

PetroFalcon Corporation

Consolidated Financial Statements
December 31, 2006, and 2005
(expressed in U.S. dollars)

PetroFalcon Corporation

Consolidated Balance Sheets

As of December 31, 2006, and 2005

(expressed in U.S. dollars)

	2006 \$	2005 \$
Assets		
Current assets		
Cash	11,894,574	9,297,444
Accounts receivable (note 5)	13,297,485	14,378,285
Income tax recoverable	1,454,140	412,423
Future income tax (note 14)	-	1,082,375
	<hr/>	<hr/>
	26,646,199	25,170,527
Property and equipment (note 8)	<hr/>	<hr/>
	50,538,243	46,004,470
	<hr/>	<hr/>
	77,184,442	71,174,997
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	10,022,193	4,801,490
Income tax payable	459,654	-
Short-term debt (note 10)	11,912,791	10,081,395
	<hr/>	<hr/>
	22,394,638	14,882,885
Future income tax liability (note 14)	-	769,833
Long-term debt (note 10)	-	8,000,000
Provision for employee future benefits (note 12)	546,130	-
Provision for asset retirement obligation (note 11)	431,983	522,557
	<hr/>	<hr/>
	23,372,751	24,175,275
Shareholders' equity		
Capital stock (note 9)	51,547,584	40,797,542
Warrants (note 9)	118,571	118,571
Contributed surplus (note 9)	6,025,665	3,268,067
Retained earnings (accumulated deficit)	<hr/>	<hr/>
	(3,880,129)	2,815,542
<i>Going Concern (note 1)</i>	<hr/>	<hr/>
	53,811,691	46,999,722
	<hr/>	<hr/>
	77,184,442	71,174,997

Approved by the Board of Directors

"William Gumma" Director
William Gumma

"Juan Francisco Clerico" Director
Juan Francisco Clerico

PetroFalcon Corporation

Consolidated Statements of Operations and Retained Earnings (Accumulated Deficit) For the years ended December 31, 2006, and 2005

(expressed in U.S. dollars)

	2006 \$	2005 \$
Revenue		
Oil and gas (note 3)	11,132,030	11,325,144
Royalties	(2,667,400)	-
Special advantage tax	(1,299,409)	-
	<u>7,165,221</u>	<u>11,325,144</u>
Expenses		
Operating, maintenance and transportation	4,346,236	3,096,612
General and administrative	2,951,380	3,729,895
Amortization, depletion and accretion	1,696,762	1,719,861
Stock-based compensation (notes 4 & 9)	2,809,668	1,995,000
	<u>11,804,046</u>	<u>10,541,368</u>
Income (loss) before other income (expenses) and income taxes	<u>(4,638,825)</u>	<u>783,776</u>
Other income (expenses)		
Interest on long-term debt	(2,186,973)	(1,392,568)
Interest on bank deposits	328,020	260,324
Gain on financing transactions (note 6)	758,279	2,443,876
Gain on foreign exchange	275	116,731
Other income (note 5)	402,613	-
	<u>(697,786)</u>	<u>1,428,363</u>
Income (loss) before income taxes	(5,336,611)	2,212,139
Income taxes (note 14)		
– current	(1,015,632)	(1,515,078)
– future	(343,428)	312,542
	<u>(1,359,060)</u>	<u>(1,202,536)</u>
Net income (loss)	(6,695,671)	1,009,603
Retained earnings— Beginning of year	<u>2,815,542</u>	<u>1,805,939</u>
Retained earnings (accumulated deficit) – End of year	<u>(3,880,129)</u>	<u>2,815,542</u>
Weighted average number of common shares outstanding	<u>81,981,372</u>	<u>76,404,818</u>
Basic and diluted earnings (loss) per share (note 18)	(0.08)	0.01
<i>Going Concern (note 1)</i>		

PetroFalcon Corporation

Consolidated Statements of Cash Flows

For the years ended December 31, 2006, and 2005

(expressed in U.S. dollars)

	2006 \$	2005 \$
Cash provided by (used in)		
Operating activities		
Net income (loss)	(6,695,671)	1,009,603
Items not affecting cash		
Amortization, depletion and accretion	1,696,762	1,719,861
Other	1,098,673	92,374
Foreign exchange expense (recovery)	(30,886)	-
Future income tax	343,428	(312,542)
Stock-based compensation	2,809,668	1,995,000
	<u>(778,026)</u>	<u>4,504,296</u>
Net change in non-cash working capital items		
Accounts receivable	2,995,621	(10,067,651)
Accounts payable and accrued liabilities	3,105,859	1,050,565
Income taxes (payable) recoverable – net	246,927	(409,645)
	<u>5,570,381</u>	<u>(4,922,435)</u>
Financing activities		
Issuance of warrants	-	118,571
Restricted cash	-	3,600,000
Issuance of debt	1,831,396	19,255,874
Proceeds received on exercise of share options	135,471	241,055
	<u>1,966,867</u>	<u>23,215,500</u>
Investing activities		
Purchase of West Falcon Hydrocarbons, S.R.L. (note 7)	(2,016,214)	-
Acquisition of property and equipment	(5,006,699)	(31,228,642)
Movement in non-cash working capital from investing activities	2,082,794	1,787,219
	<u>(4,940,119)</u>	<u>(29,441,423)</u>
Net (decrease) increase in cash during year	2,597,129	(11,148,358)
Cash – Beginning of year	9,297,444	20,445,802
Cash – End of year	<u>11,894,574</u>	<u>9,297,444</u>
Supplementary information		
Interest paid	1,879,930	1,367,232
Income taxes paid	1,000,027	1,743,897

PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2006, and 2005

(expressed in U.S. dollars)

1 Going Concern

These financial statements have been prepared in accordance with Canadian GAAP on a going concern basis, which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. Should the Corporation be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due.

