Valkyries Petroleum Corp.

Annual Report

December 31, 2005

VALKYRIES PETROLEUM CORP.

Letter to Shareholders

To our shareholders:

The three key elements of a successful oil company are reserves, production and cash flow growth and your company delivered all three in 2005. Exploration and development drilling success and new acquisitions in 2005 provided the framework for another year of tremendous growth for Valkyries. During 2005, proven and probable oil reserves grew 71% to over 22 million barrels of oil, net production rose 46% to over 3,900 bopd and the Company generated $3.0 million of cash flow from operations - achievements we are very proud of, having started at ground zero just a few short years ago.

The Company continues to focus its efforts primarily in Russia and neighboring countries as the region offers Valkyries enormous possibilities for growth. As such, late in the fiscal year, the Company took advantage of an opportunity to sell its U.S. properties to Pearl Exploration and Production Ltd. (formerly Newmex Minerals Inc.). The transaction provided Valkyries an upfront cash payment of U.S. $4.6 million and cleared the way for the Company to focus on developing its core assets in Russia and yet retain some of the upside potential from the U.S. properties through deferred bonus payments.

At the Company's offshore Caspian exploration project, the Lagansky Block, preparations are underway for drilling the first exploration well on the project. New 2D seismic has been acquired which confirms several drillable prospects and the Company is currently converting a set of shallow draft barges for the drilling operations. Valkyries expects to spud its first well at the end of the second quarter of 2006, targeting the large Morskoye prospect. The prospect is located in approximately 2 meters of water offshore. Drilling will target three main Cretaceous and Jurassic reservoirs with depths ranging from 800 to 1600 meters. The Lagansky Block encompasses over 2,000 square kilometers and is located immediately adjacent to and directly on trend with a new Lukoil discovery which flowed approximately 6,240 bopd of ultra-light (44o API), water-free, low-sulfur oil. The Company holds a 70% interest in the Lagansky Block.

In Russia, at the Company's ZAO Pechoraneftegas ("PNG") project in the Komi Republic, an aggressive development program is ongoing and progressing very well. During the course of 2005, 8 development wells were successfully completed as producers, including 3 horizontal/high angle wells resulting in gross field production reaching an all time high production capacity of 6,957 bopd. Processing and interpretation of newly acquired 90 square kilometers of 3D seismic data was completed mid-year and has assisted in the building of an enhanced geological model to refine the well selection process for further developmental drilling. The development program will ramp up to a 4 rig program and it is anticipated that 17 new wells will be brought on stream in 2006. The Company has a 50% interest in the PNG project.

At the onshore Caspian Field project in the Kalmykia Republic, the Company carried out a successful workover program on several existing wells on the project during the year which boosted production rates significantly. New development drilling got underway in the third quarter with the spudding of the first horizontal well on the project. This well was completed as a producer and is currently producing in excess of 500 bopd bringing total field production to over 1,180 bopd, a substantial increase from the 435 bopd rate when the field was taken over less than a year ago. Drilling of a second horizontal well was recently completed and is presently being placed on production. During the course of the year, the Company upgraded production facilities and constructed additional infrastructure including a permanent camp. Extensive development work is scheduled for 2006 included re-entry and workover of additional existing wells and new horizontal drilling. The Company has a 51% interest in the Caspian Field project.

The Company's newest acquisition in Russia is the Ashirovskoye Block located in the heart of the Orenburg producing region, which contains the super-giant Orenburg and Karachaganak gas and oil fields. The Company's project contains the Ashirovskoye field which was discovered in 1949 but never put on sustained production. The Company has recently drilled a new well on the field which is currently undergoing production testing. During testing, on a 10 mm choke (4/10 of an inch), the well flowed at a

rate of 907 BOPD with a flowing wellhead pressure of 200 psi. The oil recovered was 31° API gravity with no formation water. An early production system for this well is presently being fabricated. A second well in the eastern part of the structure has commenced and further development drilling is planned for 2006. Valkyries holds a 50% interest in the Ashirovskoye project.

The Company also added to its management team during the year through the appointment of David LeClair as General Manager, Russia and Chief Operating Officer. Mr. LeClair brings an extensive background and proven track record in international petroleum development and project execution with years of operating experience in Russia, Germany, the Middle East and Latin America. During the second half of 2005, the Moscow office was opened and currently has a staff of 27, including an Expatriate Operations and Exploration Manager.

During the year, the Company raised Cdn $84 million by way of equity private placement and subsequent to year end raised Cdn $28.75 million for use towards funding and development of its projects in Russia.

The year 2005 was an exciting one for Valkyries with strong growth and new opportunities. The Company focused on its mission of aggressively pursuing reserves, production and cash flow growth with a primary focus in Russia - and the Company achieved these objectives. We look forward to continued success as exploration and development drilling and new acquisitions in 2005 have set the stage for another year ahead of tremendous growth for Valkyries Petroleum Corp.

We would like to thank you, our shareholders, for your investment and continued support of the Company as it grows as an independent oil company and establishes itself as a significant player in the oil and gas industry.

On Behalf of the Board

"Keith C. Hill"
President and CEO
April 26, 2006

MANAGEMENT'S RESPONSIBILITY
FOR FINANCIAL STATEMENTS

The accompanying consolidated financial statements of Valkyries Petroleum Corp. and its subsidiaries and all information in the annual report are the responsibility of management and have been approved by the Board of Directors. The financial statements include some amounts that are based on management's best estimates, which have been made using careful judgment.

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. Financial and operating data elsewhere in the annual report are consistent with the information contained in the financial statements.

In fulfilling their responsibilities, management of the Company and its subsidiaries have developed and continue to maintain systems of internal accounting controls that are appropriate in the circumstances. Although no cost effective system of internal controls will prevent or detect all errors and irregularities, these systems are designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use, transactions are properly recorded and the financial records are reliable for preparing the financial statements.

