

Questerre Energy Corporation

Consolidated Balance Sheets

	June 30, 2004	December 31, 2003
	<i>(unaudited)</i>	<i>(as restated – note 2)</i>
Assets		
Current assets		
Cash	\$ 1,211,982	\$ 1,678,611
Accounts receivable	177,017	623,544
Inventory	113,484	680,036
Deposits and cash calls paid	798,700	–
	2,301,183	2,982,191
Restricted cash (note 4)	100,000	100,000
Petroleum and natural gas properties – net of accumulated depletion and depreciation (note 3)	6,227,615	5,158,646
	\$ 8,628,798	\$ 8,240,837
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 9,575,435	\$ 7,225,137
Bank loan (note 4)	274,700	314,900
Promissory note payable (note 5)	500,000	–
	10,350,135	7,540,037
Asset retirement obligation (note 2,6)	1,786,997	848,134
	12,137,132	8,388,171
Shareholders' Equity		
Common shares (note 7)	28,286,050	25,308,340
Contributed surplus (note 7)	164,925	–
Deficit	(31,959,309)	(25,455,674)
	(3,508,334)	(147,334)
Going Concern Matters (note 1)		
Subsequent Events (note 10)	\$ 8,628,798	\$ 8,240,837

See accompanying notes to consolidated financial statements.

Approved by the Board of Directors



Director



Director

Questerre Energy Corporation Consolidated Statements of Loss and Deficit

(unaudited)

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
	<i>(as restated – note 2)</i>		<i>(as restated – note 2)</i>	
Revenue				
Petroleum and natural gas, net of royalties	\$ 903,601	\$ 490,265	\$ 968,156	\$ 981,631
Interest income	8,205	1,503	11,709	6,739
	911,806	491,768	979,865	988,370
Expenses				
Operating	782,538	377,418	949,168	739,249
General and administrative	99,740	154,237	219,322	341,346
Restructuring costs	286,665	–	286,665	–
Stock-based compensation (note 2)	47,199	–	94,398	–
Interest expense	23,282	7,996	31,067	25,608
Gain on settlement of obligations	(291,959)	–	(291,959)	–
Depletion and depreciation	859,314	178,058	6,094,628	348,748
Accretion on asset retirement obligation (note 2.6)	14,842	13,872	29,684	27,744
	1,821,621	731,581	7,412,973	1,482,695
Net loss	(909,815)	(239,813)	(6,433,108)	(494,325)
Deficit, beginning of period	(31,049,494)	(8,985,061)	(25,455,674)	(8,322,347)
Restatement for changes in accounting policies				
Stock-based compensation (note 2)	–	–	(70,527)	–
Asset retirement obligation (note 2)	–	–	–	(408,202)
Deficit, end of period	\$ (31,959,309)	\$ (9,224,874)	\$ (31,959,309)	\$ (9,224,874)
Net loss per share				
Basic and diluted	\$ (0.02)	\$ (0.01)	\$ (0.15)	\$ (0.02)

See accompanying notes to consolidated financial statements.

Questerre Energy Corporation

Consolidated Statements of Cash Flows

(unaudited)

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
		<i>(as restated – note 2)</i>		<i>(as restated – note 2)</i>
Cash provided by (used in):				
Operating Activities				
Net loss	\$ (909,815)	\$ (239,813)	\$ (6,433,108)	\$ (494,325)
Items not affecting cash				
Depletion and depreciation	859,314	178,058	6,094,628	348,748
Accretion on asset retirement obligation	14,842	13,872	29,684	27,744
Stock-based compensation expense	47,199	–	94,398	–
	11,540	(47,883)	(214,398)	(117,833)
Deferral of crown royalties	–	62,716	–	138,062
Net change in non-cash working capital	(14,026)	32,119	77,060	255,473
	(2,486)	46,952	(137,338)	275,702
Financing Activities				
Issue of common shares	–	–	745,570	–
Issue of flow-through shares	–	–	2,442,428	–
Share issue costs	4,551	(73,613)	(210,288)	(73,613)
Proceeds of promissory note	500,000	–	500,000	–
Repayment of bank loan	(20,100)	(13,400)	(40,200)	(33,500)
	484,451	(87,013)	3,437,510	(107,113)
Investing Activities				
Expenditures on petroleum and natural gas properties	(575,143)	(184,795)	(6,254,418)	(343,263)
Disposal of petroleum and natural gas properties	–	–	–	259,100
Net change in non-cash working capital	(404,053)	132,960	2,487,617	(169,372)
	(979,196)	(51,835)	(3,766,801)	(253,535)
Decrease in cash	(497,231)	(91,896)	(466,629)	(84,946)
Cash, beginning of period	1,709,213	561,954	1,678,611	555,004
Cash, end of period	\$ 1,211,982	\$ 470,058	\$ 1,211,982	\$ 470,058

See accompanying notes to consolidated financial statements.