The Corporation reported a net loss of \$6.7 million for the year ended December 31, 2006, and the Corporation had a working capital surplus of \$4.3 million at December 31, 2006. The Corporation's ability to continue as a going concern is dependent upon the Corporation's ability to raise capital; the success of any drilling and exploration program; and the ability to access funds from PetroCumarebo. There can be no assurance that the Corporation will be successful with any of these initiatives. The accompanying financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Corporation be unable to continue as a going concern.

2 Description of business

PetroFalcon Corporation (the "Corporation") is engaged in the exploration, development, production and management of oil and natural gas properties through its indirect wholly-owned subsidiary, Vinccler Oil and Gas, C.A. ("Vinccler Venezuela"), which owns 40% of the joint venture company ("Empresa Mixta"), PetroCumarebo, S.A. ("PetroCumarebo").

PetroFalcon's revenues for the first three months ended March 31, 2006, were derived from the East Falcon Block under the Operating Service Agreement ("East Falcon OSA") with Petróleos de Venezuela, S.A. ("PDVSA"), the state-owned oil and gas company of Venezuela. Effective March 21, 2006, Vinccler Venezuela completed the acquisition of West Falcon Hydrocarbons, S.R.L. ("West Falcon"), a subsidiary of Samson International LLC, which owned a separate Operating Service Agreement for the West Falcon Block ("West Falcon OSA"). PetroFalcon's revenues for the nine months ended December 31, 2006, were derived from Vinccler Venezuela's proportional share of PetroCumarebo's revenues.

Empresa Mixta Creation

On March 31, 2006, Vinccler Venezuela reached an initial agreement with the Venezuelan government with respect to its oil and natural gas rights in Venezuela. Vinccler Venezuela signed a Memorandum of Understanding ("MOU") with Corporación Venezolana del Petróleo ("CVP"), an affiliate of PDVSA, to create an Empresa Mixta, later incorporated as PetroCumarebo, which would hold all the operating rights to the East Falcon Block and West Falcon Block.

PetroCumarebo Conversion Contract

On September 29, 2006, Vinccler Venezuela and CVP executed the Empresa Mixta Conversion Agreement ("Conversion Contract"), which identified PetroCumarebo and confirmed the ownership structure as 40% held by Vinccler Venezuela and 60% held by CVP. In accordance with the MOU, the Conversion Contract also established the following general terms for the Empresa Mixta:

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For the years ended December 31, 2006, and 2005

(expressed in U.S. dollars)

- The effective date of PetroCumarebo is April 1, 2006;
- PetroCumarebo has the exclusive right to explore for, develop and produce oil and natural gas in its area of operations (838,000 acres) for a term of 20 years;
- PetroCumarebo can only sell its oil and natural gas production to PDVSA;
- PetroCumarebo pays a royalty of 33.3% on oil and natural gas production;
- PetroCumarebo has an applicable income tax rate of 50%;
- PetroCumarebo pays a “special advantage” tax, which requires that if in any year the aggregate amount of royalties, taxes and certain other contributions is less than 50% of the gross value of the hydrocarbons produced, PetroCumarebo must pay the Venezuelan government the difference;
- When there are sufficient net and available profits, and subject to the prior approval of the shareholders, Vinccler Venezuela may receive annual dividends in US dollars, or quarterly loans against those projected dividends, derived from its 40% participation; and
- Vinccler Venezuela, as a 40% shareholder, will be responsible for 40% of PetroCumarebo’s capital expenditures and operating expenses, if no other means of financing is available.

PetroCumarebo Joint Control

The Conversion Contract provides specific legal protections for Vinccler Venezuela as the minority partner:

- Vinccler Venezuela has the right to nominate the Technical and Operations Manager;
- Certain matters require the approval of the ownership of at least 75% of the shares of PetroCumarebo;
- Each shareholder has the right to nominate a percentage of management personnel equal to its share ownership; and
- Budgets and work programs must be consistent with the business plan appended to the Conversion Contract as approved by Vinccler Venezuela and CVP.

PetroCumarebo Transitional Period

Vinccler Venezuela agreed with PDVSA to continue operating its oil and gas assets (the “East Falcon Block and West Falcon Block”) during a transitional period between April 1, 2006, and December 31, 2006, (“Transitional Period”) under the following general terms:

- PDVSA paid royalties on behalf of PetroCumarebo for oil and natural gas delivered from the East Falcon Block and West Falcon Block;

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For the years ended December 31, 2006, and 2005

(expressed in U.S. dollars)

- Vinccler Venezuela was reimbursed by PDVSA for 100% of capital expenditures and operating expenses incurred by Vinccler Venezuela on behalf of PetroCumarebo related to the East Falcon Block and West Falcon Block; and
- Vinccler Venezuela delivered oil and natural gas production from the East Falcon Block and West Falcon Block on behalf of PetroCumarebo to PDVSA, which will be invoiced later by PetroCumarebo.

