Yangarra Resources Inc.
Consolidated Financial Statements
December 31, 2004

To the Shareholders of Yangarra Resources Inc.:

Management is responsible for the preparation and presentation of the accompanying financial statements, including responsibility for significant accounting judgments and estimates in accordance with Canadian generally accepted accounting principles and ensuring that all information in the annual report is consistent with the statements. This responsibility includes selecting appropriate accounting principles and methods, and making decisions affecting the measurement of transactions in which objective judgment is required.

In discharging its responsibilities for the integrity and fairness of the financial statements, management designs and maintains the necessary accounting systems and related internal controls to provide reasonable assurance that transactions are authorized, assets are safeguarded and financial records are properly maintained to provide reliable information for the preparation of financial statements.

The Board of Directors exercises its responsibilities for financial controls through an Audit Committee. The Audit Committee is responsible for overseeing management in the performance of its financial reporting responsibilities, and for approving the financial information included in the annual report. The Committee has the responsibility of meeting with management and external auditors to discuss the internal controls over the financial reporting process, auditing matters and financial reporting issues. The Committee is also responsible for recommending the appointment of the Company's external auditors.

Meyers Norris Penny LLP, an independent firm of Chartered Accountants, is appointed by the shareholders to audit the financial statements and report directly to them; their report follows. The external auditors have full and free access to, and meet periodically and separately with, both the Board and management to discuss their audit findings.

April 6, 2005

Mr. James G. Evaskevich
Chief Executive Officer

John Aihoshi

Mr. John Aihoshi
Chief Financial Officer

Auditors' Report

To the Shareholders of Yangarra Resources Inc.:

We have audited the consolidated balance sheets of Yangarra Resources Inc. as at December 31, 2004 and 2003, and the consolidated statements of earnings, 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, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Meyers Norris Penny LLP

Calgary, Alberta
April 6, 2005

Chartered Accountants

Yangarra Resources Inc.
Consolidated Balance Sheets
As at December 31

	2004	*2003 (Restated)*
Assets		
Current		
Cash	**2,758**	2,787,200
Marketable securities	**-**	252,727
Accounts receivable	**2,285,964**	1,895,052
Prepaid expenses and deposits	**170,015**	59,012
	2,458,737	4,993,991
Property and equipment *(Note 4)*	**56,797**	41,074
Resource properties *(Note 5)*	**21,853,794**	9,291,685
Investment *(Note 6)*	**109,258**	176,805
	24,478,586	14,503,555
Liabilities		
Current		
Bank indebtedness *(Note 7)*	**4,600,073**	**-**
Accounts payable and accruals	**3,775,316**	5,500,391
	8,375,389	5,500,391
Future income taxes *(Note 8)*	**2,358,904**	1,529,553
Asset retirement obligations *(Note 9)*	**394,648**	207,502
	11,128,941	7,237,446
Shareholders' Equity		
Share capital *(Note 10)*	**18,609,811**	11,934,349
Contributed surplus	**785,691**	586,000
Deficit	**(6,045,857)**	(5,254,240)
	13,349,645	7,266,109
	24,478,586	14,503,555

