Madalena Ventures Inc.

**Quarterly Report**

**For the Three and Six Months Ended June 30, 2012**
**(unaudited)**

# President's Message

Over the past several months there have been a number of federal and other regulatory policy changes in Argentina including changes which pertain directly to the hydrocarbon industry. While there was earlier anticipation that some of these policy changes would focus on increasing oil and gas prices to encourage further investment in the sector, most of the highly publicized policy changes so far this year have been in the form of a tighter regulatory regime on investment and commercialization of hydrocarbons. While not the changes the industry expected, both current and potential new investors in Argentina's energy sector have been able to use this period to clearly present what type of economic conditions will be necessary to attract foreign capital and expertise for development of Argentina's significant non-conventional resources.

These policies have not changed the fiscal regime governing the Company's interests in the Neuquén Basin. Madalena remained very active on all of its blocks in the first half of the year. On the Coiron Amargo Block, following the successful drilling in the first half of the year of our first two development wells in the northern exploitation area (Coiron Amargo Norte) and two exploration wells in the southern portion of the block (Coiron Amargo Sur), a total of 9 wells (7 exploration, 2 development) have now been drilled on the block since it was first acquired in late 2007.

Development drilling along with other infrastructure improvements at Coiron Amargo Norte resulted in a significant increase in production in July 2012 compared to the first half of the year. Much of the production increase is from the CAN 7 development well located within the CAN X-3 Sierras Blancas structure as well as CAN 5 development well located within the CAN X-1 Sierras Blancas structure. While certain oil storage and gas processing restrictions remain, once those restrictions are eliminated and all wells in Coiron Amargo Norte and Sur placed on production, the Company's estimated share of total production would be 460 boepd (including 398 bopd). In addition, gas pricing continues to improve with Coiron Amargo Norte gas production being sold at a price of US $4.35/mmbtu effective August 1, 2012. Following the success of these wells and related fracture treatments, several additional development drilling locations have been identified in the northern Sierras Blancas structures.

While testing multiple horizons, both the CAS X-4 and CAS X-2 exploration wells drilled in the first half of the year were primarily intended to provide a more comprehensive delineation of the Vaca Muerta characteristics over the block. A third Vaca Muerta exploration well is planned for later this year approximately 10km west of the CAS X-2 well near another well that had indications of natural fracturing in the Vaca Muerta formation following a drill stem test. The industries understanding of the Vaca Muerta source shale continues to grow with a number of wells drilled and testing near our blocks this year. Madalena continues to monitor this activity as well as performing our own studies in order to ensure the most efficient exploitation of this resource in the areas we operate.

On the Curamhuele Block, operations on the CurX-1 well have been temporarily suspended in order to reduce stand-by costs after attempts to remove certain down-hole equipment in order to install casing for the fracture stimulation were unsuccessful. Various options have been reviewed to remove the down-hole equipment and plans are to re-enter the well once the necessary tools are available. Once completed, the frac would be the first hydraulic fracture stimulation of the Lower Agrio shale in the Neuquén Basin where we have already confirmed light oil production.

Like other junior oil and gas exploration companies, Madalena is subject to global economic uncertainty along with a number of other risk factors, including foreign operations. The Company is monitoring steps being taken by the Argentina federal and provincial governments to encourage investment in the country as well as continuing to work with its industry and provincial partners to both progress development of the hydrocarbon sector in general and continue further exploration and development of its blocks. In keeping with its corporate strategy the Company also periodically evaluates new opportunities as they arise.

I look forward to updating you on our progress over the second half of the year.

Dwayne Warkentin
President and Chief Executive Officer

## MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis ("MD&A") is provided by management of Madalena Ventures Inc. ("Madalena" or the "Company"), as at and for the three and six month periods ended June 30, 2012 and 2011. This MD&A should be read in conjunction with the Company's condensed consolidated unaudited financial statements for the three and six month periods ended June 30, 2012. The interim consolidated unaudited financial statements of the Company have been prepared in accordance with International Accounting Standards ("IAS") 34 Interim Financial Reporting. The Company's financial statements and other public disclosure documents, including its annual information form ("AIF"), are filed on SEDAR at www.sedar.com. The commentary in this MD&A is based on information available to August 22, 2012. Unless otherwise stated, all dollar amounts are expressed in Canadian dollars.

Unless otherwise stated, all calculations converting natural gas to barrels of oil equivalent ("boe") have been made using a conversion ratio of six thousand cubic feet (six "Mcf") of natural gas to one barrel of oil. The use of boe may be misleading, particularly if used in isolation, as the conversion ratio of six Mcf of natural gas to one barrel of oil is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

### Forward-looking Statements

This MD&A may include forward-looking statements including opinions, assumptions, estimates and management's assessment of future plans and operations, expected depletion, depreciation and accretion expenses, expectations as to the taxability of the Company and planned capital expenditures and the timing and funding thereof. When used in this document, the words "anticipate," "believe," "estimate," "expect," "intent," "may," "project," "plan", "should" and similar expressions are intended to be among the statements that identify forward-looking statements. Forward-looking statements are subject to a wide range of risks and uncertainties, and although the Company believes that the expectations represented by such forward-looking statements are reasonable, there can be no assurance that such expectations will be realized. Any number of important factors could cause actual results to differ materially from those in the forward-looking statements including, but not limited to, risks associated with petroleum and natural gas exploration, development, exploitation, production, marketing and transportation, the volatility of petroleum and natural gas prices, currency fluctuations, the ability to implement corporate strategies, the state of domestic capital markets, the ability to obtain financing, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions, changes in petroleum and natural gas acquisition and drilling programs, delays resulting from inability to obtain required regulatory approvals, delays resulting from inability to obtain drilling rigs and other services, labour supply risks, environmental risks, competition from other producers, imprecision of reserve estimates, changes in general economic conditions, ability to execute farm-in and farm-out opportunities, and other factors, all of which are more fully described from time to time in the reports and filings made by the Company with securities regulatory authorities.

Statements relating to "reserves" or "resources" are deemed to be forward looking statements, as they involve the implied assessment, based on certain estimates and assumptions, that the reserves and resources described can be profitably produced in the future.

The forward looking statements contained in this MD&A are expressly qualified by this cautionary statement. Readers are cautioned not to place undue reliance on forward-looking statements, as no assurances can be given as to future results, levels of activity or achievements. Except as required by applicable securities laws, the Company does not undertake any obligation to publicly update or revise any forward-looking statements.

### Non-GAAP Measurements

This MD&A contains the terms "funds from operations" and "funds from operations per share" which are not defined under Generally Accepted Accounting Principles ("GAAP"), and may not be comparable to similar measures reported by other companies. Management considers these measures to be useful supplementary information when analyzing operational and financial performance.

Funds from operations is a useful measure of how the Company generates funds to cover operating and capital spending. Funds from operations is defined as cash flow from operating activities before changes in non-cash working capital items. Funds from operations and cash flow from operating activities per share are calculated using the same weighted average shares outstanding as net loss per common share. The following table reconciles cash flow used in operating activities to funds used in operations:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Cash flow used in operating activities | $ (2,610,258) | $ (1,029,889) | $ (2,137,349) | $ (1,628,928) |
| Change in non-cash working capital | 1,507,376 | 344,422 | 284,365 | 22,744 |
| Funds used in operations | $ (1,102,882) | $ (685,467) | $ (1,852,984) | $ (1,606,184) |

Operating netback is a useful measure for comparing prices received, royalties paid, and operating costs incurred, with industry peers. Netback and operating netback are defined as total oil and natural gas revenue less royalties and operating expenses. Additional information on operating netbacks is provided in “Netbacks”.

## HIGHLIGHTS

Highlights in the six months ended June 30, 2012 include:

- Extension of the Company’s large acreage position in the Neuquen Basin and conversion of the northern 108 km$^2$ of the 404 km$^2$ Coiron Amargo Block to a 25 year exploitation concession;
- Successful drilling and completion of 2 development wells and 2 exploration wells on the Coiron Amargo Block;
- Positive well test results at the end of Q2 / early Q3 from CAN 5 and CAN 7 development wells, respectively;
- Commenced testing the Vaca Muerta formation at the CorS X-1 deep gas exploration well on the Cortadera Block;
- Continued preparations for regions first fracture stimulation of the Lower Agrio shale; and
- Strengthened working capital position with completion of $67.5 million equity offering.

