



**GALLEON ENERGY INC.**

FIRST QUARTER REPORT 2004

## TABLE OF CONTENTS

<i>Report to Shareholders</i>	1
<i>MD&amp;A</i>	4
<i>Consolidated Balance Sheets</i>	16
<i>Consolidated Statements of Operations and Deficit</i>	17
<i>Consolidated Statements of Cash Flow</i>	18
<i>Notes to Consolidated Financial Statements</i>	19
<i>Corporate Information</i>	IBC

# REPORT TO SHAREHOLDERS

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## ***Highlights of the first quarter of 2004 include:***

- *Grew daily production from approximately 400 Boe on January 1st to approximately 1,400 Boe on March 31st – 250% production growth in three months*
- *Increased year end 2004 production guidance to 2,500 Boe per day*
- *Closed the acquisition of Venture Energy Inc. which included over two million Boe of proven plus probable reserves*
- *Acquired a 43% interest in a gas plant at Calais, Alberta*
- *Drilled 13 wells in the quarter with a 69% success rate*
- *Drilled two significant deep discovery wells at Calais*
- *Through eight farm ins and acquisitions, expanded the undeveloped land base at Calais and Dawson, Alberta by 20%; from 202,880 gross acres to 245,760 gross acres*
- *Increased the drilling locations at Calais and Dawson to 50*
- *Closed a \$12 million bought deal equity financing*
- *Increased available bank lines to \$15 million in April 2004*
- *Recorded a profit in Galleon's second quarter as a public company*

*Galleon currently has seven natural gas wells awaiting tie in. Two natural gas wells at Calais are anticipated to be tied in by the end of July. Five natural gas wells at Dawson will be tied in next winter.*

*The importance of the two deep discovery wells at Calais cannot be overemphasized. These wells appear to have significant reserves, expected stable production and a number of follow-up drilling locations.*

*A capital budget of \$18 million has been approved for the next two quarters. At Dawson and Calais, up to 14 wells will be drilled. Three rigs have been contracted for early June and are expected to drill continuously through the balance of the year. Additionally, the assembly of drilling locations will be accelerated by the expenditure of \$4.0 million for new 2D and 3D seismic programs.*

*During the quarter, a number of property and corporate acquisitions were considered. Due to concern about asset quality and/or price, none of the acquisitions were made. Management is committed to remaining disciplined in these activities and will only make an acquisition if it can be demonstrated to enhance value for our current shareholders.*

*We look forward to reporting to you on an ongoing basis as to results of the drilling and acquisition activities.*

[signed]

**Glenn R. Carley**

*Chairman and  
Chief Executive Officer*

May 13, 2004

[signed]

**Steve Sugianto**

*President and  
Chief Operating Officer*

# Highlights

<i>As at March 31, 2004</i>	<i>1st Qtr 2004</i>	<i>4th Qtr 2003</i>	<i>3rd Qtr 2003</i>	<i>2nd Qtr 2003</i>	<i>1st Qtr 2003</i>
<b>Production</b>					
Light oil (Bbl/d)	56	–	–	–	–
Heavy/medium oil (Bbl/d)	265	152	–	–	–
Natural Gas (Mcf/d)	2,841	42	–	–	–
NGLs (Bbl/d)	1	–	–	–	–
Boe at 6:1 gas	796	159	–	–	–
Total Boe produced	72,378	14,615	–	–	–
<b>Prices</b>					
Light oil (\$/Bbl)	45.26	39.98	–	–	–
Heavy/medium oil (\$/Bbl)	27.56	24.11	–	–	–
Crude oil with hedge (\$/Bbl)	26.48	23.79	–	–	–
Natural Gas (\$/Mcf)	5.71	6.41	–	–	–
NGLs (\$/Bbl)	42.88	–	–	–	–
<b>Per Boe (\$)</b>					
Gross revenues (net of hedges)	31.13	24.43	–	–	–
Royalties	(6.56)	(5.41)	–	–	–
Operating costs	(7.08)	(11.65)	–	–	–
Field netback	17.49	7.37	–	–	–
Other revenue	0.13	5.80	–	–	–
G&A	(4.61)	(14.12)	–	–	–
Interest – cash	(0.07)	–	–	–	–
Cash flow	12.94	(0.95)	–	–	–
<b>Financial (\$)</b>					
Gross revenues (net of hedges)	2,253,149	357,090	–	–	–
Royalties	(474,615)	(79,087)	–	–	–
Other revenue	9,373	84,836	31,181	13,455	–
Operating costs	(512,095)	(170,317)	–	–	–
G&A	(333,500)	(206,481)	(112,842)	(32,787)	–
Interest – cash	(5,599)	–	–	–	–
Cash flow	936,713	(13,959)	(81,661)	(19,332)	–
Depletion, depreciation & accretion	(763,207)	(170,472)	(39,016)	(6,054)	–
Future tax recovery	37,394	94,008	–	–	–
Stock based compensation	(87,720)	–	–	–	–
Earnings (loss)	123,180	(90,423)	(120,677)	(25,386)	–
<b>Weighted average outstanding</b>					
Class A shares-basic	14,580,107	8,300,001	4,063,610	671,670	1
Cash flow \$ per share-basic	0.06	–	–	–	–
Earning (loss) \$ per share-basic	0.01	(0.01)	(0.03)	(0.04)	–

