

# **PetroFalcon Corporation**

Consolidated Financial Statements  
**December 31, 2007 and 2006**  
(expressed in U.S. dollars)

# PetroFalcon Corporation

## Consolidated Balance Sheets

As at December 31, 2007 and 2006

(expressed in U.S. dollars)

	2007 \$	2006 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash	4,773,930	11,894,574
Accounts receivable (note 5)	2,391,354	13,297,485
Income tax recoverable	958,807	1,454,140
	<u>8,124,091</u>	<u>26,646,199</u>
Investments in oil and gas activities:		
PetroCumarebo, S.A.	44,280,462	-
Cardon III Block	5,404,057	-
Other investments	350,000	-
Property and equipment	188,876	50,538,243
	<u>58,347,486</u>	<u>77,184,442</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	3,569,118	10,022,193
Income tax payable	-	459,654
Short-term debt (note 9)	2,492,857	11,912,791
	<u>6,061,975</u>	<u>22,394,638</u>
Provision for employees future benefits (note 10)	-	546,130
Provision for asset retirement obligation (note 11)	-	431,983
	<u>6,061,975</u>	<u>23,372,751</u>
<b>Shareholders' equity</b>		
<b>Capital stock (note 8)</b>	51,680,606	51,547,584
<b>Warrants (note 8)</b>	-	118,571
<b>Contributed surplus (note 8)</b>	8,072,330	6,025,665
<b>Accumulated deficit</b>	(7,467,425)	(3,880,129)
	<u>52,285,511</u>	<u>53,811,691</u>
	<u>58,347,486</u>	<u>77,184,442</u>

Approved by the Board of Directors

"William Gumma" Director  
William Gumma

"Clarence Cottman" Director  
Clarence Cottman

# PetroFalcon Corporation

Consolidated Statements of Operations, Comprehensive Operations  
and Retained Earnings (Accumulated Deficit)

For the years ended December 31, 2007 and 2006

(expressed in U.S. dollars)

	2007	2006
	\$	\$
<b>Revenue</b>		
Oil and gas (note 1)	-	11,132,030
Royalties	-	(2,667,400)
Special advantage tax	-	(1,299,409)
	-	7,165,221
<b>Expenses</b>		
Operating, maintenance and transportation	-	4,346,236
General and administrative	5,065,369	2,951,380
Depreciation, depletion and amortization	123,938	1,696,762
Stock-based compensation (note 8)	2,046,665	2,809,668
	7,235,972	11,804,046
<b>Loss before other income (expenses) and income taxes</b>	(7,235,972)	(4,638,825)
<b>Other income (expenses)</b>		
Interest on short-term debt	(1,414,568)	(2,186,973)
Interest on bank deposits	279,789	328,020
Gain on foreign transactions	-	758,279
Gain on foreign exchange	4,349,470	275
Other income (note 7)	515,912	402,613
	3,730,603	(697,786)
<b>Loss before income taxes</b>	(3,505,369)	(5,336,611)
<b>Income taxes (note 13)</b>		
– current	(81,927)	(1,015,632)
– future	-	(343,428)
	(81,927)	(1,359,060)
<b>Net loss and comprehensive loss</b>	(3,587,296)	(6,695,671)
<b>Retained earnings (accumulated deficit) – Beginning of year</b>	(3,880,129)	2,815,542
<b>Accumulated deficit – End of year</b>	(7,467,425)	(3,880,129)
<b>Weighted average number of common shares outstanding</b>	86,456,336	81,981,372
<b>Basic and diluted loss per share (note 15)</b>	(0.04)	(0.08)

# PetroFalcon Corporation

## Consolidated Statements of Cash Flows

For the years ended December 31, 2007 and 2006

(expressed in U.S. dollars)