Approved on behalf of the Board of Directors

"James G. Evaskevich" (signed)
James G. Evaskevich

"Gordon A. Bowerman" (signed)
Gordon A. Bowerman

The accompanying notes are an integral part of these financial statements

Consolidated Statements of Earnings

For the years ended December 31, 2004 and 2003

	2004	*2003* *(Restated)*
Revenue		
Petroleum and natural gas sales	**3,075,560**	52,356
Royalties, net of Alberta Royalty Tax Credit	**(620,852)**	(878)
	2,454,708	51,478
Expenses		
Administration	**854,080**	160,838
Amortization, depletion and accretion	**1,869,383**	43,084
Interest	**130,037**	6,529
Production	**637,067**	37,424
	3,490,567	247,875
Loss from operations	**(1,035,859)**	(196,397)
Other expenses		
Write-down of mining property *(Note 5)*	**(108,755)**	**-**
Impairment loss on investment *(Note 6)*	**(67,547)**	**-**
Non-cash stock-based compensation	**(199,691)**	(586,000)
	(375,993)	(586,000)
Loss before income taxes	**(1,411,852)**	(782,397)
Future income tax recovery	**(620,235)**	(1,154,516)
Net earnings (loss)	**(791,617)**	372,119
Earnings (loss) per share		
Basic	**(0.037)**	0.049
Diluted	**(0.037)**	0.037
Weighted average number of common shares		
Basic	**21,442,700**	7,539,387
Diluted	**23,637,245**	9,868,799

The accompanying notes are an integral part of these financial statements

Yangarra Resources Inc.
Consolidated Statements of Deficit
For the years ended December 31, 2004 and 2003

	2004	*2003* *(Restated)*
Deficit, beginning of year, as previously stated	**(5,253,579)**	(5,638,359)
Change in accounting policy *(Note 3)*	**(661)**	12,000
Deficit, beginning of year, as restated	**(5,254,240)**	(5,626,359)
Net earnings (loss)	**(791,617)**	372,119
Deficit, end of year	**(6,045,857)**	(5,254,240)

The accompanying notes are an integral part of these financial statements

Yangarra Resources Inc.
Consolidated Statements of Cash Flows
For the years ended December 31, 2004 and 2003

	2004	*2003 (Restated)*
Cash provided by (used for) the following:		
Operating		
Net earnings (loss)	**(791,617)**	372,119
Amortization, depletion and accretion	**1,869,383**	43,084
Future income taxes	**(620,235)**	(1,154,516)
Impairment loss on investment	**67,547**	-
Write-down of mining property	**108,755**	-
Non-cash stock-based compensation	**199,691**	586,000
	833,524	(153,313)
Changes in non-cash working capital accounts		
Accounts receivable	**(390,912)**	(1,891,516)
Prepaid expenses and deposits	**(111,003)**	(45,958)
Accounts payable and accruals	**(2,198,158)**	10,016
	(1,866,549)	(2,080,771)
Financing		
Issue of common shares	**8,813,368**	9,014,750
Share issue costs	**(688,320)**	(367,774)
Repayment of advances from shareholders	**-**	(55,000)
	8,125,048	8,591,976
Investing		
Purchases of property and equipment	**(32,663)**	(44,344)
Purchase of and expenditures on resource properties *(Note 5)*	**(13,863,078)**	(3,436,380)
Purchase of marketable securities	**-**	(252,727)
Proceeds on disposal of marketable securities	**252,727**	-
	(13,643,014)	(3,733,451)
Increase (decrease) in cash	**(7,384,515)**	2,777,754
Cash, beginning of year	**2,787,200**	9,446
Cash (deficiency), end of year	**(4,597,315)**	2,787,200
Cash is comprised of:		
Cash	**2,758**	2,787,200
Bank indebtedness *(Note 7)*	**(4,600,073)**	-
	(4,597,315)	2,787,200
Supplementary cash flow information		
Interest paid	**130,170**	6,529

The accompanying notes are an integral part of these financial statements

1. Incorporation and nature of operations

Yangarra Resources Inc. ("the Company") was incorporated under the laws of the Province of Alberta on January 22, 1985, as Ayrex Resources Ltd. The Company subsequently changed its name and began trading on the TSX Venture Exchange on July 21, 2003. The Company is involved in the production, exploration and of development resource properties.

2. Significant accounting policies

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles, and include the following significant accounting policies:

Going concern

These consolidated financial statements have been prepared on a going concern basis which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. Should the Company be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due.

The Company's ability to continue as a going concern is dependent upon its ability to attain profitable operations and generate funds therefrom and to continue to obtain capital financing from investors sufficient to meet current and future obligations.

Basis of consolidation

The Company has consolidated the assets, liabilities, revenues and expenses of the Company and its wholly owned inactive subsidiary, Mount Julian Resources Ltd., after the elimination of inter-company transactions and balances.

