

PetroFalcon Corporation

Interim Consolidated Financial Statements

(Unaudited)

September 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 nine months ended September 30, 2005 and 2004, have been prepared by management and approved by the Audit Committee of the Company.

PetroFalcon Corporation
Interim Consolidated Balance Sheets
(Unaudited)

(expressed in U.S. dollars)

	September 30, 2005	December 31, 2004
	\$	\$
Assets		
Current assets		
Cash	14,058,934	20,445,802
Restricted cash	1,000,000	3,600,000
Accounts receivable	7,280,614	4,310,634
Income tax recoverable	211,059	61,092
	<u>22,550,607</u>	<u>28,417,528</u>
Property and equipment	<u>41,536,802</u>	<u>16,413,226</u>
	<u>64,087,409</u>	<u>44,830,754</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	4,073,459	1,963,706
Income tax payable	81,497	58,314
Bank loans	3,872,093	2,825,521
	<u>8,027,049</u>	<u>4,847,541</u>
Deferred Income Tax	200,000	-
Long-term debt (note 6)	8,000,000	-
Provision for asset retirement obligation	395,346	347,720
	<u>16,622,395</u>	<u>5,195,261</u>
Shareholders' Equity		
Capital stock (note 5)	40,676,996	36,513,195
Warrants (note 5)	118,571	-
Contributed surplus	2,726,255	1,316,359
Retained earnings	<u>3,943,192</u>	<u>1,805,939</u>
	<u>47,465,014</u>	<u>39,635,493</u>
	<u>64,087,409</u>	<u>44,830,754</u>

PetroFalcon Corporation

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

(expressed in U.S. dollars)

	Nine months ended September 30,		Three months ended September 30,	
	2005 \$	2004 \$	2005 \$	2004 \$
Revenue	8,069,274	5,131,663	3,055,023	2,081,619
Expenses				
Operating, maintenance and transportation	2,111,880	1,671,594	804,754	709,415
General and administrative	2,538,468	1,630,944	703,063	671,750
Amortization, depletion and accretion	1,156,606	876,608	362,349	324,114
Stock-based compensation	1,423,000	621,450	526,000	310,000
	7,229,954	4,800,596	2,396,166	2,015,279
Income before financing income (expenses) and income tax	839,320	331,067	658,857	66,340
Financing income (expenses)				
Interest on bank loans	(547,978)	(273,240)	(286,887)	(104,906)
Interest on bank deposits	212,774	206,520	57,910	54,019
Gain on financing transactions (note 4)	2,149,941	676,041	793,969	-
Gain on foreign exchange	117,344	208,096	63,272	177,376
	1,932,081	817,417	628,264	126,489
Income before income tax	2,771,401	1,148,484	1,287,121	192,829
Income tax (note 8)	(634,148)	-	(200,000)	-
Net income	2,137,253	1,148,484	1,087,121	192,829
Retained earnings (deficit) – Beginning of period	1,805,939	(307,111)	2,856,071	648,544
Retained earnings – End of period	3,943,192	841,373	3,943,192	841,373
Weighted average number of common shares outstanding	76,352,318	63,389,958	77,519,741	72,740,189
Basic and diluted earnings per share	0.03	0.02	0.01	*

* Less than \$0.01

PetroFalcon Corporation

Interim Consolidated Statements of Cash Flows (Unaudited)

(expressed in U.S. dollars)

	Nine months ended September 30,		Three months ended September 30,	
	2005 \$	2004 \$	2005 \$	2004 \$
Cash provided by (used in)				
Operating activities				
Net income for the period	2,137,253	1,148,484	1,087,121	192,829
Items not affecting cash				
Amortization, depletion and accretion	1,156,606	876,608	362,349	324,114
Stock-based compensation	1,423,000	621,450	526,000	310,000
Deferred Income Tax	200,000	-	200,000	-
	4,916,859	2,646,542	2,175,470	826,943
Net change in non-cash working capital items				
Accounts receivable	(2,969,980)	(813,728)	(697,011)	(822,964)
Accounts payable and accrued liabilities	(997,932)	387,526	(1,904,231)	139,927
Income tax payable	(126,783)	(136,740)	(237,989)	(59,704)
	822,164	2,083,600	(663,761)	84,202
Financing activities				
Proceeds from private placement	4,000,000	15,859,165	-	-
Warrants	118,571	-	-	-
Restricted Cash	2,600,000	(2,600,000)	2,825,000	(2,600,000)
Proceeds from (repayment of) bank loans	9,046,572	(1,527,478)	(2,104,651)	944,010
Proceeds received on exercise of share options and warrants	150,697	9,435,715	20,993	1,820,118
	15,915,840	21,167,402	741,342	164,128
Investing activities				
Acquisition of property and equipment	(26,232,557)	(6,883,133)	(2,447,904)	(4,379,968)
Movement in non-cash working capital from investing activities	3,107,685	3,142,597	(5,405,731)	1,950,793
	(23,124,872)	(3,740,536)	(7,853,635)	(2,429,175)
Net (decrease) increase in cash during the period	(6,386,868)	19,510,466	(7,776,054)	(2,180,845)
Cash – Beginning of period	20,445,802	4,505,657	21,834,988	26,196,968
Cash – End of period	14,058,934	24,016,123	14,058,934	24,016,123
Supplementary information				
Interest paid, net	514,766	274,442	179,495	74,821
Income tax paid	330,609	162,280	-	59,704

