



***MANAGEMENT'S DISCUSSION AND ANALYSIS AND  
FINANCIAL STATEMENTS***

***FOR THE THREE AND SIX MONTH PERIODS ENDED  
JUNE 30, 2008 AND 2007***

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This Management's Discussion and Analysis ("MD&A") of financial condition, future prospects and results of operations of Petro-Reef Resources Ltd. ("Petro-Reef" or the "Corporation") is dated August 27, 2008. It should be read in conjunction with the audited annual financial statements and corresponding notes for the twelve month period ended December 31, 2007.

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those methods it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgments. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects. The financial information contained elsewhere in this report has been revised to ensure consistency with the financial statements.

Management has established systems of internal controls, which are designed to provide reasonable assurance that the Corporation's assets are safeguarded from loss or unauthorized use and to produce reliable accounting records for the preparation of financial information.

Petro-Reef's Board of Directors has reviewed and approved the June 30, 2008 interim financial statements and related MD&A.

This MD&A provides certain financial measures that do not have a standardized meaning prescribed by Canadian generally accepted accounting principles ("GAAP"). These non-GAAP financial measures may not be comparable to similar measures presented by other issuers. Cash flow from operations and operating netback are not recognized measures under GAAP. Management believes that in addition to net income, funds from operations and operating netback are useful supplemental measures that demonstrate the Corporation's ability to generate the cash necessary to repay debt or fund future growth through capital investment. Investors are cautioned, however, that these measures should not be construed as an alternative to net income determined in accordance with GAAP as an indication of Petro-Reef's performance. Petro-Reef's method of calculating these measures may differ from other companies and accordingly, they may not be comparable to measures used by other companies. Operating netback is calculated on a \$/boe basis and is defined as revenue less royalties and operating expenses.

## **FORWARD LOOKING ADVISORY**

Some of the statements contained herein (including without limitation, financial and business prospects and financial outlooks) may be forward-looking statements which reflect management's expectations regarding future plans and intentions, growth, results of operations, performance and business prospects and opportunities. Words such as "may", "will", "should", "could", "anticipate", "believe", "expect", "intend", "plan", "potential", "continue" and similar expressions have been used to identify these forward-looking statements. These statements reflect management's current beliefs and are based on information currently available to management. Forward-looking statements involve significant risk and uncertainties. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements including, but not limited to, changes in general economic and market conditions and other risk factors. Although the forward-looking statements contained herein are based upon what management believes to be reasonable assumptions, management cannot assure that actual results will be consistent with these forward-looking statements. Investors should not place undue reliance on forward-looking statements. These forward-looking statements are made as of the date hereof and the Corporation assumes no obligation except as required by law to update or review them to reflect new events or circumstances.

Forward-looking statements and other information contained herein concerning the oil and gas industry and the Corporation's general expectations concerning this industry are based on estimates prepared by management using data from publicly available industry sources as well as from reserve reports, market research and industry analysis and on assumptions based on data and knowledge of this industry which the Corporation believes to be reasonable. However, this data is inherently imprecise, although generally indicative of relative market positions, market shares and performance characteristics. While the Corporation is not aware of any misstatements regarding any industry data presented herein, the industry involves risks and uncertainties and is subject to change based on various factors.

## **DISCLOSURE CONTROLS AND PROCEDURES**

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed is recorded, processed, summarized and reported with the time periods specified by securities regulations and that information required to be disclosed is accumulated and communicated to management.

## **DESIGN OF INTERNAL CONTROLS OVER FINANCIAL REPORTING**

Effective for the year end 2006, securities regulations state that the Corporation is to design and implement internal controls over financial reporting and disclose in its MD&A any material changes in the Corporation's internal control over financial reporting that occurred during the Corporation's most recent interim period. Internal controls are processes designed and implemented by management to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and the preparation of financial statements and other financial information for external purposes in accordance with Canadian GAAP. For the quarter ended June 30, 2008, the Chief Executive Officer and the Chief Financial Officer have designed internal controls over financial reporting, or caused them to be designed under their supervision. Management has concluded that internal controls are adequately designed in this regard, considering the employees involved and the control procedures in place, including management and Audit Committee oversight. Occasionally, the Corporation requires outside assistance and advice on taxation, new accounting pronouncements and complex accounting and reporting issues, which is common with companies of a similar size. It should be noted, that the Corporation's control system, no matter how well designed, can provide only reasonable, but not absolute, assurance of detecting, preventing and deterring errors or fraud. There has been no changes in internal controls from the prior quarter.

## **BUSINESS RISKS**

Petro-Reef is exposed to risks inherent in the oil and gas business. Operationally, the Corporation faces risks associated with finding, developing and producing oil and gas reserves, such as the availability of rigs and inclement weather. The Corporation continues to follow strict exploration criteria on each prospect to ensure high profitability and rate of return on capital investment. Exploration risks are managed by hiring skilled technical staff and by concentrating exploration activity on areas in which Petro-Reef has experience and expertise. Petro-Reef operates most of its production, allowing the Corporation to manage costs, timing and sales of production. Estimates of economically recoverable reserves and the future net cash flow are based on factors such as commodity prices, projected production and future capital and operating costs. These assumptions may differ from actual results. The Corporation has its reserves evaluated annually by an independent engineering firm. Petro-Reef is also exposed to environmental risks and risks associated with the reliance upon relationships with partners. Petro-Reef carries environmental liability, property, drilling and general liability insurance to mitigate its risks. The Corporation is also exposed to financial risks in the form of commodity prices, interest rates, the Canadian to U.S. dollar exchange rate and inflation. Petro-Reef manages

commodity price risk by focusing its capital program on areas that are expected to generate attractive rates of return.

## ABBREVIATIONS

bbl	barrel	GJs/d	gigajoules per day
bbls	barrels	M3	cubic meters
bcf	billion cubic feet	Mbbls	thousands of barrels
bhp	brake horsepower	mcf	thousand cubic feet
boe	barrel of oil equivalent (1 boe = 6 mcf)	mcf/d	thousand cubic feet per day
bbls/d	barrels per day	MMbbls	millions of barrels
boe/d	barrels of oil per day	mmcf	million cubic feet
FNR	future net revenue	mmcf/d	million cubic feet per day
GJ	gigajoule	NGLs	natural gas liquids
		NPV	net present value

Reference is made to barrels of oil equivalent. Barrels of oil equivalent may be misleading, particularly if used in isolation. In accordance with National Instrument 51-101, a boe conversion ratio for natural gas of 6 mcf: 1 bbl has been used, which is based on an energy equivalent conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

NOTE: In this report all currency values are in Canadian dollars.

Additional information about Petro-Reef is available on SEDAR at [www.sedar.com](http://www.sedar.com).

## SELECTED QUARTERLY INFORMATION

### Financial

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>
Gross Revenue	<b>\$6,294,649</b>	\$2,228,590	182.4%
Cash Flow From Operations	<b>\$3,394,919</b>	\$1,104,425	207.4%
Net Income	<b>\$884,916</b>	\$27,455	3,123.1%

	<b>June 30, 2008</b>	<i>December 31, 2007</i>	<i>% Growth</i>
Total Assets	<b>\$34,682,220</b>	\$28,603,828	21.7%
Current Financing	<b>\$6,987,476</b>	-	n/a

## RESULTS OF OPERATIONS

### Production

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>
	<b>Average</b>	<i>Average</i>	
Crude Oil and NGL (bbls/d)	<b>145</b>	25	479.9%
Natural Gas (mcf/d)	<b>5,719</b>	3,135	82.5%
Combined (boe/d)	<b>1,098</b>	547	100.6%

<i>Six months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>
	<b>Average</b>	<i>Average</i>	
Crude Oil and NGL (bbls/d)	<b>118</b>	25	373.0%
Natural Gas (mcf/d)	<b>5,584</b>	3,274	70.6%
Combined (boe/d)	<b>1,049</b>	571	83.8%

