# Yangarra Resources Ltd.
## Consolidated Financial Statements
*December 31, 2005*

To the Shareholders of Yangarra Resources Ltd.

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 Audit Committee and management to discuss their audit findings.

April 10, 2006

*"James G. Evaskevich" (signed)*
James G. Evaskevich
Chief Executive Officer

*"Penny Payne" (signed)*
Penny Payne
Chief Financial Officer

# Auditors' Report

To the Shareholders of Yangarra Resources Ltd.:

We have audited the consolidated balance sheets of Yangarra Resources Ltd. as at December 31, 2005 and 2004, and the consolidated statements of operations and 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, 2005 and 2004, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Calgary, Alberta

Meyers Norris Penny LLP

March 31, 2006

Chartered Accountants

| | | 2005 | | 2004 |
|---|---|---|---|---|
| **Assets** | | | | |
| Current | | | | |
| Cash | $ | **81,671** | $ | – |
| Accounts receivable | | **2,667,511** | | 2,285,964 |
| Prepaid expenses and deposits | | **143,290** | | 170,015 |
| | | **2,892,472** | | 2,455,979 |
| Goodwill *(note 4)* | | **396,208** | | – |
| Investment *(note 5)* | | **109,258** | | 109,258 |
| Property and equipment *(note 6)* | | **42,150,409** | | 21,910,591 |
| | $ | **45,548,347** | $ | 24,475,828 |
| **Liabilities** | | | | |
| Current | | | | |
| Bank indebtedness | $ | **–** | $ | 178,565 |
| Bank debt *(note 7)* | | **9,450,000** | | 4,418,750 |
| Accounts payable and accrued liabilities | | **5,625,090** | | 3,775,316 |
| | | **15,075,090** | | 8,372,631 |
| Asset retirement obligation *(note 8)* | | **1,238,226** | | 394,648 |
| Future income tax liability *(note 12)* | | **4,090,121** | | 2,358,904 |
| | | **20,403,437** | | 11,126,183 |
| **Shareholders' Equity** | | | | |
| Share capital *(note 9)* | | **31,188,344** | | 18,665,195 |
| Contributed surplus *(note 10)* | | **1,099,935** | | 730,307 |
| Deficit | | **(7,143,369)** | | (6,045,857) |
| | | **25,144,910** | | 13,349,645 |
| | $ | **45,548,347** | $ | 24,475,828 |

**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*

## Yangarra Resources Ltd.
### Consolidated Statements of Operations and Deficit
*For the years ended December 31*

| | | 2005 | | 2004 |
|---|---|---|---|---|
| **Revenue** | | | | |
| Petroleum and natural gas sales | $ | **8,354,853** | $ | 3,075,560 |
| Royalties, net of Alberta Royalty Tax Credit | | **(1,391,569)** | | (620,852) |
| | | **6,963,284** | | 2,454,708 |
| Other income | | **26,791** | | – |
| | | **6,990,075** | | 2,454,708 |
| **Expenses** | | | | |
| Production | | **1,309,872** | | 560,742 |
| Transportation costs | | **120,043** | | 76,325 |
| General and administrative | | **1,152,511** | | 854,080 |
| Interest | | **397,309** | | 130,037 |
| Stock-based compensation | | **369,628** | | 199,691 |
| Depletion and depreciation | | **4,144,373** | | 1,854,858 |
| Accretion | | **34,154** | | 14,525 |
| Impairment loss on investment | | **–** | | 67,547 |
| Write-down of mineral property | | **–** | | 108,755 |
| | | **7,527,890** | | 3,866,560 |
| **Loss before income taxes** | | **(537,815)** | | (1,411,852) |
| **Income taxes** | | | | |
| Future income tax recovery *(note 12)* | | **(271,468)** | | (620,235) |
| **Net loss for the year** | | **(266,347)** | | (791,617) |
| Related party adjustment *(note 3)* | | **(831,165)** | | – |
| Deficit, beginning of year | | **(6,045,857)** | | (5,254,240) |
| **Deficit, end of year** | $ | **(7,143,369)** | $ | (6,045,857) |
| **Loss per share – basic** | $ | **(0.01)** | $ | (0.04) |
| **Weighted average number of shares – basic** | | **31,228,861** | | 21,422,700 |

[1] Diluted loss per share has not been disclosed as the effect of options and warrants is anti-dilutive.

