

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

CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

TWELVE MONTHS ENDED DECEMBER 31, 2007 AND 2006

UNAUDITED

**CONTENTS**

Condensed Consolidated Balance Sheet	<b>1</b>
Condensed Consolidated Statements of Operations	<b>2</b>
Condensed Consolidated Statements of Stockholders' Equity	<b>3</b>
Condensed Consolidated Statements of Cash Flows	<b>4</b>
Notes to Condensed Consolidated Financial Statements	<b>5 - 19</b>

**CANARY RESOURCES INC. AND SUBSIDIARIES**  
(A DEVELOPMENT STAGE COMPANY) (Note 2)  
Condensed Consolidated Balance Sheet  
December 31, 2007  
Unaudited

**ASSETS**

**Current Assets:**

Cash	\$ 1,007,958
Accounts receivable -	
Trade	100,361
Employee and other	5,764
Prepaid expenses and other	39,687
Deposits	<u>6,735</u>
<b>Total Current Assets</b>	<b><u>1,160,505</u></b>
<b>Oil and Gas Properties</b> (note 5)	<b>2,109,280</b>
<b>Field Equipment Inventory</b>	<b>88,116</b>
<b>Property, Plant and Equipment, net</b> (note 6)	<b><u>2,143,227</u></b>
<b>Total Assets</b>	<b><u>\$ 5,501,128</u></b>

**LIABILITIES**

**Current Liabilities:**

Accounts payable - Trade	\$ 431,861
Accrued liabilities	43,516
Management fees and salaries payable	193,231
Advances from stockholders (note 7)	238,425
Current portion of long-term debt (note 8)	1,047,065
Drilling advances (note 9)	<u>375,000</u>
<b>Total Current Liabilities</b>	<b><u>2,329,098</u></b>
<b>Long-term Debt, less current portion</b> (note 8)	<b><u>302,441</u></b>
<b>Total Long-term Liabilities</b>	<b><u>302,441</u></b>
<b>Total Liabilities</b>	<b><u>2,631,539</u></b>
<b>Commitments and Contingencies</b> (note 10)	

**STOCKHOLDERS' EQUITY**

**Capital Stock:** (note 11)

Class "A" convertible preferred stock, \$0.001 par value; 30,000,000 shares authorized; 18,125,000 shares issued and outstanding	18,125
Common stock, \$0.001 par value, 100,000,000 shares authorized, 46,074,425 issued and 46,174,425 shares outstanding	46,175
<b>Treasury Stock</b> (100,000 shares of common stock, at cost)	<b>(65,000)</b>
<b>Additional Paid-in Capital</b> (note 3)	<b>10,142,547</b>
<b>Accumulated (Deficit) and (Deficit) Accumulated During the Development Stage</b>	<b><u>(7,272,258)</u></b>
<b>Total Stockholders' Equity</b>	<b><u>2,869,589</u></b>
<b>Total Liabilities and Stockholders' Equity</b>	<b><u>\$ 5,501,128</u></b>

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

## CANARY RESOURCES INC. AND SUBSIDIARIES

(A DEVELOPMENT STAGE COMPANY) (Note 2)

Condensed Consolidated Statements of Operations

Twelve Months Ended December 31, 2007 and 2006, and the Period from Re-entering the Development Stage (January 14, 2005) through to December 31, 2007