The Board of Directors carries out its responsibility for the financial statements in this annual report principally through its audit committee, comprising management and outside directors. The audit committee reviews the Company's annual consolidated financial statements and recommends their approval to the Board of Directors. The Company's auditors have full access to the audit committee, with or without management being present.

These financial statements have been audited by PriceWaterhouseCoopers LLP, Chartered Accountants, and their report follows.

(signed) *"Keith C. Hill"*
President

(signed*) "Ian Gibbs"*
Chief Financial Officer

Vancouver, British Columbia
April 26, 2006

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Chartered Accountants
111 5th Avenue SW, Suite 3100
Calgary, Alberta
Canada T2P 5L3
Telephone +1 (403) 509 7500
Facsimile +1 (403) 781 1825

April 26, 2006

Auditors' Report

To the Shareholders of
Valkyries Petroleum Corp.

We have audited the consolidated balance sheet of **Valkyries Petroleum Corp.** as at December 31, 2005 and the consolidated statements of loss and deficit and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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, 2005 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The financial statements as at December 31, 2004 and for the year then ended were audited by other auditors who expressed an opinion without reservation on these financial statements in their report dated April 22, 2005.

PricewaterhouseCoopers LLP

Chartered Accountants
Calgary, Alberta

PricewaterhouseCoopers refers to the Canadian firm of PricewaterhouseCoopers LLP and the other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

VALKYRIES PETROLEUM CORP.
CONSOLIDATED BALANCE SHEET
(in Thousands of Canadian Dollars)

	December 31, 2005	December 31, 2004 (restated note 7)
ASSETS		
Current assets		
Cash and cash equivalents	$ 22,363	$ 4,724
Accounts receivable	7,346	3,779
Inventories	2,089	737
Prepaid expenses	2,509	1,038
Assets of discontinued operations (Note 7)	5,290	1,166
	39,597	11,444
Restricted cash (Note 5)	-	393
Property, plant and equipment (Note 6)	143,417	58,641
Assets of discontinued operations (Note 7)	-	3,993
Deferred financing costs (Note 8(a))	1,307	1,718
Other long term assets (Note 17(b))	2,550	120
	$ 186,871	$ 76,309
LIABILITIES		
Current liabilities		
Accounts payable and other accrued liabilities	$ 8,538	$ 4,667
Due to related parties (Note 14)	16	20
Interest payable	80	215
Loan payable - current portion (Note 8)	5,247	7,222
Current portion of deferred income	168	232
Liabilities of discontinued operations (Note 7)	3	7
	14,052	12,363
Long-term liabilities		
Loan payable (Note 8)	24,484	27,081
Asset retirement obligation (Note 9)	1,317	1,069
Deferred income (Note 2(o))	1,519	2,092
Future income tax liabilities (Note 12)	25,492	9,263
	66,864	51,868
SHAREHOLDERS' EQUITY		
Share capital (Note 10)	171,187	65,593
Contributed surplus (Note 11)	5,132	741
Deficit	(53,840)	(40,823)
Cumulative translation adjustments (Note 2(d))	(2,472)	(1,070)
	120,007	24,441
	$ 186,871	$ 76,309

Subsequent Events (Note 17)

Approved by the Board:

(signed) *"Keith C. Hill"*
Director

(signed) *"William A. Rand"*
Director

VALKYRIES PETROLEUM CORP.
CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT
(in Thousands of Canadian Dollars)

	Year ended December 31, 2005	2004 (restated note 7)
Oil and gas revenue	$ 49,349	$ 11,077
Expenses		
Production costs	6,201	1,147
Transportation expenses	2,195	420
Depletion, depreciation and amortization	10,392	2,434
General and administrative expense	6,792	2,415
Stock-based compensation	908	741
Accretion of asset retirement obligation (Note 9)	149	82
Taxes other than income taxes	23,806	4,823
	50,443	12,062
Other (income) expenses		
Interest income	(362)	(74)
Interest and financing costs (Note 8)		
Loan payable	2,996	1,056
Interim financing	9,419	554
Foreign exchange (gain)	(188)	(381)
	11,865	1,155
Loss from continuing operations before income taxes	12,959	2,140
Current income tax expense (Note 12)	3,342	814
Future income tax recovery (Note 12)	(1,623)	(204)
	1,719	610
Net loss from continuing operations	14,678	2,750
Net (earnings) from discontinued operations	(1,661)	(1,922)
Net loss for the period	13,017	828
Deficit, beginning of the period	40,823	39,995
Deficit, end of the period	53,840	40,823
Basic and diluted (earnings) loss per share		
Continuing operations	$ 0.36	$ 0.13
Discontinued operations	(0.04)	(0.10)
	$ 0.32	$ 0.03
Weighted average number of shares outstanding (000's)	40,945	22,408

VALKYRIES PETROLEUM CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in Thousands of Canadian Dollars)