## Financial

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<b>(\$ / boe)</b>	<i>(\$ / boe)</i>
Gross Revenue	<b>\$6,294,649</b>	\$2,228,590	<b>182.4%</b>	<b>\$62.98</b>	\$44.74
Royalties	<b>\$1,143,631</b>	\$421,395	<b>171.4%</b>	<b>\$11.44</b>	\$8.46
Revenue After Royalties	<b>\$5,151,018</b>	\$1,807,195	<b>185.0%</b>	<b>\$51.54</b>	\$36.28
Operating Expenses	<b>\$933,211</b>	\$404,430	<b>130.7%</b>	<b>\$9.34</b>	\$8.12
Operating Netback	<b>\$4,217,807</b>	\$1,402,765	<b>200.7%</b>	<b>\$42.20</b>	\$28.16
General & Administrative Expenses	<b>\$660,304</b>	\$364,962	<b>80.9%</b>	<b>\$6.61</b>	\$7.33
Interest Expense (Income)	<b>\$162,584</b>	(\$66,622)	<b>n/a</b>	<b>\$1.63</b>	(\$1.34)
Non-cash Expenses	<b>\$2,196,785</b>	\$1,043,538	<b>110.5%</b>	<b>\$21.97</b>	\$20.95
Income Before Income Taxes	<b>\$1,198,134</b>	\$60,887	<b>1,867.8%</b>	<b>\$11.99</b>	\$1.22
Income Tax Expense	<b>\$313,218</b>	\$33,432	<b>836.9%</b>	<b>\$3.14</b>	\$0.67
Net Income (Loss)	<b>\$884,916</b>	\$27,455	<b>3,123.2%</b>	<b>\$8.85</b>	\$0.55
Per Share – Basic	<b>\$0.02</b>	\$0.00			
Per Share - Diluted	<b>\$0.02</b>	\$0.00			

<i>Six months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<b>(\$ / boe)</b>	<i>(\$ / boe)</i>
Gross Revenue	<b>\$11,025,343</b>	\$4,772,285	<b>131.0%</b>	<b>\$57.76</b>	\$46.20
Royalties	<b>\$2,177,818</b>	\$953,149	<b>128.5%</b>	<b>\$11.41</b>	\$9.23
Revenue After Royalties	<b>\$8,847,525</b>	\$3,819,136	<b>131.7%</b>	<b>\$46.35</b>	\$36.97
Operating Expenses	<b>\$1,620,340</b>	\$818,067	<b>98.1%</b>	<b>\$8.49</b>	\$7.92
Operating Netback	<b>\$7,227,185</b>	\$3,001,069	<b>140.8%</b>	<b>\$37.86</b>	\$29.05
General & Administrative Expenses	<b>\$969,001</b>	\$389,011	<b>149.1%</b>	<b>\$5.08</b>	\$3.77
Interest Expense (Income)	<b>\$231,566</b>	(\$59,803)	<b>n/a</b>	<b>\$1.21</b>	(\$0.58)
Non-cash Expenses	<b>\$4,219,268</b>	\$1,951,219	<b>116.2%</b>	<b>\$22.10</b>	\$18.89
Income Before Income Taxes	<b>\$1,807,350</b>	\$720,642	<b>150.8%</b>	<b>\$9.47</b>	\$6.98
Income Tax Expense (recovery)	<b>\$520,740</b>	\$256,432	<b>103.1%</b>	<b>\$2.73</b>	\$2.48
Net Income (Loss)	<b>\$1,286,610</b>	\$464,210	<b>177.2%</b>	<b>\$6.74</b>	\$4.49
Per Share – Basic	<b>\$0.04</b>	\$0.01			
Per Share - Diluted	<b>\$0.04</b>	\$0.01			

## Revenue

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<b>2007</b>
				<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
Gross Revenue	<b>\$6,294,649</b>	\$2,228,590	<b>182.4%</b>	<b>\$62.98</b>	\$44.74

Gross revenue increased 182.4% to \$6,294,649 for the three month period ended June 30, 2008 compared to \$2,228,590 for the same period ended June 30, 2007. Petro-Reef realized an all in price per unit of production for the three month period ended June 30, 2008 of \$62.98, representing a 40.8% increase compared to the realized price per unit of production of \$44.74 for the same period ended June 30, 2007.

Below is a summary of gross prices realized by Petro-Reef for the three month period ended June 30:

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Change</i>
Crude Oil and NGL (\$ / bbl)	<b>\$111.98</b>	\$56.83	97.0%
Natural Gas (\$ / mcf)	<b>\$9.13</b>	\$7.34	24.3%

Revenues increased as a result of a 100.6% increase in production year over year. Revenue also increased as a result of a 97.0% increase in realized crude oil and NGL prices. Petro-Reef's crude oil production increased to 13.2% of total production during the quarter compared to 5.6% in 2007, which allowed the Corporation to benefit from the increase in crude oil prices. Natural gas prices were up 24.3% year over year. Crude oil production is expected to increase during the year as more capital is targeted towards crude oil development drilling.

<i>Six months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<b>2007</b>
				<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
Gross Revenue	<b>\$11,025,343</b>	\$4,772,285	<b>131.0%</b>	<b>\$57.76</b>	\$46.20

Gross revenue increased 131.0% to \$11,025,343 for the six month period ended June 30, 2008 compared to \$4,772,285 for the same period ended June 30, 2007. Petro-Reef realized an all in price per unit of production for the six month period ended June 30, 2008 of \$57.76, representing a 25.0% increase compared to the realized price per unit of production of \$46.20 for the same period ended June 30, 2007.

Below is a summary of gross prices realized by Petro-Reef for the six month period ended June 30:

<i>Six months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Change</i>
Crude Oil and NGL (\$ / bbl)	<b>\$101.78</b>	\$54.96	85.2%
Natural Gas (\$ / mcf)	<b>\$8.46</b>	\$7.61	11.2%

## Royalties

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<b>(\$ / boe)</b>	<i>(\$ / boe)</i>
Royalties	<b>\$1,143,631</b>	\$421,395	<b>171.4%</b>	<b>\$11.44</b>	\$8.46

Royalties increased 171.4% to \$1,143,631 for the three month period ended June 30, 2008 compared to \$421,395 for the same period ended June 30, 2007. Royalties on a per unit of production basis rose 35.3% to \$11.44 for the three month period ended June 30, 2008 compared to \$8.46 for the same period ended June 30, 2007. Royalties paid increased as a result of a 100.6% increase in production and a 40.8% increase in realized prices which resulted in a 182.4% increase in revenues during the quarter.

The effective royalty rate fell to 18.2% for the three month period ended June 30, 2008 from 18.9% for the same period ended June 30, 2007. This decrease in the effective royalty rate was a result of higher production volumes on lands which attract Freehold royalties and a one-time adjustment to Crown royalties relating to gas cost allowance from Petro-Reef's 8-1 natural gas and crude oil facility.

<i>Six months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<b>(\$ / boe)</b>	<i>(\$ / boe)</i>
Royalties	<b>\$2,177,818</b>	\$953,149	<b>128.5%</b>	<b>\$11.41</b>	\$9.23

Royalties increased 128.5% to \$2,177,818 for the six month period ended June 30, 2008 compared to \$953,149 for the same period ended June 30, 2007. Royalties on a per unit of production basis rose 23.6% to \$11.41 for the six month period ended June 30, 2008 compared to \$9.23 for the same period ended June 30, 2007.

The effective royalty rate fell slightly to 19.9% for the six month period ended June 30, 2008 from 20.0% for the same period ended June 30, 2007.

## Operating Expenses

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<b>(\$ / boe)</b>	<i>(\$ / boe)</i>
Operating Expenses	<b>\$933,211</b>	\$404,430	<b>130.7%</b>	<b>\$9.34</b>	\$8.12

Operating expenses rose 130.7% to \$933,211 for the three month period ended June 30, 2008 compared to \$404,430 for the same period ended June 30, 2007. Production expenses on a per unit of production basis increased 15.0% to \$9.34 for the three month period ended June 30, 2008 compared to \$8.12 for the same period ended June 30, 2007.

Operating expenses increased 130.7% as a result of an 100.6% increase in production year over year as well as the inclusion of approximately \$75,000 in expenditures required to repair and work-over certain key oil wells in Petro-Reef's core area of Alexander. Exclusion of the one-time expenditures would have resulted in operating expenses on a per unit of production basis falling to approximately \$8.00 which is consistent with historical operating expenses on a per unit of production basis.

## Operating Expenses

<i>Six months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
Operating Expenses	<b>\$1,620,340</b>	\$818,067	<b>98.1%</b>	<b>\$8.49</b>	\$7.92

Operating expenses rose 98.1% to \$1,620,340 for the six month period ended June 30, 2008 compared to \$818,067 for the same period ended June 30, 2007. Production expenses on a per unit of production basis rose 7.2% to \$8.49 for the six month period ended June 30, 2008 compared to \$7.92 for the same period ended June 30, 2007.

