

AUDITORS' REPORT

To the Shareholders of Questerre Energy Corporation

We have audited the consolidated balance sheets of Questerre Energy Corporation as at December 31, 2007 and 2006 and the consolidated statements of operations, comprehensive income and deficit and cash flows for each of the years in the two year period ended December 31, 2007. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2007 and 2006 and the results of its operations and its cash flows for each of the years in the two year period ended December 31, 2007 in accordance with Canadian generally accepted accounting principles.



Chartered Accountants

Calgary, Alberta, Canada

March 28, 2008

CONSOLIDATED BALANCE SHEETS

| | December 31 2007 | December 31 2006 |
|--|----------------------|---------------------|
| Assets | | |
| Current assets | | |
| Cash | \$ 13,091,476 | \$ 26,616,233 |
| Short term investments | 807,800 | – |
| Marketable securities (note 6) | 1,979,250 | 146,250 |
| Accounts receivable | 8,028,997 | 3,589,316 |
| Inventory | 204,462 | 321,437 |
| Prepays and deposits | 2,764,647 | 421,308 |
| | 26,876,632 | 31,094,544 |
| Restricted cash (note 7) | – | 100,000 |
| Goodwill (note 4) | 2,467,816 | 2,467,816 |
| Future income tax | 1,124,731 | – |
| Petroleum and natural gas properties (note 5) | 119,657,700 | 80,882,499 |
| Less: accumulated depletion and depreciation | (57,052,112) | (43,505,419) |
| | 62,605,588 | 37,377,080 |
| | \$ 93,074,767 | \$ 71,039,440 |
| Liabilities | | |
| Current liabilities | | |
| Accounts payable and accrued liabilities | \$ 16,868,786 | \$ 8,341,968 |
| Bank loan (note 7) | – | 73,700 |
| Current income taxes | – | 82,455 |
| | 16,868,786 | 8,498,123 |
| Asset retirement obligation (note 8) | 4,578,140 | 3,377,847 |
| | \$ 21,446,926 | \$ 11,875,970 |
| Shareholders' Equity | | |
| Common shares (note 9) | \$ 97,341,561 | \$ 85,809,663 |
| Contributed surplus (note 9 (f)) | 3,505,088 | 2,068,902 |
| Deficit and accumulated other comprehensive income | (29,218,808) | (28,715,095) |
| | 71,627,841 | 59,163,470 |
| | \$ 93,074,767 | \$ 71,039,440 |

Contractual Obligations and Commitments (note 13)

See accompanying notes to consolidated financial statements.

Approved by the Board of Directors




CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE INCOME AND DEFICIT

| For the years ended December 31, | 2007 | 2006 |
|---|------------------------|------------------------|
| Revenue | | |
| Petroleum and natural gas revenue | \$ 23,785,489 | \$ 12,030,736 |
| Royalties | (5,609,308) | (2,817,253) |
| | \$ 18,176,181 | \$ 9,213,483 |
| Expenses | | |
| Operating | \$ 6,126,998 | \$ 2,799,396 |
| General and administrative | 2,757,220 | 1,602,067 |
| Stock-based compensation (note 9 (e)) | 1,465,498 | 1,349,989 |
| Interest expense | 67,641 | 23,030 |
| Interest income | (1,063,886) | (356,716) |
| Foreign exchange (gain) loss | – | (66,597) |
| Realized (Gain) loss on sale of marketable securities | (903,721) | 22,806 |
| Unrealized loss on marketable securities | 785,441 | – |
| Depletion and depreciation | 13,546,694 | 7,761,047 |
| Accretion on asset retirement obligation (note 8) | 142,557 | 88,929 |
| | \$ 22,924,442 | \$ 13,223,951 |
| Net loss before the following | \$ (4,748,261) | \$ (4,010,468) |
| Gain on sale of petroleum and natural gas properties (note 5) | 1,501,044 | – |
| Net loss before income taxes | \$ (3,247,217) | \$ (4,010,468) |
| Income taxes | | |
| Current | 59,188 | 85,024 |
| Future tax recovery | (2,024,731) | (3,218,657) |
| | \$ (1,965,543) | \$ (3,133,633) |
| Net loss and comprehensive income | \$ (1,281,674) | \$ (876,835) |
| Deficit, beginning of year | \$ (28,715,095) | \$ (27,838,260) |
| Opening deficit adjustment for changes in accounting policies | | |
| Financial Instruments | 777,961 | – |
| Deficit and accumulated other comprehensive income end of year | \$ (29,218,808) | \$ (28,715,095) |
| Net loss per share | | |
| Basic and diluted (note 9(c)) | \$ 0.01 | \$ 0.01 |