	2007	2006
	\$	\$
<b>Cash provided by (used in)</b>		
<b>Operating activities</b>		
Net loss	(3,587,296)	(6,695,671)
Items not affecting cash		
Depreciation, depletion and amortization	123,938	1,696,762
Other	(118,571)	1,098,673
Foreign exchange expense (recovery)	-	(30,886)
Future income tax	-	343,428
Stock-based compensation	2,046,665	2,809,668
	<u>(1,535,264)</u>	<u>(778,026)</u>
Net change in non-cash working capital items		
Accounts receivable	10,906,131	2,995,621
Accounts payable and accrued liabilities	(6,453,076)	3,105,859
Income taxes (payable) recoverable – net	35,679	246,927
	<u>2,953,470</u>	<u>5,570,381</u>
<b>Financing activities</b>		
Reduction in PetroCumarebo cash	(2,112,167)	-
Issuance (repayment) of debt	(5,841,860)	1,831,396
Proceeds received on exercise of share options	133,022	135,471
	<u>(7,821,005)</u>	<u>1,966,867</u>
<b>Investing activities</b>		
Investment in affiliates	(2,225,626)	-
Acquisition of property and equipment, net of retirements	(27,483)	(5,006,699)
Purchase of West Falcon Hydrocarbons, S.R.L. (note 6)	-	(2,016,214)
Movement in non-cash working capital from investing activities	-	2,082,794
	<u>(2,253,109)</u>	<u>(4,940,119)</u>
<b>Net increase (decrease) in cash during year</b>	<b>(7,120,644)</b>	<b>2,597,129</b>
<b>Cash – Beginning of year</b>	<b>11,894,574</b>	<b>9,297,444</b>
<b>Cash – End of year</b>	<b>4,773,930</b>	<b>11,894,574</b>
<b>Supplementary information</b>		
Interest paid	1,403,293	1,879,930
Income taxes paid	1,354,521	1,000,027

# PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

## 1 Description of business

PetroFalcon Corporation (“PetroFalcon” or the “Company”) is engaged in the exploration, development, production and management of oil and natural gas properties in Venezuela.

### PetroCumarebo background

Through its wholly-owned Venezuelan subsidiary, Vinccler Oil and Gas, C.A. (“Vinccler Venezuela”), PetroFalcon owns 40% of PetroCumarebo, S.A. (“PetroCumarebo” or the “Empresa Mixta”).

PetroFalcon’s revenues for the 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”). 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”).

On September 29, 2006, Vinccler Venezuela and Corporación Venezolana del Petróleo (“CVP”), an affiliate of PDVSA, 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. Under the terms of the Conversion Contract, Vinccler Venezuela’s East Falcon OSA and West Falcon OSA were contributed to PetroCumarebo effective April 1, 2006.

### PetroCumarebo accounting

Prior to January 1, 2007, PetroFalcon considered its investment in and relationship with PetroCumarebo to be one of joint control and accordingly accounted for its 40%-interest in PetroCumarebo using proportional consolidation. In effect, PetroFalcon recognized 40% of PetroCumarebo’s revenues, expenses, assets and liabilities in PetroFalcon’s financial statements.

In 2007, PetroFalcon re-evaluated its relationship with PetroCumarebo and concluded that, for accounting purposes, PetroFalcon’s investment in PetroCumarebo does not currently meet the criteria for proportional consolidation or equity method accounting. Accordingly, PetroFalcon has accounted for PetroCumarebo using the cost method of accounting as the investment has been classified by the Company as an available for sale equity instrument that is not actively traded in a public market for the year ended December 31, 2007. Under the cost method, PetroFalcon does not recognize its 40%-share of revenues, expenses, assets or liabilities from PetroCumarebo and instead only recognizes income from the investment to the extent that dividends are declared by PetroCumarebo. As a result, PetroFalcon has no revenues for the year ended December 31, 2007, and has restated the first three quarters of 2007. For the year ended December 31, 2008, the Company intends to provide restated comparable quarters for the previous periods.

Despite this change for accounting purposes, PetroFalcon remains an oil and gas company carrying on active operations in Venezuela, and Management does not consider PetroFalcon to be a company with only passive investments.

# PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

## **PetroCumarebo dividends**

Under Venezuelan law, dividends can only be declared to the extent that 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 U.S. dollars, or quarterly loans against those projected dividends. If PetroCumarebo's board of directors does not propose dividends, 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.

## **Venezuelan currency exchange rate**

During the year, the Company reviewed the accounting for foreign currency transactions in Venezuela due to the increasing spread between the official rate and the implied market rate in Venezuela. It has been determined that as a consequence of the rapid decline in the valuation of the Venezuelan Bolivar as reflected in the implied market for foreign currencies in Venezuela that the method of translation from Bolivars to U.S. dollars using the official rate is no longer appropriate. As a result of this review, Management determined that Bolivar balances would be translated at implied market rates for the year ended December 31, 2007.