Unaudited

	Three Months Ended 2007	Three Months Ended 2006	Twelve Months Ended 2007	Twelve Months Ended 2006	Period from Re-entering the Development Stage through December 31, 2007 (note 1)
<b>Revenues</b>					
Gas sales	\$ 24,044	\$ 9,710	\$ 39,102	\$ 9,710	\$ 48,812
Gathering fees	16,177	-	18,520	-	18,520
Well services	118,500	78,090	477,936	162,967	640,903
Drilling services	50,425	-	232,494	-	232,494
Yard rentals	1,500	3,885	6,000	3,885	9,885
Consulting fees	-	-	-	40,000	40,000
<b>Total Revenues</b>	<b>210,646</b>	<b>91,685</b>	<b>774,052</b>	<b>216,562</b>	<b>990,614</b>
<b>Expenses:</b>					
Salaries and wages	322,999	325,681	1,221,616	1,005,199	2,421,934
Professional fees	83,465	154,938	320,653	871,257	1,353,617
General and administrative	83,376	168,562	563,280	576,495	1,407,154
Management fees and salaries (note 13)	64,078	26,987	235,607	289,940	1,095,547
Depreciation	64,017	57,159	235,566	166,014	420,182
Lease operating expenses	5,587	-	22,091	-	22,381
Field expenses	13,803	9,544	42,752	156,321	199,073
Rig expenses	39,313	76,015	217,044	123,823	340,867
Stock-based compensation cost (note 12)	65,712	32,449	243,218	113,459	356,677
Allowances paid to related parties (note 13)	10,800	10,800	43,200	51,800	157,400
Pipeline expenses	47,322	22,526	163,412	22,526	185,938
Exploratory expenditures	678	-	12,070	-	112,246
<b>Total Expenses</b>	<b>801,150</b>	<b>884,661</b>	<b>3,320,509</b>	<b>3,376,834</b>	<b>8,073,446</b>
<b>Loss from Operations</b>	<b>(590,504)</b>	<b>(792,976)</b>	<b>(2,546,457)</b>	<b>(3,160,272)</b>	<b>(7,082,832)</b>
<b>Other Income (Expenses):</b>					
(Loss) gain on sale of properties	(8,811)	-	60,111	143	60,254
Interest income	693	3,257	2,423	94,122	185,110
Interest expense	(36,722)	(70,203)	(285,235)	(141,102)	(426,337)
<b>Total Other Income (Expenses)</b>	<b>(44,840)</b>	<b>(66,946)</b>	<b>(222,701)</b>	<b>(46,837)</b>	<b>(180,973)</b>
<b>Loss Before Income Taxes</b>	<b>(635,344)</b>	<b>(859,922)</b>	<b>(2,769,158)</b>	<b>(3,207,109)</b>	<b>(7,263,805)</b>
Provision for income taxes (note 15)	-	-	-	-	-
<b>Net Loss</b>	<b>\$ (635,344)</b>	<b>\$ (859,922)</b>	<b>\$ (2,769,158)</b>	<b>\$ (3,207,109)</b>	<b>\$ (7,263,805)</b>
<b>Loss per Share</b>					
Basic and diluted	\$ (0.01)	\$ (0.03)	\$ (0.08)	\$ (0.10)	
<b>Basic and Diluted Weighted Average Number of Shares Outstanding During the Periods</b>					
	<b>42,825,974</b>	<b>30,875,309</b>	<b>35,981,907</b>	<b>30,888,316</b>	

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

**CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY) (Note 2)

Condensed Consolidated Statements of Stockholders' Equity

Twelve Months Ended December 31, 2007 and 2006, and the Period from Re-entering the Development Stage (January 14, 2005) Through to December 31, 2007 (2005 Restated (Note 3))

	Class "A" Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Treasury Stock		Accumulated Deficit and Deficit Accumulated During the Development Stage	Total Stockholders' Equity
	Shares	Amount	Shares	Amount		Shares	Amount		
<b>Balance – January 1, 2005</b>	-	\$ -	30,142,700	\$ 30,143	\$ (30,113)	-	\$ -	\$ (8,450)	\$ (8,420)
Common stock issued for cash	-	-	600,000	600	299,400	-	-	-	300,000
Common stock issued for nil consideration (Note 11)	-	-	150,000	150	(150)	-	-	-	-
Preferred stock issued for cash	18,125,000	18,125	-	-	7,231,875	-	-	-	7,250,000
Payment of deferred stock issuance costs	-	-	-	-	(351,598)	-	-	-	(351,598)
Net loss for the year	-	-	-	-	-	-	-	(1,287,538)	(1,287,538)
Restatement for Shelf payment registration event payment (Notes 3 and 10)	-	-	-	-	(1,646,453)	-	-	-	(1,646,453)
<b>Restated Balance - December 31, 2005</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>\$ -</b>	<b>\$ (1,295,988)</b>	<b>\$ 4,255,991</b>
Stock option compensation recognized (Note 11)	-	-	-	-	113,459	-	-	-	113,459
Treasury stock from settlement of lawsuits	-	-	(100,000)	-	-	100,000	(65,000)	-	(65,000)
Net loss for the year	-	-	-	-	-	-	-	(3,207,109)	(3,207,109)
<b>Balance - December 31, 2006</b>	<b>18,125,000</b>	<b>\$ 18,125</b>	<b>30,792,700</b>	<b>\$ 30,893</b>	<b>\$ 5,616,420</b>	<b>100,000</b>	<b>\$ (65,000)</b>	<b>\$ (4,503,097)</b>	<b>\$ 1,097,341</b>
Common shares issued for cash	-	-	10,722,500	10,723	2,402,288	-	-	-	2,413,011
Common shares issued for event payment settlement	-	-	4,559,225	4,559	1,819,131	-	-	-	1,823,690
"A" Warrants issued	-	-	-	-	42,827	-	-	-	42,827
"B" Warrants issued	-	-	-	-	18,664	-	-	-	18,664
Stock option compensation recognized (Note 12)	-	-	-	-	243,216	-	-	-	243,216
Net loss for the period-adjusted for rounding	-	-	-	-	-	-	-	(2,769,159)	(2,769,159)
<b>Balance - December 31, 2007</b>	<b>18,125,000</b>	<b>\$ 18,125</b>	<b>46,074,425</b>	<b>\$ 46,175</b>	<b>\$10,142,546</b>	<b>100,000</b>	<b>\$ (65,000)</b>	<b>\$ (7,272,256)</b>	<b>\$ 2,869,589</b>

