

**CANARY RESOURCES INC. AND SUBSIDIARY  
(FORMERLY SAKHA RESOURCE  
TECHNOLOGIES CORPORATION)  
(A DEVELOPMENT STAGE COMPANY)**

**CONSOLIDATED FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2005 AND 2004**

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
**Canary Resources Inc.**  
**(Formerly Sakha Resource Technologies Corporation)**  
**(A Development Stage Company)**

We have audited the accompanying consolidated balance sheets of **Canary Resources Inc. (Formerly Sakha Resource Technologies Corporation)** (a Delaware corporation in the development stage) and subsidiary as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years ended December 31, 2005 and 2004, and the period from re-entering the development stage (January 14, 2005) through to December 31, 2005. These consolidated statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States of America). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of **Canary Resources Inc. (Formerly Sakha Resource Technologies Corporation)** and subsidiary as of December 31, 2005 and 2004, and the results of their operations, and their cash flows for the years ended December 31, 2005 and 2004, and the period from re-entering the development stage (January 14, 2005) through to December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in note 2, the Company has recurring losses and negative cash flows from operations, which raises substantial doubt about its ability to continue as a going concern. Management's plans regarding these matters are also described in note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in notes 3 and 9 to the consolidated financial statements, the December 31, 2005 consolidated financial statements have been restated to correct the accounting for Shelf Registration Event Payments.

**“SF PARTNERSHIP, LLP”**

**Toronto, Canada**  
March 31, 2006, except for notes 3 and 9  
as to which the date is August 25, 2006

**CHARTERED ACCOUNTANTS**

**CANARY RESOURCES INC. AND SUBSIDIARY  
(FORMERLY SAKHA RESOURCE TECHNOLOGIES CORPORATION)  
(A DEVELOPMENT STAGE COMPANY)**

Consolidated Balance Sheets  
December 31, 2005 and 2004

	(Restated, Note 3)	
	2005	2004
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	\$ 5,751,325	\$ -
Prepaid salaries and allowances (note 13)	55,654	-
Other prepaid expenses	1,150	-
Inventories	55,573	-
	<hr/>	
<b>Total Current Assets</b>	<b>5,863,702</b>	<b>-</b>
<b>Gas Properties</b> (note 5)	<b>525,457</b>	<b>-</b>
<b>Property, Plant and Equipment - net</b> (note 6)	<b>429,848</b>	<b>-</b>
	<hr/>	
<b>Total Assets</b>	<b>\$ 6,819,007</b>	<b>\$ -</b>
	<hr/>	
<b>LIABILITIES</b>		
<b>Current</b>		
Accounts payable and accrued liabilities (note 3)	\$ 813,492	\$ 5,000
Management fees and salaries payable (note 13)	68,400	-
Advances from stockholder (note 7)	103,420	3,420
Mortgage payable (note 8)	2,666	-
	<hr/>	
<b>Total Current Liabilities</b>	<b>987,978</b>	<b>8,420</b>
<b>Mortgage Payable</b> (note 8)	<b>218,584</b>	<b>-</b>
<b>Contingent Liability</b> (notes 3 and 9)	<b>1,356,453</b>	<b>-</b>
	<hr/>	
<b>Total Liabilities</b>	<b>2,563,015</b>	<b>8,420</b>
	<hr/>	
<b>Commitments and Contingencies</b> (note 10)		
<b>STOCKHOLDERS' EQUITY</b>		
<b>Capital Stock</b> (note 11)		
Class A convertible preferred stock, \$0.001 par value, 30,000,000 shares authorized, 18,125,000 issued and outstanding (2004 - nil)	18,125	-
Common stock, \$0.001 par value, 100,000,000 shares authorized, 30,892,700 issued and outstanding (2004 -30,142,700)	30,893	30,143
<b>Additional Paid in Capital (Deficit)</b> (note 3)	<b>5,502,961</b>	<b>(30,113)</b>
<b>Accumulated Deficit and Deficit Accumulated During the Development Stage</b>	<b>(1,295,987)</b>	<b>(8,450)</b>
	<hr/>	
<b>Total Stockholders' Equity (Deficit)</b>	<b>4,255,992</b>	<b>(8,420)</b>
	<hr/>	
<b>Total Liabilities and Stockholders' Equity (Deficit)</b>	<b>\$ 6,819,007</b>	<b>\$ -</b>
	<hr/>	

(The accompanying notes are an integral part of these consolidated financial statements)

**CANARY RESOURCES INC.  
(FORMERLY SAKHA RESOURCE TECHNOLOGIES CORPORATION)  
(A DEVELOPMENT STAGE COMPANY)**

Consolidated Statements of Operations  
Years Ended December 31, 2005 and 2004, and the Period from Re-entering the  
Development Stage through to December 31, 2005

