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HOUSTON AMERICAN ENERGY CORP  
Form 10QSB  
November 14, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-QSB

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE  
ACT OF 1934

For the quarterly period ended September 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-33027

HOUSTON AMERICAN ENERGY CORP  
(Exact name of small business issuer as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

76-0675953  
(IRS Employer  
Identification No.)

801 Travis Street, Suite 2020, Houston, Texas 77002  
(Address of principal executive offices) (Zip Code)

(713) 222-6966  
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last  
report)

Indicate by check mark whether the registrant (1) has filed all reports  
required to be filed by section 13 or 15(d) of the Securities Exchange Act of  
1934 during the preceding 12 months (or for such shorter period that the  
registrant was required to file such reports), and (2) has been subject to such  
filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a shell company (as  
defined in Rule 12b-2 of the Exchange Act). Yes  No

As of November 1, 2006, we had 27,820,172 shares of \$.001 par value Common  
Stock outstanding.

Transitional Small Business Disclosure Format (check one) Yes  No

HOUSTON AMERICAN ENERGY CORP  
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PART I - FINANCIAL INFORMATION

ITEM 1. Financial Statements

HOUSTON AMERICAN ENERGY CORP  
BALANCE SHEET  
September 30, 2006  
(Unaudited)

ASSETS  
-----

CURRENT ASSETS

|                      |               |
|----------------------|---------------|
| Cash                 | \$ 14,421,365 |
| Accounts receivable  | 262,070       |
| Prepaid expenses     | 64,461        |
|                      | -----         |
| Total current assets | 14,747,896    |
|                      | -----         |

PROPERTY, PLANT AND EQUIPMENT

|   |           |
|---|-----------|
| Oil and gas properties - full cost method |           |
| Costs subject to amortization             | 5,636,687 |
| Costs not being amortized                 | 947,638   |
| Furniture and equipment                   | 11,878    |
|   | -----     |

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|  |               |
|--|---------------|
| Total property, plant and equipment  | 6,596,203     |
| Accumulated depreciation and depletion   | (1,827,796)   |
|  | -----         |
| Total property, plant and equipment, net   | 4,768,407     |
|  | -----         |
| OTHER ASSETS   | 3,167         |
|  | -----         |
| Total Assets   | \$ 19,519,470 |
|  | =====         |
| LIABILITIES AND SHAREHOLDERS' EQUITY   |               |
| -----  |               |
| CURRENT LIABILITIES  |               |
| Accounts payable   | \$ 72,353     |
| Accrued expenses   | 16,866        |
|  | -----         |
| Total current liabilities  | 89,219        |
|  | -----         |
| LONG-TERM LIABILITIES  |               |
| Reserve for plugging costs   | 41,249        |
|  | -----         |
| Total long-term liabilities  | 41,249        |
|  | -----         |
| SHAREHOLDERS' EQUITY   |               |
| Common stock, \$0.001 par value; 100,000,000 shares<br>authorized; 27,820,172 shares outstanding | 27,820        |
| Additional paid-in capital   | 21,687,835    |
| Treasury stock, at cost; 100,000 shares  | (85,834)      |
| Accumulated deficit  | (2,240,819)   |
|  | -----         |
| Total shareholders' equity   | 19,389,002    |
|  | -----         |
| Total liabilities and shareholders' equity   | \$ 19,519,470 |
|  | =====         |

The accompanying notes are an integral part of these financial statements

HOUSTON AMERICAN ENERGY CORP  
STATEMENT OF OPERATIONS  
(Unaudited)

|                     | Nine Months Ended<br>September 30, |              | Three Months Ended<br>September 30, |            |
|---------------------|------------------------------------|--------------|-------------------------------------|------------|
|                     | 2006                               | 2005         | 2006                                | 2005       |
|                     | -----                              | -----        | -----                               | -----      |
| Oil and gas revenue | \$ 2,380,593                       | \$ 1,824,582 | \$ 891,029                          | \$ 732,642 |
| Consulting fees     | -                                  | 25,000       | -                                   | 25,000     |
|                     | -----                              | -----        | -----                               | -----      |
| Total revenues      | 2,380,593                          | 1,849,582    | 891,029                             | 757,642    |
|                     | -----                              | -----        | -----                               | -----      |

