

# **INTERNATIONAL SOVEREIGN ENERGY CORP**

**Interim Consolidated Financial Statements**

**For the three and six months period**

**ended June 30, 2008**

**(unaudited- See Notice to Reader)**

## **Notice to Reader**

The accompanying unaudited interim financial statements have been prepared by the Company's management and the Company's independent auditors have not performed a review of these financial statements.

**Calgary, Alberta  
August 14, 2008**

# INTERNATIONAL SOVEREIGN ENERGY CORP.

## Interim Consolidated Balance Sheets-(unaudited-See Notice to Reader)

	June 30, 2008	December 31, 2007 (audited)
	\$	\$
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash and cash equivalent	-	247,739
Accounts receivable	3,033,003	1,442,687
Advances to operators	1,154,612	144,749
Prepaid expenses and deposits	139,632	126,173
	<u>4,327,247</u>	<u>1,961,348</u>
Restricted Cash (Note 5,6)	2,801,541	-
Property and equipment (Note 3)	29,463,513	33,482,745
	<u>36,592,301</u>	<u>35,444,093</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Bank Overdraft	13,282	-
Accounts payable and accrued liabilities	4,524,135	2,668,444
Operating loan (Note 4)	3,059,000	2,167,000
	<u>7,596,417</u>	<u>4,835,444</u>
Letter of guarantee (Note 5,6)	2,383,524	-
Future income tax liability	3,612,388	4,458,453
Asset retirement obligation	1,154,301	1,108,664
	<u>14,746,630</u>	<u>10,402,561</u>
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (Note 7)	19,671,569	19,671,569
Contributed surplus	1,268,950	1,174,293
Retained earnings	905,152	4,195,670
	<u>21,845,671</u>	<u>25,041,532</u>
	<u>36,592,301</u>	<u>35,444,093</u>

### APPROVED BY THE BOARD

(Signed) *Eugene N. Hretzay* – Director

(Signed) *John Lokker* – Director

## INTERNATIONAL SOVEREIGN ENERGY CORP.

### Consolidated Statements of Income, Comprehensive Income and Retained Earnings (unaudited-See Notice to Reader) For the six months Ended June 30,

	2008	2007
	\$	\$
	(Unaudited)	
<b>REVENUE</b>		
Petroleum and natural gas revenues	9,367,025	4,638,987
Royalties	(1,896,229)	(703,151)
Other income	48,012	70,899
	<u>7,518,808</u>	<u>4,006,735</u>
<b>EXPENSES</b>		
Operating costs	1,319,863	1,422,666
Transportation costs	212,756	244,855
Depletion, depreciation and accretion (Note 3)	2,952,946	1,431,364
Impairments (Note 3)	4,234,660	-
General and administrative	2,750,621	1,001,713
Interest	87,024	26,818
Stock-based compensation expense	94,656	73,437
Unrealized loss on exchange	2,865	6,619
	<u>11,655,391</u>	<u>4,207,472</u>
EARNINGS BEFORE INCOME TAXES	<u>(4,136,583)</u>	<u>(200,737)</u>
INCOME TAXES		
Future income tax recovery	(846,065)	(126,023)
<b>NET LOSS AND COMPREHENSIVE LOSS</b>	<u>(3,290,518)</u>	<u>(74,714)</u>
<b>RETAINED EARNINGS, BEGINNING OF PERIOD</b>	4,195,670	4,570,233
<b>RETAINED EARNINGS, END OF PERIOD</b>	<u>905,152</u>	<u>4,455,747</u>

## INTERNATIONAL SOVEREIGN ENERGY CORP.

### Consolidated Statements of Income, Comprehensive Income and Retained Earnings

(unaudited-See Notice to Reader)