Recognizing the implied exchange rate of 5.74 BsF/USD in 2007 rather than the official exchange rate of 2.15 BsF/USD significantly decreases PetroFalcon's short-term Bolivar-denominated debt when converted to U.S. dollars. The recognition of the implied exchange rate also eliminates PetroFalcon's gain on currency transactions from previous quarters.

## **2 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:

### **Cash**

Cash includes short-term and demand deposits with a term to maturity of three months or less when purchased and are recorded at fair value upon initial recognition and subsequently measured at amortized 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. Actual results could differ from these estimates.

# **PetroFalcon Corporation**

## **Notes to Consolidated Financial Statements**

### **For the years ended December 31, 2007 and 2006**

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(expressed in U.S. dollars)

#### **Investments and principles of consolidation**

The consolidated financial statements include the accounts of all wholly-owned subsidiaries. All significant inter-company balances and transactions are eliminated upon consolidation. The Company accounts for “available-for-sale” investments that are not actively traded in a public market using the cost method of accounting (see note 1).

#### **Property and equipment**

Property and equipment are related to furniture and other assets and are stated at cost. Depreciation is computed using the straight-line method with depreciation rates based upon the estimated useful life of the property, which is generally 3 years.

At December 31, 2006, property and equipment were related to petroleum and natural gas, inventories and others. The cost was depleted on the unit-of-production method based on the estimated proven reserves that PetroCumarebo could produce by the end of the Conversion Contract in 2026. Other property and equipment were amortized using the straight-line method over their estimated useful lives of 3 years.

#### **Foreign currency**

These consolidated financial statements are presented and measured in U.S. dollars (“USD”), as substantially all of the Company’s operations are located in Venezuela where the Company uses the U.S. dollar as its functional currency.

#### **Revenue**

For the three months ended March 31, 2006, oil and gas revenue was recognized at the time production was 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. Revenue recognition from PetroCumarebo represented 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. During the same period, all royalty entitlements and “special advantage” taxes were reflected as reductions in revenue and were accrued as the Company became 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 that 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 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 adjustments will produce either a taxable gain or a deductible loss. The variation between the Venezuelan

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

### For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

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 asset and liability method of accounting. Temporary differences arising from differences 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 that 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 Company has a stock-based compensation plan that is described in note 8. The Company accounts for stock options using the fair value method, whereby compensation expense for stock options is measured at the fair value at the grant date using the Black-Scholes option pricing model and is recognized over the vesting period of the options granted.

#### **Reclassification**

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

### **3 Change in accounting policy and future accounting changes**

The Company adopted CICA Handbook Section 3855, "Financial Instruments – Recognition and Measurement", along with three companion standards, Section 1530 "Comprehensive Income" and Section 3865 "Hedges", and Section 3861 "Financial Instruments – Disclosure and Presentation" effective January 1, 2007, which include the following changes:

#### *Comprehensive Income*

Section 1530 introduces Comprehensive Income, which consists of net income and other comprehensive income ("OCI"). OCI represents changes in Shareholders' equity during a period arising from transactions and other events with non-owner sources and includes unrealized gains and losses on financial assets classified as available-for-sale, unrealized foreign currency translation gains or losses arising from self-sustaining foreign operations, net of hedging activities, and changes in the fair value of the effective portion of cash flow hedging instruments. The Company has included in its Consolidated Financial Statements a Consolidated Statement of Operations and Comprehensive Operations which includes the changes in these items, net of taxes, since January 1, 2007. Cumulative changes in OCI are included in Accumulated other comprehensive income (loss) (AOCI), which is presented as a new category of Shareholders' equity on the Company's Consolidated Balance Sheet.