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|   |              |              |            |              |
|---|--------------|--------------|------------|--------------|
| Expenses of operations:   |              |              |            |              |
| Lease operating expense and severance tax   | 736,803      | 710,702      | 285,767    | 239,727      |
| Joint venture expenses  | 121,206      | 43,105       | 40,083     | 15,681       |
| General and administrative expense (including share-based compensation expenses of \$209,867, \$0, \$164,667, and \$0 respectively) | 971,698      | 542,590      | 454,257    | 200,837      |
| Depreciation and depletion  | 455,246      | 223,392      | 275,234    | 53,034       |
|   | -----        | -----        | -----      | -----        |
| Total operating expenses  | 2,284,953    | 1,519,789    | 1,055,341  | 509,279      |
|   | -----        | -----        | -----      | -----        |
| Income (loss) from operations   | 95,640       | 329,793      | (164,312)  | 248,363      |
| Other (income) expenses:  |              |              |            |              |
| Interest income   | (316,697)    | (21,084)     | (238,814)  | (13,314)     |
| Interest expense  | 57,278       | 69,420       | -          | 42,500       |
| Interest expense - derivative   | 37,773       | 304,753      | -          | 12,317       |
| Net change in fair value of derivative liabilities  | 170,949      | 351,244      | -          | 289,214      |
| Interest expense - shareholders   | 20,440       | 54,000       | -          | 18,000       |
| Financing costs   | 110,787      | 10,431       | 104        | 6,386        |
|   | -----        | -----        | -----      | -----        |
| Total other (income) expenses, net  | 80,530       | 768,764      | (238,710)  | 355,103      |
|   | -----        | -----        | -----      | -----        |
| Net income (loss) before taxes  | 15,110       | (438,971)    | 74,398     | (106,740)    |
| Income tax expense  | 198,099      | -            | 76,402     | -            |
|   | -----        | -----        | -----      | -----        |
| Net loss  | \$ (182,989) | \$ (438,971) | \$ (2,004) | \$ (106,740) |
|   | =====        | =====        | =====      | =====        |
| Basic and diluted loss per share  | \$ (0.01)    | \$ (0.02)    | \$ (0.00)  | \$ (0.01)    |
|   | =====        | =====        | =====      | =====        |
| Basic and diluted weighted average shares   | 24,158,638   | 19,968,089   | 27,820,172 | 19,968,089   |
|   | =====        | =====        | =====      | =====        |

The accompanying notes are an integral part of these financial statements

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HOUSTON AMERICAN ENERGY CORP  
STATEMENTS OF CASH FLOWS  
(Unaudited)

|                                      | For the Nine Months Ended<br>September 30, |              |
|--------------------------------------|--|--------------|
|                                      | 2006                                       | 2005         |
|                                      | -----                                      | -----        |
| CASH FLOWS FROM OPERATING ACTIVITIES |  |              |
| Net loss                             | \$ (182,989)                               | \$ (438,971) |

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|  |               |             |
|--|---------------|-------------|
| Adjustments to reconcile net loss  |               |             |
| to net cash from operations  |               |             |
| Depreciation and depletion   | 455,246       | 223,39      |
| Stock based compensation   | 209,867       |             |
| Change in fair value of derivatives  | 170,949       | 351,24      |
| Amortization of debt discount and deferred financing cost                    | 148,456       | 304,75      |
| Changes in operating assets and liabilities:                                 |               |             |
| (Increase) decrease in accounts receivable                                   | 311,251       | (233,50)    |
| (Increase) decrease in prepaid expense                                       | (54,496)      | 88,55       |
| (Increase) decrease in other assets  | -             | (117,06)    |
| Increase (decrease) in accounts payable and accrued liabilities              | (446,446)     | 118,26      |
|  | -----         | -----       |
| Net cash provided by operations  | 611,838       | 296,65      |
|  | -----         | -----       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                  |               |             |
| Acquisition of oil and gas properties  | (2,592,406)   | (1,353,08)  |
|  | -----         | -----       |
| Net cash used in investing activities  | (2,592,406)   | (1,353,08)  |
|  | -----         | -----       |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                  |               |             |
| Sale of common stock, net of costs   | 15,386,583    |             |
| Issuance of debt   | -             | 2,125,00    |
| Exercise of warrants   | 191,250       |             |
| Repayment of shareholder loan  | (900,000)     |             |
|  | -----         | -----       |
| Net cash provided by financing activities                                    | 14,677,833    | 2,125,00    |
|  | -----         | -----       |
| Increase in cash and equivalents   | 12,697,265    | 1,068,57    |
| Cash, beginning of period  | 1,724,100     | 721,61      |
|  | -----         | -----       |
| Cash, end of period  | \$ 14,421,365 | \$ 1,790,18 |
|  | =====         | =====       |
| <b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>                                   |               |             |
| Interest paid  | \$ 110,773    | \$ 54,00    |
|  | =====         | =====       |
| <b>SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b> |               |             |
| Conversion of convertible notes to common stock                              | \$ 2,445,545  | \$          |
|  | =====         | =====       |
| Warrants issued for financing fees   | -             | 162,56      |
|  | =====         | =====       |
| Exercise of warrants   | 610,719       |             |
|  | =====         | =====       |

The accompanying notes are an integral part of these financial statements

**NOTE 1. - BASIS OF PRESENTATION**

The accompanying unaudited financial statements of Houston American Energy Corp,

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a Delaware corporation (the "Company"), have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB and Item 310(b) of Regulation S-B. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for a complete financial presentation. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation, have been included in the accompanying unaudited financial statements. Operating results for the periods presented are not necessarily indicative of the results that may be expected for the full year.

These financial statements should be read in conjunction with the financial statements and footnotes which are included as part of the Company's Form 10-KSB for the year ended December 31, 2005.