## General & Administrative Expenses

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
General & Administrative Expenses	<b>\$660,304</b>	\$364,962	<b>80.9%</b>	<b>\$6.61</b>	\$7.33

General & administrative expenses rose 80.9% to \$660,304 for the three month period ended June 30, 2008 compared to \$364,962 for the same period ended June 30, 2007. General & administrative expenses on a per unit of production basis fell 9.8% to \$6.61 for the three month period ended June 30, 2008 compared to \$7.33 for the same period ended June 30, 2007.

General & administrative increased as a result higher staffing levels as well as non-recurring fees incurred to assist in the hiring of new staff for the Corporation. General & administrative expenses also rose as a result of lower overhead recoveries from industry partners as the Corporation's working interest on production wells significantly increased as a result of the acquisition which closed during the first quarter of 2008. General & administrative expenses are expected to fall in subsequent quarters both in aggregate and on a per unit of production basis as a result of higher production volumes and an elimination of one-time non-recurring expenditures.

<i>Six months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
General & Administrative Expenses	<b>\$969,001</b>	\$389,011	<b>149.1%</b>	<b>\$5.08</b>	\$3.77

General & administrative expenses rose 149.1% to \$969,001 for the six month period ended June 30, 2008 compared to \$389,011 for the same period ended June 30, 2007. General & administrative expenses on a per unit of production basis increased 34.8% to \$5.08 for the six month period ended June 30, 2008 compared to \$3.77 for the same period ended June 30, 2007.

## Interest Expense (Income)

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<i>(\$ / boe)</i>	<i>(\$ / boe)</i>
Interest Expenses	<b>\$162,584</b>	(\$66,622)	<b>n/a</b>	<b>\$1.63</b>	(\$1.34)

Petro-Reef incurred interest expense of \$162,584 for the three month period ended June 30, 2008 compared to an interest income of \$66,622 for the same period ended June 30, 2007. Net interest expense on a per unit of production basis was \$1.63, compared to an interest income of \$1.34 per unit of production in 2007.

Net interest expense increased as a result of higher debt levels during the quarter which were required to finance the acquisition of a working interest partner. Petro-Reef's interest charged fell during the quarter as a result of a renegotiation of Petro-Reef's credit facility. Interest expense is expected to modestly increase in subsequent quarters as Petro-Reef capital expenditures are expected to exceed cash flow from operations generated by the Corporation which will require additional debt financing.

<i>Six months ended June 30</i>	<b>2008</b>	2007	% Growth	<b>2008</b>	2007
				<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Interest Expenses	<b>\$231,566</b>	(\$59,803)	<b>n/a</b>	<b>\$1.21</b>	(\$0.58)

Petro-Reef incurred interest expenses of \$231,566 for the six month period ended June 30, 2008 compared to an interest income of \$59,803 for the same period ended June 30, 2007. Net interest expense on a per unit of production basis was \$1.21, compared to an interest income of \$0.58 per unit of production in 2007.

### Non Cash Expenses

<i>Three months ended June 30</i>	<b>2008</b>	2007	% Growth	<b>2008</b>	2007
				<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Depletion and Amortization	<b>\$2,032,351</b>	\$660,518	<b>207.7%</b>	<b>\$20.33</b>	\$13.41
Accretion Expense	<b>\$117</b>	\$5,778	<b>(98.0%)</b>	<b>\$0.00</b>	\$0.12
Stock-Based Compensation	<b>\$164,317</b>	\$377,242	<b>(56.4%)</b>	<b>\$1.64</b>	\$7.66
Total Non Cash Items	<b>\$2,196,785</b>	\$1,043,538	<b>110.5%</b>	<b>\$21.97</b>	\$21.18

Non cash expenses rose 110.5% to \$2,196,785 for the three month period ended June 30, 2008 compared to \$1,043,538 for the same period ended June 30, 2007. On a per unit of production basis, non cash expenses increased 3.8% to \$21.97 for the three month period ended June 30, 2008 compared to \$21.18 for the same period ended June 30, 2007.

Depletion and amortization expense increased 207.7% to \$2,032,351 as a result of a 100.6% increase in production year over year. The increase in production combined with an increase in capital expenditures resulted in higher depletion on an aggregate basis.

<i>Six months ended June 30</i>	<b>2008</b>	2007	% Growth	<b>2008</b>	2007
				<b>(\$ / boe)</b>	<b>(\$ / boe)</b>
Depletion and Amortization	<b>\$3,797,423</b>	\$1,294,933	<b>193.2%</b>	<b>\$19.89</b>	\$12.54
Accretion Expense	<b>\$14,237</b>	\$10,928	<b>30.3%</b>	<b>\$0.07</b>	\$0.11
Stock-Based Compensation	<b>\$407,608</b>	\$645,298	<b>(36.8%)</b>	<b>\$2.14</b>	\$6.25
Total Non Cash Items	<b>\$4,219,268</b>	\$1,951,219	<b>116.2%</b>	<b>\$22.10</b>	\$18.89

Non cash expenses rose 116.2% to \$4,219,268 for the six month period ended June 30, 2008 compared to \$1,951,219 for the same period ended June 30, 2007. On a per unit of production basis, non cash expenses

increased 17.0% to \$22.10 for the six month period ended June 30, 2008 compared to \$18.89 for the same period ended June 30, 2007.

### Income Taxes

<i>Three months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<b>(\$ / boe)</b>	<i>(\$ / boe)</i>
Current Tax	-	-	-	-	-
Future Tax	<b>\$313,218</b>	\$33,432	<b>836.9%</b>	<b>\$3.14</b>	\$0.68
<b>Total Income Taxes</b>	<b>\$313,218</b>	\$33,432	<b>836.9%</b>	<b>\$3.14</b>	\$0.68

Non-cash income taxes expenses were \$313,218 for the three month period ended June 30, 2008 compared to an expense of \$33,432 for the same period ended June 30, 2007. On a per unit of production basis, income taxes increased to \$3.14 for the three month period ended June 30, 2008 compared to an expense of \$0.68 for the same period ended June 30, 2007.

<i>Six months ended June 30</i>	<b>2008</b>	<i>2007</i>	<i>% Growth</i>	<b>2008</b>	<i>2007</i>
				<b>(\$ / boe)</b>	<i>(\$ / boe)</i>
Current Tax	-	-	-	-	-
Future Tax	<b>\$520,740</b>	\$256,432	<b>103.1%</b>	<b>\$2.73</b>	\$2.48
<b>Total Income Taxes</b>	<b>\$520,740</b>	\$256,432	<b>103.1%</b>	<b>\$2.73</b>	\$2.48

Income taxes expenses were \$520,740 for the six month period ended June 30, 2008 compared to an expense of \$256,432 for the same period ended June 30, 2007. On a per unit of production basis, income taxes rose to \$2.73 for the six month period ended June 30, 2008 compared to an expense of \$2.48 for the same period ended June 30, 2007.

### LIQUIDITY AND FINANCIAL CONDITION

	<b>June 30, 2008</b>	<i>December 31, 2007</i>
Working Capital	<b>(\$8,689,722)</b>	(\$120,357)
Oil and Gas Properties	<b>\$31,752,548</b>	\$20,682,771

Petro-Reef's working capital deficit at June 30, 2008 was \$8,689,722 compared to a deficit of \$120,357 at December 31, 2007. The working capital deficit increased as a result of the \$10,400,000 acquisition which closed during the first quarter, all of which was funded using existing cash holdings and an increased credit facility. Included in the working capital deficit was \$7,370,730 in outstanding bank lines of credit which is included in current liabilities. Petro-Reef's bank credit facility is structured as a \$17,000,000 revolving operating demand loan and a \$4,000,000 non-revolving acquisition / development demand loan. As at June 30, 2008, Petro-Reef Resources Ltd. was in compliance with its bank covenants.

Based on forecast cash flows from operations and available bank credit financing, Petro-Reef is confident in its ability to fund ongoing capital and operating expenditures. Petro-Reef's debt levels are expected to increase in subsequent quarters as a result of increasing capital expenditures.