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

| For the years ended December 31, | 2007 | 2006 |
|--|------------------------|------------------------|
| Cash provided by (used in): | | |
| Operating Activities | | |
| Net loss | \$ (1,281,674) | \$ (876,835) |
| Items not affecting cash | | |
| Depletion and depreciation | 13,546,694 | 7,761,047 |
| Accretion on asset retirement obligation | 142,557 | 88,929 |
| Realized (Gain) loss on marketable securities | (903,721) | 22,806 |
| Unrealized loss on marketable securities | 785,441 | – |
| Stock-based compensation expense | 1,465,498 | 1,349,989 |
| (Gain) on sale of petroleum and natural gas properties | (1,501,044) | – |
| Future tax recovery | (2,024,731) | (3,218,657) |
| Abandonment expenditures | – | (50,860) |
| | 10,229,020 | 5,076,419 |
| Net change in non-cash working capital | (7,953,721) | 1,991,338 |
| | \$ 2,275,299 | \$ 7,067,757 |
| Financing Activities | | |
| Issue of common shares | \$ 3,040,858 | \$ 35,957,852 |
| Share issue costs | (101,308) | (2,253,499) |
| Repayment of bank loan | (73,700) | (80,400) |
| | \$ 2,865,850 | \$ 33,623,953 |
| Investing Activities | | |
| Expenditures on petroleum and natural gas properties | \$ (25,161,524) | \$ (23,046,854) |
| Acquisition of Stride (note 4) | – | (6,282,000) |
| Cash acquired on acquisition of Stride (note 4) | – | 3,712,541 |
| Acquisition of Magnus (note 3) | (300,937) | – |
| Cash acquired on acquisition of Magnus (note 3) | 551,294 | – |
| Purchase of short term investment | (807,800) | – |
| Sale of petroleum and natural gas properties (note 5) | 10,000,000 | – |
| Sale of marketable securities | 1,049,971 | 330,255 |
| Purchase of marketable securities | (1,986,730) | – |
| Release of restricted cash | 100,000 | – |
| | (16,555,726) | (25,286,058) |
| Net change in non-cash working capital | (2,110,180) | 1,914,421 |
| | \$ (18,665,906) | \$ (23,371,637) |
| Increase (decrease) in cash | \$ (13,524,757) | \$ 17,320,073 |
| Cash, beginning of year | 26,616,233 | 9,296,160 |
| Cash, end of year | \$ 13,091,476 | \$ 26,616,233 |

See accompanying notes to consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the Years ended December 31, 2007 and 2006

1. Nature of Operations and Basis of Presentation

Questerre Energy Corporation ("Questerre" or the "Company") is a full cycle exploration and production company. The Company targets scalable high-impact projects. The Company is also developing a portfolio of conventional exploration and production assets primarily in Alberta and Saskatchewan.

2. Significant Accounting Policies

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Accordingly, actual results could differ from estimated amounts.

a) Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Questerre Beaver River Inc. ("QBR"), 6058931 Canada Inc. and Magnus Energy Inc. ("Magnus").

b) Cash

Cash consists of cash in the bank, less outstanding cheques and short-term deposits with a maturity of less than three months.

c) Marketable securities

Marketable securities are carried at fair value and unrecognized gains or losses are recognized in earnings in the period incurred.

d) Measurement uncertainty

Depletion and depreciation, amounts used for ceiling test calculations, stock based compensation, future tax and asset retirement obligations are estimates. The ceiling test is based on estimates of oil and natural gas reserves and commodity prices, production expenses and capital costs required to develop and produce those reserves. By their nature, these estimates are subject to measurement uncertainty, and the impact of differences between actual and estimated amounts on the consolidated financial statements of future periods could be material.