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

### For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

#### *Financial Instruments – Recognition and Measurement*

Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. It requires that financial assets and financial liabilities, including derivatives, be recognized on the Company's Consolidated Balance Sheet when it becomes a party to the contractual provisions of a financial instrument or non-financial derivative contract. Under this standard, all financial instruments are required to be measured at fair value on initial recognition except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other financial liabilities. Transaction costs are expensed as incurred for financial instruments classified or designated as held-for-trading. For other financial instruments, transaction costs are capitalized on initial recognition. Financial assets and financial liabilities held-for-trading are measured at fair value with changes in those fair values recognized in net income in the period in which they arise. Financial assets held-to-maturity, loans and receivables, and other financial liabilities are measured at amortized cost using the effective interest rate method. Available-for-sale financial assets are measured at fair value with unrealized gains and losses recognized in OCI with the exception of investments in equity instruments classified as available-for-sale that do not have a quoted market price in an active market, which are measured at cost. Section 3855 also provides an entity the option to designate a financial instrument as held-for-trading (the fair value option) on its initial recognition or upon adoption of the standard, even if the instrument was not acquired or incurred principally for the purpose of selling or repurchasing it in the near term.

#### *Financial Instruments – Disclosure and Presentation*

Section 3861 supersedes Section 3860 "Financial Instruments – Disclosure and Presentation" and provides additional guidance and disclosure requirements in respect of an entity's financial instruments.

#### *Hedges*

Section 3865 specifies the criteria that must be satisfied in order for hedge accounting to be applied and the accounting for each of the permitted hedging strategies. Where hedge accounting is applied, a hedging relationship is designated as a fair value hedge, a cash flow hedge or a hedge of foreign currency exposure of a net investment in a self-sustaining foreign operation. The Company does not have any hedging relationships to which it applies hedge accounting.

#### *Impact upon adoption of Sections 1530, 3855, 3861 and 3865*

There was no material impact to the financial statements of the Company upon adoption of these standards.

#### **Future accounting changes:**

##### **Effective January 1, 2008**

The CICA has issued four new standards which may affect the financial disclosures and results of operations of the Company for interim and annual periods beginning January 1, 2008. The Company will adopt the requirements commencing in the quarter ended March 31, 2008 and is considering the impact this will have on the Company's financial statements.

# **PetroFalcon Corporation**

## Notes to Consolidated Financial Statements

**For the years ended December 31, 2007 and 2006**

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(expressed in U.S. dollars)

Section 1535, Capital disclosures, establishes standards for disclosing information about an entity's capital and how it is managed. Under this standard, the Company will be required to disclose quantitative and qualitative information about its objectives, policies and processes for managing capital.

Section 3031, Inventories, provides guidance on the determination of costs and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Section 3862, Financial instruments – disclosures, requires entities to disclose quantitative and qualitative information that enable users to evaluate (a) the significance of financial instruments for the Company's financial performance, and (b) the nature and extent of risks arising from financial instruments to which the Company is exposed during the period and at the balance sheet date, and Management's objectives, policies and procedures for managing such risks. The Company will be required to disclose the measurement bases used, and the criteria used to determine classification of financial instruments.

Section 1400, General standards on Financial Statement Presentation, has been amended to include requirements to assess and disclose an entity's ability to continue as a going concern.

### **Effective January 1, 2009**

The CICA has issued a new standard which may affect the financial disclosures and results of operations of the Company for interim and annual periods beginning January 1, 2009. The Company will adopt the requirements commencing in the quarter ended March 31, 2009 and is considering the impact this will have on the Company's financial statements.

Section 3064, Goodwill and intangible assets, establishes revised standards for recognition, measurement, presentation and disclosure of goodwill and intangible assets. Concurrent with the introduction of this standard, the CICA withdrew EIC 27, Revenues and Expenses during the pre-operating period. As a result of the withdrawal of EIC 27, the Company will no longer be able to defer costs and revenues incurred prior to commercial production.

## **4 Investments**

### **PetroCumarebo**

Effective April 1, 2006, Vinccler Venezuela's East Falcon OSA and West Falcon OSA became a 40% investment in the Empresa Mixta PetroCumarebo.

### **Cardon III**

On January 24, 2007, Vinccler Venezuela and 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 approval of the Venezuelan Ministry of Energy and Petroleum ("MEP").