## OVERVIEW

Madalena is an independent, Canadian-based, international upstream oil and gas company whose main business activities include exploration, development and production of crude oil, natural gas liquids and natural gas. The Company currently has production and exploration operations in Argentina.

Coiron Amargo Block (35% working interest)

In March 2012 an application by the Coiron Amargo joint venture to convert the northern 108 km$^2$ of the 404 km$^2$ block to a 25 year exploitation concession (Coiron Amargo Norte) was approved by the Province of Neuquén. In addition, the exploration period for the remainder of the block (Coiron Amargo Sur) was extended to November 8, 2013.

On Coiron Amargo Norte, in May 2012 the Company completed drilling the CAN 5 development well located within the CAN X-1 Sierras Blancas structure discovered in the second half of 2010. In June 2012, initial flow testing results of the Sierras Blancas formation averaged 370 boepd (including 320 bopd), predominantly on a 5/16$^{th}$ inch choke over a 3.2 day period.

In June 2012 the Company completed drilling the CAN 7 development well located within the CAN X-3 Sierras Blancas structure. The well was drilled to a total depth ("TD") of 10,390 feet and cased to TD. The well encountered the hydrocarbon bearing Vaca Muerta unconventional shale formation as well as the conventional Sierras Blancas formation. Open hole logs could not be obtained during drilling due to continuous high pressure inflows into the well bore whilst drilling through the Vaca Muerta formation. Initial production testing of the CAN-7 development well following a fracture stimulation treatment of the Sierra Blancas formation resulted in an average flow rate of 1,340 boepd (including 940 bopd) over 2.2 days with a 20% water cut. The well was tested on a 1/2 and 5/16 inch choke with a final wellhead flowing pressure of 1,100 psi and 1,230 psi, respectively. Prior to the fracture treatment the well tested an average of 370 boepd (including 207 bopd) over a 2.2 day period on a 5/16 inch choke. Following the success of these wells and related fracture treatments, several additional development drilling locations have been identified in the northern Sierras Blancas structures.

The Company's share of production in July 2012 from Coiron Amargo Norte and Sur was 291 boepd (238 bopd). Since the completion of the CAN 5 and CAN 7 development wells, wells in Coiron Amargo Norte have been subject to periodic shut-ins due to storage limitations at the wellhead and Centenario oil storage terminal. When on production, a portion of associated gas is now flowing to the Loma Jarillosa Este gas processing facility located on an adjacent block and a portion of related water production is being injected into a water disposal well completed earlier in the period. If the storage and gas processing restrictions were eliminated and all wells in Coiron Amargo Norte and Sur placed on production, the Company's estimated share of total production would be 460 boepd (including 398 bopd). Effective August 1, 2012, Coiron Amargo Norte gas production is being sold at a price of US $4.35/mmbtu.

On Coiron Amargo Sur, in February 2012 the Company drilled and cased the CAS X-4 well approximately nine kilometers south east of the CAS X-1 discovery well drilled in 2011 and in March 2012 drilled and cased to TD the CAS X-2 vertical exploration well in the center of the block. At CAS X-4 a full diameter core was taken through most of the Vaca Muerta shale formation interval which will be used to optimize future wells in the Vaca Muerta formation. Flow testing of the CAS X-1 well from the non-conventional Vaca Muerta formation continues and it is anticipated that pumping equipment will be installed during the third quarter.

A drilling rig is expected to return to the block in September 2012 to drill one additional development well on Coiron Amargo Norte and one exploration well on Coiron Amargo Sur. The exploration well is located approximately 10km west of the CAS X-2 well near a previous well drilled on the block that during drilling indicated extensive natural fracturing in the Vaca Muerta formation.

The extension of Coiron Amargo Sur to November 8, 2013 required additional work commitments of US$ 33.5 million (Madalena share – US$ 11.7 million). The exploration block qualifies for an additional one year extension period at the end of the exploration period in the fourth quarter of 2013.

Cortadera Block (40% working interest)

In March 2012 Apache completed a two stage hydraulic fracture stimulation of the Vaca Muerta formation in the CorS X-1 vertical exploration and testing of the Vaca Muerta formation continues. Apache continues to await specialized equipment required in this high pressure environment in order to add the initial frac stage to the testing. Further work to assess additional uphole formations (Quintuco, Mulichinco, and Agrio zones) is expected to be carried out following the Vaca Muerta test. Also in March 2012, a resolution was passed approving Apache's application to qualify the Cortadera exploration block for Gas Plus pricing. The Gas Plus program was launched at the end of 2008 to stimulate investments in and production of natural gas and oil through providing incentives for new production of natural gas or oil.

The Company has agreed a work program with provincial authorities to extend the initial exploration period of the Cortadera Block beyond the initial expiry date of October 26, 2011 and despite delays in formalizing this extension, the Company believes that formal approval of the extension remains forthcoming.

Curamhuele Block (90% working interest)

At the Cur X-1 well the Company mobilized a service rig in the period for its planned three stage fracture stimulation of the Lower Agrio shale formation. Over 340 barrels of light gravity crude was flowed from the Lower Agrio formation in order to de-pressurize the well in order to perform the pre-fracture treatment well intervention. At this time operations on the CurX-1 well have been temporarily suspended in order to reduce stand-by costs after attempts to remove certain down-hole equipment in order to install casing for the fracture stimulation were unsuccessful. Various options have been reviewed to remove the down-hole equipment and plans are to re-enter the well once all necessary tools are available. Once completed, the frac would be the first hydraulic fracture stimulation of the Lower Agrio shale in the Neuquén Basin.

In March 2012 the exploration period for the block was extended to November 8, 2013. The extension of the block required additional work commitments of US$ 17.6 million (Madalena share – US$ 17.6 million). The exploration block qualifies for an additional one year extension period at the end of the exploration period in the fourth quarter of 2013.

Corporate

In March 2012, the Company issued 54,000,000 common shares at an issue price of $1.25 per share for gross proceeds to Madalena of $67,500,000. In June 2012, the Company's rolling stock option plan and shareholder rights plan ("Rights Plan") was approved by shareholders at the Company's Annual and Special Meeting. The Rights Plan is similar to other rights plans adopted by many Canadian corporations. The Rights Plan is not triggered if an offer to acquire Company shares is made as a "permitted bid" and thereby allows sufficient time for the Board and shareholders to consider and react to the offer. The plan is available for viewing at www.SEDAR.com.

## Financial and Operating Results

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2012** | **2011** | **2012** | **2011** |
| **Financial Information (1)** | | | | |
| Oil and gas revenue | $ 374,734 | $ 807,497 | $ 771,507 | $ 1,369,985 |
| Funds used in operations (2) | (1,102,882) | (685,467) | (1,852,984) | (1,606,184) |
| Funds used in operations per share (2) | - | - | (0.01) | (0.01) |
| Cash flow from (used in) operating activities | (2,610,258) | (1,029,889) | (2,137,349) | (1,628,928) |
| Cash flow from (used in) operating activities per share | (0.01) | - | (0.01) | (0.01) |
| Net loss | (1,847,984) | (12,490,603) | (3,015,349) | (14,235,108) |
| Net loss per share | (0.01) | (0.05) | (0.01) | (0.05) |
| Total assets | 105,047,273 | 45,272,876 | 105,047,273 | 45,272,876 |
| Working capital | 63,260,017 | 23,385,285 | 63,260,017 | 23,385,285 |
| Capital expenditures | 6,217,529 | 8,380,325 | 12,909,193 | 12,939,934 |
| Debt | - | - | - | - |
| **Production** | | | | |
| Oil production (barrels per day) | 66 | 105 | 64 | 123 |

(1) All amounts per common share are basic and diluted amounts per common share.
(2) See "*Non-GAAP measurements*" above.

## RESULTS OF OPERATIONS

The following paragraphs provide information about the results of Madalena's operations for the three and six month periods ended June 30, 2012.

Oil and gas revenue

Oil and gas revenue for the three months ended June 30, 2012 was $374,734 compared to $807,497 for the corresponding period in 2011. Oil and gas revenue decreased to $771,507 in the first half of 2012 compared to $1,369,985 in the first half of 2011. The Company's share of oil production from Coiron Amargo Norte in the three and six month periods ended June 30, 2012 was 6,030 barrels (66 barrels per day) and 11,617 barrels (64 barrels per day), respectively. The Company's share of oil production from Coiron Amargo Norte in the three and six month periods ended June 30, 2011 was 9,568 barrels (105 barrels per day) and 22,278 barrels (123 barrels per day), respectively. Net production declined from the corresponding period in 2011 due to a reduction in the Company's working interest in the block from 52.5% to 35% and wells waiting on pumping equipment. The Company's share of oil revenue, operating costs and royalty expenses related to production from Coiron Amargo Sur is capitalized for accounting purposes and therefore excluded from production and revenue information.