	Year ended December 31, 2005	Year ended December 31, 2004 restated note 7
Cash flows from (for) operating activities		
Net loss from continuing operations	$ (14,678)	$ (2,750)
Add non-cash items		
Depletion, depreciation and amortization	10,392	2,434
Interest and financing costs (Note 14)	9,075	548
Amortization of deferred financing costs	368	126
Accretion of asset retirement obligation	149	82
Foreign exchange	(952)	30
Future income tax recovery	(1,623)	(204)
Stock-based compensation	908	741
Other non-cash items	(650)	53
	2,990	1,060
Changes in non-cash working capital items		
Accounts receivable and prepaid expenses	(3,118)	(1,454)
Inventories	197	58
Accounts payable and other current liabilities	3,615	2,926
	3,684	2,590
Net earnings (loss) from discontinued operations	1,661	1,922
Non-cash items included in discontinued operations	1,149	1,298
Change in discontinued working capital	(382)	(155)
	6,112	5,655
Cash flows from (for) financing activities		
Common shares issued, net of issued costs	82,258	21,513
Bridge loan proceeds	34,710	-
Bridge loan repayment	(33,792)	-
Proceeds from loan payable	30,702	38,931
Repayment of loan payable	(43,050)	(1,779)
Deferred financing costs	-	(1,939)
Due to related parties	(4)	14
	70,824	56,740
Cash flows from (for) investing activities		
Business acquisition, net of cash acquired	(38,977)	(54,940)
Oil and gas interests	(17,522)	(1,757)
Other long term receivable	(2,430)	(44)
Restricted cash	393	(393)
Other	-	(38)
Discontinued operations	(901)	(2,480)
	(59,437)	(59,651)
Effect of exchange rate changes on cash	140	(90)
Increase in cash	17,639	2,653
Cash, beginning of the period	4,724	2,071
Cash, end of the period	$ 22,363	$ 4,724

Supplementary cash flow information (Note 15)

1. DESCRIPTION OF BUSINESS AND CONTINUING OF OPERATIONS

Valkyries Petroleum Corp. and its subsidiary companies and joint ventures (collectively, "Valkyries" or the "Company") is an international oil and gas company principally engaged in the acquisition, exploration and development of oil and gas properties in Russia.

These consolidated financial statements have been prepared on the basis that the Company will continue as a going concern and thereby realize its assets and discharge its liabilities in the normal course of business. The Company incurred losses of $14.7 million and $2.8 million, respectively, from continuing operations during the years ended December 31, 2005 and 2004. Consequently, the Company's ability to continue as a going concern is dependent on the Company's ability to obtain additional financing (see Subsequent Events Note 17 (a)), if, as and when required, and, ultimately, the attainment of profitable operations.

These consolidated financial statements do not give effect to adjustments that would be necessary to the carrying values and classifications of assets and liabilities should the Company be unable to continue as a going concern.

2. SIGNIFICANT ACCOUNTING POLICIES

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

The significant accounting policies used in these consolidated financial statements are as follows:

(a) Basis of consolidation

The consolidated financial statement include the accounts of Valkyries and its wholly and partially owned subsidiaries and the company's proportionate share of the assets, liabilities, revenues, expenses and cash flows of its joint-ventures.

All significant inter-company balances and transactions have been eliminated upon consolidation.

(b) Joint ventures

As more fully explained in Note 4, certain of Valkyries activities are conducted jointly with others through joint ventures. Accordingly, these consolidated financial statements reflect Valkyries' proportionate interest in such activities.

(c) Use of estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates are subject to measurement uncertainty. Actual results could differ from and affect the results reported in these consolidated financial statements.

With respect to the accounting for oil and gas properties, amounts recorded for depletion, asset retirement obligations and amounts used for impairment test calculations are based on estimates of oil and natural gas reserves and future cash flows, including development costs.

By their nature, these estimates of reserves and the related future cash flows are subject to measurement uncertainty, and the impact on the consolidated financial statements of future periods could be material.

The determination of the provision for income taxes is an inherently complex process requiring management to interpret continually changing regulations and to make certain judgments. While income tax filings are subject to audits and reassessments, management believes adequate provision has been made for all income tax obligations. However, changes in the interpretations or judgments made may result in an increase or decrease in the Corporation's income tax provisions, and future income tax assets and liabilities, in the future.

(d) Foreign currency translation

Monetary items denominated in a foreign currency are translated into Canadian dollars at the exchange rate prevailing on the balance sheet date. Exchange gains and losses arising from translation are included in operations.

For the purposes of foreign currency translation of Valkyries' United States operation and the operations of Valkyries' newly acquired Russian subsidiaries, CJSC Kalmeastern ("Kalmeastern") and LLC PetroResurs ("PetroResurs"), are classified as integrated. Integrated foreign operations are translated into Canadian dollars as follows: monetary assets and liabilities are translated at the exchange rate prevailing on the balance sheet date; non-monetary assets and liabilities, revenues and expenses are translated at exchange rates prevailing on the dates of transactions. Exchange gains and losses arising from translation are included in operations.

The Company's remaining Russian operations are considered self-sustaining. Self-sustaining foreign operations are translated into Canadian dollars as follows: assets and liabilities are translated into the Canadian dollars at the rate of exchange in effect at the balance sheet date. Revenue and expense items (including depreciation and amortization) are translated into Canadian dollars at the rate of exchange in effect on the dates on which such items are recognized in income during the period. Exchange gains and losses arising from translation are included in cumulative translation adjustments, a separate component of shareholders' equity.

(e) Cash and cash equivalents

Cash and cash equivalents comprise cash in banks, less outstanding cheques, and short – term investments, maturing within 90 days of the date of acquisition.

(f) Oil and gas interests

The Company follows the full cost method of accounting for its petroleum and natural gas operations whereby all costs relating to the exploration for and development of petroleum and natural gas reserves are capitalized in country by country cost centers and charged against income, as set out below. Such costs include land acquisition, drilling of productive and non-productive wells, geological and geophysical expenses, production facilities and corporate expenses directly related to acquisition, exploration and development activities and do not include any costs related to production or general overhead expenses. These costs along with estimated future capital costs that are based on current costs and that are incurred in developing proved reserves are depleted and depreciated on a unit of production basis using estimated proved petroleum and natural gas reserves. For purposes of this calculation, petroleum and natural gas reserves are converted to a common unit of measurement on the basis of their relative energy content where six thousand cubic feet of

gas equates to one barrel of oil. Costs of acquiring and evaluating unproved properties are excluded from costs subject to depletion and depreciation until it is determined whether proved reserves are attributable to the properties or impairment occurs. Unproved properties are evaluated for impairment on at least an annual basis.

