

PetroFalcon Corporation

Consolidated Financial Statements
December 31, 2008 and 2007
(expressed in U.S. dollars)

Auditors' Report

To the Shareholders of
PetroFalcon Corporation

We have audited the consolidated balance sheets of PetroFalcon Corporation as at December 31, 2008 and 2007 and the consolidated statements of operations, comprehensive operations and accumulated deficit, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(Signed) "PricewaterhouseCoopers LLP"

Chartered Accountants, Licensed Public Accountants
Toronto, Canada
March 17, 2009

PetroFalcon Corporation

Consolidated Balance Sheets

As at December 31, 2008 and 2007

(expressed in U.S. dollars)

ASSETS	2008 \$	2007 \$
Current assets		
Cash and cash equivalents (note 3)	26,667,337	4,773,930
Accounts receivable (note 5)	6,972,123	1,606,112
Income tax recoverable	151,699	958,807
	<hr/>	<hr/>
	33,791,159	7,338,849
Accounts receivable (note 5)	-	785,242
Investments in oil and gas companies (note 4)	54,046,990	50,034,519
Property and equipment	565,926	188,876
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	88,404,075	58,347,486
	<hr/>	<hr/>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities	919,415	3,569,118
Short-term debt (note 6)	-	2,492,857
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	919,415	6,061,975
Shareholders' equity		
Share capital (note 7)	107,556,978	51,680,606
Warrants (note 7)	1,867,386	-
Contributed surplus (note 7)	8,717,778	8,072,330
Accumulated deficit	(30,657,482)	(7,467,425)
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	87,484,660	52,285,511
	<hr/>	<hr/>
	88,404,075	58,347,486
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The notes to consolidated financial statements are an integral part of these statements.

Approved by the Board of Directors

signed "William Gumma" Director
William Gumma

signed "Clarence Cottman" Director
Clarence Cottman

PetroFalcon Corporation

Consolidated Statements of Operations, Comprehensive Operations and Accumulated Deficit

For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

	2008	2007
	\$	\$
Expenses		
General and administrative	8,217,813	5,065,369
Impairment loss from investments in oil and gas companies (note 4)	6,824,974	-
Depreciation, depletion and amortization	112,964	123,938
Stock-based compensation (note 8)	797,365	2,046,665
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	15,953,116	7,235,972
	<hr/>	<hr/>
Loss before financing (expense) income and income tax	(15,953,116)	(7,235,972)
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Financing (expense) income		
Interest income (expense)	890,377	(1,134,779)
Foreign exchange (loss) gain	(721,840)	4,349,470
Guarantee fee to a related party (note 9)	(7,878,842)	-
Other income	473,364	515,912
	<hr/>	<hr/>
	(7,236,941)	3,730,603
	<hr/>	<hr/>
Loss before income taxes	(23,190,057)	(3,505,369)
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Income taxes (note 12)	-	(81,927)
	<hr/>	<hr/>
Net loss and comprehensive loss	(23,190,057)	(3,587,296)
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Accumulated deficit – Beginning of year	(7,467,425)	(3,880,129)
Accumulated deficit – End of year	(30,657,482)	(7,467,425)
	<hr/>	<hr/>
Weighted average number of common shares outstanding	150,945,412	86,456,336
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Basic and diluted loss per share (note 13)	(0.15)	(0.04)

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

PetroFalcon Corporation
Consolidated Statements of Cash Flows
For the years ended December 31, 2007 and 2006

(expressed in U.S. dollars)

	2008 \$	2007 \$
Cash used in operating activities		
Net loss	(23,190,057)	(3,587,296)
Items not affecting cash		
Depreciation, depletion and amortization	112,964	123,938
Other	-	(118,571)
Guarantee fee	7,878,842	-
Impairment loss from investments in oil and gas companies	6,824,974	-
Bad debt expense	349,664	-
Write-off of other investments	350,000	-
Stock-based compensation	797,365	2,046,665
	<u>(6,876,248)</u>	<u>(1,535,264)</u>
Net change in non-cash working capital items		
Accounts receivable	473,622	10,906,131
Accounts payable and accrued liabilities	(2,649,703)	(6,453,076)
Income taxes recoverable	807,108	35,679
	<u>(8,245,221)</u>	<u>2,953,470</u>
Financing activities		
De-recognition of cash in a joint venture	-	(2,112,167)
Repayment of short-term debt	(2,492,857)	(5,841,860)
Proceeds received on exercise of share options and warrants	276,598	133,022
Private placement	5,110,000	-
	<u>2,893,741</u>	<u>(7,821,005)</u>
Investing activities		
Investments	-	(2,225,626)
Reimbursement of PetroCumarebo cost	3,630,811	-
Acquisition of property and equipment, net of retirements	(490,752)	(27,483)
Acquisition of Lundin Latina de Petróleos, S.A	21,153,541	-
Baripetrol pre-acquisition dividends	2,951,287	-
	<u>27,244,887</u>	<u>(2,253,109)</u>
Net increase (decrease) in cash during year	<u>21,893,407</u>	<u>(7,120,644)</u>
Cash – Beginning of year	<u>4,773,930</u>	<u>11,894,574</u>
Cash – End of year	<u>26,667,337</u>	<u>4,773,930</u>
Supplementary information		
Interest paid	161,265	1,403,293
Income taxes paid	-	1,354,521

