

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following is management's discussion and analysis ("MD&A") of the operating and financial results of Kroes Energy Inc. ("Kroes" or the "Company") for the quarter ended June 30, 2007. The information is provided as of August 29, 2007. The second quarter results have been compared to the same period in 2006. This discussion and analysis should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2006, together with the accompanying notes, and the December 31, 2006 MD&A and Annual Information Form. These documents and additional information about Kroes are available on SEDAR at www.sedar.com.

This discussion and analysis contains forward-looking statements relating to future events or future performance. In some cases forward-looking statements can be identified by terminology such as "may", "will", "should", "expects", "projects", "plans", "anticipates", and similar expressions. These statements represents management's expectations or beliefs concerning, among other things, future operating results and various components thereof or the economic performance of Kroes. The projections, estimates and beliefs contained in such forward-looking statements necessarily involve known and unknown risks and uncertainties, including the business risks discussed in the MD&A and Annual Information Form as at and for the years ended December 31, 2006 and 2005, which may cause actual performance and financial results in future periods to differ materially from any projections of future performance or results expressed or implied by such forward-looking statements. Accordingly, readers are cautioned that events or circumstances could cause results to differ materially from those predicted.

Barrel of oil equivalent (BOE) volumes are reported at 6:1 with 6 MCF = 1 BOE. BOE's may be misleading, particularly if used in isolation. A BOE conversion ratio of 6MCF:1Bbl is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

Business of the Company

Kroes Energy Inc. is a junior oil and gas company headquartered in Calgary, Alberta and is listed on the TSX Venture Exchange. On August 1, 2007 the Company closed the sale of its wholly owned subsidiary Zhoda 2001 Corporation that holds a 45% interest in a Ukrainian oil field rehabilitation project. The Company continues to expand its exploration program for shallow gas in western Canada and holds a 25% interest in a small oil field in Trinidad.

Sale of Zhoda 2001 Corporation

On August 1, 2007 Kroes closed the sale of its wholly owned subsidiary, Zhoda 2001 Corporation ("Zhoda") to Shelton Canada Corporation ("Shelton"). Zhoda owns a 45% interest in the Kashtan Petroleum Inc. oil field rehabilitation joint venture in Ukraine. Consideration from the sale included 6,997,507 shares of Shelton, \$1 million cash and Shelton's Canadian oil

and gas properties located in Flat Rock, BC and Alexander, AB. The Shelton shares have been distributed to Kroes' shareholders of record on August 17, 2007. The six month results from the 45% interest in the Ukrainian joint venture have been reflected in Kroes financial statements at June 30 but financial results for the second half of 2007 will include only the western Canada and Trinidad production operations.

The Company intends to focus its future activities on Western Canada where it has a shallow gas exploration and development program. The Company has participated in eight wells in the past year of which seven have been successful. Three wells are currently on stream and four are awaiting connection to pipelines. Kroes share of current production from the three producing wells is about 204 mcf/d or 34 boe/d.

FINANCIAL AND OPERATING

First Half 2007

Net earnings for the first six months of 2007 were \$70,082 compared to \$59,047 for the same period in 2006. Cash flow from operations was \$532,111 for the first six months compared to \$393,087 in the previous year. The improvement in results in 2007 reflect newly implemented operations in western Canada. Royalties paid during the first half of 2007 were \$1,393,640 compared to \$651,027 in 2006, reflecting another significant increase in the Ukrainian royalty rate that was effective late in 2006.

Crude oil production for the first half of 2007 averaged 230 barrels per day compared to 235 barrels per day in 2006. Crude oil prices for the first six months of 2007 averaged \$60.30 per barrel compared to \$55.54 per barrel the prior year. Natural gas production was 213 mcf per day or 36 barrels of oil equivalent reflecting the success of the western Canada natural gas strategy.

Second Quarter 2007

Net loss for the three months ended June 30, 2007 was \$26,489 compared to a net loss of \$57,527 in the same period in 2006. Cash flow from operations was \$197,260 in the second quarter compared to \$116,878 last year. Again, these improved results reflect the impact of the new natural gas production in western Canada.

Ukraine Operations

First half production from Ukraine averaged 227 barrels per day, essentially unchanged from the prior year. The combination of high royalty rates and the Value Added Tax in Ukraine continue to have a major impact on financial results as government take from these levies amounts to nearly 70% of gross revenue from the sale of crude oil.

