

Q2 2008 FINANCIAL AND OPERATING HIGHLIGHTS

	Three months ended June 30		Six months ended June 30	
	2008	2007	2008	2007
FINANCIAL (\$000's, except per share data)				
Total revenue	45,493	23,520	89,508	42,942
Cash flow from operations before working capital changes ⁽²⁾	28,023	162	47,475	5,201
Per common share				
Basic and diluted (\$)	0.15	-	0.25	0.04
Net income (loss)	6,688	(7,225)	2,898	(24,853)
Per common share				
Basic and diluted (\$)	0.04	(0.05)	0.02	(0.19)
Capital expenditures	17,605	51,310	35,117	93,341
Total assets	543,123	620,792	543,123	620,792
Total long-term financial liabilities	16,128	167,656	16,128	167,656
Working capital (deficiency)	57,371	(98,510)	57,371	(98,510)
Shareholders' equity	493,699	453,135	493,699	453,135
OPERATIONAL				
Daily Production				
Oil – net production (bbls/d)	6,660	5,934	7,679	5,282
Gas – net production (mcf/d)	9,402	11,757	10,080	12,834
Total net production (boe/d)	8,246	7,910	9,375	7,441
Product Pricing				
Oil – average selling price per bbl (\$)	84.57	41.29	72.41	39.13
Gas – average selling price per mcf (\$)	9.80	6.81	8.73	7.10
Weighted average sales price per boe (\$)	79.74	41.40	68.97	40.29
Royalties (\$/boe)	19.93	8.78	16.93	8.62
Operating costs (including transportation expenses) (\$/boe)	16.60	16.70	19.07	17.19
Petroleum and Natural Gas (“PNG”) Netback ⁽³⁾ (\$/boe)	43.21	15.92	32.97	14.48
Common Share Information				
Weighted average shares outstanding (basic)	189,241,716	133,935,248	189,241,716	132,479,881
Weighted average shares outstanding (diluted)	189,241,716	134,286,661	189,241,716	132,774,515
Shares outstanding at end of period	189,241,716	133,949,589	189,241,716	133,949,589
Volume traded during the quarter	37,100,752	38,104,966	74,455,243	52,011,946
Share price (\$)				
High	2.73	5.93	2.80	5.93
Low	1.60	4.00	1.43	3.90
Close (end of period)	2.10	5.07	2.10	5.07

(1) Oil equivalent amounts referenced have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil. BOEs may be misleading, particularly if used in isolation. A BOE conversion ratio of 6 mcf:1 bbl is based on an energy equivalency.

(2) Cash flow from operations before working capital changes and cash flow per share do not have standardized meanings prescribed by Canadian Generally Accepted Accounting Principles (“GAAP”) and therefore may not be comparable to similar measures used by other companies. Cash flow from operations before working capital changes includes all cash flow from operating activities and is calculated before changes in non-cash working capital. Cash flow from operations before working capital changes is reconciled with net loss on the Consolidated Statement of Cash. Management uses these non-GAAP measurements for its own performance measures and to provide its shareholders and investors with a measurement of the Company's efficiency and its ability to fund a portion of its future growth expenditures.

(3) Petroleum and Natural Gas (“PNG”) netback is a non-GAAP measure used by management as a measure of operating efficiency and profitability and may not be comparable to similar measures used by other companies. It is calculated by deducting royalties, operating costs and transportation costs from petroleum and natural gas revenues.

Message from the President

To our shareholders,

The second quarter of 2008 was the best financial and operational quarter in the Company's history. Primarily due to substantially higher oil and gas prices realized in the second quarter and the sale of non-core assets, the Company posted its highest profit and cash flow numbers to date of \$6.7 million and \$28 million respectively. Combining this financial performance with the closing of the sale of the non-core assets in North Central Saskatchewan, the Company is in a very strong financial position with over \$52 million in positive working capital after deducting long term debt at the end of the second quarter. Second quarter realized well-head pricing averaged \$84.57 per barrel for our heavy oil and 9.80/Mcf for gas resulting in wellhead netbacks of \$43.21/Boe.

From an operational standpoint, we continue to focus on our 4 core assets which we believe will ultimately be the main value driver in the Company. During the first half of 2008 Pearl drilled four net horizontal wells in our Mooney area. Three of the new wells will form the basis of a polymer pilot which has been accelerated to be initiated in the fourth quarter of 2008. Preliminary results from the pilot are expected by early 2009. Plans for a field wide polymer flood implementation are expected to be finalized by the second quarter of 2009 with implementation targeted as early as the end of 2009. Permitting for the implementation of the waterflood continues on schedule (have received two of five permits required) with its initiation expected in the fourth quarter, 2008 and continuing into the first half of 2009. In addition, plans are underway to commence a development drilling program by year end, 2008 to extend the productive area to the west with the goals of increasing production and proven and probable reserves.

In Onion Lake the Cyclic Steam Stimulation (CSS) thermal pilot commenced steam injection on May 15th over a month ahead of schedule. The first steam cycle on the first well was completed on June 19th and the well is currently producing over 140 barrels of oil per day which is above the expected modeling predictions. Steam injection on the second well began on June 20th and first production commenced on August 11, 2008. If these positive results continue to be observed in the pilot wells, we will be in a position to commence planning on a commercial thermal development program early in 2009 subject to successful negotiation of thermal development terms with Onion Lake Energy.

At San Miguel, Pearl and its 50% partner TXCO have finished construction of its Steam-Assisted Gravity Drainage (SAGD) pilot located within the Chittim "B" Field. Steam injection commenced on June 1, 2008 with preliminary results expected by the first quarter of 2009. Temperature monitoring of the well pair indicates that the steam chamber is building as anticipated. At the Saner Ranch Field, construction is continuing on the second production pilot. The Saner Ranch pilot includes both a vertical inverted five spot well pattern and a horizontal three well pattern utilizing a modified Fracture Assisted Steamflood Technology (FAST) process. The three horizontal wells were drilled and completed successfully in the second quarter, 2008. All major long lead time items for the pilot are on site with assembly of facilities and infrastructure installation proceeding on schedule. The pilot is expected to be operational in the third quarter of 2008 and preliminary results are expected during the first half of 2009. By the end of the second quarter of 2009, Pearl and its partner expect to select which of the three recovery techniques will be used to form the basis of a commercial development project.

At Blackrod, the Company has entered into an agreement to acquire an additional 30% working interest in 3,886 contiguous hectares of oil sands leases in the project area. In addition, Pearl is continuing with its plans to drill a 10 to 15 core well program in the 2008/2009 winter to further delineate this deposit and gather additional petrophysical data. Pearl remains on track to initiate steaming at its Steam-Assisted Gravity Drainage (SAGD) pilot, comprised of single well pair pilot and related facilities, during the first half of 2009. The application for the required governmental approvals of the thermal SAGD pilot project was submitted in May of 2008.

The Company's production for the second quarter averaged 8,246 Boe/d, down from the previous quarter due to the sale of a portion of our non-core assets and natural decline. Current production is approximately 5,600 barrels a day due to a temporary curtailment of 600 Boe/d of production in our Mooney area while we install some in-field infrastructure and approximately 300 Boe/d of shut-in production awaiting workovers in other areas. We anticipate having all of this shut-in production back on-line by late August, 2008.

Pearl is very pleased with the significant progress we have made in all of our core projects including operating steam flood pilots in both Onion Lake, Saskatchewan and San Miguel, Texas and the acceleration of our polymer pilot in the Mooney area of Alberta. Due to very favourable commodity prices and our recent disposition of some non-core properties, Pearl is in a very strong financial position to continue to work these projects through to development decision points expected in the first half of 2009. As a result of the strong financial results we have achieved in the first half of 2008 and the sale some of our non-core assets, Pearl's Board of Directors has approved an expansion of our 2008 capital budget to \$135 million, which is approximately \$75 million higher than our original approved budget. The increase in the budget will be deployed principally in our resource to reserve conversion efforts in our Mooney project as well as other areas. We strongly believe that we are now in a position to start to realize the substantial imbedded resource value in our core areas and it is our intention to pursue this value without incurring any unnecessary dilution to our shareholders and as such we have no intention of undertaking any financings in the foreseeable future. In addition, we continue to look for opportunities to divest our remaining portfolio of non-core assets as we focus our technical and financial resources exclusively on our large resource conversion projects.