## MD & A

Management's Discussion & Analysis ("MD&A") is intended to assist in the understanding of the trends and significant changes in the financial condition and results of operations of Galleon Energy Inc. ("Galleon") for the first quarter of 2004. The following information has been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP") and should be read in conjunction with the audited financial statements for the year ended December 31, 2003 and the unaudited interim consolidated financial statements as at and for the quarter ended March 31, 2004. Petroleum and natural gas reserves and volumes are converted to a common unit of measure on a basis of six thousand cubic feet (Mcf) of gas to one barrel (Bbl) of oil. This MD&A is dated as of May 13, 2004.

### **NON-GAAP MEASUREMENTS**

The MD&A contains the term cash flow from operations which should not be considered an alternative to or more meaningful than, cash flow from operating activities or net earnings as determined in accordance with Canadian GAAP as an indicator of Galleon's performance. Galleon's determination of cash flow from operations may not be comparable to that reported by other companies. The reconciliation between net earnings and cash flow from operations can be found in the Consolidated Statements of Cash Flow. The Corporation also presents cash flow per share whereby cash flow from operations is divided by the weighted average number of shares outstanding to determine per share amounts.

Galleon uses the term net debt in its MD&A and presents a table showing how it has been determined. This measure does not have any standardized meaning prescribed by Canadian GAAP and therefore may not be comparable to similar measures presented by other companies.

## FORWARD LOOKING STATEMENTS

Statements throughout this interim report that are not historical facts may be considered "forward looking statements." These forward looking statements sometimes include words to the effect that management believes or expects a stated condition or result. All estimates and statements that describe the Corporation's objectives, goals or future plans are forward looking statements. Since forward looking statements address future events and conditions, by their very nature they involve inherent risks and uncertainties. Actual results could differ materially from those currently anticipated due to any number of factors, including such variables as new information regarding recoverable reserves, changes in demand for, and commodity prices of crude oil and natural gas, legislative, environmental and other regulatory or political changes, competition in areas where the Corporation operates and other factors discussed in this interim report.

## FIRST QUARTER 2004 HIGHLIGHTS

- Cash flow from operations of \$936,713
- Operating netbacks in Q1/04 of \$17.49/Boe compared to \$7.37/Boe in Q4/03 due to production from higher quality assets and higher commodity prices
- Average daily production of 796 Boe; natural gas – 2.8 Mmcf and liquids – 322 Bbl
- Drilled 13 gross wells (100% capital interest) resulting in nine gross (7.6 net) natural gas wells; including two significant deep zone discoveries at Calais and five natural gas pool discoveries at Dawson
- Capital expenditures of \$12.4 million including the acquisition of interests in certain oil and gas properties and a gas plant in the Calais area
- Acquired Venture Energy Inc. on January 15, 2004
- Special Warrant financing of \$12 million
- Obtained a bank credit facility in the amount of \$10 million

## PETROLEUM AND NATURAL GAS REVENUES

Netbacks <i>72,378 Boe</i>	\$	<i>Q1 2004</i> \$/Boe
Gross revenue	2,375,227	32.82
Hedges	(122,078)	(1.69)
Royalties	(474,615)	(6.56)
Subtotal	1,778,534	24.57
Operating costs	(512,095)	(7.08)
Operating netback	1,266,439	17.49
Other	9,373	0.13
Administration costs	(333,500)	(4.61)
Interest costs	(5,599)	(0.07)
Cash flow from operations	936,713	12.94

Revenue contribution analysis	\$	<i>Q1 2004</i> %
Oil	895,576	38
Natural gas liquids	4,102	–
Natural gas	1,475,549	62
Subtotal	2,375,227	100
Hedging gain (loss)	(122,078)	
Total revenue	2,253,149	

