

# **PetroFalcon Corporation**

**Interim Consolidated Financial Statements  
(Unaudited)  
March 31, 2006 and 2005  
(expressed in U.S. dollars)**

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The accompanying unaudited interim consolidated financial statements of PetroFalcon Corporation for the three months ended March 31, 2006 and 2005, 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)

	<b>March 31, 2006 \$</b>	<b>December 31, 2005 \$</b>
<b>Assets</b>		
<b>Current assets</b>		
Cash	10,521,743	9,297,444
Accounts receivable	8,346,476	14,378,285
Income tax recoverable	1,180,742	412,423
Future income tax	1,079,501	1,082,375
	<hr/>	<hr/>
	21,128,462	25,170,527
<b>Property and equipment</b>	<hr/>	<hr/>
	49,818,616	46,004,470
	<hr/>	<hr/>
	70,947,078	71,174,997
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	3,391,800	4,801,490
Income tax payable (note 8)	362,211	-
Current portion of long term debt (note 6)	12,069,767	10,081,395
	<hr/>	<hr/>
	15,823,778	14,882,885
Future income tax liability (note 8)	769,833	769,833
Long-term debt (note 6)	4,000,000	8,000,000
Provision for asset retirement obligation	1,381,923	522,557
	<hr/>	<hr/>
	21,975,534	24,175,275
<b>Shareholders' equity</b>		
<b>Capital stock (note 5)</b>	43,362,206	40,797,542
<b>Warrants (note 5)</b>	118,571	118,571
<b>Contributed surplus (note 5)</b>	3,855,905	3,268,067
<b>Retained earnings</b>	<hr/>	<hr/>
	1,634,862	2,815,542
	<hr/>	<hr/>
	48,971,544	46,999,722
	<hr/>	<hr/>
	70,947,078	71,174,997

# PetroFalcon Corporation

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

(expressed in U.S. dollars)

	Three months ended March 31,	
	2006 \$	2005 \$
<b>Revenue</b>	3,129,029	2,545,038
<b>Expenses</b>		
Operating, maintenance and transportation	964,459	623,935
General and administrative	922,508	877,494
Amortization, depletion and accretion	512,688	409,560
Stock-based compensation (note 5)	590,000	444,000
	<u>2,989,655</u>	<u>2,354,989</u>
<b>Income before other income (expenses) and income taxes</b>	<u>139,374</u>	<u>190,049</u>
<b>Other income (expenses)</b>		
Interest expense	(813,509)	(98,478)
Interest on bank deposits	43,615	98,537
Gain on financing transactions (note 4)	-	675,739
(Loss) gain on foreign exchange	(7,771)	57,049
	<u>(777,665)</u>	<u>732,847</u>
<b>(Loss) income before income taxes</b>	(638,291)	922,896
<b>Income taxes (note 8)</b>	<u>(542,389)</u>	<u>(301,069)</u>
<b>Net (loss) income</b>	(1,180,680)	621,827
<b>Retained earnings – Beginning of period</b>	<u>2,815,542</u>	<u>1,805,939</u>
<b>Retained earnings – End of period</b>	<u>1,634,862</u>	<u>2,427,766</u>
<b>Weighted average number of common shares outstanding</b>	<u>78,506,407</u>	<u>75,256,515</u>
<b>Basic and diluted (loss) earnings per share (note 11)</b>	(0.02)	0.01

# PetroFalcon Corporation

## Interim Consolidated Statements of Cash Flows (Unaudited)

(expressed in U.S. dollars)

	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>\$</b>	<b>\$</b>
<b>Cash provided by (used in)</b>		
<b>Operating activities</b>		
Net (loss) income	(1,180,680)	621,827
Items not affecting cash		
Amortization, depletion and accretion	512,688	409,560
Stock-based compensation	590,000	444,000
	<u>(77,992)</u>	<u>1,475,387</u>
Net change in non-cash working capital items		
Accounts receivable	7,946,604	(467,423)
Accounts payable and accrued liabilities	744,981	302,360
Income taxes (payable) recoverable – net	425,755	33,431
	<u>9,039,348</u>	<u>1,343,755</u>
<b>Financing activities</b>		
Repayment of long-term debt	(2,011,627)	(819,707)
Proceeds received on exercise of share options	-	89,870
	<u>(2,011,627)</u>	<u>(729,837)</u>
<b>Investing activities</b>		
Purchase of West Falcon Hydrocarbons, S.R.L (note 3)	(2,016,214)	
Acquisition of property and equipment	(1,054,356)	(12,730,476)
Movement in non-cash working capital from investing activities	(2,732,852)	7,581,014
	<u>(5,803,422)</u>	<u>(5,149,462)</u>
<b>Net increase (decrease) in cash during period</b>	1,224,299	(4,535,544)
<b>Cash – Beginning of period</b>	<u>9,297,444</u>	<u>20,445,802</u>
<b>Cash – End of period</b>	<u>10,521,743</u>	<u>15,910,258</u>
<b>Supplementary information</b>		
Interest paid	73,858	108,626
Income taxes paid	339,761	230,071