*The accompanying notes are an integral part of these financial statements*

| | **2005** | 2004 |
|---|---|---|
| **Operating** | | |
| Net loss for the year | $ **(266,347)** | $ (791,617) |
| Add back non-cash items | | |
| Other income | **(1,995)** | – |
| Stock-based compensation | **369,628** | 199,691 |
| Depletion and depreciation | **4,144,373** | 1,854,858 |
| Accretion | **34,154** | 14,525 |
| Write-down of mineral property | **–** | 108,755 |
| Impairment loss on investment | **–** | 67,547 |
| Future income tax provision | **(271,468)** | (620,235) |
| | **4,008,345** | 833,524 |
| Change in non-cash working capital *(note 13)* | **(280,299)** | 2,601,589 |
| | **3,728,046** | 3,435,113 |
| **Financing** | | |
| Issue of equity instruments | **905,250** | 8,813,368 |
| Equity instrument issue costs | **(20,639)** | (688,320) |
| Proceeds from bank debt, net | **4,581,250** | 4,418,750 |
| Proceeds on repayment of related party advance *(note 3)* | **508,029** | – |
| | **5,973,890** | 12,543,798 |
| **Investing** | | |
| Expenditures on and purchase of property and equipment | **(10,573,951)** | (14,368,824) |
| Proceeds on disposition of property and equipment | **300,000** | – |
| Proceeds on sale of marketable securities | **–** | 252,727 |
| Bank indebtedness acquired *(note 3)* | **(305,169)** | – |
| Amalgamation costs *(note 3)* | **(307,532)** | – |
| Changes in non-cash working capital *(note 13)* | **1,444,952** | (4,828,579) |
| | **(9,441,700)** | (18,944,676) |
| **Increase (decrease) in cash during the year** | **260,236** | (2,965,765) |
| **(Bank indebtedness) cash, beginning of year** | **(178,565)** | 2,787,200 |
| **Cash (bank indebtedness), end of year** | $ **81,671** | $ (178,565) |

| | | |
|---|---|---|
| **Supplemental cash flow information** | | |
| Interest paid | $ **319,091** | $ 130,170 |

*The accompanying notes are an integral part of these financial statements*

### 1. Nature of operations and basis of presentation

Yangarra Resources Ltd. (the "Company") was formed by the amalgamation on November 9, 2005 (note 3), under the Business Corporations Act (Alberta) (the "ABCA"), of Yangarra Resources Inc. ("Predecessor Yangarra") and TriOil Ltd. ("TriOil"). The Company is involved in the production, exploration and development of resource properties.

Predecessor Yangarra was incorporated under the ABCA 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. TriOil was formed by the August 13, 2004 amalgamation of Entrada Energy Inc., a private company incorporated under the ABCA on November 16, 2000, and TriOil Ltd., a public company listed on the TSX Venture Exchange and incorporated under the ABCA on July 30, 2002.

In conjunction with the amalgamation, Predecessor Yangarra effected a 0.95 to 1 consolidation of its equity instruments. All equity instrument figures included herein are reflected on a post-consolidation basis.

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. As at December 31, 2005, the Company had a working capital deficit of $12,182,618 (2004 – $5,916,652) and an accumulated deficit of $7,143,369 (2004 – $6,045,857). 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.

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Yangarra Resources Corp.

### 2. Significant accounting policies

The consolidated financial statements have been prepared by management in accordance with generally accepted accounting principles in Canada. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts recorded in the financial statements and accompanying notes. Actual results could differ from these estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the significant accounting policies summarized below:

**a)** ***Cash and cash equivalents***

Cash and cash equivalents consist of bank balances (overdrafts) and term deposits with maturities of three months or less.

**b)** ***Investments***

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

**2. Significant accounting policies** (continued)

**c) *Goodwill***

Goodwill represents the excess of the cost of an acquisition over the net of the amounts assigned to assets acquired and liabilities assumed. Goodwill is not amortized but is tested for impairment at least annually. The Company monitors its goodwill balance to determine whether any impairment has occurred. In order to make that determination, the Company bases the recoverability using the current and estimated cash flows of the underlying business on an undiscounted basis. If this review indicates that goodwill will not be recovered, the Company recognizes a write-down of the unamortized portion of goodwill in excess of its recoverable amount.