Product mix analysis		<i>Q1 2004</i>
Oil (Bbls/d)	321	40
Natural gas liquids (Bbls/d)	1	–
Natural gas (Mcf/d)	2,841	60
Boe/d (6:1)	796	100

## COMMODITY PRICING AND MARKETING

<u>Prices</u>	<u>Q1 2004</u>
Light oil \$/Bbl	45.26
Heavy/Medium oil \$/Bbl	27.56
Hedge impact \$/Bbl	(4.18)
Net crude oil \$/Bbl	26.48
Natural gas \$/Mcf	5.71
Natural gas liquids \$/Bbl	42.88

Petroleum products are sold to major Canadian marketers at spot reference prices based on US WTI for crude oil and AECO-C for natural gas. The Corporation had two hedging arrangements in place during the first quarter which covered 62% of total crude oil sales in the quarter. The cost of the crude oil hedge contracts was \$122,078 in Q1/04 or \$4.18 /Bbl.

The first contract commenced on December 1, 2003 for 100 Bbl/day with a fixed price of \$38.46/Bbl WTI Cdn and expires on May 31, 2004. The second contract commenced on January 1, 2004 for 100 Bbl/day with a fixed price of \$40.80/Bbl WTI Cdn and expires on December 31, 2004.

## PERFORMANCE BY PROPERTY

<i>Q1 2004</i>	<i>Date acquired or first date on production</i>	<i>Production Boe/d</i>	<i>Netbacks/Boe %</i>	<i>\$</i>
Calais	February 27, 2004	84	11	22.39
Dawson	March 9-11, 2004	34	4	20.07
Wymark	January 15, 2004	260	33	25.17
Princess	January 15, 2004	36	5	28.28
Bindloss	January 15, 2004	14	2	20.03
John Lake	February 2, 2004	14	2	25.02
Monitor		22	3	23.18
Progress		67	8	16.98
Delta West		107	13	12.69
Lloydminster		158	19	9.58
<b>Boe/d</b>		<b>796</b>	<b>100</b>	<b>19.18</b>
<b>Netback/Boe(net of crude oil hedge)</b>				<b>17.49</b>

## ROYALTIES

Royalty expenses were 20% of gross revenues (14% crown, 5% freehold and 1% other) for first quarter 2004.

## OPERATING EXPENSES

Operating expenses averaged \$7.08/Boe in first quarter 2004. This compares to \$11.65/Boe in the fourth quarter of 2003. This decrease can be attributed to new production from lower operating cost natural gas properties.

## GENERAL AND ADMINISTRATION COSTS

	<i>\$</i>	<i>Q1 2004 \$/Boe</i>
Gross	508,976	7.03
Overhead recoveries	(175,476)	(2.42)
<b>Subtotal</b>	<b>333,500</b>	<b>4.61</b>

## INTEREST

Interest expense was \$5,599 in first quarter 2004.

## DEPLETION, DEPRECIATION AND ACCRETION

Depletion and depreciation rates for oil and gas properties were \$10.25/Boe in Q1/04. The total depletion and depreciation for the three months ended March 31, 2004 was \$741,992. Accretion expense of \$21,215 was recorded in Q1/04.

## TAXES

A future tax recovery of \$37,394 was recorded in 2004 first quarter earnings. The recovery reflects the recognition in 2004 of the Alberta provincial tax rate reduction of 1%.

<u>Future income tax</u>	<u>\$</u>
Balance at December 31, 2003	3,302,125
Tax effect of share issue costs	(292,734)
Venture acquisition	485,861
Recovery for Q1 2004	(37,394)
<u>Balance at March 31, 2004</u>	<u>3,457,858</u>

## NET EARNINGS

Net earnings of \$123,180 includes a future tax recovery of \$37,394 and non cash expenses for stock based compensation expense of \$87,720.

## CAPITAL EXPENDITURES

Property & equipment balance at December 31, 2003	\$	11,277,905
Additions (net)		10,006,431
Acquisition of property and equipment		2,368,924
Asset retirement obligation		133,532
Acquisition of venture		16,465,764
Depletion and depreciation		(741,992)
<u>Property &amp; equipment balance at March 31, 2004</u>	<u>\$</u>	<u>39,510,564</u>

Exploration and development expenditures	<i>Q1 2004</i> \$
Land	1,371,302
Geological and geophysical	1,007,481
Drilling and completion	5,900,706
Plant and facilities	1,628,662
Other assets	98,280
<u>Total exploration and development</u>	<u>10,006,431</u>

An active 13 well drilling program at Calais, Dawson and Wymark resulted in nine cased natural gas wells, with four of these wells currently on production, and five awaiting completion and tie in activities. Two additional natural gas wells drilled at Dawson in the fourth quarter of 2003 are awaiting tie in.