PetroFalcon Corporation

Notes to Interim Consolidated Financial Statements

(Unaudited) For the three and nine months ended September 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 nine months period ended September 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, and should be read in conjunction therewith.

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

The Company's subsidiary, Vinccler Venezuela, signed an agreement on August 4, 2005, with PDVSA agreeing to migrate the OSA to a mixed company ("Empresa Mixta"). It is the understanding of the Company that (i) Vinccler Venezuela will be required to transfer the East Falcon OSA to a mixed company in exchange for a 49% interest; and (ii) PDVSA will obtain the remaining 51% interest in exchange for contributing a contract extension, other oil and gas interests in the mixed company and other assets. The Company is working closely with the Ministry of Energy and Petroleum ("MEP") and PDVSA to conclude the negotiations and migration in accordance with the time frame established by the Venezuelan Government.

At this time the economic impact and actual timing of the implementation of these governmental amendments 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

(Unaudited) For the three and nine months ended September 30, 2005 and 2004

(expressed in U.S. dollars)

4 Gain on financing transactions

During the three months ended September 30, 2005, the Company's subsidiary, Vinccler Venezuela, recorded a gain of \$793,969 as a result of the acquisition and disposal of US dollar denominated Venezuelan government bonds, \$2,149,941 during the nine months ended September 30, 2005.

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	269,906	150,697
Transfer from contributed surplus	-	13,104
	<hr/>	<hr/>
As at September 30, 2005	<u>77,526,407</u>	<u>40,676,996</u>

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.

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Notes to Interim Consolidated Financial Statements

(Unaudited) For the three and nine months ended September 30, 2005 and 2004

(expressed in U.S. dollars)

Stock option plan

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

	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	(269,906)	0.69	(105,000)	0.52
Cancelled	(45,400)	1.98	(90,000)	1.23
Outstanding – September 30	8,706,194	1.92	6,420,000	1.42
Options exercisable – September 30	4,393,361	1.14	2,179,167	0.88

A summary of stock options outstanding at September 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	2.95 years	250,000
\$0.72	100,000	1.65 years	100,000
\$1.00	3,548,354	7.95 years	3,301,688
\$1.30	13,340	8.25 years	6,674
\$2.20	320,000	8.75 years	106,666
\$2.35	1,885,000	8.95 years	628,333
\$2.39	1,589,500	9.70 years	-
\$3.28	1,000,000	9.15 years	-
	<u>8,706,194</u>		<u>4,393,361</u>

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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. As of September 30, 2005, these warrants were still outstanding and none were exercised.

6 Long-term debt

The Company 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 million (the “A” Loan) is subject to the completion of certain technical tests. Principal repayments on the “C” Loan 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 September 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 of PetroFalcon’s shares 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 three months ended September 30, 2005, the Company was invoiced \$210,000 by Pacific Oil and Gas, LLC (\$180,000, during the three months ended September 30, 2004) for professional services. During the period, the Company was also invoiced \$261,858 for construction services provided by Venezolana de Inversiones y Construcciones Clerico, C.A.

During the nine months ended September 30, 2005, the Company was invoiced \$630,000 by Pacific Oil and Gas, LLC (\$510,000, during the nine months ended September 30, 2004) for professional services. During the period, the Company was also invoiced \$1,440,000 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.

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8 Income Tax

Vinccler Venezuela recorded a deferred income tax expense of \$200,000 in the three months ended September 30, 2005 result. Deferred tax is based on a timing difference in the financial and fiscal treatment of fixed assets. In addition, Vinccler Venezuela accrued Venezuelan income tax in the amount of \$434,148 for the nine months ended September 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.

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.