On behalf of the Board,

Keith Hill
President and CEO

August 13, 2008

**PEARL EXPLORATION AND PRODUCTION LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS
Three months ended June 30, 2008 and 2007**

Management's discussion and analysis ("MD&A") of Pearl Exploration and Production Ltd.'s (the "Company" or "Pearl") financial condition and results of operations should be read in conjunction with the unaudited consolidated financial statements for the three and six months ended June 30, 2008 and 2007 as contained in this interim report and the MD&A and audited financial statements for the fifteen months ended December 31, 2007 and twelve months ended September 30, 2006 contained in the Company's 2007 Financial Report. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are presented in Canadian dollars unless otherwise indicated. The effective date of this MD&A is August 13th, 2008.

Additional information relating to the Company is available on SEDAR at www.sedar.com and on the Company's web-site at www.pearleandp.com.

Forward-Looking Statements

Certain information regarding the Company contained herein may constitute forward-looking statements. Forward-looking statements may include estimates, plans, expectations, opinions, forecasts, projections, guidance or other statements that are not statements of fact. By their nature, forward-looking statements and information involve assumptions, inherent risks and uncertainties, many of which are difficult to predict, and are usually beyond the control of management, that could cause actual results to be materially different from those expressed by these forward-looking statements and information. The Company does not undertake to update or re-issue the forward-looking statements and information that may be contained herein, whether as a result of new information, future events or otherwise. The Company's forward-looking statements are expressly qualified in their entirety by this cautionary statement.

OVERVIEW

Pearl is a Canadian-based oil and gas company whose common shares are traded on the TSX Venture Exchange under the symbol "PXX". Pearl's main focus is large, heavy oil projects in Canada and the USA. The Company also holds interests in a number of natural gas properties.

Pearl's core properties include:

- Onion Lake, Saskatchewan – heavy oil;
- Mooney, Alberta – heavy oil;
- Blackrod, Alberta – heavy oil;
- San Miguel, Texas – heavy oil

OPERATIONS UPDATE

Onion Lake Heavy Oil Project – Saskatchewan

In Onion Lake the Cyclic Steam Stimulation (CSS) thermal pilot commenced steam injection on May 15th, over a month ahead of schedule. The first steam cycle on the first well was completed on June 19th and the well is currently producing approximately 140 barrels of oil per day which is above expected modeling predictions. Steam injection on the second well began on June 20th and first production commenced on August 11, 2008.

Mooney Heavy Oil Project – Alberta

During the first half of 2008 Pearl drilled four net horizontal wells in our Mooney area. Three of the new wells will form the basis of a polymer pilot which has been accelerated to be initiated in Q4 2008. Preliminary results from the pilot are expected by Q1 2009. Plans for a field wide polymer flood implementation are expected to be finalized by Q2 2009 with implementation targeted as early as the end of 2009. Permits have now been obtained for the implementation of the waterflood with its initiation expected in Q4 2008 and continuing into the first half of 2009. In addition, plans are underway to commence a development drilling program by year end to extend the productive area to the west with the goals of increasing production and proven and probable reserves

Blackrod Heavy Oil Project – Alberta

At Blackrod, as previously announced, the Company has entered into an agreement to acquire an additional 30% working interest in 3,886 contiguous hectares of oil sands leases in the project area. In addition, Pearl is continuing with its plans to drill a 10 to 15 stratigraphic core well program in the 2008/2009 winter to further delineate this deposit and gather additional petrophysical data. Pearl remains on track to initiate steaming at its Steam-Assisted Gravity Drainage (“SAGD”) pilot, comprised of single well pair pilot and related facilities, during the first half of 2009. The application for the required governmental approvals of the thermal SAGD pilot project was submitted in May of 2008.

San Miguel Heavy Oil Project – Maverick Basin, South Texas

At San Miguel, Pearl and its 50% partner TXCO have finished construction of its SAGD pilot located within the Chittim "B" field. Steam injection commenced on June 1, 2008 with preliminary results expected by Q1 2009. Temperature monitoring of the well pair indicates that the steam chamber is building as anticipated. At the Saner Ranch portion of the field, construction is continuing on the second production pilot. The Saner Ranch pilot includes both a vertical inverted five spot well pattern and a horizontal three well pattern utilizing a modified Fracture Assisted Steamflood Technology (FAST) process. The three horizontal wells were drilled and completed successfully in Q2 2008. All major long lead time items for the pilot are on site with assembly of facilities and infrastructure installation proceeding on schedule. The pilot is expected to be operational in the third quarter of 2008 and allow preliminary results to be analyzed during the first half of 2009. By the end of the second quarter of 2009, Pearl expects to select which of the three recovery techniques will be used to form the basis of a commercial development project.

Other Properties – Alberta, Saskatchewan

During the current quarter, the Company sold certain non-core heavy oil producing assets for \$75 million. These assets were located in the Lloydminster, Celtic, Pikes Peak and Thunderchild areas of Saskatchewan and were part of the non-core asset package that the Company announced its intention to rationalize on January 8, 2008.

Other Properties – U.S.

The Company also holds interests in several other areas in the United States, including Queen City gas fields, the West Rozel and Gunnison Wedge in Utah, Promised Land in Montana and Queen City gas fields in Texas, however, there is limited or no production from these areas and there are only minor evaluation plans contemplated for these lands in 2008. However, the Company believes certain of these lands contain large resource potential and may, based upon further evaluation, be developed in the future.

RESULTS OF OPERATIONS

Oil and Gas Production, Pricing and Revenue

	Three months ended June 30		Six months ended June 30	
	2008	2007	2008	2007
Daily production / sales volumes ⁽¹⁾				
Oil (bbl/d)	6,660	5,934	7,679	5,282
Natural gas (mcf/d)	9,402	11,757	10,080	12,834
Combined ⁽¹⁾ (boe/d)	8,246	7,910	9,375	7,441
Product pricing (\$)				
Crude oil - per bbl	84.57	41.29	72.41	39.13
Natural gas - per mcf	9.80	6.81	8.73	7.10
Combined - per boe	79.74	41.40	68.97	40.29
Revenue (000's)				
PNG revenue - gross	59,839	29,801	117,669	54,265
Royalties	(14,956)	(6,322)	(28,887)	(11,607)
PNG revenue - net	44,883	23,479	88,782	42,658

* gas production converted at 6:1

(1) Includes small amounts of NGLs not separately identified in the table

For the three months ended June 30, 2008 production is relatively consistent with the prior year three-months ended June 30, 2007 due to the company disposing of non-core properties during the quarter representing approximately thirty percent of daily production.

Significant increase in revenue for both the three and six months ended June 30, 2008 is primarily due to the higher market pricing for heavy oil and natural gas in 2008.

Royalties

	Three months ended June 30		Six months ended June 30	
	2008	2007	2008	2007
Royalties	14,956	6,322	28,887	11,607
as a percentage of PNG revenue	25%	21%	25%	21%

Royalties represent charges against production or revenue by governments and landowners. Royalties for the three and six months ended June 30, 2008 increased over the comparable periods of 2007. This increase is consistent with the increase in revenues during the period.

Royalties as a percentage of revenue increased from 21% during the three and six months ended June 30, 2007 to 25% in the three and six months ended June 30, 2008 principally due to higher market pricing. These percentages are consistent with the expectations given the nature of the royalty calculations.

