the Company's actual zloty-based revenues and expenditures in Poland.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reporting period. Certain accounting policies involve judgments and uncertainties to such an extent that there is reasonable likelihood that materially different amounts could have been reported under different conditions, or if different assumptions had been used. The Company evaluates their estimates and assumptions on a regular basis. The Company bases their estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates and assumptions used in preparation of the Company's financial statements. The most significant estimates with regard to these financial statements relate to the provision for income taxes including uncertain tax positions, the outcome of pending litigation, stock-based compensation, valuation of derivative instruments, future development and abandonment costs, estimates to certain oil and gas revenues and expenses and estimates of proved oil and natural gas reserve quantities used to calculate depletion, depreciation and impairment of proved oil and natural gas properties and equipment.

Net Loss per Share

Basic earnings per share are computed by dividing the net loss applicable to common shares by the weighted average number of common shares outstanding. Diluted earnings per share is computed by dividing the net loss by the sum of the weighted average number of common shares and the effect of dilutive unexercised stock options, warrants, unvested restricted stock, and convertible preferred stock or debt.

Outstanding options, warrants and unvested restricted stock as of December 31, 2008, 2007 and 2006, were as follows:

Balance sheet date:	Options, Warrants and Unvested Restricted Stock	Price Range
December 31, 2008	2,694,862	\$0.00 - \$10.65
December 31, 2007	6,320,602	\$0.00 - \$10.65
December 31, 2006	6,859,106	\$0.00 - \$10.65

The Company had a net loss in 2008, 2007 and 2006. The above options, warrants and unvested restricted stock were not included in the computation of diluted earnings per share for the years presented because the effect would have been antidilutive.

Reclassifications

Certain amounts in the 2007 and 2006 Consolidated Statements of Operations have been reclassified to conform to current year presentation. There was no change on previously reported net income.

Note 2: Asset Retirement Obligation

The Company accounts for future site restoration costs according to Statement No. 143, "Accounting for Asset Retirement Obligations" ("SFAS No. 143"). Under SFAS No. 143, the fair value of asset retirement obligations is recorded as a liability when incurred, which is typically at the time the assets are placed in service. Amounts recorded for the related assets are increased by the amount of these obligations. Over time, the liabilities are accreted for the change in their present value and the initial capitalized costs are depreciated over the useful lives of the related assets. The Company uses an expected cash flow approach to estimate its asset retirement obligations under SFAS No. 143. The Company recorded accretion expense of \$83,739, \$78,087 and \$53,038 in 2008, 2007 and 2006, respectively. At December 31, 2008, there were no assets legally restricted for purposes of settling asset retirement obligations.

Following is a reconciliation of the yearly changes in the asset retirement obligation at December 31, 2008 and 2007:

	December 31,	
	2008	2007
	(In thousands)	
Asset retirement obligations:		
Beginning balance	\$ 1,037	\$ 961
Current year revisions	811	--
Liabilities settled	--	(2)
Accretion expense	84	78
Ending balance	<u>\$ 1,932</u>	<u>\$ 1,037</u>

At year-end 2008, the economic life of the Company's oil reserves in Montana was shortened considerably due to low year-end oil prices. Accordingly, the Company increased the asset retirement obligation to reflect the shortened time period before plugging costs might be incurred.

Note 3: Other Assets

As of December 31, 2008 the Company had replacement bonds with federal and state agencies in the face amount of \$731,500, which were collateralized by certificates of deposit totaling \$381,500. In addition, there are certificates of deposit totaling \$25,000 covering performance bonds in other states. The bond face amount at December 31, 2007 was \$463,000.

Note 4: Accrued Liabilities

The Company's accrued liabilities as of December 31, 2008 and 2007 were comprised of the following:

	December 31,	
	2008	2007
	(In thousands)	
Accrued liabilities:		
Credit facility commitment fees	\$ 2	\$ 78
Partner share of oil & gas revenue and joint operating costs.....	356	1,737
Compensation-related costs.....	841	1,543
Interest expense	42	--
Foreign currency derivative contracts	888	--
UBS loan related to auction rate securities (Note 7)	2,808	--
Total	<u>\$ 4,937</u>	<u>\$ 3,358</u>

Note 5: Notes Payable

In November of 2006, the Company entered into a \$25 million Senior Facility Agreement (the Facility) with The Royal Bank of Scotland plc (RBS). The Facility is provided to FX Energy Poland Sp. z o.o., a wholly owned subsidiary. Funds from the Facility, which became available to the Company in March 2007, will cover infrastructure and development costs at a variety of the Company's Polish gas projects and are collateralized by its commercial wells and production in Poland. At December 31, 2008 the Company had drawn the full \$25 million available under the Facility.

In consideration for the Facility, the Company paid a 1% origination fee and issued warrants to purchase 110,000 shares of common stock, valid for 2 years at an exercise price of \$6.00 per share. The Black-Scholes value of these warrants (approximately \$305,000), along with the loan origination fee and associated legal fees, have been capitalized as deferred financing costs, and are being amortized over the 6 year term of the loan, beginning in 2007. An annual unused commitment fee of one-half of the applicable margin is charged quarterly based on the average daily unused portion of the Facility.

The following table provides a summary of changes in notes payable (in thousands):

	For the Year Ended December 31, 2008
Balance at January 1, 2008	\$ --
Proceeds from borrowings.....	25,000
Balance at December 31, 2008	<u>\$ 25,000</u>

Interest on borrowed funds is accrued at LIBOR plus 1.25%. The average interest rate on the outstanding balance at December 31, 2008 was 2.87% per annum. The Facility is an interest-only facility until December 31, 2010, on which date the Facility's principal amount is currently scheduled to be reduced to \$20 million. The carrying value of the long term debt at December 31, 2008 approximates its fair value.