	2005	2004	(Note 1) Period from Re-entering the Development Stage through to Dec. 31, 2005
<b>Revenues</b>	\$ -	\$ -	\$ -
<b>Expenses</b>			
Management fees and salaries (note 13)	570,000	-	570,000
General and administrative	203,899	850	203,899
Salaries and wages	195,119	-	195,119
Professional fees	161,707	5,700	161,707
Exploratory expenditures	100,175	-	100,175
Rent paid to related parties (note 13)	64,200	-	64,200
Allowances paid to related parties (note 13)	62,400	-	62,400
Depreciation	18,602	-	18,602
<b>Total Expenses</b>	<u>1,376,102</u>	6,550	<u>1,376,102</u>
<b>Loss from Operations</b>	(1,376,102)	(6,550)	(1,376,102)
Other income - interest	88,565	-	88,565
<b>Loss Before Income Taxes</b>	(1,287,537)	(6,550)	(1,287,537)
Income taxes (note 15)	-	-	-
<b>Net Loss</b>	<u>\$ (1,287,537)</u>	\$ (6,550)	<u>\$ (1,287,537)</u>
<b>Loss per Weighted Average Number of Shares Outstanding</b>			
Basic	<u>\$ (0.04)</u>	\$ 0.00	
Fully diluted	<u>\$ (0.04)</u>	\$ 0.00	
<b>Basic Weighted Average Number of Shares Outstanding During the Periods</b>	<u>30,662,974</u>	30,142,700	
<b>Fully Diluted Weighted Average Number of Shares Outstanding During the Periods</b>	<u>42,896,193</u>	30,142,700	

(The accompanying notes are an integral part of these consolidated financial statements)

**CANARY RESOURCES INC. AND SUBSIDIARY  
(FORMERLY SAKHA RESOURCE TECHNOLOGIES CORPORATION)  
(A DEVELOPMENT STAGE COMPANY)**

Consolidated Statements of Stockholders' Equity  
Years Ended December 31, 2005 and 2004, and the Period from Re-entering the  
Development Stage through to December 31, 2005

	Preferred Stock		Common Stock		Accumulated (Restated, Note 3) Additional Paid-in Capital	(Restated, Deficit Accumulated During the Development Stage	Note 3) Total Stockholders' (Deficit) Equity
	Number of Shares	Amount	Number of Shares	Amount			
Balance, January 1, 2004	-	\$ -	30,142,700	\$ 30,143	\$ (30,113)	\$ (1,900)	\$ (1,870)
Net loss for the period	-	-	-	-	-	(6,550)	(6,550)
Balance, December 31, 2004	-	-	30,142,700	30,143	(30,113)	(8,450)	(8,420)
Common shares issued for cash	-	-	600,000	600	299,400	-	300,000
Common shares issued for nil consideration (note 11)	-	-	150,000	150	(150)	-	-
Preferred shares issued for cash	18,125,000	18,125	-	-	6,880,277	-	6,898,402
Shelf Registration Event Payment (note 3 and 9)	-	-	-	-	(1,646,453)	-	(1,646,453)
Net loss for the period	-	-	-	-	-	(1,287,537)	(1,287,537)
<b>Balance, December 31, 2005 (note 3)</b>	<b>18,125,000</b>	<b>\$ 18,125</b>	<b>30,892,700</b>	<b>\$ 30,893</b>	<b>\$ 5,502,961</b>	<b>\$(1,295,987)</b>	<b>\$ 4,255,992</b>

(The accompanying notes are an integral part of these consolidated financial statements)

**CANARY RESOURCES INC. AND SUBSIDIARY  
(FORMERLY SAKHA RESOURCE TECHNOLOGIES CORPORATION)  
(A DEVELOPMENT STAGE COMPANY)**

Consolidated Statements of Cash Flows

Years Ended December 31, 2005 and 2004, and the Period from Re-entering the  
Development Stage through to December 31, 2005