During the three months ended June 30, 2004, the Company paid \$10,782 (2003 – \$7,996) of cash interest and \$Nil in cash taxes (2003 – \$Nil). During the six months ended June 30, 2004, the Company paid \$18,567 (2003 – \$25,608) of cash interest and \$Nil in cash taxes (2003 – \$Nil).

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

The interim consolidated financial statements include the accounts of Questerre Energy Corporation and its subsidiaries ("Questerre" or "the Company") and have been prepared by management in accordance with Canadian Generally Accepted Accounting Principles. The interim consolidated financial statements are unaudited and have not been subject to review by the Company's auditors. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the fiscal year ended December 31, 2003, except as noted below. The disclosure, which follows, is incremental to the disclosure included with the annual consolidated financial statements. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Company's annual report for the year ended December 31, 2003.

1. GOING CONCERN – CREDITOR PROTECTION

On April 1, 2004, Questerre Beaver River Inc. ("QBR"), a wholly owned subsidiary of Questerre was granted an Initial Order by the Court of Queen's Bench of Alberta providing for creditor protection under the *Companies' Creditors Arrangement Act* ("CCAA"). On June 22, 2004, Questerre Energy Corporation ("QEC") also applied for and was granted an Order by the Court of Queen's Bench of Alberta providing for creditor protection under CCAA. The Orders have been amended to provide for a general stay period that expires on September 9, 2004. The Orders may be further amended by the Court throughout the CCAA proceedings based on motions from QEC, QBR, their creditors and other interested parties.

QBR's financial difficulty was the result of significant problems and cost overruns associated with a re-entry operation undertaken at the Beaver River natural gas field ("the Beaver River Field") which is located approximately 100 miles northwest of Fort Nelson, British Columbia. QBR holds a 60% working interest and a 100% priority right to cash flow (subject to payouts) in the Beaver River Field. QBR held a 100% working interest in the operation as a result of joint venture partners choosing to forego participation under penalty. The filing by QEC was necessary due to claims advanced or threatened by certain parties that provided goods and services in connection with the re-entry operation.

The filing under CCAA is intended to allow the Company to restructure its affairs while continuing operations on a normalized basis. The Orders prohibits creditors from taking action against QBR and QEC and prevents QBR from paying most claims which arose before April 1, 2004 and QEC from paying most claims which arose before June 22, 2004. On August 9, 2004, the Company filed Plans of Compromise or Arrangement for QEC and QBR ("the Plans") under the CCAA. (see note 10).

These financial statements have been prepared using Canadian generally accepted accounting principles ("GAAP") and, accordingly, have been prepared using the same principles as those for a going concern. There is no assurance that the company will be able to obtain creditor acceptance of its proposed restructuring under CCAA. If the restructuring can not be completed, Questerre may not be able to realize its assets and discharge its liabilities in the normal course of business. If the going concern basis is not appropriate for either QEC or QBR, adjustments may be necessary in the carrying amounts and/or classification of assets, liabilities, revenues and expenses in these financial statements.

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

2. CHANGE IN ACCOUNTING POLICIES

a) Full cost accounting guideline

In January 2004, the Company prospectively adopted the new Accounting Guideline 16 "Oil and Gas Accounting – Full Cost" issued by the Canadian Institute of Chartered Accountants ("CICA").

Consistent with the former guideline, the net carrying cost of the Company's petroleum and natural gas properties is limited to an estimated net recoverable amount ("ceiling test"). Under the new guideline, the ceiling test calculation is a two step process. First, the Company determines whether a write-down is required by comparing the carrying value of the properties to the undiscounted cash flow of its proved reserves (based on management's best estimate of future prices) plus the lower of cost and market value for unproved properties. If there is an impairment calculated under the first step, the carrying value of properties is written down to the discounted value of the proved plus probable reserves (based on management's best estimate of future prices) plus the lower of cost and market of unproved properties.

