

PETRO-REEF RESOURCES LTD.
FINANCIAL STATEMENTS (UNAUDITED)
JUNE 30, 2004 AND 2003

In accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Company discloses that its auditors have not reviewed the unaudited interim financial statements for the period ended June 30, 2004, and have been prepared by management.

PETRO-REEF RESOURCES LTD.
Balance Sheet
As at June 30, 2004 and December 31, 2003
Unaudited

	2004	2003 (Restated - note 2)
ASSETS		
Current assets		
Accounts receivable	\$ 451,904	\$ 992,523
Prepaid expenses and deposits	18,769	6,977
	<u>470,673</u>	<u>999,500</u>
Property, plant and equipment (note 3)	<u>7,440,790</u>	<u>7,175,224</u>
	<u>\$ 7,911,463</u>	<u>\$ 8,174,724</u>
LIABILITIES		
Current liabilities		
Cheques drawn in excess of bank	\$ 107,180	\$ 409,474
Bank line of credit (note 4)	1,425,000	1,150,000
Accounts payable and accrued charges	1,394,465	1,647,684
	<u>2,926,645</u>	<u>3,207,158</u>
Future income taxes	506,424	529,424
Assets retirement obligation (note 5)	<u>198,105</u>	<u>190,436</u>
	<u>3,631,174</u>	<u>3,927,018</u>
SHAREHOLDERS' EQUITY		
Share capital (note 6)	4,753,072	4,743,176
Contributed surplus (note 7)	273,975	94,111
Deficit	<u>(746,758)</u>	<u>(589,581)</u>
	<u>4,280,289</u>	<u>4,247,706</u>
	<u>\$ 7,911,463</u>	<u>\$ 8,174,724</u>

SIGNED ON BEHALF OF THE BOARD
"Joseph Werner"
 Director

"Robert N. Maertens-Poole"
 Director

PETRO-REEF RESOURCES LTD.
Statements of Operations and Deficit
Unaudited

	3 Months Ended June 30, 2004	3 Months Ended June 30, 2003 (Restated note 2)	6 Months Ended June 30, 2004	6 Months Ended June 30, 2003 (Restated note 2)
Revenue				
Oil and gas sales, net of royalties and ARTC	\$ 531,591	\$ 176,756	\$ 885,879	\$ 388,249
Expenses				
Accretion expense	3,361	3,125	6,834	6,194
Depletion and depreciation	125,146	71,925	379,950	140,983
General and administrative	102,035	102,778	165,208	186,640
Interest expense	13,665	16,734	40,878	16,734
Production	149,916	61,999	288,426	110,003
Stock based compensation	180,839	3,921	184,760	7,842
	<u>574,962</u>	<u>260,482</u>	<u>1,066,056</u>	<u>468,396</u>
Earnings (loss) before the following	(43,371)	(83,726)	(180,177)	(80,147)
Future income tax (recovery)	<u>32,000</u>	<u>(98,690)</u>	<u>(23,000)</u>	<u>(94,502)</u>
Net earnings (loss) for the period	(75,371)	14,964	(157,177)	14,355
Deficit - Beginning of period	<u>(671,387)</u>	<u>(441,470)</u>	<u>(589,581)</u>	<u>(440,861)</u>
Deficit - End of period	<u>\$ (746,758)</u>	<u>\$ (426,506)</u>	<u>\$ (746,758)</u>	<u>\$ (426,506)</u>
Basic and diluted earnings (loss) per common share	<u>\$ 0.00</u>	<u>\$ 0.00</u>	<u>\$ (0.01)</u>	<u>\$ 0.00</u>

PETRO-REEF RESOURCES LTD.
Statement of Cash Flows
Unaudited

	3 Months Ended June 30, 2004	3 Months Ended June 30, 2003 (Restated note 2)	6 Months Ended June 30, 2004	6 Months Ended June 30, 2003 (Restated note 2)
Cash provided by (used in)				
Operating activities				
Net earnings (loss) for the period	\$ (75,371)	\$ 14,964	\$ (157,177)	\$ 14,355
Items not effecting working capital				
Depletion and depreciation	125,146	71,925	379,950	140,983
Stock based compensation	180,839	3,921	184,760	7,842
Accretion expense	3,361	3,125	6,834	6,194
Future income taxes	32,000	(98,690)	(23,000)	(94,502)
Cash flow from operations	<u>265,975</u>	<u>(4,755)</u>	<u>391,367</u>	<u>74,872</u>
Net change in non-cash operating working capital items (note 9)	<u>19,856</u>	<u>309,008</u>	<u>261,394</u>	<u>(555,070)</u>
	<u>285,831</u>	<u>304,253</u>	<u>652,761</u>	<u>(480,198)</u>
Financial activities				
Bank line of credit	(50,000)	25,000	275,000	750,000
Proceeds from exercise of stock options	<u>5,000</u>	<u>-</u>	<u>5,000</u>	<u>-</u>
	(45,000)	25,000	280,000	750,000
Investing activities				
Expenditures on property, plant and equipment	(306,151)	(104,529)	(644,682)	(234,864)
Net change in non-cash investing working capital items (note 9)	<u>(32,315)</u>	<u>(254,133)</u>	<u>14,215</u>	<u>(328,303)</u>
	<u>(338,466)</u>	<u>(358,662)</u>	<u>(630,467)</u>	<u>(563,167)</u>
Change in cheques drawn in excess of bank during the period	(97,635)	(29,409)	302,294	(293,365)
Cheques drawn in excess of bank - Beginning of period	<u>(9,545)</u>	<u>(5,092)</u>	<u>(409,474)</u>	<u>258,864</u>
Cheques drawn in excess of bank - End of period	<u>\$ (107,180)</u>	<u>\$ (34,501)</u>	<u>\$ (107,180)</u>	<u>\$ (34,501)</u>
Supplemental information				
Interest paid	<u>\$ 13,665</u>	<u>\$ 16,734</u>	<u>\$ 40,878</u>	<u>\$ 16,734</u>