Royalties

Royalty expense totaled $56,736 for the three months ended June 30, 2012 compared to $141,073 for the corresponding period in 2011. Royalty expense decreased to $126,536 in the first half of 2012 compared to $249,347 in the first half of 2011. In 2011 production from the Coiron Amargo Block was subject to a 15% provincial royalty rate. With conversion of the northern portion of the block into a 25 year exploitation concession, effective March 9, 2012 production from Coiron Amargo Norte is subject to a 12% provincial royalty payable to the Province of Neuquén. Royalty expense also includes a 3% provincial turnover tax on sales.

Operating costs

Operating costs decreased to $271,208 for the three months ended June 30, 2012 compared to $377,985 for the corresponding period in 2011. Operating costs decreased to $601,364 in the first half of 2012 compared to $618,065 in the first half of 2011. Operating costs decreased primarily due to lower production volumes offset by unscheduled maintenance at CAN X-2, completion of necessary road works, adjustment to surface rental rates payable to private land owners and higher transportation costs.

Netbacks

| | Three months ended June 30, 2012 | | Six months ended June 30, 2012 | |
|---|---|---|---|---|
| | Amount | Per boe | Amount | Per boe |
| Oil and gas revenues | $ 374,734 | $ 76.64 | $ 771,507 | $ 76.92 |
| Royalties | (56,736) | (11.60) | (126,536) | (12.62) |
| Operating costs | (271,208) | (55.47) | (601,364) | (59.96) |
| Operating netback (1) | $ 46,790 | $ 9.57 | $ 43,607 | $ 4.34 |

| | Three months ended June 30, 2011 | | Six months ended June 30, 2011 | |
|---|---|---|---|---|
| | Amount | Per boe | Amount | Per boe |
| Oil and gas revenues | $ 807,497 | $ 57.40 | $ 1,369,985 | $ 55.91 |
| Royalties | (141,073) | (10.03) | (249,347) | (10.18) |
| Operating costs | (377,985) | (26.87) | (618,065) | (25.22) |
| Operating netback (1) | $ 288,439 | $ 20.50 | $ 502,573 | $ 20.51 |

(1) Operating netbacks are a non-GAAP measure - see "*Non-GAAP measurements*" above.

The Company realized an operating netback of $9.57/boe and $4.34/boe in the three and six month periods ended June 30, 2012, respectively, compared to $20.50/boe and $20.51/boe for the corresponding periods in 2011. Operating netbacks per boe decreased due to lower production in the quarter, unscheduled maintenance costs and higher fixed and variable operating costs compared to the corresponding period in 2011.

General and administrative ("G&A") expenses

G&A expenses totaled $1,214,923 for the three months ended June 30, 2012 compared to $805,650 for the corresponding period in 2011. G&A expenses increased as a result of higher compensation in the second quarter of 2012 with respect to bonuses and higher professional fees and travel costs. G&A expenses decreased slightly to $1,948,267 in the first half of 2012 compared to $1,970,960 in the first half of 2011.

A breakdown of general and administrative expenses is as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Compensation | $ 410,776 | $ 236,052 | $ 602,441 | 767,548 |
| Office and administration | 303,983 | 316,210 | 560,224 | 630,895 |
| Professional fees | 374,432 | 223,496 | 581,498 | 470,226 |
| Travel | 125,732 | 29,892 | 204,104 | 102,291 |
| | $ 1,214,923 | $ 805,650 | $ 1,948,267 | $ 1,970,960 |

Share-based payments ("SBP") expense

SBP expense totaled $654,564 for the three months ended June 30, 2012 compared to $737,609 for the corresponding period in 2011. SBP expense decreased to $979,400 in the first half of 2012 compared to $1,450,965 in the first half of 2011 as a result of fewer option grants in 2011 compared to 2010.

At June 30, 2012, the Company has approximately $1.6 million (December 31, 2011 - $1.45 million) of unamortized SBP that will be charged to income over the remaining vesting period of the outstanding options.

Depletion and depreciation expense

Depletion and depreciation expense totaled $74,802 for the three months ended June 30, 2012 compared to $127,122 for the corresponding period in 2011. Depletion and depreciation expense totaled $155,365 in the first half of 2012 compared to $223,423 for the first half of 2011. Depletion and depreciation expense decreased due to lower production from the Corion Amargo Block. Depletion expense for the three months ended June 30, 2012 was $14.22 per barrel compared to $8.67 per barrel for the corresponding period in 2011.

Interest Income

Interest income totaled $208,713 for the three months ended June 30, 2012 compared to $81,767 for the corresponding period in 2011. Interest income in the first half of 2012 totaled $295,407 compared to $177,306 in the first half of 2011. Interest income increased in the periods due to higher cash balances.

Foreign exchange loss

The Company recorded a foreign exchange loss of $14,796 in the three months ended June 30, 2012 compared to a loss of $22,981 for the corresponding period in 2011. Foreign exchange loss in the first half of 2012 totaled $10,950 compared to $49,327 in the first half of 2011. In accordance with IFRS, foreign currency transactions are translated into the respective functional currencies of Madalena and its subsidiaries using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at period end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognized in profit or loss.

## Finance costs

Finance costs consist of accretion of decommissioning obligations. Finance costs increased to $16,005 in the three months ended June 30, 2012 compared to $13,086 for the corresponding period in 2011. Finance costs in the first half of 2012 totaled $29,031 compared to $27,872 in the first half of 2011. Finance costs increased as a result of an increase in the number of wells in which the Company has a working interest offset by a decrease in the Company's working interest in the Coiron Amargo and Cortadera blocks.

## Income tax expense

Income tax expense for the three months ended June 30, 2012 totaled $128,397 compared to $147,724 for the corresponding period in 2011. Income tax expense in the first half of 2012 totaled $231,350 compared to $185,803 in the first half of 2011. Current income tax expense relates to minimum taxes based on the book value of assets in Argentina.

## Net loss and other comprehensive loss

The Company realized a net loss of $1,847,984 for the three months ended June 30, 2012 compared to $12,490,603 for the corresponding period in 2011. Net loss decreased to $3,015,349 in the first half of 2012 compared to $14,235,108 in the first half of 2011. Net loss decreased primarily due to an impairment loss recorded in the second quarter of 2011 with respect to drilling the Curamhuele X-1001 exploration well. Total comprehensive loss decreased to $2,353,821 for the three months ended June 30, 2012 compared to a loss of $13,541,655 for the corresponding period in 2011. Total comprehensive loss in the first half of 2012 totaled $2,151,620 compared to a loss of $16,138,822 in the first half of 2011. Total comprehensive income loss decreased due to the decrease in net loss above as well as income on translation of foreign operations. Exchange differences on translation of foreign operations resulted in a loss of $505,837 for the three months ended June 30, 2012 compared to a loss of $1,051,052 for the corresponding period in 2011 as a result of a slight decrease in the second quarter of 2012 in the value of the Argentina peso relative to the Canadian dollar.

## Funds used in operations

Funds used in operations increased to $1,102,882 for the three months ended June 30, 2012 compared to $685,467 for the corresponding period in 2011. Funds used in operations increased to $1,852,984 in the first half of 2012 compared to $1,606,184 in the first half of 2011. Funds used in operations increased as a result of lower oil revenue and higher operating costs per boe.

## Capital expenditures

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Argentina: | | | | |
| Geological and geophysical | $ 79,899 | $ 7,629 | $ 309,152 | $ 15,054 |
| Land | 577,493 | (6,305) | 577,493 | (6,305) |
| Drilling and completion | 2,847,065 | 6,901,143 | 7,612,055 | 10,740,666 |
| Well equipment and facilities | 1,591,589 | - | 2,393,308 | 22,724 |
| Other | 1,119,661 | 1,474,442 | 2,005,541 | 2,164,089 |
| | 6,215,707 | 8,376,909 | 12,897,549 | 12,936,228 |
| Canada: | | | | |
| Other | 1,822 | 3,416 | 11,644 | 3,706 |
| | 1,822 | 3,416 | 11,644 | 3,706 |
| Total Capital Expenditures | $ 6,217,529 | $ 8,380,325 | $ 12,909,193 | $ 12,939,934 |

Capital expenditures decreased to $6,217,529 for the three months ended June 30, 2012 compared to $8,380,325 for the corresponding period in 2011. Capital expenditures decreased slightly to $12,909,193 in the first half of 2012 compared to $12,939,934 in the first half of 2011. Capital expenditures in 2012 consisted primarily of costs associated with drilling the CAS X-4 and CAS X-2 exploration wells, the CAN 5 and CAN 7 development wells and completion of the pipeline to the Loma Jarillosa Este gas processing facility.

## LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2012 Madalena had working capital of $63,260,017 compared to $14,442,910 at December 31, 2011. Working capital increased as the Company issued 54,000,000 common shares at an issue price of $1.25 per share for gross proceeds to Madalena of $67,500,000.

The Company had negative funds from operations in the three and six month periods ended June 30, 2012 totaling $1,102,882 (2011 - $685,467) and $1,852,984 (2011 – $1,606,184), respectively. Funds used in operations increased as a result of lower oil revenue and higher operating costs per boe.

Historically, the Company has raised funds from equity financings to fund its exploration and development activities and operating cash flow requirements. The Company's ability to continue operations is dependent on successfully producing economic quantities of petroleum and natural gas from its exploration properties in Argentina, raising sufficient capital to complete planned exploration and development activities, properly managing its existing cash resources, identifying additional commercial oil and gas reserves, and generating profitable operations. The Company has no outstanding debt.

## TRANSACTIONS WITH RELATED PARTIES

In the three and six month periods ended June 30, 2012, the Company incurred fees of $43,587 (2011 - $13,756) and $138,342 (2011 – $16,561), respectively, payable to a law firm in which a director of the Company is a partner.

## SHARE INFORMATION

At June 30, 2012 and August 22, 2012, the Company had 314,307,185 common shares and 16,323,699 stock options outstanding.

## BUSINESS RISKS AND UNCERTAINTIES

The Company operates in the petroleum and natural gas industry which is subject to numerous risks that can affect the amount of cash flow from operating activities and the ability to grow. These risks include but are not limited to:

- Global economic uncertainty;
- Risks associated with operating in foreign jurisdictions;
- Competition with more established companies and the availability of services;
- Volatility in commodity pricing, exchange and interest rates;
- Government and regulatory risk with respect to royalty and income tax regimes;
- Operation risks that may affect the quality and recoverability of reserves;
- Geological risks associated with accessing and recovering new quantities of reserves;
- Ability to capitalize on farm-in and farm-out opportunities as they arise;
- Production risks associated with the ability to extract commercial quantities of petroleum and natural gas;
- Transportation risk with respect to the ability to transport petroleum and natural gas to market;
- Third party credit risk and the resulting ability to collect amounts owed;
- Capital markets risk and the ability to finance future growth;
- Uncertainty as to the nature of evolving environmental legislation that is likely to result in stricter standards and enforcement; and
- Environmental risk with respect to the ability to remedy spills, releases or emissions of various substances produced in association with petroleum and natural gas operations.

The Company will seek to minimize these business risks by:

- Employing management, technical staff and consultants with extensive industry experience;
- Maintaining a low cost structure;
- Maintaining prudent financial practices;
- Controlling timing and magnitude of operating and capital costs;
- Working with established industry partners; and
- Maintaining insurance in accordance with industry standards to address the risk of liability for pollution, blow-outs, property damage, personal injury and other hazards.

<u>Foreign operations</u>

All of the Company's oil and gas operations are in Argentina. A number of risks are associated with conducting foreign operations over which the Company has no control, including currency instability, potential and actual civil disturbances, restriction of funds movement outside of these countries, the ability of joint venture partners to fund their obligations, changes of laws affecting foreign ownership and existing contracts, crude oil and natural gas price and production regulation, royalty rates, potential expropriation of property without fair compensation, retroactive tax changes and possible interruption of oil deliveries.

On May 3, 2012, Law No. 26,741 was passed by the Argentine Congress and, on May 7, it was published in the Official Gazette of the Republic of Argentina. The law has declared achieving self-sufficiency in the supply of hydrocarbons as well as in the exploitation, industrialization, transportation and sale of hydrocarbons, a national public interest and a priority for Argentina. In addition, its stated goal is to guarantee socially equitable economic development, the creation of jobs, the increase of the competitiveness of various economic sectors and the equitable and sustainable growth of the Argentine provinces and regions.

On July 27, 2012 the Federal Government published Decree 1277/12 (the "Decree") in the Official Gazette, regulating Law No. 26741 which introduces a tighter regime on investments and commercialization of hydrocarbons in Argentina. Although there has been no change to the fiscal regime, the Company is currently evaluating what impact the Decree may have on the Company's business, financial condition, results of operations and prospects. Future regulatory changes could have a material adverse effect on the Company's business, financial condition, results of operations and prospects.

<u>Expiration of licences and leases</u>

The Company's properties are held in the form of licences and leases and working interests in licences and leases. If the Company or the holder of the licence or lease fails to meet the specific requirement of a licence or lease, the licence or lease may terminate or expire. There can be no assurance that any of the obligations required to maintain each licence or lease will be met. The termination or expiration of the Company's licences or leases or the working interests relating to a licence or lease may result in an impairment of the costs incurred with respect to this block.

In response to declining oil and gas production volumes in Argentina, the federal and various provincial governments in Argentina are calling for oil and gas companies operating in the country to increase investment. Any federal changes to the licencing regime or changes to the provincial licencing regime in Neuquen Province, Argentina where the Company's acreage is located could have a material adverse effect on the Company.

The Company has agreed a work program with provincial authorities to extend the initial exploration period of the Cortadera Block beyond the initial expiry date of October 26, 2011 and despite delays in formalizing this extension, the Company believes that formal approval of the extension remains forthcoming. A delay or rejection of the extension terms may have a material adverse effect on the Company.

Substantial capital requirements

In order to completely exploit its existing properties and create future growth, the Company anticipates making substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the future. In addition, uncertain levels of near term industry activity and uncertain global markets may impair the Company's ability to access capital. There can be no assurance that debt or equity financing, or cash generated by operations will be available or sufficient to meet these requirements or for other corporate purposes or, if debt or equity financing is available, that it will be on terms acceptable to the Company. The inability of the Company to access sufficient capital for its operations could have a material adverse effect on the Company's business financial condition, results of operations and prospects.

Equipment availability

Following the government expropriation of YPF S.A. and a desire within the government and YPF S.A. to rapidly expand exploration activities throughout its portfolio, the Company anticipates high utilization rates for existing drilling and hydraulic fracturing equipment in Argentina. While the Company is aware of service companies plans to expand operations and capacity in Argentina, there is a risk in the short to medium term that certain equipment necessary to perform large scale hydraulic fracture operations may not be available in a timely manner.

For addition detail regarding the Company's risks and uncertainties, refer to the Company's most recent AIF on SEDAR at www.sedar.com.

## CONTRACTUAL OBLIGATIONS

The Company has lease commitments for office space and rental accommodations in Canada and Argentina. The total estimated remaining lease payments at June 30, 2012, including operating costs, are approximately $215,000 through 2014.

In March 2012 the northern 108 km$^2$ of the 404 km$^2$ Coiron Amargo Block was converted to a 25 year exploitation concession by the Province of Neuquén. In addition, the exploration period for the remainder of the Coiron Amargo Block and the Curamhuele Block was extended to November 8, 2013. The extension of the Coiron Amargo and Curamhuele blocks required additional work commitments of US$ 51.1 million (Madalena share – US$ 29.3 million). Both exploration blocks qualify for an additional one year extension period at the end of their exploration periods in the fourth quarter of 2013.

The initial exploration period on the Cortadera Block in the Province of Neuquén expired on October 26, 2011. The joint venture has agreed a work plan with provincial authorities which will require additional work commitments and is currently working with provincial authorities to formalize the extension of the initial exploration period.