On October 24, 2006, PetroCumarebo, S.A. was legally incorporated as the joint venture entity described in the Conversion Contract. On November 24, 2006, PetroCumarebo received the presidential transfer decree to operate the East Falcon Block and West Falcon Block, the ceremonial last step in the conversion from the East Falcon OSA and West Falcon OSA to PetroCumarebo. On December 28, 2006, as required by the Conversion Contract, Vinccler Venezuela contributed its 40% share of PetroCumarebo's first month of working capital, a total of approximately \$2.1 million (U.S.\$200,000 and 4.1 billion Bolivars). As a result of the conversion to PetroCumarebo, management has included Vinccler Venezuela's proportional share of PetroCumarebo's revenues and earnings in PetroFalcon's consolidated financial statements as of December 31, 2006.

PetroCumarebo Dividends

Under Venezuelan law, dividends can only be declared to the extent a company has net and available profits as stated in a company's approved financial statements. Therefore, if there are sufficient net and available profits, subject to the prior approval of the shareholders, PetroFalcon, through Vinccler Venezuela, may receive annual dividends in US dollars, or quarterly loans against those projected dividends. If PetroCumarebo's board of directors does not propose dividends, or PetroCumarebo's shareholders do not approve dividends, or PetroCumarebo does not have net and available profits to declare dividends, Vinccler Venezuela cannot expect to receive payment from PetroCumarebo. Dividends from PetroCumarebo must be proposed by four out of the five board members (80%), and Vinccler Venezuela only has two out of the five board seats (40%). Dividends proposed by the board are approved by a qualified majority (75%) of the shareholders, and Vinccler Venezuela only accounts for 40% of the shareholders. Given PetroCumarebo's large non-cash charges for depreciation and the resulting losses reported in its financial statements, PetroCumarebo may not be able to legally declare dividends for the foreseeable future.

PetroCumarebo Funding

As of March 30, 2007, Vinccler Venezuela has been reimbursed by PDVSA for the operating and capital expenditures advanced by Vinccler Venezuela on behalf of PetroCumarebo during the Transitional Period in the second, third and fourth quarters of 2006. PetroCumarebo is now operating as an independent entity with its own working capital, and funds are no longer advanced by Vinccler Venezuela for subsequent reimbursement by PDVSA. PetroCumarebo is now operating on contributed working capital and will finance its future operations through cash flow from operations, cash calls to shareholders (Vinccler Venezuela and CVP) and/or through debt using its own balance sheet.

Due to the Empresa Mixta Transitional Period, PetroCumarebo was not able to officially invoice PDVSA for oil production delivered in the second, third and fourth quarters of 2006 until March 29, 2007.

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PetroCumarebo has now invoiced PDVSA for oil production (net of royalties), and PDVSA has officially received the invoice, totaling approximately \$12.3 million. PetroCumarebo should receive payment from PDVSA within 45 days in accordance with the terms of the Conversion Contract. PetroCumarebo has not yet officially invoiced PDVSA for natural gas production delivered in the second, third and fourth quarters of 2006 (an amount equal to approximately \$1.7 million net of royalties), because it has not yet received confirmation from the Ministry of Energy and Petroleum (“MEP”) for the natural gas volumes delivered during this period. However, PetroCumarebo expects to finalize the natural gas invoice in the second quarter of 2007.

PDVSA has paid royalties on the oil and natural gas production on behalf of PetroCumarebo, and PDVSA has reimbursed Vinccler Venezuela for 100% of the operating and capital expenditures for the Transitional Period. Given the sequence of events and the recent submission of the initial invoice to PDVSA, PetroCumarebo does not have a history of payment from PDVSA under the Conversion Contract. Until the parties have established a pattern of invoicing and receiving payment, it is possible that amounts invoiced may not be paid by PDVSA in a timely manner in accordance with the terms of the Conversion Contract.

3 Measurement uncertainty

During the second, third and fourth quarters of 2006, the Corporation delivered oil and natural gas to PDVSA on behalf of PetroCumarebo. The Conversion Contract provides different formulas to price deliveries of crude oil and natural gas. Due to the various procedures involved in incorporating a new company (PetroCumarebo) with a pre-incorporation effective date (April 1, 2006), PetroCumarebo was not able to invoice PDVSA for oil production delivered between April 1 and December 31, 2006, until March 29, 2007. In addition, as of March 30, 2007, PetroCumarebo has still not been able to invoice PDVSA for natural gas production delivered between April 1 and December 31, 2006. PetroCumarebo expects to invoice PDVSA for natural gas production as soon as it receives confirmation from MEP of the natural gas volumes delivered to PDVSA for this period. Due to the joint control established by the terms of the Conversion Contract, the Corporation’s share of PetroCumarebo’s revenues and accounts receivable have been recorded for the period April 1 to December 31, 2006. As of March 30, 2007, no cash has been received by PetroCumarebo from PDVSA related to this revenue, but PetroCumarebo expects to receive payment from PDVSA within 45 days of invoicing. PDVSA has paid royalties on the oil and natural gas production on behalf of PetroCumarebo, and PDVSA has reimbursed Vinccler Venezuela for 100% of the operating and capital expenditures for the Transitional Period. Given the sequence of events and the recent submission of the initial invoice to PDVSA, PetroCumarebo does not have a history of payment from PDVSA under the Conversion Contract. Until the parties have established a pattern of invoicing and receiving payment, it is possible that amounts invoiced may not be paid by PDVSA in a timely manner in accordance with the terms of the Conversion Contract.

4 Significant accounting policies

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”) and include the following significant accounting policies:

PetroFalcon Corporation

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For the years ended December 31, 2006, and 2005

(expressed in U.S. dollars)

Cash

Cash includes short-term and demand deposits with a term to maturity of three months or less when purchased and are recorded at cost.

Use of estimates

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reported years.