PETRO-REEF RESOURCES LTD.
Notes to Financial Statements
As at June 30, 2004
Unaudited

1. Accounting policies

The interim financial statements of Petro-Reef Resources Ltd. (the "Company") have been prepared following the same accounting policies and methods of computation as for the financial statements of the Company as at December 31, 2003. The interim financial statements contain disclosures, which are supplemental to the Company's annual financial statements. Certain disclosures, which are normally required to be included in the notes to the annual financial statements, have been condensed or omitted except as noted below. The year end financial statements should be read in conjunction with the Company's financial statements and notes thereto for the year ended December 31, 2003.

The Company has a working capital deficit of \$2,455,972 as at June 30, 2004 and \$2,207,658 as at December 31, 2003. 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 the carrying amounts could be adjusted materially.

2. Change in accounting policies

Asset retirement obligation

Effective January 1, 2004, the Company adopted the new Canadian accounting standard for asset retirement obligations. The new standard requires the Company to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The associated asset retirement costs are capitalized as part of the carrying amount of the property, plant and equipment and depleted and depreciated using a unit of production method over estimated gross proved reserves. Subsequent to the initial measurement of the asset retirement obligation, the obligation is adjusted at the end of each period to reflect the passage of time (accretion), and changes in the estimated future cash flows underlying the obligation. The effect of adoption of the new standard on the financial statements is disclosed below.

The effect of this change in accounting policy has been recorded retroactively with restatement of prior periods. The effect of the adoption is presented below as increases (decreases):

Balance Sheet	<u>December 31, 2003</u>
Asset retirement costs, included in property, plant and equipment	\$ 122,861
Accumulated depletion and depreciation on asset retirement costs, included in property, plant and equipment	41,294
Asset retirement obligations	190,436
Accumulated future site restoration liability	(50,575)
Future income tax liability	(16,466)
Deficit	(41,561)

	<u>Six months ended June 30, 2003</u>	<u>Three months ended March 31, 2003</u>
Statement of Operations		
Accretion expense	\$ 6,194	\$ 3,069
Depletion and depreciation on asset retirement costs	1,837	938
Provision for future site restoration	<u>(3,263)</u>	<u>(1,675)</u>
Net earnings (loss) impact	<u>\$ 5,488</u>	<u>\$ 2,332</u>
Basic and diluted earnings (loss) per share	<u>\$ 0.00</u>	<u>\$ 0.00</u>

PETRO-REEF RESOURCES LTD.
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There was no impact on the Company's cash flow as a result of adopting this new policy. See note 5 for additional information on the asset retirement obligation and the impact on the financial statements.

Stock based compensation

On October 1, 2003 the Company adopted the new Canadian accounting standards with respect to stock based compensation, prospectively with an effective date of January 1, 2003. As a result, the net loss for the six months ended June 30, 2003 has been adjusted by \$7,842 to reflect the portion of the December 31, 2003 adjustment of stock based compensation related to that period.

3. Property, plant, and equipment

	<u>June 30, 2004</u>		
	Cost	Accumulated depletion and depreciation	Net
Petroleum and natural gas	\$ 10,724,825	\$ 3,300,732	\$ 7,424,093
Furniture and fixtures	33,992	17,295	16,697
	<u>\$ 10,758,817</u>	<u>\$ 3,318,027</u>	<u>\$ 7,440,790</u>
	<u>December 31, 2003</u>		
	Cost	Accumulated depletion and depreciation	Net
Petroleum and natural gas	\$ 10,085,109	\$ 2,922,946	\$ 7,162,163
Furniture and fixtures	35,777	22,716	13,061
	<u>\$ 10,120,886</u>	<u>\$ 2,945,662</u>	<u>\$ 7,175,224</u>

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

Unproven property costs of \$244,131 (2003 – \$244,131) have been excluded from capitalized costs subject to depletion.

4. Bank line of credit

The current line of credit is \$2,000,000, with an additional \$500,000 available for development drilling and acquisition financing. Interest is at prime plus 1.25% per annum for the current loan and 1.5% per annum for the development loan. At June 30, 2004 the balance owing on the current loan was \$1,425,000 (2003 - \$1,150,000).

