

PetroFalcon Corporation

Interim Consolidated Financial Statements
(Unaudited)

June 30, 2004 and 2003

(expressed in U.S. dollars)

PetroFalcon Corporation
Interim Consolidated Balance Sheets
(Unaudited)

(expressed in U.S. dollars)

	June 30, 2004	December 31, 2003
	\$	\$ (Restated – note 3)
Assets		
Current assets		
Cash	26,196,968	4,505,657
Accounts receivable	2,508,830	2,518,066
Income taxes recoverable	119,420	42,384
Inventories	487,959	257,302
	<hr/>	<hr/>
	29,313,177	7,323,409
Property and equipment	<hr/>	<hr/>
	9,896,230	8,163,338
	<hr/>	<hr/>
	39,209,407	15,486,747
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 6)	2,177,820	738,417
Current portion of long-term debt	1,728,125	3,732,927
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	3,905,945	4,471,344
Long-term debt	-	466,686
Provision for asset retirement obligation	<hr/>	<hr/>
	334,842	321,964
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	4,240,787	5,259,994
Shareholders' equity		
Capital stock (note 5)	33,670,076	10,195,314
Contributed surplus	650,000	338,550
Retained earnings (accumulated deficit)	<hr/>	<hr/>
	648,544	(307,111)
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	34,968,620	10,226,753
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	39,209,407	15,486,747

PetroFalcon Corporation

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

(expressed in U.S. dollars)

	Six months ended June 30,		Three months ended June 30,	
	2004 \$	2003 \$ (Restated – note 3)	2004 \$	2003 \$ (Restated – note 3)
Revenue	3,050,044	875,810	1,677,465	548,068
Expenses				
Operating and maintenance	962,179	572,259	537,987	319,225
General and administrative	959,194	879,805	568,507	629,023
Amortization, depletion and accretion	552,494	255,889	294,627	172,806
Stock-based compensation	311,450	60,350	179,450	60,350
	2,785,317	1,768,303	1,580,571	1,181,404
Income (loss) before financing income (expenses) and income taxes	264,727	(892,493)	96,894	(633,336)
Financing income (expenses)				
Interest on long-term debt	(168,334)	(343,210)	(73,538)	(149,876)
Interest on bank deposits	152,501	26,342	120,814	20,973
Gain on financing transaction (note 4)	676,041	-	-	-
Gain (loss) on foreign exchange	30,720	538,793	(599,092)	316,766
	690,928	221,925	(551,816)	187,863
Net income (loss)	955,655	(670,568)	(454,922)	(445,473)
(Deficit) retained earnings as previously reported	(307,111)	(762,465)	1,103,466	(980,434)
Change in accounting policy	-	(77,837)	-	(84,963)
(Deficit) retained earnings – Beginning of period	(307,111)	(840,302)	1,103,466	(1,065,397)
Retained earnings (deficit) – End of period	648,544	(1,510,870)	648,544	(1,510,870)
Weighted average number of common shares outstanding	62,976,952	39,763,102	71,167,042	41,967,314
Basic and diluted income (loss) per share	0.02	(0.02)	(0.01)	(0.01)

PetroFalcon Corporation

Interim Consolidated Statements of Cash Flows (Unaudited)

(expressed in U.S. dollars)