# PetroFalcon Corporation

Notes to Interim Consolidated Financial Statements

**(Unaudited) For the three months ended March 31, 2006 and 2005**

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(expressed in U.S. dollars)

## 1 Description of business

The principal business of PetroFalcon Corporation (“PetroFalcon” or the “Corporation”) is conducted through its indirect wholly owned subsidiaries, Vinccler Oil and Gas, C.A. (“Vinccler Venezuela”) and West Falcon Hydrocarbons, S.R.L (“Samson”) which provide oil and gas operating services in Venezuela. All of the revenues of Vinccler Venezuela and Samson are generated through Operating Service Agreements (“OSA”) with Petroleos de Venezuela, S.A. (“PDVSA”), the state oil company of Venezuela.

### Business with PDVSA

All of PetroFalcon’s production and operating revenues are derived from Vinccler Venezuela and Samson through its operations at the East Falcon and West Falcon blocks pursuant to the terms of the OSA with PDVSA. During 2005, Vinccler Venezuela executed a gas addendum (the “Gas Addendum”) to the OSA to produce up to 249 billion cubic feet (“bcf”) of natural gas and 11 million barrels (“mmbbl”) of oil from the Cumarebo and La Vela fields. The Gas Addendum allows Vinccler Venezuela to deliver the natural gas produced by Vinccler Venezuela to PDVSA for a price of \$1.33 per thousand cubic feet (“Mcf”). On August 4, 2005, Vinccler Venezuela signed a transitory agreement (the “Transitory Agreement”) under which Vinccler Venezuela agreed to convert the current OSA into a joint venture (“Empresa Mixta”). The terms and conditions of the Empresa Mixta are currently under negotiations. In addition to the Transitory Agreement, Vinccler and PDVSA entered into a confidentiality agreement to facilitate the exchange of information during the negotiations.

On March 31, 2006, Vinccler Venezuela reached initial agreement with the Venezuelan government with respect to its oil and natural gas rights in Venezuela. Vinccler Venezuela signed a memorandum of understanding with PDVSA and its affiliated entity, Corporacion Venezolana de Petroleo (“CVP”) to create an Empresa Mixta which would hold all operating rights to the West Falcon Block and the East Falcon Block. It was determined that the ownership structure of the Empresa Mixta would be 40% held by Vinccler Venezuela and 60% held by CVP. The impact of the Empresa Mixta is that it converts Vinccler Venezuela’s interests in the East Falcon Block and West Falcon Block into a single development entity, of which Vinccler Venezuela will hold 40%, and gives the Empresa Mixta the exclusive right to produce and sell oil and associated natural gas from the two Blocks.

The Empresa Mixta contract has not yet been executed and the final agreements have not yet been fully negotiated between the parties, however, Vinccler Venezuela has been advised by PDVSA and CVP that it is intended to have an April 1, 2006 effective date. Therefore, the Corporation has determined that it is prudent to govern their actions in accordance with the following intended general structure of the Empresa Mixta:

# PetroFalcon Corporation

## Notes to Interim Consolidated Financial Statements

**(Unaudited) For the three months ended March 31, 2006 and 2005**

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(expressed in U.S. dollars)

- The Empresa Mixta will pay a royalty at the rate of 33.3% on the oil and natural gas production
- The Empresa Mixta will have an applicable income tax rate of 50%
- The Empresa Mixta will have a term of 20 years
- Vinccler Venezuela will receive dividends from the Empresa Mixta on a quarterly basis derived from its 40% participation in the Empresa Mixta
- Vinccler Venezuela will be responsible for 40% of the approved 2006 capital expenditure budget of \$40.7 million and 40% of the operating costs.