Western Canada Operations

The shallow gas program in western Canada was initiated in 2006 and at year end, three wells were on production. In the first half of 2007, production averaged 213,000 cubic feet per day (36 boe) and the average price received was \$7.56 per mcf. Revenue totalled \$270,798 and the operating netback to the company was \$3.77 per mcf. During the first half, three successful wells were drilled and are presently awaiting connection to pipelines. A fourth successful well was completed in July 2007 and also is awaiting pipeline connection. Wet weather and competitive considerations have delayed hook-up of these wells. Capital expenditures in western Canada were \$446,729 for the first half of 2007.

Wells Drilled

	Three Months Ended June 30				Six Months Ended June 30			
	2007		2006		2007		2006	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Net Wells Drilled								
Ukraine	1	0.45	0	0	1	0.45	0	0
Canada	2	0.50	2	0.375	3	0.75	2	0.375
	3	0.95	2	0.375	4	1.20	2	0.375

Revenue

Gross revenue for the first six months of 2007 totalled \$2,820,452 compared with \$1,915,921 in the same period last year. Higher sales and crude oil prices accounted for this increase in revenue as well as new production of natural gas in western Canada. Daily crude oil production volumes averaged 230 barrels per day in 2007 compared with 235 barrels per day for the same period in 2006. Crude oil prices in the first six months of 2007 were higher in Ukraine with the average Ukrainian price at \$60.37 per barrel versus \$55.31 in 2006. Oil prices in Trinidad fell from \$63.34 per barrel in 2006 to \$55.11 in 2007.

Second quarter operations provided 229 barrels per day of crude oil production and \$948,308 in revenue compared with 232 barrels per day and \$550,953 of revenue in 2006. Western Canada natural gas added 204 mcf per day (34 boes) and revenue of 126,432. During the second quarter, the average price received for crude oil in Ukraine was \$67.31 per barrel and \$52.89 in Trinidad. Prices received in Canada for natural gas for the quarter averaged \$7.30 per mcf.

The table below sets out the relevant statistics for Kroes' oil and gas production.

	Three Months Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Revenue				
Trinidad – Crude Oil	\$10,630	\$34,569	\$33,561	\$62,139
Ukraine – Crude Oil	937,678	516,384	2,516,093	1,853,782
Canada – Natural gas	126,432	-	270,798	-
	\$1,074,740	\$550,953	\$2,820,452	\$1,915,921
Royalties				
Trinidad – Crude Oil	\$2,959	\$11,596	\$10,911	\$19,936
Ukraine – Crude Oil	568,307	138,516	1,314,141	631,091
Canada – Natural gas	32,167	-	68,588	-
	\$603,433	\$150,112	\$1,393,640	\$651,027
Crude Oil Daily Production Volumes				
Trinidad (Bbls per day)	2	5	3	5

Ukraine (Bbls per day)	227	227	227	230
Total (Bbls per day)	229	232	230	235
Natural Gas Daily Production Volumes				
Canada (Mcf per day)	204	-	213	-
Boe equivalent Daily Production Volumes (6 mcf to 1 barrel)	263	232	266	235
Crude Oil				
Barrels produced	20,656	20,675	41,118	41,519
Barrels sold	13,930	8,683	41,675	33,514
Prices per Barrel				
Trinidad – Crude Oil	\$52.89	\$57.33	\$55.11	\$63.34
Ukraine – Crude Oil	\$67.31	\$59.47	\$60.37	\$55.31
Prices per Mcf				
Canada	\$7.30	-	\$7.56	-

Royalties/Production Taxes

Royalty payments in the first half of 2007 were \$1,393,640 as compared to \$651,027 in the same period of 2006. This represents an increase of 114% over the comparable period last year and the majority of the increase was the result of the Ukrainian government's increase in royalty rates from the first half of 2006. The balance of the increase was applicable to the royalties paid on new natural gas production in western Canada.

In the first half 2007, the royalty payments in Ukraine amounted to \$1,314,141 compared with \$631,091 in the same period 2006.

In western Canada, royalty payments were \$68,588 or approximately 25% of natural gas revenue. The western Canada shallow gas program began late in 2006. There was no revenue in the first half of 2006.