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

### For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

On March 9, 2007, Vinccler Venezuela paid Chevron \$2.2 million, which included 30% of all Chevron's costs related to the Cardon III Block before the effective date. On December 31, 2007, Vinccler Venezuela was invoiced \$3.2 million for its 30% share of costs related to the Cardon III Block in 2007. Under the agreement, all funds paid by Vinccler Venezuela to Chevron will be returned if MEP approval is denied.

#### 5 Accounts receivable

At December 31, 2007, the Company had \$2.4 million in accounts receivable. This accounts receivable included \$0.3 million of IVA credit (Value Added Taxes) derived from the Company's expenditures during the year and \$1.6 million related to inventory sold to PetroCumarebo.

At December 31, 2006, the accounts receivable was mainly related to \$3 million of IVA credit derived from the Company's expenditures during the year; \$4 million of expected reimbursements for expenses and capital investments incurred by Vinccler Venezuela related to PetroCumarebo's operations as of December 31, 2006 and \$5.6 million related to Vinccler Venezuela's 40% share in PetroCumarebo's oil and gas revenues.

#### 6 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 Company, equivalent to \$2.56 million (see note 8).

The business combination has been accounted for using the purchase method of accounting. The following table summarizes the purchase price allocation for the 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>
<b>Total net assets acquired</b>	<b><u>5,112,575</u></b>

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. Effective

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

### For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

October 30, 2006, West Falcon Hydrocarbons, S.R.L, was merged into Vinccler Venezuela, and West Falcon Hydrocarbons, S.R.L. ceased to exist.

#### 7 Other income

Other income relates to certain Venezuelan levies recovered during the year ended December 31, 2007, as well as the collection of drilling insurance claims.

#### 8 Capital stock

##### Authorized

Unlimited number of common shares

Unlimited number of preferred shares issuable in series

##### Issued

	<u>Number of Shares</u>	<u>Amount \$</u>
As at December 31, 2005	77,631,407	40,797,542
Issue of shares	1,750,000	2,562,501
Conversion of long-term debt	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	86,331,336	51,547,584
Issue of shares (for options exercised)	250,000	133,022
As at December 31, 2007	86,581,336	51,680,606

##### Contributed Surplus

	<u>\$</u>
As at December 31, 2005	3,268,067
Stock-based compensation expense	2,809,668
Transfer from contributed surplus related to exercise of stock options	(52,070)
As at December 31, 2006	6,025,665
Stock-based compensation expense	2,046,665
As at December 31, 2007	8,072,330

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

### 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 after discharging all liabilities.

### Stock option plan

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

	2007		2006	
	Share Options	Weighted- average exercise price CDN\$	Share Options	Weighted- average exercise price CDN\$
Outstanding – beginning of year	10,406,494	1.85	8,896,194	1.86
Granted	1,070,000	1.00	1,925,000	1.72
Exercised	(250,000)	0.59	(149,700)	1.04
Cancelled	(430,000)	1.95	(265,000)	1.91
Outstanding – end of year	10,796,494	1.81	10,406,494	1.85
Options exercisable – December 31	9,393,322	1.81	7,302,649	1.68

# PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006

(expressed in U.S. dollars)

A summary of stock options outstanding at December 31, 2007 is set out below:

Exercise price CDN\$	Outstanding stock options		Exercisable stock options
	Number	Weighted average remaining contractual life	Number
\$0.50	100,000	0.05 years	100,000
\$1.00	3,148,654	5.39 years	3,148,654
\$1.00	1,070,000	9.50 years	106,666
\$1.13	75,000	8.63 years	50,000
\$1.23	150,000	8.99 years	50,000
\$1.30	13,340	5.75 years	13,340
\$1.45	40,000	8.50 years	30,000
\$1.55	450,000	8.19 years	450,000
\$1.93	920,000	8.25 years	920,000
\$2.05	30,000	7.83 years	20,000
\$2.20	290,000	6.25 years	290,000
\$2.35	1,750,000	6.45 years	1,750,000
\$2.38	300,000	7.75 years	200,000
\$2.39	1,459,500	7.45 years	1,264,662
\$3.28	1,000,000	6.93 years	1,000,000
	<u>10,796,494</u>		<u>9,393,322</u>

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	4.86%
Expected volatility	60%
Dividend yield rate	0.00%
Weighted average expected life of options	5 years

On February 1, 2008, all of PetroFalcon's outstanding stock options vested immediately due to the change of control provision in the stock option agreements (see note 16).