Gains or losses on the disposition of petroleum and natural gas properties are recognized only when crediting the proceeds to capitalized costs would result in a change of 20 percent or more in the depletion rate.

The net amount at which petroleum and natural gas properties are carried is subject to a cost recovery test (the "ceiling test"). The ceiling test is a two-stage process which is to be performed at least annually. The first stage of the test is a recovery test which compares the undiscounted estimated future cash flow from proved reserves at forecast prices plus the cost less impairment of unproved properties to the net book value of the petroleum and natural gas assets to determine if the assets are impaired. An impairment loss exists when the net book value of the petroleum and natural gas assets exceeds such undiscounted cash flow. The second stage determines the amount of the impairment loss to be recorded. The impairment is measured as the amount by which the net book value of the petroleum and natural gas assets exceeds the future discounted cash flow from proved plus probable reserves at forecast prices. Any impairment is recorded as additional depletion and depreciation.

(g) Equipment

Equipment is recorded at cost. Amortization is provided on a declining balance basis over the expected life of the computer equipment at a rate of 30% per annum.

(h) Asset Retirement Obligations

The Company recognizes a liability at discounted fair value for the future abandonment and reclamation costs associated with the petroleum and natural gas properties. The fair value of the liability is capitalized as part of the cost of the related asset and amortized to expense over its useful life. The liability accretes until the date of expected settlement of the retirement obligations. The related accretion expense is recognized in the statement of operations. The provision will be revised for the effect of any changes to timing related to cash flow or undiscounted abandonment costs. Actual expenditures incurred for the purpose of site reclamation are charged to the asset retirement obligations to the extent that the liability existed on the balance sheet. Differences between the actual costs incurred and the fair value of the liability recorded are recognized in income in the period the actual costs are incurred. Reclamation costs have been estimated based on the Company's interpretation of regulatory requirements.

(i) Inventories

Crude oil inventory consists of the production cost of unsold oil and is carried at the lower of cost and net realizable value.

Materials and supplies are valued at the lower of cost and net realizable value. Cost is determined on the first-in, first-out basis.

(j) Revenue recognition

Revenue from the sale of oil and gas is recognized when: (i) persuasive evidence of an arrangement exists; (ii) the risks and rewards of ownership pass to the purchaser including

delivery of the products; (iii) the selling price is fixed or determinable, and (iv) collectibility is reasonably assured.

(k) Income taxes

The Company accounts for income taxes using the asset and liability method. Under this method, future income tax assets and liabilities are determined based on differences between the financial statement carrying values of assets and liabilities and their respective income tax bases (temporary differences), and losses carried forward. Future income tax assets and liabilities are measured using the tax rates expected to be in effect when the temporary differences are likely to reverse. The effect on future income tax assets and liabilities of a change in tax rates is included in operations in the period in which the change is substantively enacted. The amount of future income tax assets recognized is limited to the amount of the benefit that is more likely than not to be realized.

(l) Loss per share

Basic loss per share is calculated using the weighted average number of common shares outstanding during the year. For calculating the diluted loss per share, the treasury stock method is used for the purpose of determining the common share equivalents with respect to outstanding stock options and warrants to be included in the weighted average number of common shares outstanding, if dilutive.

(m) Stock-based compensation

The Company's Option Plan provides for granting stock options to directors, officers and employees. The Company uses the fair value method for valuing stock option grants. Compensation costs attributed to share options granted are measured at fair value at the grant date and expensed over the expected vesting time-frame with a corresponding increase to contributed surplus. Upon exercise of the stock options, consideration paid by the option holder together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

(n) Financial instruments

Canadian accounting standards require the disclosure of the fair value of financial assets and liabilities. The fair value of the company's current financial assets and liabilities are considered to approximate book value due to their current nature, as does the loans payable as the facility bears interest at variable rates of interest.

(o) Deferred income

Deferred income relates to Mineral Replacement tax credits received in Russia. Deferred income is recognized in the statement of operations at a rate consistent with the rate of depletion calculated using the unit of production method.

(p) Comparative figures

Certain of the comparative figures have been reclassified to conform to the current year's presentation.

3. ACQUISITIONS

LLC PetroResurs

On July 22, 2005, Valkyries completed the acquisition of 70% of the shares of Mintley (Caspian) Limited ("Mintley Caspian"), a Cyprus company which owns 100% of the issued and outstanding common shares of LLC PetroResurs, a Russian company. The results of operations have been included in the Consolidated Financial Statements since the date of acquisition.

In consideration for this acquisition, Valkyries paid the vendor, Mintley Kalmykia Limited ("Mintley Kalmykia"), US$28.5 million. An additional US$12.5 million will be due to Mintley Kalmykia in the event of a commercial discovery on the Lagansky Block and a further US$10 million bonus will be due to Mintley Kalmykia upon the award of a development license for any resulting discovery. The contingent consideration has not been recognized as part of the acquisition price as the likelihood of a commercial discovery on the Lagansky Block and award of a development license cannot currently be determined without reasonable doubt.

$ thousands	
Cash consideration (US$ 28.5 million)	34,727
Transaction costs	428
Total consideration	35,155

The acquisition was accounted for by the purchase method of accounting. The allocation of fair value to the assets acquired and liabilities assumed was:

$ thousands	
Property, plant and equipment	46,227
Current assets	253
Total assets acquired	46,480
Current liabilites	(265)
Other non-current liabilites	-
Future income taxes	(11,060)
Total liabilities assumed	(11,325)
Net assets acquired	35,155

CJSC Kalmeastern

On May 19, 2005, Valkyries completed the acquisition of 100% of the issued and outstanding common shares of Mintley Cyprus Limited ("Mintley Cyprus"), a Cyprus company which holds a 51% interest in CJSC Kalmeastern ("Kalmeastern"), a Russian oil company, registered in the semi-autonomous Republic of Kalmykia. The results of operations have been included in the Consolidated Financial Statements since the date of acquisition.