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

PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007

(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. Through its wholly-owned Venezuelan subsidiary, Vinccler Oil and Gas, C.A. (“Vinccler Venezuela”), PetroFalcon owns 40% of PetroCumarebo, S.A. (“PetroCumarebo”) and 5% of Baripetrol, S.A. (“Baripetrol”). PetroFalcon previously held its interest in Baripetrol through another Venezuelan subsidiary, Lundin Latina de Petr leos, S.A. (“Lundin Venezuela”). Effective December 31, 2008, Lundin Venezuela was merged with Vinccler Venezuela and ceased to exist.

2 Summary of significant accounting policies

The following is a summary of significant accounting policies used in the preparation of these financial statements:

a) Basis of consolidation

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”). The consolidated financial statements include the accounts of all wholly-owned subsidiaries. All significant inter-company balances and transactions are eliminated upon consolidation.

b) 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 may differ from these estimates. Accounts that require management to make material estimates in determining amounts recorded include oil and gas investments, property and equipment, depreciation and amortization, equity instruments, stock-based compensation and other accrued liabilities.

c) Cash and cash equivalents

Cash and cash equivalents include cash on hand and short-term and demand deposits with an initial term to maturity of three months or less that are readily convertible into cash.

d) Accounts receivable

Accounts receivable are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method, less provision for impairment. A provision for impairment of accounts receivable is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivables. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognised in the statement of operations within ‘general and administrative expenses’. When a trade receivable is uncollectible, it is

PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

written off against the allowance account for trade receivables. Subsequent recoveries of amounts previously written off are credited against 'general and administrative expenses' in the statement of operations.

e) Investments in oil and gas companies

Investments in oil and gas companies are recognized in the financial statements using the equity method or the cost method of accounting. If the Company holds less than 20% of the voting interest in the investee, it is presumed that the Company does not have the ability to exercise significant influence and the cost method is used, unless such influence is clearly demonstrated. If the Company holds 20% or more of the voting interest in the investee and has the ability to exercise significant influence, the equity method is used. Investments where the Company does not have significant influence are classified as financial assets carried at cost.

Under the cost method of accounting, the Company does not recognize its share of revenues, expenses, assets or liabilities from investees and instead only recognizes income from the investment to the extent that dividends are received.

Interests in jointly controlled entities are recognized in the Company's financial statements using the proportionate consolidation method. As of December 31, 2008, and 2007, the Company had no interests in jointly controlled entities.

f) Property and equipment

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

g) Foreign currency translation

The functional and reporting currency of the Company is the US dollar. The Company's wholly-owned subsidiary is classified as integrated for foreign currency translation purposes. Monetary assets and liabilities denominated in foreign currencies are translated at the exchange rates in effect at the balance sheet date. Non-monetary items are translated at historical rates. Revenues and expenses are translated at the average exchange rate during the year with the exception of depreciation and amortization, which is translated at the historical rate recorded for property and equipment. Exchange gains and losses arising from the translation of monetary assets and liabilities are included in the determination of income for the current period.

Venezuelan currency exchange rate

During the year ended December 31, 2007, 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 was determined that as a consequence of the rapid decline in the valuation of the Venezuelan Bolivar ("Bs") as reflected in the implied market for foreign currencies in Venezuela that the method of translation from Bolivars to US dollars using the official rate was no longer appropriate. As a result,

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For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

management determined that Bolivar balances would be translated at implied market rates of 5.70 Bs/USD and 5.74 Bs/USD for the years ended December 31, 2008, and 2007, respectively.

h) Income taxes

Income taxes are calculated using the asset and liability method of tax accounting. Under this method, current income taxes are recognized for the estimated income taxes payable for the current period. Future income tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and on unclaimed losses carried forward and are measured using the substantially enacted tax rates that are expected to be in effect when the differences are expected to reverse or losses are expected to be utilized. The effect on future income tax assets and liabilities of a change in the enacted tax rate is included in income in the period in which the change is substantially enacted. Future income tax assets are recorded to recognize tax benefits only to the extent that, based on available evidence, it is more likely than not that they will be realized.