## OUTLOOK

The expropriation of YPF S.A. and Decree 1277/12 introducing a tighter regime on investments and commercialization of hydrocarbons in Argentina has cast some doubt in financial markets that independent oil and gas companies can play an economic role in the development of Argentina's non-conventional resources. The Company is monitoring steps being taken by the Argentina federal and provincial governments to encourage investment in the country as well as continuing to work with its industry and provincial partners to both progress development of the hydrocarbon sector in general and continue further exploration and development of its blocks.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Significant accounting policies used by Madalena are disclosed in note 3 to the December 31, 2011 consolidated financial statements. Preparing financial statements in accordance with IFRS requires management to make certain judgments and estimates. Changes to these judgments and estimates could have a material effect on the Company's financial statements and financial position. There were no changes to Madalena's critical accounting estimates during the three months ended June 30, 2012.

Following are the accounting policies subject to such judgments and the key sources of estimation uncertainty that the Company believes could have the most significant impact on the reported results and financial position:

*Reserves*

The estimate of petroleum and natural gas reserves is integral to the calculation of the amount of depletion charged to the statement of operations and is also a key determinant in assessing whether the carrying value of any of the Company's development and production assets has been impaired. Changes in reported reserves can impact asset carrying values and the decommissioning provision due to changes in expected future cash flows.

The Company's reserves are evaluated and reported on by independent reserve engineers at least annually in accordance with Canadian Securities Administrators' National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities. Reserve estimation is based on a variety of factors including engineering data, geological and geophysical data, projected future rates of production, commodity pricing and timing of future expenditures, all of which are subject to significant judgment and interpretation. Changes in market and regulatory conditions and assumptions can materially impact the estimation of net reserves.

*Carrying value of development and production and exploration and evaluation assets*

The Company assesses at each reporting date whether there is an indication that an asset or cash generating unit ("CGU") may be impaired. A CGU is defined as the lowest grouping of assets that generate identifiable cash inflows that are largely independent of cash inflows of other assets or groups of assets. The allocation of assets into CGU's requires significant judgment and interpretations with respect to the way in which management monitors operations.

If any indication exists that an asset or CGU may be impaired, the Company estimates the recoverable amount. The recoverable amounts of individual assets and CGU's have been determined based on the higher of value-in-use calculations and fair value less costs to sell. These calculations require the use of estimates and assumptions, such as estimates of proved plus probable reserves, future production rates, oil and natural gas prices, future costs and other relevant assumptions, all of which are subject to change. A material adjustment to the carrying value of the Company's development and production and exploration and evaluation assets may be required as a result of changes to these estimates and assumptions.

*Decommissioning obligations*

Amounts recorded for decommissioning obligations require the use of management's best estimates of future decommissioning expenditures, expected timing of expenditures and future inflation rates. The estimates are based on internal and third party information and calculations and are subject to change over time and may have a material impact on profit and loss or financial position.

*Share-based payments*

The Company measures the cost of its share-based payments to directors, officers and employees by reference to the fair value of the equity instruments at the date at which they are granted. The assumptions used in determining fair value include: expected lives of options, risk-free rates of return and stock price volatility. These assumptions, by their nature, are subject to measurement uncertainty.

*Deferred tax*

Deferred tax is recorded, using the balance sheet method, on temporary differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. A deferred tax asset is recognized only to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations from multiple jurisdictions. Rates are also affected by legislative changes. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from that estimated and recorded in the financial statements.

*Legal, environmental remediation and other contingent matters*

In respect of these matters, the Company is required to determine both whether a loss is probable based on judgment and interpretation of laws and regulations and if such a loss can reasonably be estimated. When any such loss is determined, it is charged to net income (loss). Management continually monitors known and potential contingent matters and makes appropriate provisions by charges to net income (loss) when warranted by circumstances.

**NEW ACCOUNTING STANDARDS AND PRONOUNCEMENTS**

Unless otherwise noted, the following pronouncements and amendments are effective for annual periods beginning on or after January 1, 2013 with earlier application permitted. The Company is in the process of evaluating the impact of adopting these standards.

IFRS 9 - Financial Instruments applies to the classification and measurement of financial assets and liabilities as defined in IAS 39. It is effective for annual periods beginning on or after January 1, 2015.

IFRS 10 - Consolidated Financial Statements was issued in May 2011 and establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS 10 replaces SIC-12 *Consolidation—Special Purpose Entities* and parts of IAS 27 *Consolidated and Separate Financial Statement.*

IFRS 11 - Joint Arrangements focuses on the rights and obligations of a joint arrangement, rather than its legal form (as is currently the case). To address reporting inconsistencies, the standard requires a single method to account for interests in jointly controlled entities. IFRS 11 supersedes IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities—Non-Monetary Contributions by Venturers.*

IFRS 12 - Disclosure of Interests in Other Entities applies to entities that have an interest in a subsidiary, a joint arrangement, an associate or an unconsolidated structured entity.

IFRS 13 - Fair Value Measurements defines fair value, sets out a single IFRS framework for measuring fair value and requires disclosures about fair value measurements.

IAS 27 - Separate Financial Statements addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements.

IAS 28 - Investments in Associates and Joint Ventures has been amended to included joint ventures in its scope and to address the changes in IFRS 10 - 13.

IAS 1 - Presentation of Financial Statements has been amended to require components of other comprehensive income to be separately presented between those that may be reclassified to income and those that will not. The amendments are effective for annual periods beginning on or after July 1, 2012.

IAS 32 - Financial Instruments has been amended to provide clarification on the application of offsetting rules. The amendments are effective for annual periods beginning on or after July 1, 2012.

## QUARTERLY FINANCIAL INFORMATION

| | | Oil and Gas Revenue | | Net Loss | | Net Loss Per Share (1) |
|---|---|---|---|---|---|---|
| 2012 | | | | | | |
| Second quarter | **$** | **374,734** | **$** | **(1,847,984)** | **$** | **(0.01)** |
| First quarter | | 396,773 | | (1,167,365) | | - |
| Total | $ | 771,507 | $ | (3,015,349) | $ | - |
| 2011 | | | | | | |
| Fourth quarter | $ | 609,340 | $ | (1,585,520) | $ | (0.01) |
| Third quarter | | 619,178 | | (315,915) | | - |
| Second quarter | | 807,497 | | (12,490,603) | | (0.05) |
| First quarter | | 562,488 | | (1,744,505) | | (0.01) |
| Total | $ | 2,598,503 | $ | (16,136,543) | $ | (0.07) |
| 2010 | | | | | | |
| Fourth quarter | $ | 244,235 | $ | (1,719,762) | $ | (0.01) |
| Third quarter | | - | | (624,144) | | - |
| Second quarter | | - | | (757,919) | | - |
| First quarter | | - | | (784,240) | | (0.01) |
| Total | $ | 244,235 | $ | (3,886,065) | $ | (0.02) |

(1) Basic and diluted amounts per common share.

Condensed Consolidated Interim Financial Statements of

# MADALENA VENTURES INC.

As at and for the three and six month period ended June 30, 2012 (unaudited)

# MADALENA VENTURES INC.

Condensed Consolidated Balance Sheets (unaudited)

| As at | Note | June 30, 2012 | December 31, 2011 |
|---|---|---|---|
| **Assets** | | | |
| Current assets | | | |
| Cash and cash equivalents | | **$ 64,849,788** | $ 16,439,077 |
| Trade and other receivables | | **793,530** | 712,737 |
| Prepaid expenses | | **567,692** | 212,913 |
| Inventory | | **203,628** | 42,876 |
| | | **66,414,638** | 17,407,603 |
| Non-current assets | | | |
| Property and equipment | 3 | **13,949,127** | 7,120,404 |
| Exploration and evaluation assets | 4 | **24,439,623** | 17,338,614 |
| Other non-current assets | | **243,885** | 231,166 |
| | | **38,632,635** | 24,690,184 |
| | | **$ 105,047,273** | $ 42,097,787 |
| **Liabilities** | | | |
| Current liabilities | | | |
| Trade and other payables | | **$ 3,154,621** | $ 2,964,693 |
| Decommissioning provisions | 5 | **568,994** | 330,981 |
| | | **3,723,615** | 3,295,674 |
| **Shareholders' equity** | | | |
| Share capital | 6 | **141,676,214** | 77,862,747 |
| Contributed surplus | | **10,933,370** | 10,073,672 |
| Accumulated other comprehensive loss | | **(4,298,468)** | (5,162,197) |
| Deficit | | **(46,987,458)** | (43,972,109) |
| | | **101,323,658** | 38,802,113 |
| | | **$ 105,047,273** | $ 42,097,787 |

Commitments (note 9)

*See accompanying notes to the condensed consolidated interim financial statements*