### NOTE 2. - CHANGES IN PRESENTATION

Certain financial presentations for the periods presented for 2005 have been reclassified to conform to the 2006 presentation.

### NOTE 3. - ISSUANCES OF COMMON STOCK AND WARRANTS

#### April 2006 Private Placement

On April 28, 2006, the Company entered into Subscription Agreements (the "Purchase Agreements") with multiple investors pursuant to which the Company sold 5,533,333 shares of common stock (the "Shares") for \$16,599,999.

The Shares were offered and sold in a private placement transaction pursuant to the exemption from registration provided by Section 4(2) of the Securities Act of 1933 and Rule 506 promulgated thereunder. Each investor was an "accredited investor" as defined in Rule 501 promulgated under the Securities Act.

Pursuant to the terms of the Subscription Agreements, the Company and the investors entered into Registration Rights Agreements under which the Company agreed to file with the Securities and Exchange Commission, within 60 days, a registration statement covering the Shares. In conjunction with the placement of the Shares, John Terwilliger, O. Lee Tawes III and Edwin Broun III each entered into lock-up agreements pursuant to which each agreed not to offer or sell any shares of the Company's common stock until the earlier of the effective date of the registration statement relating to the Shares or one year from the sale of the Shares.

Sanders Morris Harris Inc. acted as placement agent in connection with the offer and sale of the Shares. For its services as placement agent, Sanders Morris Harris Inc. received commissions totaling \$1,162,000 and a warrant (the "Placement Agent Warrant") to purchase 415,000 shares of common stock at \$3.00 per share. The Registration Rights Agreements provide that the shares of common stock underlying the Placement Agent Warrant are to be included in the registration statement to be filed.

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#### Conversion of 8% Subordinated Convertible Notes

On May 2, 2006, the Company notified the holders of its 8% Subordinated Convertible Notes (the "Convertible Notes") of its election to convert the Convertible Notes into shares of the Company's common stock. As a result of such election, the full principal amount of the Convertible Notes of \$2,125,000 has been satisfied by conversion of the same into 2,125,000 shares of common

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stock.

The shares of common stock issued on conversion of the Convertible Notes were offered and issued pursuant to the exemption from registration provided by Section 4(2) of the Securities Act of 1933. Each of the investors is an "accredited investor", as defined in Rule 501 promulgated under the Securities Act.

### Exercise of Warrants

In May 2006, the holders of warrants issued in conjunction with the May 2005 private placement of the Convertible Notes exercised all 191,250 warrants and were issued an aggregate of 191,250 shares of common stock for aggregate consideration of \$191,250.

The shares of common stock issued on exercise of the warrants were offered and issued pursuant to the exemption from registration provided by Section 4(2) of the Securities Act of 1933. Each of the investors is an "accredited investor", as defined in Rule 501 promulgated under the Securities Act.

### NOTE 4. - SUBORDINATED CONVERTIBLE NOTES AND WARRANTS - DERIVATIVE LIABILITIES

In conjunction with the issuance in May 2005 of Convertible Notes, the conversion feature, the conversion price, reset provision and the Company's optional early redemption right in the Convertible Notes were bundled together as a single compound embedded derivative liability and, using a layered discounted probability-weighted cash flow approach, were initially fair valued at \$2,368,485 at May 4, 2005. The fair value model comprises multiple probability-weighted scenarios under various assumptions reflecting the economics of the Convertible Notes, such as the risk-free interest rate, expected Company stock price and volatility, likelihood of conversion and or redemption, and likelihood default status and timely registration. At inception, the fair value of this single compound embedded derivative was bifurcated from the host debt contract and recorded as a derivative liability which resulted in a reduction of the initial notional carrying amount of the Convertible Notes (as an amortized discount which will be amortized over a five-year period under the effective interest method). At inception the excess of the unamortized discount over the notional amount of the Convertible Note in the amount of \$285,547 was charged to expense in the Company's statement of operations.

As noted above, the Convertible Notes were satisfied in full in May 2006 upon the conversion of the same to common stock. As a result of conversion of the Convertible Notes, the compound embedded derivative liability of \$2,373,405 was reclassified as additional paid in capital, and the unamortized discount in the amount of \$2,053,060 was credited as a reduction of additional paid in capital, during the nine month period ended September 30, 2006.

Also as noted above, the warrants issued in conjunction with the Convertible Notes were exercised in full. As a result of exercise of the warrants, the derivative liability associated with the warrants, in the amount of \$610,719, was reclassified as additional paid in capital during the nine month period ended September 30, 2006.

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### NOTE 5. - SHAREHOLDER LOAN

Shareholder loans, in the principal amount of \$900,000, were repaid in full from the proceeds of the April 2006 private placement.

### NOTE 6. - STOCK BASED COMPENSATION

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We maintain performance incentive plans under which incentive stock options and non-qualified stock options may be granted to employees, consultants and non-employee directors. Stock options are granted at the market price on the date of grant, vesting over varying periods, and generally expire ten years from the date of grant. We issue new shares of common stock upon exercise of stock options.