Temporary differences also arise due to fluctuations in the exchange rate between the US dollar and the Venezuelan Bolivar that are not matched by corresponding rates of inflation in the same period.

i) 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. The fair value of stock-based compensation is determined using the Black-Scholes option pricing model and management's assumptions as disclosed in Note 8. Upon exercise of the stock options, consideration paid by the option holder, together with the amount previously recognized in contributed surplus, is recorded as an increase to share capital. The fair value of any stock options granted to directors, officers, consultants and employees is recorded as an expense over the vesting period of the options with a corresponding increase recorded to contributed surplus.

j) Earnings per share

Basic earnings or loss per share is computed by dividing net income or loss by the weighted-average number of common shares outstanding during the year. Diluted earnings per share are computed using the "treasury stock method". The treasury stock method assumes that all "in the money" option proceeds are used to purchase common shares of the Company at the average market price during the year. Loss per share is the same as basic loss per share since the exercise of options and warrants would be anti-dilutive. (Note 13)

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For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

k) Impairment of oil and gas investments

The Company evaluates the carrying amount of its interest in oil and gas companies when there is objective evidence that an investment may be impaired. When measuring and recognizing impairment losses, the Company compares the investment carrying amount against the Company's share participation in the sum of the undiscounted cash flows expected to result from the production of proved reserves associated with its oil and gas interests. If the carrying amount exceeds the undiscounted cash flows, the Company then compares the carrying amount against the Company's share participation in the fair value of proved and probable reserves associated with its oil and gas interests. Accordingly, impairment losses should be measured as the amount by which the carrying value of the investment exceeds the Company's share participation in the fair value.

l) Financial instruments

Effective January 1, 2007, all financial instruments have been classified into one of the following five categories: held-for-trading assets or liabilities, held-to-maturity investments, loans and receivables, available-for-sale financial assets or other financial liabilities. Held-for-trading financial instruments are measured at fair value and all gains and losses are included in net income in the period in which they arise. Available-for-sale financial instruments are measured at fair value with revaluation gains and losses included in accumulated other comprehensive income until the instruments are de-recognized or impaired, with the exception of investments in equity instruments that do not have a quoted market price in an active market that are measured at cost. Loans and receivables, investments held to maturity and other financial liabilities are measured at amortized cost using the effective interest method. The Company made the following classifications:

Cash and cash equivalents	Held for trading
Accounts receivable	Loans and receivables
Investment in oil and gas companies	Financial asset carried at cost
Accounts payable and accrued liabilities	Other financial liabilities

Transaction costs are expensed for all financial instruments.

m) Change in accounting policy and future accounting changes

The Canadian Institute of Chartered Accountants ("CICA") has issued four new standards that affect the financial disclosures and the results of operations of the Company for interim and annual periods beginning January 1, 2008. The Company adopted the requirements commencing in the quarter ended March 31, 2008.

Section 1535, Capital disclosures, establishes standards for disclosing information about an entity's capital and how it is managed. Under this standard, the Company is required to disclose quantitative and qualitative information about its objectives, policies and processes for managing capital. (Note 11)

Sections 3862 and 3863, Financial instruments – disclosures and presentation, requires entities to disclose quantitative and qualitative information that enables 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, as well as management's objectives, policies and procedures for managing such risks. The Company is required to

PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

disclose the measurement bases used and the criteria used to determine classification of financial instruments. The Company has expanded its financial risk and financial instruments disclosures. (Note 10)

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. The adoption of this standard had no impact on the Company's financial statements.

Future accounting changes

Effective January 1, 2009:

The CICA has issued a new standard that 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. The Company does not expect the adoption of this standard to have a material impact on the financial statements.

Section 1582, replaces the former CICA 1581, Business Combinations and is effective for business combinations for which the acquisition date is on/after the beginning of the first annual reporting period beginning on/after January 1, 2011.

