

Petro-Reef Resources Ltd.

Financial Statements
December 31, 2003 and 2002

March 23, 2004

Auditors' Report

To the Shareholders of Petro-Reef Resources Ltd.

We have audited the balance sheets of **Petro-Reef Resources Ltd.** as at December 31, 2003 and 2002 and the 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 financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

Petro-Reef Resources Ltd.

Balance Sheets

As at December 31, 2003 and 2002

	2003 \$	2002 \$
Assets		
Current assets		
Cash and short-term investments	-	258,865
Accounts receivable	992,523	328,170
Prepaid expenses and deposits	6,977	18,595
	<u>999,500</u>	<u>605,630</u>
Property, plant and equipment (note 3)	<u>7,093,657</u>	<u>6,080,717</u>
	<u>8,093,157</u>	<u>6,686,347</u>
Liabilities		
Current liabilities		
Cheques drawn in excess of bank	409,474	-
Bank line of credit (note 6)	1,150,000	-
Accounts payable and accrued charges	1,647,684	1,500,335
	<u>3,207,158</u>	<u>1,500,335</u>
Future site restoration	50,575	39,346
Future income taxes (note 5)	545,890	802,790
	<u>3,803,623</u>	<u>2,342,471</u>
Shareholders' Equity		
Capital stock (note 4)	4,743,176	4,743,176
Contributed surplus (note 4)	94,111	-
Deficit	<u>(547,753)</u>	<u>(399,300)</u>
	<u>4,289,534</u>	<u>4,343,876</u>
	<u>8,093,157</u>	<u>6,686,347</u>

The accompanying notes are integral to the financial statements.

Approved by the Board of Directors

Director

Director

Petro-Reef Resources Ltd.

Statements of Operations and Deficit

For the years ended December 31, 2003 and 2002

	2003 \$	2002 \$
Revenue		
Oil and gas sales, net of royalties and ARTC	894,261	643,712
Interest income	-	1,647
	<hr/> 894,261	<hr/> 645,359
Expenses		
Production	266,312	174,425
General and administrative	342,680	284,453
Stock based compensation (notes 2 and 4)	94,111	-
Depletion, depreciation and site restoration	555,728	379,799
Interest expense	40,783	18,268
	<hr/> 1,299,614	<hr/> 856,945
Loss before the following	(405,353)	(211,586)
Future income tax recovery (note 5)	256,900	85,088
	<hr/> (148,453)	<hr/> (126,498)
Net loss for the year	(148,453)	(126,498)
Deficit – Beginning of year	(399,300)	(272,802)
	<hr/> (547,753)	<hr/> (399,300)
Deficit – End of year	(547,753)	(399,300)
Basic and diluted loss per common share	<hr/> (0.01)	<hr/> (0.01)

The accompanying notes are integral to the financial statements.

Petro-Reef Resources Ltd.

Statements of Cash Flows

For the years ended December 31, 2003 and 2002

	2003 \$	2002 \$
Cash provided by (used in)		
Operating activities		
Net loss for the year	(148,453)	(126,498)
Items not affecting working capital		
Depletion, depreciation and site restoration	555,728	379,799
Stock based compensation	94,111	-
Future income taxes	(256,900)	(85,088)
	<hr/>	<hr/>
Cash flow from operations	244,486	168,213
Net change in non-cash operating working capital items (note 7)	(227,457)	431,945
	<hr/>	<hr/>
	17,029	600,158
Financing activities		
Issuance of common shares	-	49,000
Bank line of credit	1,150,000	-
	<hr/>	<hr/>
	1,150,000	49,000
Investing activities		
Expenditures on property, plant and equipment	(1,557,439)	(872,447)
Disposal of property, plant and equipment	-	65,000
Net change in non-cash investing working capital items (note 7)	(277,929)	145,820
	<hr/>	<hr/>
	(1,835,368)	(661,627)
Change in cash and short-term investments during the year	(668,339)	(12,469)
Cash and short-term investments – Beginning of year	258,865	271,334
	<hr/>	<hr/>
(Outstanding cheques) cash and short-term investments – End of year	(409,474)	258,865
	<hr/>	<hr/>
Supplemental information		
Interest paid	40,783	18,268
Interest received	-	1,697

The accompanying notes are integral to the financial statements.