Balances that are significantly affected by estimates include amortization, depletion and accretion, stock-based compensation, future income tax, as well as provision for asset retirement obligations. Actual results could differ from these estimates.

Amounts used for the cost recovery calculation for the annual assessment of oil and gas properties are based on estimates of oil and natural gas reserves in the area covered by PetroCumarebo. The reserve estimates are reviewed annually by an independent engineering firm. By their nature, these estimates of reserves and future cash flows are subject to measurement uncertainty and the impact on the financial statements of future periods could be material.

Property and equipment

The Corporation follows the full cost method of accounting for oil and gas properties and related expenditures, whereby all costs relating to the exploration for and development of petroleum and natural gas reserves are capitalized and accumulated. Such costs include geological and geophysical studies, drilling, equipment and facilities, carrying charges on non-producing properties and related overhead. General and administrative expenses and interest are expensed as incurred. Unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proven reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion. Proceeds from the sale of oil and gas properties and equipment are applied against capitalized costs. Gains and losses are not recognized upon disposition of oil and natural gas properties unless such disposition would alter the rate of depletion by 20% or more. The costs are depleted on the unit-of-production method based on the estimated proven reserves that PetroCumarebo is able to produce by the end of the Conversion Contract in 2026. The ratio of production to proved reserves determines the proportion of depletable costs to be expensed. Undeveloped properties are excluded from the depletion calculation until quantities of proved reserves are found or impairment occurs. Other property and equipment is amortized using the straight-line method over their estimated useful lives of three years.

A ceiling test is performed at least annually to assess the carrying value of oil and gas assets. The assets are tested for recoverability using undiscounted future cash flows from proved reserves and forward indexed commodity prices, adjusted for contractual obligations and product quality differentials. The assets are written down to their fair value when the carrying value, less the cost of unproved properties, is in excess of the related undiscounted cash flows. Fair value is estimated using techniques that incorporate risk and

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Notes to Consolidated Financial Statements

For the years ended December 31, 2006, and 2005

(expressed in U.S. dollars)

uncertainty when determining expected future cash flows. Unproved properties are excluded from the ceiling test calculation and are subject to a separate impairment test.

The fair value of estimated asset retirement obligations is recognized in the Consolidated Balance Sheet when identified and a reasonable estimate of fair value can be made. Asset retirement obligations include those legal obligations where the Corporation will be required to retire tangible long lived assets. The asset retirement cost, equal to the initially estimated fair value of the asset retirement obligation, is capitalized as part of the cost of the related long-lived asset. Changes in the estimated obligation resulting from revisions to estimated timing or amount of undiscounted cash flows are recognized as a change in the asset retirement obligation and the related asset retirement cost. Asset retirement costs are amortized using the unit-of-production method. Increases in the asset retirement obligation resulting from the passage of time are recorded as accretion of asset retirement obligation in the Consolidated Statement of Operations. Actual expenditures incurred are charged against the accumulated obligation.

Expression of foreign currencies

These consolidated financial statements are presented and measured in U.S. dollars (“USD”), as substantially all of the Corporation’s operations are located in Venezuela where the Corporation uses the U.S. dollar as its functional currency. Transactions and balances using the Venezuelan Bolivar (“Bs”) are expressed in U.S. dollars using the temporal method at the official exchange rate (2,150 Bs/USD as of December 31, 2006, and 2005). Under this method, monetary assets and liabilities are expressed at the period-end exchange rate. Non-monetary assets and liabilities are expressed at historical exchange rates. Revenue and expenses are expressed at the weighted average exchange rate for the period. Exchange gains and losses from the expression of monetary items are included in the consolidated statements of operations and retained earnings (accumulated deficit).

Revenue

Oil and gas revenue is recognized at the time production is delivered to PDVSA with the remuneration in accordance with a formula set forth in the East Falcon OSA and its addendum approved on May 27, 2005, for the three months ended March 31, 2006. Revenue recognition from PetroCumarebo represents 40% of total oil and natural gas delivered to PDVSA from April 1 through December 31, 2006, with the remuneration in accordance with the formulas set forth in the Conversion Contract.

All royalty entitlements and “special advantage” taxes are reflected as reductions in revenue, and are accrued as the Corporation becomes liable for the payments.

Income taxes

Vinccler Venezuela files its Venezuelan income tax return using the Venezuelan Bolivar as the reporting currency in accordance with the Venezuelan income tax law which also provides regular adjustments for inflation. Vinccler Venezuela recognizes the effects of the inflation in non-monetary assets and liabilities through the application of the Consumer General Price Index, based on procedures established in the Venezuelan tax legislation. This adjustment for inflation is considered to be a taxable gain or, in the case of deflation, a deductible loss in determining the taxable income. As the majority of Vinccler Venezuela’s net assets are held in U.S. dollars but the tax return is filed in Venezuelan Bolivars, foreign currency exchange

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For the years ended December 31, 2006, and 2005

(expressed in U.S. dollars)

adjustments will produce either a taxable gain or a deductible loss. The variation between the Venezuelan statutory tax rate of 50% and the income tax rate presented in these financial statements is due to the adjustments required for inflation and foreign currency translation.

Future income taxes

Income taxes are calculated using the liability method of tax allocation accounting. Temporary differences arising from the difference between the tax basis of an asset or liability and its carrying amount on the balance sheet are used to calculate future income tax liabilities or assets. Future income tax liabilities or assets are calculated using the substantively enacted tax rates and laws that are expected to be in effect in the periods that the temporary differences are expected to reverse. The effect of changes in rates is included in earnings in the period which includes the substantive enactment of the rate changes. Temporary differences also arise due to fluctuations in the exchange rate between the U.S. dollar and the Venezuelan Bolivar that are not matched by corresponding rates of inflation in the same period.