e) Inventory

Inventory is recorded at the lower of weighted average cost and market, measured by replacement cost.

f) Revenue recognition

Revenue from the sale of petroleum and natural gas are recorded when the title passes to a third party.

g) Petroleum and natural gas properties

The Company follows the full cost method of accounting whereby all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized. Such costs include lease acquisition costs, geological and geophysical expenses, carrying charges of non-producing property, costs of drilling both productive and non-productive wells, petroleum and natural gas production equipment and overhead charges related to exploration and development activities. Proceeds received from the disposition of petroleum and gas properties and equipment are credited against the capitalized costs unless the disposition would significantly alter the rate of depletion and depreciation, in which case a gain or loss on disposal would be recorded.

All costs of acquisition, exploration and development of petroleum and natural gas reserves, associated tangible plant and equipment costs, and estimated costs of future development of proven undeveloped reserves are depleted and depreciated using the unit of production method based on estimated proven reserves before royalties as determined by independent reservoir engineers. For purposes of this calculation, reserves and production are converted to equivalent units of oil based on relative energy content.

Depreciation of capital assets not related to petroleum and natural gas properties is provided using the straight line method over periods ranging from five to ten years.

Costs of unproved properties are initially excluded from petroleum and natural gas properties for the purpose of calculating depletion. These properties are assessed periodically to determine whether impairment has occurred. When proven reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion.

The Company reviews the carrying amount of its petroleum and natural gas properties ("the properties") relative to their recoverable amount ("the ceiling test") at each annual balance sheet date, or earlier if circumstances or events indicate impairment may have occurred. The recoverable amount is calculated as the undiscounted cash flow from the properties using proved reserves and expected future prices and costs. If the carrying amount of the properties exceeds their recoverable amount, then an impairment loss, equal to the amount by which the carrying amount of the properties exceeds the discounted cash flow from those properties using proved and probable reserves and expected future prices and costs, is recognized in depletion.

h) Asset retirement obligation

The fair value of asset retirement obligations related to long-term assets is recognized as a liability in the period in which they are incurred. The fair value of the asset retirement obligation is estimated by discounting the expected future cash flows to settle the asset retirement obligation at the Company's credit adjusted risk free rate. Asset retirement costs equal to the discounted asset retirement obligation are capitalized as part of the cost of the associated capital asset and amortized to expense through depletion over the life of the asset. In subsequent periods, the asset retirement obligation is adjusted for the passage of time and for any changes in the amount or timing of the underlying future cash flows.

i) Joint operations

Significant portions of the Company's exploration and production activities are conducted jointly with others and accordingly, the financial statements reflect only the Company's proportionate interest in such activities.

j) Foreign currency translation

Monetary assets and liabilities, denominated in foreign currencies, are translated into Canadian dollars at rates of exchange in effect at the balance sheet date. Other assets and revenue and expense items are translated at rates prevailing when they were acquired or incurred. Foreign exchange gains and losses are included in the statement of operations.

k) Flow-through shares

The resource expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with tax legislation. Future tax liabilities and share capital are adjusted by the estimated cost of the renounced tax deductions at the date of renouncement.

l) Stock -based compensation plan

The company has a stock option plan for directors and employees. The stock option plan is described in note 9(d). The compensation cost attributable to share options granted is measured at fair value at the grant date and expensed over the vesting period with a corresponding increase in contributed surplus.

m) Per share information

Basic per share amounts are calculated using the weighted average number of shares outstanding during the year. Diluted per share amounts are calculated based on the treasury-stock method, which assumes that any proceeds obtained on exercise of options would be used to purchase common shares at the average market price during the period. The weighted average number of shares outstanding is then adjusted by the net change.

n) Goodwill

Goodwill is the excess purchase price over the fair value of identifiable assets and liabilities acquired. Goodwill is not amortized. However, goodwill impairment will be assessed annually, or as economic events dictate, by comparing the fair value of the net assets to its carrying value, including goodwill. If the fair value of the net assets is less than its carrying value, the fair value of the goodwill is compared with its carrying value to measure the amount of goodwill impairment loss.