# MADALENA VENTURES INC.

Condensed Consolidated Statements of Loss and Comprehensive Loss (unaudited)

| | Note | Three months ended June 30, 2012 | Three months ended June 30, 2011 | Six months ended June 30, 2012 | Six months ended June 30, 2011 |
|---|---|---|---|---|---|
| **Revenue** | | | | | |
| Oil and gas | | **$ 374,734** | $ 807,497 | **$ 771,507** | $ 1,369,985 |
| Royalties | | **(56,736)** | (141,073) | **(126,536)** | (249,347) |
| | | **317,998** | 666,424 | **644,971** | 1,120,638 |
| **Expenses** | | | | | |
| Operating | | **271,208** | 377,985 | **601,364** | 618,065 |
| General and administrative | | **1,214,923** | 805,650 | **1,948,267** | 1,970,960 |
| Share-based payments | 6 | **654,564** | 737,609 | **979,400** | 1,450,965 |
| Depletion and depreciation | 3 | **74,802** | 127,122 | **155,365** | 223,423 |
| Impairment of exploration and evaluation assets | 4 | **-** | 11,006,637 | **-** | 11,006,637 |
| | | **2,215,497** | 13,055,003 | **3,684,396** | 15,270,050 |
| **Operating loss** | | **(1,897,499)** | (12,388,579) | **(3,039,425)** | (14,149,412) |
| **Other income (expenses)** | | | | | |
| Interest and other income | | **208,713** | 81,767 | **295,407** | 177,306 |
| Foreign exchange gain (loss) | | **(14,796)** | (22,981) | **(10,950)** | (49,327) |
| Finance cost | 5 | **(16,005)** | (13,086) | **(29,031)** | (27,872) |
| | | **177,912** | 45,700 | **255,426** | 100,107 |
| **Loss before tax** | | **(1,719,587)** | (12,342,879) | **(2,783,999)** | (14,049,305) |
| **Current income tax expense** | | **(128,397)** | (147,724) | **(231,350)** | (185,803) |
| **Net loss for the period** | | **(1,847,984)** | (12,490,603) | **(3,015,349)** | (14,235,108) |
| Exchange differences on translation of foreign operations | | **(505,837)** | (1,051,052) | **863,729** | (1,903,714) |
| **Total comprehensive loss for the period** | | **$ (2,353,821)** | $ (13,541,655) | **$ (2,151,620)** | $ (16,138,822) |
| Weighted average number of shares: | | | | | |
| Basic and diluted | 6 | **314,307,185** | 259,995,517 | **294,631,423** | 259,391,105 |
| Net loss per share: | | | | | |
| Basic and diluted | | **$ (0.01)** | $ (0.05) | **$ (0.01)** | $ (0.05) |

*See accompanying notes to the condensed consolidated interim financial statements*

# MADALENA VENTURES INC.

Condensed Consolidated Statements of Cash Flows (unaudited)

| | Note | Three months ended June 30, 2012 | Three months ended June 30, 2011 | Six months ended June 30, 2012 | Six months ended June 30, 2011 |
|---|---|---|---|---|---|
| **Cash provided by (used in):** | | | | | |
| **Operating activities** | | | | | |
| Net loss for the period | | **$ (1,847,984)** | $ (12,490,603) | **$ (3,015,349)** | $ (14,235,108) |
| Items not involving cash: | | | | | |
| Share-based payments | | **654,564** | 737,609 | **979,400** | 1,450,965 |
| Depletion and depreciation | | **74,802** | 127,122 | **155,365** | 223,423 |
| Impairment of exploration and evaluation assets | 4 | **-** | 11,006,637 | **-** | 11,006,637 |
| Accretion on provisions | | **16,005** | 13,086 | **29,031** | 27,872 |
| Abandonment expenditures | 5 | **-** | (78,472) | | (78,472) |
| Change in other non-current assets | | **(269)** | (846) | **(1,431)** | (1,501) |
| | | **(1,102,882)** | (685,467) | **(1,852,984)** | (1,606,184) |
| Change in non-cash working capital items | 8 | **(1,507,376)** | (344,422) | **(284,365)** | (22,744) |
| | | **(2,610,258)** | (1,029,889) | **(2,137,349)** | (1,628,928) |
| **Financing activities** | | | | | |
| Issue of common shares | | **-** | - | **67,685,450** | 1,661,511 |
| Share issue costs | | **2,271** | - | **(4,014,574)** | - |
| Change in non-cash working capital items | 8 | **(105,441)** | - | **-** | (3,880) |
| | | **(103,170)** | - | **63,670,876** | 1,657,631 |
| **Investing activities** | | | | | |
| Additions to exploration and evaluation assets | | **(1,476,053)** | (8,309,149) | **(6,202,252)** | (12,821,510) |
| Additions to property and equipment | | **(4,741,476)** | (71,176) | **(6,706,941)** | (118,424) |
| Change in non-cash working capital items | 8 | **(535,579)** | 166,232 | **(165,383)** | (856,618) |
| | | **(6,753,108)** | (8,214,093) | **(13,074,576)** | (13,796,552) |
| Change in cash and cash equivalents | | **(9,466,536)** | (9,243,982) | **48,458,951** | (13,767,849) |
| Cash and cash equivalents, beginning of the period | | **74,385,917** | 35,908,886 | **16,439,077** | 40,719,947 |
| Impact of foreign exchange on cash balances | | **(69,593)** | (403,685) | **(48,240)** | (690,879) |
| **Cash and cash equivalents, end of the period** | | **$ 64,849,788** | $ 26,261,219 | **$ 64,849,788** | $ 26,261,219 |

*See accompanying notes to the condensed consolidated interim financial statements*

# MADALENA VENTURES INC.

Condensed Consolidated Statements of Changes in Equity (unaudited)

| | Share Capital | | | Contributed | | Accumulated Other Comprehensive | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Number | | Amount | | Surplus | | Income | | Deficit | | Equity |
| **Balance at December 31, 2010** | **257,285,885** | **$** | **75,403,123** | **$** | **7,932,605** | **$** | **(1,662,102)** | **$** | **(27,835,566)** | **$** | **53,838,060** |
| Loss for the period | | | | | | | | | (14,235,108) | | (14,235,108) |
| Exercise of stock options | 2,709,632 | | 2,394,449 | | (732,938) | | - | | - | | 1,661,511 |
| Share-based payments | - | | - | | 1,492,734 | | - | | - | | 1,492,734 |
| Comprehensive loss for the period | - | | - | | - | | (1,903,714) | | - | | (1,903,714) |
| **Balance at June 30, 2011** | **259,995,517** | **$** | **77,797,572** | **$** | **8,692,401** | **$** | **(3,565,816)** | **$** | **(42,070,674)** | **$** | **40,853,483** |
| Loss for the period | | | | | | | | | (1,901,435) | | (1,901,435) |
| Exercise of stock options | 25,000 | | 65,175 | | (57,175) | | - | | - | | 8,000 |
| Share-based payments | - | | - | | 1,438,446 | | - | | - | | 1,438,446 |
| Comprehensive loss for the period | - | | - | | - | | (1,596,381) | | - | | (1,596,381) |
| **Balance at December 31, 2011** | **260,020,517** | **$** | **77,862,747** | **$** | **10,073,672** | **$** | **(5,162,197)** | **$** | **(43,972,109)** | **$** | **38,802,113** |
| Loss for the period | | | | | | | | | (3,015,349) | | (3,015,349) |
| Public offering | 54,000,000 | | 63,485,426 | | - | | - | | - | | 63,485,426 |
| Exercise of stock options | 286,668 | | 328,041 | | (142,591) | | - | | - | | 185,450 |
| Share-based payments | - | | - | | 1,002,289 | | - | | - | | 1,002,289 |
| Comprehensive loss for the period | - | | - | | - | | 863,729 | | - | | 863,729 |
| **Balance at June 30, 2012** | **314,307,185** | **$** | **141,676,214** | **$** | **10,933,370** | **$** | **(4,298,468)** | **$** | **(46,987,458)** | **$** | **101,323,658** |

*See accompanying notes to the condensed consolidated interim financial statements*

## 1. Corporate Information

Madalena Ventures Inc. ("Madalena" or the "Company") is incorporated pursuant to the laws of the Province of Alberta. Madalena is based in Calgary, Alberta and is involved in the exploration, development and production of petroleum and natural gas in Argentina.