International Financial Reporting Standards ("IFRS") - In January 2006, the CICA's Accounting Standards Board ("AcSB") formally adopted the strategy of replacing Canadian GAAP with IFRS for Canadian enterprises with public accountability. The current conversion timetable calls for financial reporting under IFRS for accounting periods commencing on or after January 1, 2011. On February 13, 2008, the AcSB confirmed that the use of IFRS will be required in 2011 for publicly accountable profit-oriented enterprises. IFRS will be required for PetroFalcon's interim and annual financial statements for the fiscal year beginning January 1, 2011. The Company is currently assessing the impact of IFRS on its consolidated financial statements.

n) Comparative information

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

PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

3 Cash and cash equivalents

Cash and cash equivalents consisted of the following:

	2008	2007
	\$	\$
Cash at Canadian banks	25,972,887	3,650,296
Cash at foreign banks	694,450	1,123,634
	<u>26,667,337</u>	<u>4,773,930</u>

The Company's cash and cash equivalents are on deposit with highly-rated banks in Canada, Curacao and Venezuela. Short-term deposits in US dollars were at variable annual interest rates from 3.08% to 0.80% in 2008 and from 4.86% to 4.61% in 2007.

4 Investments in oil and gas companies

The Company's investments consisted of the following:

	2008	2007
	\$	\$
PetroCumarebo	40,649,650	44,280,462
Baripetrol	13,397,340	-
Cardon III Block	-	5,404,057
Other investments	-	350,000
	<u>54,046,990</u>	<u>50,034,519</u>

PetroCumarebo

Effective April 1, 2006, Vinccler Venezuela's Operating Service Agreements ("OSA") for the East and West Falcon blocks became a 40% investment in the mixed company, PetroCumarebo. On May 9, 2008, Vinccler Venezuela received \$3.6 million from PDVSA related to capital expenditures incurred during the first quarter of 2006 under the former OSA. These costs had been considered as part of the investment cost in PetroCumarebo and have been deducted from the carrying value of the investment.

In 2007, PetroFalcon re-evaluated its relationship with PetroCumarebo and concluded that, for accounting purposes, effective January 1, 2007, PetroFalcon's investment in PetroCumarebo does not meet the criteria for proportionate consolidation or equity method accounting. Accordingly, PetroFalcon has accounted for PetroCumarebo using the cost method of accounting for the years ended December 31, 2008, and 2007, and the investment has been classified by the Company as a financial asset carried at cost since it is an investment in an equity instrument that is not actively traded in a public market. 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

PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

received from PetroCumarebo. As a result, PetroFalcon had no revenues for the years ended December 31, 2008, and 2007.

Baripetrol

On February 1, 2008, PetroFalcon acquired 100% of the issued and outstanding shares of Lundin Venezuela from Lundin Petroleum BV (“Lundin BV”) in consideration for the issuance of 57,254,505 common shares of the Company. Concurrent with the completion of the acquisition, Lundin BV subscribed for 6,665,995 units of the Company at a purchase price of CDN\$0.80 for aggregate proceeds of \$5.1 million. Each unit consists of one common share and approximately 0.75 warrants, such that an aggregate of 5,000,000 warrants were issued. Each whole warrant expires on February 1, 2010, and is exercisable for one common share of the Company upon payment of CDN\$1.20 per share. (Note 7)

The cost of the acquisition includes PetroFalcon common shares with a fair value of \$0.77 (CDN\$0.80) per share, plus PetroFalcon’s transaction cost of \$980,000, for a total cost of \$44,870,000. In connection with the acquisition, the Company paid a cash finder’s fee in the amount of \$543,600 and issued an additional 569,284 common shares of the Company.

The value of the PetroFalcon common shares issued was calculated using the average share price of PetroFalcon’s shares during the five days before, the day of and five days after the announcement of the acquisition. The excess of the purchase consideration over the adjusted book values of Lundin Venezuela’s assets and liabilities has been allocated to the 5% interest in Baripetrol.

The allocation of the purchase price is summarized in the table below expressed in US dollars:

Cost of purchase:

57,254,505 common shares of PetroFalcon	43,890,000
Acquisition costs	980,000
	<hr/>
	\$44,870,000

Allocation of the purchase price:

Cash and cash equivalents	257,141
Accounts receivable and other	114,886
Cash (settlement of accounts receivable from Lundin BV)	21,350,479
Investment in Baripetrol	23,173,601
Fixed assets	980
Accounts payable and accruals	(18,547)
Accounts payable to related companies	(8,540)
	<hr/>
	\$44,870,000

PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

PetroCumarebo and Baripetrol 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 may receive annual dividends in US dollars, or quarterly loans against those projected dividends from Baripetrol and PetroCumarebo.

During the year ended December 31, 2008, Lundin Venezuela received \$2.9 million of dividends from Baripetrol for operations between January and December 2007. The dividends were credited against the historical cost of the investment instead of being recognized as income during the year ended December 31, 2008, because the dividends were related to pre-acquisition earnings.