o) Income taxes

The Company follows the liability method of accounting for income taxes. Under this method the Company records future income tax assets and liabilities based on "temporary differences" (differences between the accounting basis and the tax basis of the assets and liabilities) measured using the substantively enacted tax rates and laws expected to apply when these differences reverse. The effect of a change in substantively enacted income tax rates on future income tax assets and liabilities is recognized in income in the period that the change occurs.

p) Financial instruments

Effective January 1, 2007, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") section 3855, "Financial Instruments – Recognition and Measurement," section 3865, "Hedges," section 1530, "Comprehensive Income". These standards have been adopted retroactively without restatement.

i) Financial Instruments

Section 3855 establishes a framework for classifying and measuring financial instruments. Under this section all financial instruments must be initially recognized at their fair value on the balance sheet. In accordance with section 3855, the Company has classified each financial instrument into the five categories set out in the standard: financial assets and liabilities held for trading, financial assets held to maturity, loans and receivables, financial assets available for sale and other liabilities. Measurement of each of these items is contingent upon initial classification. Unrealized gains and losses on financial instruments classified as held for trading are recognized in earnings in the period incurred. Gains and losses on assets available for sale are recognized in other comprehensive income, and are charged to earnings when the asset is derecognized or impaired. The amortized cost using the effective interest rate method is applied to the remaining categories of financial instruments.

As a result of adopting this change in accounting policy, the consolidated financial statements at January 1, 2007 were changed as follows: Marketable securities increased by \$777,961, and the deficit decreased by the same amount. The Company's marketable securities are classified as held for trading. Any changes in the fair value of the marketable securities at the end of the fiscal period are classified as unrealized gains or losses on the income statement.

The classification of financial instruments occurred upon adoption of the standard, and is irrevocable.

ii) Derivative instruments and hedging

The Company currently does not use derivative instruments to manage its exposure to the volatility in commodity prices.

iii) Embedded derivatives

An embedded derivative is a component of a financial instrument or other contract that has a feature similar to a derivative. New accounting section 3855 requires certain embedded derivatives be identified and recorded separately from the host contract if the economic characteristics and risks of the embedded derivative are not closely related to that of the host contract. The terms of the embedded derivatives are the same as the terms of a freestanding derivative, and the hybrid instrument is not re-measured at fair value.

iv) Comprehensive income

Comprehensive income is the change in equity of the Company from net earnings and other comprehensive income ("OCI"). OCI consists of the change in the fair value of any financial instruments classified as available for sale. Amounts recognized in OCI must eventually be reclassified to income when the related gains or losses are realized.

q) Accounting Changes

Effective January 1, 2007, the Company adopted the revised CICA section 1506, "Accounting Changes." Under the revised section, voluntary changes in accounting policy are permitted only if they result in financial statements that provide more reliable and relevant information to the reader. Changes in accounting policy must be applied retroactively, while changes in accounting estimates are to be applied prospectively. The revised section also outlines additional disclosure required when accounting changes are applied, including the justification for the change, a complete description of the policy, the primary source of GAAP and the detailed effect on financial statement line items.

r) Recent accounting pronouncements issued and not yet adopted

The following accounting standards will apply to fiscal periods commencing on or after October 1, 2007:

i) Section 3031, "Inventories"

This section provides revised guidance on measurement and disclosures for inventories. The Company does not expect this standard to have any impact upon adoption, as its current inventory policies continue to be permitted under the revised standard. The Company will adopt this new standard effective January 1, 2008.

ii) Section 1535, "Capital Disclosures"

This section establishes standards for disclosing information about an entity's objectives, policies and processes for how it manages its capital. A company must also disclose qualitative data about what the entity regards as capital; and whether the company has complied with any capital requirements and if not, the consequences of such non-compliance. The Company will adopt this new standard effective January 1, 2008.

iii) Section 3862, "Financial Instruments – Disclosures"