Marketable securities

Marketable securities are valued at the lower of cost and market value.

Investments

Investments are stated at the lower of cost less any provisions for other than temporary impairment. They have been classified as a long-term asset in concurrence with the nature of the investment.

Property and equipment

Property and equipment are initially recorded at cost. Amortization is provided using methods and rates intended to amortize the cost of assets over their estimated useful lives.

	Method	Rate
Computer equipment	declining balance	30 %
Leasehold improvements	straight-line	3 years
Office equipment	declining balance	20 %

In the year of acquisition, amortization is taken at one-half of the above rates.

Resource properties

The Company follows the full cost method of accounting for its petroleum and natural gas operations. Under this method all costs related to the acquisition of, exploration for, and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses and costs of drilling both productive and non-productive wells and overhead costs directly related to exploration and development activities. Proceeds from the sale of resource properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would significantly alter the rate of depletion.

2. Significant accounting policies *(Continued from previous page)*

Depletion and amortization

Depletion of resource properties and amortization of production equipment, net of estimated salvage or residual value, is provided using the unit of production method based upon estimated proven resource reserves before royalties, as determined by independent engineers. For depletion and amortization purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

Long-lived assets

Long-lived assets consist of property and equipment and resource properties. Long-lived assets held for use are measured, depleted or amortized as described in the applicable accounting policies.

The Company performs impairment testing on long-lived assets held for use whenever events or changes in circumstances indicate that the carrying value of property and equipment or resource properties may not be recoverable. Impairment losses are recognized when undiscounted future cash flows from the Company's proved reserves, undeveloped land and future development projects are less than the carrying value of property and equipment and resource properties. Any impairment is included in earnings for the year.

If the carrying value is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the property and equipment and resource properties exceeds the sum of the discounted cash flows from proved plus probable reserves, undeveloped land and future development projects. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

Investments in joint ventures

Substantially all of the Company's petroleum and natural gas exploration and production activities are conducted jointly with others, and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

Bank indebtedness

The Company classifies borrowings as a current liability where the lender has a right to demand payment within twelve months, or where the lender may not re-finance the borrowing for a further lending period longer than twelve months.

Asset retirement obligations

An asset retirement obligation is recognized at its fair value when the related asset is acquired and a reasonable estimate of its fair value is determinable. Discounted cash flows are used to measure fair value.

When a liability is recognized, a corresponding asset retirement cost is capitalized to the carrying amount of the related asset. The asset retirement cost is amortized over the estimated useful life of the related asset.

The Company accrues asset retirement obligations on a future discounted basis as accretion expense. The Company recognizes changes due to revisions or new obligations as an increase in the asset retirement obligation and resource properties. Actual costs, as incurred, are charged to the asset retirement obligation.

Future income taxes

The Company follows the asset and liability method of accounting for future income taxes. Under this method, future income tax assets and liabilities are recorded based on temporary differences between the carrying amount of balance sheet items and their corresponding tax bases. In addition, the future benefits of income tax assets, including unused tax losses, are recognized, subject to a valuation allowance, to the extent that it is more likely than not that such future benefits will ultimately be realized. Future income tax assets and liabilities are measured using enacted tax rates and laws expected to apply when the tax liabilities or assets are to be either settled or realized.

2. Significant accounting policies *(Continued from previous page)*

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period.

Accounts receivable are stated after evaluation as to their collectibility and an appropriate allowance for doubtful accounts is provided where considered necessary.

Amounts recorded for depletion of resource properties, amortization of property and equipment, asset retirement obligations and impairment calculations are based on estimates of natural gas and crude oil reserves and future costs required to develop those reserves. By their nature, these estimates of reserves, including the estimates of future prices and costs, and the related future cash flows are subject to measurement uncertainty, and the impact in the consolidated financial statements
of future periods could be material.

These assumptions are reviewed periodically and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

Revenue recognition

Revenue is recognized from oil sales when the oil is delivered to the buyer and from gas sales when the gas passes through the pipeline at the delivery point.