In consideration for this acquisition, Valkyries paid Mintley Investments Limited US$1.0 million and issued 4 million common shares, valued at $13.9 million. An additional 1 million common shares are due to be issued to Mintley Investments Limited upon the Caspian Field sustaining a gross production rate of 2,500 barrels per day ("bbl/d"), for a period of 30 consecutive days. Valkyries' conditional obligation to issue the additional 1 million common shares, valued at $3.5 million, has been recognized as a liability in the September 30, 2005 balance sheet. A $3.49 per share value was assigned to the shares issued or issuable in association with this transaction, based on the average closing price of Valkyries' shares on the three days prior to and three days following the announcement of the acquisition.

$ thousands	
Cash consideration (US$ 1 million)	1,251
Valkyries common shares issued (4 million)	13,943
Valkyries common shares to be issued (1 million)	3,486
Transaction costs	399
Total consideration	19,079

The acquisition was accounted for by the purchase method of accounting. The allocation of fair value to the assets acquired and liabilities assumed was:

$ thousands	
Property, plant and equipment	31,480
Current assets	2,938
Total assets acquired	34,418
Current liabilites	(283)
Long term liabilites	(8,525)
Future income taxes	(6,531)
Total liabilities assumed	(15,339)
Net assets acquired	19,079

Ulan Khol Cyprus Limited

On December 23, 2005, Valkyries completed the acquisition of 100% of the issued and outstanding common shares of Ulan Khol Cyprus Limited ("Ulan Khol"), a Cyprus company which holds a 50% interest in Limited Liability Company Oil Service ("Oil Service"). Oil Service, a Russian company, registered in the semi-autonomous Republic of Kalmykia, owns and operates an oil loading and rail terminal located in Kalmykia. The rail loading terminal is used for the transportation of Kalmeastern oil. In consideration for this acquisition, Valkyries paid the vendor, Oscar Enterprises Inc., $2.2 million.

The acquisition has been accounted for using the purchase method. The allocations of fair values to the assets acquired and liabilities assumed were:

$ thousands	
Property, plant and equipment	2,794
Current assets	13
Total assets acquired	2,807
Current liabilites	(13)
Future income taxes	(622)
Total liabilities assumed	(635)
Net assets acquired	2,172

Ulan Khol's 50% percent shareholding in Oil Service is considered to be a joint venture and has been accounted for using the proportionate consolidation method.

RF Energy Investments Limited

On August 20, 2004 the Company acquired 50% of the issued and outstanding common shares of Samson/Vitol (Cyprus) Limited ("SVC"), a Cyprus company which owns a 100% interest in ZAO Pechoraneftegas ("PNG") in the Komi Republic of Russia. SVC's name was changed to RF Energy

Investments Limited ("RFE") with effect from September 8, 2004. The total acquisition cost, net of cash acquired, consisting of cash consideration and related acquisition costs, was $55.3 million and the results of these operations have been included in the Consolidated Financial Statements since the date of acquisition.

The acquisition has been accounted for using the purchase method. The allocations of fair values to the assets acquired and liabilities assumed were:

($ thousands)	
Property, plant and equipment	63,099
Current assets	7,034
Other non-current assets	1,546
Total assets acquired	71,679
Current liabilities	2,633
Other non-current liabilities	3,516
Future income taxes	10,275
Total liabilities assumed	16,424
Net assets acquired	55,255

4. JOINT VENTURES

The Company's 50% percent equity shareholding with equivalent voting rights in RFE is considered to be a joint venture and has been accounted for using the proportionate consolidation method. Under this method, the Company's balance sheets, statements of income, retained earnings and deficit and cash flow include the Company's share of income, expenses, assets, liabilities and cash flows of this joint venture.

The following amounts are included in the Company's consolidated financial statements as a result of the proportionate consolidation of its joint venture:

($ thousands)	2005
Cash	2,922
Current assets, excluding cash	7,209
Long term assets	59,125
Current liabilities	7,884
Long term liabilities	35,762
Revenue	44,606
Expenses	35,903
Net Income	8,703
Cash flow from operating activities	8,476
Cash flow from financing activities	25,500
Cash flow used in investing activities	(6,278)

During 2004, substantially all of the activities of the Company were carried out through joint ventures. Accordingly, separate disclosure of the proportionate share of assets, liabilities,

revenues, expenses, net income and cash flows of the joint ventures is not presented for the comparative period.

5. RESTRICTED CASH

Restricted cash is dedicated to a debt service reserve account for Valkyries borrowing base revolving loan facility (Note 8(a)). Restricted cash is not available for current purposes.

6. PROPERTY PLANT AND EQUIPMENT

	2005			2004		
($ thousands)	Cost	Accumulated depletion	Net book value	Cost	Accumulated depletion	Net book value
Oil and gas properties	150,944	9,785	141,159	59,128	1,434	57,694
Other facilities and equipment	3,576	1,318	2,258	1,027	80	947
	154,520	11,103	143,417	60,155	1,514	58,641

During 2005, the Company capitalized $784,000 (2004 - $278,000) of general and administrative costs related to exploration and development activities. Capitalized costs of $64.4 million (2004 - $1.2 million) relating to unproven properties have been excluded from the depletion calculation. Estimated future development costs on proven undeveloped reserves of $38.8 million (2004 - $18.9 million) are included in the depletion and depreciation calculation.