	(Restated, Note 3) 2005	2004	(Restated, Note 3) Period from Re-entering the Development Stage through to Dec. 31, 2005
<b>Cash Flows from Operating Activities</b>			
Net loss	\$ (1,287,537)	\$ (6,550)	\$ (1,287,537)
Adjustment for:			
Depreciation	18,602	-	18,602
	<u>(1,268,935)</u>	(6,550)	<u>(1,268,935)</u>
Changes in non-cash working capital			
Prepaid salaries and allowances	(55,654)	-	(55,654)
Other prepaid expenses	(1,150)	-	(1,150)
Inventories	(55,573)	-	(55,573)
Accounts payable and accrued liabilities(note 3)	808,492	5,000	808,492
Management fees and salaries payable	68,400	-	68,400
Advances from stockholder	100,000	1,550	100,000
Contingent liability (note 3)	1,356,453	-	1,356,453
	<u>952,033</u>	-	<u>952,033</u>
Net cash provided by operating activities			
<b>Cash Flows from Investing Activities</b>			
Acquisition of gas properties	(525,457)	-	(525,457)
Acquisition of property, plant and equipment	(448,450)	-	(448,450)
Mortgage payable	221,250	-	221,250
	<u>(752,657)</u>	-	<u>(752,657)</u>
Net cash used in investing activities			
<b>Cash Flows from Financing Activities</b>			
Issuance of common shares	300,000	-	300,000
Issuance of preferred shares (note 3)	5,251,949	-	5,251,949
	<u>5,551,949</u>	-	<u>5,551,949</u>
Net cash provided by financing activities			
<b>Net Change in Cash and Cash Equivalents</b>	<u>5,751,325</u>	-	<u>5,751,325</u>
<b>Cash and Cash Equivalents- beginning of year</b>	-	-	-
<b>Cash and Cash Equivalents - end of year</b>	<u>\$ 5,751,325</u>	\$ -	<u>\$ 5,751,325</u>
<b>Supplemental Cash Flow Information</b>			
Interest paid	\$ -	\$ -	\$ -
Income taxes paid	\$ -	\$ -	\$ -

(The accompanying notes are an integral part of these consolidated financial statements)

**CANARY RESOURCES INC. AND SUBSIDIARY  
(FORMERLY SAKHA RESOURCE TECHNOLOGIES CORPORATION)  
(A DEVELOPMENT STAGE COMPANY)**

Notes to Consolidated Financial Statements  
December 31, 2005 and 2004

**1. Operations and Business**

Canary Resources Inc. ("the Company"), was incorporated on April 16, 1997 as The Heritage Collection Limited under the laws of the State of Delaware. The Heritage Collection Limited was operated with the intent to manufacture and market various personal jewellery items, however, it never operated in this area. On June 25, 2004, the Heritage Collection Limited changed its name to Sakha Resource Technologies Corporation ("Sakha"). Sakha operated with the intent of developing forest products but was unable to raise capital and remained inactive in this area.

On January 12, 2005, Sakha changed its name to Canary Resources Inc. On January 14, 2005, the Company subscribed for 100% of the common stock of Canary Resources, Inc. ("Canary"), a private Nevada corporation. Canary is a coal-bed methane drilling company with an active leasing program and farm-out agreements covering acreage in the Eastern Forest City Basin of Kansas and Missouri, for which it is the operator. On January 14, 2005 the Company is considered to have re-entered the development stage. On August 29, 2005, Canary changed its name to Canary Operating Corporation.

**2. Going Concern**

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America with the assumption that the Company will be able to realize its assets and discharge its liabilities in the normal course of business.

The Company is in the development stage and has not yet realized revenues from its planned operations. The Company has sustained losses of \$1,287,537 for the year ended December 31, 2005 (2004: \$6,550). At December 31, 2005, the Company had working capital of \$4,875,724 (2004: \$(8,420)) and an Accumulated Deficit of \$1,295,987 (2004: \$8,450). The Company has funded operations through the issuance of capital stock. On July 22, 2005, the Company closed a private placement for gross proceeds of \$7,250,000 (see note 11). Management's plan is to continue raising additional funds through future equity or debt financing until it achieves profitable operations from its gas drilling activities. The Company's continuation as a going concern depends upon its ability to raise funds and achieve and sustain profitable operations.

The consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the inability of the Company to continue as a going concern.

**CANARY RESOURCES INC. AND SUBSIDIARY  
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Notes to Consolidated Financial Statements  
December 31, 2005 and 2004

**3. Restatement**

On July 31, 2006, management concluded that the Company's consolidated financial statements for fiscal year ended December 31, 2005 and the first interim period of 2006 should be restated to correct an error relating to the accounting of shelf registration event payments. The Company failed to file an Initial Registration Statement by September 30, 2005 in accordance with Section 6.1 of the Securities Purchase Agreement dated July 22, 2005. This event (failure to file) requires that an "Event Payment" be made monthly to the purchasers in the amount of 1% of the aggregate securities purchase price paid by each purchaser until the event is cured but no later than the second anniversary of the Securities' Purchase Agreement closing date. Event Payments incur interest of 1.5% per month, beginning ten days after demand, until paid in full. Demand was made on April 28, 2006. The Company's total potential liability is \$1,646,453 excluding interest. The Company has determined that this liability should have been recorded as of December 31, 2005. The effect of this restatement to the Company's consolidated financial statements as of December 31, 2005 was a decrease to paid-in-capital of \$1,646,453, an increase in accounts payable and accrued liabilities of \$290,000 and an increase in contingent liability of \$1,356,453.