**d) *Property and equipment***

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 which have been charged in accordance with standard industry operating agreements. 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.

Depletion of resource properties and related 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 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.

Other property and equipment, such as computer and office equipment and leasehold improvements (“office equipment”), are initially recorded at cost.

Depreciation is provided using methods and rates intended to depreciate the cost of office equipment over 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.

**e) *Long-lived assets***

Long-lived assets consist of property and equipment and resource properties. Long-lived assets held for use are measured, depleted or depreciated 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.

**2. Significant accounting policies** (continued)

**f) *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.

**g) *Bank debt***

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.

**h) *Asset retirement obligation***

Asset retirement costs and liabilities associated with site restoration and abandonment of long-lived assets are initially measured at a fair value which approximates the cost a third party would incur in performing the tasks necessary to retire such assets. Such costs are capitalized as part of the cost of property and equipment and amortized to expense through depletion over the life of the asset. The change in the liability due to the passage of time is measured by applying an interest method of allocation to the opening liability and is recognized as an increase in the carrying value of the liability and an expense. The expense is recorded as accretion expense in the statement of operations. A change in the liability resulting from revisions to either the timing or the amount of the original estimate of undiscounted cash flows is recognized as an increase or decrease in the carrying amount of the liability, with an offsetting increase or decrease in the carrying amount of the associated asset.

**i) *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.

**j) *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.

**2. Significant accounting policies** (continued)

**k)** ***Flow through shares***

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through equity instruments are renounced to investors in accordance with income tax legislation. The Company provides for the future effect on income taxes related to flow-through equity instruments as a reduction of share capital and an increase in future income tax liabilities when the renouncement documents are filed with taxation authorities.

**l)** ***Stock-based compensation***

Stock-based compensation expense is based on the estimated fair value of options granted at the time of the grant. The fair value is recognized in current earnings as stock-based compensation expense with a corresponding increase to contributed surplus over the vesting period of the options. Upon the exercise of the stock options, consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase in share capital. In the event that vested options expire, previously recognized compensation expense associated with such stock options is not reversed. In the event that unvested options are cancelled, previously recognized compensation expense associated with such stock options is reversed.

**m)** ***Per share amounts***

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 is not disclosed where the effect of options and warrants is anti-dilutive.

**n)** ***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.

**o)** ***Commodity contracts***

Commodity contracts that do not meet the criteria for the use of hedge accounting are recorded on the balance sheet at fair value and changes in fair value are recognized in income in the period in which the change occurs.

**3. Business acquisition and amalgamation**

On November 9, 2005, Predecessor Yangarra and TriOil, companies related through common directors, completed a non-arm's length amalgamation. Pursuant to the amalgamation, the Company issued 0.95 shares for each outstanding share of Predecessor Yangarra, 0.95 options for each outstanding option of Predecessor Yangarra, one share for each outstanding TriOil share, one warrant for each outstanding TriOil warrant, and one option for each outstanding TriOil option. The transaction was accounted for as a purchase with Predecessor Yangarra deemed the acquirer.

As the amalgamation is a related party transaction, it has been measured at the carrying amount of the net assets acquired, as recorded in the accounts of TriOil. The difference between the carrying amount of the net assets and TriOil's share capital in the amount of $645,323 plus $185,842 of amalgamation costs incurred by Predecessor Yangarra (net of tax of $121,690), has been recorded as a charge to the Company's deficit.

### 3. Business acquisition and amalgamation (continued)

The carrying amount has been allocated to TriOil's net assets as follows:

| | | |
|---|---|---|
| Current assets | $ | 1,449,621 |
| Due to related party | | 508,029 |
| Property and equipment | | 13,929,922 |
| Goodwill | | 396,208 |
| Bank indebtedness | | (305,169) |
| Other current liabilities | | (2,229,920) |
| Asset retirement obligation | | (631,101) |
| Future income tax liability | | (2,009,624) |
| Related party transaction adjustment, net of tax of $121,690 | | 831,165 |
| Net assets acquired | $ | 11,939,131 |
| Purchase price | | |
| 24,219,700 common shares | $ | 11,631,599 |
| Amalgamation costs | | 307,532 |
| | $ | 11,939,131 |

### 4. Goodwill

Goodwill was acquired through the amalgamation between Yangarra and TriOil as described in note 3. Goodwill represents the excess of the cost over the net of the amounts assigned to assets acquired and liabilities assumed through the August 13, 2004 amalgamation between TriOil and Entrada Energy Inc. (see note 1).

