

**CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE
COMPANY)**

CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED MARCH 31, 2006, AND 2005

UNAUDITED

CONTENTS

Consolidated Balance Sheets	1
Consolidated Statements of Operations	2
Consolidated Statements of Stockholders' Equity	3
Consolidated Statements of Cash Flows	4
Notes to Consolidated Financial Statements	5 - 21

**CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)**

Consolidated Balance Sheets

March 31, 2006

Unaudited

(Restated, Note 3)

ASSETS

Current

Cash and cash equivalents	\$ 4,226,565
Prepaid expenses and other (note 5)	120,234
Deposits	61,235
Inventories	<u>86,214</u>

Total Current Assets 4,494,248

Gas Properties (note 6) 935,947

Property, Plant and Equipment, net (note 7) 463,566

Total Assets \$ 5,893,761

LIABILITIES

Current

Accounts payable and accrued liabilities (note 3)	\$ 817,552
Advances from stockholders (note 8)	112,396
Current portion of mortgage payable (note 9)	<u>3,038</u>

Total Current Liabilities 932,986

Mortgage Payable, less current portion (note 9) 216,377

Contingent Liability (notes 3 and 10) 1,138,953

Total Liabilities 2,288,316

Commitments and Contingencies (note 11)

STOCKHOLDERS' EQUITY

Capital Stock (note 12)

Class A convertible preferred stock, \$0.001 par value, 30,000,000 shares authorized, 18,125,000 issued and outstanding (2005 - 18,125,000)	18,125
Common stock, \$0.001 par value, 100,000,000 shares authorized, 30,892,700 issued and outstanding (2005 -30,892,700)	30,893

Additional Paid in Capital (note 3) 5,523,214

**Accumulated Deficit and Deficit Accumulated During the
Development Stage** (1,966,787)

Total Stockholders' Equity 3,605,445

Total Liabilities and Stockholders' Equity \$ 5,893,761

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

CANARY RESOURCES INC.
(A DEVELOPMENT STAGE COMPANY)

Consolidated Statements of Operations
Three Months Ended March 31, 2006, and 2005, and the
Period from Re-entering the Development Stage through to
March 31, 2006
Unaudited

	2006	2005	(Note 1) Period from Re-entering the Development Stage through to Mar. 31, 2006
Revenues	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Expenses			
General and administrative	683,220	214,081	1,976,519
Rent paid to related parties (note 14)	16,050	-	80,250
Depreciation	11,596	-	30,199
Total Expenses	<u>710,866</u>	<u>214,081</u>	<u>2,086,968</u>
Loss from Operations	(710,866)	(214,081)	(2,086,968)
Other income interest	40,066	-	128,631
Loss Before Income Taxes	(670,800)	(214,081)	(1,958,337)
Income taxes (note 16)	-	-	-
Net Loss	<u>\$ (670,800)</u>	<u>\$ (214,081)</u>	<u>\$ (1,958,337)</u>
Loss per Share			
Basic	<u>\$ (0.02)</u>	<u>\$ (0.01)</u>	
Basic weighted average number of shares outstanding during the periods	<u>30,892,700</u>	<u>30,143,522</u>	
Diluted weighted average number of shares outstanding during the periods	<u>58,963,440</u>	<u>30,143,522</u>	

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

**CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)**

Consolidated Statements of Stockholders' Equity
Three Months Ended March 31, 2006 and 2005, and the
Period from Re-entering the Development Stage through to
March 31, 2006

Unaudited

	Preferred Stock		Common Stock		(Restated, Note 3) Additional Paid-in Capital	Accumulated Deficit Accumulated During the Development Stage	(Restated, Note 3) Total Stockholders' 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 12)	-	-	150,000	150	(150)	-	-
Preferred shares issued for cash	18,125,000	18,125	-	-	6,880,277	-	6,898,402
Shelf Registration Event Payment (notes 3 and 10)	-	-	-	-	(1,646,453)	-	(1,646,453)
Net loss for the period	-	-	-	-	-	(1,287,537)	(1,287,537)
Balance, December 31, 2005 (note 3)	18,125,000	18,125	30,892,700	30,893	5,502,961	(1,295,987)	4,255,992
Stock option expense recognized	-	-	-	-	20,253	-	20,253
Net loss for the period	-	-	-	-	-	(670,800)	(670,800)
Balance, March 31, 2006 (note 3)	18,125,000	\$ 18,125	30,892,700	\$ 30,893	\$ 5,523,214	\$(1,966,787)	\$ 3,605,445

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

**CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)**

Consolidated Statements of Cash Flows
Three Months Ended March 31, 2006, and 2005, and the
Period from Re-entering the Development Stage through to
March 31, 2006
Unaudited