This section describes the required disclosures to evaluate the significance of financial instruments for the entity's financial position and performance as well as the nature and extent of risks arising from both recognized and unrecognized financial instruments to which the entity is exposed and how the entity manages those risks. The Company will adopt this new standard effective January 1, 2008.

iv) Section 3863, "Financial Instruments – Presentation"

This section establishes standards for presentation of financial instruments and non-financial derivatives. It details the presentation of the standards described in Section 3861, "Financial Instruments – Disclosure and Presentation". The Company will adopt this new standard effective January 1, 2008.

v) The CICA plans to converge Canadian GAAP with International Financial Reporting Standards ("IFRS") over a transition period ending in 2011. The impact of the transition to IFRS on the Company's financial statements is not yet determinable.

3. Acquisition of Magnus Energy Inc.

Effective November 1, 2007, Questerre acquired all the outstanding common shares of Magnus, a public exploration and production company in consideration of the issuance of 7,840,804 Questerre common shares.

The purchase price was allocated based on the fair value of the assets and liabilities as follows:

| | |
|--------------------------------------|--------------------|
| Consideration Paid: | |
| Common shares | \$ 7,386,037 |
| Transaction costs | 300,937 |
| | <hr/> 7,686,974 |
| Allocation of Purchase Price: | |
| Current assets | 11,386,250 |
| Current liabilities | (24,219,199) |
| | <hr/> (13,367,923) |
| Petroleum and natural gas properties | 21,566,975 |
| Asset retirement obligations | (512,078) |
| | <hr/> \$ 7,686,974 |

4. Acquisition of Stride Energy Inc.

Effective April 24, 2006, Questerre acquired all of the outstanding common shares of Stride Energy Ltd. ("Stride"), a private exploration and development company. Total consideration of \$12,310,076 was paid through the issuance of 7,262,742 Questerre common shares and a cash payment of \$6,282,000.

The purchase price was allocated based on the fair value of the assets and liabilities as follows:

| | |
|--------------------------------------|---------------------|
| Consideration Paid: | |
| Cash | \$ 6,282,000 |
| Common shares | 6,028,076 |
| | <hr/> 12,310,076 |
| Allocation of Purchase Price: | |
| Current assets | 4,837,086 |
| Current liabilities | (1,378,564) |
| | <hr/> 3,458,522 |
| Petroleum and natural gas properties | 6,743,152 |
| Goodwill | 2,467,816 |
| Asset retirement obligations | (359,414) |
| | <hr/> \$ 12,310,076 |

5. Petroleum and Natural Gas Properties

| | December 31 2007 | December 31 2006 |
|--|-----------------------------|---------------------|
| Petroleum and natural gas properties | \$ 119,657,700 | \$ 80,882,499 |
| Accumulated depletion and depreciation | (57,052,112) | (43,505,419) |
| | \$ 62,605,588 | \$ 37,377,080 |

During the year ended December 31, 2007, the Company capitalized administrative overhead charges of \$1,474,269 (2006 – \$1,117,037) relating to exploration and development activities.

During the year ended December 31, 2007, petroleum and natural gas properties included \$11,895,668 (2006: \$9,457,946), net of any dispositions, relating to seismic expenditures and unproved properties which have been excluded from the depletion calculation. Included in the depletion calculation are future development costs of \$2.7 million.

In April 2007, Questerre received a payment of \$10 million in settlement of earn-in obligations from a partner. The amount was treated as a disposition of interest in petroleum and natural gas properties. Based on a cost of \$8,498,956, Questerre realized a gain of \$1,501,044 on this disposition.

The Company has performed an impairment test as of December 31, 2007, using the estimated average sales price for each of the next five years as follows:

| Year | 2008 | 2009 | 2010 | 2011 | 2012 |
|---------------|-------------|-------------|-------------|-------------|-------------|
| Gas (C\$/GJ) | 6.45 | 7.00 | 7.00 | 7.00 | 7.10 |
| Oil (C\$/bbl) | 89.00 | 85.70 | 82.20 | 78.50 | 77.40 |

The benchmark gas price is projected to increase by an average of 2% after 2012. The benchmark oil price is projected to increase by an average of 3% after 2012.