Capitalized resource properties as at June 30, 2008 were \$31,752,548 net of accumulated depletion, compared to \$20,682,771 as at December 31, 2007. Oil and gas properties increased as a result of continued developments of oil and gas properties, the construction of infrastructure and the acquisition of undeveloped land. For the three and six month periods ended June 30, 2008 Petro-Reef incurred \$1,811,045 and \$14,921,369 in net capital expenditures, respectively, broken down as follows:

	<b>3-Month Period Ended June 30, 2008</b>	6-Month Period Ended June 30, 2008
Exploration	<b>\$151,320</b>	\$528,771
Development	<b>\$495,514</b>	\$1,905,219
Property Acquisitions	<b>\$21,075</b>	\$9,975,415
Undeveloped Land	<b>\$113,124</b>	\$332,657
Geological / Geotechnical	<b>\$193,711</b>	\$244,247
Facilities	<b>\$771,655</b>	\$1,818,023
Other Assets	<b>\$64,647</b>	\$117,038
<b>Total Capital Expenditures</b>	<b>\$1,811,045</b>	\$14,921,369

As a result of a longer than anticipated spring break-up in the Corporation's core area of Alexander, no new wells were drilled during the quarter. Capital expenditures during the quarter were targeted towards finishing outstanding capital projects from the winter as well as preparatory work in anticipation of Petro-Reef's summer drilling program.

### **Cash Flow From Operations**

For the three month period ended June 30, 2008, Petro-Reef generated cash flows from operations of \$3,394,919 (\$0.10 per basic share), an increase of 207.4% compared to \$1,104,425 (\$0.04 per basic share) for the three month period ended June 30, 2007.

Cash flow from operations, representing cash generated from operating activities before changes in non-cash working capital items, is a non-GAAP measure. Management utilizes cash flow as a key measure to assess the ability of the Corporation to finance operating activities and capital expenditures. In addition, cash flow has been described and presented in order to provide shareholders and potential investors with information regarding the Corporation's liquidity and its ability to generate funds to finance its operations. This performance indicator may not be comparable to similar measures used by other companies.

<i>Three months ended June 30</i>	<b>2008</b>	2007
Net Income For The Period	<b>\$884,916</b>	\$27,455
Future Income Tax Provision	<b>\$313,218</b>	\$33,432
Accretion Expense	<b>\$117</b>	\$5,778
Stock-Based Compensation	<b>\$164,317</b>	\$377,242
Depletion And Amortization	<b>\$2,032,351</b>	\$660,518
<b>Cash Flow From Operations</b>	<b>\$3,394,919</b>	\$1,104,425

For the six month period ended June 30, 2008, Petro-Reef generated cash flows from operations of \$6,026,618 (\$0.18 per basic/diluted share), an increase of 125.6% compared to \$2,671,861 (\$0.10 per basic - \$0.08 per diluted share) for the six month period ended June 30, 2007.

<i>Six months ended June 30</i>	<i>2008</i>	<i>2007</i>
Net Income For The Period	<b>\$1,286,610</b>	\$464,210
Future Income Tax Provision	<b>\$520,740</b>	\$256,432
Accretion Expense	<b>\$14,237</b>	\$10,928
Stock-Based Compensation	<b>\$407,608</b>	\$645,298
Depletion And Amortization	<b>\$3,797,423</b>	\$1,294,993
Cash Flow From Operations	<b>\$6,026,618</b>	\$2,671,861

## Capital Resources

The Corporation's share capital is as follows:

	<i>June 30, 2008</i>		<i>December 31, 2007</i>	
	<i>No. of Shares</i>	<i>Amount</i>	<i>No. of Shares</i>	<i>Amount</i>
Common Shares	<b>34,104,781</b>	<b>\$17,505,304</b>	33,714,781	\$17,946,983

For the six month period ended June 30, 2008, 240,000 stock options were exercised generating cash proceeds of \$153,500. During the six month period ended June 30, 2008, 150,000 warrants were exercised generating cash proceeds of \$172,500. In the second quarter 2007, the Corporation issued 1,500,000 flow-through shares priced at \$2.00. As part of the flow-through share offering, Petro-Reef has renounced to investors and must incur \$3,000,000 in eligible exploration expenditures on or before December 31, 2008. Petro-Reef met its exploration expenditure obligation as of December 31, 2007. The actual renunciation of eligible exploration expenditures was filed with the Federal Government in Q1 – 2008 and, as a result, a tax adjustment of \$765,000 to share capital has been accounted for during this period.

## OFF-BALANCE SHEET ARRANGEMENTS

The Corporation does not have any off-balance sheet arrangements.

## OUTLOOK

Petro-Reef has commenced with a significant drilling program combining development oil and exploration natural gas opportunities. For the balance of the year, Petro-Reef has 8-10 new wells it intends to drill in the Corporation's core area of Alexander in Alberta. Included in the 8-10 new wells is 4-5 development crude oil locations focusing on continued development of Petro-Reef's existing crude oil development as well as a new slightly sour crude oil formation which has yet to produce in the area. Based on preliminary drilling results and interpretation of proprietary 3-D seismic, Petro-Reef anticipates that it has approximately 20 sweet crude development locations and the potential for between 25-30 sour crude oil locations providing Petro-Reef with a multi-year drilling inventory.

Petro-Reef continues to expand our 8-1 crude oil and natural gas facility with the recent approval of a sour oil battery. Petro-Reef currently has approximately 125 bbls/d of sour crude oil waiting to be tied-in to the facility once the sour oil facility is completed.

Petro-Reef has aggressively acquired undeveloped acreage in the Corporation's core area of Alexander, acquiring approximately 6 sections of freehold lands and 3 sections of Crown land at recent land sales. Petro-Reef is preparing a large proprietary 3-D seismic program which will overlap a majority of the recently acquired lands, complimenting an existing 2-D and partial 3-D seismic database currently controlled by the Corporation.

## **RELATED PARTY TRANSACTIONS**

All related party transactions are in the normal course of operations and have been measured at the agreed to exchange amounts, which is the amount of consideration established and agreed to by the related parties. During the period ended June 30, 2008, the Corporation purchased engineering services in the amount of \$721,659 (2007 - \$794,775) from a Corporation controlled by a Director of the Corporation. The Corporation also purchased professional services in the amount of \$60,079 (2007 - \$179,552) from a law firm which a Director of the Corporation is a partner of. At June 30, 2008, Petro-Reef had a payable of \$111,898 owed to the engineering firm providing services to the Corporation and \$0 owed to the law firm in the Corporation's accounts payable.

## **COMMITMENTS**

The present office lease agreement expires on September 30, 2011. Future lease payments to the end of the lease term under the Corporation's office lease are as follows:

2008	\$40,461
2009	\$84,258
2010	\$86,762
2011	\$65,070

## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of financial statements in conformity with GAAP requires the Corporation to make assumptions, judgments and estimates that may have a significant impact on the financial statements. Estimates are reviewed periodically and as adjustments become necessary they are reported in earnings in the periods in which they become known. The Corporation's significant accounting policies are described in Note 1 of these financial statements and in the Corporation's annual MD&A for the year ended December 31, 2007.

## **NEW ADOPTED ACCOUNTING STANDARDS**

Effective January 1, 2008, the Corporation was required to adopt the CICA Handbook Section 1506 - Accounting Changes that provides expanded disclosures for changes in accounting policies, accounting estimates and corrections of errors. Under the new standard, accounting changes should be applied retroactively unless otherwise permitted or where the effect is impracticable to determine. As well, voluntary changes in accounting policy are made only when required by a primary source of GAAP or the change results in more relevant and reliable information. The adopted accounting standard did not have any effect on the Corporation.

As of January 1, 2008, the Corporation was required to adopt two new CICA standards, Section 3862 – Financial Instruments – Disclosures, and Section 3863 – Financial Instruments – Presentation, which will replace Section 3861 – Financial Instruments – Disclosure and Presentation. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments

and how those risks are managed. The new presentation standard carries forward the former presentation requirements.

As of January 1, 2008, the Corporation adopted CICA Handbook Section 1535 – Capital Disclosures, which requires entities to disclose objectives, policies and processes for managing capital, and in addition, whether the entity has complied with any externally imposed capital requirements.