PNG Operating Expenses and Netbacks

	Three months ended June 30				Six months ended June 30			
	2008		2007		2008		2007	
	Total	Per boe	Total	Per boe	Total	Per boe	Total	Per boe
Average daily production	8,246		7,910		9,375		7,441	
Gross PNG revenue	59,839	79.74	29,801	41.40	117,669	68.97	54,265	40.29
Royalties	(14,956)	(19.93)	(6,322)	(8.78)	(28,887)	(16.93)	(11,607)	(8.62)
Net PNG revenue	44,883	59.81	23,479	32.62	88,782	52.04	42,658	31.67
Operating costs	(11,453)	(15.26)	(10,949)	(15.21)	(30,337)	(17.78)	(21,081)	(15.65)
Transportation	(1,003)	(1.34)	(1,074)	(1.49)	(2,201)	(1.29)	(2,073)	(1.54)
PNG netback	32,427	43.21	11,456	15.92	56,244	32.97	19,504	14.48

Operating Expenses

Second quarter operating costs on a per boe basis were fairly consistent when compared to the same period in 2007, averaging \$15.26 for the three months ended June 30, 2008 in comparison to \$15.21 per boe in 2007. For the six months ended June 30, 2008 operating costs were \$17.78 per boe as compared to \$15.65 for the six months ended June 30, 2007. The increase in per unit operating costs for the six month period is principally due to several factors, that occurred in the first quarter, including (i) high cost of propane; (ii) timing of focusing resources on developing efficiencies with regards to operating costs; and (iii) \$2.2 million or \$2.28 per boe of underestimated 3rd party costs that related to prior periods that was recognized in the first quarter. Installation of a fuel gas system has helped to alleviate the high cost of propane in the second quarter.

PNG netbacks are significantly higher in both the three and six months ended June 30, 2008 when compared to 2007 results. The increase is largely due to the higher price of oil and gas in 2008.

General and Administrative Expenses ("G&A")

General and administrative expenses were \$3.4 million in the second quarter of 2008 compared to \$4.0 million in 2007. On a per unit basis, G&A was \$4.51 per boe compared to \$5.49 per boe in 2007. General and administrative costs have decreased by \$0.98 per boe from the same period in 2007 due to an increase in production and a corporate focus on decreasing administrative costs and an overall decrease in corporate acquisition activities.

G&A for the six months ended June 30, 2008 was \$6.4 million or \$3.76 per boe compared to \$6.5 million or \$4.83 per boe in 2007. The decrease of \$1.07 per boe from 2007 is again principally due to an increase in production and a corporate focus on decreasing administrative costs and an overall decrease in corporate acquisition activities.

Depletion, Depreciation and Accretion (“DD&A”)

DD&A expense was \$19.0 million or \$24.49 per boe for the three months ended June 30, 2008 in comparison to \$22.3 million or \$31.01 per boe for the three months ended June 30, 2007. For the six months ended June 30, DD&A expense was \$44.0 million or \$25.17 per boe in comparison to \$39.9 million or \$29.60 for the same period of 2007. The lower rate in 2008 is due to increased proved reserves as a result of the significant drilling and acquisition activity in 2007.

Interest Expense

Interest expense for the three months ended June 30, 2008 was \$0.4 million in comparison to \$1.2 million for the three months ended June 30, 2007. Interest expense relates to the Company's bank debt. The Company had an average debt level of \$27.6 million and an effective interest rate of 5.77% for the three months ended June 30, 2008. Lower interest expense is due to a lower dependence on debt financing during the period.

For the six months ended June 30, 2008 interest expense was \$0.8 million in comparison to \$1.6 million for the same period in 2007. The Company's average debt balance was \$22.2 million with an effective interest rate of 6.11% for the six months ended June 30, 2008. Lower interest expense is due to a lower dependence on debt financing during the period.

Change in unrealized loss of gas pricing contracts

The change in unrealized loss of gas pricing contracts for the six months ended June 30, 2007 relates to gas contracts acquired as part of the Atlas acquisition in December, 2006.

Income Taxes

The provision for future income taxes for the quarter ended June 30, 2008 was \$2.3 million compared to a recovery of \$3.1 million for the three months ended June 30, 2007. As at June 30, 2008, the Company has recognized a future tax asset of \$2.4 million as the Company believes, based on estimated cash flows from existing reserves, that it is more likely than not to realize these assets

For the six months ended June 30, 2008, future income taxes were \$0.01 million in comparison to \$0.4 million for the comparable period in 2007.

Current tax of \$0.7 million for the three months ended June 30, 2008 is comprised of Saskatchewan capital tax and resource surcharge. The \$6.6 million for the same period of 2007 is taxes payable as a result of the sale of certain assets in the United States.

Net Income (Loss)

Net income for the quarter ended June 30, 2008 was \$6.7 million in comparison to a net loss of \$7.2 million for the quarter ended June 30, 2007. Earnings for the six months ended June 30, 2008 were \$2.9 million, a \$27.8 million improvement over the six months ended June 30, 2007 reported net loss of \$24.9 million. The significant increase in 2008 net income is mainly due to increased revenues caused by the high market price for heavy oil and natural gas in the first half of 2008.

LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2008, the Company had \$42.0 million of remaining credit capacity available under its \$37.0 million extendible term credit facility and \$10.0 million demand revolving credit facility.

At June 30, 2008, the Company had working capital of \$57.4 million compared to a working capital deficit of \$34.2 million at December 31, 2007.

Funds from operations were \$28.0 million for the three months ended June 30, 2008 compared to funds from operations of \$0.2 million for the three months ended June 30, 2007. For the six months ended June 30, 2008 funds

from operations were \$47.5 million as compared to \$5.2 million for the six months ended June 30, 2007. The improvement in funds from operations is principally due to higher commodity prices and to a lesser extent lower G&A expenses.

Net cash used in financing activities for the quarter ended June 30, 2008 was \$20.0 million compared to net cash from financing activities of \$35.5 million for the quarter ended June 30, 2007. During the current quarter the Company repaid \$20.0 million on its credit facility. Significant financing activities from the quarter ended June 30, 2007 included (i) an advance of \$35.4 million of debt, and (ii) the exercise of \$0.1 million in stock options.

Net cash from financing activities was \$5.0 million for the six months ended June 30, 2008 in comparison to net cash used in financing activities of \$20.1 million for the six months ended June 30, 2007. An advance of \$5.0 million on the Company's bank loan was the only financing activity for the current period. Significant financing activities from the six months ended June 30, 2007 included a net repayment of \$20.7 million of the Company's debt.

Net cash from investing activities was \$44.1 million for the three months ended June 30, 2008 compared to net cash used in investing activities of \$35.2 million for the three months ended June 30, 2007. During the current quarter, the Company sold certain non-core heavy oil producing assets for \$75 million and spent \$17.6 million on exploration, development and lease acquisition activities. Investing activities during the quarter ended June 30, 2007 included: (i) \$51.3 million spent on exploration, development and lease acquisition activities; (ii) \$2.5 million used to acquire additional shares in Serrano, and (iii) \$10.0 million from the sale of Bayou Bend shares.

Net cash from investing activities for the six months ended June 30, 2008 was \$8.0 million compared to net cash used in investing activities of \$70.6 million in the same period of 2007. In addition to the \$75 million from the sale of assets, the Company spent \$35.1 million on exploration, development and lease acquisition activities during the first six months of 2008. During the six months ended June 30, 2007 the Company's exploration, development and lease acquisition activities totaled \$93.3 million, corporate acquisition costs totaled \$11.7 million and the sale of Bayou Bend shares generated \$10.0 million.

The 2008 capital program and budget of \$61.0 million has been established based on the Company's projected cash flow for the year. In 2008, the Company intends to focus its efforts chiefly on converting resources to reserves and increasing operational efficiencies in core areas.

In the future the Company may consider additional issuances of common shares or debt instruments to assist with financing its ongoing oil and gas exploration, development and acquisition activities to the extent that sufficient cash flow from operations is unavailable. In addition, the Company may consider divesting additional non-core oil and gas assets or farming out interests in oil and gas properties to finance its operations. Accordingly, the Company's consolidated financial statements are presented on a going-concern basis.