Impairment loss

Management conducted an impairment test of its oil and gas investments for the year ended December 31, 2008, and concluded that the carrying amount of the investment in Baripetrol exceeds its fair value. The fair value calculation considers the Company's 5% share participation in the discounted future after-tax cash flow projections of the proved and probable reserves associated with Baripetrol's assets covering the period until the end of Baripetrol's contract. As a result, management recorded an impairment loss of \$6.8 million against the carrying value of the investment, included in the statement of operations

Cardon III Block

On February 26, 2007, Vinccler Venezuela and Chevron Corporation ("Chevron") announced signing a Heads of Terms agreement whereby Vinccler Venezuela would acquire a 30% interest from Chevron in the offshore natural gas license for the Cardon III Block in the Gulf of Venezuela.

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 April 9, 2008, Vinccler Venezuela paid Chevron an additional \$3.2 million for 30% of the costs related to the Cardon III Block in 2007.

On December 29, 2008, the Company terminated the agreement to acquire the 30% interest in the offshore natural gas license for the Cardon III Block. According to the agreement, Chevron will reimburse all amounts paid by Vinccler Venezuela plus interest. (Note 14)

PetroFalcon Corporation

Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

5 Accounts receivable

The Company's accounts receivable consisted of the following:

	2008	2007
	\$	\$
Chevron	5,762,698	-
PetroCumarebo	396,075	1,606,112
Value added tax	694,869	785,242
Miller Insurance Services	226,953	-
Others	211,926	-
	<u>7,292,521</u>	<u>2,391,354</u>
Bad debt provision	(320,398)	-
	<u>6,972,123</u>	<u>2,391,354</u>
Accounts receivable – current portion	6,972,123	1,606,112
Accounts receivable – long-term portion	-	785,242
	<u>6,972,123</u>	<u>2,391,354</u>

At December 31, 2008, the Company had \$7.0 million of accounts receivable. This amount included \$5.8 million related to the reimbursement of funds paid to Chevron for Cardon III plus accrued interest (Note 4), \$0.4 million of value added tax ("VAT") billed to PetroCumarebo, \$0.4 million of net fiscal credits related to VAT and goods and services tax, \$0.2 million related to insurance claims and \$0.2 million of other accounts receivable.

At December 31, 2007, the Company had \$1.6 million of current accounts receivable related to inventory sold to PetroCumarebo. On May 6, 2008, Vinccler Venezuela received \$1.0 million from PetroCumarebo related to the sale of inventory. The long-term portion of the accounts receivable corresponds to VAT credit derived from the Company's expenditures. On December 31, 2008, Vinccler Venezuela recorded a \$0.3 million VAT provision and reclassified the remaining amount as the current portion of accounts receivable.

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For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

6 Short-term debt

As of December 31, 2008, and 2007, the Company's short-term debt consisted of the following:

	2008	2007
	\$	\$
Due to Vinccler Construction (see Note 9) with no specific terms of repayment, unsecured and interest bearing at LIBOR plus 2%	-	350,000
Unsecured bank loans bearing average annual interest of 20% for 2007, 90-day revolving basis, payable in Bolivars	-	2,142,857
	-	2,492,857

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

As of December 31, 2007, the short-term bank loans consisted of Vinccler Venezuela's credit line with Banco Exterior to meet its short-term working capital needs. On April 1, 2008, Vinccler Venezuela repaid its outstanding short-term debt to Banco Exterior.

On October 13, 2008, Vinccler Venezuela received a \$0.7 million loan from Banco Exterior to meet its short-term working capital needs. On December 23, 2008, Vinccler Venezuela repaid the outstanding amount of the loan.

7 Shareholders' equity

The Company's authorized share capital was comprised of an unlimited number of:

- a) Common shares; and
- b) Preferred shares issuable in series

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.

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Notes to Consolidated Financial Statements

For the years ended December 31, 2008 and 2007

(expressed in U.S. dollars)

Issued shares and contributed surplus

Changes in common shares and contributed surplus were as follows:

	Number of Shares	Amount \$	Contributed Surplus \$
As at December 31, 2006	86,331,336	51,547,584	6,025,665
Issue of shares (for option exercised)	250,000	133,022	-
Stock-based compensation expense	-	-	2,046,665
As at December 31, 2007	86,581,336	51,680,606	8,072,330
Private placement	6,665,995	5,110,000	-
Acquisition of Lundin Venezuela	57,254,505	43,890,000	-
Issuance of broker's shares	569,284	436,400	-
Issuance of shares (for options exercised)	330,000	428,516	(151,918)
Agent's warrants	-	(1,867,386)	-
Guarantee fee paid to Lundin Petroleum	7,100,000	7,878,842	-
Stock-based compensation expense	-	-	797,366
As at December 31, 2008	158,501,120	107,556,978	8,717,778