In 2003, the Corporation issued \$10.25 million in flow-through shares and had renounced the tax benefit of \$10.25 million to the shareholders. Under the look back provision governing flow-through shares, the Corporation is required to spend the \$10.25 million in eligible capital expenditures in 2004. As of March 31, 2004, the Corporation had spent \$8 million of eligible expenditures which includes seismic and drilling, and will be required to spend the remaining \$2.25 million prior to December 31, 2004.

## LIQUIDITY AND CAPITAL RESOURCES

For the first quarter of 2004, cash flow from operations of \$936,713 and an equity issuance of \$12 million were used to fund the \$12.4 million capital expenditure program. Cash flow from operations per average weighted basic share was \$0.06 in Q1/04.

At March 31, 2004, the market value of Galleon's class A shares was approximately \$100 million based on the March 31, 2004 closing price of \$6 per share and 16,753,438 class A shares outstanding.

## Debt and Working Capital

	<i>March 31, 2004</i>	<i>December 31, 2003</i>
	\$	\$
Cash	1,181,590	3,204,663
Working capital (deficiency)	(3,785,871)	(3,755,208)
Total net debt	2,604,281	550,545

## Source of funds used in Q1 2004

Issuance of shares, net of costs	\$	11,169,651
Funds provided by operations		936,713
Change in cash and working capital		268,991
		12,375,355
Net additions to property and equipment	\$	12,375,355

Galleon has no off-balance sheet financing arrangements. The Corporation has lease arrangements for office space to April 30, 2006. The future minimum lease payments total \$684,358 (balance of 2004 – \$246,369; 2005 – \$328,492; and, 2006 – \$109,497).

## CHANGES IN ACCOUNTING POLICIES

### *Stock-based compensation*

Effective January 1, 2004, the Corporation adopted a new accounting standard on stock based compensation as presented in the CICA Handbook section 3870. The standard requires the recognition of stock based compensation expense for all employees and non-employees using the fair value method.

For 2003, options were issued at current market value and had no intrinsic value, therefore no compensation expense was recorded when the options were granted. Consideration paid by employees and directors on the exercise of stock options was credited to share capital.

The standard was amended in November 2003 requiring all stock based compensation awards to be expensed. The Corporation adopted the new accounting policy in 2004 on a retroactive basis with no restatement of prior periods.

The Black-Scholes option pricing model has been used to calculate the fair value of the stock options granted. For the first quarter of 2004, the Corporation recognized a compensation expense of \$87,720.

### *Asset retirement obligation*

Effective January 1, 2004, the Corporation has adopted the new standard for asset retirement obligations as set out in the CICA Handbook section 3110. The new standard requires the recognition and measurement of liabilities related to the legal obligation to abandon and reclaim property, plant and equipment upon acquisition, construction, development and/or normal use of the asset. The initial liability must be measured at fair value and subsequently adjusted for the accretion of discount and changes in the fair value. The asset retirement cost is capitalized as part of property and equipment and depleted into earnings over time.

The adoption of this standard has increased the asset retirement liability by \$644,357 at December 31, 2003, and added an asset retirement cost of \$660,271 to property, plant and equipment which was reduced by depletion on the increased asset retirement cost for 2003 of \$8,796. The comparative balance sheet for 2003 has been restated. For the first quarter of 2004, \$133,533 of additional asset retirement liability and \$21,215 in accretion expense were recognized. The accretion expense was applied to depletion, depreciation and accretion expense on the Consolidated Statements of Operations and Deficit.

### *Full cost accounting guideline*

Effective January 1, 2004, the Corporation adopted the new guidelines for full cost accounting as per CICA accounting guideline 16. Under the new guideline, future net revenues from total proven reserves used in the ceiling test calculation are estimated using expected future product prices and costs (escalating), whereas prior to the adoption, constant pricing was used. Future general and administrative, and financing charges, associated with the future net revenues are no longer deducted in arriving at the ceiling value.

Where a ceiling test failure occurs, probable reserve values may now be included in determining the impairment amount which is based on the fair value of the associated reserves.

The adoption of the new guideline at December 31, 2003 resulted in no change to net income, fixed assets or any reported amounts in the December 31, 2003 financial statements.

## CRITICAL ACCOUNTING ESTIMATES

There are a number of critical estimates underlying the accounting policies we employ in preparing the Consolidated Financial Statements.

### *Revenue estimates*

Payment for sales in the oil and gas industry occurs up to two months after the month of production. Sales are estimated based upon information received from field offices regarding production levels and published industry pricing and transportation data.