	Six months ended June 30,		Three months ended June 30,	
	2004 \$	2003 \$ (Restated – note 3)	2004 \$	2003 \$ (Restated – note 3)
Cash provided by (used in)				
Operating activities				
Net income (loss) for the period	955,655	(670,568)	(454,922)	(445,473)
Items not affecting cash				
Amortization, depletion and accretion	552,494	255,889	294,627	172,806
Stock-based compensation	311,450	60,350	179,450	60,350
	1,819,599	(354,329)	19,155	(212,317)
Net change in non-cash working capital items				
Accounts receivable	9,236	(367,971)	(511,288)	(161,637)
Inventories	(230,657)	180,747	(230,657)	180,747
Accounts payable and accrued liabilities	247,599	178,453	463,120	81,369
Income taxes payable	(77,036)	(33,169)	(92,078)	(30,952)
	1,768,741	(396,269)	(351,748)	(142,790)
Financing activities				
Cash acquired on recapitalization and acquisition (note 3)	-	2,266,590	-	2,266,590
Proceeds from private placement	15,859,165	3,967,824	-	3,967,824
Proceeds from (repayment of) long-term debt	(2,471,488)	689,100	(444,293)	58,961
Proceeds received on exercise of share options and warrants	7,615,597	117,950	337,880	117,950
	21,003,274	7,041,464	(106,413)	6,411,325
Investing activities				
Acquisition of property and equipment	(2,272,508)	(1,956,352)	(1,718,843)	(686,052)
Movement in non-cash working capital from investing activities	1,191,804	-	1,088,561	-
	(1,080,704)	(1,956,352)	(630,282)	(686,052)
Net increase (decrease) in cash during the period	21,691,311	4,688,843	(1,088,443)	5,582,483
Cash – Beginning of period	4,505,657	1,732,381	27,285,411	838,741
Cash – End of period	26,196,968	6,421,224	26,196,968	6,421,224
Supplementary information				
Interest paid, net	199,621	257,838	61,984	69,192
Income taxes paid	102,576	-	92,077	-

PetroFalcon Corporation

Notes to Interim Consolidated Financial Statements

(Unaudited)

For the three months ended June 30, 2004 and 2003

(expressed in U.S. dollars)

1 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 its interest in an operating service contract dated July 3, 1995 with Petroleos de Venezuela, S.A. (“PDVSA”), the state oil company of Venezuela.

Reverse takeover

On June 4, 2003 the Company acquired 100% of the issued and outstanding securities of Vinccler Oil and Gas Corporation (“Vinccler”) and as a result indirectly, acquired 100% of the securities of Vinccler Venezuela, the wholly owned subsidiary of Vinccler (the “Reverse Takeover”). As consideration, the Company issued a sufficient number of securities to the holders of securities of Vinccler that control of the Company passed to the former security holders of Vinccler. The Reverse Takeover was accounted for as a recapitalization of the Company.

The consolidated statements of operations and retained earnings (deficit) and cash flows of the Company prior to June 4, 2003 are those of Vinccler.

Previous reverse takeover

On June 18, 2002, Vinccler entered into a subscription and contribution agreement with Venezolana de inversiones y Construcciones Clerico Compania Anonima, pursuant to which Vinccler acquired all of the issued and outstanding shares of Vinccler Venezuela in exchange for an aggregate of 8,333,333 Vinccler common shares.

Vinccler Venezuela was accounted for as the acquiring party and the surviving accounting entity because the former shareholders of Vinccler Venezuela received an amount of voting shares which constitutes an effective controlling interest in the combined corporation. The shares issued by Vinccler pursuant to the June 18, 2002 subscription and contribution agreement have been accounted for as if those shares had been issued upon the organization of Vinccler Venezuela.

Because Vinccler Venezuela is the accounting survivor, the consolidated financial statements presented for the period up to June 18, 2002 are those of Vinccler Venezuela since its inception, effective April 1, 2000. From June 19, 2002 on, the financial statements represent operations in both Vinccler Venezuela and Vinccler.

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Notes to Interim Consolidated Financial Statements

(Unaudited)

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2 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 as at and for the year ended December 31, 2003, except as described in note 3.

3 Changes in accounting policies

Asset retirement obligations

Effective January 1, 2004, the Company adopted the new Canadian accounting standard with respect to asset retirement obligations. Under the new standard, legal obligations associated with the retirement of tangible long-lived assets are recorded as liabilities. The liabilities are calculated using the net present value of the cash flows required to settle the obligation. A corresponding amount is capitalized to the related asset. Asset retirement costs are charged to earnings over the life of the asset.

The total undiscounted amount of the estimated cash flows required to settle the obligations is \$510,000, which has been discounted using a credit-adjusted risk free rate of 8%. Payments to settle the obligations will occur on an ongoing basis over the next 10 years.

The new standard has been applied retroactively and financial statements of prior periods have been restated. The impact of this change on the December 31, 2003 consolidated balance sheet is a net increase in property and equipment of \$216,450, an increase in asset retirement and other long-term obligations of \$321,964, and a reduction of retained earnings of \$105,514.

