

Questerre Energy Corporation

Consolidated Balance Sheets

	September 30 2004	December 31 2003
	<i>(unaudited)</i>	<i>(as restated – note 2)</i>
Assets		
Current assets		
Cash	\$ 370,888	\$ 1,678,611
Accounts receivable	104,050	623,544
Inventory	193,083	680,036
Restricted cash (note 4)	100,000	100,000
Deposits and cash calls paid	892,264	–
	1,660,285	3,082,191
Petroleum and natural gas properties – net of accumulated depletion and depreciation (note 3)	6,238,886	5,158,646
	\$ 7,899,171	\$ 8,240,837
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 574,837	\$ 7,225,137
Bank loan (note 4)	254,600	314,900
Promissory note payable (note 5)	600,000	–
	1,429,437	7,540,037
Asset retirement obligation (note 2,6)	1,817,750	848,134
	3,247,187	8,388,171
Shareholders' Equity		
Common shares (note 7)	29,729,504	25,308,340
Contributed surplus (note 7)	183,428	–
Deficit	(25,260,948)	(25,455,674)
	4,651,984	(147,334)
	\$ 7,899,171	\$ 8,240,837

See accompanying notes to consolidated financial statements.

Approved by the Board of Directors


Director


Director

Questerre Energy Corporation

Consolidated Statements of Income (Loss) and Deficit

(unaudited)

	For the Three Months Ended September 30		For the Nine Months Ended September 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	\$ 286,365	\$ 124,850	\$ 1,254,520	\$ 1,106,481
Interest income	5,897	11,349	17,606	18,088
	292,262	136,199	1,272,126	1,124,569
Expenses				
Operating	348,576	242,421	1,297,743	981,670
General and administrative	192,231	236,499	411,567	577,716
Restructuring costs	285,699	–	572,350	–
Stock-based compensation (note 2)	18,503	–	112,901	–
Interest expense	18,019	13,186	49,086	38,923
Gain on settlement of obligations	(7,356,552)	–	(7,648,510)	–
Depletion and depreciation	56,672	182,561	6,151,299	534,949
Accretion on asset retirement obligation (note 2 and 6)	30,753	13,872	60,437	41,616
	(6,406,099)	688,539	1,006,873	2,174,874
Net income (loss)	6,698,361	(532,340)	265,253	(1,050,305)
Deficit, beginning of period	(31,959,309)	(9,248,514)	(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	\$ (25,260,948)	\$ (9,780,854)	\$ (25,260,948)	\$ (9,780,854)
Net income (loss) per share				
Basic and diluted	\$ 0.15	\$ (0.02)	\$ 0.03	\$ (0.04)

See accompanying notes to consolidated financial statements.

Questerre Energy Corporation

Consolidated Statements of Cash Flows

(unaudited)

	For the Three Months Ended September 30		For the Nine Months Ended September 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 income (loss)	\$ 6,698,361	\$ (532,340)	\$ 265,253	\$ (1,050,305)
Items not affecting cash				
Depletion and depreciation	56,672	182,561	6,151,299	534,949
Accretion on asset retirement obligation	30,753	13,872	60,437	41,616
Gain on settlement of obligations	(7,356,552)	–	(7,648,510)	–
Stock-based compensation expense	18,503	–	112,901	–
	(552,263)	(355,907)	(1,058,620)	(473,740)
Deferral of crown royalties	–	14,326	–	152,388
Net change in non-cash working capital	140,200	(380,368)	217,260	(124,895)
	(412,063)	(721,949)	(841,360)	(446,247)
Financing Activities				
Issue of common shares	1,443,454	3,544,680	2,189,023	3,544,681
Issue of flow-through shares	–	4,137,700	2,442,428	4,137,700
Share issue costs	–	(974,721)	(210,288)	(1,048,335)
Proceeds of promissory note	100,000	–	600,000	–
Repayment of bank loan	(20,100)	–	(60,300)	(33,500)
Net change in non-cash working capital	(1,443,454)	–	(1,443,454)	–
	79,900	6,707,659	3,517,409	6,600,546
Investing Activities				
Expenditures on petroleum and natural gas properties	(67,943)	(4,258,665)	(6,322,361)	(4,342,829)
Net change in non-cash working capital	(440,988)	1,459,869	2,338,589	1,290,498
	(508,931)	(2,798,796)	(3,983,772)	(3,052,331)
Increase (decrease) in cash	(841,094)	3,186,914	(1,307,723)	3,101,968
Cash, beginning of period	1,211,982	470,058	1,678,611	555,004
Cash, end of period	\$ 370,888	\$ 3,656,972	\$ 370,888	\$ 3,656,972

See accompanying notes to consolidated financial statements.