The borrowing base is redetermined at the beginning of each year based on reserve volumes and values estimated by independent engineers as of the last day of the prior year. As the Company increased both its reserve volumes and values from year-end 2007 to year-end 2008, it does not anticipate any reductions in its borrowing base amount.

Note 6: Commitments and Contingencies

In November and December 2007, three actions were filed in the United States District Court for the District of Utah against the Company and its officers or directors David N. Pierce, Clay Newton, Thomas B. Lovejoy, Andrew W. Pierce, and Richard Hardman, by three separate plaintiffs, each seeking class certification to proceed on behalf of all others similarly situated and alleging violations by the defendants of the antifraud provisions of the federal securities laws set forth in Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated there under relating to our public statements about our oil and gas activities and prospects in Poland between March 2004 and January 2006. The complaints seek damages to be determined at trial, interest, and costs, together with such other relief as the court may deem appropriate. The three actions have now been consolidated into a single matter, *In re FX Energy, Inc., Securities Litigation*, US District Court, District of Utah, case no. 2:07-cv-00874, and the lead plaintiffs and counsel have been specified. The consolidated actions have not been certified to proceed as a class action.

A consolidated complaint has been filed by the lead plaintiff that alleges that the defendants violated the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 there under by making material misrepresentations and omissions regarding our Sroda-5 and Lugi-1 projects between January 20, 2005, and January 5, 2006. The consolidated complaint seeks damages to be determined at trial, interest, costs and such other relief as the court may deem appropriate. On June 20, 2008, the Company filed a motion to dismiss, with a supporting memorandum, for failure to state a claim upon which relief can be granted. Plaintiffs filed an opposition to the defendants' motion on August 19, 2008, to which defendants filed a reply on October 3, 2008. Following a hearing on February 23, 2009, on defendants' motion to dismiss, the matter is under advisement by the court. The Company intends to defend vigorously this consolidated action on behalf of all defendants.

Another pending action filed in the United States District Court for the District of Utah entitled *Leilani York, derivatively on behalf of nominal defendant FX Energy, Inc., plaintiff, v. David N. Pierce, Dennis B. Goldstein, Arnold S. Grundvig, Jr., Richard Hardman, Tom Lovejoy, Jerzy Maciolek, Clay Newton, Andrew W. Pierce, and David Worrell, defendants, and FX Energy, Inc., nominal defendant*, case no. 2:08-cv-00143, asserts derivative claims on the Company's behalf against certain of its current and former directors and certain of its current and former executive officers, arising from the same set of facts, has been stayed pending final resolution of the *In re FX Energy, Inc., Securities Litigation*.

Note 7: Fair Value Measurements and Marketable Securities

Fair Value Measurements

Effective January 1, 2008, the Company partially adopted SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"), which defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). This statement establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements for financial assets and liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. FASB Staff Position No. 157-2 delayed the effective date of SFAS No. 157 by one year for nonfinancial assets and liabilities measured on a nonrecurring basis. The Company is currently evaluating the impact of implementation with respect to nonfinancial assets and liabilities measured on a nonrecurring basis on the consolidated financial statements, which will be primarily limited to asset retirement obligations.

Fair Value Hierarchy

In accordance with SFAS No. 157, the Company has categorized its cash and cash equivalents, marketable securities, and foreign currency contracts based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

Financial assets recorded on the Consolidated Balance Sheets are categorized based on the inputs to the valuation techniques as follows:

Level 1. Financial assets whose values are based on unadjusted quoted prices for identical assets or liabilities in an active market that the Company has the ability to access.

Level 2. Financial assets whose values are based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the asset or liability. Level 2 inputs include the following:

- (a) quoted prices for similar assets in active markets;
- (b) quoted prices for identical or similar assets in non-active markets;
- (c) pricing models whose inputs are observable for substantially the full term of the asset; and
- (d) pricing models whose inputs are derived principally from or corroborated by observable market data through correlation or other means for substantially the full term of the asset or liability.

Level 3. Financial assets whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management's own assumptions about the assumptions a market participant would use in pricing the asset or liability.

A review of fair value hierarchy classifications is conducted on a quarterly basis. Changes in the observability of valuation inputs may result in a reclassification for certain financial assets or liabilities. During the first quarter of 2008, certain assets were classified as Level 3 assets. This classification primarily relates to investments in auction-rate securities.

Recurring Fair Value

As required by SFAS No. 157, the Company's assessment of the significance of a particular input to fair value requires judgment and may affect the fair value of assets and their placement within the fair value hierarchy.

The following table presents the Company's fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis as of December 31, 2008 (in thousands).

	December 31, 2008	Level 1 ⁽¹⁾	Level 2 ⁽²⁾	Level 3 ⁽³⁾
Assets:				
Cash equivalents:				
Money market funds	\$ 1,122	\$ 1,122		
Treasury bills.....	1,400	1,400		
Treasury bill funds	8,907	8,907		
Marketable securities:				
Auction rate securities.....	4,105			\$ 4,105
Auction rate securities "put" rights	545			545
Liabilities:				
Foreign currency derivative contracts	\$ 888	\$ 888		

(1) Quoted prices in active markets for identical assets.

(2) Significant other observable inputs.

(3) Significant unobservable inputs.

Level 3 assets include \$4,105,000 of auction-rate securities and \$545,000 related to certain “put” rights associated with the auction-rate securities. The receivable for the “put” rights is included in other receivables as of December 31, 2008.