Petro-Reef Resources Ltd.

Notes to Financial Statements
December 31, 2003 and 2002

1 Accounting policies

These financial statements of Petro-Reef Resources Ltd. (the “company”) have been prepared in accordance with accounting principles generally accepted in Canada. Management has made the necessary estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses in the preparation of the financial statements. Accordingly, actual results may differ from estimated amounts but management does not believe such differences will materially affect the company’s financial position or results of operations.

The company has a working capital deficit of \$2,207,658 at December 31, 2003 (2002 – \$894,705). The company’s ability to continue as a going concern is dependent upon the continued support of the company’s creditors, which management expects will be received. Without such creditor support, the company’s assets and liabilities may not be realized or discharged in the normal course, with the result that carrying amounts could be adjusted materially.

Significant accounting policies are summarized as follows:

Oil and gas operations

The company is engaged in the exploration for and production of oil and natural gas in Canada.

The company follows the full cost method of accounting for oil and gas operations whereby all costs related to the acquisition of, exploration for and development of oil and gas reserves are capitalized. Such costs include leasehold acquisition costs, geological and geophysical costs, lease rentals, drilling, plant and equipment costs and related overhead. Government incentives are credited to the cost of the oil and gas properties at the time the expenditures are incurred. Proceeds from the disposal of properties are applied as a reduction of the cost of the remaining assets with no gain or loss recognized, unless such a sale would result in a change of more than twenty percent in the depletion rate.

The company places a limit on the carrying value of property, plant and equipment and other assets, which may be depleted against revenues of future periods (the “ceiling test”). The carrying value is assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves, the lower of cost and market of unproved properties and the cost of major development projects exceeds the carrying value. When the carrying value is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value of assets exceeds the fair value of proved and probable reserves, and the cost, less any impairment, of unproved properties that contain no probable reserves.

Depletion is computed using the unit-of-production method based on gross estimated proved oil and gas reserves (converted to equivalent units on the basis of estimated relative energy content). In determining the appropriate depletion rate, the company includes the net book value of its oil and gas properties, as well as the estimated future costs to be incurred in developing proved reserves and excludes the unimpaired cost attributable to unproved properties.

Estimated costs of future abandonment and restoration of well sites and associated facilities are amortized over the life of the properties on a unit-of-production basis.

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Depreciation

Depreciation of furniture and fixtures is calculated using the declining balance method at an annual rate of 20%. Depreciation of computer equipment is calculated using the declining balance method at an annual rate of 30%.

Income taxes

The company follows the liability method of accounting for income taxes. Under this method, the company records future income taxes for the effect of any differences between the accounting and the income tax basis of an asset or liability using income tax rates substantially enacted on the balance sheet date. The effect of a change in income tax rates on the future income tax assets and liabilities is recognized in income in the period of the change.

Revenue recognition

Revenue associated with the sale of crude oil, natural gas and natural gas liquids owned by the company are recognized when title passes from the company to its customers.

Earnings per share

The company uses the treasury stock method to determine the dilutive effect of stock options and other dilutive instruments. This method assumes that any proceeds from the exercise of in-the-money stock options or other dilutive instruments are assumed to be used to purchase common shares at the average market price during the period.

Joint ventures

Substantially all of the company's activities are conducted jointly with other industry partners and accordingly, these financial statements reflect only the company's proportionate interest in such activities.

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2 Change in accounting policies

Full cost accounting guideline

Effective January 1, 2003, the company adopted a new Canadian accounting guideline relating to full cost accounting for oil and gas operations, as outlined in note 1.