## 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 financing received by the World Bank's private investment arm, the International Finance Corporation ("IFC"). There were no proceeds received by the Corporation from the issue of these warrants. The warrants expired unexercised as of June 30, 2007.

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

### 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, at a total cost of CDN\$2.984 million (\$2.563 million).

### Conversion of long-term debt

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 IFC's conversion of \$4 million of long-term debt. 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 million of long-term debt.

## 9 Short-term debt

The Company's short-term debt consists of the following:

	2007 \$	2006 \$
Due to Vinccler Construction (see note 12) with no specific terms of repayment, unsecured and interest bearing at LIBOR plus 2%	350,000	350,000
Unsecured bank loans bearing average annual interest of 20% for 2007 and 13% for 2006, 90-day revolving basis, payable in Bolivars	2,142,857	11,562,791
	<u>2,492,857</u>	<u>11,912,791</u>

Short-term bank loans consisted of Vinccler Venezuela's credit line with Banco Exterior to meet its short-term working capital needs. Vinccler Venezuela's local currency credit line is guaranteed by a \$3.1 million deposit in USD with Banco Exterior.

## 10 Employee future benefits

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. 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 current and past service costs recognized was \$546,130.

# PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

## 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:

	<b>2006</b>
	<b>\$</b>
Asset retirement obligation, beginning of year	522,557
Liabilities recorded during the period	-
Accretion expense	-
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>

The total undiscounted amount of the estimated cash flows required to settle the obligations is \$933,894, 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 Related party transactions and balances

Pacific Oil and Gas, LLC and Venezolana de Inversiones y Construcciones Clerico, C.A. (“Vinccler Construction”) are controlled by officers of PetroFalcon. For the year ended December 31, 2007, the Company received invoices from Pacific Oil and Gas, LLC, controlled by PetroFalcon’s Vice-Chairman, Clarence Cottman, and the Company’s President, William Gumma, for \$540,000 for professional services (2006 -- \$840,000). These invoices were for professional services, including the salaries of Mr. Gumma and PetroFalcon’s Chief Financial Officer, Garrett Soden, as well as the operating expenses of PetroFalcon’s technical office in Carpinteria, California.

PetroFalcon also receives construction services provided by Vinccler Construction, an independent operating construction company controlled by the Company’s Chairman and Chief Executive Officer, Juan Francisco Clerico. During the year ended December 31, 2007, PetroFalcon did not receive services from Vinccler C.A., compared to \$11,669 during the year ended December 31, 2006. 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 (see note 16 “Subsequent events”).

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.

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

### 13 Income tax

During the year ended December 31, 2007, the Company recorded a current income tax expense of \$81,927, related to Vinccler Oil and Gas Corporation, the Company's wholly-owned Canadian subsidiary. Effective October 30, 2007, Vinccler Oil and Gas Corporation was amalgamated with PetroFalcon and continued as PetroFalcon.

During the year ended December 31, 2006, the Company recorded a current income tax expense of \$1.0 million, 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 Company realized a future income tax asset of \$851,258 related to Vinccler Oil and Gas Corporation and PetroFalcon'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.

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

### For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

A reconciliation of the consolidated income tax expense for 2007 and 2006 is set forth below:

	2007 \$	2006 \$
Net loss before taxes	(3,505,369)	(5,336,611)
Combined statutory income tax	32.12%	34%
	(1,125,925)	(1,814,448)
Increase (decrease) resulting from:		
Benefit of tax losses not recognized	1,828,016	1,812,431
Non taxable transactions	(1,647,577)	(534,996)
Non deductible expenses	950,240	1,677,400
Inflation adjustments (Venezuela)	-	(329,821)
Benefit of recognizing previous years' losses	-	(914,924)
Increase resulting from taxation in Venezuela	-	921,029
Difference in foreign tax rates	12,141	-
Other	65,032	-
Additional income tax from tax assessment	-	542,389
	<u>81,927</u>	<u>1,359,060</u>

## 14 Financial instruments

The Company is exposed to fluctuations in commodity prices, interest rates and Canadian/U.S. dollar and Venezuelan Bolivar/U.S. dollar exchange rates. The Company, where appropriate, utilizes financial instruments to manage its exposure to these risks. During the year, the Company did not hold or issue any derivative financial instruments. The Company's financial assets and liabilities as at December 31, 2007 and 2006 included cash, accounts receivable, accounts payable and short-term debt and investments as at December 31, 2007. Fair values approximate carrying values unless otherwise stated with the exception of investments in available for sale equity instruments not traded actively in a public market, the fair value of which cannot be reliably measured at year-end.