The following table provides a summary of changes in fair value of the Company’s Level 3 marketable securities (in thousands):

	For the Year Ended December 31, 2008
Balance at January 1, 2008	\$ 9,700
Transfers in	545
Purchases, issuances and settlements	(5,596)
Unrealized gains included in other comprehensive income	1
Balance at December 31, 2008	<u>\$ 4,650</u>

Marketable Securities

Marketable securities on the Consolidated Balance Sheets include investments held by the Company that are classified in accordance with the provisions of SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities.” The marketable securities have historically been classified as available-for-sale. The Company’s marketable securities as of December 31, 2008, included \$4,104,711 of auction-rate securities at their fair market value.

In August of 2008, UBS Financial Services (“UBS”), the Company’s financial advisor, announced a settlement plan to restore liquidity to its clients holding auction rate securities. According to the terms of the settlement agreement, the Company has the ability to borrow from UBS Bank up to 75% of the par value of its auction rate securities at an interest rate that is equivalent to the yield of the underlying securities. As of December 31, 2008, the Company had borrowed a total of \$2,808,000 from UBS, using certain auction rate securities as collateral. These loans are included in accrued liabilities on the balance sheet. As individual auction rate securities are redeemed by their issuers, the proceeds from those redemptions will be used to reduce the loans.

As part of the settlement, the Company also received certain “put” rights, which enable the Company to require UBS to purchase, at par value plus accrued interest, all of the auction rate securities at fixed, future dates. As of December 31, 2008, the Company had certain auction rate securities with a market value of \$2,535,000 that are eligible to be “put” to UBS on January 2, 2009 and certain other auction rate securities with a market value of \$1,570,000 that are eligible to be “put” to UBS on June 30, 2010. Subsequent to December 31, 2008, auction rate securities valued at \$2,535,000 on December 31, 2008 with a put date of January 2, 2009, were redeemed at their full par value of \$3,000,000. The proceeds from the redemption were used to satisfy a loan relating to those securities at December 31, 2008 of \$1,944,000.

In February of 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities — Including an amendment of FASB Statement No. 115.” This statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities.

The Company has elected to use the provisions of SFAS No. 159 to determine a fair value for the UBS “put” rights. The Company has determined the value of the “put” rights to be \$545,000, which is the difference between the par value and the fair value of the auction rate securities. This amount has been recorded as a current receivable on the balance sheet, with a corresponding gain of \$545,000 recorded as other income in the statement of operations.

In order to record the receivable associated with the “put” rights, the Company also changed the classification of its marketable securities from ‘available-for-sale’ to ‘trading’ securities. This change resulted in a loss of \$545,000 associated with transferring the historical temporary losses related to auction rate securities from other comprehensive income (loss) to earnings. The loss is recorded as other expense in the statement of operations. There was no cash impact on the Company’s balance sheet or statements of operations and cash flow associated with the gain and loss that resulted from these transactions.

Liabilities

At December 31, 2008, the Company had three outstanding zloty forward purchase contracts denominated in U.S. dollars as follows: \$2,500,000 that matured January 30, 2009; \$2,100,000 that matured February 27, 2009; and \$1,100,000 that matures March 31, 2009. The exchange rate for each contract is 2.50 zlotys per U.S. dollar. In connection with these outstanding contracts, the Company recorded a foreign exchange loss of \$887,599 when the contracts were marked to market at December 31, 2008, using the year-end exchange rate of 2.96 zlotys per U.S. dollar.

Note 8: Income Taxes

The Company recognized no income tax benefit from the losses generated during 2008, 2007 and 2006. The components of the net deferred tax asset as of December 31, 2008 and 2007 are as follows:

	December 31,	
	2008	2007
	(In thousands)	
Deferred tax liability:		
Property and equipment basis differences	\$ (288)	\$ (2,388)
Deferred tax asset:		
Net operating loss carryforwards:		
United States	27,795	25,615
Poland.....	5,607	9,252
Oil and gas properties.....	6,806	2,713
Foreign exchange translation losses	8,320	--
Options issued for services.....	1,256	1,359
Asset retirement obligation	721	387
Valuation allowance.....	(50,217)	(36,938)
Total	<u>\$ --</u>	<u>\$ --</u>

The change in the valuation allowance during 2008, 2007 and 2006 is as follows:

	Year Ended December 31,		
	2008	2007	2006
	(In thousands)		
Valuation allowance:			
Balance, beginning of year.....	\$ (36,938)	\$ (32,028)	\$ (24,887)
Change in property and equipment basis differences.....	(6,193)	(1,249)	2,511
Increase due to foreign exchange translation loss.....	(8,320)	--	--
Decrease (Increase) due to net operating loss	1,465	(2,179)	(8,875)
Other	(231)	(1,482)	(777)
Total	<u>\$ (50,217)</u>	<u>\$ (36,938)</u>	<u>\$ (32,028)</u>

SFAS No. 109, "Accounting for Income Taxes," requires that a valuation allowance be provided if it is more likely than not that some portion or all of a deferred tax asset will not be realized. The Company's ability to realize the benefit of its deferred tax asset will depend on the generation of future taxable income through profitable operations and expansion of the Company's oil and gas producing activities. The risks associated with that growth requirement are considerable, resulting in the Company's conclusion that a full valuation allowance be provided at December 31, 2008, 2007 and 2006. Due to the full valuation allowance, the Company's effective income tax rate for all three years was zero percent.

United States NOL

At December 31, 2008, the Company had net operating loss (“NOL”) carryforwards in the United States of approximately \$74,518,000 available to offset future taxable income. The carryforwards begin to expire in 2009 and will fully expire in 2028. The utilization of the NOL carryforwards against future taxable income in the United States may become subject to an annual limitation if there is a change in ownership. The NOL carryforwards in the United States include \$19,664,000 relating to tax deductions resulting from the exercise of stock options. The tax benefit from adjusting the valuation allowance related to this portion of the NOL carryforward will be credited to additional paid-in capital.