CAPITAL EXPENDITURES

Capital expenditures for the three and six months ended June 30, 2008 and 2007 are as follows:

	2008	2007	2008	2007
Land	172,341	202,102	863,993	804,703
Seismic	202,845	250,971	561,214	1,009,467
Drilling and completion	8,945,931	35,020,604	13,505,511	68,203,944
Equipment	6,767,716	11,551,858	19,187,757	17,700,630
Other	439,289	180,725	561,003	1,266,994
Total exploration and development	16,528,122	47,206,260	34,679,478	88,985,738
Corporate acquisition	-	-	-	8,809,049
Property acquisitions	1,133,391	5,450,595	1,279,712	5,702,996
Property dispositions	(75,392,870)	(8,847,317)	(76,178,194)	(8,847,317)
Total capital expenditures	(57,731,357)	43,809,538	(40,219,005)	94,650,466

RELATED PARTY TRANSACTIONS

Tanganyika Oil Company Ltd. ("Tanganyika") provides administrative and technical services to the Company from time to time based upon time and expenses incurred by Tanganyika. For the six months ended June 30, 2008, Tanganyika charged the Company \$56,099 (2007 - \$89,902). Tanganyika and Pearl have certain directors and officers in common.

Namdo Management Services Ltd. ("Namdo") provides executive and support services to the Company. For the six months ended June 30, 2008, the Company paid Namdo \$90,000 (2007 - \$nil). Namdo is a private corporation owned by Lukas H. Lundin, a director of the Company.

RISKS AND UNCERTAINTIES

The Company is exposed to a number of risks and uncertainties inherent in exploring for, developing and producing crude oil and natural gas. These risks and uncertainties include, but are not limited to, the following:

- risk of finding and producing reserves economically;
- uncertainty associated with obtaining drilling licenses and other consents and approvals;
- production risks associated with sour hydrocarbons;
- marketing reserves at acceptable prices;
- cost of capital risk associated with securing the needed capital to carry out the Company's operations;
- risk of fluctuating foreign currency exchange rates;
- risk of governmental policies, social instability or other political, economic or diplomatic developments in its operations;
- market risks associated with investing the Company's cash reserves in interest bearing depository instruments; and
- environmental risks related to its oil and gas properties.

Many of the previously mentioned risks are beyond the Company's control, and it is impossible to ensure that any exploration drilling program will result in commercial operations. The Company does not currently utilize derivative instruments to hedge its commodity price, foreign currency exchange or interest rate risks.

Pearl strives to minimize and manage these risks in a number of ways, including:

- Employing qualified professional and technical staff;
- Communicating openly with members of the public regarding its activities;
- Concentrating in a limited number of areas;
- Utilizing the latest technology for finding and developing reserves;
- Constructing high-quality, environmentally sensitive, safe production facilities;
- Maximizing operational control of drilling and producing operations; and

ENVIRONMENTAL RISKS

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial and local laws and regulations. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liability and potentially increased capital expenditures and operating costs. In 2002, the Government of Canada ratified the Kyoto Protocol (the "Protocol"), which calls for Canada to reduce its greenhouse gas emissions to specified levels. There has been much public debate with respect to Canada's ability to meet these targets and the government's strategy or alternative strategies with respect to climate change and the control of greenhouse gases. Implementation of strategies for reducing greenhouse gases, whether to meet the limits required by the Protocol or as otherwise determined, could have a material impact on the nature of oil and natural gas operations, including those of the Company. Given the evolving nature of the debate related to climate change and the control of greenhouse gases and resulting requirements, it is not possible to predict either the nature of those requirements or the impact on the Company and its operations and financial condition.

NEW ACCOUNTING STANDARDS ADOPTED

As disclosed in the December 31, 2007 annual audited consolidated financial statements, on January 1, 2008, the Company adopted the new CICA Handbook Sections 3862 "Financial Instruments – Disclosures", 3863 "Financial Instruments – Presentation", and 1535 "Capital Disclosures". The adoption of these standards has had no material

impact on the Company's net income or cash flows. Additional information on the implementation of these new standards can be found in Note 3 to the Interim Consolidated Financial Statements.

RECENT ACCOUNTING PRONOUNCEMENTS

Goodwill and Intangible Assets

As of January 1, 2009, Pearl will be required to adopt Section 3064 "Goodwill and Intangible Assets," which revises the requirement for recognition, measurement, presentation and disclosure of intangible assets and replaces the existing Goodwill and Intangible Asset standard. The adoption of this standard should not have a material impact on the Company's consolidated financial statements.

International Financial Reporting Standards

In January 2006, the CICA Accounting Standards Board ("AcSB") adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, the Accounting Standards Board confirmed in February, 2008 that International Reporting Standards ("IFRS") will replace Canadian GAAP for profit-oriented Canadian publicly accountable enterprises in 2011. Pearl is assessing the potential impact of this change and developing a plan accordingly.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

The Company has, under the supervision of its chief financial officer, designed a process for internal control over financial reporting, which process has been effected by the Company's board of directors and management. The process was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the Company's GAAP and incorporates policies and procedures as described above. There have been no changes in the Company's systems of internal control over financial reporting that would materially affect, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

It should be noted that a control system, including the Company's disclosure and internal controls and procedures, no matter how well conceived can provide only reasonable, but not absolute, assurance that the objectives of the control system will be met and it should not be expected that the disclosure and internal controls and procedures will prevent all errors or fraud.

OUTLOOK

The Company plans to continue pursuing large North American heavy oil resource opportunities to add to its portfolio, to seek to rationalize non-core assets, and to focus on conversion of resources to reserves and development of its existing interests in the USA and Canada.

BOEs

Throughout this MD&A the calculation of barrels of oil equivalent (boe) is calculated at a conversion rate of six thousand cubic feet (mcf) of natural gas for one barrel of oil and is based on an energy equivalence conversion method. BOEs may be misleading, particularly if used in isolation. A boe conversion ratio of 6 mcf:1 bbl is based on an energy equivalence conversion method primarily applicable at the burner tip and does not represent a value equivalence at the wellhead.

NON-GAAP MEASURES

Included in this report are references to terms commonly used in the oil and gas industry, such as, cash flow and funds from operations which represent cash flow from operating activities expressed before changes in non-cash working capital, long-term receivable and asset retirement costs incurred and are used by the Company to analyze operating performance, leverage and liquidity. These terms do not have standardized meanings prescribed by Generally Accepted Accounting Principles and therefore may not be comparable with the calculations of similar measures for other entities. Consequently, these are referred to as non-GAAP measures.

PEARL EXPLORATION AND PRODUCTION LTD.

Consolidated Balance Sheet
(unaudited)

	June 30, 2008	December 31, 2007
Assets		
Current assets		
Cash	\$ 54,749,247	\$ 4,799,186
Accounts receivable	31,438,092	25,134,435
Income taxes and capital taxes receivable	2,770,506	2,618,015
Prepaid expenses and deposits	<u>1,709,938</u>	<u>3,195,770</u>
	<u>90,667,783</u>	<u>35,747,406</u>
Investments (note 5)	9,362,895	9,362,895
Petroleum and natural gas properties (note 6)	440,703,675	528,352,540
Future income tax	<u>2,388,711</u>	<u>2,402,532</u>
	<u>\$ 543,123,064</u>	<u>\$ 575,865,373</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	<u>33,296,598</u>	<u>69,899,310</u>
	<u>33,296,598</u>	<u>69,899,310</u>
Long-term liabilities		
Asset retirement obligation (note 8)	11,127,830	16,586,030
Bank loan (note 7)	<u>5,000,000</u>	<u>-</u>
	<u>49,424,428</u>	<u>86,485,340</u>
Shareholders' equity		
Share capital (note 10)	723,121,821	723,121,821
Contributed surplus (note 11)	10,199,209	8,778,124
Deficit	<u>(239,622,394)</u>	<u>(242,519,912)</u>
	<u>493,698,636</u>	<u>489,380,033</u>
	<u>\$ 543,123,064</u>	<u>\$ 575,865,373</u>
Commitments (note 13)		
Contingencies (note 16)		
<i>See accompanying notes to consolidated financial statements</i>		

PEARL EXPLORATION AND PRODUCTION LTD.