## 2. Basis of Preparation

### a) Future operations

These condensed consolidated interim financial statements have been prepared on the basis that the Company is a going concern and will realize assets and discharge liabilities in the normal course of operations for the foreseeable future. Presently, Madalena has minimal production and limited cash flow from operating activities. The Company currently relies on equity financing to pay for exploration activities and overhead expenses. Therefore, the Company's ability to continue operations is dependent on identifying commercial oil and gas reserves, generating profitable operations and raising sufficient capital to complete planned exploration and development activities. The outcome of these matters cannot be predicted at this time.

### b) Statement of compliance

The Company prepares its financial statements in accordance with International Accounting Standards ("IAS") 34 *Interim Financial Reporting*. These interim consolidated financial statements have been prepared following the same accounting policies and methods of computation as the consolidated financial statements of the Company for the year ended December 31, 2011. The disclosures below are incremental to those included with the annual consolidated financial statements and certain disclosures, which are normally required to be included in the notes to the annual consolidated financial statements, have been condensed or omitted.

These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Company's annual filings for the year ended December 31, 2011. The interim consolidated financial statements were authorized for issuance by the Board of Directors on August 22, 2012.

### c) Basis of measurement

These consolidated interim financial statements have been prepared on a historical cost basis. The Company's presentation currency is Canadian dollars ($).

### d) Use of estimates, judgments and estimation uncertainty

The preparation of consolidated financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Significant estimates and judgment used in the preparation of the financial statements are described in the Company's consolidated annual financial statements for the year ended December 31, 2011.

### 3. Property and equipment

| | Development and Production Assets $ | Furniture and Fixtures $ | Total $ |
|---|---|---|---|
| **Cost** | | | |
| At December 31, 2010 | 4,599,092 | 223,276 | 4,822,368 |
| Additions | 3,542,118 | 10,080 | 3,552,198 |
| Effect of movement in exchange rates | (651,404) | (6,049) | (657,453) |
| At December 31, 2011 | 7,489,806 | 227,307 | 7,717,113 |
| Additions | 6,737,046 | 13,016 | 6,750,062 |
| Effect of movement in exchange rates | 281,161 | 2,373 | 283,534 |
| At June 30, 2012 | 14,508,013 | 242,696 | 14,750,709 |
| **Depletion and depreciation** | | | |
| At December 31, 2010 | 88,682 | 128,229 | 216,911 |
| Depletion and depreciation charge | 396,383 | 20,077 | 416,460 |
| Effect of movement in exchange rates | (32,698) | (3,964) | (36,662) |
| At December 31, 2011 | 452,367 | 144,342 | 596,709 |
| Depletion and depreciation charge | 173,811 | 9,974 | 183,785 |
| Effect of movement in exchange rates | 19,531 | 1,557 | 21,088 |
| At June 30, 2012 | 645,709 | 155,873 | 801,582 |
| **Net book value** | | | |
| At December 31, 2010 | 4,510,410 | 95,047 | 4,605,457 |
| At December 31, 2011 | 7,037,439 | 82,965 | 7,120,404 |
| At June 30, 2012 | 13,862,304 | 86,823 | 13,949,127 |

Development and production assets consist of costs less depletion and depreciation with respect to the northern portion of the Company's Coiron Amargo Block. The amounts capitalized as development and production ("D&P") assets in Argentina at June 30, 2012 includes $2,014,075 of Value Added Tax ("VAT") (December 31, 2011 - $822,157). VAT is payable on goods and services supplied to the Company and is not recoverable from the Government of Argentina, however the Company is allowed to retain VAT on any sales that it collects to the extent of the VAT recorded and paid on previous expenditures.

The depletion expense calculation for the three month period ended June 30, 2012 included $9.7 million (2011 – $11.1 million) for estimated future development costs associated with proved and probable reserves in Argentina.

## 4. Exploration and evaluation assets

| | $ |
|---|---|
| **Cost** | |
| At December 31, 2010 | 12,829,447 |
| Additions | 17,431,140 |
| Effect of movement in exchange rates | (2,511,468) |
| At December 31, 2011 | 27,749,119 |
| Additions | 6,378,029 |
| Effect of movement in exchange rates | 1,231,873 |
| At June 30, 2012 | 35,359,021 |
| | |
| **Depletion, depreciation and impairment losses** | |
| At December 31, 2010 | - |
| Depletion and depreciation charge in period | - |
| Impairment losses | 11,006,637 |
| Effect of movement in exchange rates | (596,132) |
| At December 31, 2011 | 10,410,505 |
| Depletion and depreciation charge in period | - |
| Impairment losses | - |
| Effect of movement in exchange rates | 508,893 |
| At June 30, 2012 | 10,919,398 |
| | |
| **Net book value** | |
| At December 31, 2010 | 12,829,447 |
| At December 31, 2011 | 17,338,614 |
| At June 30, 2012 | 24,439,623 |

E&E assets consist of the Company's intangible exploration projects in Argentina which are pending the determination of proven or probable reserves. Additions represent the Company's share of costs incurred on E&E assets during the period. E&E assets are not depreciated or depleted.

The amounts capitalized as Argentina E&E assets at June 30, 2012 before impairment losses include $5,174,994 of VAT (December 31, 2011 - $4,506,863). Included in impairment losses is $1,891,738 of VAT incurred during drilling of the Curamhuele X-1001 exploration well. During the six month period ended June 30, 2012, share-based payments directly related to exploration and evaluation activities totaling $22,889 (2011 - $41,769) were capitalized.

## 5. Decommissioning provisions

The Company's decommissioning obligations result from net ownership interests in petroleum and natural gas assets including well sites, gathering systems and processing facilities. At June 30, 2012, the Company estimates the total undiscounted inflation-adjusted amount of cash flows required to settle its decommissioning obligations to be approximately $2.3 million (December 31, 2011 - $1.7 million). The costs are expected to be incurred in the period between 2023 and 2025. The decommissioning obligations have been estimated using existing technology at current prices and discounted using discount rates that reflect current market assessments of the time value of money and the risks specific to each liability. A non-credit risk adjusted rate for Argentina of 13.04% (December 31, 2011 – 15.49%) was used to calculate the fair value of the decommissioning obligations.

A reconciliation of the decommissioning obligations is provided below:

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| Balance, beginning of period | $ 330,981 | $ 602,366 |
| Additions | 79,873 | 232,145 |
| Revisions in interest rates | 115,050 | (308,189) |
| Accretion | 29,031 | 56,534 |
| Costs incurred | - | (78,472) |
| Disposition | - | (122,967) |
| Effect of movement in exchange rates | 14,059 | (50,436) |
| Balance, end of period | $ 568,994 | $ 330,981 |

## 6. Share capital

### a) Common shares

Authorized

The authorized share capital of the Company consists of an unlimited number of common shares without nominal or par value.

Issued and outstanding common share activity

In March 2012, the Company issued 54,000,000 common shares at a price of $1.25 per common share for gross proceeds of $67,500,000.

### b) Share-based payments

Employee stock option plan

Under the Company's stock option plan, directors, officers, employees and certain consultants are eligible to receive options to acquire common stock of the Company. The exercise price of the granted options is no less than the closing trading price per share on the last day preceding the date of the grant. Total options granted cannot exceed 10% of the issued and outstanding common shares of the Company. Options granted to directors, officers, employees and consultants may vest immediately or over three years on each anniversary of the grant date. Options expire three to five years from the grant date. There are no cash settlement alternatives for employees under the Company's stock option plan. Movements in the number of stock options outstanding and their related weighted average exercise prices are summarized as follows:

| As at and for the period ended | June 30, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price | Number of options | Weighted average exercise price |
| Outstanding - beginning of period | 13,977,034 | $ 0.57 | 16,565,000 | $ 0.57 |
| Granted | 3,470,000 | 0.42 | 2,480,000 | 0.76 |
| Exercised | (286,668) | 0.65 | (2,734,632) | 0.61 |
| Forfeited | (36,666) | 0.74 | (333,334) | 0.73 |
| Expired / cancelled | (800,001) | 0.60 | (2,000,000) | 0.66 |
| Outstanding - end of period | 16,323,699 | $ 0.54 | 13,977,034 | $ 0.57 |
| Exercisable - end of period | 9,223,702 | $ 0.54 | 7,570,372 | $ 0.61 |

The Company recognized share-based payment expense related to stock options of $979,400 for the six month period ended June 30, 2012 (June 30, 2011 – $1,450,965).