### 5. Investment

As at December 31, 2005, the fair value of the Company's investment was estimated to be $75,800 (2004 – $109,258). The decline in value is not considered to be permanent.

### 6. Property and equipment

| | *December 31, 2005* | | |
|---|---|---|---|
| | *Cost* | *Accumulated depletion and depreciation* | *Net book value* |
| Office equipment | $ 237,094 | $ 57,973 | $ 179,121 |
| Petroleum and natural gas properties | 48,649,879 | 6,678,591 | 41,971,288 |
| | $ 48,886,973 | $ 6,736,564 | $ 42,150,409 |

| | *December 31, 2004* | | |
|---|---|---|---|
| | *Cost* | *Accumulated depletion and depreciation* | *Net book value* |
| Office equipment | $ 77,007 | $ 20,210 | $ 56,797 |
| Petroleum and natural gas properties | 24,425,776 | 2,571,981 | 21,853,794 |
| | $ 24,502,782 | $ 2,592,191 | $ 21,910,591 |

**6. Property and equipment** (continued)

During the year, property and equipment additions totaled $24,684,191 (2004 - $14,541,445) of which $180,318 (2004 - $172,621) was due to asset retirement obligations and $13,929,922 (2004 - $ nil) was acquired through the business acquisition and amalgamation described in note 3.

At December 31, 2005, the Company has excluded $1,266,105 (2004 - $3,214,845) of resource properties relating to unproved properties from the depletion calculation and impairment test. Unproved properties have been separately evaluated by management for impairment. In addition, $9,263,750 (2004 - $7,467,000) of future development costs were included in the depletion calculation.

The Company did not capitalize any general and administrative costs during 2005 or 2004 other than to the extent of the Company's working interest in operated capital expenditure programs on which operator's fees have been charged in accordance with standard industry operating agreements.

The Company applied the ceiling test to its capitalized assets as at December 31, 2005 and determined that there was no impairment. For purposes of this impairment test, the following future commodity prices were used:

| | Edmonton Par Price Cdn $/bbl | Alberta AECO-C Spot Cdn $/mcf |
|---|---:|---:|
| 2006 | 70.07 | 11.58 |
| 2007 | 70.99 | 10.84 |
| 2008 | 62.73 | 8.95 |
| 2009 | 57.53 | 7.87 |
| 2010 | 54.65 | 7.57 |
| Escalation rate thereafter | 1.5% | 1.5% |

**7. Bank debt**

| | *2005* | *2004* |
|---|---:|---:|
| Revolving operating demand loan available to a maximum of $11,500,000 (2004 - $5,500,000), requiring payments of interest only subject to availability, lender's review and right of demand. Interest is calculated daily and payable monthly at prime plus 0.5% (2004 – prime plus 0.75%). | $ 9,450,000 | $ 3,575,000 |
| Demand loan available to a maximum of $1,000,000 bearing interest at prime plus 1% and repayable in monthly principal payments of $31,250 over the half-life of proved petroleum and natural gas reserves. | – | 843,750 |
| | $ 9,450,000 | $ 4,418,750 |

In November 2005, the Company revised the credit facilities with its lender, following the amalgamation described in note 3. In addition to the revolving operating demand loan facility, the Company has a treasury risk line available for interest rate, foreign exchange and commodity risk management. The treasury risk line is repayable per contract maturities. As at December 31, 2005 and 2004, there were no amounts outstanding under the treasury risk line.

The credit facilities are secured by a general assignment of book debts, a $10,000,000 debenture, a $35,000,000 supplemental debenture, evidence of insurance coverage with the lender as first loss payee, title representation of petroleum and natural gas reserves, and assignment of revenues and monies under material contracts. The debentures contain 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.

## 7. Bank debt (continued)

Pursuant to the terms of the credit facilities, the Company is subject to a financial covenant with respect to working capital. As at December 31, 2005, the Company was in breach of the covenant and has obtained a letter from the lender acknowledging the breach. The revolving operating demand loan is a current liability by its nature therefore no reclassification between long-term and current liabilities is required.