Prior to adopting the new standard, the ceiling test limit on the aggregate carrying value of oil and gas property, plant and equipment was based on the sum of the undiscounted cash flows expected from the production of proved reserves, the lower of cost or market of unproved properties and the cost of major development projects less the estimated future costs for administration, financing, asset retirement obligations and income taxes.

A property, plant and equipment ceiling test write down of approximately \$850,000, net of income tax, as at December 31, 2003 would have been required had the new standard not been adopted.

Stock options

Effective January 1, 2003, the company prospectively adopted the new Canadian accounting standard with respect to stock based compensation. The standard requires that the fair value method of accounting be applied for stock options awarded to directors, officers and employees after January 1, 2003. Compensation expense is recorded over the vesting period using the estimated fair value of the option on the grant date. Consideration paid on the exercise of stock options is recorded as share capital. The calculation of the compensation expense is disclosed in note 4.

3 Property, plant and equipment

	2003		
	Cost	Accumulated depletion and depreciation	Net
	\$	\$	\$
Petroleum and natural gas	9,962,248	2,881,652	7,080,596
Furniture and fixtures	35,777	22,716	13,061
	<u>9,998,025</u>	<u>2,904,368</u>	<u>7,093,657</u>

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	2002		
	Cost \$	Accumulated depletion and depreciation \$	Net \$
Petroleum and natural gas	8,406,140	2,341,362	6,064,778
Furniture and fixtures	34,447	18,508	15,939
	8,440,587	2,359,870	6,080,717

No interest or general and administrative expenses were capitalized during the year.

Unproven property costs of \$244,131 (2002 – \$294,575) have been excluded from capitalized costs subject to depletion.

The company performed a ceiling test calculation at December 31, 2003 in accordance with the policy described in note 1. The oil and gas future prices used in the calculation were based on the company's January 1, 2004 commodity price forecast which is consistent with the price forecast used by its independent reserve evaluators. These prices have been adjusted for commodity price differentials specific to the company. The following table summarizes the benchmark prices used in the ceiling test calculation.

Year	WTI Oil (\$US/bbl)	Foreign Exchange rate	Edmonton Light (crude oil) (\$Cdn/bbl)	AECO Gas (\$Cdn/bbl)
2004	29.63	0.75	37.99	6.04
2005	26.80	0.75	34.24	5.36
2006	25.76	0.75	32.87	4.80
2007	26.14	0.75	33.37	4.91
2008	26.53	0.75	33.87	4.98
2009 – 2015	28.17	0.75	35.98	5.33
Escalate thereafter	1.5% per year		1.5% per year	1.5% per year

The ceiling test calculation did not result in any impairment write down at December 31, 2003.

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4 Capital stock

The authorized share capital of the company is comprised of an unlimited number of preferred shares and an unlimited number of common shares. Details of the changes in the company's issued share capital during 2003 and 2002 are as follows:

	2003		2002	
	Number of shares	Amount \$	Number of shares	Amount \$
Common shares				
Balance – Beginning of year	17,688,937	4,743,176	17,588,937	4,694,176
Issued for the exercise of stock options	-	-	100,000	49,000
Balance – End of year	17,688,937	4,743,176	17,688,937	4,743,176

Earnings per common share are calculated using the weighted average number of common shares outstanding during the year of 17,688,937 (2002 – 17,602,362).

Stock options

The company has a stock option plan for directors, officers and key employees. The exercise price of each option equals the market price of the company's stock on the date of grant. Options are vested over three years and expire after a maximum exercise period of five years from the date of issuance. A summary of the status of the company's stock option plan as of December 31, 2003 and 2002 and changes during the year is presented below:

	2003		2002	
	Shares	Weighted-average exercise price \$	Shares	Weighted-average exercise price \$
Outstanding – Beginning of year	1,150,000	0.67	1,250,000	0.66
Granted	960,000	0.40	-	-
Exercised	-	-	(100,000)	0.49
Expired	(800,000)	0.49	-	-
Options exercisable at year end	1,310,000	0.42	1,150,000	0.67