Stock-based compensation

The Corporation records compensation cost in the consolidated financial statements for stock options granted using the Black-Scholes option-pricing model to determine its fair value. Compensation costs are recognized over the vesting period.

Reclassification

Certain information provided for prior years has been reclassified to conform to the current year presentation.

PetroCumarebo interest

Ownership in and results of operations from Vinccler Venezuela's interest in the PetroCumarebo joint venture is recorded under the proportionate consolidation method whereby only Vinccler Venezuela's 40% share of the assets, liabilities, revenue and expenses is recognized.

Vinccler Venezuela's interest in PetroCumarebo is proportionately consolidated as the Corporation has determined that Vinccler Venezuela has joint control of PetroCumarebo. PetroCumarebo's Conversion Contract requires the approval of 75% of the shareholders (being CVP and Vinccler Venezuela) to determine its strategic operating, investing and financing activities.

5 Accounts Receivable

At December 31, 2006, PetroFalcon had \$13.3 million (2005 - \$14.4 million) in accounts receivable.

The outstanding Accounts Receivable are mainly related to \$3 million (2005 - \$3 million) of IVA credit (Value Added Taxes) derived from the Corporation's expenditures during the year; \$4 million of expected reimbursements for expenses and capital investments incurred by Vinccler Venezuela related to

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(expressed in U.S. dollars)

PetroCumarebo's operations as of December 31, 2006 (See Note 2), and \$5.6 million, related to Vinccler Venezuela's 40% share in PetroCumarebo's oil and gas revenues.

Due to the Empresa Mixta Transitional Period, PetroCumarebo was not able to officially invoice PDVSA for oil production delivered in the second, third and fourth quarters of 2006 until March 29, 2007.

PetroCumarebo has now invoiced PDVSA for oil production (net of royalties), and PDVSA has accepted the invoice, totaling approximately \$12.3 million. PetroCumarebo expects payment from PDVSA within 45 days in accordance with the terms of the Conversion Contract. PetroCumarebo has not yet officially invoiced PDVSA for natural gas production delivered in the second, third and fourth quarters of 2006 (an amount equal to approximately \$1.7 million net of royalties), because it has not yet received confirmation from MEP for the natural gas volumes delivered during this period. However, PetroCumarebo expects to finalize the natural gas invoice in the second quarter of 2007.

PDVSA has paid royalties on the oil and natural gas production on behalf of PetroCumarebo, and PDVSA has reimbursed Vinccler Venezuela for 100% of the operating and capital expenditures for the Transitional Period. Given the sequence of events and the recent submission of the initial invoice to PDVSA, PetroCumarebo does not have a history of payment from PDVSA under the Conversion Contract. Until the parties have established a pattern of invoicing and receiving payment, it is possible that amounts invoiced may not be paid by PDVSA in accordance with the terms of the Conversion Contract (See note 3).

On November 1, 2006, PetroFalcon received a final settlement payment from previous shareholders for CDN \$450,000 relating to funds advanced to previous senior management for a residence and property purchased in the Czech Republic and repaid in accordance with a settlement agreement.

At December 31, 2005, PetroFalcon had \$7.4 million in accounts receivable related to the return of the bid for the Castilletes Block made by Vinccler Venezuela on November 15, 2005. This amount was repaid to Vinccler Venezuela by MEP on February 14, 2006.

6 Gain on financing transactions

During the year ended December 31, 2006, Vinccler Venezuela recorded a gain of \$0.8 million as a result of the acquisition and disposal of U.S. dollar denominated Venezuelan government bonds (2005-\$2.4 million)

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(expressed in U.S. dollars)

7 Acquisition of West Falcon

Effective March 21, 2006, Vinccler Venezuela completed the acquisition of West Falcon, a subsidiary of Samson International LLC, which owned a separate Operating Service Agreement for the West Falcon Block. The West Falcon OSA was converted pursuant to the Conversion Contract, and the oil and gas rights are now owned by PetroCumarebo. The purchase price consisted of a cash payment of \$2.55 million. In addition, PetroFalcon issued 1.75 million common shares of the Corporation (See note 9).

The business combination has been accounted for using the purchase method of accounting. The following table summarizes the purchase price allocation for the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition.

Cash	488,851
Accounts receivable	1,413,988
Property, plant and equipment	4,481,066
Income tax recoverable	339,886
Accounts payable	(761,216)
Asset retirement obligations	<u>(850,000)</u>
Total net assets acquired	<u>5,112,575</u>

Following the acquisition, Vinccler Venezuela owned 100% of the West Falcon OSA, which was contributed to PetroCumarebo as of April 1, 2006, pursuant to the Conversion Contract (see note 2). Effective October 30, 2006, PetroFalcon's indirect wholly-owned subsidiary, West Falcon Hydrocarbons, S.R.L., was merged into Vinccler Venezuela, and West Falcon Hydrocarbons, S.R.L. ceased to exist.