**4. Summary of Significant Accounting Policies**

The accounting policies of the Company are in accordance with generally accepted accounting principles of the United States of America and their basis of application is consistent with that of the previous year. Outlined below are the significant accounting policies:

a) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Canary under the accrual method of accounting. On consolidation, all material intercompany transactions and balances have been eliminated.

b) Unit of Measurement

The United States currency is being used as the unit of measurement in these consolidated financial statements.

c) Cash and Cash Equivalents

Cash includes currency, other currency equivalents, current deposits and passbook deposits. Cash equivalents includes securities and short-term money market instruments that can be easily converted into cash. The investments that mature within three months from the investment date, are also included as cash equivalents.

d) Inventories

Inventories of materials and supplies are valued at the lower of average cost or market.

**CANARY RESOURCES INC. AND SUBSIDIARY  
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Notes to Consolidated Financial Statements  
December 31, 2005 and 2004

**4. Summary of Significant Accounting Policies (cont'd)**

e) Deferred Offering Costs

The Company defers as other assets the direct incremental costs of raising capital until such time as the offering is completed. At the time of the completion of the offering, the costs are charged against the capital raised. Should the offering be terminated, deferred offering costs are charged to operations during the period in which the offering is terminated.

f) Gas Properties

Proved

Gas properties are accounted for using the successful efforts method. Under this method, all development costs and acquisition costs of proved properties are capitalized and amortized on a unit-of-production basis over the remaining life of proved developed reserves and proved reserves, respectively. Costs of drilling exploratory wells are initially capitalized, but charged to expense if and when a well is determined to be unsuccessful. The Company evaluates the impairment of its proved gas properties on a field-by-field basis whenever events or changes in circumstances indicate an asset's carrying amount may not be recoverable. Unamortized capital costs are reduced to fair value if the expected undiscounted future cash flows are less than the asset's net book value. Cash flows are determined based upon reserves using prices and costs consistent with those used for internal decision making. Costs of retired, sold or abandoned properties that constitute a part of an amortization base are charged or credited, net of proceeds, to accumulated depreciation, depletion and amortization unless doing so significantly affects the unit-of-production amortization rate, in which case a gain or loss is recognized currently. Gains or losses from the disposal of other properties are recognized currently. Expenditures for maintenance, repairs and minor renewals necessary to maintain properties in operating condition are expensed as incurred. Major replacements and renewals are capitalized. Estimated dismantlement and abandonment costs for gas properties are capitalized, net of salvage, at their estimated net present value and amortized on a unit-of-production basis over the remaining life of the related proved developed reserves. See note 5.

Unproved

Unproved properties consist of costs incurred to acquire unproved leases ("property acquisition costs"). The Company assesses the impairment of unproved properties at least annually or when events or circumstances warrants an assessment. See note 5.

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Notes to Consolidated Financial Statements  
December 31, 2005 and 2004

**4. Summary of Significant Accounting Policies (cont'd)**

f) Gas Properties (cont'd)

Exploration

Costs of drilling exploratory wells are initially capitalized, but charged to expense if and when a well is determined to be unsuccessful. Determination is usually made on or shortly after completing or drilling the well, however, in certain situations determination cannot be made when drilling is completed. The Company defers capitalized exploratory drilling costs for wells that have found a sufficient quantity of producible hydrocarbons but cannot be classified as proved because they are located in areas that require major capital expenditures or governmental or other regulatory approvals before production can begin. These costs continue to be deferred as wells in progress as long as development is underway, is firmly planned for the near future or the necessary approvals are actively being sought. For all other exploratory wells, determination is made within one year from the date drilling and other necessary activities have been completed. If a determination cannot be made after one year, all costs associated with the well are expensed. See note 5.

g) Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation, based on the estimated useful lives of the assets, are provided as follows:

Building	30 years	straight line, 25% salvage
Office and furniture	7 years	straight line
Computer equipment	3 years	straight line
Vehicles	3 years	straight line, 20% salvage
Drilling equipment	7 years	straight line

h) Impairment of Long-Lived Assets

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", long-lived assets to be held and used are analyzed for impairment whenever events or changes in circumstances indicate that the related carrying amounts may not be recoverable. The Company evaluates at each balance sheet date whether events and circumstances have occurred that indicate possible impairment. If there are indications of impairment, the Company uses future undiscounted cash flows of the related asset or asset grouping over the remaining life in measuring whether the assets are recoverable. In the event such cash flows are not expected to be sufficient to recover the recorded asset values, the assets are written down to their estimated fair value. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value of asset less cost to sell. As described in note 2, the long-lived assets have been valued on a going concern basis. However, substantial doubt exists as to the ability of the Company to continue as a going concern. If the Company ceases operations, the asset values may be materially impaired.