Effective January 1, 2006, the first day of our 2006 fiscal year, we adopted Financial Accounting Standards Board ("FASB") Statement No. 123(R), "Share-Based Payment" ("SFAS 123R"), using the modified prospective transition method, and as a result, did not retroactively adjust results from prior periods. Under this transition method, stock-based compensation was recognized for expense related to the options vesting in the first nine months of 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. We apply the Black-Scholes valuation model in determining the fair value of share-based payments to employees, non-employee directors and consultants. The resulting compensation expense is recognized over the requisite service period, which is generally the option vesting term. Options issued to non-employee directors are vested 100% at grant date. 20,000 options were granted to non-employee directors during the nine months ended September 30, 2006. Prior to fiscal 2006, stock-based compensation was included as a pro forma disclosure in the Notes to the Consolidated Financial Statements as permitted by SFAS 123.

Compensation expense is recognized only for those options expected to vest, with forfeitures estimated based on our historical experience and future expectations. Prior to the adoption of SFAS 123R, the effect of forfeitures on the pro forma expense amounts was recognized as the forfeitures occurred.

200,000 options were granted to employees during the quarter and nine months ended September 30, 2006. Adoption of SFAS 123R resulted in a compensation charge of \$164,667 in the Statement of Operations for the quarter ended September 30, 2006.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar options, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. For fiscal 2006, expected stock price volatility is based on the historical volatility of our stock. The risk-free interest rate is based on the U.S. Treasury yield in effect at the time of grant with an equivalent remaining term. The Company has not paid dividends in the past and does not currently plan to pay any dividends in the near future.

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The fair value of each option grant issued is estimated at the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions for the periods indicated:

|                         | For the three months<br>September 30, 2006 |
|-------------------------|--|
| -----                   |  |
| Expected volatility     | 77.0%                                      |
| Risk free interest rate | 5.24%                                      |
| Expected option life    | 10 years                                   |



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|                                  |         |
|----------------------------------|---------|
| Dividend yield                   | 0%      |
| Fair value of options granted \$ | 494,000 |

Stock option activity during the nine months ended September 30, 2006 was as follows:

|   | Shares  | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|---|---------|---------------------------------|--|---------------------------|
| Outstanding at December 31, 2005                  | 89,000  | \$ 2.42                         | 8.95   |                           |
| Granted   | 220,000 | 3.08                            | 9.75   |                           |
| Exercised   | -       |                                 |  |                           |
| Cancelled   | -       |                                 |  |                           |
| Outstanding at September 30, 2006                 | 309,000 | 2.89                            | 9.52   | \$ 24,000                 |
| Vested and expected to vest at September 30, 2006 | 309,000 | 2.89                            | 9.52   | \$ 24,000                 |
| Exercisable at September 30, 2006                 | 109,000 | 2.73                            | 9.07   | \$ 24,000                 |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between our closing stock price on September 30, 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2006. This amount changes based on the fair market value of our stock. No options were exercised for the nine months ended September 30, 2006. As of September 30, 2006, total unrecognized stock-based compensation expense related to non-vested stock options was \$329,333, which is expected to be recognized over 1.75 years. As of September 30, 2006 there were 191,000 shares of common stock available for issuance pursuant to future stock option grants.

Additional information regarding options outstanding as of September 30, 2006 is as follows:

| Range of Exercise Price | Options Outstanding                      |   |                                 | Options Exercisable                      |                                 |
|-------------------------|--|---|---------------------------------|--|---------------------------------|
|                         | Number Outstanding at September 30, 2006 | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price | Number Exercisable at September 30, 2006 | Weighted-Average Exercise Price |
| 2.00                    | 60,000                                   | 8.87  | \$ 2.00                         | 60,000                                   | \$ 2.00                         |
| 2.98                    | 200,000                                  | 9.76  | \$ 2.98                         | 0  | \$ -                            |
| 3.30                    | 29,000                                   | 9.12  | \$ 3.30                         | 29,000                                   | \$ 3.30                         |
| 4.10                    | 20,000                                   | 9.63  | \$ 4.10                         | 20,000                                   | \$ 4.10                         |

NOTE 7. - COMMITMENTS AND CONTINGENCIES

In May 2006, the Company named an additional director to its board and revised the compensation of its President and its non-employee directors.

Pursuant to a resolution adopted by the board of directors, the base salary of the Company's president was increased, effective June 1, 2006 from \$180,000 annually to \$300,000 annually.

Pursuant to a resolution adopted by the board of directors, the Company fixed the compensation of non-employee directors to consist of (1) an annual retainer of \$6,000 payable in quarterly installments, (2) an annual retainer of \$2,000 per committee on which a director serves, payable in quarterly installments, (3) an annual retainer of \$2,500 for service as audit committee chair, payable in quarterly installments, (4) an annual retainer of \$1,500 for service as chair of committees other than the audit committee, payable in quarterly installments, (5) a grant of 20,000 stock options on initial election or appointment as a director exercisable at fair market value on the date of grant for a term of 10 years, and (6) a grant of 10,000 stock options immediately following each subsequent shareholders meeting at which a director stands for reelection and is reelected.