**Consolidated Statement of Operations and Deficit
(unaudited)**

	Three months ended June 30		Six months ended June 30	
	2008	2007	2008	2007
Revenue				
Oil and gas sales	\$ 59,838,652	\$ 29,801,464	117,668,622	\$ 54,265,280
Interest income	609,621	40,057	726,137	283,540
Royalties	(14,955,541)	(6,321,753)	(28,886,998)	(11,606,568)
	<u>45,492,732</u>	<u>23,519,768</u>	<u>89,507,761</u>	<u>42,942,252</u>
Expenses				
Production costs	11,453,121	10,948,973	30,336,956	21,081,407
Transportation costs	1,003,274	1,074,032	2,200,605	2,073,150
General and administrative	3,386,367	3,952,930	6,413,160	6,511,460
Depletion, depreciation and accretion	18,992,228	22,322,286	44,035,359	39,859,293
Stock-based compensation	519,964	917,621	1,421,084	1,875,396
Interest	442,942	1,239,918	781,725	1,638,583
Change in unrealized loss of gas pricing contracts	-	-	-	487,760
Foreign currency exchange loss (gain)	(1,026)	96,673	(36,711)	268,222
	<u>35,796,870</u>	<u>40,552,433</u>	<u>85,152,178</u>	<u>73,795,271</u>
Other items				
Gain on sale of assets	-	(13,270,044)	-	(13,270,044)
	<u>-</u>	<u>(13,270,044)</u>	<u>-</u>	<u>(13,270,044)</u>
Income (loss) before income taxes	<u>9,695,862</u>	<u>(3,762,621)</u>	<u>4,355,583</u>	<u>(17,582,975)</u>
Income taxes				
Future income taxes (recovery)	2,263,340	(3,120,243)	13,821	392,770
Income taxes and capital taxes	744,976	6,582,979	1,444,244	6,877,671
	<u>3,008,316</u>	<u>3,462,736</u>	<u>1,458,065</u>	<u>7,270,441</u>
Net income (loss) for the period	<u>6,687,546</u>	<u>(7,225,357)</u>	<u>2,897,518</u>	<u>(24,853,416)</u>
Deficit, beginning of period	<u>(246,309,940)</u>	<u>(38,205,227)</u>	<u>(242,519,912)</u>	<u>(20,577,168)</u>
Deficit, end of period	\$ <u>(239,622,394)</u>	\$ <u>(45,430,584)</u>	\$ <u>(239,622,394)</u>	\$ <u>(45,430,584)</u>
Basic and diluted income (loss) per share	\$ 0.04	\$ (0.05)	0.02	\$ (0.19)
Weighted average number of common shares used in computing earnings per share:				
basic	189,241,716	133,935,248	189,241,716	132,479,881
diluted	189,241,716	133,935,248	189,241,716	132,479,881

See accompanying notes to consolidated financial statements

PEARL EXPLORATION AND PRODUCTION LTD.

**Consolidated Statement of Comprehensive Income (Loss) and Accumulated Other Comprehensive Income
(unaudited)**

	Three months ended June 30		Six months ended June 30	
	2008	2007	2008	2007
Net income (loss)	\$ 6,687,546	\$ (7,225,357)	\$ 2,897,518	\$ (24,853,416)
Other comprehensive income, net of tax				
Items affecting comprehensive income	-	750,000	-	750,000
Comprehensive income (loss)	\$ 6,687,546	\$ (6,475,357)	\$ 2,897,518	\$ (24,103,416)
Accumulated other comprehensive income, beginning of period	\$ -	\$ -	\$ -	\$ -
Other comprehensive income, net of taxes	-	750,000	-	750,000
Accumulated other comprehensive income end of period	\$ -	\$ 750,000	\$ -	\$ 750,000

See accompanying notes to consolidated financial statements

PEARL EXPLORATION AND PRODUCTION LTD.

Consolidated Statements of Cash Flows
(unaudited)

	Three months ended June 30		Six months ended June 30	
	2008	2007	2008	2007
Operating activities				
Comprehensive income (loss)	\$ 6,687,546	\$ (6,475,357)	\$ 2,897,518	\$ (24,103,416)
Items not involving cash:				
Mark to market gain on available-for-sale financial asset	-	(750,000)	-	(750,000)
Writedown (recovery) of accounts receivable	(189,597)	1,252,000	(189,597)	1,252,000
Gain on sale of assets	-	(13,270,044)	-	(13,270,044)
Depletion, depreciation and accretion	18,992,228	22,322,286	44,035,359	39,859,293
Stock-based compensation	519,964	917,621	1,421,084	1,875,396
Future income tax (recovery)	2,263,340	(3,120,243)	13,821	392,770
Change in unrealized loss of gas pricing contracts	-	-	-	487,760
Foreign exchange loss (gain)	(1,026)	96,673	(36,711)	268,222
Abandonment costs	(248,971)	(811,338)	(666,129)	(811,338)
	<u>28,023,484</u>	<u>161,598</u>	<u>47,475,345</u>	<u>5,200,643</u>
Changes in non-cash working capital balances related to operations	3,165,847	(1,283,202)	(10,558,937)	(2,146,070)
Long term accounts receivable	-	-	-	1,066,758
	<u>31,189,331</u>	<u>(1,121,604)</u>	<u>36,916,408</u>	<u>4,121,331</u>
Financing activities				
Advances of bank loan	-	35,400,000	25,000,000	74,000,000
Repayments of bank loan	(20,000,000)	-	(20,000,000)	(94,670,719)
Exercise of stock options	-	119,100	-	571,225
	<u>(20,000,000)</u>	<u>35,519,100</u>	<u>5,000,000</u>	<u>(20,099,494)</u>
Investing activities				
Acquisition of Cipher Exploration Inc.	-	-	-	(8,809,049)
Acquisition of Serrano shares	-	(2,500,000)	-	(2,500,000)
Proceeds from sale of investments	-	10,000,000	-	10,000,000
Proceeds from sale of assets	75,336,231	-	75,336,231	-
Additions to petroleum and natural gas properties	(17,604,874)	(51,309,538)	(35,117,226)	(93,341,417)
Changes in non-cash working capital from investing	(13,664,741)	8,566,025	(32,185,352)	24,035,820
	<u>44,066,616</u>	<u>(35,243,513)</u>	<u>8,033,653</u>	<u>(70,614,646)</u>
Net increase (decrease) in cash	55,255,947	(846,017)	49,950,061	(86,592,809)
Cash, beginning of period	(506,700)	5,311,410	4,799,186	91,058,203
Cash, end of period	\$ 54,749,247	\$ 4,465,393	\$ 54,749,247	\$ 4,465,394
Supplementary Information				
Interest paid	\$ 442,942	\$ 1,185,719	\$ 781,725	\$ 1,602,360
Capital taxes paid	\$ 651,554	\$ -	\$ 1,009,957	\$ -

See accompanying notes to consolidated financial statements

PEARL EXPLORATION AND PRODUCTION LTD.
Notes to the Consolidated Financial Statements
(unaudited)

1. NATURE OF OPERATIONS

Pearl Exploration and Production Ltd. (collectively with its subsidiaries, the “Company” or “Pearl”) is listed and traded on the TSX Venture Exchange under the trading symbol “PXX”. The Company is engaged in the business of oil and gas exploration and development in North America.

2. BASIS OF PRESENTATION

The interim consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries: Pearl E&P Canada Ltd., Pearl Exploration and Production USA Ltd., Pearl Exploration and Production Montana Ltd., Newmex Energy (USA) Inc., Valkyries Texas Corp., and Valkyries Texas Gas Ltd. Both Cipher Exploration Inc. and Watch Resources Ltd. were amalgamated with Pearl E & P Canada Ltd. on January 1, 2008.

The interim consolidated financial statements for the Company have been prepared in accordance with accounting principles generally accepted in Canada, using the same accounting policies and methods of computation as set out in note 3 to the audited consolidated financial statements in the Company’s Financial Report for the fifteen months ended December 31, 2007. The disclosures provided herein are incremental to those included with the audited consolidated financial statements. The interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the fifteen months ended December 31, 2007 and the interim consolidated financial statements for the quarter ended March 31, 2008.