For the three months ended June 30,

	2008	2007
	\$	\$
	(Unaudited)	
<b>REVENUE</b>		
Petroleum and natural gas revenues	5,389,527	2,121,375
Royalties, net of ARTC	(1,074,952)	(439,153)
Other income	21,060	31,270
	<u>4,335,635</u>	<u>1,713,492</u>
<b>EXPENSES</b>		
Operating costs	643,386	801,760
Transportation costs	115,130	152,507
General and administrative	2,295,426	484,474
Depletion, depreciation and accretion (Note 3)	1,940,551	542,188
Impairments (Note 3)	4,234,660	-
Interest	43,604	24,220
Stock-based compensation expense	47,328	(16,756)
Unrealized loss on exchange	3,923	6,377
	<u>9,324,008</u>	<u>1,994,770</u>
<b>EARNINGS BEFORE INCOME TAXES</b>	<u>(4,988,373)</u>	<u>(281,278)</u>
<b>INCOME TAXES</b>		
Future income tax recovery	(1,208,389)	(166,792)
<b>NET LOSS AND COMPREHENSIVE LOSS</b>	<u>(3,779,982)</u>	<u>(114,486)</u>
<b>RETAINED EARNINGS, BEGINNING OF PERIOD</b>	4,685,134	4,570,233
<b>RETAINED EARNINGS, END OF PERIOD</b>	<u>905,152</u>	<u>4,455,747</u>

## INTERNATIONAL SOVEREIGN ENERGY CORP.

Consolidated Statements of Cash Flows (unaudited-See Notice to Reader)  
For the six month period ended June 30,

	2008	2007
	\$	\$
	(Unaudited)	
<b>CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:</b>		
<b>OPERATING</b>		
Net earnings (Loss)	(3,290,518)	(74,714)
Adjustments for non-cash items		
Depletion, depreciation and accretion	7,187,606	1,431,364
Stock-based compensation expense	94,656	73,437
Future income tax expense	(846,065)	(126,023)
Cash flow from operations	3,145,679	1,304,064
Asset retirement costs incurred	(13,174)	(12,997)
	<b>3,132,505</b>	1,291,067
Changes in non-cash working capital		
Accounts receivable and prepaid expenses and deposits	(1,600,460)	439,246
Accounts payable and accrued liabilities	3,248,971	1,434,539
	<b>4,781,016</b>	3,164,870
<b>FINANCING</b>		
Operating loan	892,000	-
Exercise of Stock options	-	5,200
	<b>892,000</b>	5,200
<b>INVESTING</b>		
Restricted cash, letter of guarantee issued	(418,017)	-
Additions to property and equipment	(3,137,564)	(2,221,853)
Proceeds on sale of property and equipment	28,001	65,000
Changes in non-cash working capital		
Accounts receivable and prepaid expenses and deposits	(1,013,178)	(276,462)
Accounts payable and accrued liabilities	(1,393,279)	(2,713,462)
	<b>(5,934,037)</b>	(5,146,777)
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(261,021)</b>	<b>(1,976,706)</b>
<b>CASH, BEGINNING OF PERIOD</b>	<b>247,739</b>	<b>1,318,231</b>
<b>BANK OVERDRAFT, END OF PERIOD</b>	<b>(13,282)</b>	<b>(658,475)</b>
<b>SUPPLEMENTARY INFORMATION</b>		
Cash interest paid	87,024	26,818

# INTERNATIONAL SOVEREIGN ENERGY CORP.

## Consolidated Statements of Cash Flows (unaudited-See Notice to Reader) For the three months ended June 30,

	2008	2007
	\$	\$
	(Unaudited)	
<b>CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:</b>		
<b>OPERATING</b>		
Net earnings (Loss)	(3,779,982)	(114,486)
Adjustments for non-cash items		
Depletion, depreciation and accretion	6,175,211	542,188
Stock-based compensation expense	47,328	(16,756)
Future income tax expense	(1,208,389)	(166,792)
Cash flow from operations	1,234,168	244,154
Asset retirement costs incurred	(12,298)	(11,485)
	1,221,870	232,669
Changes in non-cash working capital		
Accounts receivable and prepaid expenses and deposits	(747,428)	399,390
Accounts payable and accrued liabilities	1,943,822	1,316,185
	2,418,264	1,948,245
<b>FINANCING</b>		
Operating loan	210,000	-
Exercise of Stock options	-	-
	210,000	-
<b>INVESTING</b>		
Letter of guarantee issued	-	-
Additions to property and equipment	(1,099,304)	(1,329,350)
Changes in non-cash working capital		
Accounts receivable and prepaid expenses and deposits	(153,275)	(352,530)
Accounts payable and accrued liabilities	(657,026)	(391,665)
	(1,927,605)	(2,073,546)
<b>INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>700,659</b>	<b>(125,301)</b>
<b>BANK OVERDRAFT, BEGINNING OF PERIOD</b>	<b>(713,941)</b>	<b>(533,174)</b>
<b>BANK OVERDRAFT, END OF PERIOD</b>	<b>(13,282)</b>	<b>(658,475)</b>
<b>SUPPLEMENTARY INFORMATION</b>		
Cash interest paid	43,604	24,221

# **INTERNATIONAL SOVEREIGN ENERGY CORP.**

## **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2008**

### **1. NATURE OF BUSINESS**

International Sovereign Energy Corp., and its wholly owned subsidiaries, International Sovereign Energy Corp SA, and Bellwether International Inc., (collectively the “Company”), are in the business of exploration for and development of petroleum and gas interests.