### *Cost estimates*

Costs for services performed but not yet billed are estimated based on original quotes and historical cost information.

### *Reserves*

The full cost method of accounting, which we use to account for our oil and gas activities, relies on estimates of proven reserves that will ultimately be recoverable from our properties. These estimates are utilized in calculating our unit-of-production depletion, potential impairment of asset carrying costs and future site restoration expense. The process of estimating reserves is complex and requires significant judgment, based on available geological, geophysical, engineering and economic data.

Reserves are evaluated at year-end by an independent engineering firm and quarterly updates to those reserves, as well as new reserves from wells drilled in the current year, are estimated by the Corporation's engineers.

Although every effort is made to ensure that critical estimates are accurate, changing economic and operational conditions, as well as governmental regulations, can significantly affect those estimates, which may cause significant fluctuation in earnings and cash flows.

### ***Business Risks***

Galleon is engaged in the exploration, development and production of crude oil and natural gas. The oil and gas business is inherently risky and there is no assurance that hydrocarbon reserves will be discovered and economically produced. Operational risks include competition, reservoir performance uncertainties, environmental factors, and regulatory, environment and safety concerns. Financial risks associated with the petroleum industry include fluctuations in commodity prices, interest rates, currency exchange rates and the cost of goods and services.

Galleon employs highly qualified people, uses sound operating and business practices, and evaluates all potential and existing wells using the latest applicable technology. Galleon complies with government regulations and has in place an up-to-date emergency response test. Environment and safety policies and standards are adhered to. Asset retirement obligations are recognized upon acquisition, construction, development and/or normal use of the assets. Galleon maintains property and liability insurance coverage. The coverage provides a reasonable amount of protection from risk of loss; however, not all risks are foreseeable or insurable.

A commodity hedging program is in place to protect product pricing on a portion of production and ensure cash flows are available for reinvestment.

### *Cash Flow Sensitivities*

	<i>Cash Flow (\$000)</i>	<i>\$ Per Share Basic</i>
Natural gas price change of \$0.10/Mcf	196	0.01
Natural gas production change of 1 Mmcf/day	1,754	0.10
Crude oil and NGLs price change of \$1.00 US WTI per Bbl	115	0.01
Interest rate change of 1%	53	-
Foreign exchange rate of 1% point (\$US – Cdn)	703	0.04

Cash flow sensitivities are calculated as they relate to the Corporation's 2004 budgeted revenues and expenses, and outstanding shares at March 31, 2004. Budgeted commodity prices are \$6.00/Mcf and \$29/Bbl WTI US. The Corporation's current hedging contracts have not been reflected in these sensitivities.

### **OUTLOOK**

The second and third quarter will be characterized by an active drilling program and large seismic programs. Daily production is expected to increase to an average of 1,400 barrels of oil equivalent in the second quarter.

## Consolidated Balance Sheets

	<i>March 31</i> <i>2004</i>	<i>December 31</i> <i>2003</i>
<b>ASSETS</b>	(Unaudited)	(Restated - Note 1)
<b>Current</b>		
Cash	\$ 1,181,590	\$ 3,204,663
Accounts receivable	3,373,068	1,230,087
Deposits and prepaid expenses	460,210	14,442
	<u>5,014,868</u>	<u>4,449,192</u>
Goodwill (note 3)	2,534,267	-
Property and equipment (notes 1, 4 and 5)	39,510,564	11,277,905
	<u>47,059,699</u>	<u>15,727,097</u>
<b>LIABILITIES</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	7,619,149	4,999,737
	<u>7,619,149</u>	<u>4,999,737</u>
Asset retirement obligation (note 1)	1,274,133	660,271
Future income taxes (note 7)	3,457,858	3,302,125
	<u>12,351,140</u>	<u>8,962,133</u>
Commitments (note 8)		
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (note 6)	36,109,145	7,001,450
Contributed surplus (notes 1 and 6)	87,720	-
Deficit	(1,488,306)	(236,486)
	<u>34,708,559</u>	<u>6,764,964</u>
	<u>\$ 47,059,699</u>	<u>\$ 15,727,097</u>

See accompanying notes

# Consolidated Statements of Operations and Deficit

Three Months Ended March 31 (unaudited)