Polish NOL

As of December 31, 2008, the Company had NOL carryforwards in Poland totaling approximately \$29,512,000. The NOLs began to expire in 2008 and will fully expire in 2013. The normal carryforward period in Poland is five years. However, no more than 50% of the NOL carryforward for any given year may be applied against Polish income in succeeding years.

The following table lists the years of expiration for the Company’s net operating losses:

Year of NOL expiration:	United States	Poland
	(In thousands)	
2009.....	\$ 1,052	\$ 4,644
2010.....	3,565	6,755
2011.....	8,368	10,612
2012.....	4,995	--
2013 and thereafter.....	56,538	7,501

The domestic and foreign components of the Company’s net loss are as follows:

	Year Ended December 31,		
	2008	2007	2006
	(In thousands)		
Domestic	\$ (11,230)	\$ (6,078)	\$ (6,764)
Foreign	(24,922)	(5,613)	(7,003)
Total	<u>\$ (36,152)</u>	<u>\$ (11,691)</u>	<u>\$ (13,767)</u>

Note 9: Stockholders’ Equity

The Company received proceeds from the exercise of 3,648,369 stock options and warrants of \$12,312,649 during 2008.

During 2007, the Company sold 1.5 million shares of stock in a registered direct offering, resulting in net proceeds to the Company of \$12,434,475. In addition, 672,165 options and warrants were exercised during the year, resulting in proceeds to the Company of an additional \$1,914,598.

Note 10: Stock Options, Warrants and Restricted Stock

Equity Compensation Plans

The Company’s equity compensation consists of annual stock option and award plans that are each subject to approval by the board of directors and are subsequently presented for approval by the stockholders at the Company’s annual meetings.

The following table summarizes information regarding the Company's stock option and award plans as of December 31, 2008:

	Number of Shares Authorized Under Plan	Weighted Average Exercise Price of Outstanding Options	Number of Options Available for Future Issuance
Equity compensation plans approved by stockholders:			
1995 Stock Option and Award Plan	500,000	\$7.49	--
1996 Stock Option and Award Plan	500,000	3.55	--
1997 Stock Option and Award Plan	500,000	5.87	--
1998 Stock Option and Award Plan	500,000	5.63	--
1999 Stock Option and Award Plan	500,000	8.37	78
2000 Stock Option and Award Plan	600,000	2.61	958
2001 Stock Option and Award Plan	600,000	3.22	1,891
2003 Long Term Incentive Plan	800,000	6.64	9,484
2004 Long Term Incentive Plan	1,000,000	8.43	214,330
Total.....	<u>5,500,000</u>	<u>\$5.65</u>	<u>226,741</u>

All stock option and award plans are administered by the Compensation Committee (the "Committee"), consisting of the independent members of the board of directors. At its discretion, the Committee may grant stock, incentive stock options ("ISOs") or non-qualified options to any employee, including officers. The granted options have terms ranging from five to seven years and vest in three equal annual installments. Under terms of the stock option award plans, the Company may also issue restricted stock.

The following table summarizes option activity for 2008, 2007 and 2006:

	2008		2007		2006	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Options outstanding:						
Beginning of year.....	2,315,441	\$5.19	2,836,833	\$5.08	3,193,333	\$5.16
Granted.....	--	--	--	--	--	--
Exercised.....	(335,000)	2.44	(466,726)	4.13	--	--
Cancelled.....	--	0.00	(54,666)	8.42	--	--
Expired.....	--	--	--	--	(356,500)	5.82
End of year	<u>1,980,441</u>	\$5.65	<u>2,315,441</u>	\$5.19	<u>2,836,833</u>	\$5.08
Exercisable at year-end	<u>1,980,441</u>	\$5.65	<u>2,303,776</u>	\$5.16	<u>2,497,177</u>	\$4.61

In 2008, the Company recognized \$15,508 in expense related to unvested stock options granted prior to the adoption of FAS 123R. There was no unamortized expense related to unvested options at December 31, 2008. All options outstanding at December 31, 2008 are fully vested.

During 2008, the Company issued 367,000 shares of restricted stock resulting in deferred compensation of \$1,005,580 which will be amortized ratably over the three year vesting period. Expense recognized during 2008 totaled \$9,184.

During 2007 the Company issued 370,925 shares of restricted stock resulting in deferred compensation of \$2,284,991 which will be amortized ratably over the three year vesting period. Expense recognized for these shares during 2008 and 2007 totaled \$761,805 and \$52,088 respectively.

In December of 2006, the Company issued 318,400 shares of restricted stock resulting in deferred compensation of \$2,053,680 which will be amortized ratably over the three year vesting period. Expense recognized for these shares during 2008, 2007 and 2006 totaled \$684,608, \$684,557 and \$18,756, respectively.

In November of 2005, the Company issued 298,950 shares of restricted stock resulting in deferred compensation of \$3,096,600 which will be amortized ratably over the three year vesting period. Expense recognized for these shares during 2008, 2007 and 2006 totaled \$895,805, \$1,024,862 and \$1,028,633, respectively.