The Company recorded a \$5.2 million ceiling test writedown for the six months ended June 30, 2004 related to the Beaver River Field (see note 1). This amount was calculated in accordance with the new accounting guideline utilizing an internal estimate of reserves and cash flows. The writedown is included in the depletion and depreciation provision on the income statement.

b) Asset retirement obligation

In January 2004, the Company adopted CICA Handbook Section 3110 "Asset Retirement Obligations". This change in accounting policy has been applied retroactively with restatement of prior periods presented.

Utilizing the new accounting policy, the Company recognizes asset retirement obligations in the period in which they are incurred if a reasonable estimate of fair value can be determined. The liability is recorded at fair value and is adjusted to its present value in subsequent periods as accretion expense is recorded. The associated asset retirement costs are capitalized as part of the carrying amount of the related asset. The capitalized amount is depleted on a unit of production basis in accordance with the Company's depletion policies. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost would also result in an increase or decrease to the asset retirement obligation. Actual costs incurred upon settlement of the obligation are charged against the liability to the extent the liability is recorded. Any difference between actual costs incurred upon settlement of the asset retirement obligation and the recorded liability is recognized as a gain or loss in the Company's earnings in the period in which settlement occurs.

The previously reported amounts for 2003 have been restated due to the retroactive application of this new standard. Net loss for the six months ended June 30, 2003 decreased by \$13,857. The asset retirement obligation at December 31, 2003 decreased by \$30,699 to \$848,134, property, plant and equipment increased by \$20,599, net of accumulated depletion. Opening 2003 accumulated deficit increased by \$408,202 to reflect the cumulative impact of accretion and depletion expense, less the previously recorded cumulative site restoration provision. Net loss for 2004 included accretion expense of \$14,842 for the three months and \$29,684 for the six months ended June 30, 2004. There was no impact on the Company's cash flow as a result of adopting this new policy.

c) Stock based compensation plan

In January 2004, the Company adopted the amended CICA Handbook Section 3870 "Stock-based Compensation and Other Stock-based Payments". This change in accounting policy has been applied retroactively without restatement of prior periods presented.

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

Under this amended standard, the Company must account for compensation expense based on the fair value of rights granted under its stock-based compensation plan (see note 7(e)). Compensation cost attributable to share options granted to employees or directors is measured at fair value at the grant date and expensed over the expected exercise time frame with a corresponding increase to contributed surplus. Upon exercise of the stock options, consideration paid by the unit holder together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

As a result of adopting this change in accounting policy, the consolidated financial statements at January 1, 2004 were changed as follows: contributed surplus increased by \$70,527 and the opening deficit was increased by \$70,527. Net loss for 2004 included stock-based compensation expense of \$47,199 for the three months and \$94,398 for the six months ended June 30, 2004

3. CAPITAL ASSETS

	June 30, 2004	December 31, 2003
		<i>(as restated – note 2)</i>
Petroleum and natural gas properties	\$ 39,815,680	\$ 32,652,083
Less: Accumulated depletion and depreciation	(33,588,065)	(27,493,437)
	\$ 6,227,615	\$ 5,158,646

During the six months ended June 30, 2004, the company capitalized administrative overhead charges of \$323,238 (year ended December 31, 2003 – \$594,911) relating to exploration and development activities.

The company incurred a ceiling test writedown of \$5.2 million for the six months ended June 30, 2004 (December 31, 2003 – \$16.7 million) related to the Beaver River Project (see note 1). This amount is included in the depletion and depreciation provision on the income statement.

At June 30, 2004, petroleum and natural gas properties included \$4.6 million (December 31, 2003 – \$4.3 million) relating to unproved properties which have been excluded from the depletion and depreciation calculation. All costs associated with the Beaver River property, net of estimated salvage values, have been written down and included in depletion except \$2.8 million of geological and geophysical costs. Questerre does not include costs of \$1.8 million associated with its St. Lawrence Lowlands, Quebec exploration acreage in the calculation of depletion or in costs subject to the ceiling test calculation. The Quebec property remains undeveloped at June 30, 2004.