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(expressed in U.S. dollars)

8 Property and equipment

	2006		
	Cost	Accumulated	Net
	\$	amortization	\$
		and depletion	
		\$	
Petroleum and natural gas properties	52,119,954	(6,583,911)	45,536,043
Inventories	4,792,816	-	4,792,816
Other assets	733,188	(523,804)	209,384
	<u>57,645,958</u>	<u>(7,107,715)</u>	<u>50,538,243</u>

	2005		
	Cost	Accumulated	Net
	\$	amortization	\$
		and depletion	
		\$	\$
Petroleum and natural gas properties	45,622,789	(4,607,104)	41,015,685
Inventories	4,474,079	-	4,474,079
Other assets	1,196,113	(681,407)	514,706
	<u>51,292,981</u>	<u>(5,288,511)</u>	<u>46,004,470</u>

The prices used in the ceiling test evaluation of the Corporation's oil and gas assets for all future years at December 31, 2006, were \$61.04 per barrel of oil for the East Falcon Block, \$51.88 per barrel of oil for the West Falcon Block and \$1.50 per thousand cubic feet ("mcf") of natural gas for the East Falcon Block and West Falcon Block. At December 31, 2005, the prices used were \$53.75 per barrel of oil and \$1.33 per mcf of natural gas for the East Falcon Block. Prices used were obtained from the Corporation's independent engineering reserves report produced by Huddleston & Co., Inc.

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9 Capital stock

Authorized

Unlimited number of common shares

Unlimited number of preferred shares issuable in series

Issued

	Number of Shares	Amount \$
As at December 31, 2004	75,178,228	36,513,195
Conversion of long-term debt (note 10)	2,078,273	4,000,000
Exercise of stock options	374,906	241,055
Transfer from contributed surplus related to exercise of stock options	-	43,292
As at December 31, 2005	77,631,407	40,797,542
Issue of shares (note 7)	1,750,000	2,562,501
Conversion of long-term debt (note 10)	6,800,229	8,000,000
Exercise of share options	149,700	135,471
Transfer from contributed surplus related to exercise of stock options	-	52,070
As at December 31, 2006	<u>86,331,336</u>	<u>51,547,584</u>

Common stock

The common shares of PetroFalcon are all of the same class, are voting and entitle shareholders to receive dividends as and when declared by the Board of Directors. In the event of a liquidation, dissolution or winding up, the shareholders are entitled to receive equal distributions of net assets or any dividends that may be declared.

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Stock option plan

A summary of the status of the PetroFalcon's stock option plan and changes during the periods is presented below:

	2006		2005	
	Share Options	Weighted- average exercise price CDN\$	Share Options	Weighted- average exercise price CDN\$
Outstanding – beginning of year	8,896,194	1.86	7,420,000	1.67
Granted	1,925,000	1.72	1,931,500	2.38
Exercised	(149,700)	1.04	(374,906)	0.78
Cancelled	(265,000)	1.91	(80,400)	2.00
Outstanding – end of year	10,406,494	1.85	8,896,194	1.86
Options exercisable – December 31	7,302,649	1.68	4,515,029	1.34

A summary of stock options outstanding at December 31, 2006 is set out below:

Exercise price	Outstanding stock options		Exercisable stock options
	Number	Weighted average remaining contractual life	Number
\$0.50	250,000	1.06 years	250,000
\$0.72	100,000	0.12 years	100,000
\$1.00	3,298,654	6.44 years	3,298,654
\$1.13	75,000	9.63 years	25,000
\$1.23	150,000	9.99 years	0
\$1.30	13,340	7.75 years	13,340
\$1.45	40,000	9.50 years	10,000
\$1.55	480,000	9.19 years	235,000
\$1.93	980,000	9.25 years	490,000
\$2.05	30,000	8.83 years	10,000
\$2.20	290,000	7.25 years	193,332
\$2.35	1,870,000	7.45 years	1,246,663
\$2.38	300,000	9.75 years	100,000
\$2.39	1,529,500	8.45 years	663,994
\$3.28	1,000,000	7.93 years	666,666
	<u>10,406,494</u>		<u>7,302,649</u>

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The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with weighted average assumptions for grants as follows:

Risk-free interest rate	3.33%
Expected volatility	60%
Dividends yield rate	0.00%
Weighted average expected life of options	5 years

Issue of warrants

On June 28, 2005, PetroFalcon issued 100,000 warrants with an exercise price of CDN\$2.17 per warrant in connection with the IFC financing. There were no proceeds received by the Corporation from the issue of warrants. Each warrant is exercisable into one common share of PetroFalcon until June 30, 2007. As of December 31, 2006, these warrants remained outstanding.

West Falcon equity payment

On March 21, 2006, PetroFalcon issued 1,750,000 common shares at a price of CDN\$1.71 per share as part of the purchase of West Falcon, a subsidiary of Samson International LLC (see note 7), at a total cost of CDN\$2.984 million (\$2.563 million).

Conversion of long-term debt

On June 26, 2005, PetroFalcon issued 2,078,273 common shares at a price of CDN\$2.37 per share as a result of the conversion of \$4,000,000 of long-term debt (see note 10). On April 20, 2006, PetroFalcon issued 2,639,651 common shares at a price of CDN\$1.77 per share as a result of the conversion of \$4,000,000 of long-term debt (see note 10). On December 11, 2006, PetroFalcon issued 4,160,578 common shares at a price of CDN\$1.11 per share as a result of the conversion of the remaining \$4,000,000 of long-term debt (see note 10).