In Trinidad, the government amended the petroleum royalties in 2005 and imposed a royalty that varies between 0% and 35% for onshore operations dependent on crude oil prices. The rate is 35% on prices over \$49.51 US per barrel. In the first half 2007, the royalty payment in Trinidad was \$10,911 as compared with \$19,936 in the first half of 2006.

Operating Expenses

In the second quarter 2007, total production costs were \$112,119 compared with \$102,555 in the same period last year. On a year-to-date basis, production costs increased to \$496,026 from \$393,927 in the first half 2006. For the first six months of 2007, Ukraine production costs were \$9.72 per barrel compared with \$11.02 in 2006. The overall increase in operating costs reflects the new production in western Canada.

General and Administrative

General and administrative expenses for the six months were \$366,102 compare to \$459,552 in 2006. A reduction in management fees in 2007, the repatriation of our consultant based in Ukraine and the termination of Kroes' investor relations consultant accounted for the majority of the decrease in general and administrative expenses during the period.

The table below provides a summary of general and administrative expenses.

	Three Months Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Canada/Trinidad				
Administration	\$52,911	\$103,531	\$107,119	\$184,496
Accounting & Audit	59,246	21,480	74,246	53,050
Legal	8,089	10,757	17,911	20,662
Consultant's Fees	47,155	47,832	49,758	71,005
Trustee & Listing Fees	9,704	6,378	16,253	11,484
Investor Relations & Communications	6,288	27,872	6,752	43,268
Office Rent	25,839	17,240	46,566	32,800
Other	26,813	17,408	47,497	42,787
	\$236,045	\$252,498	\$366,102	\$459,552

Stock Based Compensation

In the first half of 2007, stock based compensation expenses of \$50,877 were charged against earnings. This compares with \$103,781 charged to earnings in the first half of 2006. Under policies mandated by the Security and Exchange Commissions, the Company records compensation expense for stock options granted to directors, officers and employees using the fair value method. Fair values are determined using the Black-Scholes option pricing model. Compensation costs are recognized over the vesting period of the stock options.

Depletion and Depreciation

In the second quarter of 2007, depletion and depreciation increased to \$196,361 from \$93,462 in 2006, due to the ongoing capital spending on wells and facilities. On a year-to-date basis depletion and depreciation costs increased to \$408,486 from \$189,020 in the first half of 2006. The western Canada capital expenditure program and the resulting success accounted for \$159,188 of the year-to-date increase in depletion expenses.

Asset Retirement Expenses

In the second quarter 2007, accretion expense related to the retirement of assets increased to \$1,203 from \$934 in 2006. On a year-to-date basis, accretion expenses increased to \$2,666 from \$2,549 in the first half 2006. In 2004, the Company retroactively adopted recommendations of the Canadian Institute of Chartered Accountants (CICA) on accounting for asset retirement obligations. These recommendations replaced the previous policy on future site restoration that was in place prior to 2004. Due to the long life of Kroes' reserves, the calculation results in lower asset retirement costs under the new CICA recommendations.

Capital Expenditures

The capital expenditures for the period are as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Canada				
Land acquisition	\$28,269	\$37,500	\$131,999	\$37,500
Seismic	11,882	100,000	78,159	100,000
Exploration drilling	59,939	78,216	195,202	78,216
Production equipment and facilities	24,602	-	41,369	2,665
	<u>124,692</u>	<u>215,716</u>	<u>446,729</u>	<u>218,381</u>
Ukraine				
Seismic	-	-	-	-
Development drilling	60,879	127,295	60,879	156,387
Production equipment and facilities	246,072	145,117	550,097	467,899
	<u>306,951</u>	<u>\$272,412</u>	<u>610,976</u>	<u>\$624,286</u>
Total Capital Expenditures	<u>\$431,643</u>	<u>\$488,128</u>	<u>\$1,057,705</u>	<u>\$842,667</u>

Netbacks

The consolidated operating netback to the Company in the 1st half of 2007 was \$19.29 per barrel compared with \$25.25 in 2006 as higher prices in Ukraine were more than offset by higher royalty rates.