	(Restated, Note 3) 2006	2005	(Restated, Note 3) Period from Re-entering the Development Stage through to Mar. 31, 2006
Cash Flows from Operating Activities			
Net loss	\$ (670,800)	\$ (214,081)	\$ (1,958,337)
Adjustment for:			
Depreciation	11,596	-	30,198
Stock option expense recognized	20,253	-	20,253
	<u>(638,951)</u>	(214,081)	<u>(1,907,886)</u>
Changes in non-cash working capital			
Inventories	(30,641)	-	(86,214)
Prepaid expenses and other	(64,580)	(3,000)	(120,234)
Deposits	(60,085)	-	(61,235)
Accounts payable and accrued liabilities (note 3)	(64,340)	204,400	812,552
Advances from stockholders	8,976	-	108,976
Contingent liability (note 3)	(217,500)	-	1,138,953
	<u>(1,067,121)</u>	(12,681)	<u>(115,088)</u>
Cash Flows from Investing Activities			
Acquisition of gas properties	(410,490)	-	(935,947)
Acquisition of property, plant and equipment	(45,314)	-	(493,764)
	<u>(455,804)</u>	-	<u>(1,429,711)</u>
Cash Flows from Financing Activities			
Issuance of common shares	-	150,000	300,000
Issuance of preferred shares	-	-	5,251,949
Mortgage payable	(1,835)	-	219,415
	<u>(1,835)</u>	150,000	<u>5,771,364</u>
Net cash (used in) provided financing activities			
Net Change in Cash and Cash Equivalents	(1,524,760)	137,319	4,226,565
Cash and Cash Equivalents - beginning of year	5,751,325	-	-
Cash and Cash Equivalents - end of year	\$ 4,226,565	\$ 137,319	\$ 4,226,565
Supplemental Cash Flow Information			
Interest paid	\$ -	\$ -	\$ -
Income taxes paid	\$ -	\$ -	\$ -

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

**CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)**

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

1. Business, Operations, and Development Stage Activities

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 incorporated 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. Canary currently has nine wells in this area, which are presently shut-in pending pipeline connection. The purchase, site preparation, and construction of the pipeline tap have commenced. 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

The accompanying 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 \$670,800 for the period ended March 31, 2006 (2005: \$214,081). At March 31, 2006, the Company had working capital of \$3,561,262 (2005: \$4,875,724) and an Accumulated Deficit of \$1,966,787 (2005: \$1,295,987). 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 12). 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. Although the Company plans to pursue additional financing there can be no assurance that the Company will be able to secure financing when needed or obtain such on terms satisfactory to the Company, if at all. The Company's continuation as a going concern depends upon its ability to raise funds and achieve and sustain profitable operations.

The accompanying 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
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

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 these restatements to the Company's consolidated financial statements as of March 31, 2006 was a decrease to paid-in-capital of \$1,646,453, accounts payable and accrued liabilities of \$507,500 and an increase in contingent liability of \$1,138,953.

4. Summary of Significant Accounting Policies

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

The accompanying unaudited condensed consolidated financial statements 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. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Interim results are not necessarily indicative of the results that may be expected for a full year. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report to Stockholders on Form 10-KSB for the fiscal year ended December 31, 2005, as filed with the Securities and Exchange Commission.

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.

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

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

b) Unit of Measurement

The United States dollar is being used as the unit of measurement in the accompanying 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.

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

Proven

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 6.

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

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

f) Gas Properties (cont'd)

Unproven

Unproven 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 6.

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 6.

g) Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation, based on the estimated useful lives of the assets, is 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

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

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

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.

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 March 31, 2006 and 2005, the carrying value of accounts payable and accrued liabilities and advances from stockholders 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.

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

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

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.

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 13.

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. The Company maintains cash with major United States and Canadian Financial Institutions.

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.

**CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)**

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

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.

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

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.

In March 2006, the Financial Accounting Standards Board ("FASB") issued Statement 156, Accounting for Servicing of Financial Assets, which amends FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. In a significant change to current guidance, the Statement of Financial Accountant Standards ("SFAS") No. 156 permits an entity to choose either of the following subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities: (1) Amortization Method or (2) Fair Value Measurement Method. SFAS No. 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company is currently reviewing the effect, if any, the proposed guidance will have on its financial statements.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments amendment of FASB Statements No. 133 and 140. This Statement permits fair value of remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities; establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and amended SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company is currently reviewing the effect, if any, the proposed guidance will have on its financial statements.

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(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

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

p) Recent Accounting Pronouncements (cont'd)

In July 2005, the FASB issued an exposure draft of a proposed interpretation, Accounting for Uncertain Tax Positions-an Interpretation of FASB Statement No. 109 ("SFAS No. 109"). This interpretation would apply to all open tax positions accounted for in accordance with SFAS No. 109, including those acquired in business combinations. It is a proposed asset recognition approach to apply a dual threshold for uncertain tax positions. The interpretation would allow the recognition of a tax benefit when it is probable that it could be sustained upon audit. The interpretation defines "probable" as it is defined in SFAS No. 5, "Accounting for Contingencies." FASB has not established an effective date for the interpretation. The Company is currently reviewing the effect, if any, the proposed guidance will have on its financial statements..

5. Prepaid Expenses

Included in this amount is approximate \$64,000 of salaries and allowances paid in advance to a director.