6. Marketable Securities

As at December 31, 2007, the Company held marketable securities with a market value of \$1,979,250 (2006: \$511,875). For the year ended December 31, 2007, the Company realized a gain of \$903,721 (2006: (\$22,806)) on the disposition of marketable securities and an unrealized loss of \$785,441.

7. Bank Loan

In July 2002, the Company obtained a five-year, \$400,000 term loan with a Canadian bank. Under the terms of the loan, the Company was required to make monthly payments of \$6,700 in principal plus interest until the loan was paid out. The interest rate under the loan was the bank's floating base rate plus 2.0% and the Company had the right to fix the rate at any time. The loan was secured by the first assignment to the bank of a \$100,000 Guaranteed Investment Certificate ("GIC") and by a General Security Agreement over the assets of the Company and QBR. Financial covenants included maintaining a minimum long term debt to tangible equity ratio of 0.8 to 1.0 and maintaining a working capital ratio of at least 1.0 to 1.0.

In January 2007, the term loan was paid out.

As at December 31, 2007, Questerre had no drawdowns against its credit facility for \$7.5 million with a major Canadian bank. The facility is secured by a general security agreement and a fixed and floating charge on the assets of the Company.

8. Asset Retirement Obligation

The total future asset retirement obligation was estimated by management based on Questerre's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods. The Company estimates its total undiscounted asset retirement obligations to be \$5,877,776 at December 31, 2007. Questerre used a credit adjusted risk free rate of seven per cent and an inflation rate of three per cent over the varying lives of the assets to calculate the present value of the asset retirement obligation.

The following table provides a reconciliation of the Company's total asset retirement obligation:

| | December 31 2007 | December 31 2006 |
|--|-----------------------------|---------------------|
| Balance, beginning of period | \$ 3,377,847 | \$ 2,271,192 |
| Liabilities assumed on corporate acquisition | 512,078 | 359,414 |
| Increase due to drilling activity | 545,658 | 709,172 |
| Accretion expense | 142,557 | 88,929 |
| Liabilities settled during the period | – | (50,860) |
| Balance, end of period | \$ 4,578,140 | \$ 3,377,847 |

9. Share Capital

a) Authorized

The Company is authorized to issue an unlimited number of Class A common voting shares. The Company is also authorized to issue an unlimited number of Class B common voting shares and an unlimited number of preferred shares, issuable in one or more series. At December 31, 2007, there were no Class B common voting shares or preferred shares outstanding.

b) Issued and outstanding – Class A common shares

| | Number | Amount |
|--|--------------------|----------------------|
| Common Shares | | |
| Balance, December 31, 2005 | 113,014,594 | \$ 49,268,507 |
| Issued for cash | 34,709,000 | 35,910,270 |
| Issued for cash on exercise of options | 185,414 | 47,582 |
| Issued on acquisition of Stride Energy Ltd. (note 4) | 7,262,742 | 6,028,076 |
| Tax effect of flow-through share issuance | | (3,212,000) |
| Stock-based compensation | | 20,727 |
| Share issue costs | | (2,253,499) |
| Balance, December 31, 2006 | 155,171,750 | \$ 85,809,663 |
| Issued for cash | 3,500,000 | 3,000,000 |
| Issued in settlement of Magnus debt | 2,250,000 | 2,077,000 |
| Issued for cash on exercise of options | 167,916 | 40,857 |
| Issued on acquisition of Magnus Energy Inc. (Note 3) | 7,840,804 | 7,386,037 |
| Tax effect of flow-through share issuance | | (900,000) |
| Stock-based compensation | | 29,312 |
| Share issue costs | | (101,308) |
| Balance, December 31, 2007 | 168,930,470 | \$ 97,341,561 |

Common Shares

In November 2007, the Company issued 2,250,000 common shares in settlement of \$2.077 million of debt owed by Magnus.