### **2. ACCOUNTING POLICIES**

#### **Interim Financial Statements**

The accompanying interim consolidated financial statements of International Sovereign Energy Corp. have been prepared in accordance with the Canadian generally accepted accounting principles, consistent with accounting policies disclosed in the Company’s consolidated financial statements for the years ended December 31, 2007 and 2006. The note disclosure requirements for annual financial statements provide additional disclosures than required for interim financial statements. Accordingly, these financial statements and the notes thereto should be read in conjunction with the Company’s Annual Report for the year ended December 31, 2007.

Accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end and the results of operations for the interim periods shown in this report are not necessarily indicative of results to be expected for the fiscal year. In the opinion of management, the accompanying unaudited interim consolidated financial statements include all adjustments (of a normal recurring nature) necessary to present fairly the financial position of the company as of June 30, 2008.

#### **Segmented Information**

The Company’s core area of operation is in Canada. The Company is currently investigating opportunities in other countries. Total costs spent for the period ending June 30, 2008 on international investigations were \$752,954 (2007 - \$968,204).

#### **Property, plant and equipment**

The Company follows the full cost method of accounting for oil and gas operations as prescribed by the Canadian Institute of Chartered Accountants (“CICA”). All costs related to exploration and development of oil and gas reserves are capitalized into cost centers on a country by country basis. Such costs include lease acquisition costs, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling productive and non-productive wells and overhead charges related directly to acquisition, exploration and development activities.

The Company’s international projects are in pre-production stage. The Company defers and capitalizes all costs relating to the investigation and acquisition of international projects on country by country basis until such time as the costs no longer meet the deferral requirements under Canadian generally accepted accounting principles (“GAAP”). These projects are assessed at least annually for impairment, as well as when events indicate that impairment may have occurred.

**INTERNATIONAL SOVEREIGN ENERGY CORP.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2008**

**2. ACCOUNTING POLICIES (Cont'd)**

Costs of acquiring and evaluating unproven properties in Canada and costs of exploration in international cost centers are excluded initially from costs subject to depletion, until it is determined whether or not proved reserves are attributable to the properties or, in the case of major development projects, commercial production has commenced, or impairment has occurred. Impairment occurs whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. When proven reserves are determined or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to the costs subject to depletion for that country's cost centre. Proceeds from disposal of properties will normally be applied as a reduction of the cost of the remaining assets unless the disposal would result in a greater than 20% change in the depletion rate, in which case a gain or loss will be recorded.

**Asset Retirement Obligation**

The Company recognizes as a liability the estimated fair value of the future retirement obligations associated with property and equipment. The fair value is capitalized and amortized over the same period as the underlying asset. The Company estimates the liability based on the estimated costs to abandon and reclaim its net ownership interest in all wells and facilities and the estimated timing of the costs to be incurred in future periods. This estimate is evaluated on a periodic basis and any adjustment to the estimate is prospectively applied. As time passes, the change in net present value of the future retirement obligation is expensed through accretion. Retirement obligations settled during the period reduce the future retirement liability.

For the first six months of 2008 the asset retirement obligation ("ARO") increased by \$45,637; property plant and equipment ("PP&E") decreased by \$38,002 net of depletion and net income decreased by \$77,722 to reflect impact of accretion and depletion expense for the quarter. In the comparative quarter of 2007, the ARO increased by \$43,459, PP&E decreased by \$19,084 net of depletion and net income decreased by \$56,611 to reflect the impact of accretion and depletion expense for the quarter.