The establishment of the Empresa Mixta will have a significant impact on the consolidated financial statements of the Corporation in future periods. However, at this time, the exact terms and conditions of the structure and management of the Empresa Mixta entity have not yet been finalized. As a result, management is unable to determine how the entity will be accounted for by the Corporation under Canadian GAAP. The accounting will ultimately depend on a number of different factors, including the level of control that Vinccler Venezuela will have over the entity

## **2 Significant accounting policies**

The interim consolidated financial statements include the accounts of the Corporation 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, 2005.

## **3 Acquisition of West Falcon Block**

Effective March 21, 2006, Vinccler Venezuela completed the acquisition of Samson a subsidiary from Samson International, LLC. Vinccler Venezuela now owns 100% of the West Falcon Operating Service Agreement (“West Falcon Block”) in Venezuela. The purchase price consisted of a cash payment of \$ 2.55 million. In addition, PetroFalcon issued 1.75 million common shares of the Corporation (see note 5).

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

# PetroFalcon Corporation

## Notes to Interim Consolidated Financial Statements

(Unaudited) For the three months ended March 31, 2006 and 2005

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(expressed in U.S. dollars)

Cash	533,859
Accounts receivable	1,914,796
Property, plant and equipment	3,263,112
Income tax recoverable	828,989
Accounts payable	(578,181)
Asset retirement obligations	<u>(850,000)</u>
<b>Total net assets acquired</b>	<b><u>5,112,575</u></b>

#### 4 Gain on financing transactions

During the three months ended March 31, 2005, Vinccler Venezuela recorded a gain of \$675,739 as a result of the purchase and disposal of US dollar denominated Venezuelan government bonds. No gain on financing transaction was recorded during the three months ended March 31, 2006.

#### 5 Capital stock

##### Authorized

Unlimited number of common shares

Unlimited number of preferred shares issuable in series

##### Issued

	<b>Number of Shares</b>	<b>Amount \$</b>
As at December 31, 2005	77,631,407	40,797,542
Issue of shares (note 3)	1,750,000	2,562,501
Transfer to contributed surplus		<u>2,163</u>
As at March 31, 2006	<u>79,381,407</u>	<u>43,362,206</u>

#### Common stock

The common shares of PetroFalcon are all of the same class, have voting rights 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 which may be declared.

# PetroFalcon Corporation

Notes to Interim Consolidated Financial Statements

**(Unaudited) For the three months ended March 31, 2006 and 2005**

(expressed in U.S. dollars)

## Stock option plan

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

	March 31, 2006		March 31, 2005	
	Share Options	Weighted- average exercise price CDN\$	Share Options	Weighted- average exercise price CDN\$
Outstanding – Beginning of period	8,896,194	1.86	7,420,000	1.67
Granted	1,660,000	1.79	-	-
Exercised	-	-	(156,573)	0.71
Cancelled	(7,500)	2.39	-	-
Outstanding – End of period	10,548,694	1.85	7,263,427	1.70
Options exercisable – End of period	4,926,685	1.39	2,048,420	0.90

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

	Outstanding stock options		Exercisable stock options
Exercise price	Number	Weighted average remaining contractual life	Number
\$0.50	250,000	2.45 years	250,000
\$0.72	100,000	1.15 years	100,000
\$1.00	3,438,354	7.45 years	3,096,683
\$1.30	13,340	7.75 years	6,673
\$1.55	590,000	9.97 years	147,500
\$1.93	1,070,000	10.00 years	267,500
\$2.05	30,000	9.58 years	-
\$2.20	290,000	8.25 years	96,665
\$2.35	1,885,000	8.45 years	628,331
\$2.38	300,000	9.50 years	-
\$2.39	1,582,000	9.20 years	-
\$3.28	1,000,000	8.65 years	333,333
	10,548,694		4,926,685

# PetroFalcon Corporation

## Notes to Interim Consolidated Financial Statements

(Unaudited) For the three months ended March 31, 2006 and 2005

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(expressed in U.S. dollars)

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

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

### Issue of warrants

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

### Samson 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 Samson (see note 3) at a total cost of CDN\$2.984 million (\$2.563 million).