**c) Per share information**

The diluted weighted average number of shares outstanding for the six month period ended June 30, 2012 was 294,631,423 (June 30, 2011 – 259,391,105). For the six month period ended June 30, 2012 and 2011, all share options were excluded from the calculation of diluted weighted average shares outstanding as they were anti-dilutive.

## 7. Segmented information

The Company's segmented information is reported by geographical area. The Company has two segments, Canada (representing corporate functions) and Argentina. The segments are based on the information that is internally provided to the Chief Executive Officer, who is the Company's chief operating decision maker. No operating segments have been aggregated to form the reportable segments.

Financial information pertaining to the reportable segments is presented in the following tables:

As at and for the six months ended June 30, 2012

| | Canada | Argentina | Total |
|---|---|---|---|
| Total assets | $ 63,723,762 | $ 41,323,511 | $ 105,047,273 |
| Total liabilities | (296,212) | (3,427,403) | (3,723,615) |
| Revenue | - | 771,507 | 771,507 |
| Loss | (1,917,162) | (1,098,187) | (3,015,349) |
| Depletion and depreciation | 5,600 | 149,765 | 155,365 |
| Other income (expenses) | 294,159 | (38,733) | 255,426 |
| Capital expenditures | 11,644 | 12,897,549 | 12,909,193 |

As at and for the six months ended June 30, 2011

| | Canada | Argentina | Total |
|---|---|---|---|
| Total assets | $ 25,558,613 | $ 19,714,263 | $ 45,272,876 |
| Total liabilities | (135,126) | (4,284,267) | (4,419,393) |
| Revenue | - | 1,369,985 | 1,369,985 |
| Income (loss) | (2,481,625) | (11,753,483) | (14,235,108) |
| Depletion and depreciation | 5,156 | 218,267 | 223,423 |
| Other income (expenses) | 177,719 | (77,612) | 100,107 |
| Capital expenditures | 3,706 | 12,936,228 | 12,939,934 |

## 8. Supplemental cash flow information

| Decrease (increase) in non-cash working capital | Three months ended June 30, 2012 | Three months ended June 30, 2011 | Six months ended June 30, 2012 | Six months ended June 30, 2011 |
|---|---|---|---|---|
| Trade and other receivables | $ (121,636) | $ (179,837) | $ (46,942) | $ 284,348 |
| Prepaid expenses | (276,559) | 38,734 | (350,269) | (42,614) |
| Inventory | (104,690) | 129,304 | (131,997) | 21,857 |
| Trade and other payables | (1,645,511) | (166,391) | 79,460 | (1,146,833) |
| Change in non-cash working capital | $ (2,148,396) | $ (178,190) | $ (449,748) | $ (883,242) |
| Attributable to: | | | | |
| Operating activities | $ (1,507,376) | $ (344,422) | $ (284,365) | $ (22,744) |
| Financing activities | (105,441) | - | - | (3,880) |
| Investing activities | (535,579) | 166,232 | (165,383) | (856,618) |
| Change in non-cash working capital | $ (2,148,396) | $ (178,190) | $ (449,748) | $ (883,242) |

## 9. Commitments

The Company's commitment for office space and rental accommodation is as follows:

| Year | Amount |
|---|---|
| 2012 | $ 65,000 |
| 2013 | 104,000 |
| 2014 | 46,000 |
| 2015 | - |

In March 2012 the northern 108 $km^2$ of the 404 $km^2$ Coiron Amargo Block was converted to a 25 year exploitation concession by the Province of Neuquén. In addition, the exploration period for the remainder of the Coiron Amargo Block and the Curamhuele Block was extended to November 8, 2013. The extension of the Coiron Amargo and Curamhuele blocks required additional work commitments of US$ 51.1 million (Madalena share – US$ 29.3 million). Both exploration blocks qualify for an additional one year extension period at the end of their exploration periods in the fourth quarter of 2013.

The initial exploration period on the Cortadera Block in the Province of Neuquén expired on October 26, 2011. The joint venture has agreed a work plan with provincial authorities which will require additional work commitments and is currently working with provincial authorities to formalize the extension of the initial exploration period. As at June 30, 2012 the Company had incurred cumulative costs of approximately $2.4 million with respect to this block. A delay or rejection of the extension terms may result in an impairment of these costs.

## 10. Capital management and financial risk

<u>Capital management</u>

The Company's objective is to maintain a strong capital position in order to execute on its exploration and development plans and maximize shareholder value.

In order to maintain a strong capital position the Company may consider any or all of the following activities, depending on existing economic conditions and access to external capital sources:

- Issue new shares through a public offering or private placement;
- Raise fixed or floating interest rate debt;
- Consolidate outstanding common shares; or
- Farm-out existing exploration opportunities.

The Company is not subject to any external restrictions on its capital structure and has no debt facilities.

The Company periodically reviews its capital structure in relation to its expected exploration and development budgets. As the Company is primarily in the exploration phase, certain quantitative measures used by industry peers, such as return on equity, return on capital employed and debt to equity ratios, are not relevant measures for the Company.

Foreign currency exchange rate risk

Substantially all of the Company's exploration and development activities are conducted in foreign jurisdictions and a portion of the Company's cash and cash equivalents are denominated in US dollars (USD) and Argentina Pesos (ARS). Consequently, the Company is exposed to foreign currency exchange risk on a substantial portion of its financial assets. The Company has not entered into derivative exchange rate contracts to mitigate this risk.

The following table provides information on the foreign currency denominated working capital balances of the Company at June 30, 2012:

| | Balance denominated in | | Total CAD |
|---|---|---|---|
| | USD | ARS | equivalent |
| Cash and cash equivalents | 48,625 | 5,768,567 | $ 1,349,163 |
| Trade and other receivables | 460,591 | 995,143 | 693,134 |
| Prepaid expenses | - | 2,417,660 | 544,699 |
| Inventory | - | 903,810 | 203,628 |
| Trade and other payables | 2,116,263 | 3,298,652 | $ 2,897,754 |

## 11. Related party transactions

These consolidated financial statements incorporate the financial statements of the Company and the subsidiaries listed in the following table:

| | % of Ownership | Jurisdiction |
|---|---|---|
| Madalena Austral S.A. | 100% | Argentina |
| Madalena Ventures International Holding Company Inc. | 100% | Barbados |
| Madalena Ventures International Inc. | 100% | Barbados |

Transactions between the Company's subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note. During the six month period ended June 30, 2012, the Company incurred fees of $138,342 (June 30, 2011 - $16,561) payable to a law firm in which a director of the Company is a partner.

The personnel expenses of key management personnel, including directors, were as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Salaries and short-term benefits | $ 315,635 | $ 116,017 | $ 440,271 | $ 582,325 |
| Share-based payments | 545,308 | 597,701 | 812,791 | 1,267,474 |
| | $ 860,943 | $ 713,718 | $ 1,253,062 | $ 1,849,799 |

DIRECTORS

Raymond G. Smith
*Chairman, Madalena Ventures Inc.*
*President and Chief Executive Officer,*
*Bellatrix Exploration Ltd.*

Dwayne H. Warkentin
*President and Chief Executive Officer,*
*Madalena Ventures Inc.*

Barry B. Larson
*Vice President Operations and Chief Operating Officer,*
*Parex Resources Inc.*

Michael J. Lock
*President,*
*Upsilon Holdings Ltd.*

Keith MacDonald
*President,*
*Bamako Investment Management Ltd.*

Anthony J. Potter
*Vice President, Finance and Chief Financial Officer,*
*Madalena Ventures Inc.*

Jay Reid
*Partner,*
*Burnet, Duckworth and Palmer LLP*

Ving Y. Woo
*Vice-President and Chief Operating Officer,*
*Bellatrix Exploration Ltd.*

OFFICERS

Dwayne H. Warkentin
*President and Chief Executive Officer*

Anthony J. Potter
*Vice President, Finance and Chief Financial Officer*

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TD Canada Trust

AUDITORS

KPMG LLP
*Calgary, Alberta*

INDEPENDENT ENGINEERS

InSite Petroleum Consultants Ltd.

REGISTRAR AND TRANSFER AGENT

Inquiries regarding change of address, registered shareholdings, stock transfers or lost certificates should be directed to:

Alliance Trust Company
*Calgary, Alberta*

STOCK EXCHANGE LISTING

TSX Venture Exchange
Trading Symbol: "MVN"