## 8. Asset retirement obligation

The following table presents the reconciliation of the carrying amount of the obligation associated with the retirement of the Company's property and equipment:

| | *2005* | *2004* |
|---|---|---|
| Asset retirement obligation, beginning of year | $ 394,648 | $ 207,502 |
| Liabilities acquired *(note 3)* | 631,101 | – |
| Liabilities incurred | 159,167 | 172,621 |
| Dispositions | (10,861) | – |
| Effect of change in estimates | 30,017 | – |
| Accretion | 34,154 | 14,525 |
| Asset retirement obligation, end of year | $ 1,238,226 | $ 394,648 |

The following significant assumptions were used to estimate the asset retirement obligation:

| | *2005* | *2004* |
|---|---|---|
| Undiscounted cash flows | $ 2,343,048 | $ 1,425,122 |
| Discount rate | 7% | 7% |
| Inflation rate | 2% | 2% |
| Weighted average expected timing of cash flows | 9.5 years | 17.5 years |

## 9. Share capital

All share capital figures included herein are on a post-consolidation basis (see notes 1 and 3).

### a) Authorized

Unlimited number of common shares, without nominal or par value
Unlimited number of first preferred shares, without nominal or par value
Unlimited number of second preferred shares, without nominal or par value

## 9. Share capital (continued)

### b) Issued

| Common shares | Number of shares | | Amount |
|---|---|---|---|
| **Balance, December 31, 2003** | **17,304,725** | $ | **11,934,349** |
| Private placement of common shares (i) | 2,375,000 | | 3,625,000 |
| Private placement of flow-through shares (ii) | 6,089,741 | | 4,999,998 |
| Exercise of warrants (iii) | 268,375 | | 84,750 |
| Exercise of options (iv) | 307,325 | | 159,004 |
| Tax effect of flow-through shares | – | | (1,680,999) |
| Share issue costs, net of tax of $231,413 | – | | (456,907) |
| **Balance, December 31, 2004** | **26,345,166** | $ | **18,665,195** |
| Exercise of warrants (v) | 2,866,625 | | 905,250 |
| Issued in relation to amalgamation *(note 3)* | 24,219,700 | | 11,631,599 |
| Share issue costs, net of tax of $6,939 | – | | (13,700) |
| **Balance, December 31, 2005** | **53,431,491** | $ | **31,188,344** |

i) On April 7, 2004, the Company completed a financing of 2,375,000 common shares at a price of $1.53 per common share for gross proceeds of $3,625,000.

ii) On November 8, 2004, the Company completed a financing of 6,089,741 common shares on a "flow-through" basis at a price of $0.82 per share for gross proceeds of $4,999,998. These proceeds were renounced to investors on December 31, 2004 and the Company had until December 31, 2005 to incur qualifying expenditures. As at December 31, 2005, all expenditures had been incurred.

iii) During 2004, 268,375 shares were issued on the exercise of the same number of warrants at an exercise price of $0.32 per share for gross cash proceeds of $84,750.

iv) During 2004, 307,325 shares were issued on the exercise of the same number of options at a weighted average exercise price of $0.34 per share for total cash proceeds of $103,620 plus a pro-rata share of the related fair value previously recorded to contributed surplus in the amount of $55,384.

v) During 2005, 2,866,625 shares were issued on the exercise of the same number of warrants at an exercise price of $0.32 per share for gross cash proceeds of $905,250.

### c) 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 expire not more than five years from the date of grant, or earlier if the individual ceases to be associated with the Company, and vest over terms determined at the time of grant.

**9. Share capital** (continued)

**c) Stock options** (continued)

During 2005, the Company granted the following options with an expiry of five years from the date of grant:

| Date of grant | Number of options | Exercise price | Vesting term | Total estimated fair value | Related 2005 portion of stock-based compensation expense (note 10) |
|---|---|---|---|---|---|
| February 2005 | 665,000 | $0.74 | Immediately | $ 290,850 | $ 290,850 |
| September 2005 | 123,500 | 0.45 | Immediately | 39,347 | 39,347 |
| September 2005 | 142,500 | 0.45 | Two years | 43,294 | 9,519 |
| November 2005 | 999,175 | 0.50 | Two years | 348,100 | 22,173 |
| | 1,930,175 | | | | $ 361,889 |

The Black-Scholes option pricing model was used to estimate the fair value of options granted based on the following significant assumptions:

| | *2005* | *2004* |
|---|---|---|
| Risk-free interest rate | 3.5% to 5% | 3.75% |
| Expected volatility | 75% to 86% | 50% |
| Expected life | 5 years | 5 years |

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. For the purposes of recording stock-based compensation, the estimated fair value of the options is recognized over the vesting period of the option.

