

PetroFalcon Corporation

Interim Consolidated Financial Statements

(Unaudited)

June 30, 2005 and 2004

(expressed in U.S. dollars)

Management's Comments on Unaudited Interim Consolidated Financial Statements

The accompanying unaudited interim consolidated financial statements of PetroFalcon Corporation for the three and six months ended June 30, 2005 and 2004, have been prepared by management and approved by the Audit Committee and the Board of Directors of the Company.

PetroFalcon Corporation
Interim Consolidated Balance Sheets
(Unaudited)

(expressed in U.S. dollars)

	June 30, 2005	December 31, 2004
	\$	\$
Assets		
Current assets		
Cash	21,834,988	20,445,802
Restricted cash (note 11)	3,825,000	3,600,000
Accounts receivable	6,583,603	4,310,634
Income tax recoverable	137,212	61,092
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	32,380,803	28,417,528
Property and equipment		
	<hr/>	<hr/>
	39,443,778	16,413,226
	<hr/>	<hr/>
	71,824,581	44,830,754
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	11,383,421	1,963,706
Income tax payable	245,640	58,314
Bank loans	5,976,744	2,825,521
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	17,605,805	4,847,541
Long-term debt (note 6)	8,000,000	-
Provision for asset retirement obligation	387,876	347,720
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	25,993,681	5,195,261
Shareholders' Equity		
Capital stock (note 5)	40,651,603	36,513,195
Warrants (note 5)	118,571	-
Contributed surplus	2,204,655	1,316,359
Retained earnings	2,856,071	1,805,939
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	45,830,900	39,635,493
	<hr/>	<hr/>
	71,824,581	44,830,754

PetroFalcon Corporation

Interim Consolidated Statements of Operations and Retained Earnings (Deficit) (Unaudited)

(expressed in U.S. dollars)

	Six months ended		Three months ended	
	June 30,		June 30,	
	2005	2004	2005	2004
	\$	\$	\$	\$
Revenue	5,014,251	3,050,044	2,469,213	1,677,465
Expenses				
Operating and maintenance	1,307,126	962,179	683,191	537,987
General and administrative	1,835,405	959,194	957,911	568,507
Amortization, depletion and accretion	794,257	552,494	384,697	294,627
Stock-based compensation	897,000	311,450	453,000	179,450
	4,833,788	2,785,317	2,478,799	1,580,571
Income (loss) before financing income (expenses) and income tax	180,463	264,727	(9,586)	96,894
Financing income (expenses)				
Interest on bank loans	(261,091)	(168,334)	(162,613)	(73,538)
Interest on bank deposits	154,865	152,501	56,328	120,814
Gain on financing transactions (note 4)	1,355,972	676,041	680,233	-
Gain (loss) on foreign exchange	54,072	30,720	(2,977)	(599,092)
	1,303,818	690,928	570,971	(551,816)
Income before income tax	1,484,281	955,655	561,385	(454,922)
Income tax (note 8)	(434,149)	-	(133,080)	-
Net income (loss)	1,050,132	955,655	428,305	(454,922)
Retained earnings (deficit) – Beginning of period	1,805,939	(307,111)	2,427,766	1,103,466
Retained earnings – End of period	2,856,071	648,544	2,856,071	648,544
Weighted average number of common shares outstanding	76,345,651	62,976,952	76,423,938	71,167,042
Basic and diluted earnings (loss) per share	0.01	0.02	0.01	(0.01)

PetroFalcon Corporation

Interim Consolidated Statements of Cash Flows (Unaudited)

(expressed in U.S. dollars)