The following table summarizes information about stock options outstanding as of December 31, 2008:

Exercise Price Range	Outstanding			Exercisable	
	Number of Options Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
\$2.40 - \$2.40.....	435,000	.62	2.40	435,000	2.40
\$3.14 - \$3.20.....	51,000	1.69	3.19	51,000	3.19
\$3.98 - \$3.98.....	587,109	1.82	3.98	587,109	3.98
\$6.06 - \$6.06.....	4,167	2.07	6.06	4,167	6.06
\$8.37 - \$8.37.....	843,165	2.67	8.37	843,165	8.37
\$9.00 - \$10.65.....	60,000	2.86	9.52	60,000	9.52
Total	<u>1,980,441</u>	1.95	\$5.65	<u>1,980,441</u>	\$5.65

The aggregate intrinsic value of outstanding stock options at December 31, 2008 was \$169,650. The aggregate intrinsic value of unvested restricted stock at December 31, 2008 was \$1,993,235. The aggregate intrinsic value represents the total pretax intrinsic value, based on the Company's stock price of \$2.79 as of December 31, 2008, which would have been received by the restricted stock award and stock option holders had all in-the-money restricted stock awards and options been vested or exercised as of that date.

Restricted Stock

The following table summarizes restricted stock activity during 2008, 2007 and 2006:

	2008	2007	2006
	Number of Shares	Number of Shares	Number of Shares
Unvested restricted stock outstanding:			
Beginning of year.....	679,788	516,900	298,950
Issued	367,000	370,925	318,400
Forfeited.....	(8,690)	(4,020)	(1,200)
Vested	<u>(323,677)</u>	<u>(204,017)</u>	<u>(99,250)</u>
End of year.....	<u>714,421</u>	<u>679,788</u>	<u>516,900</u>

Warrants

The following table summarizes warrant activity during 2008, 2007 and 2006:

	2008		2007		2006	
	Number of Shares	Price Range	Number of Shares	Price Range	Number of Shares	Price Range
Warrants outstanding and exercisable:						
Beginning of year.....	3,325,373	\$3.60--\$6.00	3,615,373	\$3.60--\$6.00	3,505,373	\$3.60--\$3.75
Issued	--	--	--	--	110,000	\$6.00
Exercised.....	(3,215,373)	\$3.66	(290,000)	\$3.60	--	--
Expired.....	<u>(110,000)</u>	\$6.00				
End of year.....	<u>--</u>		<u>3,325,373</u>	<u>\$3.60--\$6.00</u>	<u>3,615,373</u>	<u>\$3.60--\$6.00</u>

Note 11: Business Segments

The Company operates within two business segments of the oil and gas industry: exploration and production (“E&P”) and oilfield services. The Company’s revenues associated with its E&P activities are comprised of oil sales from its producing properties in the United States and oil and gas sales from its producing properties in Poland. Over 90% of the Company’s oil sales in the United States were to Cenex during 2008, 2007 and 2006. During 2008, 2007 and 2006 all sales of oil and gas in Poland were made to POGC or its affiliated companies. The Company believes the purchasers of its oil production in the United States could be replaced, if necessary, without a loss in revenue. Gas sales in Poland are sold pursuant to long term sales contracts which obligate the buyer to purchase all gas produced. Individual oil sales are negotiated with POGC affiliated entities and are not subject to sales contracts.

E&P operating costs are comprised of: (1) exploration costs (geological and geophysical costs, exploratory dry holes, and proved property and non-producing leasehold impairments) and, (2) lease operating costs (lease operating expenses and production taxes). Substantially all exploration costs are related to the Company’s operations in Poland. The majority of lease operating costs are related to the Company’s domestic production.

The Company’s revenues associated with its oilfield services segment are comprised of contract drilling and well servicing fees generated by the Company’s oilfield servicing equipment in Montana. Oilfield servicing costs are comprised of direct costs associated with its oilfield services.

DD&A directly associated with a respective business segment is disclosed within that business segment. The Company does not allocate current assets, corporate DD&A, general and administrative costs, amortization of deferred compensation, interest income, interest expense, other income or other expense to its operating business segments for management and business segment reporting purposes. All material inter-company transactions between the Company’s business segments are eliminated for management and business segment reporting purposes.

Information on the Company’s operations by business segment for 2008, 2007 and 2006 is summarized as follows:

	2008			
	Exploration & Production		Oilfield Services	Total (In thousands)
	U.S.	Poland		
Operations summary:				
Revenues	\$ 5,695	\$ 7,799	\$ 4,347	\$ 17,841
Lease operating expense.....	(2,548)	(893)	--	(3,441)
Oilfield services costs.....	--	--	(2,751)	(2,751)
Exploration expense	(464)	(14,925)	--	(15,389)
Impairment expense	(3,774)	(10,972)	--	(14,746)
Accretion expense	(56)	(28)	--	(84)
Bad debt expense.....	--	--	(460)	(460)
DD&A expense	(700)	(529)	(411)	(1,640)
Operating income (loss)	<u>\$ (1,847)</u>	<u>\$ (19,548)</u>	<u>\$ 725</u>	<u>\$ (20,670)</u>
Identifiable net property and equipment:				
Unproved properties	\$ 20	\$ 2,750	\$ --	\$ 2,770
Proved properties.....	261	21,839	--	22,100
Equipment and other	--	101	1,772	1,873
Total	<u>\$ 281</u>	<u>\$ 24,690</u>	<u>\$ 1,772</u>	<u>\$ 26,743</u>
Net Capital Expenditures:				
Property and equipment	\$ 1,828	\$ 22,811	\$ 1,020	\$ 25,659
Total	<u>\$ 1,828</u>	<u>\$ 22,811</u>	<u>\$ 1,020</u>	<u>\$ 25,659</u>