The following tables summarize information about stock options outstanding as at:

| | December 31, 2005 | | December 31, 2004 | |
|---|---|---|---|---|
| | Options | Weighted – Average Exercise Price | Options | Weighted – Average Exercise Price |
| Opening | 1,946,550 | $ 0.76 | 1,645,875 | $ 0.57 |
| Granted | 1,930,175 | 0.58 | 1,173,250 | 1.19 |
| Acquired (note 3) | 2,045,000 | 0.55 | – | – |
| Exercised | – | – | (307,325) | 0.34 |
| Cancelled | (671,625) | 0.68 | (565,250) | 1.59 |
| Closing | 5,250,100 | $ 0.62 | 1,946,550 | $ 0.76 |

**9. Share capital** (continued)

**c) Stock options** (continued)

December 31, 2005

| Range of Exercise Price | Number Outstanding | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Number Exercisable |
|---|---|---|---|---|
| $ 0.21 – $ 0.45 | 542,450 | 3.66 | $ 0.39 | 406,450 |
| $ 0.46 – $ 0.55 | 2,500,175 | 4.33 | 0.52 | 800,667 |
| $ 0.63 – $ 0.74 | 900,750 | 3.66 | 0.69 | 811,083 |
| $ 0.79 – $ 1.05 | 1,306,725 | 3.30 | 0.87 | 1,306,725 |
| | 5,250,100 | 3.89 | $ 0.62 | 3,324,925 |

**d) Warrants**

The following table summarizes information about warrants outstanding as at:

| | December 31, 2005 | | December 31, 2004 | |
|---|---|---|---|---|
| | Warrants | Weighted – Average Exercise Price | Warrants | Weighted – Average Exercise Price |
| Opening | 2,866,625 | $ 0.29 | 3,135,000 | $ 0.29 |
| Acquired (note 3) | 1,328,711 | 0.87 | – | – |
| Exercised | (2,866,625) | 0.29 | (268,375) | 0.29 |
| Expired | (137,049) | 0.65 | – | – |
| Closing | 1,191,662 | $ 0.90 | 2,866,625 | $ 0.29 |

All 1,191,662 warrants outstanding at December 31, 2005 are exercisable and have a weighted average remaining contractual life of 0.17 years. These warrants expired unexercised in March 2006.

**10. Contributed surplus**

| | | *2005* | | *2004* |
|---|---|---|---|---|
| Balance – beginning of year | $ | 730,307 | $ | 586,000 |
| Stock-based compensation – options granted in 2005 / 2004 | | 361,889 | | 199,691 |
| Stock-based compensation – options acquired on amalgamation | | 14,911 | | – |
| Stock-based compensation on unvested cancelled options (note 9(c)) | | (7,172) | | – |
| Stock-based compensation on exercised options (note 9(b)(iv)) | | – | | (55,384) |
| Balance – end of year | $ | 1,099,935 | $ | 730,307 |

## 11. Commodity contracts

During 2005, the Company entered into a Commodity European Producer Collar to sell 1000 GJ of gas per day to a third party from May 1, 2005 to December 31, 2005 at a ceiling price of $9 per GJ and a floor price of $7 per GJ. As at December 31, 2005, the Company had fulfilled the terms of the Collar.

During 2004, the Company entered Commodity Put Option to sell 2500 GJ of gas per day to a third party from May 1, 2004 to October 31, 2004 at a strike price of $5 per GJ and a total premium cost to the Company of $65,780 based on $0.143 per GJ. As at December 31, 2004, the Company had fulfilled the terms of the Option.