	Three Months Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Ukraine				
Revenue	\$67.31	\$59.47	\$60.37	\$55.31
Royalties	(40.79)	(15.95)	(31.53)	(18.83)
Operating	<u>(5.00)</u>	<u>(10.91)</u>	<u>(9.72)</u>	<u>(11.02)</u>
Netback	\$21.52	\$32.61	\$19.12	\$25.46
Trinidad				
Revenue	\$52.89	\$57.33	\$55.11	\$63.34
Royalties	(14.72)	(19.23)	(17.92)	(20.32)
Operating	<u>(58.67)</u>	<u>(12.98)</u>	<u>(39.33)</u>	<u>(25.07)</u>
Netback	(\$20.50)	\$25.12	(\$2.14)	\$17.95
Canada (Per Mcf)				
Revenue	\$7.30	-	\$7.56	-
Royalties	(1.86)	-	(1.92)	-
Operating	<u>(1.77)</u>	<u>-</u>	<u>(1.87)</u>	<u>-</u>
Netback	\$3.67	-	\$3.77	-

Financial, Liquidity and Solvency

At June 30, 2007 the Company had working capital of \$2,210,334 compared to \$1,923,830 at December 31, 2006.

Share Capital and Stock Options

In the first half 2007, 100,000 stock options were granted to a contractor at a price of \$0.155.

On August 21, 2007, 1,660,000 stock options were granted to directors and officers of the Company at a price of \$0.085.

Securities at the end of the reporting period

Common Shares (see note 5 to the financial statements)

Authorized: An unlimited number of common and preferred shares without par value
Issued: 36,233,488 common shares

Stock Options Outstanding

1,075,000 expiring February 19, 2008; exercisable at \$0.25
200,000 expiring January 8, 2009; exercisable at \$0.33
975,000 expiring June 1, 2010; exercisable at \$0.56
100,000 expiring March 21, 2011; exercisable at \$0.345
100,000 Expiring March 31, 2012, exercisable at \$0.155
2,450,000

Agents Options Outstanding

220,417 expiring December 28, 2007; options to purchase two common shares at \$0.30

Warrants Outstanding

893,750 expiring on December 28, 2007; exercisable at \$0.45.
110,208 agents warrants expiring on December 28, 2007; exercisable at \$0.45.
1,003,958

Quarterly Information

The following table sets forth certain quarterly financial information of the company for the eight most recent quarters.

	2007		2006				2005	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Financial								
Oil and gas gross revenue (\$000's)	\$1,074	\$1,746	\$1,291	\$1,998	\$551	\$1,365	\$1,411	\$1,567
Royalties (\$000's)	603	790	\$719	\$783	\$150	501	\$483	\$360
Cash flow from operations (\$000's)	\$197	\$335	(\$1)	\$404	\$117	\$276	\$154	\$540
Per basic share	\$0.005	\$0.009	\$0.000	\$0.011	\$0.004	\$0.009	\$0.005	\$0.016
Per fully diluted share	\$0.005	\$0.009	\$0.000	\$0.011	\$0.004	\$0.008	\$0.005	\$0.016
Net Income (Loss) (\$000's)	(\$26)	\$97	(\$151)	\$242	(\$58)	\$117	\$7	\$374
Per basic share	(\$0.001)	\$0.003	(\$0.005)	\$0.007	(\$0.002)	\$0.004	\$0.000	\$0.012
Per fully diluted share	(\$0.001)	\$0.003	(\$0.005)	\$0.007	(\$0.002)	\$0.004	\$0.000	\$0.011
Weighted shares outstanding (millions)								
Basic	36.2	36.2	36.0	35.7	32.4	32.2	32.2	32.2
Fully diluted	36.2	36.2	36.1	36.0	33.1	32.9	33.0	33.3
Operating								
Liquids production (Bbl/d)	229	232	238	245	232	237	259	268
Natural gas production (Mcf/d)	204	222	-	-	-	-	-	-
Liquids price \$/bbl - Ukraine	\$67.31	\$56.89	\$58.81	\$72.67	\$59.47	\$53.86	\$57.31	\$57.61
Liquids price \$/bbl - Trinidad	\$52.89	\$56.20	\$54.82	\$64.59	\$57.33	\$72.94	\$56.27	\$61.33
Natural gas price \$/Mcf	\$7.30	\$7.80	\$7.14	\$5.05	-	-	-	-