6. Gas Properties

The carrying value of the Company's gas properties are attributable to unproven 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 unproven property balance. The following is a breakdown of gas properties:

	2006	2005
Property acquisition costs	\$ 728,949	\$ 421,292
Wells-in-progress	206,998	104,165
	\$ 935,947	\$ 525,457

**CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)**

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

7. Property, Plant and Equipment

Property, plant and equipment are comprised as follows:

	2006		2005	
	Cost	Accumulated Depreciation	Cost	Accumulated Depreciation
Land	\$ 25,000	\$ -	\$ 25,000	\$ -
Building	281,110	(1,757)	281,110	-
Office and furniture	14,259	(1,427)	12,478	(936)
Computer equipment	53,413	(12,463)	53,413	(8,012)
Vehicles	52,278	(11,326)	52,278	(7,841)
Drilling equipment	67,704	(3,225)	24,171	(1,813)
	<u>\$ 493,764</u>	<u>\$ (30,198)</u>	<u>\$ 448,450</u>	<u>\$ (18,602)</u>
Net carrying amount		<u>\$ 463,566</u>		<u>\$ 429,848</u>

8. Advances From Stockholders

The advances from stockholders are unsecured, non-interest bearing and have no fixed terms of repayment.

9. 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 \$306,110, 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%.

	2006	2005
Total mortgage payable	\$ 219,415	\$ -
Less: current portion	<u>(3,038)</u>	<u>-</u>
Long-term portion	<u>\$ 216,377</u>	<u>\$ -</u>

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

9. Mortgage Payable (cont'd)

Future minimum mortgage payments required are as follows:

2006	\$	3,038
2007		2,493
2008		3,579
2009		3,892
2010		4,233
2011		4,604
Thereafter		<u>197,576</u>
	\$	<u>219,415</u>

10. 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 March 31, 2006, \$1,138,953 was a contingent liability and \$507,500 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.

11. Commitments and Contingencies

Lease Obligations

The Company is committed to operating lease payments for its office premises. Future minimum payments required are as follows:

2006	\$	22,553
2007		22,404
2008		22,404
2009		<u>22,404</u>
	\$	<u>89,765</u>

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

11. Commitments and Contingencies (cont'd)

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 March 31, 2006 and December 31, 2005, the Company is not obligated to make any royalty payments.

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 March 31, 2006 and 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's counter 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.

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

12. 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 of its common stock for gross proceeds of \$7,250,000. Expenses associated with the private placement are approximately \$351,598. 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.

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

12. 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.

13. 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.

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

13. Stock-Based Compensation (cont'd)

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. The compensation cost that has been charged against income for this plan at March 31, 2006 was \$20,253.

The value of each option award using the Black-Scholes pricing model was \$0.16 based upon the following assumptions:

Risk-free interest rate	4.66%
Expected life in years	6.0
Exercise price	\$0.50
Stock price	\$0.45
Volatility	30%
Expected dividend yield	0%

The Company uses the method provided by SAB No. 107 to calculate the expected term of the options. The risk-free rate for the period within the expected term of the option is based on U.S. Treasury yield curve in effect at the time of the grant. Stock options outstanding during the three-month period ended March 31, 2006 is 2,300,000. The weighted average exercise price was \$0.50. The weighted average life in years was 9.84. The weighted average grant-date fair value was \$0.16.

14. 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.

15. 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

	2006	2005
Revenues by Segment:		
Corporate	\$ -	\$ -
Canary	-	-
	<hr/>	<hr/>
Consolidated revenues	<u>\$ -</u>	<u>\$ -</u>

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

15. Segmented Information (cont'd)

Operating Income (Loss) by Segment:		
Corporate	\$ (242,370)	\$ (179,081)
Canary	(428,430)	(35,000)
	<hr/>	<hr/>
Consolidated operating loss	\$ (670,800)	\$ (214,081)
Total Assets by Segment:		
Corporate	\$ 4,632,360	\$ 140,319
Canary	1,261,401	-
	<hr/>	<hr/>
Consolidated total assets	\$ 5,893,761	\$ 140,319

16. 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:

	2006	2005
Expected income tax recovery at the statutory rates of 40% (2005 - 34%)	\$ (268,320)	\$ (72,788)
Valuation allowance	268,320	72,788
	<hr/>	<hr/>
Provision for income taxes	\$ -	\$ -

The Company has deferred income tax assets as follows:

	2006	2005
Deferred Income Tax Assets		
Net operating loss carryforward	\$ 1,002,454	\$ 612,966
Net book value and tax value differences	(185,328)	(172,331)
Valuation allowance for deferred income tax assets	(817,126)	(440,635)
	<hr/>	<hr/>
	\$ -	\$ -

CANARY RESOURCES INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE COMPANY)

Notes to Consolidated Financial Statements

March 31, 2006, and 2005

Unaudited

16. Income Taxes (cont'd)

As of March 31, 2006 the Company had approximately \$2,506,134 (December 31, 2005 - \$1,802,000) of net operating loss carryforwards available to offset future taxable income. These losses expire as follows.

2018	\$	1,900
2019		6,550
2020		1,794,392
2021		<u>703,292</u>
	\$	<u>2,506,134</u>