	2004	2003
<b>REVENUE</b>		
Petroleum and natural gas	\$ 2,375,227	\$ -
Crude oil hedge cost	(122,078)	-
Royalties, net of ARTC	(474,615)	-
Other income	9,373	-
	<u>1,787,907</u>	<u>-</u>
<b>EXPENSES</b>		
Operating	512,095	-
General and administration	333,500	-
Stock based compensation	87,720	-
Interest	5,599	-
Depletion, depreciation and accretion (note 1)	763,207	-
	<u>1,702,121</u>	<u>-</u>
Earnings before income taxes	85,786	-
Recovery of future income taxes (note 7)	37,394	-
	<u>123,180</u>	<u>-</u>
<b>NET EARNINGS</b>	<b>123,180</b>	<b>-</b>
<b>DEFICIT, BEGINNING OF PERIOD</b>	<b>(236,486)</b>	<b>-</b>
Repurchase of class A shares (notes 4 and 6)	(1,375,000)	-
	<u>(1,488,306)</u>	<u>-</u>
<b>DEFICIT, END OF PERIOD</b>	<b>\$ (1,488,306)</b>	<b>\$ -</b>
<b>NET EARNINGS PER SHARE</b>		
(Basic and diluted)	\$ 0.01	\$ -
Weighted average shares – basic	<u>14,580,107</u>	<u>1</u>

See accompanying notes

# Consolidated Statements of Cash Flow

Three Months Ended March 31 (unaudited)

	2004	2003
Cash provided by (used in):		
<b>OPERATING ACTIVITIES</b>		
Net earnings	\$ 123,180	\$ -
Add items not requiring cash:		
Depletion, depreciation and accretion	763,207	-
Recovery of future income taxes	(37,394)	-
Stock based compensation (note 1)	87,720	-
<b>CASH FLOW FROM OPERATIONS</b>	<b>936,713</b>	<b>-</b>
Change in non-cash working capital relating to operating activities	30,664	-
	<b>967,377</b>	<b>-</b>
<b>FINANCING ACTIVITIES</b>		
Issue of common shares	12,010,500	1
Share issue costs	(840,849)	-
Repayment of bank debt assumed in Venture acquisition (note 4)	(1,784,746)	-
	<b>9,384,905</b>	<b>1</b>
<b>INVESTING ACTIVITIES</b>		
Additions to oil and gas properties	(10,006,431)	-
Acquisition of oil and gas properties (note 5)	(2,368,924)	-
	<b>(12,375,355)</b>	<b>-</b>
<b>INCREASE (DECREASE) IN CASH</b>	<b>(2,023,073)</b>	<b>1</b>
<b>CASH, BEGINNING OF PERIOD</b>	<b>3,204,663</b>	<b>-</b>
<b>CASH, END OF PERIOD</b>	<b>\$ 1,181,590</b>	<b>\$ 1</b>
<b>SUPPLEMENTARY INFORMATION</b>		
Cash interest paid	\$5,599	-
Cash taxes paid	-	-

See accompanying notes

# Notes to Consolidated Financial Statements

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## 1. ACCOUNTING POLICIES

These unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"), and follow the same accounting policies as for the financial statements for the fiscal year ended December 31, 2003 except as noted below. These notes are incremental to, and should be read in conjunction with, the audited financial statements for the fiscal year ended December 31, 2003.

### *Stock-based compensation*

Effective January 1, 2004, the Corporation adopted a new accounting standard on stock based compensation as presented in the CICA Handbook section 3870. The standard requires the recognition of stock based compensation expense for all employees and non-employees using the fair value method.

In 2003, options were issued at current market value and had no intrinsic value, therefore no compensation expense was recorded when the options were granted. Consideration paid by employees and directors on the exercise of stock options was credited to share capital.

The amended standard requires all stock based compensation awards to be expensed. The Corporation adopted the new accounting policy in 2004 on a retroactive basis with no restatement of prior periods as the amount was not material. The Black-Scholes option pricing model has been used to calculate the fair value of the stock options granted. For the first quarter of 2004, the Corporation recognized a compensation expense of \$87,720.

### *Asset retirement obligation*

Effective January 1, 2004, the Corporation adopted, on a retroactive basis with restatement, the new standard for asset retirement obligations as set out in the CICA Handbook section 3110.

The new standard requires the recognition and measurement of liabilities related to the legal obligation to abandon and reclaim property, plant and equipment upon acquisition, construction, development and/or normal use of the asset. The initial liability must be measured at fair value and subsequently adjusted for the accretion of discount and changes in the fair value. The asset retirement cost is capitalized as part of property and equipment and depleted into earnings over time.

A credit adjusted risk free rate of 5% and an inflation rate of 1.5% were used to calculate the fair value of the asset retirement obligation.