# PetroFalcon Corporation

## Notes to Consolidated Financial Statements

For the years ended December 31, 2007 and 2006

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(expressed in U.S. dollars)

### 15 Earnings per share

	<u>2007</u>	<u>2006</u>
Net loss	(\$3,587,296)	(\$6,695,671)
Weighted average number of outstanding shares	86,456,336	81,981,372
Stock options and warrants*	<u>100,000</u>	<u>3,648,654</u>
Basic earnings (loss) per share	(\$0.04)	(\$0.08)
Diluted earnings (loss) per share*	<u>(\$0.04)</u>	<u>(\$0.08)</u>

\* The calculation of diluted earnings per common share excludes 10,696,494 options and 100,000 warrants in 2007 and 6,657,840 options and 100,000 warrants in 2006 as these would have been anti-dilutive to the calculation.

### 16 Subsequent events

#### Lundin transaction

On February 1, 2008, PetroFalcon acquired 100% of the issued and outstanding shares of Lundin Venezuela, which owns 5% of Baripetrol, a mixed company with PDVSA, Tecpetrol de Venezuela, S.A. ("Tecpetrol") and Perenco Oil and Gas International Limited ("Perenco"). The Company acquired Lundin Venezuela from Lundin Petroleum BV ("Lundin BV"), a wholly-owned subsidiary of Lundin Petroleum AB ("Lundin Petroleum"), in consideration for the issuance of 57,254,505 common shares of the Company at a price of CDN\$0.80 per share. At closing, Lundin Venezuela had approximately \$22 million in cash.

Concurrent with the acquisition, Lundin BV subscribed for 6,665,995 units of PetroFalcon at a purchase price of CDN\$0.80 per unit, resulting in additional proceeds to the Company of approximately \$5.1 million. Each unit consists of one common share and approximately 0.75 warrants, such that Lundin BV holds an aggregate of 5,000,000 warrants. Each whole warrant expires on February 1, 2010, and is exercisable for one common share of PetroFalcon upon payment of CDN\$1.20 per share.

In total, Lundin BV acquired 63,920,500 common shares, representing 42% of the issued and outstanding common shares of PetroFalcon on an undiluted, post-closing basis, plus 5,000,000 warrants of the Company. All of PetroFalcon's outstanding stock options vested immediately at the closing of the transactions with Lundin BV due to the change of control provision in the stock option agreements.

On March 4, 2008, Lundin Venezuela received a \$1.9 million dividend from Baripetrol for operations between January and September 2007. According to the sale and purchase agreement with Lundin BV, all Baripetrol dividends for 2007 are for the benefit of PetroFalcon.

# **PetroFalcon Corporation**

Notes to Consolidated Financial Statements

**For the years ended December 31, 2007 and 2006**

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(expressed in U.S. dollars)

## **Cardon IV letter of intent**

On March 12, 2008, PetroFalcon announced the signing of a letter of intent with Repsol, whereby Vinccler Venezuela will acquire 25% of the Cardon IV Block. The transaction is subject to the approval of Eni and MEP, as well as the negotiation and execution of a sale and purchase agreement.

Under the terms of the farm-in agreement, Vinccler Venezuela has no obligations relating to past sunk costs on the Cardon IV Block. The Cardon IV budget for 2008 is \$5.2 million, 25% net to Vinccler Venezuela being \$1.3 million. If Vinccler Venezuela, Repsol and Eni decide to drill an exploration well in 2009, Vinccler Venezuela will be responsible for 50% of gross drilling costs.

## **Debt repayment**

On March 27, 2008, Vinccler Venezuela repaid \$350,000 plus interest at LIBOR plus 2% to a related party, Vinccler Construction, for the August 25, 2006 purchase of the Delta Caribe data package for the offshore natural gas license bid process.