2007

	Exploration & Production		Oilfield Services	Total (In thousands)
	U.S.	Poland		
Operations summary:				
Revenues	\$ 4,336	\$ 10,567	\$ 3,093	\$ 17,996
Lease operating expense.....	(2,390)	(1,148)	--	(3,538)
Oilfield services costs.....	--	--	(1,998)	(1,998)
Exploration expense	(52)	(10,572)	--	(10,624)
Impairment expense	--	(2,299)	--	(2,299)
Accretion expense	(50)	(28)	--	(78)
DD&A expense	(742)	(935)	(267)	(1,944)
Operating income (loss)	<u>\$ 1,102</u>	<u>\$ (4,415)</u>	<u>\$ 828</u>	<u>\$ (2,485)</u>
Identifiable net property and equipment:				
Unproved properties	\$ 61	\$ 1,940	\$ --	\$ 2,001
Proved properties.....	3,167	15,377	--	18,544
Equipment and other	--	--	1,178	1,178
Total	<u>\$ 3,228</u>	<u>\$ 17,317</u>	<u>\$ 1,178</u>	<u>\$ 21,723</u>
Net Capital Expenditures:				
Property and equipment	\$ 494	\$ 5,092	\$ 893	\$ 6,479
Total	<u>\$ 494</u>	<u>\$ 5,092</u>	<u>\$ 893</u>	<u>\$ 6,479</u>

2006

	Exploration & Production		Oilfield Services	Total (In thousands)
	U.S.	Poland		
Operations summary:				
Revenues	\$ 4,260	\$ 2,273	\$ 1,696	\$ 8,229
Lease operating expense.....	(2,358)	(289)	--	(2,647)
Oilfield services costs.....	--	--	(1,245)	(1,245)
Exploration expense	(739)	(4,869)	--	(5,608)
Impairment expense	--	(3,583)	--	(3,583)
Accretion expense	(46)	(7)	--	(53)
DD&A expense	(654)	(304)	(155)	(1,113)
Operating income (loss)	<u>\$ 463</u>	<u>\$ (6,779)</u>	<u>\$ 296</u>	<u>\$ (6,020)</u>
Identifiable net property and equipment:				
Unproved properties	\$ --	\$ 2,912	\$ --	\$ 2,912
Proved properties.....	3,124	12,898	--	16,022
Equipment and other	--	22	534	556
Total	<u>\$ 3,124</u>	<u>\$ 15,832</u>	<u>\$ 534</u>	<u>\$ 19,490</u>
Net Capital Expenditures:				
Property and equipment	\$ 613	\$ 9,008	\$ 295	\$ 9,916
Total	<u>\$ 613</u>	<u>\$ 9,008</u>	<u>\$ 295</u>	<u>\$ 9,916</u>

A reconciliation of the segment information to the consolidated totals for 2008, 2007 and 2006 follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(In thousands)		
Revenues:			
Reportable segments.....	\$ 17,841	\$ 17,996	\$ 8,229
Non-reportable segments.....	--	--	--
Total revenues	<u>\$ 17,841</u>	<u>\$ 17,996</u>	<u>\$ 8,229</u>
Net loss:			
Operating loss, reportable segments	\$ (20,669)	\$ (2,485)	\$ (6,020)
Expense or (revenue) adjustments:			
Corporate DD&A expense	(81)	(120)	(177)
General and administrative costs (G&A)	(7,030)	(7,061)	(5,728)
Amortization of deferred compensation (G&A).....	(2,367)	(2,604)	(2,759)
Total net operating loss	(30,147)	(12,270)	(14,684)
Non-operating income:			
Interest income (net of interest expense) and other income	(278)	433	795
Foreign exchange gain (loss).....	(24,279)	146	122
Net loss.....	<u>\$ (54,704)</u>	<u>\$ (11,691)</u>	<u>\$ (13,767)</u>
Net property and equipment:			
Reportable segments.....	\$ 26,743	\$ 21,723	\$ 19,490
Corporate assets.....	130	162	205
Net property and equipment	<u>\$ 26,873</u>	<u>\$ 21,885</u>	<u>\$ 19,695</u>
Property and equipment capital expenditures:			
Reportable segments.....	\$ 25,659	\$ 6,479	\$ 9,916
Corporate assets.....	20	73	59
Total property and equipment capital expenditures.....	<u>\$ 25,679</u>	<u>\$ 6,552</u>	<u>\$ 9,975</u>

Note 12: Quarterly Financial Data (Unaudited)

Summary quarterly information for 2008 and 2007 is as follows:

	Quarter Ended			
	<u>December 31</u>	<u>September 30</u>	<u>June 30</u>	<u>March 31</u>
	(In thousands, except per share amounts)			
2008:				
Revenues.....	\$ 3,325	\$ 5,096	\$ 5,195	\$ 4,225
Net operating loss	(23,002)	(3,602)	(1,564)	(4,315)
Net loss	(45,236)	(3,688)	(1,488)	(4,292)
Basic and diluted net loss per common share ...	\$ (1.09)	\$ (0.09)	\$ (0.04)	\$ (0.11)
2007:				
Revenues.....	\$ 4,064	\$ 5,243	\$ 4,511	\$ 4,178
Net operating loss	(6,728)	(53)	(2,711)	(2,632)
Net income (loss).....	(6,550)	166	(2,682)	(2,625)
Basic and diluted net loss per common share ...	\$ (0.17)	\$ (0.00)	\$ (0.08)	\$ (0.07)

The net operating loss for the fourth quarter of 2008 includes a \$7.2 million and \$3.8 million impairment loss associated with the Grundy-1 and Sroda-6 wells in Poland and a \$3.7 million impairment loss on properties located in Montana. The net loss for 2008 includes a foreign exchange loss of \$24.3 million primarily related to FX Energy Poland's intercompany loans from FX Energy, Inc. The net operating loss for the fourth quarter of 2007 includes a \$2.3 million impairment loss associated with the Wilga well in Poland.