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10 Debt

The Corporation's debt consists of the following:

	2006 \$	2005 \$
Due to Venezolana de Inversiones y Construcciones Clerico, C.A. (Vinccler Construction) with no specific terms for repayment, unsecured and non-interest bearing (See note 13)	350,000	3,000,000
Unsecured bank loans bearing annual interest at 12%,90 day revolving basis, payable in Bolivars	11,562,791	7,081,395
Due to International Finance Corporation bearing annual interest at LIBOR plus 1%, with maturity in 2011	-	8,000,000
	<u>11,912,791</u>	<u>18,081,395</u>
Short-Term	11,912,791	10,081,395
Long-Term	-	8,000,000

During 2005, the Corporation reached an agreement with the IFC, pursuant to which the IFC would provide up to \$36 million in two loans ("A" and "C") to Vinccler Venezuela for the development of the Corporation's oil and gas properties. During the second quarter of 2005, the IFC disbursed \$12 million from the "C" Loan. Principal repayments on the "C" Loan were due in 2011. Interest was payable semi-annually on May 15 and November 15 at the London Inter Bank Offered Rate ("Libor") plus 1% for the "C" Loan from September 27, 2005, the date of the full disbursement of the "C" loan. IFC was also entitled to receive 3% of Vinccler Venezuela's cash flow as Additional Interest as long as it did not exceed 10% per annum of the principal amount of the "C" loan on an aggregate accumulated basis.

On June 26, 2005, the IFC provided notice pursuant to the terms of the "C" Loan Agreement of its intention to convert \$4 million of its outstanding loan into common shares of PetroFalcon Corporation. The IFC received 2,078,273 shares at an average price of CDN\$2.37 per share based on the market-weighted average share price over the previous 20 trading days to the notice date (see note 9).

On April 5, 2006, the IFC again provided notice pursuant to the terms of the "C" Loan Agreement of its intention to convert another \$4 million of its outstanding loan into common shares of PetroFalcon Corporation. The IFC received 2,639,651 shares at an average price of CDN\$1.77 per share based on the market-weighted average share price over the previous 20 trading days to the notice date (see note 9).

On October 12, 2006, Vinccler Venezuela gave notice to the IFC to cancel the "A" Loan option, effective November 11, 2006.

On December 8, 2006, the IFC provided notice of its intention to convert the remaining \$4 million of its outstanding loan into common shares of PetroFalcon. The IFC received 4,160,578 shares at an average price of CDN\$1.11 per share based on the market-weighted average share price over the previous 20 trading days to the notice date (see note 9).

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11 Asset retirement obligations

The following table presents the reconciliation of the beginning and ending aggregate asset retirement obligation associated with the retirement of oil and gas properties:

	2006	2005
	\$	\$
Asset retirement obligation, beginning of year	522,557	347,720
Liabilities recorded during the period	-	139,943
Accretion expense	-	34,894
Net reduction of obligation as a result of contribution of oil and gas activities to PetroCumarebo	(90,574)	-
Asset retirement obligation, end of year	<u>431,983</u>	<u>522,557</u>

The total undiscounted amount of the estimated cash flows required to settle the obligations is \$933,894 (2005 - \$570,000), which has been discounted using a credit-adjusted risk free rate of 12%. Payments to settle the obligations will occur on an ongoing basis over the next 20 years.

12 Employee future benefits

Pension Plan

PetroCumarebo participates in a multi-employer defined benefit pension scheme administered by PDVSA (“Pension Plan”), through a joint trust with Vinccler Venezuela and CVP for its employees. The Corporation’s portion of the current service cost for this plan for the year ended December 31, 2006, was approximately \$23,464.

Under the terms of employment given by PetroCumarebo to former Vinccler Venezuela employees, years worked under the OSA will be recognised as if the employee had worked in PetroCumarebo. During 2006, PetroCumarebo also recognised a liability for past service costs for employees that migrated from the OSA to PetroCumarebo. This liability for past service cost recognized was \$234,640.

13 Related party transactions and balances

Pacific Oil and Gas, LLC and Vinccler Construction are controlled by officers of PetroFalcon. For the year ended December 31, 2006, the Corporation paid to Pacific Oil and Gas, LLC, controlled by PetroFalcon’s Vice-Chairman, Clarence Cottman and the Corporation’s President, William Gumma, \$840,000 for professional services (\$840,000, for the year ended December 31, 2005).

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PetroFalcon also receives construction services provided by Venezolana de Inversiones y Construcciones Clerico, C.A. an independent operating construction company controlled by the Corporation's Chairman of the Board and Chief Executive Officer, Juan Francisco Clerico. During the year ended December 31, 2006, PetroFalcon was invoiced \$11,669 for construction services from Venezolana de Inversiones y Construcciones Clerico, C.A ("Vinccler Construction") (\$1.8 million during the year ended December 31, 2005). On August 25, 2006, Vinccler Construction paid on behalf of Vinccler Venezuela the amount of \$350,000 to purchase the data package for the Delta Caribe offshore natural gas bid process in Venezuela. This amount has not been repaid as of December 31, 2006.

On November, 26, 2005, Vinccler Venezuela received a short-term loan for the amount of \$3 million from its Chief Executive Officer. The purpose of the facility was to finance the bid for the Castilletes Noreste II Block in the Rafael Urdaneta Phase B lease sale in the Gulf of Venezuela (the "Block"). On February 15, 2006, the short-term loan received by Vinccler Venezuela from its Chief Executive Officer was fully repaid.