## SELECTED QUARTERLY INFORMATION

	2008		2007	
	Q2	Q1	Q4	Q3
<b>Revenue</b>	\$6,294,649	\$4,730,694	\$1,957,256	\$1,795,473
<b>Cash flow</b>	\$3,394,919	\$2,631,699	\$779,831	\$951,444
<b>Net Income (Loss)<sup>(1)</sup></b>	\$884,916	\$401,694	(\$665,008)	(\$199,246)
<b>Net Income (Loss) Per Share<sup>(1)</sup></b>	\$0.02	\$0.01	(\$0.02)	(\$0.01)
<b>Capital Expenditures</b>	\$1,811,045	\$13,110,324	\$3,126,358	\$2,960,159
<b>Total Assets</b>	\$34,682,220	\$35,324,313	\$28,603,828	\$26,488,367
<b>Shareholders Equity</b>	\$20,594,571	\$19,369,032	\$19,483,847	\$19,473,249
<b>Avg. Daily Production (boe/d)</b>	1,098	1,000	771	595

  

	2007		2006	
	Q2	Q1	Q4	Q3
<b>Revenue</b>	\$2,228,590	\$2,543,695	\$1,456,725	\$1,190,883
<b>Cash flow</b>	\$1,104,425	\$1,567,436	\$604,010	\$590,330
<b>Net Income (Loss)</b>	\$62,025	\$444,680	\$54,337	(\$67,349)
<b>Net Income (Loss) Per share</b>	\$0.00	\$0.01	\$0.00	(\$0.00)
<b>Capital Expenditures</b>	\$2,190,597	\$2,427,755	\$2,694,363	\$2,478,043
<b>Total Assets</b>	\$26,691,045	\$25,712,699	\$15,056,446	\$13,565,661
<b>Shareholders Equity</b>	\$19,347,503	\$16,168,187	\$7,919,194	\$7,003,587
<b>Avg. Daily Production (boe/d)</b>	544	594	354	338

**PETRO-REEF RESOURCES LTD.  
CORPORATE INFORMATION**

**DIRECTORS AND OFFICERS**

**Joseph Werner**<sup>(3) (5)</sup>

Chief Executive Officer  
President & Director  
Calgary, Alberta

**Theodore M. Donhuysen**<sup>(4) (5)</sup>

Vice-President Exploration & Production  
Chief Operating Officer & Director  
Calgary, Alberta

**John R. Pantazopoulos**<sup>(5)</sup>

Vice President Finance  
Chief Financial Officer & Director  
Calgary, Alberta

**Larry A. Ness**

Vice President Engineering  
Calgary, Alberta

**R. Greg Powers Q.C.**<sup>(2)(3)</sup>

Director, Corporate Secretary  
Calgary, Alberta

**Richard W. DeVries**<sup>(1)(2)</sup>

Director  
Freeport, The Bahamas

**Jack P. Donhuysen**<sup>(1) (4)</sup>

Director  
Calgary, Alberta

**Alan P. Hallman**<sup>(2) (3)</sup>

Director  
Calgary, Alberta

**Peter A. Lubey**<sup>(4)</sup>

Director  
Calgary, Alberta

**Huba A. Sebo**<sup>(1)</sup>

Director  
Calgary, Alberta

**Head Office**

970 – 10655 Southport Road S.W.  
Calgary, Alberta T2W 4Y1  
Telephone: +1 (403) 265-6444  
Facsimile: +1 (403) 264-1348  
E-mail: [info@petro-reef.ca](mailto:info@petro-reef.ca)  
Website: [www.petro-reef.ca](http://www.petro-reef.ca)

**Auditors**

PricewaterhouseCoopers LLP  
Chartered Accountants  
3100, 111 - 5<sup>th</sup> Avenue S.W.  
Calgary, Alberta T2P 5L3

**Bank**

National Bank of Canada  
301 – 6<sup>th</sup> Avenue S.W.  
Calgary, Alberta T2P 4M9

**Registrar and Transfer Agent**

CIBC Mellon Trust Corporation  
600, 333 - 7<sup>th</sup> Avenue S.W.  
Calgary, Alberta T2P 2Z1

**Stock Listing**

TSX Venture Exchange  
Trading Symbol: **PER**

- (1) Member of the Audit Committee
- (2) Member of the Compensation Committee
- (3) Member of the Governance Committee
- (4) Member of the Reserves Committee
- (5) Member of the Management Committee

**PETRO-REEF RESOURCES LTD.**  
**FINANCIAL STATEMENTS (Unaudited)**  
**FOR THE THREE AND SIX MONTH PERIODS ENDED**  
**JUNE 30, 2008 AND 2007**

**PETRO-REEF RESOURCES LTD.**  
**Balance Sheet**  
**As at June 30, 2008 and December 31, 2007**  
**Unaudited**

<b>ASSETS</b>	<b>June 30, 2008</b>	<b>December 31, 2007</b>
<b>Current assets</b>		
Cash and cash equivalents	\$400	\$4,921,309
Accounts receivable	\$2,605,207	\$2,833,229
Prepaid expenses and deposits	\$324,065	\$166,519
	<u>\$2,929,672</u>	<u>\$7,921,057</u>
<b>Property, plant and equipment</b> (note 2)	<u>\$31,752,548</u>	<u>\$20,682,771</u>
	<u>\$34,682,220</u>	<u>\$28,603,828</u>
<b>LIABILITIES</b>		
<b>Current liabilities</b>		
Overdraft	\$383,254	-
Bank line of credit (note 3)	\$6,987,476	-
Accounts payable and accrued charges	\$4,248,663	\$8,041,414
	<u>\$11,619,393</u>	<u>\$8,041,414</u>
<b>Future income taxes</b>	\$1,762,950	\$538,727
<b>Asset retirement obligation</b> (note 4)	<u>\$705,307</u>	<u>\$539,840</u>
	<u>\$14,087,650</u>	<u>\$9,119,981</u>
<b>SHAREHOLDERS' EQUITY</b>		
<b>Share capital</b> (note 5a)	\$17,505,304	\$17,946,983
<b>Warrants</b> (note 5b)	\$850,577	\$840,429
<b>Broker warrants</b> (note 5c)	\$160,123	\$212,685
<b>Contributed surplus</b> (note 5d)	\$1,967,400	\$1,659,194
<b>Retained Earnings (Deficit)</b>	<u>\$111,166</u>	<u>(\$1,175,444)</u>
	<u>\$20,594,570</u>	<u>\$19,483,847</u>
	<u>\$34,682,220</u>	<u>\$28,603,828</u>
Commitments (note 8)		
See accompanying notes to the financial statements		
<b>SIGNED ON BEHALF OF THE BOARD</b>		
<u>"Joseph Werner"</u> Director	<u>"Huba A. Sebo"</u> Director	

**PETRO-REEF RESOURCES LTD.****Statement of Operations, Comprehensive Income and Retained Earnings (Deficit)**

For the three and six month periods ended June 30, 2008 and 2007

Unaudited

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	<b>3-months Ended June 30, 2008</b>	<b>3-months Ended June 30, 2007</b>	<b>6-months Ended June 30, 2008</b>	<b>6-months Ended June 30, 2007</b>
<b>Revenue</b>				
Gross Revenue	\$6,294,649	\$2,228,590	\$11,025,343	\$4,772,285
Royalties	\$1,143,631	\$421,395	\$2,177,818	\$953,149
Revenue After Royalty	<u>\$5,151,018</u>	<u>\$1,807,195</u>	<u>\$8,847,525</u>	<u>\$3,819,136</u>
<b>Expenses</b>				
Production expenses	\$933,211	\$404,430	\$1,620,340	\$818,067
Accretion expense (note 4)	\$117	\$5,778	\$14,237	\$10,928
Depletion and depreciation	\$2,032,351	\$660,518	\$3,797,423	\$1,294,993
Stock-based compensation (note 6)	\$164,317	\$377,242	\$407,608	\$645,298
General and administrative	\$660,304	\$364,962	\$969,001	\$389,011
Net interest expense (income)	\$162,584	(\$66,622)	\$231,566	(\$59,803)
	<u>\$3,952,834</u>	<u>\$1,746,308</u>	<u>\$7,040,175</u>	<u>\$3,098,494</u>
<b>Earnings before taxes</b>	\$1,198,134	\$60,887	\$1,807,350	\$720,642
<b>Future income tax</b>	<u>\$313,218</u>	<u>\$33,432</u>	<u>\$520,740</u>	<u>\$256,432</u>
<b>Net income and comprehensive Income for the period</b>	\$884,916	\$27,455	\$1,286,610	\$464,210
<b>Deficit – Beginning of period</b>	<u>(\$773,750)</u>	<u>(\$381,139)</u>	<u>(\$1,175,444)</u>	<u>(\$817,894)</u>
<b>Retained Earnings (Deficit) – End of period</b>	<u>\$111,166</u>	<u>(\$353,684)</u>	<u>\$111,166</u>	<u>(\$353,684)</u>
<b>Basic and diluted net income per common share</b>	<u>\$0.02</u>	<u>\$0.00</u>	<u>\$0.04</u>	<u>\$0.01</u>