**CANARY RESOURCES INC. AND SUBSIDIARY  
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Notes to Consolidated Financial Statements  
December 31, 2005 and 2004

**4. Summary of Significant Accounting Policies (cont'd)**

i) Fair Value of Financial Instruments

The estimated fair value of financial instruments has been determined by the Company using available market information and valuation methodologies. Considerable judgment is required in estimating fair value. Accordingly, the estimates may not be indicative of the amounts the Company could realize in a current market exchange. As of December 31, 2005 and 2004, the carrying value of accounts payable and accrued liabilities and advances from shareholder approximate their fair value due to the short-term maturity of such instruments.

j) Income Taxes

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes". Deferred tax assets and liabilities are recorded for differences between the financial statement and tax basis of the assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is recorded for the amount of income tax payable or refundable for the period increased or decreased by the change in deferred tax assets and liabilities during the period.

k) Revenue Recognition

Gas revenue is recognized when the gas is produced and sold. The Company records revenues from the sale of natural gas when delivery to the customer has occurred, collectability is reasonably assured and title has transferred.

l) Earnings or Loss Per Share

The Company adopted FAS No.128, "Earnings per Share" which requires disclosure on the financial statements of "basic" and "diluted" earnings (loss) per share. Basic earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the year. Diluted earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding plus common stock equivalents (if dilutive) related to stock options and warrants for each year.

**CANARY RESOURCES INC. AND SUBSIDIARY  
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Notes to Consolidated Financial Statements  
December 31, 2005 and 2004

**4. Summary of Significant Accounting Policies (cont'd)**

m) Stock-Based Compensation

The Company adopted the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation" for stock options and similar equity instruments (collectively, "options") issued to employees. The Company applies the fair value base method of accounting as prescribed by SFAS No. 123. Under the fair value based method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. For stock options, the fair value is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. SFAS No. 123 also applies to transactions in which an entity issues its equity instruments to acquire goods or services from non-employees. Those transactions must be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. See note 12.

n) Concentration of Credit Risk

SFAS No. 105, "Disclosure of Information About Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentration of Credit Risk", requires disclosure of any significant off-balance sheet risk and credit risk concentration. The Company does not have significant off-balance sheet risk or credit concentration.

o) Use of Estimates

Preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and related notes to financial statements. These estimates are based on management's best knowledge of current events and actions the Company may undertake in the future. Actual results may ultimately differ from estimates, although management does not believe such changes will materially affect the financial statements in any individual year.

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Notes to Consolidated Financial Statements  
December 31, 2005 and 2004

**4. Summary of Significant Accounting Policies (cont'd)**

p) Recent Accounting Pronouncements

In March 2005, the FASB issued FASB Staff Position ("FSP") No. 46(R)-5, "Implicit Variable Interests under FASB Interpretation No. ("FIN") 46 (revised December 2003), Consolidation of Variable Interest Entities" ("FSP FIN 46R-5"). FSP FIN 46R-5 provides guidance for a reporting enterprise on whether it holds an implicit variable interest in Variable Interest Entities ("VIEs") or potential VIEs when specific conditions exist. This FSP is effective in the first period beginning after March 3, 2005 in accordance with the transition provisions of FIN 46 (Revised 2003), "Consolidation of Variable Interest Entities — an Interpretation of Accounting Research Bulletin No. 51" ("FIN 46R"). The adoption of this standard is not expected to have a material impact on the Company's results of operations or financial position.

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"), which will result in (a) more consistent recognition of liabilities relating to asset retirement obligations, (b) more information about expected future cash outflows associated with those obligations, and (c) more information about investments in long-lived assets because additional asset retirement costs will be recognized as part of the carrying amounts of the assets. FIN 47 clarifies that the term "conditional asset retirement obligation" as used in SFAS 143, "Accounting for Asset Retirement Obligations," refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. Uncertainty about the timing and/or method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. FIN 47 is effective no later than the end of fiscal years ending after December 15, 2005. Retrospective application of interim financial information is permitted but is not required. Early adoption of this interpretation is encouraged. As FIN 47 was recently issued, the Company has not determined whether the interpretation will have a significant effect on its financial position or results of operations.