Internal Controls over Financial Reporting

There were no material changes in Kroes' internal controls over financial reporting during the first half of 2007 that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

On behalf of the Board,

"Fred Callaway"

Fred Callaway, President
August 29, 2007

Consolidated Statements of Income and Deficit

(unaudited)

	Three months ended		Six months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Revenues				
Oil and natural gas sales	\$1,074,740	\$550,953	\$2,820,452	\$1,915,921
Royalties	(603,433)	(150,112)	(1,393,640)	(651,027)
	<u>471,307</u>	<u>400,841</u>	<u>1,426,812</u>	<u>1,264,894</u>
Expenses				
Operating	112,119	102,555	496,026	393,927
General and administrative	236,045	252,498	366,102	459,552
Stock Based compensation	26,185	37,058	50,877	103,781
Depletion and depreciation	196,361	93,462	408,486	189,020
Accretion expense	1,203	934	2,666	2,549
Foreign exchange (gain) loss	28,081	62,943	36,656	58,553
	<u>599,994</u>	<u>549,450</u>	<u>1,360,813</u>	<u>1,207,382</u>
Income before Other items and income taxes	(128,687)	(148,609)	65,999	57,512
Other items				
Interest and other items	7,976	25,981	36,126	54,073
	<u>(120,711)</u>	<u>(122,628)</u>	<u>102,125</u>	<u>111,585</u>
Earnings before income taxes	(120,711)	(122,628)	102,125	111,585
Income taxes	94,222	65,101	(32,043)	(52,538)
	<u>(26,489)</u>	<u>(57,527)</u>	<u>\$70,082</u>	<u>\$59,047</u>
Net earnings for the period	(26,489)	(57,527)	\$70,082	\$59,047
Retained earnings - Beginning of period	\$1,831,479	\$1,700,737	\$1,734,908	\$1,584,867
Change in accounting policy				
Reclassification for asset retirement obligations				
Premium on redemption of common shares		-		((704)
Retained earnings - End of period	<u>\$1,804,990</u>	<u>\$1,643,210</u>	<u>\$1,804,990</u>	<u>\$1,643,210</u>
Net income attributable per common share	<u>(\$0.001)</u>	<u>(\$0.002)</u>	<u>\$0.002</u>	<u>\$0.002</u>
Weighted average number of shares outstanding	<u>36,233,488</u>	<u>33,077,361</u>	<u>36,233,488</u>	<u>32,977,998</u>

Consolidated Statements of Accumulated Other Comprehensive Income Loss

(unaudited)

	Three months ended		Six months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Accumulated Other Comprehensive Income Loss				
Beginning of period	\$(823,647)	\$(829,859)	\$(763,370)	\$(832,610)
Other comprehensive income				
Unrealized gains(losses on translation of consolidated financial statements into reporting currency	(551,898)	(230,986)	(612,175)	(228,235)
Accumulated Other Comprehensive Income Loss				
End of period	<u>\$(1,375,545)</u>	<u>\$(1,060,845)</u>	<u>\$(1,375,545)</u>	<u>\$(1,060,845)</u>

Consolidated Statements of Cash Flows

(unaudited)

	Three months ended		Six months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Operating Activities				
Net income for period	(\$26,489)	(\$57,527)	\$70,082	\$59,047
Items not affecting cash				
Stock option compensation	26,185	37,058	50,877	103,781
Depletion, depreciation and amortization	196,361	93,462	408,486	189,020
Accretion expense	1,203	934	2,666	2,549
Exchange gains (losses)		42,951		38,690
Cash flow from operations	197,260	116,878	532,111	393,087
Change in non-cash working capital	85,001	(690,301)	(74,964)	(449,285)
	282,261	(573,423)	457,147	(56,198)
Financing Activities				
Issue of common shares, net of issue costs	-	1,007,459	-	1,007,459
Redemption of common shares	-	-	-	(1,701)
	-	1,007,459	-	1,005,758
Investing Activities				
Additions to capital assets	(431,643)	(488,128)	(1,057,705)	(842,667)
Restricted funds	93,419	(10,239)	1,001,429	(19,474)
	(338,224)	(498,367)	(56,276)	(862,141)
Increase (decrease) in cash	(55,963)	(64,331)	400,871	87,419
Cash and short term investments, beginning of period	1,349,013	1,710,156	892,179	1,558,406
Cash and short term investments, end of period	\$1,293,050	\$1,645,825	\$1,293,050	\$1,645,825