	Six months ended		Three months ended	
	2005	2004	2005	2004
	\$	\$	\$	\$
Cash provided by (used in)				
Operating activities				
Net income (loss) for the period	1,050,132	955,655	428,305	(454,922)
Items not affecting cash				
Amortization, depletion and accretion	794,257	552,494	384,697	294,627
Stock-based compensation	897,000	311,450	453,000	179,450
	2,741,389	1,819,599	1,266,002	19,155
Net change in non-cash working capital items				
Accounts receivable	(2,272,969)	9,236	(1,805,546)	(511,288)
Accounts payable and accrued liabilities	906,299	247,599	603,939	463,120
Income tax payable	111,206	(77,036)	77,775	(92,078)
	1,485,925	1,999,398	142,170	(121,091)
Financing activities				
Proceeds from private placement	4,000,000	15,859,165	4,000,000	-
Warrants (note 5)	118,571	-	118,571	-
Restricted Cash	(225,000)	-	(225,000)	-
Proceeds from (repayment of) bank loans	11,151,223	(2,471,488)	11,970,930	(444,293)
Proceeds received on exercise of share options and warrants	129,704	7,615,597	39,834	337,880
	15,174,498	21,003,274	15,904,335	(106,413)
Investing activities				
Acquisition of property and equipment	(23,784,653)	(2,503,165)	(11,054,177)	(1,949,500)
Movement in non-cash working capital from investing activities	8,513,416	1,191,804	932,402	1,088,561
	(15,271,237)	(1,311,361)	(10,121,775)	(860,939)
Net increase (decrease) in cash during the period	1,389,186	21,691,311	5,924,730	(1,088,443)
Cash – Beginning of period	20,445,802	4,505,657	15,910,258	27,285,411
Cash – End of period	21,834,988	26,196,968	21,834,988	26,196,968
Supplementary information				
Interest paid, net	335,271	199,621	226,645	61,984
Income tax paid	330,609	102,576	132,161	92,077

PetroFalcon Corporation

Notes to Interim Consolidated Financial Statements

(Unaudited) For the three and six months ended June 30, 2005 and 2004

(expressed in U.S. dollars)

1 Basis of presentation:

These interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles for interim financial statements. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for annual financial statements. In the opinion of management, all adjustments considered necessary for fair presentation have been included. Operating results for the six months period ended June 30, 2005, are not necessarily indicative of the results that may be expected for the year ended December 31, 2005.

The interim financial statements have been prepared by management in accordance with the accounting policies described in the Company's annual financial statements and footnotes thereto for the year ended December 31, 2004.

2 Description of business and reorganization

The principal business of the Company is conducted through its indirect wholly owned subsidiary, Vinccler Oil and Gas C.A. ("Vinccler Venezuela") which provides oil and gas operating services in Venezuela. All of the revenues of Vinccler Venezuela are generated through an Operating Service Agreement ("OSA") with Petroleos de Venezuela, S.A. ("PDVSA"), the state oil company of Venezuela.

Business with PDVSA

Vinccler Venezuela received notice from the Ministry of Energy and Petroleum in Venezuela ("MEP") and PDVSA that existing relationships governed by operating services agreements are to be restructured into joint ventures. It is the understanding of the Company that (i) Vinccler Venezuela will be required to transfer the East Falcon Unit to a mixed company in exchange for a 49% interest; and (ii) PDVSA will obtain the remaining 51% interest in exchange for contributing other oil and gas interests and assets. The Company has been advised that PDVSA intends to conclude these negotiations within the next six months.

As a result of these various governmental amendments, the operating results of the Company may be adversely impacted, however, at this time the economic impact and actual timing of the implementation of these are unknown to the Company.

3 Significant accounting policies

The interim consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. These interim consolidated financial statements were prepared in accordance with Canadian generally accepted accounting principles using the same accounting policies and methods of computation as the consolidated financial statements for the year ended December 31, 2004.

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Notes to Interim Consolidated Financial Statements

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4 Gain on financing transactions

During the six months ended June 30, 2005, the Company's subsidiary, Vinccler Venezuela, realized a foreign exchange gain of \$1,355,972 as a result of the acquisition and disposal of US dollar denominated Venezuelan government bonds (2004 – \$676,041).

5 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
Private Placement	2,078,273	4,000,000
Exercise of share options	256,573	129,705
Transfer from contributed surplus		8,703
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As at June 30, 2005	77,513,074	40,651,603

Common stock

The common shares of the Company are all of the same class, are voting and entitle shareholders to receive dividends. In the event of a liquidation, dissolution or winding up, the common stockholders are entitled to receive equal distributions of net assets or any dividends which may be declared.

Stock option plan

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

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	2005		2004	
	Share Options	Weighted-average exercise price CDN\$	Share Options	Weighted-average exercise price CDN\$
Outstanding – December 31	7,420,000	1.67	4,365,000	0.93
Granted	1,601,500	2.39	2,250,000	2.33
Exercised	(256,573)	0.54	(65,000)	0.50
Cancelled	-	-	(75,000)	1.00
Outstanding – June 30	8,764,927	1.83	6,475,000	1.42
Options exercisable – June 30	4,300,093	1.19	2,219,167	0.88

A summary of stock options outstanding at June 30, 2005 is set out below:

Exercise price	Outstanding stock options		Exercisable stock options
	Number	Weighted average remaining contractual life	Number
\$0.50	250,000	3.20 years	250,000
\$0.72	100,000	1.90 years	100,000
\$1.00	3,551,687	8.20 years	3,205,020
\$1.30	26,740	8.50 years	73
\$2.20	350,000	9.00 years	116,667
\$2.35	1,885,000	9.20 years	628,333
\$2.39	1,601,500	9.95 years	-
\$3.28	1,000,000	9.40 years	-
	<u>8,764,927</u>		<u>4,300,093</u>

Issue of warrants

On June 28, 2005, the Company issued in connection with the IFC financing, an aggregate of 100,000 warrants at an exercise price of CDN\$2.17 per share. Each warrant is exercisable into one common share of the Company until June 30, 2007.

6 Long-term debt

The Company has reached an agreement with the International Finance Corporation (“IFC”), the private sector arm of the World Bank, pursuant to which the IFC will provide up to \$36 million in loans to Vinccler Venezuela for the development of the Company’s oil and gas properties. During the second quarter of 2005, the IFC disbursed \$12 million from the “C” Loan. The disbursement of the remaining \$24

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million (the "A" Loan) is subject to the completion of certain technical tests. Principal repayments on the \$12 million are due in 2011. Interest will be payable semi-annually on May 15 and November 15 and will accrue at the London Inter Bank Offered Rate ("Libor") plus 1% for the "C" Loan from June 27, 2005, the date of the full disbursement of the "C" loan. IFC is also entitled to receive three percent of Vinccler Venezuela's cash flow so long it does not exceed 10% per annum of the principal amount of the "C" loan on an aggregate accumulated basis. At June 30, 2005, the outstanding principal due to IFC was \$8 million as a result of IFC's conversion of \$4 million of debt into 2,078,273 common shares of PetroFalcon. IFC has the option, commencing December 27, 2005, until December 27, 2008, to convert all or portion of the \$8 million "C" loan into shares of PetroFalcon at the market price at the time of conversion. The facility contains a number of covenants that Vinccler Venezuela must fulfill including the satisfaction of minimum financial tests, compliance with IFC and World Bank environmental and social policies and compliance with restrictions on the use and application of the proceeds.

7 Related party transactions and balances

Pacific Oil and Gas, LLC and Venezolana de Inversiones y Construcciones Clerico, C.A. are controlled by officers of the Company. During the six months ended June 30, 2005, the Company was invoiced \$420,000 by Pacific Oil and Gas, LLC (2004 – \$330,000) for professional services. During the period, the Company was also invoiced \$1.18 million for construction services provided by Venezolana de Inversiones y Construcciones Clerico, C.A.

During the three months ended June 30, 2005, the Company was invoiced \$210,000 by Pacific Oil and Gas, LLC (2004 – \$165,000) for professional services. During the period, the Company was also invoiced \$378,994 for construction services provided by Venezolana de Inversiones y Construcciones Clerico, C.A.

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.

8 Income Tax

Vinccler Venezuela accrued Venezuelan income tax in the amount of \$133,080 for the three months ended June 30, 2005. Vinccler Venezuela's taxability depends on a number of factors including the extent of operating expenditures, interest expensed, general and administrative costs and incremental income associated with new production and oil prices.

The Company has been advised that the SENIAT, the Venezuelan income tax authority, has stated that the income tax rates for activities conducted under the various operating service agreements in Venezuela, including Vinccler Venezuela's OSA, will increase from 34% to 50%. The SENIAT is currently auditing Vinccler Venezuela, however, the timing or impact of such audit is unknown at this time.

9 Financial instruments

The Company is exposed to fluctuations in commodity prices, interest rates and Canada/U.S. dollars and Venezuelan Bolivar/U.S. dollars exchange rates. The Company, when appropriate, utilizes financial instruments to manage its exposure to these risks.

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(expressed in U.S. dollars)

10 Economic dependence

Payments to the Company from PDVSA under the Operating Service Agreement are the primary source of revenues. Any material failure of PDVSA to fulfill its obligations under the Operating Service Agreement would have a material adverse effect on the Company's business, financial condition and results of operations.

11 Subsequent events

Vinccler Venezuela has increased its line of credit with Banco Exterior to ten billion Bolivars (US\$4.65 million). Vinccler Venezuela utilizes lines of credit with Venezuelan banks to meet its short term working capital and local currency financing needs.

On August 10, 2005, the Company repaid the BOD line of credit and had the related Letter of Credit for \$2.6 million (restricted cash) released.