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Notes to Consolidated Financial Statements  
December 31, 2005 and 2004

**4. Summary of Significant Accounting Policies (cont'd)**

p) Recent Accounting Pronouncements (cont'd)

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), which replaces Accounting Principles Board ("APB") Opinion No. 20, "Accounting Changes", and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements — An Amendment of APB Opinion No. 28". SFAS No. 154 provides guidance on the accounting for and reporting of changes in accounting principles and error corrections. SFAS No. 154 requires retrospective application to prior period financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. SFAS No. 154 also requires certain disclosures for restatements due to correction of an error. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005, and is required to be adopted by the Company as of January 1, 2006. The impact that the adoption of SFAS No. 154 will have on the Company's results of operations and financial condition will depend on the nature of future accounting changes adopted by the Company and the nature of transitional guidance provided in future accounting pronouncements.

**5. Gas Properties**

The carrying value of the Company's gas properties are attributable to unproved properties. These costs are not currently being depreciated, depleted or amortized. As exploration and development work progresses and the reserves on these properties are proven, capitalized costs attributable to the properties will be reclassified to producing properties and subject to depletion. If the exploration and development work were to be unsuccessful, the capitalized costs of the properties related to this unsuccessful work would be expensed in the year in which the determination was made. The timing of any write-downs of these unproven properties, if warranted, depends upon the nature, timing and extent of future exploration and development activities and their results. The Company believes its exploration and development efforts will allow it to realize the unproved property balance. The following is a breakdown of gas properties:

	<b>2005</b>	2004
Property acquisition costs	\$ 421,292	\$ -
Wells-in-progress	104,165	-
	<hr/>	<hr/>
	<b>\$ 525,457</b>	<b>\$ -</b>

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**6. Property, Plant and Equipment**

Property, plant and equipment are comprised as follows:

	<b>2005</b>		2004	
	<b>Cost</b>	<b>Accumulated Depreciation</b>	Cost	Accumulated Depreciation
Land	\$ 25,000	\$ -	\$ -	\$ -
Building	281,110	-	-	-
Office and furniture	12,478	936	-	-
Computer equipment	53,413	8,012	-	-
Vehicles	52,278	7,841	-	-
Drilling equipment	24,171	1,813	-	-
	<u>\$ 448,450</u>	<u>\$ 18,602</u>	\$ -	\$ -
Net carrying amount		<u>\$ 429,848</u>		<u>\$ -</u>

**7. Advances From Shareholder**

The advances from a shareholder and an individual related to the shareholder are unsecured, non-interest bearing and have no fixed terms of repayment.

**8. Mortgage Payable**

On December 30, 2005, the Company purchased a 23,000 square foot warehouse set on approximately 7 acres located in Drexel, Missouri at a total cost of \$306,109.50, including all survey, environmental & closing costs. This facility, located in the southwest corner of Cass County, Missouri, is just south of the initial drilling operations that have begun and will be used primarily for equipment repair, storage and bulk inventory delivery.

This property was purchased with a combination of cash coupled with a \$221,250 initial 10-year mortgage from a commercial bank, amortized on a 30-year basis at a fixed interest rate of 8.43%.

	<b>2005</b>	2004
Total mortgage payable	\$ 221,250	-
Less: Current portion	<u>2,666</u>	-
Long-term portion	<u>\$ 218,584</u>	-

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**8. Mortgage Payable (cont'd)**

Future minimum mortgage payments required are as follows:

2006	\$	2,666
2007		2,903
2008		3,107
2009		3,437
2010		3,442
Thereafter		<u>205,695</u>
	\$	<u>221,250</u>

**9. Contingent Liability**

The Company failed to file an Initial Registration Statement by September 30, 2005 in accordance with Section 6.1 of the Securities Purchase Agreement dated July 22, 2005. This event (failure to file) requires that an "Event Payment" be made monthly to the purchasers in the amount of 1% of the aggregate securities' purchase price paid by each purchaser until the event is cured or until the second anniversary of the Securities Purchase Agreement closing date. Event Payments incur interest of 1.5% per month, beginning ten days after demand, until paid in full. Demand was made on April 28, 2006. The Company's total potential liability is \$1,656,453 excluding interest. At the passage of each monthly event anniversary, the Company reclassified the liability from a contingent liability to an accrued liability. Of the total liability recorded at December 31, 2005, \$1,356,453 was a contingent liability and \$290,000 was an accrued liability. The Company is negotiating with the purchasers to cure the event and expects to make payment in shares to satisfy the majority of the liability.

**10. Commitments and Contingencies**

Lease Obligations

The Company is committed to operating lease payments for its office premises which expire in the next fiscal year. Future minimum payments for 2006 total \$18,350.

Contingent Royalties Payable

The Company has entered into various contractual land lease agreements with the owners of the gas properties which requires the Company to make royalty payments at varying rates. The payments are contingent on the Company's ability to discover, extract and sell gas reserves. At December 31, 2005 and 2004, the Company is not obligated to make any royalty payments.