## 6 Bank loans

The Corporation's debt consists of the following:

	Three months ended	
	March 31,	
	2006	2005
	\$	\$
Short-term local bank loans bearing interest at an average of 17%, due within 90 days	8,069,767	2,005,814
Short-term due to International Finance Corporation bearing interest at Libor plus 1% (5.44%), converted into shares of PetroFalcon .	4,000,000	-
Due to International Finance Corporation bearing interest at Libor plus 1% (5.44%), with maturity in 2011	4,000,000	-
	<u>16,069,767</u>	<u>2,005,814</u>
Short -Term	12,069,767	2,005,814
Long -term	<u>4,000,000</u>	<u>-</u>

# PetroFalcon Corporation

## Notes to Interim Consolidated Financial Statements

**(Unaudited) For the three months ended March 31, 2006 and 2005**

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(expressed in U.S. dollars)

Short-term local bank loans (\$8,069,767) consisted of Vinccler Venezuela's lines of credit with Venezuelan banks to meet its short-term working capital and local currency financing.

The Corporation 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 Corporation's oil and gas properties. During the second quarter of 2005, the IFC disbursed \$12 million from the "C" Loan. Principal repayments on the "C" Loan are due in 2011. Interests are payable semi-annually on May 15 and November 15 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 ("Additional Interest") so long it does not exceed 10% per annum of the principal amount of the "C" loan on an aggregate accumulated basis (see note 12).

### **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 PetroFalcon. For the three months ended March 31, 2006, the Corporation paid to Pacific Oil and Gas, LLC, controlled by PetroFalcon's Chief Financial Officer, Clarence Cottman and the Corporation's President, William Gumma, \$210,000 for professional services (\$210,000, for the three months ended March 31, 2005). During the three months ended March 31, 2006, PetroFalcon was also invoiced \$11,619 (\$800,000 during the three months ended March 31, 2005) for construction services provided by Venezolana de Inversiones y Construcciones Clerico, C.A. an independent operating construction company controlled by the Corporation's Chairman of the Board and Chief Executive Officer, Juan Francisco Clerico.

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**

During the three months ended March 31, 2006, the Corporation recorded a current income tax expense of \$542,389 as compared to \$301,069 during the three months ended March 31, 2005.

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 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

# PetroFalcon Corporation

## Notes to Interim Consolidated Financial Statements

### (Unaudited) For the three months ended March 31, 2006 and 2005

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(expressed in U.S. dollars)

31, 2006, Vinccler Venezuela received the final settlement resulting additional income tax expense of \$542,389 for the years ended December 31, 2001 to 2004.

#### 9 Financial instruments

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

Additionally, the Corporation's financial instruments include long-term debt that bears interest at market-related rates, which approximates fair value.

#### 10 Economic dependence

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

#### 11 Earnings per share

	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2006</b>	<b>2005</b>
Net (loss) income	(\$1,180,680)	\$621,827
Weighted average number of common shares	78,506,407	75,256,515
Stock Options and Warrants*	4,391,694	7,263,427
Basic (loss) earnings per share	(\$0.02)	\$0.01
Diluted (loss) earnings per share*	(\$0.02)	\$0.01

\* The calculation of diluted earnings per common share excludes 6,257,000 options outstanding in 2006 as these would have been anti-dilutive to the calculation.

# **PetroFalcon Corporation**

Notes to Interim Consolidated Financial Statements

**(Unaudited) For the three months ended March 31, 2006 and 2005**

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(expressed in U.S. dollars)

## **12 Subsequent Events**

On April 5, 2006, the IFC provided notice pursuant to the terms of the “C” Loan Agreement, of its intention to convert \$4 million of its outstanding loan into common shares of PetroFalcon Corporation. The IFC received 2,639,651 shares of PFC at a price of CDN \$1.77 per share based on the market weighted average share price over the previous 20 trading days to the notice date. The IFC has now converted \$8 million of the original \$12 million disbursed in 2005 into common shares of PetroFalcon Corporation. With this conversion, the remaining outstanding principal due to IFC is \$4 million.

On May 5, 2006 in its Official Gazette, the National Assembly of Venezuela published the Accord which authorizes the incorporation of the Empresa Mixta and the conversion of the operating services agreements for both the East Falcon Block and the West Falcon Block. The Accord also confirmed the 40% proposed ownership of Vinccler Venezuela.