See accompanying notes to the financial statements

**PETRO-REEF RESOURCES LTD.**  
**Statement of Cash Flow**  
**For the three and six month periods ended June 30, 2008 and 2007**

<b>Cash provided by (used in)</b>	<b>3-months Ended June 30, 2008</b>	<b>3-months Ended June 30, 2007</b>	<b>6-months Ended June 30, 2008</b>	<b>6-months Ended June 30, 2007</b>
<b>Operating activities</b>				
Net income for the year	\$884,916	\$27,455	\$1,286,610	\$464,210
Items not effecting working capital				
Accretion expense	\$117	\$5,778	\$14,237	\$10,928
Depletion and depreciation	\$2,032,351	\$660,518	\$3,797,423	\$1,294,993
Stock-based compensation	\$164,317	\$377,242	\$407,608	\$645,298
Future income taxes	\$313,218	\$33,432	\$520,740	\$256,432
Cash flow from operations	<u>\$3,394,919</u>	<u>\$1,104,425</u>	<u>\$6,026,618</u>	<u>\$2,671,861</u>
Net change in non-cash operating working capital items	<u>(\$1,675,431)</u>	<u>(\$755,181)</u>	<u>(\$3,147,025)</u>	<u>(\$561,259)</u>
	<u>\$1,719,488</u>	<u>\$349,244</u>	<u>\$2,879,593</u>	<u>\$2,110,602</u>
<b>Financing activities</b>				
Bank line of credit	(\$292,699)	-	\$7,370,730	(\$375,000)
Proceeds from share issue	-	\$3,000,000	-	\$9,050,000
Share issue costs	-	(\$370,379)	-	(\$827,233)
Proceeds from exercise of stock options and warrants	\$320,900	\$145,000	\$326,100	\$2,096,034
	<u>\$28,201</u>	<u>\$2,774,621</u>	<u>\$7,696,830</u>	<u>\$9,943,801</u>
<b>Investing activities</b>				
Expenditures on property, plant and equipment	(\$1,811,045)	(\$2,190,597)	(\$14,921,369)	(\$4,618,352)
Net change in non-cash investing working capital items	\$63,756	\$396,674	(\$575,963)	\$655,291
	<u>(\$1,747,289)</u>	<u>(\$1,793,923)</u>	<u>(\$15,497,332)</u>	<u>(\$2,595,716)</u>
<b>Change in cash during the period</b>	<b>\$400</b>	<b>\$1,329,942</b>	<b>(\$4,920,909)</b>	<b>\$8,091,342</b>
<b>Cash and cash equivalents</b>				
- Beginning of period	<u>-</u>	<u>\$6,759,787</u>	<u>\$4,921,309</u>	<u>(\$1,613)</u>
<b>Cash and cash equivalents, End of period</b>	<u>\$400</u>	<u>\$8,089,729</u>	<u>\$400</u>	<u>\$8,089,729</u>

See accompanying notes to the financial statements

## **1. Accounting policies**

Petro-Reef Resources Ltd. (the "Corporation") is engaged in the exploration for and production of crude oil and natural gas in Canada. The financial statements of the Corporation have been prepared in accordance with accounting principles generally accepted in Canada.

Significant accounting policies are summarized as follows:

### **Oil and gas operations**

The Corporation follows the full cost method of accounting for crude oil and gas operations whereby all costs related to the acquisition of, exploration for and development of crude oil and natural gas reserves are capitalized. Such costs include leasehold acquisition costs, geological and geophysical costs, lease rentals, drilling, plant and equipment costs and related overhead. 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 depletion rate.

The Corporation 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 using forward pricing, the lower of cost and market of unproved properties and the cost of major development projects exceed 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 Corporation 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.

### **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 45%. Leasehold improvements are amortized over the useful life of 5 years using the straight-line method.

### **Asset retirement obligation**

The Corporation records a liability for the fair value of legal obligations associated with the retirement of long lived tangible assets in the period in which they are incurred, normally when the asset is purchased or developed. On recognition of the liability there is a corresponding increase in the carrying amount of the related asset known as the asset retirement cost, which is depleted on a unit-of-production basis over the life of the reserves. The liability is adjusted each reporting period to reflect the passage of time, with the accretion charged to earnings, and for revisions to the estimated future cash flows. Actual costs incurred upon settlement of the obligations are charged against the liability.

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### **Stock options**

The Corporation has an incentive stock option plan for employees, officers, directors and consultants as described in note 6. The Corporation records stock based compensation expense using the fair value method. The fair value of an option is calculated at the grant date, and expensed on a straight line basis over the vesting term of the option. The Corporation records the cumulative stock based compensation as a contributed surplus. When options are exercised, contributed surplus is reduced and share capital is increased by the amount of accumulated stock based compensation for the exercised option. Any consideration received on the exercise of stock options is credited to share capital.

### **Revenue recognition**

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

### **Income taxes**

The Corporation follows the liability method of accounting for income taxes. Under this method, the Corporation 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 substantively 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 as income in the period of the change.

### **Earnings per share**

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

### **Cash and Cash equivalents**

Cash and cash equivalents consist of all cash on hand and balances with banks, as well as all highly liquid short-term investments. The Corporation considers all highly liquid short-term investments with original terms to maturity of three months or less to be cash equivalents.

### **Flow Through Share Issuance**

The Corporation finances a portion of its exploration program through the issuance of flow-through shares. Under the terms of the flow-through share agreements, and as provided for under the Income Tax Act, the tax attributes of qualifying exploration costs incurred by the Corporation are renounced to subscribers. To recognize the foregone tax benefits to the Corporation, the amount for which the shares are issued is reduced by the tax effect of the tax benefits renounced to subscribers at the time the renunciation documents are filed with the tax authorities.

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### **Measurement uncertainty**

The preparation of consolidated financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions and to use judgment regarding assets, liabilities, revenues and expenses. Accordingly, actual results may differ from those estimated amounts.

Recorded amounts for depletion and depreciation, asset retirement obligations and amounts used for the ceiling test and impairment calculations are based on estimates of oil and natural gas reserves and future costs required to develop those reserves. By their nature, these estimates of reserves and the related future cash flows and costs are subject to measurement uncertainty, and the effect on the financial statements of future periods could be significant.

### **Share Purchase Warrants**

The Corporation estimated the fair value of share purchase warrants that were issued. Fair value is estimated using the Black-Scholes method. When exercised the fair value is added to share capital to represent the cost to the Corporation of issuing the warrants.

### **New Adopted Accounting Standards**

Effective January 1, 2008, the Corporation was required to adopt the CICA Handbook Section 1506 - Accounting Changes that provides expanded disclosures for changes in accounting policies, accounting estimates and corrections of errors. Under the new standard, accounting changes should be applied retroactively unless otherwise permitted or where the effect is impracticable to determine. As well, voluntary changes in accounting policy are made only when required by a primary source of GAAP or the change results in more relevant and reliable information. The adopted accounting standard did not have any effect on the Corporation.

As of January 1, 2008, the Corporation was required to adopt two new CICA standards, Section 3862 – Financial Instruments – Disclosures, and Section 3863 – Financial Instruments – Presentation, which will replace Section 3861 – Financial Instruments – Disclosure and Presentation. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. The new presentation standard carries forward the former presentation requirements.

As of January 1, 2008, the Corporation adopted CICA Handbook Section 1535 – Capital Disclosures, which requires entities to disclose objectives, policies and processes for managing capital, and in addition, whether the entity has complied with any externally imposed capital requirements.