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**10. Commitments and Contingencies (cont'd)**

Legal Proceedings

In December 2005, a civil lawsuit was filed in the District Court of Miami County, Kansas by Osborn Energy, LLC, the company with which Canary entered into certain joint venture agreements in December 2004, for the exploration and development of coal-bed methane in Johnson and Miami Counties in Kansas, and Cass and Bates Counties in Missouri. The lawsuit names the Company, Canary, and several of the Company's employees and directors as defendants, and makes multiple allegations of contract and tort claims. The Company denies these allegations, believes it has numerous meritorious defences, and intends to defend the case vigorously. As it is not possible to estimate the ultimate cost or outcome, if any, relative to the lawsuit, no loss accruals have been recorded for this matter at December 31, 2005. Management believes that the ultimate resolution of the lawsuit will not have a material adverse effect on the Company's financial position, results of operations or liquidity. Nevertheless, due to uncertainties inherent in litigation, the ultimate disposition of the lawsuit cannot be presently determined.

In January 2006, the Company filed multiple counterclaims in the civil lawsuit in the District Court of Miami County, Kansas brought by Osborn Energy, LLC. The Company counter's claims against Osborn Energy, LLC include fraudulent and negligent misrepresentation, breach of fiduciary duty, and tortious interference with Canary's contractual relationships. The Company also seeks a court order compelling specific performance of the contract by Osborn Energy, LLC, and a permanent injunction requiring Osborn Energy, LLC to comply with its contractual obligations. Damages being sought by the Company are as yet undetermined. Under Kansas law, a party may not seek punitive damages until after a suit is on file and the party has gathered sufficient evidence to support the claim. The Company believes that evidence already exists to support such a claim, and expects to ask the court to allow it to file a punitive damage claim at an early juncture in the litigation.

In February 2006, the Company filed a civil lawsuit in the District Court of Miami County, Kansas against James L. Osborn, Jr., individually, for fraudulent and negligent misrepresentation and tortious interference with a contract. James L. Osborn, Jr. controls and is the majority owner of Osborn Energy, LLC. Damages being sought by the Company are as yet undetermined. Under Kansas law, a party may not seek punitive damages until after a suit is on file and the party has gathered sufficient evidence to support the claim. The Company believes that evidence already exists to support such a claim, and expects to ask the court to allow it to file a punitive damage claim at an early juncture in the litigation.

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## **11. Capital Stock**

On June 21, 2004, the Company authorized a ten for one forward stock split of its common shares. This stock split has been retroactively taken into consideration in the financial statements and the calculation of earnings per share.

In March and April 2005, three investors purchased 600,000 common shares of the Company at \$0.50 per share. The price per share is subject to adjustment to lower the price per share to equal the price per share of common stock in any "Qualified Financing" of the Company within one year. A "Qualified Financing" is an equity financing of a minimum of \$1,500,000. In no event shall the price per share be increased.

On July 22, 2005, the Company closed a private placement for gross proceeds of \$7,250,000. Expenses associated with the private placement are approximately \$351,598. A contingent liability was set up in the amount of \$1,646,453 for contingent Event Payments as described in note 9. Funds raised from the placement are to be used for development of coal-bed methane in the Eastern Forest City Basin in Kansas and Missouri, and for general working capital purposes.

The private placement was comprised of one convertible preferred share and one half of one warrant amounting to 18,125,000 convertible preferred shares of a new series designated as Class A Convertible Preferred Stock and 9,062,500 Warrants. The Class A Convertible Preferred Stock has a par value \$0.001 per share and a conversion price of \$0.40 per share which is subject to usual adjustment provisions. The convertible preferred shares carry no dividend and are convertible at any time. The Warrants have a \$1.00 exercise price, and each whole Warrant permits the holder to purchase one common share of the Company. The Warrants expire on July 22, 2009, four years from the date of the private placement. The cashless exercise provisions allow the Warrant holder to elect instead to receive the Net Number of shares of common stock determined according to the following formula:

$$\text{Net Number} = ((A \times B) - (A \times C)) / B$$

Where:

A= the total number of shares with respect to which the Warrants are being exercised.

B= the closing price of the common stock.

C= the exercise price of the Warrants.

The Warrants also carry provisions for mandatory exercise if, inter alia, the Company's common shares trade above \$2.00 per share for twenty days.