Consolidated Balance Sheets

Unaudited

	June 30, 2007	December 31, 2006
ASSETS		
Current		
Cash and cash equivalents	\$1,293,050	\$ 892,179
Receivables	1,550,436	1,482,052
Prepays and deposits	85,422	96,649
Inventory	308,178	213,842
	<u>3,237,086</u>	<u>2,684,722</u>
Capital assets		
Petroleum and natural gas properties and equipment - net	6,562,769	6,328,516
Restricted Funds (Note 3)	-	1,001,429
	<u>\$9,799,855</u>	<u>\$ 10,014,667</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Payables and accruals	\$419,249	\$ 382,800
Income taxes payable (Note 2)	607,503	378,092
	<u>1,026,752</u>	<u>760,892</u>
Asset retirement obligations	127,029	115,665
Future income taxes	540,281	541,101
Shareholders' equity		
Capital stock (Note 5)	6,814,320	6,814,320
Warrants issued (Note 7)	131,984	131,984
Contributed surplus	730,044	679,167
Retained earnings	1,804,990	1,734,908
Accumulated other comprehensive income	(1,375,545)	(763,370)
	<u>8,105,793</u>	<u>8,597,009</u>
	<u>\$9,799,855</u>	<u>\$10,014,667</u>

Notes to Consolidated Financial Statements

Note 1 – Summary of Significant Accounting Policies

The Interim Consolidated Financial Statements of Kroes Energy Inc. have been prepared by management in accordance with accounting principles generally accepted in Canada. The interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements for the year ended December 31, 2006. The statements should be read in conjunction with the financial statements and the notes thereto in the Company's annual report for the year ended December 31, 2006.

Change in Accounting Policy

The Corporation adopted the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1506, Accounting Changes: Section 1530, Comprehensive Income; Section 3251, Equity; Section 3855, Financial Instruments – Recognition and Measurement; Section 3861, Financial Instruments – Disclosure and Presentation; and Section 3865, Hedges, as of January 1, 2007.

Accounting Changes

CICA Section 1506 provides expanded disclosures for changes in accounting policies, accounting estimates and correction of errors. Under the new standard, accounting changes should be applied retrospectively unless otherwise permitted or where impracticable to determine. As well, voluntary changes in accounting policy are made only when required by a primary source of GAAP or the change results in more relevant and reliable information. The application of this revised standard did not have a material impact on the financial statements.

Comprehensive Income

CICA Section 1530 introduces a new requirement to temporarily present certain gains and losses from changes in fair value outside net income. It includes unrealized gains and losses on available-for-sale investments; and the effective portion of gains or losses on derivatives designed as cash flow hedges. Upon adoption of Section 1530, the Corporation incorporated the new requirements of Comprehensive Income by creating a "Consolidated Statement of Other Comprehensive Income (Loss)". The application of this revised standard did result in comprehensive income (loss) being different from net income (loss) for the period presented. The cumulative changes in comprehensive income have been recognized in Accumulated Other Comprehensive Income which is presented as a new category within shareholder's equity on the balance sheet.

Financial Instruments

CICA Section 3855 prescribes when a financial instrument is to be recognized on the balance sheet and at what amount. It also specifies how financial instrument gains and losses are to be presented. All financial instruments have been classified into one of the following five categories: 1) assets held-to-maturity; 2) loans and receivables; 3) other financial liabilities; 4) assets available-for-sale; and 5) held-for-trading.

Initial and subsequent measurement and recognition of changes in the value of financial instruments depends on their initial classification:

- Held-to-maturity investments, loans and receivables, and other financial liabilities are initially measured at fair value and subsequently measured at amortized cost. Amortization of premiums or discounts and losses due to impairment are included in current period net earnings.
- Available-for-sale financial assets are measured at fair value. Revaluation gains and losses are included in other comprehensive income until the asset is removed from the balance sheet.
- Held –for-trading financial instruments are measured at fair value. All gains and losses are included in net earnings in the period in which they arise.
- All derivative financial instruments are classified as held- for -trading financial instruments and are measured at fair value, even when they are part of a hedging relationship. All gains and losses are included in net earnings in the period in which they arise.