Valkyries performs a ceiling test at least annually in accordance with the Canadian Institute of Chartered Accountants' full cost accounting guidelines. No write-down was required for the year ended December 31, 2005 and December 31, 2004 based on expected prices per barrel of oil which are summarized as follows:

	West Texas Intermediate US$/bbl		Brent US$/bbl		Urals Mediterranean US$/bbl	
Years ended December 31	2005	2004	2005	2004	2005	2004
2005	-	45.00	-	42.00	-	37.00
2006	59.00	40.50	56.00	37.50	51.52	32.50
2007	58.00	38.00	55.00	35.00	50.60	30.00
2008	55.00	36.00	52.00	33.00	47.84	28.00
2009	50.00	34.00	47.00	31.00	43.24	26.00
2010	48.00	33.00	45.00	30.00	41.40	25.00
increase to 2023	16%	2%	17%	2%	17%	2%

7. DISCONTINUED OPERATIONS AND ASSETS HELD FOR SALE

During the fourth quarter of 2005, Valkyries reached an agreement with Newmex Minerals Inc. to sell all of its oil and gas assets located in the United States. These assets have been classified as assets held for sale and are reflected as discontinued operations. Certain financial information has been reclassified in the prior period as discontinued operations.

The sale transaction closed subsequent to year-end, on January 24, 2006. Valkyries received proceeds of US$4.6 million plus adjustments for the net cash flow related to the United States oil and gas assets from September 1, 2005 until the closing date. The anticipated pre-tax gain on sale, as at December 31, 2005 is $371,000. Under the terms of the agreement, additional contingent consideration may be due to Valkyries and will be calculated on the second anniversary date of the sale transaction based on a formula of US$1 per barrel of oil equivalent

of additional net proved oil and gas reserves on three agreed upon exploration prospects. This contingent consideration has not been considered in calculating the anticipated pre-tax gain.

Selected financial information for the operations included in discontinued operations and the major classes of assets and liabilities categorized as discontinued operations are separately disclosed in the financial statements.

8. LOANS PAYABLE

($ thousands)	2005	2004
Current portion	5,247	7,222
Long term portion	24,484	27,081
Loan payable	29,731	34,303

(a) On September 1, 2005, ZAO Pechoraneftegas ("PNG"), Valkyries' 50% owned joint venture, entered into a US$51.0 million borrowing base facility agreement with BNP Paribas S.A. ("Paribas"). The funds received by PNG have been remitted to the shareholders. Valkyries used its portion to repay the US$24 million balance that was outstanding under an existing $US30 million borrowing base facility, established with Paribas in 2004.

Included in deferred charges at December 31, 2005 are $1.3 million of bank fees and other costs related to the original facility, which will be amortized over the term of the replacement facility.

The replacement facility bears interest at a rate of LIBOR plus 4.4% per annum and is repayable by September 1, 2010. Quarterly $US3 million repayments commence on July 1, 2006 and continue until the facility is repaid. There are no penalties for early repayment and in certain circumstances PNG is required to accelerate repayment. Valkyries has granted certain security, including a guarantee of 50% of PNG's obligations to Paribas.

	2006	2007	2008	2009	2010
Principal repayments US$ millions	9.0	12.0	12.0	12.0	6.0

(b) On August 8, 2005, the Company entered into a bridge loan agreement with Ferrier Lullin Cie SA bank, which provided a nine month US$50 million bridge loan to Valkyries. Funds drawn on the bridge loan were used to fund the acquisition of LLC PetroResurs. At December 31, 2005, no amount is outstanding under this loan agreement. Lorito Holdings Ltd. ("Lorito"), an investment company wholly owned by a trust whose settler is Mr. Adolf H. Lundin, the former Chairman of Valkyries, provided a guarantee to the bank. As consideration for providing the loan guarantee, Lorito received 2,160,714 common shares of the Company (Note 10(b)) with a total market of 15% of the amount available under the bridge loan facility, such shares having a market value of $4.20 per share at the date of issue.

(c) On May 4, 2004, the Company borrowed $2,739,400 (US$2 million) from the former Chairman of the Company which was non-interest bearing and due on or before November 3, 2004. The loan was repaid on September 7, 2004. As a bonus under the loan agreement, the lender received common shares of the Company (Note 10(b)) with a total market value of 20% of the amount of the loan, such shares having a fair market value of $2.50 per share at April 30, 2004.

9. ASSET RETIREMENT OBLIGATIONS

($ thousands)	2005	2004
Balance, beginning of year	1,069	-
Obligations assumed with business acquisition	-	1,037
Obligations assumed with development activities	206	26
Accretion	149	82
Effect of foreign currency translation	(107)	(76)
Balance, end of year	1,317	1,069

The total future asset retirement obligation was estimated based on the Company'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 cost to be incurred in future periods. Estimated cash flows required to settle future asset retirement obligations are calculated using an annual inflation rate of 12.2% and discounted at 7%. The total undiscounted estimated cash flows required to settle the obligations are $4.8 million with the majority of the costs expected to be incurred between 2013 and 2025.

10. SHARE CAPITAL

(a) Authorized

Unlimited number of common shares with no par value.

(b) Common shares issued

	2005		2004	
	Number of Shares	Amount ($ thousands)	Number of Shares	Amount ($ thousands)
Balance, beginning of year	27,743,700	65,593	17,378,048	43,499
Private placements (c)	17,000,000	84,000	7,700,000	19,250
Business Acquisition (Note 2)	4,000,000	13,942	-	-
Issue of bonus shares (Note 8 (c))	-	-	219,152	548
Finder's fee	100,000	315	-	-
Loan guarantee fee (d)	2,160,714	9,075	-	-
Exercise of warrants	1,335,000	1,602	2,070,000	2,853
Exercise of options	4,000	15	376,500	299
Share issue costs (net of tax effect)		(3,355)		(856)
Balance, end of year	52,343,414	171,187	27,743,700	65,593

(c) Private placements

I. During the year ended December 31, 2004, the Company completed two private placements:

The first private placement consisted of 1 million units of the Company at a price of $2.50 per unit. Each unit comprised one common share of the Company and one-half of one share purchase warrant. Each whole warrant was exercisable over a period of one year at a price of $2.50.