Acquisition of Lundin Venezuela

The Company issued 57,254,505 common shares at a price of CDN\$0.80 per share in connection with the Lundin Venezuela acquisition. (Note 4)

Private placement

Concurrent with the acquisition of Lundin Venezuela, 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 \$5,110,000. Each unit consists of one common share and approximately 0.75 warrants, such that Lundin BV now 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 connection with the acquisition and private placement, PetroFalcon paid a cash finder's fee in the amount of \$543,600 and issued 569,284 common shares of the Company to Nanes Delorme Capital Management, LLC, a boutique investment bank in New York City that is arm's length to the Company.

The following assumptions were used in the Black-Scholes option pricing model for the fair value of the warrants:

Risk-free interest rate	3.13%
Expected volatility	110%
Dividend yield rate	0.00%
Expected life	2 years

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8 Stock-based compensation

The Company maintains a stock option plan whereby options can be granted to officers and certain employees. Stock options have a term of between 5 and 10 years. All stock options vest over 3 years and are exercisable at the market prices for the shares on the dates that the options were granted. PetroFalcon's stock option agreements have a change of control provision that causes all stock options to vest immediately when more than 20% of the Company is purchased. Therefore, all of the Company's outstanding stock options immediately vested at the closing of the Lundin transaction on February 1, 2008.

A summary of changes in the number of outstanding stock options during the periods is presented below:

	2008		2007	
	Share Options	Weighted average exercise price CDN\$	Share Options	Weighted average exercise price CDN\$
Outstanding – beginning of year	10,796,494	1.81	10,406,494	1.85
Granted	450,000	1.24	1,070,000	1.00
Exercised	(330,000)	0.85	(250,000)	0.59
Forfeited	(1,582,834)	1.99	(430,000)	1.95
Outstanding – end of year	9,333,660	1.77	10,796,494	1.81
Options exercisable – December 31	8,883,660	1.80	9,393,322	1.81

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A summary of stock options outstanding at December 31, 2008, is set out below:

Exercise price CDN\$	Outstanding stock options		Exercisable stock options
	Number	Weighted average remaining contractual life	Number
\$0.25	100,000	4.94 years	-
\$1.00	2,585,320	4.39 years	2,585,320
\$1.00	1,010,000	8.50 years	1,010,000
\$1.13	75,000	7.63 years	75,000
\$1.23	150,000	7.99 years	150,000
\$1.30	13,340	4.75 years	13,340
\$1.37	100,000	4.62 years	-
\$1.55	370,000	7.19 years	370,000
\$1.59	250,000	9.32 years	-
\$1.93	830,000	7.25 years	830,000
\$2.05	30,000	6.83 years	30,000
\$2.20	230,000	5.25 years	230,000
\$2.35	1,300,000	5.45 years	1,300,000
\$2.38	300,000	6.75 years	300,000
\$2.39	1,090,000	6.45 years	1,090,000
\$3.28	900,000	5.93 years	900,000
	<u>9,333,660</u>		<u>8,883,660</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:

	2008	2007
Risk-free interest rate	3.26%	4.86%
Expected volatility	86.73%	60.00%
Dividend yield rate	0.00%	0.00%
Weighted average expected life of options	5 years	5 years

During the year ended December 31, 2008, the Company recorded \$797,365 in stock-based compensation expense compared to \$2,046,665 during the year ended December 31, 2007.

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9 Related party transactions and balances

Pacific Oil and Gas

Pacific Oil and Gas is controlled by PetroFalcon's Vice Chairman, Clarence Cottman, and PetroFalcon's President and CEO, William Gumma. The Company paid Pacific Oil and Gas for the year ended December 31, 2008, and 2007, \$613,000 and \$540,000, respectively. These payments include the salaries of Mr. Gumma and PetroFalcon's Chief Financial Officer, Garrett Soden, as well as administrative services from Pacific Oil and Gas.

Vinccler Construction

PetroFalcon occasionally receives construction services from Venezolana de Inversiones y Construcciones Clérico, C.A. ("Vinccler Construction"), an independent operating construction company controlled by the Company's Chairman, Juan Francisco Clerico. During the year ended December 31, 2008, and 2007, PetroFalcon did not receive services from Vinccler Construction. 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. On March 27, 2008, Vinccler Venezuela repaid this amount plus interest of \$42,200.