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 for 2005.

5. Asset retirement obligation

The total future asset retirement obligation was estimated based on the Company's net ownership in all wells and facilities, estimated costs to reclaim and abandon the wells and the estimated timing of costs to be incurred in future periods. The Company has estimated the net present value of its asset retirement obligation to be \$198,105 as at June 30, 2004 based on a total future liability of \$329,133 which will be incurred between

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2004 and 2024. A credit adjusted risk free rate of 7.5 percent and an inflation rate of 2 percent were used to calculate the fair value of the asset retirement obligation.

A reconciliation of the asset retirement obligation is provided below:

	Six months ended		Year Ended
	June 30	June 30	December 31
	2004	2003	2003
Balance, beginning of period	\$ 190,436	\$ 168,190	\$ 168,190
Liabilities incurred in period	835	-	9,632
Liabilities settled in period	-	-	-
Accretion expense	6,834	6,194	12,614
	<u>6,834</u>	<u>6,194</u>	<u>12,614</u>
Balance, end of period	<u>\$ 198,105</u>	<u>\$ 174,384</u>	<u>\$ 190,436</u>

6. Share capital

	Six months ended		Year end	
	June 30, 2004		December 31, 2003	
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>
Balance, beginning of period	17,688,937	4,743,176	17,688,937	4,743,176
Exercise of options	<u>16,666</u>	<u>9,896</u>	<u>-</u>	<u>-</u>
Balance, end of period	<u>17,705,603</u>	<u>4,753,072</u>	<u>17,688,937</u>	<u>4,743,176</u>

Basic and diluted loss per common share are calculated using the weighted average number of common shares outstanding during the period of 17,691,043 (2003 – 17,688,937)

7. Contributed Surplus

	Six months ended	Year end
	June 30, 2004	December 31, 2003
Balance beginning of period	\$ 94,111	\$ -
Compensation recognized in the period	184,760	94,111
Adjustment for options exercised in the period	<u>(4,896)</u>	<u>-</u>
Balance, end of period	<u>\$ 273,975</u>	<u>\$ 94,111</u>

8. Stock based compensation

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 vest after one year and expire after a maximum exercise period of five years from the date of issue. Compensation costs attributable to share options granted is measured at fair value at the grant date and expensed over the expected exercise time frame with a corresponding increase to contributed surplus. Upon exercise of the stock options, consideration paid by the option holder together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

During the period, the Company changed the vesting period for all outstanding stock options to be one year from issuance of the option, from previously being vested equally over three years. As a result of this change to the stock option plan, compensation costs for the three month period ending June 30, 2004 increased by \$174,734.

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The 300,000 options granted during the second quarter vest one year after issuance and expire June 16, 2009.

As at March 31, 2004, the following options were issued:

	Number of Options	Weighted Average Exercise Price
Outstanding at January 1, 2004	1,310,000	\$ 0.42
Granted	350,000	0.70
Exercised	(16,666)	(0.30)
Expired	(100,000)	-
	<u>1,543,334</u>	<u>0.49</u>
Outstanding at June 30, 2004	<u>1,543,334</u>	<u>0.49</u>
Exercisable at June 30, 2004	<u>493,334</u>	<u>\$ 0.44</u>

The outstanding options have a range of exercise prices between \$.30 and \$.71 per share and a weighted average number of years to expiry of 3.8. The exercisable options have a range of exercise prices between \$.30 and \$.49 per share and have a weighted average number of years to expiry of 2.5.

The fair value of each option granted during the three month period ended June 30, 2004 is estimated on the date of grant using the Black-Scholes options pricing model with the following weighted average assumptions:

	Three months ended June 30, 2004
Fair value of options granted (\$/share)	.61
Risk-free interest rate (%)	4.50
Expected life (years)	5
Expected volatility (%)	132
Expected dividend yield (%)	-

9. Cash flows

	3 Months Ended June 30, 2004	3 Months Ended June 30, 2003	6 Months Ended June 30, 2004	6 Months Ended June 30, 2003
Changes in non-cash working capital				
Operating Activities:				
Accounts receivable	\$ (75,969)	\$ 31,421	\$ 427,971	\$ (4,461)
Prepaid deposits	20,946	10,216	(11,792)	(12,760)
Accounts payable and accrued charges	<u>74,879</u>	<u>267,371</u>	<u>(154,785)</u>	<u>(537,849)</u>
	<u>19,856</u>	<u>309,008</u>	<u>261,394</u>	<u>(555,070)</u>
Investing Activities:				
Accounts receivable	43,398	(304,447)	112,648	(294,224)
Accounts payable and accrued charges	<u>(75,713)</u>	<u>50,314</u>	<u>(98,433)</u>	<u>(34,079)</u>
	<u>(32,315)</u>	<u>(254,133)</u>	<u>14,215</u>	<u>(328,303)</u>
	<u>\$ (12,459)</u>	<u>\$ 54,875</u>	<u>\$ 275,609</u>	<u>\$(883,373)</u>