Flow through shares

Share capital includes flow through shares issued pursuant to certain provisions of the Income Tax Act (Canada) ("the Act"). Under the Act, where the proceeds are used for eligible expenditures, the related income tax deductions may be renounced to subscribers.

Share capital is reduced by an amount equal to the estimated future income taxes payable by the Company as a result of the renunciations and the estimated future income taxes payable are recorded as an increase to the future income tax liability when the expenditures are renounced to the shareholders.

Stock-based compensation

The fair value for each stock option granted is estimated on the date of the grant using the Black Scholes option pricing model. These fair values are recognized in current earnings with a corresponding increase to contributed surplus over the vesting period of the grant. As the options are exercised, the consideration paid, together with the amount previously recognized in contributed surplus, is recorded as an increase to share capital.

Earnings per share

Basic earnings per share is calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share is calculated based on the treasury stock method which assumes that any proceeds obtained on the exercise of options and warrants would be used to purchase common shares at the average price during the period. Diluted earnings per share are not disclosed where the effect of options and warrants is anti-dilutive.

3. Change in accounting policies

Impairment of long-lived assets

Effective January 1, 2004, the Company adopted AcG-16 "Oil and Gas Accounting - Full Cost". The new guideline issued by the Canadian Institute of Chartered Accountants ("CICA") replaces AcG-5 "Full Cost Accounting in the Oil and Gas Industry". AcG-16 modifies how impairment is tested and is consistent with CICA section 3063 "Impairment of Long lived Assets". Under AcG-16, impairment is recognized if the carrying amount of the assets exceed the sum of the undiscounted cash flows expected to result from the Company's proved reserves. Pursuant to this guideline, the change was applied prospectively and prior periods have not been restated. The adoption of the new guideline had no effect on the financial statements.

Asset retirement obligations

Effective January 1, 2004, the Company adopted the CICA's new recommendations for asset retirement obligations. Pursuant to these recommendation, the change was applied retroactively, and prior periods have been restated.

Previously, the Company accrued a provision for future removal and site restoration costs, net of recoveries, which was charged to income on a rational and systematic basis. Under the new recommendations, an asset retirement obligation is recognized at fair value when incurred, and a concurrent asset retirement cost is capitalized to the related asset and amortized to income over its estimated useful life, as described in Note 2, Accounting Policies.

The cumulative effect in the prior year, as of January 1, 2004, of adopting this new recommendation is to decrease the future site restoration provision by $12,914 (2003 - $12,000), increase asset retirement obligations by $207,502 (2003 - $193,927), increase the carrying value of the related asset by $193,927 (2003 - $193,927), reduce site restoration expense by $914 (2003 - $12,000), and increase accretion expense by $13,575 (2003 - nil). The net effect on the opening deficit was an increase to the deficit by $661 (2003 - decrease deficit by $12,000).

4. Property and equipment

			2004	*2003*
				(Restated)
	Cost	*Accumulated amortization*	*Net book value*	*Net book value*
Computer equipment	**47,461**	**10,775**	**36,686**	14,102
Office equipment	**9,775**	**2,213**	**7,562**	8,382
Leasehold improvements	**19,771**	**7,222**	**12,549**	18,590
	77,007	**20,210**	**56,797**	41,074

Included in "amortization, depletion and accretion" is amortization of $16,940 (2003 - $3,270) relating to property and equipment.

5. Resource properties

			2004	*2003 (Restated)*
	Cost	***Accumulated depletion***	***Net book value***	*Net book value*
Petroleum and natural gas properties	**23,717,951**	**1,864,157**	**21,853,794**	9,182,930
Mining properties	**-**	**-**	**-**	108,755
	23,717,951	**1,864,157**	**21,853,794**	9,291,685

During the year, resource property expenditures and acquisitions totaled $14,508,781, (2003 - $8,948,041) of which $473,082 (2003 - $5,301,661) were accrued in accounts payable and accruals, $172,621 (2003 - nil) were due to asset retirement obligations, $nil (2003 - $210,000) were acquired through issue of common shares and $13,863,078 (2003 -$3,436,380) were acquired with cash.