In July 2006, the Company appointed James "Jay" Jacobs as Chief Financial Officer and fixed Mr. Jacobs' compensation as follows: (1) base salary of \$125,000; and (2) a stock option to purchase 200,000 shares of common stock at \$2.98 per share, the closing price on first day of employment, vesting over a 2 year period and exercisable over a period of ten years. The Company has agreed, by the end of the 2nd quarter of 2007, to retain the services of an outside compensation consulting firm to review and make recommendations with respect to the compensation of Mr. Jacobs and each of the Company's executive officers and directors.

NOTE 8. - LOSS PER SHARE

Pursuant to SFAS No. 128, "Earnings Per Share," basic net income per share is computed by dividing the net income attributable to common shareholders by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income attributable to common shareholders by the weighted-average number of common and common equivalent shares outstanding during the period. Common share equivalents included in the diluted computation represent shares issuable upon assumed exercise of stock options, warrants, and convertible notes using the treasury stock and "if converted" method. Our securities do not have a contractual obligation to share in the losses in any given period. As a result these securities were not allocated any losses in the periods of net losses.

For the three months ended September 30, 2006, 309,000 options and 415,000 warrants to purchase common stock were excluded from the calculation of diluted net loss per share because they were anti-dilutive. For the three months ended September 30, 2005, 2,125,000 shares of common stock issuable upon conversion of convertible notes and 191,250 warrants to purchase common stock were excluded from the calculation of diluted net loss per share because they were anti-dilutive.

For the nine months ended September 30, 2006, 309,000 options and 415,000 warrants to purchase common stock were excluded from the calculation of diluted net loss per share because they were anti-dilutive. For the nine months ended September 30, 2005, 2,125,000 shares of common stock issuable upon conversion of convertible notes and 191,250 warrants to purchase common stock were excluded from the calculation of diluted net loss per share because they were

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anti-dilutive.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

#### FORWARD-LOOKING INFORMATION

This Form 10-QSB quarterly report of Houston American Energy Corp (the "Company") for the nine months ended September 30, 2006, contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are intended to be covered by the safe harbors created thereby. To the extent that there are statements that are not recitations of historical fact, such statements constitute forward-looking statements that, by definition, involve risks and uncertainties. In any forward-looking statement, where the Company expresses an expectation or belief as to future results or events, such expectation or belief is expressed in good faith and believed to have a reasonable basis, but there can be no assurance that the statement of expectation or belief will be achieved or accomplished.

The actual results or events may differ materially from those anticipated and as reflected in forward-looking statements included herein. Factors that may cause actual results or events to differ from those anticipated in the forward-looking statements included herein include the Risk Factors described in Item 1 of the Company's Form 10-KSB for the year ended December 31, 2005.

Readers are cautioned not to place undue reliance on the forward-looking statements contained herein, which speak only as of the date hereof. The Company believes the information contained in this Form 10-QSB to be accurate as of the date hereof. Changes may occur after that date, and the Company will not update that information except as required by law in the normal course of its public disclosure practices.

Additionally, the following discussion regarding the Company's financial condition and results of operations should be read in conjunction with the financial statements and related notes contained in Item 1 of Part 1 of this Form 10-QSB, as well as the Risk Factors in Item 1 and the financial statements in Item 7 of Part II of the Company's Form 10-KSB for the fiscal year ended December 31, 2005.

#### CRITICAL ACCOUNTING POLICIES

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The Company believes certain critical accounting policies affect its more significant judgments and estimates used in the preparation of its financial statements. A description of the Company's critical accounting policies is set forth in the Company's Form 10-KSB for the year ended December 31, 2005. As of, and for the nine months ended, September 30, 2006, there have been no material changes or updates to the Company's critical accounting policies other than (1) the adoption of stock-based compensation in accordance with the provisions of SFAS 123R, constituting a new critical accounting policy, and (2) the following updated information relating to Unevaluated Oil and Gas Properties:

**STOCK-BASED COMPENSATION.** We account for stock-based compensation in accordance with the provisions of SFAS 123R. We use the Black-Scholes option-pricing model, which requires the input of highly subjective assumptions. These assumptions include estimating the volatility of the Company's common stock

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price over the vesting term and the number of options that will ultimately not complete their vesting requirements ("forfeitures"). Changes in the subjective assumptions can materially affect the estimated fair value of stock-based compensation and consequently, the related amount recognized on the Statements of Operations. See Note 6 of the Notes to the Financial Statements in this Form 10-QSB for further discussion of stock-based compensation.

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UNEVALUATED OIL AND GAS PROPERTIES. Unevaluated oil and gas properties not subject to amortization include the following at September 30, 2006:

|                   | September 30, 2006 |
|-------------------|--------------------|
| Acquisition costs | \$ 177,993         |
| Evaluation costs  | 769,645            |
|                   | -----              |
| Total             | \$ 947,638         |
|                   | =====              |

The carrying value of unevaluated oil and gas prospects include \$729,445 expended for properties in the South American country of Colombia at September 30, 2006. We are maintaining our interest in these properties and development has or is anticipated to commence within the next twelve months.