## **2. Property, plant, and equipment**

	<b>June 30, 2008</b>		
	<b>Cost</b>	<b>Accumulated Depletion and Depreciation</b>	<b>Net</b>
Petroleum and Natural Gas	\$47,367,288	(\$15,664,404)	\$31,702,884
Furniture and Fixtures	\$111,768	(\$62,104)	\$49,664
<b>Total</b>	<b>\$47,479,056</b>	<b>(\$15,726,508)</b>	<b>\$31,752,548</b>

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	<b>December 31, 2007</b>		
	<b>Cost</b>	<b>Accumulated Depletion and Depreciation</b>	<b>Net</b>
Petroleum and Natural Gas	\$32,501,687	(\$11,866,980)	\$20,634,707
Furniture and Fixtures	\$103,325	(\$55,261)	\$48,064
<b>Total</b>	<b>\$32,605,012</b>	<b>(\$11,922,241)</b>	<b>\$20,682,771</b>

At June 30, 2008, unproven oil and gas properties with a cost of \$2,958,449 (2007 - \$1,345,465) have been excluded from the depletion and depreciation calculation. Future capital costs required to develop proved reserves in the amount of \$4,165,000 (2007 - \$2,708,000) are included in the depletion and depreciation calculation.

During the six month period ended June 30, 2008, the Corporation capitalized \$101,992 (2007 - \$140,818) with respect to overhead expenditures relating to the exploration and development of the Corporation's properties.

**3. Demand operating facilities**

Facility A is a revolving operating demand loan with a maximum limit of \$17,000,000. Facility B is a non-revolving acquisition/development demand loan that provides an additional \$4,000,000 of financing. Interest is at prime plus 0.375% per annum for Facility A and prime plus 0.5% per annum for the Facility B. Petro-Reef also has the ability to borrow by way of Bankers Acceptances. At June 30, 2008 the balance owing on both facilities was \$6,987,476 (2007 - \$0).

The facilities are secured by \$40,000,000 floating charge debenture over all the Corporation's assets with a negative pledge and undertaking to provide fixed charges on the Corporation's major producing properties at the request of the bank. The facilities are repayable on demand.

**4. Asset retirement obligation**

The total future asset retirement obligation was estimated based on the Corporation'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 Corporation has estimated the net present value of its asset retirement obligation to be \$705,307 (June 30, 2007 - \$435,151) as at June 30, 2008. A credit adjusted risk free rate of 5.74 percent (2007 - 5.36 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:

	<b>Period Ended June 30, 2008</b>	<b>Year Ended December 31, 2007</b>
Balance, beginning of period	\$539,840	\$391,648
Liabilities incurred in period	\$45,449	\$128,708
Liabilities incurred – revisions	\$105,781	
Liabilities settled in period	-	-
Accretion Expense	\$14,237	\$19,484
<b>Balance, end of period</b>	<b>\$705,307</b>	<b>\$539,840</b>

The estimated undiscounted amount of asset retirement obligation of \$1,115,669 (2007 - \$875,924)

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**5. Share capital**

**a) Class A common shares**

	Period Ended June 30, 2008		Year Ended December 31, 2007	
	Shares	Amount	Shares	Amount
Balance, beginning of period	33,714,781	\$17,946,983	23,685,291	\$7,559,760
Exercise of options (iii)	240,000	\$252,902	510,000	\$444,714
Exercise of warrants (iv)	150,000	\$225,152	2,758,620	\$2,495,758
Unit private placement (i)	-	-	5,260,870	\$5,209,568
Flow through shares (ii)	-	(\$765,000)	1,500,000	\$3,000,000
Share issue costs (net of tax effect) (i) (ii)	-	(\$154,733)	-	(\$762,817)
Balance, end of period	34,104,781	\$17,505,304	33,714,781	\$17,946,983

- (i) In the first quarter 2007, the Corporation issued 5,260,870 units priced at \$1.15 per unit. Each unit consisted of one Common Share and one-half of one common share Purchase Warrant. Each whole common share Purchase Warrant entitles the holder to purchase one additional Common Share at an exercise price of \$1.75 per Common Share until July 25, 2008. The warrants have been ascribed a fair value of \$0.32 using the Black-Scholes pricing model assuming a risk-free interest rate of 4.01%; weighted average life of 1.5 years; dividend yield of nil; and expected volatility rate of 70%. Primary Capital Inc., the agent, was paid a cash commission of \$423,500, and was granted non transferable Broker Warrants to acquire 368,260 Common Shares at an exercise price of \$1.15 until July 25, 2008 and to acquire one half of one common share Purchase Warrant. Each whole common share Purchase Warrant entitles the holder to purchase one additional Common Share at an exercise price of \$1.75 per Common Share until July 25, 2008. These Broker Warrants have been recorded as share issue costs estimated at \$129,264 using the Black-Scholes pricing model assuming a risk-free interest rate of 4.01%; weighted average life of 1.5 years; dividend yield of nil; and expected volatility rate of 70%. Legal and other costs incurred, related to this private placement, were \$116,779.
- (ii) In the second quarter 2007, the Corporation issued 1,500,000 flow - through shares priced at \$2.00. Primary Capital Inc. was paid a cash commission of \$225,000, and was granted non transferable Broker Warrants to acquire 97,500 Common Shares at an exercise price of \$2.00 until July 25, 2008. These Broker Warrants have been recorded as share issue costs estimated at \$36,198 using the Black-Scholes pricing model assuming a risk-free interest rate of 4.047%; weighted average life of 1.25 years; dividend yield of nil; and expected volatility rate of 58%. Legal and other costs incurred, related to the issuance of these flow - through shares, were \$61,935. As part of the flow – through share offering, Petro-Reef has renounced to investors and must incur \$3,000,000 in eligible exploration expenditures on or before December 31, 2008. Petro-Reef met its obligations as of December 31, 2007. The actual renunciation was filed with the government in early Q1 – 2008 and, as a result, a tax adjustment to share capital has been accounted for during this period.
- (iii) During the six month period ended June 30, 2008, 240,000 stock options were exercised at an average exercise price of \$0.64.
- (iv) The increase in share capital in 2007 was a result of the exercise of warrants is comprised of the amount of cash received of \$1,931,038 and the reclassification to share capital of the ascribed value related to the warrants exercised of \$564,720. These warrants were issued by the Corporation under financings that closed in August and September of 2005. During the second quarter of 2008, 150,000 broker warrants were exercised at a price of \$1.15 per warrant.

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**b) Warrants**

	<b>Period Ended June 30, 2008</b>		
	<b>Exercise Price</b>	<b>Number</b>	<b>Amount</b>
Balance, beginning of period	\$1.75	2,630,435	\$840,429
Granted by way of exercise of Broker Warrants	\$1.75	150,000	\$10,148
Exercise of warrants	-	-	-
Balance, end of period	\$1.75	2,780,435	\$850,577

	<b>Year Ended December 31, 2007</b>		
	<b>Exercise Price</b>	<b>Number</b>	<b>Amount</b>
Balance, beginning of period	\$0.70	2,933,620	\$606,719
Exercise of warrants	\$0.70	(2,758,620)	(\$564,719)
Expiry of warrants	\$0.70	(175,000)	(\$42,000)
Unit private placement ((note 5(1)(i)))	\$1.75	2,630,435	\$840,429
Balance, end of period	\$1.75	2,630,435	\$840,429

**c) Broker warrants**

	<b>Period Ended June 30, 2008</b>		
	<b>Exercise Price</b>	<b>Number</b>	<b>Amount</b>
Balance, beginning of period	\$1.33	465,760	\$212,685
Exercise of Warrants	\$1.15	(150,000)	(\$52,562)
Balance, end of period	\$1.41	315,760	\$160,123

	<b>Year Ended December 31, 2007</b>		
	<b>Exercise Price</b>	<b>Number</b>	<b>Amount</b>
Balance, beginning of period	-	-	-
Unit private placement (note 5(a)(i))	1.15	368,260	129,264
Flow through shares (note 5(a)(ii))	2.00	97,500	83,421
Balance, end of period	\$1.33	465,760	\$212,685

**d) Contributed surplus**

	<b>Period Ended June 30, 2008</b>	<b>Year Ended December 31, 2007</b>
	Balance, beginning of period	\$1,659,194
Stock-based compensation recognized in the period	\$407,608	\$1,236,299
Adjustments for stock options exercised in the period	(\$99,402)	(\$189,714)
Expiry of warrants	-	\$42,000
Balance, end of period	\$1,967,400	\$1,659,194

**e) Per share amounts**

Earnings per common share are calculated using the weighted average number of common shares outstanding during the period. A reconciliation of the denominators used in the per share calculation is outlined below:

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	<b>3-Month Period Ended June 30, 2008</b>	<b>3-Month Period Ended June 30, 2007</b>
Basic weighted average common shares	33,854,671	32,852,034
Effect of diluted options and warrants	469,701	1,146,405
Diluted weighted average common shares	<u>34,324,372</u>	<u>33,998,439</u>

  

	<b>6-Month Period Ended June 30, 2008</b>	<b>6-Month Period Ended June 30, 2007</b>
Basic weighted average common shares	33,786,649	27,325,192
Effect of diluted options and warrants	203,217	6,408,464
Diluted weighted average common shares	<u>33,989,866</u>	<u>33,733,657</u>

**6. Stock based compensation**

The Corporation has a stock option plan for directors, officers and key employees. The exercise price of each option equals the market price of the Corporation's stock on the date of grant. Options vest after one year and expire after a maximum period of five years from the date of issue.