The financial instruments recognized on Kroes' balance sheet are deemed to approximate their estimated fair values, therefore no further adjustments were required upon adoption of the new sections. There were no financial assets on the balance sheet which were designated as held-for-trading, held-to-maturity or available-for-sale. All financial liabilities were classified as other liabilities.

Hedging

CICA Section 3865 provides alternative treatments to Section 3855 for entities who choose to designate qualifying transactions as hedges for accounting purposes.

The Corporation is exposed to market risks resulting from fluctuations in commodity prices in the normal course of its business. The Corporation may use a variety of instruments to manage these exposures. The Corporation does not enter into financial instruments for trading or speculative purposes. The Corporation has not applied hedge accounting and, therefore, the Corporation accounts for such instruments using the fair value method by initially recording an asset or liability, and recognizing changes in the fair value of the instruments in income as an unrealized gain or loss on commodity contracts.

Accounting Pronouncements

The Corporation is assessing new and revised accounting pronouncements that have been issued but are not yet effective, to determine the impact on the Corporation.

As of January 1, 2008, the Corporation will be required to adopt two new CICA standards: Section 3862 Financial Instruments – Disclosures; and Section 3863 Financial Instruments – Presentation, which will replace Section 3861 Financial Instruments – Disclosure and Presentations. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. The new presentation standard carries forward the former presentation requirements. The new financial instruments presentation and disclosure requirements were issued in December 2006 and the Corporation is assessing the impact on its financial statements.

As of January 1, 2008, the Corporation will be required to adopt two new CICA standards: Section 1535 Capital Disclosures, which will require disclosure of objectives, policies and processes for managing capital. In addition, disclosures will include whether companies have complied with externally imposed capital requirements. The new capital disclosure requirements were issued in December 2006 and the Corporation is assessing the impact on its financial statements.

In January 2006, the CICA Accounting Standards Board ("ASB") 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 end of 2011. The Corporation continues to monitor and assess the impact of the convergence of Canadian GAAP and IFRS.

Note 2 – Income Taxes

The income tax expense of \$32,043 on the Statement of Operations and Retained Earnings relates entirely to the Ukrainian operation and represents the Company's 45% share of Kashtan's first half income tax expense. Similarly, the amount of \$607,503 shown on the Balance Sheet as Income Tax Payable is the 45% portion of Kashtan's income tax payable at the end of the second quarter.

Note 3 – Restricted Funds

The Company's financing arrangement with respect to the Ukrainian project was to place a deposit of US\$787,500 with the Calyon Bank in Kyiv, Ukraine to provide 105% security for a US\$750,000 line of credit the Bank extended to Kashtan Petroleum Ltd.. As at June 30, 2007 all the funds have been withdrawn from the Calyon Bank.

Note 4 – Asset Retirement Obligations

The following table represents the reconciliation of the beginning and ending aggregate carrying amount of the obligations associated with the retirement of oil and gas assets:

	Period ended	
	June 30, 2007	December 31, 2006
Asset retirement obligations, beginning of period	\$115,665	\$114,203
Liabilities incurred/revisions	8,698	3,268
Revision of estimates	-	(6,903)
Accretion expenses	2,666	5,097
Asset retirement obligations, end of period	<u>\$127,029</u>	<u>\$115,665</u>

Note 5 – Share Capital

Common Shares Issued	Number of Shares	Amount
Balance December 31, 2006	36,233,488	\$6,814,320
Balance June 30, 2007	<u>36,233,488</u>	<u>\$6,814,320</u>

Note 6 – Weighted Average Number of Common Shares

The following table summarizes the common shares used in the calculating net income and cash flow from operations per common share.

	Three months ended		Six months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Basic	36,233,488	32,354,917	36,233,488	32,257,046
Fully Diluted	36,233,488	33,077,361	36,233,488	32,977,998

The reconciling items between the basic and diluted weighted average common shares are outstanding options and broker warrants.

Note 7 – Share Purchase Warrants

As part of the June 2006 financing, the Company issued to subscribers 893,750 share purchase warrants, exercisable at \$0.45 for 18 months from the initial closing of June 27, 2006. The fair value of these warrants approximated \$131,984 or \$0.1477 per warrant. The fair value of these warrants were estimated using the Black-Scholes option pricing model with an average risk-free interest rate of 4.6%, expected life of 1.5 years, volatility in the price of the Company's common shares of 134% and a dividend yield of 0.00%.