The adoption of this standard increased the asset retirement liability by \$644,357 at December 31, 2003 and added a gross asset retirement cost of \$660,271 to property, plant and equipment which was reduced by depletion on the increased asset retirement cost for 2003 of \$8,796. The comparative balance sheet for 2003 has been restated. For the first quarter of 2004, \$133,533 of additional asset retirement liability and \$21,215 in accretion expense were recognized. The accretion expense was recorded in depletion, depreciation and accretion expense on the Consolidated Statements of Operations and Deficit.

### *Full cost accounting guideline*

Effective January 1, 2004, the Corporation has adopted the new guidelines for full cost accounting as per CICA accounting guideline 16. Under the new guideline, future net revenues from total proven reserves used in the ceiling test calculation are estimated using expected future product prices and costs (escalating), whereas prior to the adoption, constant pricing was used. Future general and administrative, and financing charges, associated with the future net revenues are no longer deducted in arriving at the ceiling value. Where a ceiling test failure occurs, probable reserve values may now be included in determining the impairment amount which is based on the fair value of the associated reserves.

The adoption of the new guideline resulted in no change to net income, fixed assets or other reported amounts in the December 31, 2003 financial statements.

### *Transportation*

Clean oil trucking charges and transportation charges related to the delivery of natural gas are deducted from gross prices received for these products.

## **2. AVAILABLE CREDIT FACILITY**

The Corporation has an extendible revolving credit facility in place with a Canadian chartered bank. The amount of the facility is \$10,000,000 Cdn with interest at the bank's prime rate plus 0.25%. In addition, the Corporation has in place a \$2.5 million US swap facility. Collateral for the facilities consists of a demand debenture for \$50,000,000 secured by a first floating charge over all of the property and equipment of the Corporation. At March 31, 2004, no amount was drawn against the credit facility.

On April 29, 2004, the extendible revolving credit facility was increased to \$15,000,000 Cdn with interest charged at the bank's prime rate. The collateral for the facility was increased to a demand debenture for \$75,000,000 secured by a first floating charge over all of the property and equipment of the Corporation.

### 3. GOODWILL

Goodwill, which represents the excess of purchase price over fair value of net assets acquired, is not amortized and is assessed by the Corporation for impairment at least annually. Impairment is assessed based on a comparison of the fair value of the net assets acquired to the carrying value of the net assets, including goodwill. Any excess of carrying value over and above fair value is the impairment amount, and is charged to earnings in the period identified.

### 4. ACQUISITION OF VENTURE ENERGY INC.

On January 15, 2004, the Corporation acquired all of the issued and outstanding shares of Venture Energy Inc. ("Venture"). The Venture acquisition was accounted for by the purchase method and shares were acquired for an aggregate of \$17,770,311 by the issuance of 5,923,437 Class A shares of Galleon at a deemed value of \$3.00 per share plus the assumption of \$1.785 million of net debt. Prior to the acquisition, Venture owned 500,000 of the Class A shares of the Corporation. At the time of the acquisition, the fair value of the 500,000 Class A shares was \$1,500,000. An adjustment of \$1,375,000 being the difference between cost and fair value was made to retained earnings.

### *Calculation of Purchase Price*

Fair value of shares issued	\$	17,770,311
Transaction costs		34,236
	\$	17,804,547

### *Allocation of Purchase Price*

Goodwill	\$	2,534,267
Property and equipment		16,500,000
Fair value of Galleon class A shares		1,500,000
Bank debt		(1,784,746)
Asset retirement obligation		(459,113)
Future income tax		(485,861)
	\$	17,804,547

## 5. PROPERTY AND EQUIPMENT

On January 30, 2004, the Corporation completed the purchase of interests in certain oil and gas properties and a gas plant for cash of \$2.4 million net of adjustments.

## 6. SHARE CAPITAL

### *Authorized*

Unlimited number of preferred shares with no par value

Unlimited number of voting Class A shares with no par value

Unlimited number of voting Class B shares with no par value, convertible (at the option of the Corporation) at any time after December 31, 2006 and before December 31, 2008, into Class A shares. The fraction is calculated by dividing \$10 by the greater of \$1 and the then current market price of Class A shares. If conversion has not occurred by the close of business on December 31, 2008, the Class B shares become convertible (at the option of the shareholder) into Class A shares on the same basis. Effective February 1, 2009, all remaining Class B shares will be deemed to be converted to Class A shares.