FX ENERGY, INC. AND SUBSIDIARIES
Supplemental Information

Disclosure about Oil and Gas Properties and Producing Activities (Unaudited)

Capitalized Oil and Gas Property Costs

Capitalized costs relating to oil and gas exploration and production activities as of December 31, 2008 and 2007, are summarized as follows:

	<u>United States</u>	<u>Poland</u>	<u>Total</u>
	(In thousands)		
December 31, 2008:			
Proved properties	\$ 3,514	\$ 25,086	\$ 28,600
Unproved properties	20	2,750	2,770
Total gross properties	<u>3,534</u>	<u>27,836</u>	<u>31,370</u>
Less accumulated depreciation, depletion and amortization	(3,254)	(3,247)	(6,501)
	<u>\$ 280</u>	<u>\$ 24,589</u>	<u>\$ 24,869</u>
December 31, 2007:			
Proved properties	\$ 5,986	\$ 17,505	\$ 23,491
Unproved properties	61	1,940	2,001
Total gross properties	<u>6,047</u>	<u>19,445</u>	<u>25,492</u>
Less accumulated depreciation, depletion and amortization	(2,819)	(2,128)	(4,947)
	<u>\$ 3,228</u>	<u>\$ 17,317</u>	<u>\$ 20,545</u>

Results of Operations

Results of operations are reflected in Note 12, Business Segments. There is no tax provision as the Company is not likely to pay, nor has it received any benefit from, any federal or local income taxes due to its operating losses. Total production costs (in thousands) for 2008, 2007 and 2006 were \$3,440, \$3,538 and \$2,647, respectively.

Property Acquisition, Exploration and Development Activities

Costs incurred in property acquisition, exploration and development activities during 2008, 2007 and 2006, whether capitalized or expensed, are summarized as follows:

	<u>United States</u>	<u>Poland</u>	<u>Total</u>
	(In thousands)		
Year ended December 31, 2008:			
Acquisition of unproved properties.....	\$ 67	\$ 1,810	\$ 1,877
Exploration costs.....	691	35,436	36,127
Development costs.....	1,760	126	1,886
Total.....	<u>\$ 2,518</u>	<u>\$ 37,372</u>	<u>\$ 39,890</u>
Year ended December 31, 2007:			
Acquisition of unproved properties.....	\$ 61	\$ 744	\$ 805
Exploration costs.....	77	14,884	14,961
Development costs.....	434	10	444
Total.....	<u>\$ 572</u>	<u>\$ 15,638</u>	<u>\$ 16,210</u>

FX ENERGY, INC. AND SUBSIDIARIES
Supplemental Information
--continued--

	<u>United States</u>	<u>Poland</u>	<u>Total</u>
	(In thousands)		
Year ended December 31, 2006:			
Acquisition of unproved properties	\$ 4	\$ 366	\$ 370
Exploration costs	932	11,159	12,091
Development costs	580	5,762	6,342
Total	\$ 1,516	\$ 17,287	\$ 18,803

Impairment of Oil and Gas Properties

The Company recorded impairment charges in its E&P segment related to oil and gas properties as follows (in thousands):

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Impairment of properties	<u>\$14,746</u>	<u>\$2,299</u>	<u>\$3,583</u>

Exploratory dry hole costs

Total dry hole costs in 2008 included three wells plugged and abandoned in the United States in the amount of \$463,744. There were no dry holes drilled in 2007. During 2006, the Company plugged and abandoned the one well in Poland and two wells in Nevada, incurring total dry hole costs of \$1,572,749.

Summary Oil and Gas Reserve Data (Unaudited)

Estimated Quantities of Proved Reserves

Proved reserves are the estimated quantities of crude oil and natural gas that geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reserves under existing economic and operating conditions. The Company's proved oil and gas reserve quantities and values are based on estimates prepared by independent reserve engineers in accordance with guidelines established by the Securities and Exchange Commission. Operating costs, production taxes and development costs were deducted in determining the quantity and value information. Such costs were estimated based on current costs and were not adjusted to anticipate increases due to inflation or other factors. No price escalations were assumed and no amounts were deducted for general overhead, depreciation, depletion and amortization, and interest expense. The proved reserve quantity and value information is based on the weighted average price on December 31, 2008, of \$24.58 per bbl for oil in the United States and \$36.56 per bbl of oil and \$5.29 per Mcf of gas in Poland. The determination of oil and gas reserves is based on estimates and is highly complex and interpretive, as there are numerous uncertainties inherent in estimating quantities and values of proved reserves, projecting future rates of production and timing of development expenditures. The estimates are subject to continuing revisions as additional information becomes available or assumptions change.

Estimates of the Company's proved domestic reserves were prepared by Larry Krause Consulting, an independent engineering firm in Billings, Montana. Estimates of the Company's proved Polish reserves were prepared by RPS Energy, an independent engineering firm in the United Kingdom.

FX ENERGY, INC. AND SUBSIDIARIES
Supplemental Information
--continued--

Proved Developed Reserves:

The following unaudited summary of proved developed reserve quantity information represents estimates only and should not be construed as exact:

	Crude Oil		Natural Gas	
	United States	Poland	United States	Poland
	(In thousand barrels of oil)		(In millions of cubic feet)	
December 31, 2008	45	47	--	7,873
December 31, 2007	482	14	--	5,288
December 31, 2006	382	202	--	11,382

Total Proved Reserves:

The following unaudited summary of proved developed and undeveloped reserve quantity information represents estimates only and should not be construed as exact:

	Crude Oil		Natural Gas	
	United States	Poland	United States	Poland
	(In thousand barrels of oil)		(In millions of cubic feet)	
December 31, 2008:				
Beginning of year	482	14	--	31,116
Extensions or discoveries ⁽¹⁾	--	--	--	11,295
Revisions of previous estimates ⁽²⁾	(371)	37	--	4,152
Production	(66)	(4)	--	(1,251)
End of year	<u>45</u>	<u>47</u>	<u>--</u>	<u>45,312</u>
December 31, 2007:				
Beginning of year	382	202	--	19,264
Extensions or discoveries ⁽³⁾	--	--	--	17,939
Revisions of previous estimates ⁽⁴⁾	170	(163)	--	(4,247)
Production	(70)	(25)	--	(1,840)
End of year	<u>482</u>	<u>14</u>	<u>--</u>	<u>31,116</u>
December 31, 2006:				
Beginning of year	408	209	--	19,788
Revisions of previous estimates	50	2	--	(63)
Production	(76)	(9)	--	(461)
End of year	<u>382</u>	<u>202</u>	<u>--</u>	<u>19,264</u>

- (1) Volume increase in Poland attributable to new Kromolice-1 well drilled during 2008.
(2) Positive gas revisions in Poland attributable to Sroda-4 and Zaniemysl-3 wells due to additional technical data acquired during 2008. Negative oil revisions due to lower year-end oil prices in the United States.
(3) Volume increase in Poland attributable to new Roszkow-1 well drilled during 2007.
(4) Negative oil and gas revisions in Poland attributable to Wilga-4 well due to water encroachment. Positive oil revisions due to higher year-end oil prices in the United States.

FX ENERGY, INC. AND SUBSIDIARIES
Supplemental Information
--continued--

Standardized Measure of Discounted Future Net Cash Flows (“SMOG”) and Changes Therein Relating to Proved Oil Reserves

Estimated discounted future net cash flows and changes therein were determined in accordance with SFAS No. 69, “Disclosures about Oil and Gas Activities.” Certain information concerning the assumptions used in computing the valuation of proved reserves and their inherent limitations are discussed below. The Company believes such information is essential for a proper understanding and assessment of the data presented. The assumptions used to compute the proved reserve valuation do not necessarily reflect the Company’s expectations of actual revenues to be derived from those reserves nor their present worth. Assigning monetary values to the reserve quantity estimation process does not reduce the subjective and ever-changing nature of such reserve estimates. Additional subjectivity occurs when determining present values because the rate of producing the reserves must be estimated. In addition to errors inherent in predicting the future, variations from the expected production rates also could result directly or indirectly from factors outside the Company’s control, such as unintentional delays in development, environmental concerns and changes in prices or regulatory controls. The reserve valuation assumes that all reserves will be disposed of by production. However, if reserves are sold in place, additional economic considerations also could affect the amount of cash eventually realized. Future development and production costs are computed by estimating expenditures to be incurred in developing and producing the proved oil reserves at the end of the period, based on period-end costs and assuming continuation of existing economic conditions. A discount rate of 10% per year was used to reflect the timing of the future net cash flows. The future net cash flows for the Company’s Polish reserves are based on a gas and condensate sales contract the Company has with POGC.

The components of SMOG are detailed below:

	<u>United States</u>	<u>Poland</u>	<u>Total</u>
	(In thousands)		
December 31, 2008:			
Future cash flows	\$ 1,103	\$ 239,220	\$ 240,323
Future production costs	(510)	(14,310)	(14,820)
Future development costs	--	(16,720)	(16,720)
Future income tax expense	--	(29,270)	(29,270)
Future net cash flows	<u>593</u>	<u>178,920</u>	<u>179,513</u>
10% annual discount for estimated timing of cash flows	(275)	(61,670)	(61,945)
Discounted net future cash flows	<u>\$ 318</u>	<u>\$ 117,250</u>	<u>\$ 117,568</u>
December 31, 2007:			
Future cash flows	\$ 39,056	\$ 179,698	\$ 218,754
Future production costs	(22,459)	(15,051)	(37,510)
Future development costs	--	(10,029)	(10,029)
Future income tax expense	--	(16,835)	(16,835)
Future net cash flows	<u>16,597</u>	<u>137,783</u>	<u>154,380</u>
10% annual discount for estimated timing of cash flows	(5,130)	(46,282)	(51,412)
Discounted net future cash flows	<u>\$ 11,467</u>	<u>\$ 91,501</u>	<u>\$ 102,968</u>
December 31, 2006:			
Future cash flows	\$ 19,719	\$ 103,903	\$ 123,622
Future production costs	(13,511)	(12,046)	(25,557)
Future development costs	--	(2,502)	(2,502)
Future income tax expense	--	(4,595)	(4,595)
Future net cash flows	<u>6,208</u>	<u>84,760</u>	<u>90,968</u>
10% annual discount for estimated timing of cash flows	(1,643)	(25,568)	(27,211)
Discounted net future cash flows	<u>\$ 4,565</u>	<u>\$ 59,192</u>	<u>\$ 63,757</u>

FX ENERGY, INC. AND SUBSIDIARIES
Supplemental Information
--continued--

The principal sources of changes in SMOG are detailed below:

	Year Ended December 31,		
	2008	2007	2006
	(In thousands)		
SMOG sources:			
Balance, beginning of year	\$ 102,968	\$ 63,757	\$ 41,915
Sale of oil and gas produced, net of production costs.....	(10,053)	(11,364)	(3,886)
Net changes in prices and production costs	(9,220)	7,866	16,111
Acquisition of minerals in place	--	--	--
Extensions and discoveries, net of future costs	27,000	62,343	--
Changes in estimated future development costs	(4,940)	(5,022)	3,953
Previously estimated development costs incurred during the year ..	--	420	580
Revisions in previous quantity estimates	10,383	(13,561)	(169)
Accretion of discount.....	10,297	6,376	4,192
Net change in income taxes	(7,941)	(8,008)	1,911
Changes in rates of production and other	(926)	161	(850)
Balance, end of year	<u>\$ 117,568</u>	<u>\$ 102,968</u>	<u>\$ 63,757</u>