During the three months ended September 30, 2004, the Company paid \$18,019 (2003 – \$13,186) of cash interest and \$Nil in cash taxes (2003 – \$Nil). During the nine months ended September 30, 2004, the Company paid \$49,086 (2003 – \$38,923) of cash interest and \$Nil in cash taxes (2003 – \$Nil).

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Nine Months Ended September 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. 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. CORPORATE RESTRUCTURING

On April 1, 2004, Questerre Beaver River Inc. ("QBR"), a wholly owned subsidiary of Questerre ("QEC") was granted an 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, QEC also applied for and was granted an Order by the Court of Queen's Bench of Alberta providing for creditor protection under CCAA.

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 CCAA 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 and was intended to allow the Company to restructure its affairs while continuing operations on a normalized basis.

On August 9, 2004, the Company filed Plans of Compromise or Arrangement (the "Plans") under the CCAA for the settlement of all outstanding claims. Pursuant to the Plans proposed by QEC and QBR, unsecured creditors would receive either the lesser of the amount of their claim or \$2,000. Alternatively, unsecured creditors could elect to receive either a cash dividend of \$0.05 plus one Common Share of QEC for each dollar of their claims. The Common Shares of QEC would be subject to a contractual escrow and released in two equal instalments on the four and eight month anniversary of the date the Plans received final Court approval.

In addition to the proposed settlement, QEC arranged for a liquidity option. Under this liquidity option, unsecured creditors would still receive \$0.05 for each dollar of their claims, and would also receive an additional \$0.07 for each dollar of their claim in exchange for foregoing 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 would be issued to Terrenex Acquisition Corporation ("Terrenex"), a related party, pursuant to the terms of the Liquidity Option Agreement (See Note 9). In consideration, Terrenex would establish a fund to finance the liquidity option up to a maximum of \$668,500.

The Plans were approved by the requisite majority of unsecured creditors at meetings of creditors held on August 31, 2004 and sanctioned by the Court of Queen's Bench of Alberta on September 9, 2004. A total of \$0.56 million in cash and 9,623,012 Common Shares of QEC were issued on the implementation of these plans. QEC and QBR subsequently emerged from Court protection on October 8, 2004.

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Nine Months Ended September 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 nine months ended September 30, 2004 related to the Beaver River Project (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 nine months ended September 30, 2003 decreased by \$11,931. 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 income for 2004 included accretion expense of \$30,753 for the three months and \$60,437 for the nine months ended September 30, 2004. There was no impact on the Company's cash flow as a result of adopting this new policy.

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Nine Months Ended September 30, 2004 (unaudited)

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. 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 income for 2004 included stock-based compensation expense of \$18,503 for the three months and \$112,901 for the nine months ended September 30, 2004.

3. CAPITAL ASSETS

	September 2004	December 31 2003
		<i>(as restated – note 2)</i>
Petroleum and natural gas properties	\$ 39,883,624	\$ 32,652,083
Less: Accumulated depletion and depreciation	(33,644,738)	(27,493,437)
	\$ 6,238,886	\$ 5,158,646

During the nine months ended September 30, 2004, the company capitalized administrative overhead charges of \$326,619 (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 nine months ended September 30, 2004 (December 31, 2003 – \$16.7 million) related to the Beaver River Field (see note 1). This amount is included in the depletion and depreciation provision on the income statement.

At September 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 Field, net of estimated salvage values, have been written down and included in depletion expense 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 prospect in the calculation of depletion or in costs subject to the ceiling test calculation. The Quebec property remains undeveloped at September 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 Nine Months Ended September 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 (see note 10). 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.

In August 2004, the Company amended its \$0.5 million financing agreement with Rupert's when Rupert's advanced an additional \$0.1 million which was placed in trust with the Company's legal counsel. Upon the approval of the Plans by the unsecured creditors, these funds were advanced to the Company on the same terms as the original \$0.5 million. The funds were used to finance a portion of the cash component of the Plans.

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 \$1,817,750 at September 30, 2004 based on a total future liability of \$1,848,500. The liability related to the Beaver River Field 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:

	September 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	60,437	55,488
Balance, end of period	\$ 1,817,750	\$ 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 September 30, 2004, there were no Class B common voting shares or preferred shares outstanding.

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Nine Months Ended September 30, 2004 (unaudited)

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
Issued under Plans	9,623,012	1,443,454
Share issue costs	-	(210,288)
Balance, September 30, 2004	54,288,904	\$ 29,700,904

	Number	Amount
Warrants		
Balance, December 31, 2003	8,232,256	\$ 28,760
Exercised for common shares	(31,995)	(160)
Expired	(2,861,931)	-
Balance, September 30, 2004	5,338,330	\$ 28,600
Total Common Share Capital		\$ 29,729,504

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 income (loss) per common share:

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2004	2003	2004	2003
Basic	45,576,112	33,268,062	44,597,493	29,137,534
Diluted	46,097,851	33,268,062	44,743,877	29,137,534

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.