These related party transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

14 Income Tax

During the year ended December 31, 2006, the Corporation recorded a current income tax expense of \$1.0 million (\$1.5 million during the year ended December 31, 2005) out of which \$473,243 was related to PetroFalcon and \$542,389 was related to Vinccler Venezuela. During 2005, Vinccler Venezuela received tax assessments from the National Integrated Customs and Tax Administration Service ("SENIAT"), the Venezuelan tax authorities, with respect to the income tax returns for the years ended December 31, 2001, to 2004 for a total of \$3.3 million (Bs. 7.7 billion), payable in nominal Bolivars (the local currency). The revised tax assessment was mainly due to the SENIAT's reinterpretation of Vinccler Venezuela's business purpose. The SENIAT stresses that under its income tax laws, Vinccler Venezuela is an oil and gas producing company instead of an operating service company. Thus, the income tax expense for the audited years had to be recalculated at the rate of 50% (rather than the previous rate of 34%). On January 26, 2006, Vinccler Venezuela filed a discharge claim with SENIAT. During the three months ended March 31, 2006, Vinccler Venezuela received the final settlement resulting in additional income tax expense of \$542,389 for the years ended December 31, 2001, to 2004. During the nine months ended September 30, 2006, the SENIAT performed a review of Vinccler Venezuela's income tax expense for the fiscal year ended December 31, 2005. The review concluded that no amount was due to the SENIAT. During the year ended December 31, 2006, the corporation realized a future income tax asset of \$851,258 related to Vinccler Oil and Gas Corporation and PetroFalcon Corporation's carry-forward losses and reduced Vinccler Venezuela's future income tax asset of \$262,003. In addition, Vinccler Venezuela reversed future income tax liability of \$769,833 related to a timing difference in the financial and fiscal treatment of fixed assets transferred to PetroCumarebo.

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A reconciliation of the consolidated income tax expense for 2006 and 2005 is set forth below:

	2006	2005
	\$	\$
Earnings (loss) before taxes	(5,336,611)	2,212,139
Combined statutory income tax	34%	34%
	(1,814,448)	752,127
Increase (decrease) resulting from:		
Benefit of tax losses not recognized	1,812,431	465,868
Non taxable transactions	(534,996)	(2,340,359)
Non deductible expenses	1,677,400	678,300
Inflation adjustments (Venezuela)	(329,821)	(283,041)
Benefit of recognizing previous years' losses	(914,924)	(709,212)
Increase resulting from taxation in Venezuela	921,029	353,942
Property and equipment	-	769,833
Additional income tax from tax assessment	542,389	1,515,078
	<u>1,359,060</u>	<u>1,202,536</u>

The Corporation's future income tax asset (liability) is comprised of the following tax-affected temporary differences:

	2006	2005
	\$	\$
Foreign exchange losses	-	820,372
Operating loss carry-forwards	-	365,119
Provisions	-	373,162
Valuation allowance	-	(476,279)
Difference in property basis	-	(769,832)
	<u>-</u>	<u>312,542</u>

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15 Financial instruments

The Corporation is exposed to fluctuations in commodity prices, interest rates and Canada/U.S. dollars and Venezuelan Bolivar/U.S. dollars exchange rates. The Corporation, where appropriate, utilizes financial instruments to manage its exposure to these risks. During the year, the Corporation did not hold or issue any derivative financial instruments. The Corporation's financial assets and liabilities as at December 31, 2006 and 2005 included cash, accounts receivable, accounts payable and short-term debt. Fair values approximate carrying values unless otherwise stated.

16 Economic dependence

The Corporation depends on annual dividend payments, and potential quarterly loans against those dividends, derived from its 40% interest in PetroCumarebo. Any material failure of PetroCumarebo to be paid for the oil and natural gas production delivered to PDVSA would affect PetroCumarebo's ability to pay dividends, which would have a material adverse effect on the Corporation's business, financial condition and results of operations. In addition, any decision by PetroCumarebo not to pay dividends to its shareholders would have a material adverse effect on the Corporation's business, financial condition and results of operations.

17 Commitments

At December 31, 2006, the Corporation's significant commitments were derived from its participation in PetroCumarebo, which had one drilling rig contracted for 8 months expiring July 2007 for \$45,000 per month; two compressors leased for a total of \$7,242 per month; and four compressors leased for a period of 5 years with a total monthly payment of \$103,000 per month.

18 Earnings per share

	2006	2005
Net income (loss)	(\$6,695,671)	\$1,009,603
Weighted average number of common shares	81,981,372	76,404,818
Stock options and warrants*	3,648,654	7,996,194
Basic earnings per share	(\$0.08)	\$0.01
Diluted earnings per share*	(\$0.08)	\$0.01

* The calculation of diluted earnings per common share excludes 6,657,840 options and 100,000 warrants in 2006 and 1,000,000 options in 2005 as these would have been anti-dilutive to the calculation.

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19 Subsequent Events

On January 24, 2007, Vinccler Venezuela and Chevron Corporation (“Chevron”) signed a Heads of Terms agreement whereby Vinccler Venezuela will acquire a 30% working interest from Chevron in the offshore natural gas license for the Cardon III Block in the Gulf of Venezuela. Under the terms of the agreement effective January 1, 2007, Chevron remains operator and majority partner with a 70% interest. PDVSA retains the right to acquire up to 35% of the project after declaration of commerciality. The transaction is subject to the negotiation and execution of an assignment agreement and a joint operating agreement between Chevron and Vinccler Venezuela within 6 months of the effective date of January 1, 2007, as well as the receipt of approval from MEP within 12 months of the effective date.

On March 9, 2007, Vinccler Venezuela paid Chevron \$2.2 million, which included Vinccler Venezuela’s 30% of the 2005 bid bonus and all related costs before the effective date. Under the agreement, all funds paid by Vinccler Venezuela to Chevron will be returned without interest if MEP approval is denied.