In December 2007, the Company completed a private placement of 2,500,000 common shares, issued on a flow-through basis at \$0.80 per common share for gross proceeds of \$2.0 million. During this month the Company also completed another common share private placement of 1,000,000 common shares issued on a flow-through basis at \$1.00 per common share for gross proceeds of \$1.0 million.

c) Per share amounts

The following table summarizes the weighted average common shares used in calculating net income (loss) per common share:

| | 2007 | 2006 |
|---------|--------------------|-------------|
| Basic | 157,078,211 | 132,918,644 |
| Diluted | 163,260,612 | 137,493,898 |

The reconciling item between the basic and diluted average common shares is stock options.

d) Stock options

The Company has a stock option plan that provides for the issuance of options to its directors, officers and employees at or above market prices. The stock options granted under the plan vest evenly over a three year period and expire five years from the date of grant.

The following table sets forth a reconciliation of the stock option plan activity for the year ended December 31, 2007:

| | Number of Options | Weighted Avg. Exercise Price |
|---------------------------------------|-------------------|------------------------------|
| Outstanding, December 31, 2005 | 9,205,000 | \$0.44 |
| Granted | 3,920,000 | \$0.93 |
| Exercised | (185,414) | \$0.26 |
| Forfeited | (70,000) | \$0.82 |
| Outstanding, December 31, 2006 | 12,869,586 | \$0.59 |
| Granted | 445,000 | \$0.96 |
| Exercised | (167,916) | \$0.24 |
| Forfeited | (82,500) | \$0.68 |
| Outstanding, December 31, 2007 | 13,064,170 | \$0.59 |
| Exercisable, December 31, 2007 | 9,183,822 | \$0.50 |

The outstanding options have a range of exercise prices from \$0.10 to \$1.34, and a weighted average number of years to expiry of 2.78 (2006 – 3.6 years). The exercisable options have a range of exercise prices from \$0.10 to \$1.34 and 2.5 years to expiry (2006 – 3.3 years). For options with an exercise price ranging between \$0.10 to \$0.65, there are 7,529,170 options outstanding, 6,426,739 options exercisable, a weighted average exercise price of \$0.35 and a weighted average contractual life of 2.31 years. For options with an exercise price ranging between \$0.72 and \$1.34, there are 5,535,000 options outstanding, 2,757,083 options exercisable, a weighted average exercise price of \$0.95 and a weighted average contractual life of 3.41 years.

e) Stock-based compensation costs

The Company accounts for its stock-based compensation plan using the fair value method. Under this method, compensation cost attributable to share options granted to employees or directors is measured at fair value at the grant date and expensed over the vesting period with a corresponding increase to contributed surplus.

The fair value of each option granted is estimated at the date of grant using the Black-Scholes option pricing model with weighted average assumptions for grants as follows:

| | 2007 | 2006 |
|--|----------------|---------|
| Weighted average fair value per option | \$ 0.45 | \$ 0.45 |
| Risk free interest rate (%) | 4.0% | 4.0% |
| Expected life (years) | 3.0 | 3.0 |
| Expected volatility (%) | 63% | 72% |
| Dividends | - | - |

f) Contributed surplus

The following table sets forth a reconciliation of contributed surplus for the year ended December 31, 2007:

| | | |
|-----------------------------------|-----------|------------------|
| Balance, December 31, 2005 | \$ | 739,640 |
| Stock-based compensation expense | | 1,349,989 |
| Option exercise | | (20,727) |
| Balance, December 31, 2006 | \$ | 2,068,902 |
| Stock-based compensation expense | | 1,465,498 |
| Option exercise | | (29,312) |
| Balance, December 31, 2007 | \$ | 3,505,088 |

10. Future Income Tax

The provision for income taxes in the financial statements differs from the result which would have been obtained in applying the combined federal and provincial tax rate to the Company's earnings before income taxes. The difference results from the following items:

| Item | Year Ended December 31, | |
|---|-------------------------|-------------|
| | 2007 | 2006 |
| Net loss before income taxes | (3,247,217) | (876,835) |
| Combined federal and provincial tax rate | 32.12% | 33.15% |
| Computed "expected" income tax recovery | (1,043,006) | (290,710) |
| Increase in income taxes resulting from: | | |
| Non-deductible differences | 325,580 | 262,573 |
| Resource allowance | - | (201,922) |
| Tax rate reduction | 2,149,359 | - |
| Previously unrecognized future tax asset now recognized | (2,024,025) | - |
| Unrecognized tax benefit of accounting losses | (1,585,501) | 230,059 |
| Recognition of future income tax in recognition of tax on flow-through shares | - | (3,218,657) |
| Current tax | 59,188 | - |
| Other | 152,862 | - |
| Future income tax recovery | (1,965,543) | (3,218,657) |