<i>Issued and outstanding</i>	<i>Number of Shares</i>	<i>Amount \$</i>
<b>Class A shares</b>		
Balance at December 31, 2003	8,300,001	\$ 1,633,985
Issued on acquisition of Venture (note 4)	5,923,437	17,770,311
Repurchase of shares held by Venture (note 4)	(500,000)	(125,000)
Issue of Special Warrants for cash (a)	3,000,000	12,000,000
Share issue costs, net of tax of \$292,734 (a)	–	(548,115)
Issued for cash on exercise of stock options (c)	30,000	10,500
<b>Balance at March 31, 2004</b>	<b>16,753,438</b>	<b>\$ 30,741,681</b>
<b>Class B shares</b>		
Balance at December 31, 2003 and March 31, 2004	922,500	5,367,464
<b>Total share capital - March 31, 2004</b>	<b>17,675,938</b>	<b>\$ 36,109,145</b>

- a) On February 10, 2004, the Corporation issued 3,000,000 Special Warrants at \$4.00 each for gross proceeds of \$12 million. Each Special Warrant entitled the holder to receive one Class A share without payment of any additional consideration, subject to adjustment in certain events. The resale of the Special Warrants and the Class A shares issuable on exercise thereof was initially subject to a hold period expiring February 11, 2005. On March 30, 2004 certain amendments to securities legislation came into effect which changed the hold period to June 11, 2004. Also as a result of the amendment, the Special Warrants were deemed to be exercised into class A shares.
- b) The Corporation renounced \$10,250,000 of expenditures to the shareholders in 2003, and under the look back provision governing flow-through shares is required to expend the amount in 2004. At March 31, 2004 \$8 million in eligible costs had been expended leaving a balance of \$2.25 million to be expended before December 31, 2004.
- c) As described in note 1, the Corporation has adopted the amendments to the stock based compensation plan for 2004. Options granted vest 1/3 immediately upon grant, 1/3 on the first anniversary date of the grant and 1/3 on the second anniversary date of the grant.

During the first quarter of 2004, the Corporation granted an additional 590,000 options at a weighted average price of \$4.35 per share. Under the amended stock based compensation standard, an expense of \$87,720 was recognized. The fair value of options granted during the quarter was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following assumptions: risk-free interest rate of 3%; dividend yield of 0%; volatility factor of the market price of the Corporation's common shares of 46%; and, an average expected life of the options of three years.

	<i>Number of Shares</i>	<i>Weighted Average Exercise Price \$</i>
Outstanding, December 31, 2003	900,000	0.35
Granted	590,000	4.35
Exercised	(30,000)	(0.35)
Outstanding, March 31, 2004	1,460,000	1.97

## 7. FUTURE INCOME TAXES

A recovery to the Corporation's future income tax of \$37,394 was recognized during the first quarter of 2004. This was primarily due to the Alberta provincial tax rate reduction announced in the quarter which reduces statutory corporate income tax rates by 1%.

## 8. FINANCIAL INSTRUMENTS

Galleon has a crude oil fixed price commodity hedge in place for 100 barrels of oil per day commencing on December 1, 2003 for a 6 month period. The fixed price for the hedge is \$38.46 WTI Cdn.

The Corporation has another crude oil fixed price commodity hedge in place for 100 barrels of oil per day commencing on January 1, 2004 for a 12 month period. The fixed price for the hedge is \$40.80 WTI Cdn.

At March 31, 2004, the unrealized cost of the two commodity hedges on a mark to market basis was \$142,642.

# C O R P O R A T E   I N F O R M A T I O N

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## *Board of Directors*

John A. Brussa <sup>2</sup>

Glenn R. Carley, Chairman <sup>2</sup>

Fred C. Coles <sup>1, 2</sup>

William L. Cooke <sup>1</sup>

Brad R. Munro <sup>1</sup>

Steve Sugianto

<sup>1</sup> *Member of the Audit and Reserves Committee*

<sup>2</sup> *Member of the Compensation Committee*

## *Officers*

Glenn R. Carley  
Chairman and Chief Executive Officer

Steve Sugianto  
President and Chief Operating Officer

Shivon M. Crabtree  
VP Finance & Chief Financial Officer

C. Steve Cohen  
Secretary

## *Auditor*

Ernst & Young LLP  
Calgary, Alberta

## *Bank*

The Canadian Imperial Bank of Commerce  
Calgary, Alberta

## *Legal Counsel*

Burnet, Duckworth & Palmer LLP  
Calgary, Alberta

## *Evaluation Engineers*

Sproule Associates Limited  
Calgary, Alberta

## *Registrar and Transfer Agent*

Valliant Trust Company  
Calgary, Alberta

## *Stock Exchange Listing*

TSX Venture Exchange,  
Trading Symbols GO.A and GO.B



GALLEON  
ENERGY INC.

GO.A