As part of the agent's commission the Company issued non-transferable options to the agent to purchase 41,667 units, as well as an option to purchase non-transferable options equalling 10% of the units sold (1,787,500 units). These units have non-transferable warrants attached to them that total 110,208. These warrants are exercisable at \$0.45 for 18 months from the initial closing date of June 27, 2006. The Agent's financing warrants are accounted for as a charge to share issuance costs and a credit to contributed surplus. The fair value of these agent warrants approximated \$16,275 or \$0.1477 per warrant. The fair value of these warrants were estimated using the Black-Scholes option pricing model with an average risk-free interest rate of 4.6%, expected life of 1.5 years, volatility in the price of the Company's common shares of 134% and a dividend yield of 0.00%.

	Number of Warrants	Amount
Balance December 31, 2006	1,003,958	\$131,984
Balance June 30, 2007	<u>1,003,958</u>	<u>\$131,984</u>

Note 8 – Agent Options

In 2006, 220,417 agents financing options were issued in connection with the June 27, 2006 public financing referred to in note 7. One option is composed of two common shares and one half one common share purchase warrant. The unit price is \$0.60 per unit and one full warrant entitles the purchaser to purchase a common share for \$0.45 prior to December 28, 2007.

	Number of Shares	Exercise Price
Balance December 31, 2006	440,834	\$0.45
Balance June 30, 2007	<u>440,834</u>	<u>\$0.45</u>

Note 9 – Stock-Based Compensation Plans

The Company has a Stock Option Plan for Directors, Officers and Consultants. As of June 30, 2007 there were 2,450,000 options granted with an exercise price of \$0.13, \$0.25, \$0.33, \$0.56, \$0.0345 and \$0.155 per share exercisable at various dates to March 1, 2012. The exercise price of each option equalled or exceeded the market price of the Company's common shares on the date of each grant.

The following table summarises the information about the stock options:

	June 30, 2007		December 31, 2006	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Options				
Outstanding, beginning	2,350,000	\$0.39	2,920,000	\$0.33
Granted	100,000	\$0.155	100,000	\$0.345
Exercised	-	-	(500,000)	\$0.13
Cancelled	-	-	(170,000)	\$0.13
	<u>2,450,000</u>	<u>\$0.38</u>	<u>2,350,000</u>	<u>\$0.39</u>

The new CICA requirement to determine a compensation cost associated with the granting of Stock Options was implemented by the Company on January 01, 2004

The assumptions used to calculate stock-based compensation expense for the options granted in 2007 is estimated at the date of grant using the Black-Scholes Option Pricing Model with the following weighted average assumptions:

	2007	2006
Volatility factor of expected market prices (%)	168%	143%
Weighted average risk-free interest rate (%)	3.88%	4.10%
Weighted average expected life of options (years)	5	5
Dividend yield (%)	-	-

The options granted in 2005, 2006 and 2007 vest over a three year period and will be charged to earnings over that three year period.

Note 10 – Subsequent Event

On March 28, 2007, the Company entered into an agreement with Shelton Canada Corp. (“Shelton”) whereby Shelton acquired Kroes’ wholly owned subsidiary Zhoda 2001 Corporation (“Zhoda”). Zhoda’s only operating asset is a 45% interest in Kashtan Petroleum Ltd. a joint venture oilfield exploitation and development project in Ukraine. This transaction closed on August 1, 2007.

Note 11 – Management Disclosure

These financial statements have been prepared by management and have not been reviewed by an external auditor.

Names of directors and officers as at the date of this report:

Fred Callaway	President and Director
C. Jim Cummings	Director
Stewart D. Gossen	Director, Vice President & Secretary
David R. Malarchuk	Controller
David E. Powell	Director
Edward M. Southern	Director & Executive Vice-President
Dr. James E. Werbicki	Director
Darrell M. Zakreski	Director

Corporate Information

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Auditor: Grant Thornton LLP
Solicitors: Dunphy Best Blocksom LLP
Transfer Agent: Computershare Trust
Company of Canada