3. CHANGES IN ACCOUNTING POLICIES

As disclosed in the December 31, 2007 annual audited Consolidated Financial Statements, on January 1, 2008, the Company adopted the following Canadian Institute of Chartered Accountants (“CICA”) Handbook Sections:

- Section 3862 “Financial Instruments – Disclosures” and Section 3863 “Financial Instruments – Presentation,” which replace Section 3861 “Financial Instruments – Disclosure and Presentation.” The new disclosure standard increases the emphasis on the risks associated with financial instruments and how those risks are managed (See Note 14). The new presentation standard carries forward the former presentation requirements.
- Section 1535 “Capital Disclosures,” The new standard requires the Company to disclose its objectives, policies and processes for managing its capital structure (See Note 12).

4. RECENT ACCOUNTING PRONOUNCEMENTS

As of January 1, 2009, the Company will be required to adopt the CICA Handbook Section 3064, “Goodwill and Intangible Assets”, which will replace the existing Goodwill and Intangible Assets standard. The new standard revises the requirement for recognition, measurement, presentation and disclosure of intangible assets. The adoption of this standard should not have a material impact on the Company’s Consolidated Financial Statements.

In January 2006, 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”) for fiscal periods commencing on or after January 1, 2011. The Company is assessing the potential impacts of this changeover and developing its plan accordingly.

5. INVESTMENTS

	June 30, 2008	December 31, 2007
Investment in Serrano Energy Ltd. ("Serrano")	\$5,500,000	\$5,500,000
Asset-backed commercial paper ("ABCP")	3,862,895	3,862,895
	<u>\$9,362,895</u>	<u>\$9,362,895</u>

The Company owns approximately 4.0 million shares of Serrano. On April 29, 2008 Serrano executed a subscription agreement which will change Pearl's ownership interest in Serrano from 37 percent to approximately 18 percent, this transaction has not closed as of June 30, 2008.

The Company holds an investment in ABCP as part of the Watch acquisition on October 19, 2007. Prior to the acquisition of Watch major participants in the third party sponsored ABCP market announced a proposed solution to the liquidity problem in the ABCP market. A restructuring plan was ultimately submitted to the Ontario Superior Court of Justice under the Companies Creditors Arrangement Act (CCAA) which was sanctioned on June 5, 2008. The restructuring plan is now currently under appeal and the Ontario Court of Appeal has not yet issued a decision on the matter. Should the restructuring plan be successful, the ABCP investment will be converted into notes with maturities matching the underlying assets. The notes will bear interest rates commensurate with the nature of the underlying assets including the cost of a margin funding facility.

At the time of the acquisition of Watch the Company determined that the estimated fair value of the ABCP was \$1.1 million less than the face value. The valuation technique used by the Company to estimate the fair value of its investments in ABCP incorporates probability – weighted discounted cash flows considering the best available public information regarding market conditions and other factors that a market participant would consider for such investments. The Company has determined that no further adjustment is required at this time. However, continuing uncertainties regarding the value of the assets which underlie the ABCP, the amount and timing of cash flows and the outcome of the restructuring process could give rise to a further change in the value of the Company's investment in ABCP which would impact the Company's earnings.

6. PETROLEUM AND NATURAL GAS PROPERTIES

	June 30, 2008		
	Cost	Accumulated depreciation and depletion	Net book value
Petroleum and natural gas properties	\$579,165,224	\$139,983,506	\$439,181,718
Office equipment	2,081,291	559,334	1,521,957
	<u>\$581,246,515</u>	<u>\$140,542,840</u>	<u>\$440,703,675</u>
	December 31, 2007		
	Cost	Accumulated depreciation and depletion	Net book value
Petroleum and natural gas properties	\$623,916,051	\$96,763,951	\$527,152,100
Office equipment	1,520,287	319,847	1,200,440
	<u>\$625,436,338</u>	<u>\$97,083,798</u>	<u>\$528,352,540</u>

The depletion and ceiling test calculations have excluded the cost of unproved properties of \$59.8 million (December 31, 2007 – \$61.0 million) and included the cost of future development costs of \$102.3 million (December 31, 2007 – \$145.0 million).

7. BANK CREDIT FACILITY

The Company has a credit facility with a Canadian chartered bank which is comprised of a \$37 million revolving 364-day extendible term facility, and a \$10 million demand revolving operating facility. The Company may borrow, repay and re-borrow advances with the aggregated outstanding not to exceed the total credit facility. The facility bears interest at the bank prime rate payable monthly and is secured by a general securities agreement.

The facility is subject to annual reviews. The next scheduled review will take place on May 31, 2009.

8. ASSET RETIREMENT OBLIGATION

The total future asset retirement obligation was estimated based on the Company's net ownership interest in all wells and facilities, the estimated costs to abandon and reclaim the wells and facilities and the estimated timing of the costs to be incurred in future periods. The total undiscounted amount of the estimated cash flows required to settle the asset retirement obligations is approximately \$27.6 million which will be incurred over the next 48 years with the majority of costs incurred between 2008 and 2025. A credit adjusted risk-free rate of 8 percent and an inflation factor of 1.5 percent was used to calculate the fair value of the asset retirement obligation.

Changes to the asset retirement obligation were as follows:

	<u>June 30, 2008</u>	<u>December 31, 2007</u>
Asset retirement obligation at beginning of period	\$ 16,586,030	\$ 3,772,479
Liabilities acquired through acquisitions, net of dispositions	(5,866,897)	9,822,642
Liabilities incurred during the period	498,509	2,987,539
Actual remediation expenses	(666,129)	(1,164,822)
Accretion	576,317	1,168,192
Asset retirement obligation at end of period	\$ 11,127,830	\$ 16,586,030

9. RELATED PARTY TRANSACTIONS

During the six months ended June 30, 2008 the Company entered into the following transactions with related parties in the normal course of business, which are recorded at the exchange amount established and agreed to by the related parties:

(a) The Company paid \$56,099 (2007 – \$59,111) to Tanganyika Oil Company Ltd. ("Tanganyika") for administrative and other services. The Company and Tanganyika have certain officers and directors in common.

(b) The Company paid \$45,000 (2007 – \$nil) to Namdo Management Services Ltd. ("Namdo") for executive and support services pursuant to a services agreement. Namdo is a private corporation owned by Lukas H. Lundin, a director of the Company.

10. SHARE CAPITAL

(a) Authorized:

The Company is authorized to issue an unlimited number of common shares.

(b) Common Shares Issued:

	<u>Number of Shares</u>	\$	<u>Attributed Value</u>
Balance as at June 30, 2008 and December 31, 2007	189,241,716		723,121,821

(c) Warrants Outstanding:

	Number of whole warrants	\$	Weighted average exercise price per share
Balance as at June 30, 2008 and December 31, 2007	4,091,800		0.98

(i) Four million warrants were issued pursuant to the San Miguel acquisition in November 2005. Each warrant entitles the holder thereof to purchase an additional common share of the Company at a price of \$1.00, exercisable from the date the San Miguel heavy oil project achieves an average daily producing rate of 5,000 barrels of oil per day, averaged over 30 consecutive days, until November 18, 2008.

(ii) In connection with the December, 2005 Palo Duro acquisition, the Company issued 270,000 warrants. This number was subsequently reduced by 66% to 91,800 when the vendor exercised a back-in right on March 3, 2006. Each remaining warrant provides the warrant holder with the right to receive an additional common share of the Company, within 75 days of September 15, 2008, for no additional consideration, if the average production rate per well drilled in the Palo Duro shale gas project is at least 1.5 million cubic feet equivalent per day, based on the initial 60 days of production. The number of warrants ultimately issued will be reduced pro rata to the actual average production rate if the actual average production rate per well drilled by September 15, 2008 is less than 1.5 million cubic feet equivalent per day.

11. STOCK-BASED COMPENSATION

The Company has a stock option plan (the "plan") for directors, officers, consultants and employees of the Company and its subsidiaries. A total of 18,924,172 stock options are authorized to be issued under the plan. Stock options have terms of two to five years, vest over periods of up to three years and are exercisable at the market prices of the shares on the dates that the options were granted. All of the options are subject to a four-month "hold" period.