4. 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 must make monthly payments of \$6,700 principal plus interest until the loan is paid out. The interest rate under the loan is the bank's floating base rate plus 2.0% and the Company may lock in the rate at any time. The loan is secured by the first assignment to the bank of a \$100,000 Guaranteed Investment Certificate and by a General Security Agreement over the assets of the Company and its subsidiary, Questerre Beaver River Inc. Financial covenants include 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. The Company is not in compliance with the financial covenants and, therefore, the bank loan has been classified as a current liability.

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

5. PROMISSORY NOTE PAYABLE

In June 2004, the Company obtained \$0.5 million on the issue of a \$0.5 million promissory note to Rupert's Crossing, an Investment Corporation ("Rupert's"). Rupert's is a private investment holding company controlled by the President and Chief Executive Officer of Questerre. The promissory note is due on November 14, 2004 with interest calculated at 12% per annum, payable monthly. The promissory note is secured by a General Security Agreement over the assets of the Company and the hypothecation of the Company's exploration licenses in Quebec.

6. 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 the net present value of its total asset retirement obligations to be \$1,786,997 at June 30, 2004 based on a total future liability of \$1,848,500. Based on the current financial position of its subsidiary, QBR (note 1), the liability related to the Beaver River Project has been included as a current year liability. Questerre used a credit adjusted risk free rate of seven per cent and an inflation rate of 2 per cent to calculate the present value of the asset retirement obligation.

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

	June 30, 2004	December 31, 2003
		<i>(as restated – note 2)</i>
Balance, beginning of period	\$ 848,134	\$ 353,548
Adoption of asset retirement obligation	–	439,098
Increase in estimate of obligation	909,179	
Accretion expense	29,684	55,488
Balance, end of period	\$ 1,786,997	\$ 848,134

7. 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 June 30, 2004, there were no Class B common voting shares or preferred shares outstanding.

b) Issued and outstanding

Class A common shares and common share warrants

	Number	Amount
Common Shares		
Balance, December 31, 2003	42,112,246	\$ 25,279,580
Issued for cash	642,860	713,575
Flow through shares issued for cash	1,878,791	2,442,428
Issued for cash on exercise of warrants	31,995	32,155
Share issue costs	–	(210,288)
Balance, June 30, 2004	44,665,892	\$ 28,257,450

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

	Number	Amount
Warrants		
Balance, December 31, 2003	8,232,256	\$ 28,760
Exercised for common shares	(31,995)	(160)
Balance, June 30, 2004	8,200,261	\$ 28,600
Total Common Share Capital		\$ 28,286,050

The future tax liability associated with the renunciation of tax expenditures under the flow through shares was offset by existing losses and tax deductions not previously recognized.

c) Per share Amounts

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

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2004	2003	2004	2003
Basic	44,665,892	26,835,000	44,053,299	26,835,000
Diluted	44,665,892	26,835,000	44,059,591	26,835,000

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 six months ended June 30, 2004:

	Number of Options	Weighted Avg Exercise Price
Outstanding, December 31, 2003	3,643,500	\$ 1.28
Granted	313,000	1.41
Outstanding, June 30, 2004	3,956,500	\$ 1.29
Exercisable, June 30, 2004	2,734,417	\$ 1.28

The outstanding options have a range of exercise prices between \$0.38 per share and \$1.50 per share, and a weighted average number of years to expiry of 2.7. The exercisable options have a range of exercise prices between \$1.00 and \$1.50 per share and have a weighted average number of years to expiry of 2.1.

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 expected exercise time frame with a corresponding increase to contributed surplus.

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

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

Risk free interest rate (%)	3.0
Expected life (years)	3.0
Expected volatility (%)	60.0

f) Contributed surplus

The following table sets forth a reconciliation of contributed surplus for the six months ended June 30, 2004:

Balance, December 31, 2003	\$	-
Adoption of stock based compensation (note 2)		70,527
Stock based compensation expense		94,398
Balance, June 30, 2004	\$	164,925

8. FUTURE INCOME TAXES

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:

	Six Months Ended June 30,	
	2004	2003
Loss before income taxes	\$ (6,433,108)	\$ (494,325)
Combined federal and provincial tax rate	35.16%	42.24%
Computed "expected" income tax expense	(2,261,881)	(208,803)
Increase (decrease) in income taxes resulting from:		
Non-deductible crown charges and recoveries	6,694	70,700
Unrecognized tax benefit of accounting losses	2,255,187	138,103
	\$ -	\$ -