At December 31, 2004, the Company has excluded $3,214,845 (2003 - $2,131,095) of resource properties relating to unproved properties from, and included $7,467,000 (2003 - $8,128,000) of future development costs in, the depletion calculation.

During 2004 and 2003, no general and administrative expenses relating to exploration and development were capitalized.

The impairment test as at December 31, 2004 excluded $3,214,845 of unproved properties which have been separately evaluated by management for impairment. This measurement calculation resulted in no impairment of the Company's resource properties.

The future commodity prices used in the impairment test were based on December 31, 2004 and March 31, 2005 commodity price forecasts of the Company's independent reserve engineers adjusted for differentials specific to the Company's reserves as follows:

	WTI Cushing $US/bbl		***Edmonton 40 API $Cdn/bbl***		***US Gulf Coast Henry Hub $US/mmbtu***		***AECO"C" Spot $Cdn/mmbtu***	
	December 31	*March 31*	*December 31*	*March 31*	*December 31*	*March 31*	*December 31*	*March 31*
2005	44.29	53.00	51.25	63.89	6.74	7.07	6.60	7.61
2006	41.60	50.82	48.03	60.50	6.48	7.20	6.35	7.73
2007	37.09	40.31	42.64	47.66	6.08	6.40	6.15	6.75
2008	33.46	33.46	38.31	39.29	5.70	5.70	6.00	5.92
2009	31.84	31.84	36.36	37.30	5.41	5.41	6.00	5.55

The escalation rate of the above prices after 2009 is 1.5%.

During the year, the Company's mineral claims in Quebec expired. The mining property carrying value of $108,755 was charged to current year's earnings.

6. Investment

Included in "Other expenses" is an asset impairment charge of $67,547 to reduce the carrying value of the investment to its market value of $109,258 (2003 - $ 196,664).

7. Bank indebtedness

	2004	*2003* *(Restated)*
Demand loan	**843,750**	-
Revolving operating loan	**3,575,000**	-
Cheques issued in excess of bank balances	**181,323**	-
	4,600,073	-

The demand loan has a maximum available credit limit of $1,000,000 (2003 - nil), is repayable in monthly principal payments of $31,250 over the half life of proved petroleum and natural gas reserves and accrues interest at prime plus 1.0%.

The revolving operating loan has a maximum available credit limit of $5,500,000 (2003 - $nil), requires interest only monthly repayments and accrues interest at prime plus 0.75%.

Other Credit Facilities

The Company has access to a treasury risk line to manage its interest rate and foreign exchange risk through the use of risk management products such as swaps and forwards. The maximum available credit limit is $650,000 (2003 - nil) and is repayable as per contract maturities.

The above credit facilities are secured by a general assignment of book debts, $10,000,000 debenture with a floating charge over all assets of the Company with a negative pledge and undertaking to provide fixed charges on the Company's major producing petroleum and natural gas reserves, and evidence of insurance coverage with the Bank as first loss payee.

The demand loan and operating demand loan are subject to certain financial covenants with respect to working capital. As at December 31, 2004, the Company is in compliance with all such covenants.

8. Future income taxes

The components of the net future income tax liability are as follows:

	2004	2003 (Restated)
Future income tax liabilities		
Property and equipment	**(64,106)**	(67,183)
Resource properties	**(2,958,006)**	(2,090,656)
Future income tax assets		
Investment	**22,709**	-
Share issue costs	**259,317**	110,385
Asset retirement obligations	**132,681**	4,845
Provincial royalties	**26,787**	2,583
Non-capital losses	**221,714**	510,473
Future income tax liability	**(2,358,904)**	(1,529,553)

The income tax recovery differs from the amount that would be expected by applying the current tax rates for the following reasons:

	2004	2003 (Restated)
Loss before taxes	**(1,411,852)**	(782,397)
Expected tax recovery at 38.87% (2003 @ 40.79%)	**(548,786)**	(319,140)
Increase (decrease) in income taxes resulting from:		
Stock-based compensation	**77,620**	239,029
Crown royalty payments	**184,477**	-
Resource loss (allowance)	**(115,468)**	20,632
Alberta Royalty Tax Credit	**(59,033)**	-
Reversal of valuation allowance	**-**	(1,127,253)
Rate differential	**(81,949)**	(51,966)
Attributed Canadian Royalty Income	**(24,312)**	-
Other	**(52,784)**	84,182
Future income tax recovery	**(620,235)**	(1,154,516)

8. Future income taxes *(Continued from previous page)*

At December 31, 2004, the Company has the following estimated tax pools available for deduction against future taxable income:

	2004	*2003* *(Restated)*
Canadian oil and gas property expense	**5,351,000**	3,855,000
Canadian development expense	**2,973,000**	1,259,000
Canadian exploration expense	**2,396,000**	89,000
Foreign exploration and development expense	**228,000**	228,000
Undepreciated capital cost	**5,876,000**	2,034,000
Share issuance costs	**771,000**	294,000
Non-capital losses	**659,000**	1,360,000

The non-capital losses will expire as follows:

2006	18,000
2007	120,000
2008	86,000
2009	64,000
2010	371,000

9. Asset retirement obligations

	2004	*2003* *(Restated)*
Asset retirement obligations, beginning of year	**207,502**	193,927
Additional obligation	**172,621**	-
Accretion	**14,525**	13,575
Asset retirement obligations, end of year	**394,648**	207,502

The total undiscounted amount of estimated cash flows required to settle the obligation is $1,425,122 (2003 - $830,462). The obligation has been discounted using a credit adjusted risk free rate of 7 percent (2003 - 7 percent) and inflated at a rate of 2 percent per year. Most of these obligations are not expected to be paid for 15 to 20 years in the future and will be funded from general company resources at that time.

10. Share capital

Authorized:

Unlimited number of common shares, without nominal or par value

Unlimited number of preferred shares, without nominal or par value

Issued:

Common shares

	Number	***Amount***
Balance ending, December 31, 2002	13,346,999	5,761,441
Share consolidation 4 to 1	(10,010,249)	-
Private placement	3,300,000	660,000
Private placement	2,500,000	1,050,000
Finder's fees	500,000	210,000
Flow-through shares issued	5,000,000	3,750,000
Flow-through shares issued	3,500,000	3,500,000
Effect of future income taxes on flow-through expenditures	-	(2,827,500)
Options exercised	78,750	54,750
Share issuance costs	-	(367,774)
Effect of future income taxes on share issuance costs	-	143,432
Balance ending, December 31, 2003	18,215,500	11,934,349
Private placement (i)	2,500,000	3,625,000
Flow-through shares issued (ii)	6,410,254	4,999,998
Warrants exercised	282,500	84,750
Options exercised	323,500	103,620
Share issuance costs	-	(688,320)
Effect of future income taxes on share issuance costs	-	231,413
Effect of future income taxes on flow-through expenditures	-	(1,680,999)
Balance ending, December 31, 2004	27,731,754	18,609,811

(i) On April 7, 2004, the Company completed a financing of 2,500,000 common shares at a price of $1.45 per common share for gross proceeds of $3,625,000.

(ii) On November 8, 2004, the Company completed a financing of 5,810,256 common shares on a "flow-through" basis at a price of $0.78 per share. In addition, the financing agent elected to exercise their option to sell an additional 599,998 flow-through common shares for a total offering of 6,410,254 shares, for gross proceeds of $4,999,998. All of the qualifying expenditures relating to this issue have been renounced to the shareholders, with $901,532 incurred during the year.