Lundin Services BV

PetroFalcon also receives technical services from Lundin Services BV, a wholly-owned subsidiary of Lundin Petroleum. Lundin Petroleum's CEO, Ashley Heppenstall, is a board member of PetroFalcon. For the year ended December 31, 2008, and 2007, the Company paid Lundin Services BV for professional services in the amount of \$80,170 and nil, respectively. These payments for professional services include oil and gas geology, reserve and legal advice for PetroFalcon's business development activities.

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.

Lundin Petroleum

On April 7, 2008, PetroFalcon announced the signing of a binding sale and purchase agreement for the acquisition of 100% of the issued and outstanding shares of Anadarko Venezuela Company ("Anadarko Venezuela") from an affiliate of Anadarko Petroleum Corporation ("Anadarko Petroleum") for \$200 million in cash. Anadarko Venezuela indirectly owns 18% of Petroritupano, S.A. ("Petroritupano"), a mixed company with PDVSA and Petrobras Energía, S.A. The agreement was subject to the approval of the Venezuelan Ministry of Energy and Petroleum ("MEP"). Anadarko Petroleum has since terminated the sale and purchase agreement with PetroFalcon and returned PetroFalcon's \$5 million cash deposit with interest.

Lundin Petroleum AB ("Lundin Petroleum") provided a guarantee to Anadarko Petroleum for the full purchase price. In consideration for the guarantee, PetroFalcon agreed to issue 17.1 million common shares of the Company to Lundin Petroleum or one of its subsidiaries, subject to regulatory approval. On April 11, 2008, PetroFalcon issued 7.1 million of these shares to Lundin Petroleum, which, as of December

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31, 2008, indirectly owned 45% of the issued and outstanding shares of the Company. The initial shares were expensed by the Company as stock-based financing fees over the effective period of the sale and purchase agreement. The remaining 10 million shares that would have been due at closing were not issued, in accordance with the agreement with Lundin Petroleum.

10 Financial instruments

Financial instruments and risk factors

The Company's activities expose it to a variety of financial risks: credit risk, liquidity risk, market risk (including interest rate, foreign currency and commodity price risk) and other risks. Risk management is carried out by the Company's management team with guidance from the Audit Committee under policies approved by the Board of Directors. The Board of Directors also provides regular guidance for overall risk management.

Credit risk

Credit risk is the risk of loss associated with a counterparty's inability to fulfill its payment obligations. The Company's credit risk is primarily attributable to value-added tax receivable and tax credits of the wholly-owned subsidiary with the Venezuelan tax authorities and third party credits (Note 14). The Company has no concentration of credit risk. Value added tax receivables are collectable from the Venezuelan government and are in good standing as of December 31, 2008. Management believes that the credit risk with respect to financial instruments attributable to value added tax receivables is moderate.

In addition, the majority of the Company's cash and cash equivalents are on deposit with one highly-rated chartered bank in Canada. A lesser amount is held in a bank in Curacao. (Note 3)

Liquidity risk

At December 31, 2008, the Company had sufficient funds to settle current liabilities. All of the Company's accounts payable and accrued liabilities have contractual maturities of less than 30 days, except for severance employee benefits, and are subject to normal trade terms. The Company's subsidiary's line of credit is based on contractual terms between related companies and with a Venezuelan financial institution. This bank credit facility is backed by US dollar deposits.

Market risk

Market risk is the risk of loss that may arise from changes in market factors such as interest rates, foreign exchange rates and oil prices.

(i) Interest rate risk

PetroFalcon has significant cash balances and short-term investments, with the latter having a variable annual interest rates from 3.08% to 0.80% (Note 3). The Company's current policy is to invest excess cash in investment grade short-term deposit certificates issued by banks. The Company periodically monitors the investments it makes and is satisfied with the credit ratings of its banks.

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Vinccler Venezuela's line of credit is based on contractual terms with its parent company and on contractual terms with a Venezuelan financial institution, bearing annual interest of 3% and 28%, respectively. The Company periodically monitors and evaluates the interest between related parties and interest rates for loans in the Venezuelan market to adjust its leverage strategy as necessary.

(ii) Foreign currency risk

PetroFalcon's functional currency is the US dollar. Any annual dividends from its oil and gas investments are in US dollars, and major purchases are transacted in US dollars. The Company maintains US dollar bank accounts in Canada and Curacao. The Company funds some of its subsidiary's operating and administrative expenses in Venezuelan Bolivars from its US dollar bank accounts.