**Stock-based compensation plan**

The Company uses the fair-value based method of accounting for stock options and recognizes stock compensation expense based on the estimated fair value of the option on the date of grant, which is determined using the Black-Scholes option-pricing model. The fair value of the options is recognized over the vesting period of the options granted as stock compensation expense and contributed surplus. The contributed surplus balance is reduced when the options are exercised and the amount initially recorded as contributed surplus is credited to share capital.

**INTERNATIONAL SOVEREIGN ENERGY CORP.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2008**

**2. ACCOUNTING POLICIES (Cont'd)**

**Section 1506 “Accounting Changes”**

Beginning January 1, 2007 the Company adopted Section 1506 “Accounting Changes” the only impact of which is to provide disclosure of when an entity has not applied a new source of GAAP that has been issued but is not yet effective. This is the case with Section 3862 “Financial Instruments Disclosures” and Section 3863 “Financial Instruments Presentation” which are required to be adopted for fiscal years beginning on or after October 1, 2007. The Company adopted these standards on January 1, 2008 and it is expected the only effect on the Company will be incremental disclosures regarding the significance of financial instruments for the entity’s financial position and performance and the nature, extent and management of risks arising from financial instruments to which the entity is exposed.

As of January 1, 2008 the Company has adopted CICA Handbook section 1535, “Capital Disclosures”, which requires entities to disclose their objectives, policies and processes for managing capital, and in addition, whether the entity has complied with any externally imposed capital requirements. Refer to note 9 for further information regarding the Company’s management of capital.

As of July 1, 2007, the Company will be required to adopt *CICA Handbook Section 3031, Inventory*. This new standard is effective for interim and annual financial statements relating to fiscal years beginning on or after July 1, 2007. This new standard will have no impact on the Company’s consolidated financial statements.

In February 2008, the CICA issued Section 3064, Goodwill and intangible assets, replacing Section 3062, Goodwill and other intangible assets and Section 3450, Research and development costs. Various changes have been made to other sections of the CICA Handbook for consistency purposes. The new section will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company will adopt the new standards for its fiscal year beginning January 1, 2009. It establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The Company is currently evaluating the impact of the adoption of this new Section on its consolidated financial statements.

The CICA Accounting Standards Board (“AcSB”) adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, accounting standards in Canada for public companies are expected to converge with International Financial Reporting Standards (“IFRS”) by the start of 2011. The Company continues to monitor and assess the impact of convergence of Canadian GAAP and IFRS.

On January 1, 2007 the Company adopted the CICA Handbook Section 1530 “Comprehensive Income”, Section 3251 “Equity”, Section 3855 “Financial Instruments Recognition and Measurement”, and Section 3865 “Hedges”. The Company has evaluated the impact of these new standards and determined that the adoption of these standards has had no material impact on the Company’s net earnings or cash flows. The other effects of the implementation of the new standards are discussed below.

**INTERNATIONAL SOVEREIGN ENERGY CORP.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2008**

**2. ACCOUNTING POLICIES (Cont'd)**

**Comprehensive Income**

The new standards introduce comprehensive income, which consists of net earnings and other comprehensive income ("OCI"). Because the Company does not have any OCI, the Company's consolidated financial statements do not include a Statement of Comprehensive Income, which would otherwise describe the components of comprehensive income. Accordingly, since there are no cumulative changes in OCI to be included in accumulated other comprehensive income ("AOCI"), the Company has not presented AOCI as a new category within shareholder's equity in the consolidated balance sheet and has not included a Statement of Accumulated Other Comprehensive Income, which would otherwise provide the continuity of the AOCI balance.

**Financial Instruments**

Effective January 1, 2008, the Company adopted Section 3862 "Financial Instruments – Disclosures" and Section 3863 "Financial Instruments – Disclosure and Presentation". These disclosures require entities to assess the significance of financial instruments for an entity's financial position and performance and the nature and extent of the entity's exposure to risks arising from financial instruments and how the entity manages those risks.

Effective January 1, 2008, the Company adopted Section 1535 "Capital Disclosures" which requires an entity to disclose its objectives, policies and processes for managing capital and also disclose compliance with any externally imposed capital requirements.

**Inventories**

Effective January 1, 2008, the Company adopted Section 3031 "Inventories", which replaces section 3030 and establishes standards for the measurement of inventories, allocation of overhead, accounting for write-downs and disclosures. The adoption of this new accounting standard did not impact the Company's net earnings or financial position.