The components of the Company's future income tax asset are as follows:

| | December 31 2007 | December 31 2006 |
|---|-----------------------------|---------------------|
| Future income tax assets: | | |
| Asset retirement obligation | 1,281,871 | 1,131,851 |
| Share issue expenses | 1,750,516 | 1,601,819 |
| Marketable securities | 231,705 | – |
| Non-capital loss carryforwards | 3,937,416 | 1,033,963 |
| Valuation adjustment | (2,783,403) | (2,318,211) |
| | 4,418,105 | 3,218,657 |
| Future income tax liabilities: | | |
| Petroleum and natural gas properties | (1,508,374) | 1,769,235 |
| Flow through share renouncements to be incurred | (1,785,000) | (3,218,657) |
| | (3,293,374) | – |
| Net future income tax asset | 1,124,731 | – |

Non-capital loss carryforwards at December 31, 2007 represent non-capital losses and expire from 2010 to 2027.

11. Financial Instruments

The Company's financial instruments included in the balance sheet are comprised of cash, accounts receivable, accounts payable, accrued liabilities and marketable securities. The fair value of financial instruments classified as current assets, excluding marketable securities, and current liabilities approximate their carrying amounts due to the short-term maturity of these instruments. Marketable securities are carried at fair value.

Virtually all of the Company's accounts receivable are for revenue on its operated and non-operated properties in Alberta, British Columbia and Saskatchewan. The Company is exposed to credit risks normal for the oil and gas industry.

12. Related Party Transactions

At December 31, 2007, Questerre had no amounts owing to Terrenex Ltd. ("Terrenex") (2006: \$715). All of the directors of Terrenex serve as directors and officers of Questerre. Amounts due from Rupert's Crossing Ltd. ("Rupert's"), a related party with common directors and officers, and its affiliates, were \$155,469 (2006: \$0).

Questerre incurred fees of \$126,000 for the years ended December 31, 2007 and 2006 to Rupert's. The transactions were in the normal course of business and payments were made pursuant to an Office Rental Agreement for the provision of office space, equipment and support personnel. The agreement may be terminated by either party with six months' notice.

13. Contractual Obligations and Commitments

Questerre was party to an Office Rental Agreement with a related party for the provision of offices, office equipment and support personnel in 2007. Either party had the right to terminate the agreement with six months' written notice. The agreement was terminated effective December 31, 2007. Questerre's obligation on termination is \$63,000.

As of December 31, 2007, the Company has a commitment to incur qualifying Canadian Exploration Expenses of \$6.0 million by December 31, 2008. The commitment arises from flow-through share issues completed by Questerre and Magnus in 2007. The Company expects to satisfy these commitments by March 31, 2008.

In December 2007, the Company entered into a seismic and farm-out agreement with a major Canadian independent exploration and production company. Pursuant to the agreement, Questerre has an obligation to fund the drilling and completion of two wells and a seismic acquisition program prior to March 31, 2008 to earn a 50% interest in 54 square miles of acreage. Questerre fulfilled its obligations under this agreement prior to March 28, 2008.

The Company is obligated to make total payments under an operating lease of \$115,812 for each of 2008, 2009 and 2010. Questerre has obligations under a lease for office space of \$322,519 for 2008, 2009 and 2010.

14. Subsequent Events

In February 2008, the Company entered into an agreement to acquire Terrenex. The transaction is subject to receipt of requisite regulatory approval and Terrenex shareholder approval. Closing is scheduled to occur no later than April 30, 2008. Total consideration for this transaction is 15,892,785 common shares and a cash payment of \$0.5 million.