During 2007, the Company's management 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 US dollars using the official rate was no longer appropriate. The Company recognizes the foreign currency transactions of its Venezuelan subsidiary at the implied market rate in Venezuela, which had a spread of 165% over the official rate as of December 31, 2008. The Company has exposure to the volatility of the implied market rate in Venezuela that may result in significant foreign exchange gains or losses from its Venezuelan subsidiary.

(iii) Commodity price risk

Oil price risk is the potential adverse impact on the Company's dividends from its oil and gas investments due to oil price movements and volatility. The Company closely monitors oil prices to determine the appropriate course of action to be taken by the Company, to the extent possible, through its participation on the board of directors of PetroCumarebo and in the private party consortium in Baripetrol (Note 2e and 4).

Sensitivity analysis

As of December 31, 2008, the carrying values of the Company's financial instruments approximate fair value. Based on management's knowledge and experience of the financial markets, PetroFalcon believes the following movements are "reasonably possible" to have affected the twelve month period ended December 31, 2008:

(i) Cash and cash equivalents are subject to floating interest rates. Sensitivity to a plus or minus change in rates of one percentage point would have affected net loss by \$250,000 for the year ended December 31, 2008.

(ii) Balances in foreign currency of the Company's wholly-owned subsidiary may be subject to foreign currency exchange fluctuations. Sensitivity to a plus or minus change of ten percent of devaluation or revaluation of the implied market rates against the US dollar would have affected net loss by \$60,125 or \$73,000, respectively for the year ended December 31, 2008.

(iii) Net loss would not be impacted by changes in average realized oil prices since the Company did not recognize any dividend income from its oil and gas investments in Venezuela for the twelve month period ended December 31, 2008.

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11 Capital management

The Company's objectives when managing capital are to preserve cash and maintain flexibility between providing liquidity for investment opportunities in the oil and gas sector and providing acceptable returns to shareholders. These objectives are primarily met through cash management and continuous review of attractive acquisition and development opportunities. In order to maintain or adjust the capital structure, PetroFalcon may obtain long-term debt, and/or project-based financing sufficient to maintain and expand its presence in Venezuela or abroad. There are no assurances that such financing will be available on terms acceptable to the Company.

Management reviews its capital management approach on an ongoing basis and believes that this approach, given the relative size of the Company, is appropriate.

The Company defines capital as shareholders' equity, long-term debt (excluding non-recourse debt and transaction costs), short-term borrowings and non-controlling interests less cash and cash equivalents (excluding cash and cash equivalents from joint ventures and other interests not exclusively controlled by the Company). The Company currently has no externally imposed capital requirements.

12 Income tax

During the year ended December 31, 2008, PetroFalcon recorded no income tax expense as the Company had no taxable income for the period. During the year ended December 31, 2007, PetroFalcon recorded current income tax of \$81,927.

At December 31, 2008, the Company had consolidated carry forward losses of \$8,361,620 (equivalent to Bs 47,661,232 at the implied market rate) from Vinccler Venezuela. The Company did not recognize any future income tax asset related to these carry forward losses since it is not likely that the Company will be able to utilize these losses before they begin to expire in 2009.

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 until December 31, 2008. Vinccler Venezuela recognized the effects of the inflation in non-monetary assets and liabilities through the application of the General Consumer 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. Since the majority of Vinccler Venezuela's net monetary assets are held in US dollars, and 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 statutory tax rate of 34% and the income tax rate presented in these financial statements is due to the adjustments required for inflation and foreign currency translation. A reconciliation of the consolidated income tax expense for 2008 and 2007 is set forth below:

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	2008	2007
	\$	\$
Net loss before taxes	(23,190,057)	(3,505,369)
Combined statutory income tax	29.50%	32.12%
	(6,841,067)	(1,125,925)
Increase (decrease) resulting from:		
Difference in foreign tax rates	(151,976)	12,141
Benefit of tax losses not recognized	604,081	1,828,016
Non taxable transactions	(861,105)	(1,647,577)
Non deductible expenses	5,818,122	950,240
Inflation adjustments (Venezuela)	2,204,837	-
Benefit of recognizing previous years' losses	(772,892)	-
Other	-	65,032
	-	81,927

13 Earnings per share

	2008	2007
Net loss	(\$23,190,057)	(\$3,587,296)
Weighted average number of outstanding shares	150,945,412	86,456,336
Basic and diluted loss per share*	(\$0.15)	(\$0.04)

* The calculation of diluted loss per common share excludes options and warrants outstanding as the effect would be anti-dilutive.

14 Subsequent events

On January 19, 2009, Vinccler Venezuela received \$5.8 million from Chevron as reimbursement for Vinccler Venezuela's past Cardon III expenses and accrued interest. (Note 4)