Stock-based compensation

During the fourth quarter of 2003, the Company elected to adopt amendments to CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments" pursuant to the transitional provisions contained therein. Under the amended standard, the Company accounts for stock-based compensation costs based on the fair value of options granted under its stock option plan. The change in accounting policy was implemented by the Company effective January 1, 2003, and each quarter of 2003 was restated to account for the change in policy (except for the quarter ended March 31, 2003, where the effect of the change in accounting policy was nil because of the accounting for the reverse takeover (see note 1)). The effect of this change in accounting policy was to increase stock-based compensation expense and reduce net income by \$39,200 for the three month and six month periods ended June 30, 2003. See note 5 for additional information regarding the nature of the plan and the associated compensation expense.

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Full cost accounting

Effective January 2004, the Company adopted AcG-16 "Oil and Gas Accounting – Full Cost", the new guideline issued by the Canadian Institute of Chartered Accountants which replaces AcG-5 "Full Cost Accounting in the Oil and Gas Industry".

There were no changes to net income, property, plant and equipment or any other reported amounts in the financial statements as a result of adopting this guideline.

4 Gain on financing transaction

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

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, 2003	52,853,379	10,195,314
Exercise of Canadian warrants	6,840,000	6,431,407
Exercise of U.S. warrants	967,214	717,409
Exercise of agents' options	588,249	442,490
Exercise of special warrants	10,240,000	15,859,165
Exercise of share options	65,000	24,291
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As at June 30, 2004	71,553,842	33,670,076

Common stock

The common stock 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.

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Canadian warrants

During the period from February 3, 2004 to March 1, 2004, the trading price of PetroFalcon Corporation common shares was greater than CDN\$1.75 for 20 consecutive trading days. This constituted an "Accelerated Event" under the warrant indenture, which provided for the issuance of up to 6,890,000 warrants, which entitled the holder thereof to purchase one common share of the Company at a price of CDN\$1.25. Subsequently, 6,840,000 warrants were exercised for proceeds of \$6,431,407 (CDN\$8,550,000); the remaining 50,000 warrants expired on March 31, 2004.

US warrants

During the three month period ended June 30, 2004, 967,214 of the total 4,551,600 US warrants were exercised for proceeds of \$717,409 (CDN\$967,214), leaving 3,584,386 additional unexercised US warrants as at June 30, 2004.

Agents' options

During the three month period ended March 31, 2004, all of the remaining 588,249 of agents' options were exercised, resulting in proceeds of \$442,490 (CDN\$588,249).

Exercise of special warrants

On March 18, 2004, the Company announced it had closed a bought deal financing. The financing consisted of the issuance of an aggregate of 10,240,000 special warrants at a price of CDN\$2.20 per special warrant which raised gross proceeds of \$16,948,540 (CDN\$22,528,000). Costs related to the financing were \$1,089,375 (CDN\$1,447,364), resulting in net proceeds to the Company of \$15,859,165 (CDN\$21,080,636).

The terms of the special warrant were such that they were exercisable, without payment of additional consideration, for one common share of the Company. The special warrants were exercisable by the holders thereof at any time, and would convert automatically with no further action required by the holder thereof, upon the earlier of: (i) receipt of confirmation in writing to Orion Securities Inc. ("Orion") that new Multilateral Instrument 45-102 ("New 45-102") has come into effect; and (ii) 5:00 p.m. (Calgary time) on the fifth business day after a final receipt is issued by the last of the relevant securities in each jurisdiction where New 45-102 is not in effect on March 30, 2004 for a prospectus qualifying the distribution of the common shares to be issued upon the exercise of the special warrants.

New 45-102 subsequently came into effect. The special warrants were deemed to be exercised resulting in the increase of 10,240,000 common shares effective March 30, 2004.