Questerre Energy Corporation Selected Notes to Consolidated Financial Statements

For the Nine Months Ended September 30, 2004 (unaudited)

The following table sets forth a reconciliation of the stock option plan activity for the nine months ended September 30, 2004:

	Number of Options	Weighted Avg Exercise Price
Outstanding, December 31, 2003	3,643,500	\$ 1.28
Granted – First Quarter	313,000	1.41
Granted – Third Quarter	2,315,000	0.10
Cancelled	(3,956,500)	1.29
Outstanding, September 30, 2004	2,315,000	\$ 0.10
Exercisable, September 30, 2004	0	\$ 0.00

The outstanding options have an exercise price of \$0.10 per share, and 5 years to expiry. Pursuant to the successful completion of the corporate restructuring during the third quarter, the Company cancelled 3,956,500 outstanding stock options.

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.

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 (%)	161.0

f) Contributed surplus

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

Balance, December 31, 2003	\$ –
Adoption of stock based compensation (note 2)	70,527
Stock based compensation expense	112,901
Balance, September 30, 2004	\$ 183,428

Questerre Energy Corporation

Selected Notes to Consolidated Financial Statements

For the Nine Months Ended September 30, 2004 (unaudited)

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:

	Nine Months Ended September 30	
	2004	2003
Gain (loss) before income taxes	\$ 265,253	\$ (1,050,305)
Combined federal and provincial tax rate	35.16%	42.24%
Computed "expected" income tax recovery	93,263	(443,649)
Increase in income taxes resulting from:		
Non-deductible crown charges and recoveries	6,694	70,700
Unrecognized tax benefit of accounting losses	86,569	372,949
	\$ -	\$ -

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

	September 30 2004	December 31 2003
Future income tax assets:		
Property, plant and equipment	\$ 4,206,026	\$ 5,325,981
Asset retirement obligation	477,193	234,489
Share issue expenses	293,051	293,051
Non-capital loss carryforwards (expire 2007 - 2011)	724,986	1,199,865
Valuation adjustment	(5,701,256)	(6,707,186)
	-	346,200
Future income tax liabilities:		
Flow through share renouncements to be incurred	-	(346,200)
	-	(346,200)
Net future income tax liability	\$ -	\$ -

9. RELATED PARTY TRANSACTIONS

At September 30, 2004, Questerre had amounts owing to Terrenex totaling \$723 (December 31, 2003 - \$1,237). All of the directors of Terrenex serve as directors or officers of Questerre. Questerre incurred fees of \$94,500 for the nine months ended September 30, 2004 (2003 - \$94,500) 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 August 2004, the Company amended its \$0.5 million financing agreement with Rupert's when Rupert's advanced an additional \$0.1 million which was placed in trust with the Company's legal counsel. Upon the approval of the Plans by the unsecured creditors, these funds were advanced to the Company on the same terms as the original \$0.5 million. The funds were used to finance a portion of the cash component of the Plans.

In August 2004, the Company entered into a Liquidity Option Agreement with Terrenex to facilitate acceptance of the Plans by the unsecured creditors of QBR and QEC. Pursuant to the Liquidity Option Agreement, Terrenex funded a payment of \$0.07 per Common Share to those unsecured creditors that did not wish to hold the QEC Common Shares received under the Plans (the "Liquidity Option"). In consideration for this payment, Terrenex was issued that number of Common Shares of QEC that, but for their election to participate in the Liquidity Option, would have been issued to the unsecured creditors. The Common Shares issued to Terrenex are subject to the same contractual hold period were they issued to these unsecured creditors. For fulfilling its obligations under the Liquidity Option Agreement, Terrenex was granted 300,000 Common Shares of QEC.

On the acceptance of the Plans on August 31, 2004, unsecured creditors of QBR and QEC with claims totaling \$6.7 million elected to participate in the Liquidity Option. Terrenex funded a payment of \$0.47 million to these unsecured creditors and was issued 6,756,102 common shares of QEC.

10. SUBSEQUENT EVENTS

In October 2004, the Company further amended the terms of the \$0.5 million financing agreement with Rupert's when Rupert's advanced an additional \$0.08 million to the Company for general working capital. This advance was made on the same terms as the original advance of \$0.5 million.

In November 2004, the Company and Rupert's amended the terms of the financing agreement extending the due date of the promissory note from November 14, 2004 to November 14, 2006 and reducing the interest rate from 12% per annum to 8% per annum. The Company has been granted the right to prepay the entire amount or any portion thereof with 30 days' notice in writing to Rupert's. Rupert's has been granted the option, subject to regulatory approval, to convert the entire amount into Common Shares of the Company at a conversion rate of \$0.30 per Common Share. As at November 11, 2004, a total of \$0.68 million is due to Rupert's under this financing agreement.