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The following table summarizes information about fixed stock options outstanding at December 31, 2003:

Range of Exercise price	Options outstanding			Options exercisable	
	Number outstanding	Weighted-average remaining contractual life	Weighted-average exercise price (\$/share)	Number exercisable	Weighted-average exercise price (\$/share)
\$0.30 – \$0.49	1,310,000	3.4 years	0.42	670,000	0.45

Contributed surplus

	2003 \$	2002 \$
Balance – Beginning of year	-	-
Stock options granted	94,111	-
Balance – End of year	94,111	-

Compensation cost of \$94,111 has been recognized for stock options granted after January 1, 2003.

The fair value of options granted to employees and directors was estimated at the date of the grant using a Black-Scholes option pricing model with the following assumptions:

Volatility factor of expected market price	1.25
Weighted average risk-free interest rate	3.84%
Weighted average expected life in years	3
Weighted average expected annual dividends per share	-

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5 Income taxes

The following table summarizes the temporary differences which give rise to the future income tax liability at December 31:

	2003 \$	2002 \$
Future income tax liabilities		
Property, plant and equipment	607,808	941,214
Future income tax assets		
Site restoration	(17,838)	(16,572)
Share issue costs	-	(3,490)
Non-capital loss carryforwards	(44,080)	(118,362)
	<u>545,890</u>	<u>802,790</u>

At December 31, 2003, the company has successor tax pools of approximately \$365,399 available for deduction from future taxable income. These successor pools have not been recognized for purposes of the future tax calculation due to the uncertainty as to whether sufficient revenue will be realized from the related properties to utilize the pools.

The income tax provision differs from the amount computed by applying the expected income tax rate of 40.62% (2002 – 42.24%) to earnings before taxes. The reasons for this difference are as follows:

	2003 \$	2002 \$
Loss before taxes	<u>(405,353)</u>	<u>(211,586)</u>
Expected tax rate	<u>40.62%</u>	<u>42.24%</u>
Expected tax expense at combined federal and provincial rates	(164,654)	(89,374)
Crown royalties and production taxes	11,625	7,542
Alberta royalty tax credit	(2,906)	(1,886)
Resource allowance	(27,620)	-
Stock based compensation	38,228	-
Decrease in future taxes due to tax rate reduction	(112,129)	(10,416)
Other	556	9,046
Income tax recovery	<u>(256,900)</u>	<u>(85,088)</u>

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6 Bank line of credit

The company has a bank operating line of credit to a maximum of \$2,000,000, bearing interest at prime plus 1% per annum, with an additional \$500,000 available for acquisition financing or for development drilling, at an interest rate of prime plus 1.25%. At December 31, 2003, the outstanding balance under the line of credit was \$1,150,000 (2002 – \$nil).

The line of credit is secured by \$5,000,000 floating charge debenture over all the company's assets with a negative pledge and undertaking to provide fixed charges on the company's major producing properties at the request of the bank. The credit facilities are repayable on demand, and are reviewed periodically by the bank, the next review being scheduled on May 1, 2004.

7 Cash flows

Changes in non-cash working capital:

	2003 \$	2002 \$
Operating activities		
Accounts receivable	(573,814)	59,171
Prepaid expenses and deposits	11,618	40,862
Accounts payable and accrued charges	334,739	331,912
	<u>(227,457)</u>	<u>431,945</u>
Investing activities		
Accounts receivable	(90,539)	49,732
Accounts payable and accrued charges	(187,390)	96,088
	<u>(277,929)</u>	<u>145,820</u>
	<u>(505,386)</u>	<u>577,765</u>

8 Commitments

The present office lease agreement expires on August 31, 2004. Future lease payments to the end of the lease term under the company's office lease will total \$28,027.

9 Financial instruments

Financial instruments include bank indebtedness, accounts receivable, and accounts payable and accrued charges. At December 31, 2003, the fair market value of the financial instruments approximated their carrying value due to the short-term maturity of these instruments.