### CURRENT YEAR DEVELOPMENTS

#### Drilling Activity

During the nine months ended September 30, 2006, the Company drilled 3 on-shore domestic wells as follows:

- The Obenhaus #1, a 7,100 -foot well on the Obenhaus Prospect in Wilbarger County, Texas was drilled and was a dry hole.
- The Riggins #1, a 6,400-foot test well on the West Fargo Prospect in Wilbarger County, Texas was drilled and was deemed non-commercial.
- The DDD-Evans #1, a 8,500-foot test well on the West Turkey Prospect in Hardeman County, Texas, was completed in April 2006 and began production in May 2006.

At September 30, 2006, the Company had no domestic wells being drilled.

At September 30, 2006, the Company had no plans to drill additional domestic wells during the balance of 2006.

During the nine months ended September 30, 2006, the Company drilled 9 international wells in Colombia. Of the wells drilled in Colombia, 5 were successfully drilled and producing at September 30, 2006 and 4 were dry holes.

At September 30, 2006, the Company had 1 well being drilled in Colombia with plans to drill 7 wells during the balance of 2006.

#### Leasehold Activity

During the nine months ended September 30, 2006, the Company acquired interests in an additional domestic prospect, a 10% working interest with a 7.5% net

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revenue interest in the 91.375 acre West Turkey Prospect in Hardeman County, Texas.

During the 2006 period, the Company terminated its interest in the Green Jacket Prospect in Iberville Parish, Louisiana.

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### Seismic Activity

During the nine months ended September 30, 2006, the Company continued its ongoing investment in acquiring and developing seismic data with respect to its Colombian properties with shooting being completed on approximately 133 square miles of prospect acreage during the period.

### Capital Raising Activity

In April 2006, the Company sold, in a private placement, 5,533,333 shares of common stock for gross proceeds of \$16,599,999. In connection with the private placement of shares, the Company paid to the placement agent commissions of \$1,162,000 and issued to the placement agent five year warrants to purchase 415,000 shares of common stock at \$3.00 per share.

In May 2006, the Company repaid loans from its principal shareholder, in the principal amount of \$900,000, from the proceeds of the April 2006 private placement.

In May 2006, the Company exercised its right to cause its outstanding Subordinated Convertible Notes, in the aggregate principal amount of \$2,125,000, to be converted into 2,125,000 shares of common stock.

In May 2006, the holders of \$1.00 warrants issued in connection with the Subordinated Convertible Notes exercised all of the warrants resulting in the issuance of 191,250 shares of common stock for aggregate consideration of \$191,250.

### Corporate Developments

During May 2006, the Company's board of directors appointed an additional non-employee director and revised the compensation of the Company's President and non-employee directors. Effective June 1, 2006, the base salary of the Company's President was increased from \$180,000 to \$300,000 annually. The board fixed the compensation of non-employee directors to consist of (1) an annual retainer of \$6,000 payable in quarterly installments, (2) an annual retainer of \$2,000 per committee on which a director serves, payable in quarterly installments, (3) an annual retainer of \$2,500 for service as audit committee chair, payable in quarterly installments, (4) an annual retainer of \$1,500 for service as chair of committees other than the audit committee, payable in quarterly installments, (5) a grant of 20,000 stock options on initial election or appointment as a director exercisable at fair market value on the date of grant for a term of 10 years, and (6) a grant of 10,000 stock options immediately following each subsequent shareholders meeting at which a director stands for reelection and is reelected.

In July 2006, the Company appointed James "Jay" Jacobs as Chief Financial Officer and fixed Mr. Jacobs' compensation, subject to review and adjustment by mid-2007, as follows: (1) base salary of \$125,000; and (2) a stock option to purchase 200,000 shares of common stock at \$2.98 per share, the closing price on first day of employment, vesting over a 2 year period and exercisable over a period of ten years.

## RESULTS OF OPERATIONS

Oil and Gas Revenues. Total oil and gas revenues increased 28.7% to \$2,380,593 in the nine months ended September 30, 2006 when compared to the nine months ended September 30, 2005. The increase in revenue is due to (1) increased production resulting from the development of the Columbian fields and the new domestic wells that have come on line since September 2005, and (2) increases in oil and gas prices. The Company had interests in 21 producing wells in Colombia and 12 producing wells in the U.S. during the 2006 period as compared to 16 producing wells in Columbia and 8 producing wells in the U.S. during the 2005 period. Average prices from sales were \$58.66 per barrel of oil and \$6.72 per mcf of gas during the 2006 period as compared to \$47.81 per barrel of oil and \$6.32 per mcf of gas during the 2005 period.

|             | Columbia    | U.S.      | Total       |
|-------------|-------------|-----------|-------------|
|             | -----       | -----     | -----       |
| 2006 Period |             |           |             |
| Oil sales   | \$1,816,048 | \$ 69,916 | \$1,885,964 |
| Gas sales   | -           | 494,629   | 494,629     |
| 2005 Period |             |           |             |
| Oil sales   | 1,360,647   | 62,978    | 1,423,625   |
| Gas sales   | -           | 400,957   | 400,957     |