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**11. Capital Stock** (cont'd)

The value of each Warrant using the Black-Scholes pricing model was \$0.00 based upon the following assumptions:

Risk-free Interest rate	3.75%
Expected life in years	2.0
Exercise Price	\$1.00
Stock price	\$0.40
Volatility	30%
Expected Dividend Yield	0%

The private placement met the conditions for a "Qualified Financing," namely an equity financing of a minimum of \$1,500,000 within one year, for price adjustment purposes regarding shares sold to investors in March and April 2005. The pricing of the \$300,000 of shares sold to investors at \$0.50 per common share in March and April 2005 was, therefore, adjusted downwards to reflect the terms of the private placement in July 2005. Adjustment to the common share price from \$0.50 per share to \$0.40 per share resulted in the issuance of an additional 150,000 common shares to those investors who invested in March and April 2005, and those investors also received 375,000 Warrants with the same terms and conditions as the Warrants issued in the July 2005 private placement.

Upon closing of the July 2005 private placement and after giving effect to the above adjustment regarding the price of shares sold to investors in March and April 2005 and the issuance of Warrants to them, the Company had 30,892,700 common shares, 18,125,000 Class A Convertible Preferred Stock and 9,437,500 Warrants issued and outstanding. After conversion of all of the Class A Convertible Preferred Stock and excluding exercise of any Warrants, the Company would have 49,017,700 common shares outstanding.

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**12. Stock-Based Compensation**

On August 12, 2005, the Board of Directors approved an employee stock option plan ("2005 Stock Option Plan"), the purpose of which is to enhance the Company's stockholder value and financial performance by attracting, retaining and motivating the Company's officers, directors, key employees and consultants and to encourage stock ownership by such individuals by providing them with a means to acquire a proprietary interest in the Company's success through stock ownership. Under the 2005 Stock Option Plan, officers, directors, employees and consultants who provide services to the Company may be granted options to acquire common shares of the Company at not less than 110 percent of the Fair Market Value of the Stock on the date of grant. Options have a term of 10 years, and vest over three years. The total number of shares reserved for issuance under the 2005 Stock Option Plan is 7,500,000. As of December 31, 2005, no options had been granted under the 2005 Stock Option Plan.

Subsequent Event

On January 31, 2006, under the 2005 Stock Option Plan, the Board of Directors granted options to purchase 2,300,000 common shares at a price of \$0.50 per common share until January 30, 2016.

**13. Related Party Transactions**

Management fees, salaries, allowances and rents were paid and advanced to directors of the Company and companies controlled by the directors. These transactions were in the normal course of business and recorded at an exchange value established and agreed upon by the above mentioned parties.

**14. Segmented Information**

The Company's operations were conducted in the United States.

Canary Resources Inc. ("Corporate") – a parent company  
Canary Operating Corporation ("Canary") – a subsidiary

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**14. Segmented Information** (cont'd)

	2005	2004
Revenues by Segment:		
Corporate	\$ -	\$ -
Canary	-	-
	<hr/>	<hr/>
Consolidated revenues	<b>\$ -</b>	<b>\$ -</b>
	<hr/>	<hr/>
Operating Income (Loss) by Segment:		
Corporate	\$ (285,000)	\$ (6,550)
Canary	(1,091,102)	-
	<hr/>	<hr/>
Consolidated operating loss	<b>\$ (1,376,102)</b>	<b>\$ (6,550)</b>
	<hr/>	<hr/>
Total Assets by Segment:		
Corporate	\$ 6,057,435	\$ -
Canary	761,572	-
	<hr/>	<hr/>
Consolidated total assets	<b>\$ 6,819,007</b>	<b>\$ -</b>
	<hr/>	<hr/>

Comparative segment information is not presented for 2004 as the acquisition of Canary only occurred in 2005.

**15. Income Taxes**

The Company has tax losses available to be applied against future years income. Due to the losses incurred in the current year and expected future operating results, management determined that it is more likely than not that the deferred tax asset resulting from the tax losses available for carryforward will not be realized through the reduction of future income tax payments. Accordingly a valuation allowance has been recorded for deferred income tax assets.

The Company's current income taxes are as follows:

	2005	2004
Expected income tax recovery at the statutory rates of 34% (2004 - 34%)	\$ (437,763)	\$ (2,227)
Other	(2,872)	-
Valuation allowance	440,635	2,227
	<hr/>	<hr/>
Provision for income taxes	<b>\$ -</b>	<b>\$ -</b>
	<hr/>	<hr/>

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**15. Income Taxes (cont'd)**

The Company has deferred income tax assets as follows:

	2005	2004
Net operating loss carryforward	\$ 612,966	\$ 2,873
Net book value and tax value differences	(172,331)	-
Valuation allowance for deferred income tax assets	<u>(440,635)</u>	<u>(2,873)</u>
	<u>\$ -</u>	<u>\$ -</u>

As of December 31, 2005 the Company had approximately \$1,802,000 (2004:\$8,000) of federal and state net operating loss carryforwards available to offset future taxable income. These losses expire as follows.

2018	\$ 1,900
2019	6,550
2020	<u>1,794,392</u>
	<u>\$ 1,802,842</u>