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Shares previously subject to cease trade

During fiscal 2001, the Company commenced an action against Sheldon Zelitt, Joy Zelitt (collectively the “Zelitts”) and the Downsview Investment Group Limited (“Downsview”). Subsequently a settlement agreement was reached to settle the lawsuit (the “Settlement Agreement”). The Zelitts and Downsview agreed to the cancellation of 6,474,625 common shares relating to the original issue and the cancellation of an additional 200,000 common shares as an offset against a CDN\$250,000 limited recourse share purchase loan that was outstanding pursuant to a previously existing share purchase assistance plan of the Company. In addition, the Zelitts acknowledged in the Settlement Agreement that a total of CDN\$1,575,133 comprised of CDN\$47,432 and CDN\$1,527,701 was owed (the “Debt”) and agreed to the provision of security against the debt by way of pledging the net after-tax proceeds, if any, from the remaining 999,998 of the 1,000,000 common shares owned by the Zelitts and providing a first charge (or equivalent) on the residence and property purchased in the Czech Republic with the funds that gave rise to the Debt.

On August 21, 2003 the Alberta Securities Commission granted an order to vary the cease trade solely to permit the sale of the common shares required to pay down the Debt. As of December 31, 2003, upon the sale of the entire 999,998 of the shares held by the Zelitts, \$701,781 (CDN\$923,517) was delivered by the depository to the Company in compliance with the Settlement Agreement. Upon receipt of the funds, the Company applied the entire payment to the Debt leaving an outstanding amount of CDN\$651,616. Pursuant to the Settlement Agreement, any balance on the Debt remaining after January 1, 2004 will bear interest at 6% per annum and be payable by monthly payments commencing February 1, 2004 until January 1, 2009.

Stock option plan

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

	2004		2003	
	Share Options	Weighted- average exercise price CDN\$	Share options	Weighted- average exercise price CDN\$
Outstanding – Beginning of period	4,365,000	0.93	200,000	0.72
Granted	2,250,000	2.33	4,555,000	0.90
Exercised	(65,000)	0.50	(275,000)	0.58
Cancelled	(75,000)	1.00	-	
Outstanding – End of period	6,475,000	1.42	4,480,000	0.92
Options exercisable – End of period	2,219,167	0.88	1,690,000	0.55

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A summary of stock options outstanding at June 30, 2004 is set out below:

Exercise price	Outstanding stock options		Exercisable stock options
	Number	Weighted average remaining contractual life	Number
\$0.50	485,000	3.7 years	485,000
\$0.72	100,000	2.6 years	100,000
\$1.00	3,600,000	8.9 years	1,634,167
\$1.30	40,000	9.3 years	-
\$2.20	350,000	9.75 years	-
\$2.35	1,900,000	9.9 years	-
	<u>6,475,000</u>		<u>2,219,167</u>

The Company has elected to recognize compensation costs for stock options granted to employees and directors. Canadian generally accepted accounting principles require that options granted during the reporting period be valued using the fair value method. The Company estimated the fair value of the options granted using the Black-Scholes option pricing model with assumptions as follows:

Risk free interest rate	2.25% – 3.33%
Expected volatility	60%
Dividends yield rate	0.00%
Weighted average expected life of options	5 years

Options issued in 2002 relate to Pretium Industries, Inc., the predecessor of the Company. There is no proforma disclosure of the 2002 net income for options granted as Pretium Industries, Inc. is not the predecessor for accounting purposes due to the reverse takeover. Vinccler, the accounting predecessor, did not grant any options in 2002.

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(expressed in U.S. dollars)

6 Related party transactions and balances

During the six months ended June 30, 2004 and 2003, PetroFalcon was invoiced \$330,000 by Pacific Petroleum LLC. Pacific Petroleum is controlled by officers of the Company.

During the three months ended June 30, 2004 and 2003, PetroFalcon was invoiced \$165,000 by Pacific Petroleum LLC.

At June 30, 2004, \$81,492 (2003 – \$50,648) is due to Pacific Petroleum LLC.

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

Under Venezuelan law, taxpayers who have transactions with foreign related parties have to determine their incomes, costs and deductions using methodology established by law. Transfer prices will be established by the Company to comply with the regulations but as of the year end date, no regulations have been issued. The Company has begun the process to obtain the required information in order to determine if any adjustments to the transfer prices will need to be made.

7 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.

8 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.