Lease Operating Expenses. Lease operating expenses, excluding joint venture expenses relating to our Columbian operations discussed below, increased 3.7% to \$736,803 in the 2006 period from \$710,702 in the 2005 period. The increase in lease operating expenses was attributable to the increase in the number of wells operated during the 2006 period (33 wells as compared to 24 wells) partially offset by improved operating efficiencies. Following is a summary comparison of lease operating expenses for the periods.

|             | Columbia   | U.S.      | Total      |
|-------------|------------|-----------|------------|
|             | -----      | -----     | -----      |
| 2006 Period | \$ 584,810 | \$151,993 | \$ 736,803 |
| 2005 Period | 660,446    | 50,256    | 710,702    |

Joint Venture Expenses. The Company's allocable share of joint venture expenses attributable to the Colombian Joint Venture totaled \$121,206 during the 2006 period and \$43,105 for the 2005 period. The increase in joint venture expenses was attributable to an increase in operational activities of the joint venture in acquiring new concessions.

Depreciation and Depletion Expense. Depreciation and depletion expense was \$455,246 and \$223,392 for the nine months ended September 30, 2006 and 2005, respectively. The increase is due to increases in domestic and Colombian production.

General and Administrative Expenses. General and administrative expense increased by 79.1% to \$971,698 during the 2006 period from \$542,590 in the 2005 period. The increase in general and administrative expense was primarily attributable to (1) payment of state taxes (\$19,383), (2) compensation expense

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relating to the grant of stock options to a new director and a new officer (\$209,867), (3) an increase in officer salary, director compensation and the hiring of a new officer, (\$95,135), (4) an increase in travel and entertainment expense (\$19,808), and (5) transfer agent fees and fees relating to the listing of the Company's stock on the American Stock Exchange (\$87,926). General and administrative expense is expected to continue at an increased level during the 4th quarter of 2006 due to an increase in salary of the Company's President, the hiring of a Chief Financial Officer and the recognition of compensation associated with options granted to the Chief Financial Officer.

Other Income/Expense, Net. Other income/expense, net, consists of interest income, net of financing costs in the nature of interest and deemed interest associated with outstanding shareholder loans and convertible notes and warrants issued in May 2005. Certain features of the convertible notes and warrants resulted in

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the recording of a deemed derivative liability on the balance sheet and periodic interest associated with the deemed derivative liabilities and changes in the fair market value of those deemed liabilities.

Other income/expenses, net, totaled \$768,764 of net expenses in the 2005 period compared to \$80,530 of net expenses in the 2006 period. The improvement in other income/expense, net, was attributable to interest earned on funds received from the 2006 private placement, reduced interest on shareholder debt, derivative interest expense, interest expense on convertible notes net changes in fair value of derivatives partially offset by increases in financing costs, which charges primarily related to retirement of the convertible notes and warrants. As a result of the retirement of the shareholder loan and the convertible notes, the Company had no substantial debt at September 30, 2006 and, accordingly, following the conversion or retirement of the shareholder loans and convertible notes and related warrants the Company will no longer incur interest or derivative related charges associated with the loans, notes and warrants.

Income Tax. Income taxes totaled \$198,099 during the 2006 nine month period as compared to \$0 during the 2005 nine month period. Income taxes for the 2006 period relates to foreign taxes in connection with the Company's Colombian operations. The increase in income tax expense was attributable to increased production and profitability in Colombia. The Company had no provision for U.S. income taxes for either period due to the availability of net operating losses.

### FINANCIAL CONDITION

Liquidity and Capital Resources. At September 30, 2006 the Company had a cash balance of \$14,421,365 and working capital of \$14,658,677 compared to a cash balance of \$1,724,100 and working capital of \$1,771,722 at December 31, 2005. The increase in cash and working capital during the period was primarily attributable to the receipt of \$15,386,583 of net proceeds from the April 2006 private placement of common stock as well as the receipt of \$191,250 from the exercise of warrants, partially offset by acquisitions of and investments in oil and gas properties and the retirement of \$900,000 of shareholder loans.

Derivative liabilities are \$0 at September 30, 2006 as compared to \$2,813,175 at December 31, 2005 but are not considered in computing working capital. The decrease in derivative liabilities was attributable to the conversion, during 2006, of the convertible notes and warrants into common stock and the accompanying reclassification of the derivative liability in the amount of \$2,894,124 to additional paid in capital. The derivative liabilities represented the deemed fair value of the embedded derivatives included in the

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subordinated convertible notes and accompanying warrants that were issued during 2005 as measured at September 30, 2006 and December 31, 2005.

Cash Flows. Cash flows provided by operations for the 2006 period totaled \$611,838 as compared to cash provided by operations during the 2005 period of \$296,656. The increase in operating cash flow was primarily attributable to decreases in accounts receivable, increased changes in the fair value of derivatives and non cash expenses, offset by decreases in accounts accrued liabilities and increases in prepaid expenses.