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

	June 30,	December 31,
	2004	2003
Future income tax assets:		
Property, plant and equipment	\$ 5,643,259	\$ 5,325,981
Asset retirement obligation	476,907	234,489
Share issue expenses	293,051	293,051
Non-capital loss carryforwards (expire 2007 - 2011)	1,768,265	1,199,865
Valuation adjustment	(8,181,482)	(6,707,186)
	-	346,200
Future income tax liabilities:		
Flow through share renunciations to be incurred	-	(346,200)
	-	(346,200)
Net future income tax liability	\$ -	\$ -

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Six Months Ended June 30, 2004 (unaudited)

9. RELATED PARTY TRANSACTIONS

At June 30, 2004, Questerre had amounts owing to Terrenex Acquisition Corporation ("Terrenex") totalling \$2,824 (December 31, 2003 – \$1,237). Three directors of Terrenex are also directors of Questerre.

Questerre incurred fees of \$63,000 for the six months ended June 30, 2004 (2003 – \$63,000) to a company with common directors and officers. The transactions were in the normal course of business paid pursuant to an Office Rental Agreement for the provision of office space, office equipment and support personnel. The agreement may be terminated by either party with six months written notice.

In June 2004, Questerre entered into a farmout agreement with a director of the Company. The farmout agreement covers the Company's exploration acreage in Quebec utilizing the same terms and conditions of a farmout agreement with independent arm's length parties.

In June 2004, the Company completed a financing arrangement whereby Questerre issued a \$0.5 million promissory note to Rupert's Crossing, an Investment Corporation ("Rupert's"). Rupert's is a private investment holding company controlled by the President and Chief Executive Officer of Questerre.

10. SUBSEQUENT EVENTS

On August 9, 2004, the Company filed Plans of Compromise or Arrangement for QEC and QBR ("the Plans") under the CCAA. Pursuant to the Plans proposed by QEC and QBR, unsecured creditors will receive either the lesser of the amount of their claim or \$2,000. Alternatively, unsecured creditors can elect instead to receive a cash dividend of \$0.05 plus one Common Share of QEC for each dollar of their claims. The Common Shares of QEC will be subject to a contractual escrow and released in two equal installments on the four and eight month anniversary of the date the Plan receives final Court approval. In addition to the proposed settlement, QEC arranged for a liquidity option. Under this liquidity option, unsecured creditors will still receive \$0.05 for each dollar of their claim, and will also receive an additional \$0.07 for each dollar of their claim in exchange for forgoing each Common Share of QEC they would have otherwise received. This would result in a cash settlement of \$0.12 per dollar of claim outstanding.

The Common Shares that would otherwise have been issued to these unsecured creditors will be issued to Terrenex pursuant to the terms of a Liquidity Option Agreement. Under the Liquidity Option Agreement, Terrenex will establish a fund to finance the liquidity option up to a maximum of \$668,500, representing the maximum number of Common Shares of QEC to be issued under the plans of arrangement multiplied by \$0.07. In consideration for providing this liquidity option, Terrenex will receive 300,000 Common Shares of QEC. It will also be issued Common Shares of QEC that, but for the election of the unsecured creditors to participate in the liquidity option, would have been issued to the creditors of QBR and QEC. These Common Shares that would be issued to Terrenex, will be subject to the same hold obligations were they issued to the creditors of QBR and QEC. The Plans will be voted on at meetings of the respective unsecured creditors to be held on August 31, 2004 at the offices of the Monitor, Ernst & Young Inc. Each Plan is conditional upon both Plans being approved by creditors representing at least two-thirds in dollar value and one-half in number of the creditors voting at each meeting. The Plans are also conditional upon the receipt of requisite regulatory approvals and other conditions precedent set forth in the Plans.

In August 2004, Questerre amended its \$0.5 million financing agreement with Rupert's (see note 5) when Rupert's advanced an additional \$100,000 which was placed in trust with the Company's legal counsel. If these Plans are approved, these funds will be advanced to the Company on the same terms and conditions as the original advance of \$0.5 million. The funds will be used to finance a portion of the cash component of the Company's proposed Plans of Arrangement.