The continuity of stock options issued and outstanding is as follows:

	<u>Number of Options</u>	<u>Weighted Average Exercise Price \$</u>
Outstanding December 31, 2007	7,726,357	3.98
Granted	172,000	1.93
Cancelled	(856,098)	4.21
Expired	(1,321,667)	4.13
Outstanding at June 30, 2008	<u>5,720,592</u>	<u>3.84</u>

The following stock options were outstanding at June 30, 2008:

Options Outstanding				Options Exercisable		
Range of Exercise Prices (\$)	Number	Weighted-Average Exercise Price (\$)	Weighted-Average Life (Years)	Number	Weighted-Average Exercise Price (\$)	Weighted-Average Life (Years)
1.59 - 3.00	2,052,500	2.48	4.49	-		
3.01 - 4.50	1,520,759	3.92	3.07	770,759	4.30	1.93
4.51 - 5.28	2,147,333	5.10	3.32	835,666	5.12	2.94
	5,720,592	3.84	3.68	1,606,425	4.73	2.46

Compensation expense of \$1,804,097, net of recovery of \$383,012 for cancelled stock options, has been recorded in the Consolidated Statements of Operations and Deficit for the six months ended June 30, 2008 (2007 – \$1,875,396). The fair value of common share options granted is estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of options granted during 2008 and the assumptions used in their determination are as noted below:

	Six Months Ended June 30, 2008
Weighted average fair value of stock options granted (per option)	\$0.82
Expected life of stock options (years)	3.00
Volatility (weighted average)	61%
Risk free rate of return (weighted average)	3.04%
Expected dividend yield	0%

Contributed surplus continuity	June 30, 2008	December 31, 2007
Balance, beginning of the period	\$ 8,778,124	\$ 4,791,060
Stock-based compensation	1,804,097	4,636,916
Stock-based compensation allocated to contributed surplus as part of Watch acquisition	-	575,448
Recovery of expense on cancelled stock options	(383,012)	(590,137)
Transfer to share capital on exercise of options	-	(635,163)
Balance, end of period	<u>\$ 10,199,209</u>	<u>\$ 8,778,124</u>

12. CAPITAL MANAGEMENT

The Company's capital management strategy is designed to minimize the use of long term debt and maintaining positive working capital. This strategy should provide the financial flexibility to fund the Company's capital program and profitable growth opportunities.

Financial covenants associated with the Company's credit facility are reviewed regularly and controls are in place to maintain compliance with these covenants. The Company complied with all covenants for the six months ended June 30, 2008.

13. COMMITMENTS AND CONTRACTUAL OBLIGATIONS

The Company enters into commitments and contractual obligations in the normal course of business, including the purchase of services, farm-in agreements, royalty agreements, operating agreements, transportation agreements, processing agreements, right of way agreements and lease agreements for vehicles.

The Company has a nine-year operating lease for office space.

	2008	2009	2010	2011	2012	Subsequent to 2012
Office rent	\$542,380	\$1,084,760	\$1,084,760	\$1,152,557	\$1,220,355	\$4,576,331

The Company has contracted drilling rig services over the next two years. In the event that the Company does not utilize the minimum contracted days, the Company would be obligated to pay the rig operators a variable rate based on days not utilized under the contracts. Subsequent to quarter end the Company completed renegotiating the contract and the maximum commitment related to these contracts is approximately \$4.2 million, which can be reduced by farm-outs to other operators.

14. FINANCIAL INSTRUMENTS

The Company does not utilize derivative instruments to manage risks. The Company is exposed to the following risks related to financial assets and liabilities:

(a) Commodity price risk

The Company is exposed to risks associated with fluctuating commodity prices. At this time, the Company does not use derivative financial instruments to manage its exposure to this risk.

(b) Foreign currency exchange risk

The Company is exposed to risks arising from fluctuations in foreign currency exchange rates and the volatility of those rates. This exposure primarily relates to: (i) certain expenditure commitments, deposits, accounts receivable, and accounts payable which are denominated in US dollars, and (ii) its operations in the United States.

(c) Fair values

The carrying amounts of financial instruments comprising cash, accounts receivable and accounts payable approximate their fair value due to the immediate or short-term nature of these financial instruments.

(d) Credit Risk

The Company's accounts receivable are with customers and joint venture partners in the petroleum and natural gas business and are subject to normal credit risks. Management believes that there is no unusual exposure associated with the collection of the receivables due to the size and reputation of the companies and to the continuing joint venture relationship.

(e) Interest Rate Risk

The Company is exposed to interest rate risk in relation to interest expense on its revolving credit facility.

15. SEGMENTED INFORMATION

The Company presently has one reportable business segment, that being oil and gas exploration and development. The Company's operations are carried on in the following geographic locations:

	Three Months Ended June 30, 2008		
	Canada	USA	Consolidated
Total revenues, net of royalties	45,208,914	283,818	45,492,732
Expenses	35,255,324	542,572	35,797,896
Foreign currency gain	(6,942)	5,916	(1,026)
Net income (loss) before income taxes	9,960,532	(264,670)	9,695,861
Income taxes (recovery)	3,019,878	(11,562)	3,008,316
Net income (loss)	6,940,654	(253,108)	6,687,545
Segment assets	480,145,188	62,977,876	543,123,064
Segment petroleum and natural gas Properties	385,191,972	55,511,703	440,703,675
Capital additions	11,713,508	5,891,366	17,604,874
	Six Months Ended June 30, 2008		
	Canada	USA	Consolidated
Total revenues, net of royalties	88,845,179	662,582	89,507,761
Expenses	84,392,158	796,731	85,188,889
Foreign currency gain	(11,288)	(25,423)	(36,711)
Net income (loss) before income taxes	4,464,309	(108,726)	4,355,582
Income taxes (recovery)	1,460,989	(2,924)	1,458,065
Net income (loss)	3,003,320	(105,802)	2,897,517
Segment assets	480,145,188	62,977,876	543,123,064
Segment petroleum and natural gas Properties	385,191,972	55,511,703	440,703,675
Capital additions	25,215,281	9,901,945	35,117,226
	Three Months Ended June 30, 2007		
	Canada	USA	Consolidated
Total revenues, net of royalties	23,330,845	188,923	23,519,768
Expenses	40,214,337	241,423	40,455,760
Foreign currency loss	96,673	-	96,673
Gain on sale of assets	-	(13,270,044)	(13,270,044)
Loss before income taxes	(16,980,165)	13,217,544	(3,762,621)
Income taxes (recovery)	(2,988,890)	6,451,626	3,462,736
Net loss	(13,991,275)	6,765,918	(7,225,357)
Segment assets	581,178,300	39,613,292	620,791,592
Goodwill	159,863,578	-	159,863,578
Segment petroleum and natural gas Properties	384,617,319	26,393,375	411,010,694
Capital additions	49,351,062	1,958,476	51,309,538

	Six Months Ended June 30, 2007		
	Canada	USA	Consolidated
Total revenues, net of royalties	42,419,896	522,356	42,942,252
Expenses	72,568,796	958,253	73,527,049
Foreign currency loss	268,222	-	268,222
Gain on sale of assets	-	(13,270,044)	(13,270,044)
Loss before income taxes	(30,417,122)	12,834,147	(17,582,975)
Income taxes (recovery)	818,815	6,451,626	7,270,441
Net loss	(31,235,937)	6,382,521	(24,853,416)
Segment assets	581,178,300	39,613,292	620,791,592
Goodwill	159,863,578	-	159,863,578
Segment petroleum and natural gas Properties	384,617,319	26,393,375	411,010,694
Capital additions	87,566,854	5,774,563	93,341,417

16. CONTINGENCIES

(a) In connection with the November, 2007 property acquisition from PetroHunter, the Company may be required to pay a performance payment of US \$9.8 million in cash at such time as either: (i) production from the assets reaches 5,000 bopd; or (ii) proven reserves from the assets is greater than 50 million barrels of oil, if either condition is met prior to November 6th, 2010. The Company did not reach an agreement with a third party and therefore the performance payment was reduced and the contingent shares were not issued.