A summary of the status of the Corporation's stock option plan as of June 30, 2008 and December 31, 2007 and changes during the period are presented below:

	<b>Period Ended June 30, 2008</b>		<b>Year Ended December 31, 2007</b>	
	<b>Weighted Number of Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Number of Options</b>	<b>Weighted Average Exercise Price</b>
Balance beginning of Period	3,050,000	\$1.18	1,980,000	\$0.89
Granted	390,000	\$1.43	1,580,000	\$1.48
Exercised	(240,000)	\$0.64	(510,000)	\$0.50
Expired	(30,000)	\$1.58	-	-
Balance end of period	<u>3,170,000</u>	<u>\$1.16</u>	<u>3,050,000</u>	<u>\$1.18</u>
Exercisable end of period	<u>2,455,000</u>	<u>\$1.32</u>	<u>1,470,000</u>	<u>\$1.02</u>

Compensation costs of \$164,317 (2007 - \$268,056) has been recognized for stock options granted during the period. Assumptions used in the calculation of the Corporation's stock based compensation costs include a risk free rate of 3.05% - 3.49%, volatility of approximately 75% and an expected life of 3 years.

**7. Related party transactions**

All related party transactions are in the normal course of operations and have been measured at the agreed to exchange amounts, which is the amount of consideration established and agreed to by the related parties. During the period ended June 30, 2008, the Corporation purchased engineering services in the amount of \$721,659 (2007 - \$794,775) from a Corporation controlled by a Director of the Corporation. The Corporation also purchased professional services in the amount of \$60,079 (2007 - \$179,552) from a law firm which a Director of the Corporation is a partner of. At June 30, 2008, Petro-Reef had a payable of \$111,898 owed to both parties included in the Corporation's accounts payable.

## **8. Commitments**

The present office lease agreement expires on September 30, 2011. Future lease payments to the end of the lease term under the Corporation's office lease are as follows:

2008	\$40,461
2009	\$84,258
2010	\$86,762
2011	\$65,070

## **9. Financial instruments**

The Corporation holds various forms of financial instruments which by nature expose the Corporation to market risk, credit risk and liquidity risks. The Corporation manages these risks by operating in a manner that minimizes these risks. Management monitors and administers these risks while the Board of Directors has overall responsibility for overseeing the Corporation's risk management process.

### Fair value

The Corporation is exposed to financial risk in a range of financial instruments including cash and cash equivalents, accounts receivable, accounts payable, bank overdraft, deposits and bank line of credit. The Corporation manages its exposure to financial risks by operating in a manner that minimizes its exposure to the extent practical.

The main financial risks affecting the Corporation are discussed below:

### Credit Risk

Credit risk arises when a failure by counter parties to discharge their obligations could reduce the amount of future cash inflows from financial assets on hand at the balance sheet date. The Corporation's accounts receivable at the balance sheet date arise from crude oil, natural gas liquids and natural gas sales.

Industry standard dictates that commodity sales are settled on the 25th day of the month following the month of production. The Corporation markets its oil and natural gas to several marketers so that the exposure to any one entity is minimized. In addition, when joint operations are conducted on behalf of a joint venture partner relating to capital expenditures, costs of such operations are paid for in advance to the Corporation by way of a cash call by the partner of the operation being conducted.

Joint venture receivables are generated from conducting joint operating or capital operations with joint venture partners. Collections from these operations are usually paid within three months of the joint venture bill being issued to the partner. Circumstances can arise which extend the terms of collection beyond this period as specific items on these joint venture billings need to be resolved between partners. Smaller partners may be cash called to pay for their share of costs in advance of a project. The Corporation has the ability to take measures such as withholding production volumes as recourse for collections on receivables as well. The Corporation monitors receivables accounts and actively pursues collection and payment. If any accounts are considered impaired they will be charged to an allowance for doubtful accounts. At June 30, 2008 no allowance for doubtful accounts was recorded.

The Corporation assesses quarterly if there should be any impairment of the financial assets of the Corporation. During the three and six month periods ended June 30, 2008 there was no impairment required on any of the financial assets of the Corporation due to historical success of collecting receivables. The Corporation does not have any significant credit risk exposure with respect to accounts receivable to any single counterparty or any group of counterparties having similar

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characteristics. The credit risk on cash and cash equivalents is considered by management to be limited because the counterparties are financial institutions with high credit ratings assigned by international credit rating agencies. The carrying value of accounts receivable approximates its fair value due to the relatively short periods to maturity on this instrument. The maximum exposure to credit risk is represented by the carrying amount on the balance sheet. There are no material financial assets that the Corporation considers past due and at risk of collection.

<b><u>Financial Assets</u></b>	<b><u>Carrying Value</u></b>	<b><u>Fair Value</u></b>
Prepaid Expenses	\$324,065	\$324,065
Accounts Receivable	\$2,605,207	\$2,605,207

  

<b><u>Financial Liabilities</u></b>		
Accounts Payable	\$4,248,663	\$4,248,663
Credit Facility	\$7,370,730	\$7,370,730

**Liquidity Risk**

Liquidity risk includes the risk that, as a result of the Corporation's operational liquidity requirements:

- The Corporation will not have sufficient funds to settle a transaction on the due date; or
- The Corporation will be forced to sell financial assets at a value which is less than what they are worth.

The Corporation's operating cash requirements, including amounts projected to complete the Corporation's existing capital expenditure program, are continuously monitored and adjusted as input variables change. These variables include but are not limited to, available credit, oil and natural gas production from existing wells, results from new wells drilled, commodity prices, cost overruns on capital projects and regulations relating to prices, taxes, royalties, land tenure, allowable production and availability of markets. As these variables change, liquidity risks may necessitate the Corporation to conduct equity issues or obtain project debt financing. The Corporation also mitigates liquidity risk by maintaining an insurance program to minimize exposure to insurable losses.

**Interest rate risk**

The Corporation is exposed to interest rate cash flow risk to the extent that its bank loans are at a floating rates of interest. The related disclosure regarding these debt instruments is included in note 3 of these financial statements.

**Market risk**

Market risk is the risk that changes in market prices, such as foreign exchange rates, commodity prices, and interest rates will affect the Corporation's net earnings. These risks are generally outside the control of the Corporation. The objective of market risk management is to minimize market risk exposures within acceptable limits, while maximizing returns. The Corporation may utilize commodity contracts to manage market risk and all such contracts are approved by the Board of Directors.

**Foreign currency exchange rate risk**

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange risks. Although substantially all of the Company's petroleum and natural gas sales are denominated in Canadian dollars, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar.

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Commodity price risk

Commodity price risk is the risk that the fair value of future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by not only the relationship between the Canadian and United States dollar, as outlined above, but also world economic events that dictate the levels of supply and demand. The Corporation may utilize commodity price contracts to manage commodity price risk and all such contracts are approved by the Board of Directors.

**10. Capital Management**

The Corporation's objectives when managing capital is to safeguard its ability to continue as a going concern, so that it can continue to provide returns to shareholders and benefits for other stakeholders. The Corporation manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. The Corporation's objective is met by retaining adequate equity to provide for the possibility that cash flows from assets will not be sufficient to meet future cash flow requirements. The Board of Directors does not establish quantitative return on capital criteria for management. The Corporation defines capital as the aggregate of total equity, cash and debt. The Corporation is not subject to any externally imposed cash flow requirements other than covenants on its operating credit facility with its lender. At June 30, 2008 the Corporation was in compliance with its financial covenants.