On September 17, 2004 the Company closed a second private placement consisting of 6.7 million share of the Company at a price of $2.50 per share.

II. During the year ended December 31, 2005, the Company completed two private placements:

On February 14, 2005 the Company closed a private placement consisting of 6 million shares of the Company at a price of $3.00 per share.

On September 14, 2005 the Company closed a private placement consisting of 11 million shares of the Company at a price of $6.00 per share.

(d) Loan guarantee fee

On August 17, 2005, the Company issued 2,160,714 common shares, valued at $9.1 million, of the Company to Lorito Holdings Ltd. ("Lorito"), an investment company wholly owned by a trust whose settler is Mr. Adolf H. Lundin. Lorito provided a loan guarantee to Ferrier Lullin Cie SA, who provided the Company with a 9 month US$50 million bridge loan.

(e) Warrants

At December 31, 2004, 1,335,000 warrants were outstanding with an exercise price of $1.20 per warrant. All outstanding warrants were exercised during 2005. No further warrants were issued during 2005.

(f) Stock-based compensation

The continuity of incentive stock options issued and outstanding during 2005 and 2004 is as follows:

	2005		2004	
	Number of shares	Weighted average exercise price	Number of shares	Weighted average exercise price
Outstanding at beginning of year	732,000	$2.80	376,500	$0.76
Granted	426,000	$4.82	832,000	$2.80
Expired	-	-	(100,000)	$2.80
Exercised	(4,000)	$2.80	(376,500)	$0.76
Outstanding at year end	1,154,000	$3.55	732,000	$2.80

The fair value of each option granted is estimated on the date of grant using the Black-Scholes options pricing model with the following weighted average assumptions:

	2005	2004
Fair value of options granted ($/share)	2.13	1.01
Risk-free interest rate (%)	3.14	3.19
Expected life (years)	2.00	2.00
Expected volatility (%)	78.86	67.00
Expected dividend yield	-	-

The following table summarizes information regarding stock options outstanding at December 31, 2005.

Exercise price	Number outstanding	Weighted average remaining contractual life
2.80	703,000	0.40
2.85	45,000	0.73
2.90	45,000	1.10
3.75	40,000	1.33
3.80	150,000	1.40
5.79	20,000	1.86
6.45	35,000	1.67
6.48	12,500	1.98
7.00	103,500	1.73
3.55	1,154,000	0.80

All options are exercisable at December 31, 2005.

11. CONTRIBUTED SURPLUS

($ thousands)	2005	2004
Stock-based compensation	1,646	741
Conditional consideration on business acquisition (Note 3)	3,486	-
Contributed surplus	5,132	741

12. INCOME TAXES

The difference between the income tax provision recorded and the provision obtained by applying the combined federal and provincial statutory rates is as follows:

($ thousands)	2005	2004
Combined basic federal and provincial rates	34.9%	35.6%
Income tax recovery based on statutory income tax rates	(3,938)	(78)
Tax benefits not recognised on current year losses	2,530	970
Tax benefits realized on prior year losses	(579)	(716)
Lower tax rates on foreign operations	1,406	(69)
Change in valuation allowance	2,206	-
Other	94	503
Income tax expense	1,719	610

The Company has Canadian non-capital loss carryforwards of approximately $6.5 million which expires as follows:

	($ thousands)
2006	109
2007	426
2008	653
2009	629
2010	793
2011	1,637
2012	2,236
	6,483

At December 31, 2005, a future tax asset of $2.3 million, net of valuation allowance of $2.3 million has been recorded relating to these losses. An additional future tax asset of $1.2 million, net of valuation allowance of $1.2 million, has been recorded relating to shares issue costs.

At December 31, 2005, a future tax liability of $25.7 million (2004: $9.2 million) relates to the difference in the unclaimed deductible costs of capital assets and the future income tax liability recognized as a result of the consideration paid for corporate acquisitions exceeding the fair value of the identifiable assets acquired. The deferred tax credit recognized as a result of business acquisitions is amortized in proportion to the realization of the oil and gas assets in the acquired businesses.

13. FINANCIAL INSTRUMENTS

The company's financial instruments recognized in the Consolidated Balance Sheets consist of cash, accounts receivable, accounts payable, all other current liabilities and loans payable. The carrying value of these balances approximates their fair market value.

The Company has exposure to risks associated with fluctuations in foreign exchange rates and does not use derivative instruments to reduce its exposure to these risks.

The Company's revenues are derived principally from sales to customers in the oil and gas industry. The concentration of credit risk in a single industry affects the Company's overall exposure to credit risk because customers may be similarly affected by changes in economic and other conditions.

The Company's loan payable bears interest at a variable interest rate. The Company had no interest rate swaps or hedges at December 31, 2005.

14. RELATED PARTY TRANSACTIONS

During 2005, the Company incurred management and administrative service fees of $212,000 (2004: $192,000) with a company owned by the Chairman of the Company which provides investor relations, office premises, secretarial and other services in Vancouver. At December 31, 2005 an amount of $16,000 (2004: $20,000) was due to this company. These transactions, occurring in the normal course of operations, are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

During 2005, the Company reached an agreement to sells all of its U.S. oil and gas assets to Newmex Minerals Inc. ("Newmex"). Newmex is considered a related party of Valkyries. The consideration agreed upon between the parties was based on fair market values.

During 2005, Lorito Holdings Ltd. ("Lorito"), an investment company wholly owned by a trust whose settler is Mr. Adolf H. Lundin, the former Chairman of Valkyries, provided a loan guarantee to secure a bridge loan obtained by the Company (Note 8(b)). Lorito received common shares of the Company (Note 10(d)) with a total market value of 15% of the amount available under the

bridge loan facility, such shares having a market value of $4.20 per share at the date of issue. Interest and financing costs of $9.1 million were recorded during the year related to this guarantee fee.