(b) Four million warrants were issued pursuant to the San Miguel property acquisition in November 2005. Each warrant entitles the holder thereof to purchase an additional common share of the Company at a price of \$1.00, exercisable from the date the San Miguel heavy oil project achieves an average daily producing rate of 5,000 barrels of oil per day, averaged over 30 consecutive days, until November 18, 2008.

(c) In connection with the December, 2005 Palo Duro property acquisition, the Company has 91,800 warrants outstanding, entitling the holder to receive an additional Pearl common share within 75 days of September 15, 2008, for no additional consideration, if the average production rate per well drilled in the Palo Duro shale gas project is at least 1.5 million cubic feet equivalent per day, based on the initial 60 days of production. The number of warrants ultimately issued will be reduced pro rata to the actual average production rate if the actual average production rate per well drilled by September 15, 2008 is less than 1.5 million cubic feet equivalent per day.

17. SUBSEQUENT EVENTS

On July 16th, 2008 the Company announced that it had entered into an agreement to acquire an additional 30% working interest in 3,886 contiguous hectares of oil sands leases in its Blackrod project, located south of Fort McMurray, in the Athabasca Oil Sands region of northern Alberta. The acquisition is expected to close in August, 2008. The cost of the acquisition will be paid in increments with \$4.5 million payable at closing; \$4 million payable when the steam assisted gravity drainage ("SAGD") pilot achieves gross accumulated production of 100,000 Bbls; \$4 million payable when full scale commercial development achieves 5,000 Bbl/d of production as reported to the Alberta government for one month; and \$3 million payable when full scale commercial development achieves 10,000 Bbl/d of production as reported to the Alberta government for the duration of one month.

In July 2008, SemCanada sought protection under the Companies' Creditors Arrangement Act (CCAA). The Company uses SemCanada to market some of its oil and natural gas production and is exposed to approximately \$500,000 in receivables relating to the period from June 1 to July 21, 2008. At this time it is unknown how much of that amount will be collectible.

18. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the presentation adopted in 2008.

SELECTED QUARTERLY INFORMATION

	2008		2007				2006	
	30-Jun	31-Mar	31-Dec	30-Sep	30-Jun	31-Mar	31-Dec	30-Sep
FINANCIAL (\$000's, except per share data)								
Total revenue	45,493	44,015	27,973	24,916	23,520	19,422	5,318	1,924
Cash flow from operations before working capital changes ⁽²⁾	28,023	19,452	9,609	6,268	973	5,039	569	(980)
Per common share								
Basic and diluted (\$)	0.15	0.10	0.05	0.04	0.01	0.04	0.01	(0.02)
Net and comprehensive income (loss)	6,688	(3,790)	(183,407)	(13,683)	(7,225)	(17,628)	(5,263)	(1,990)
Per common share								
Basic and diluted (\$)	0.04	(0.02)	(1.01)	(0.09)	(0.05)	(0.13)	(0.08)	(0.04)
Capital expenditures	17,605	17,512	61,971	47,446	53,810	50,841	17,680	31,034
Total assets	543,123	584,237	575,865	654,543	620,792	586,276	640,195	129,067
Total long-term financial liabilities	16,128	41,682	16,586	14,512	15,902	16,211	13,433	3,772
Working capital surplus (deficiency)	57,371	(7,177)	(34,152)	(87,588)	(98,510)	(53,633)	(5,836)	(3,757)
Shareholders' equity	493,699	486,491	489,380	500,882	453,135	458,574	468,106	102,091
OPERATIONAL								
Daily Production								
Oil – net production (bbls/d)	6,660	8,698	7,703	6,973	5,934	4,622	1,238	246
Gas – net production (mcf/d)	9,402	10,757	10,734	12,608	11,757	13,923	2,620	1,250
Total net production (boe/d)*	8,246	10,503	9,507	9,093	7,910	6,966	1,674	454
Product Pricing								
Oil – average selling price per bbl (\$/)	84.57	63.11	40.73	41.94	41.29	35.89	38.44	48.9
Gas – average selling price per mcf (\$)	9.80	7.79	6.23	5.01	6.81	7.32	6.80	6.44
Weighted average sales price per boe (\$)	79.74	60.50	40.30	39.17	41.4	39.02	40.4	44.9
Royalties (\$/boe)	19.93	14.58	8.95	9.43	8.78	8.43	7.60	8.75
Operating costs (including transportation expenses) (\$/boe)	16.60	21.01	17.91	15.23	16.7	17.75	16.47	12.60
PNG Netback ⁽³⁾ (\$/boe)	43.21	24.91	13.44	14.51	15.92	12.84	16.33	23.55
Share Information (000's)								
Weighted average shares outstanding (basic)	189,242	189,242	181,212	145,616	133,935	132,472	62,939	50,422
Shares outstanding at end of period	189,242	189,242	189,242	147,435	133,950	133,920	131,737	51,913
Volume traded during the quarter	37,101	37,354	26,080	26,012	38,105	13,907	9,673	6,578
Share price (\$)								
High	2.73	2.80	4.04	5.30	5.93	5.20	6.20	6.00
Low	1.60	1.43	2.15	3.30	4.00	3.90	4.40	4.20
Close (end of period)	2.10	1.63	2.60	3.94	5.07	4.15	5.08	4.85

(1) Oil equivalent amounts referenced have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil. BOEs may be misleading, particularly if used in isolation. A BOE conversion ratio of 6 MCF:1 bbl is based on an energy equivalency.

(2) Cash flow from operations before working capital changes and cash flow per share do not have standardized meanings prescribed by Canadian Generally Accepted Accounting Principles ("GAAP") and therefore may not be comparable to similar measures used by other companies. Cash flow from operations before working capital changes includes all cash flow from operating activities and is calculated before changes in non-cash working capital. Cash flow from operations before working capital changes is reconciled with net loss on the Consolidated Statement of Cash Flows and in the accompanying Management Discussion & Analysis. Management uses these non-GAAP measurements for its own performance measures and to provide its shareholders and investors with a measurement of the Company's efficiency and its ability to fund a portion of its future growth expenditures.

(3) PNG netback is a non-GAAP measure used by management as a measure of operating efficiency and profitability. It is calculated by deducting royalties, operating costs and transportation costs from petroleum and natural gas revenues.

DIRECTORS

Brian D. Edgar
Director
Vancouver, British Columbia

Gary S. Guidry
Director
Calgary, Alberta

Gordon D. Harris
Director
Calgary, Alberta

Keith C. Hill
Director
Vancouver, British Columbia

John W. Ladd
Director
Houston, Texas

Lukas Lundin
Director
Vancouver, British Columbia

A. Murray Sinclair
Director
Vancouver, British Columbia

OFFICERS

Gary S. Guidry
Chairman
Calgary, Alberta

Keith C. Hill
President & Chief Executive Officer
Vancouver, British Columbia

Dean Tucker
VP Operations
Calgary, Alberta

Randy Neely
Chief Financial Officer
Calgary, Alberta

Diane Phillips
Corporate Secretary
Calgary, Alberta

CORPORATE INFORMATION

CORPORATE OFFICE

700, 444 – 7th Avenue S.W.
Calgary, Alberta
T2P 0X8 Canada
Telephone: (403) 215-8313
Facsimile: (403) 265-8324
Website: www.pearleandp.com

BANKER

ATB Financial
Calgary, Alberta

AUDITOR

PricewaterhouseCoopers LLP
111—5th Avenue S.W.
Calgary, Alberta

TRANSFER AGENT

Computershare Trust Company of Canada
600, 530—8th Avenue S.W.
Calgary, Alberta

STOCK EXCHANGE LISTING

TSX Venture Exchange
Trading Symbol: PXX
First North
Trading Symbol: PXXS

COMPANY REGISTRATION NUMBER

409596-1

CERTIFIED ADVISOR ON FIRST NORTH

E. Öhman J:or Fondkommission AB.

The report for the quarter ending
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on or before November 14, 2008.