**General Standards of Financial Statement Presentation**

Effective January 1, 2008, the Company adopted Section 1400 "General Standards of Financial Statement Presentation", which was amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The adoption of this new accounting standard did not impact the Company's net earnings or financial position.

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**INTERNATIONAL SOVEREIGN ENERGY CORP.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2008**

**3. PROPERTY PLANT AND EQUIPMENT**

	<b>2008</b>	2007
	\$	\$
Petroleum and natural gas properties		
- Canada	<b>46,435,658</b>	41,931,060
- International	<b>9,208,924</b>	7,628,224
Furniture and equipment	<b>296,272</b>	287,338
	<b>55,940,854</b>	49,846,621
Less: accumulated depletion, depreciation and impairments	<b>26,477,342</b>	17,583,269
	<b>29,463,513</b>	32,263,352

During the period, costs of \$4,524,976 (2007 – \$4,524,976) related to undeveloped properties in Canada and \$9,208,924 (2007 – \$7,628,224) of deferred expenditures related to international projects have been excluded from depletion.

The Company has performed an impairment test calculation on June 30, 2008 in accordance with “AcG-16, Oil and Gas Accounting- Full Cost” to assess the recoverable value of the asset. As a result of this calculation the Company has made a depletion provision against its international petroleum and natural gas properties specifically in Ecuador, Ghana, Columbia and Yemen, in total for the quarter ended June 30, 2008, \$4,234,660. Accumulated depletion on international projects at June 30, 2008 was \$7,496,506 (2007 - \$2,334,999).

None of the international projects have proved reserves assigned to them as at June 30, 2008.

**4. OPERATING LOAN**

The Company’s revolving line of credit is currently in default as the financial institution has not granted its consent to a “change of control” as defined in the Commitment Letter dated September 5, 2007. The financial institution has indicated that the facility will be reduced to \$4,000,000 (December 31, 2007- \$6,000,000) until September 30, 2008 when it will be subject to a review. The operating loan bears interest at prime plus 0.75% and is secured by a demand debenture for a minimum of \$10,000,000 providing a floating charge over all assets of the Company and a letter of undertaking not to encumber or dispose of assets, other than in the normal course of business without consent of the financial institution and to provide security under section 426 of the bank Act and/or assign natural gas contracts. In addition the financial institution has issued on behalf of the Company letters of credit totaling \$7,500 (2007- \$7,500) to maintain its status as a licensed well operator in the province of British Columbia.

**INTERNATIONAL SOVEREIGN ENERGY CORP.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2008**

**5. ACQUISITION OF BELLWETHER INTERNATIONAL INC.**

In the quarter ending March 31, 2008 the Company completed the acquisition of Bellwether International Inc. (“BII”), the holder and operator of the Charapa Hydrocarbon Concession Contract, Ecuador (the “Charapa Contract”), pursuant to the Memorandum of Agreement between the Company and South American Investment Inc. (SAI). The Company acquired all the issued and outstanding shares of BII for \$1. The Company will also obtain all rights, title and interest to the US\$2,340,000 BII funds, which funds provide a performance guarantee under the terms and conditions of the Charapa Contract. The guaranteed funds will be progressively released to the Company upon completion of certain qualified expenditures under the Charapa Contract terms and conditions.

The allocation of the purchase price for the assets, based on fair values, was as follows:

Oil and gas assets assumed	US\$ 500,000
Restricted cash	US\$ 2,340,000
Current liabilities assumed	US\$ 500,000
Letter of Guarantee to Petroleos del Ecuador, PetroEcuador	US\$ 2,340,000

The oil and gas assets acquired in Ecuador have been fully provided for. (See note 3). The Company did not record any goodwill on acquisition.

The purchase price is based on information currently available and the Company is allocating purchase price between assets and liabilities as of the date of this statement. The price will be finalized as the information is available. In the first quarter the transaction was not recorded as the financial information was not available to record the assets or liabilities acquired.

**6. RESTRICTED CASH, LETTER OF GUARANTEE**

The restricted funds US\$2,340,000 acquired through acquisition of BII, provide a performance guarantee of US\$2,340,000 to Petroleos del Ecuador, PetroEcuador under the terms and conditions of the Charapa Contract.

The Company on January 31, 2008 issued unconditional, irrevocable bank guarantee for US\$ 414,000 in favour of Mari Gas Company Limited, in relation to petroleum exploration development and production in Pakistan, to guarantee the Company’s financial obligations. The guarantee will be reduced by an amount proportionate to 50% of the discharge of minimum work, and expires July 20, 2009.