## 12. Income taxes

The provision for future income taxes differs from the amount computed by applying the combined federal and provincial tax rates to the loss before taxes. The difference results from the following:

| | 2005 | 2004 |
|---|---|---|
| Expected income tax recovery at 37.62% (2004 – 38.87%) | $ (202,326) | $ (548,786) |
| Non-deductible crown and other charges | 290,065 | 184,477 |
| Stock-based compensation | 139,054 | 77,620 |
| Amalgamation costs | (76,793) | – |
| Resource allowance | (181,585) | (115,468) |
| Alberta Royalty Tax Credit | (93,224) | (59,033) |
| Attributed Canadian Royalty Income | (13,814) | (24,312) |
| Rate adjustments and other | (132,845) | (134,733) |
| | $ (271,468) | $ (620,235) |

The components of future income taxes at December 31 are:

| | 2005 | 2004 |
|---|---|---|
| Future income tax assets | | |
| Asset retirement obligation | $ 416,292 | $ 132,681 |
| Non-capital loss carryforwards | 389,026 | 221,714 |
| Share issue costs | 343,996 | 259,317 |
| Amalgamation costs | 121,690 | – |
| Attributed Canadian Royalty Income | 90,858 | 26,787 |
| Other | – | 22,709 |
| Future income tax liabilities | | |
| Carrying amount of property and equipment in excess of tax basis | (5,451,983) | (3,022,112) |
| | $ (4,090,121) | $ (2,358,904) |

As at December 31, 2005, the Company has approximately $27 million of tax pools available for deduction against future taxable income. The Company also has non-capital tax losses of $1.2 million available for deduction against future taxable income that expire between 2006 and 2014.

### 13. Change in non-cash working capital

| | | *2005* | | *2004* |
|---|---|---|---|---|
| Accounts receivable | $ | 1,024,736 | $ | (390,912) |
| Prepaid expenses and deposits | | 70,063 | | (111,003) |
| Accounts payable and accrued liabilities | | 69,854 | | (1,725,075) |
| | $ | 1,164,653 | $ | (2,226,990) |

The change in non-cash working capital has been allocated to the following activities:

| | | *2005* | | *2004* |
|---|---|---|---|---|
| Operating | $ | (280,299) | $ | 2,601,589 |
| Investing | | 1,444,952 | | (4,828,579) |
| | $ | 1,164,653 | $ | (2,226,990) |

### 14. Commitments

**a)** The Company has entered into lease agreements for office premises and equipment with estimated minimum annual payments as follows:

| | |
|---|---|
| 2006 | $ 363,597 |
| 2007 | 224,097 |
| 2008 | 73,708 |

**b)** In January 2006, the Company entered into a six month contract with an investor relations firm at a fee of $5,810 per month (US$5,000), plus expenses. The Company may renew the contract under the same terms for an additional six months with prior written notice.

### 15. Related party transactions

Except as disclosed elsewhere in these financial statements, the Company had the following related party transactions:

**a)** During the years ended December 31, 2005 and 2004, the Company was charged or invoiced the following amounts by certain of its officers and directors and by companies controlled by certain of the Company's officers and directors:

| | | *2005* | | *2004* |
|---|---|---|---|---|
| Administration and consulting fees | $ | 284,454 | $ | 169,911 |
| Production and capital expenditures | $ | 293,070 | $ | 2,798,403 |

**b)** During the year ended December 31, 2005, the Company was charged $103,341 (2004 – $60,746) by a law firm in which a director of the Company is a partner.

Included in accounts payable and accrued liabilities is $147,007 (2004 - $167,720), and in accounts receivable is $nil (2004 – $1,225,319), 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.

## 16. 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.

**a)** ***Fair value***

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

**b)** ***Credit risk***

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of trade accounts receivable. The majority of the Company's accounts receivable are in respect of oil and natural gas operations with joint venture partners and are therefore subject to normal industry risks. Company sales are concentrated in the oil and gas industry.

**c)** ***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.

**d)** ***Commodity price risk***

The Company's operations are exposed to commodity price fluctuations. The Company was not a party to any hedging arrangements as at December 31, 2005 (see note 11) and up to the date of the audit report.

## 17. Subsequent event

In February 2006, the Company granted 150,000 options to two companies providing consulting and investor relations services. 75,000 options are exercisable at $0.71 per share and vest over two years and 75,000 options are exercisable at $0.70 per share and vest over five years. An additional 10,000 options were granted to an employee with a vesting period of two years and an exercise price of $0.66 per share. All of the options expire 5 years from the date of grant.

## 18. Comparative figures

Certain prior year comparative figures have been reclassified to conform to the presentation used in the current year.