12. Share capital *(Continued from previous page)*

Stock options

The Company has a stock option plan under which the Board of Directors may grant options to directors, officers, other employees and key consultants. The purpose of the plan is to advance the interests of the Company by encouraging these individuals to acquire shares in the Company and thereby remain associated with, and seek to maximize the value of, the Company. Under the plan, the number of shares reserved for issuance pursuant to the exercise of all options under the plan may not exceed 10% of the issued and outstanding common shares on a non-diluted basis at any time. The options vest immediately and expire not more than five years from the date of grant, or earlier if the individual ceases to be associated with the Company.

	Number of Options	***Price Range***	***Weighted Average Price***	***Expiry Date***
Balance, December 31, 2002	1,325,000	0.15 - 0.20	0.16	2005-2007
Share consolidation 4 to 1	(993,750)	0.15 - 0.20	0.16	2005-2007
Granted	1,480,000	0.20 - 1.00	0.63	2007
Exercised	(78,750)	0.15 - 1.00	0.70	2005-2007
Balance, December 31, 2003	1,732,500	0.15 - 1.00	0.54	2005-2007
Granted	1,235,000	0.78 - 1.51	1.13	2009
Cancelled	(595,000)	1.51	1.51	2009
Exercised	(323,500)	0.20 - 0.80	0.32	2005 - 2007
Balance, December 31, 2004	2,049,000	0.20 - 1.00	0.73	2007 - 2009

The Company uses the Black-Scholes option pricing model to estimate the fair value at the date of grant for options granted. During 2004, 640,000 options with an estimated fair value of $199,691 and a weighted average of $0.78 were expensed as stock-based compensation with a corresponding credit to contributed surplus. The estimated fair value was determined using the following assumptions:

	2004	*2003*
Risk free interest rate	**3.75%**	4.75%
Expected volatility rate	**50%**	75 to 80%
Expected life	**5 years**	4 to 5 years

Option pricing models require the input of highly subjective assumptions including the expected price volatility. Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company's stock options.

Subsequent to year end, the Company issued 700,000 stock options to directors, officers and consultants. The options will vest immediately, have an exercise price of $0.65 per share and expire during 2010.

12. Share capital *(Continued from previous page)*

Warrants
In connection with financing activities, the Company has the following warrants outstanding:

	Number of Warrants	*Price Range*	*Weighted Average Price*	*Expiry Date*
Balance, December 31, 2003	3,300,000	0.30	0.30	2005
Exercised	(282,500)	0.30	0.30	2005
Balance, December 31, 2004	3,017,500	0.30	0.30	2005

11. Commitments

The Company has entered into various lease agreements with estimated minimum annual payments as follows:

2005	285,149
2006	278,305
2007	97,740

12. Related party transactions

During the year, the Company had the following transactions with companies controlled by certain of the Company's officers and directors:

	2004	*2003*
Administration and consulting expenses	**169,911**	148,479
Production and capital expenditures	**2,798,403**	1,876,878

During the year, an aggregate of $60,746 (2003 - $50,114) was paid to Burstall Winger LLP for legal fees and disbursements. A director of the Company is a partner of Burstall Winger LLP.

Included in accounts payable and accruals is $167,720 (2003 - $260,665), and in accounts receivable is $1,225,319 (2003 -$1,384,249), relating to the above transactions.

These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

13. Financial instruments

The Company, as part of its operations, carries a number of financial instruments. It is management's opinion that the Company is not exposed to significant interest or currency risks arising from these financial instruments except as otherwise disclosed.

Fair value

The carrying amount of cash, accounts receivable, bank indebtedness and accounts payable and accrued liabilities approximates their fair value due to the short-term maturities of these items.

Credit concentration

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of trade accounts receivable. Company sales are concentrated in the oil and gas industry. As at December 31, 2004, one working interest partner accounted for 53% (2003 - 65%) of the accounts receivable balance.

Interest rate risk

Interest rate risk is the risk that the value of a financial instrument might be adversely affected by a change in the interest rates. In seeking to minimize the risks from interest rate fluctuations, the Company manages exposure through its normal operating and financing activities. The Company is exposed to interest rate risk primarily through its variable interest rate bank loans.