Investing activities used \$2,592,406 during the 2006 period as compared to \$1,353,085 used during the 2005 period. The increase in funds used in investing activities during the current period was primarily attributable to seismic costs incurred in South America and increased drilling activity.

Financing activities provided \$14,677,833 during the 2006 period as compared to \$2,125,000 provided during the 2005 period. Cash flows from financing activities during 2006 related to the private placement of common stock resulting in the receipt of net proceeds of \$15,386,583 and the receipt of \$191,250 from the exercise of warrants partially offset by the repayment of shareholder loans of \$900,000.

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Long-Term Liabilities. At September 30, 2006, the Company had long-term liabilities of \$41,249 as compared to \$975,416 at December 31, 2005. Long-term liabilities at September 30, 2006 consisted of a reserve for plugging costs. The change in long-term debt was attributable to the retirement of shareholder loans of \$900,000 and the conversion of convertible notes into common stock.

Capital and Exploration Expenditures and Commitments. The Company's principal capital and exploration expenditures relate to our ongoing efforts to acquire, drill and complete prospects. With the receipt of additional financing in 2006 and prior years, and the increase in our revenues, profitability and operating cash flows, the Company expects that future capital and exploration expenditures will be funded principally through funds on hand and funds generated from operations.

During the first nine months of 2006, the Company invested \$2,592,406 for the acquisition and development of oil and gas properties, consisting of (1) drilling of 3 domestic wells (\$320,971), (2) drilling 9 wells in Colombia (\$1,327,964), (3) acquisition of leases domestically (\$294,401) and (4) seismic activity in Colombia (\$649,070).

At September 30, 2006, the Company's only material contractual obligations requiring determinable future payments were a lease relating to the Company's executive offices which was unchanged when compared to the 2005 Form 10-KSB.

At September 30, 2006, the Company's acquisition and drilling budget for the balance of 2006 totaled approximately \$1,346,000, consisting entirely of the budget for drilling of 7 wells in South America on the Cara Cara and Cabiona concessions. The Company's acquisition and drilling budget has historically been subject to substantial fluctuation over the course of a year based upon successes and failures in drilling and completion of prospects and the identification of additional prospects during the course of a year.

Management anticipates that the Company's current financial resources will meet our anticipated objectives and business operations, including our planned property acquisitions and drilling activities, for at least the next 12 months without the need for additional capital. Management continues to evaluate producing property acquisitions as well as a number of drilling prospects. It



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is possible, although not anticipated, that the Company may require and seek additional financing if additional drilling prospects are pursued beyond those presently under consideration.

### OFF-BALANCE SHEET ARRANGEMENTS

The Company had no off-balance sheet arrangements or guarantees of third party obligations at September 30, 2006.

### INFLATION

The Company believes that inflation has not had a significant impact on operations since inception.

### ITEM 3. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision and with the participation of our chief executive officer ("CEO") and chief financial officer ("CFO"). Based on this evaluation, our management, including the CEO and CFO, concluded that our disclosure controls and procedures were not effective at September 30, 2006.

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During the quarter ended September 30, 2006, we hired a full-time Chief Financial Officer to oversee and manage the accounting and financial reporting functions. Otherwise, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, internal controls over financial reporting.

In connection with the quarterly review for the period ended September 30, 2006, our independent registered public accounting firm informed us that we have significant deficiencies constituting material weaknesses as defined by the standards of the Public Company Accounting Oversight Board. The material weaknesses identified consisted of a lack of certain procedures to properly account for non-routine transactions and preparation of certain financial statement disclosures in accordance with U.S. GAAP. Additionally, the independent registered public accounting firm identified, during its review, certain closing and adjusting entries that had not been made prior to the review.

In addition to the weaknesses identified by our independent registered public accounting firm, management notes that the Company continues to lack adequate segregation of duties in our financial reporting process, as our CFO serves as our only internal accounting and financial reporting personnel and, as such, performs all accounting and financial reporting functions. Accordingly, the preparation of financial statements and the related monitoring controls surrounding this process were not segregated.

The Company plans to increase its emphasis on identification of, and accounting for, non-routine transactions, in particular SFAS 123R accounting, and timely preparation of closing and adjusting entries. The Company has no current plans to add accounting or financial reporting personnel and, accordingly, expects to continue to lack segregation of accounting, financial reporting and oversight functions. As operations increase in scope, the Company intends to evaluate hiring additional in-house accounting personnel so as to provide for appropriate segregation of duties within the accounting function.

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PART II

ITEM 6. EXHIBITS

| Exhibit<br>Number<br>----- | Description<br>-----  |
|----------------------------|---|
| 31.1                       | Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2                       | Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1                       | Certification of CEO Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2                       | Certification of CFO Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on behalf by the undersigned thereunto duly authorized.

HOUSTON AMERICAN ENERGY CORP.

By: /s/ John Terwilliger  
John Terwilliger  
CEO and President

By: /s/ James Jacobs  
James Jacobs  
Chief Financial Officer

Date: November 13, 2006

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