During 2004, the Company borrowed $2,739,400 (US$2 million) from the former Chairman of the Company. The loan was repaid in 2004. As a bonus under the loan agreement, the lender received common shares of the Company with a total market value of 20% of the loan. Interest expense of $548,000 was recorded during 2004 in relation to this bonus.

15. CASH FLOW INFORMATION

Non-cash financing activity:

($ thousands)	2005	2004
Common shares issued as consideration for business acquisition	13,942	-
Common shares to conditionally be issued as consideration for business acquisition	3,486	-
Common shares issued on settlement of bonus on loan payable	-	548
Common shares issued on settlement of guarantee fee on bridge loan	9,075	

Interest and income taxes paid:

($ thousands)	2005	2004
Interest paid	3,055	709
Income taxes paid	2,781	1,110

16. SEGMENTED INFORMATION

During the fourth quarter of 2005, Valkyries reached an agreement with Newmex Minerals Inc. to sell all of its oil and gas assets located in the United States. Accordingly, Valkyries oil and gas exploration and development activities are now solely conducted in one identifiable geographic location: Russia. Certain financial information related to Valkyries oil and gas assets in the United States has been reclassified in the prior period as discontinued operations.

17. SUBSEQUENT EVENTS

Subsequent to December 31, 2005, Valkyries:

(a) On February 9, 2006, closed a private placement consisting of 2.5 million common shares of the Company at a price of $11.50 per share.

(b) During February 2006, completed the acquisition of a 50% interest in Closed Joint Stock Company Oilgaztet ("OGT"). OGT holds the exploration and production license for the Ashirovskoye Field located in the Orenburg region of Russia. In consideration for this acquisition, Valkyries:

- Paid US$9 million, at closing;
- Issued 120,000 common shares as a finder's fee related to this transaction;

- Agrees to pay an additional US$1 million following the first calendar year in which production from the Ashirovskoye Field exceeds 100,000 metric tons;
- Agrees to pay an additional US$1 per metric ton of oil discovered on newly discovered fields, assuming commercial quantities of oil;
- Agrees to arrange financing for the cost of the development work required under the Ashirovskoye Field exploration and production license;
- At December 31, 2005 Valkyries had advanced $2.3 million to OGT under a loan agreement. There is no security provided for under the loan agreement and interest is charged at a rate of LIBOR plus 5%. An additional $0.2 million of costs associated with the acquisition had been recorded. Both of these items have been recorded in Other long term assets on the Consolidated Balance Sheet.

18. Material Differences Between Canadian GAAP and IFRS

Accounting practices under Canadian GAAP and International Financial Reporting Standards ("IFRS") are, as they affect these financial statements, substantially the same except for the following:

Property and equipment

Under Canadian GAAP, an impairment loss should be recognized when the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition. Unproved properties and major development projects are included in this recoverability test. A cost centre impairment loss should be measured as the amount by which the carrying amount of assets capitalized in a cost centre exceeds the sum of:

the fair value of proved and probable reserves; and
the costs (less any impairment) of unproved properties that have been subject to a separate test for impairment and contain no probable reserves

IFRS requires (i) an impairment to be recognized when the recoverable amount of an asset (cash generating unit) is less than the carrying amount, rather than when there is a significant or prolonged decline in value below the carrying amount; (ii) the impairment loss to be determined as the excess of the carrying amount above the recoverable amount (the higher of fair value less costs to sell and value in use, calculated as the present value of future cash flows from the asset), rather than the excess of the carrying amount above the undiscounted future cash flows of the asset; and (iii) the reversal of an impairment loss when the recoverable amount changes. IFRS 6, which has been adopted effective January 1, 2005, provides limited guidance on the financial reporting for exploration for, and evaluation of, mining resources. Upon adoption of IFRS 6, continued application of an entity's existing policy is permitted with modified procedures on impairment tests.

In the absence of specific guidance on the applicability of full cost accounting under IFRS, the Company continues to apply the full cost method for IFRS purposes. A ceiling test based on cash generating units did not reveal the need for an impairment charge.

This difference in accounting policy had no impact on these financial statements.

Impairment of long-lived assets

Under Canadian GAAP, a long-lived asset should be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. An impairment loss should be recognized when the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. Under IFRS, the carrying amounts of the Company's assets, other than oil and gas properties, inventories and deferred tax assets, are reviewed at

each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the assets' recoverable amounts are estimated. An impairment loss is recognized when the carrying amount of an asset exceeds its recoverable amount. Impairment losses, if any, are recognized in the income statement. This difference in accounting policy has no impact on these financial statements.

Under Canadian GAAP, the carrying amount of a long-lived asset is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition. This assessment is based on the carrying amount of the asset at the date it is tested for recoverability, whether it is in use or under development. Under IFRS, the recoverable amount of the Company's assets other than oil and gas properties is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflect current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the cash-generating unit to which the asset belongs. This difference in accounting policy has no impact on these financial statements.

In respect of impairment of assets other than oil and gas properties, under Canadian GAAP, an impairment loss is not reversed if the fair value subsequently increases. For IFRS, an impairment loss may be reversed if there has been a change in the estimates used to determine the recoverable value.

An impairment loss, on assets other than oil and gas properties, is only reversed to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized. This difference in accounting policy has no impact on these financial statements.

Asset retirement obligation

In re-measuring an asset retirement obligation for the passage of time, Canadian GAAP requires re-measurement based on the risk-free rate that existed when the liability was initially measured. IFRS requires the use of current market assessed interest rates in each estimate. This difference did not result in a material reconciling item.

Inventory

Under Canadian GAAP, the Company measures its supplies inventory at the lower of historical cost or net replacement cost. Under IFRS, the lower of cost or net realizable value principle would apply. This difference did not result in a material reconciling item.