**INTERNATIONAL SOVEREIGN ENERGY CORP.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2008**

**7. SHARE CAPITAL**

	Number of Shares	Amount \$
Authorized		
Unlimited number of Class A common voting shares		
Unlimited number of Class B common non-voting shares		
Unlimited number of Class A preferred voting, 7%, non-cumulative, redeemable shares		
Issued		
Class A common shares		
Balance, December 31, 2007 and June 30, 2008	13,928,084	\$ 19,671,569

**Stock option plan**

Under the Company's stock option plan, the Company may grant options to its directors, officers and key employees to purchase Class A common shares ("Common Shares") from the Company at a fixed price not less than the fair market value of the stock on the day preceding the grant date. The Company has reserved 1,400,000 common shares for the grant of options. The options vest equally over three years. The option's maximum term is five years.

	Options	Weighted Average Exercise Price \$
Balance, as at December 31, 2007	537,667	1.93
Cancelled	30,000	2.00
Balance, as at June 30, 2008	507,667	1.93
Exercisable at June 30, 2008	227,667	1.85

**INTERNATIONAL SOVEREIGN ENERGY CORP.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2008**

**8. EARNINGS PER COMMON SHARE**

	<b>3 months ended June 30, 2008</b>	3 months ended June 30, 2007	<b>6 months ended June 30, 2008</b>	6 months ended June 30, 2007
Loss per common share				
Basic and diluted	<b>(\$0.27)</b>	\$(0.01)	<b>(\$0.23)</b>	\$(0.01)
Weighted average number of common shares				
Basic	<b>13,928,084</b>	12,584,360	<b>13,928,084</b>	12,970,416

All options and warrants were excluded from diluted loss per share, as they were anti-dilutive.

The weighted average number of common shares outstanding during the period ended June 30, 2008 of 13,928,084 (period ended June 30, 2007 – 12,970,416) was used to calculate per share amounts. To calculate diluted common shares outstanding, the treasury method was used. Under this method, in-the-money options are assumed exercised and the proceeds used to repurchase shares at the year-end date of December 31, 2007. As at June 30, 2008, an additional nil (June 30, 2007 – nil) common shares were used to calculate diluted earnings per share. Excluded from this calculation were 507,667 shares relating stock options, and 330,644 relating to warrants.

**9. RELATED PARTY TRANSACTIONS**

General and administrative expenses include approximately \$1.2 million unilaterally withdrawn from the Company's bank account by the previous executives of the Company, who considered themselves to be terminated. The Company is attempting to recover these severance payouts through the courts.

# **INTERNATIONAL SOVEREIGN ENERGY CORP.**

## **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2008**

### **10. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT**

The Company is subject to normal industry credit risk on its accounts receivable with customers and joint venture partners. The Company mitigates these risks by only entering into agreements with credit worthy parties.

The Company is exposed to fluctuations in commodity prices for natural gas, crude oil and natural gas liquids. Commodity prices are affected by many factors including supply, demand and the Canadian to US dollar exchange rate. The Company's operating loan is also exposed to fluctuations in short-term Canadian interest rates.

The Company has no financial hedges or fixed price commodity contracts in place at June 30, 2008 and 2007.

The fair values of financial instruments consisting of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their carrying values due to their short-term nature. The operating loan bears interest at a floating market rate and, accordingly, its carrying value approximates fair value.

At June 30, 2008, \$414,000 USD of the cash and cash equivalents was held in a bank account denominated in Pakistani rupees, and US\$2,340,000 of cash and cash equivalents was held in a bank account denominated in United States dollars. As such, the Company is exposed to foreign exchange currency risk.

### **11. CAPITAL MANAGEMENT**

The Company's objectives when managing capital is to safeguard the entity's ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders. The Company sets the amount of capital in proportion to risk. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. Methods employed to adjust the Company's capital structure could include any, all, or a combination of; issue new shares through public offering or private placement; issue equity linked or convertible debt; refinance existing bank debt facilities to change amount or terms.

The Company is not subject to any externally imposed restrictions on capital, other than restriction on use of its credit lines (see Note 4) and no changes in approach to capital management have occurred in the six months ended June 30, 2008.