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

## CANARY RESOURCES INC. AND SUBSIDIARIES

(A DEVELOPMENT STAGE COMPANY) (Note 2)

Condensed Consolidated Statements of Cash Flows

Twelve Months Ended December 31, 2007 and 2006, and the Period from Re-entering  
the Development Stage (January 14, 2005) through to December 31, 2007

Unaudited

	2007	(Restated, Note 3) 2006	(Restated, Note 3) Period from Re-entering the Development Stage through to December 31, 2007
<b>Cash Flows from Operating Activities:</b>			
Net loss	\$ (2,769,158)	\$ (3,207,109)	\$ (7,263,805)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	235,566	166,014	420,182
Gain on sale of property, plant and equipment	-	-	-
Gain on sale of gas properties	(60,111)	(143)	(60,254)
Stock option expense recognized	243,218	113,459	356,677
Treasury stock received in legal settlement	-	(65,000)	(65,000)
Changes in assets and liabilities:			
Accounts receivable – Trade	34,899	(127,621)	(92,722)
Accounts receivable – Employee and other	(3,121)	-	(3,121)
Prepaid expenses and other	(778)	7,612	(49,970)
Deposits	48,701	(55,436)	(6,735)
Accounts payable – Trade	(255,564)	358,987	431,857
Accrued liabilities	(1,228,618)	(135,261)	(1,173,821)
Drilling advances received	992,600	-	992,600
Drilling advances utilized	(617,600)	-	(617,600)
Management fees and salaries payable	103,939	20,892	193,231
<b>Net Cash Used in Operating Activities</b>	<b>(3,276,027)</b>	<b>(2,923,606)</b>	<b>(6,938,481)</b>
<b>Cash Flows from Investing Activities:</b>			
Acquisition of oil and gas properties	(316,367)	(1,349,745)	(2,191,569)
Proceeds on disposal of oil and gas properties	154,400	-	154,400
Acquisition of property, plant and equipment	(482,303)	(1,636,512)	(2,567,265)
Proceeds on disposal of property, plant and equipment	-	4,000	4,000
Net adjustments to field equipment inventory	17,899	(50,442)	(88,116)
<b>Net Cash Used in Investing Activities</b>	<b>(626,371)</b>	<b>(3,032,699)</b>	<b>(4,688,550)</b>
<b>Cash Flows from Financing Activities:</b>			
Issuance of common shares for cash	2,401,012	-	2,701,012
Issuance of warrants for cash	61,489	-	61,489
Issuance of class “A” convertible preferred stock for cash	-	-	7,250,000
Payment of deferred issuance cost	-	-	(351,598)
Issuance of common shares for event payment settlement	1,823,689	-	1,823,689
Contingent liability (note 3)	(486,453)	52,337	(434,116)
Long-term debt – proceeds and repayments	(43,535)	1,171,791	1,349,506
Advances from stockholders	35,748	99,258	235,006
<b>Net Cash Provided by Financing Activities</b>	<b>3,791,950</b>	<b>1,323,386</b>	<b>12,634,988</b>
<b>Net (Decrease) Increase in Cash</b>	<b>(110,448)</b>	<b>(4,632,919)</b>	<b>1,007,958</b>
<b>Cash - Beginning of Period</b>	<b>1,118,406</b>	<b>5,751,325</b>	<b>-</b>
<b>Cash - End of Period</b>	<b>\$ 1,007,958</b>	<b>\$ 1,118,406</b>	<b>\$ 1,007,958</b>

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

## **CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

### **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 incorporated with the intent to manufacture and market various personal jewelry 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. ("Canary"). On January 14, 2005, the Company subscribed for 100% of the common stock of Canary, a private Nevada corporation. Canary is a coal bed methane exploration and production company with acreage in the Eastern Forest City Basin of Kansas and Missouri, for which it is the operator. Canary currently has twenty-five wells shut-in pending pipeline connection and eleven producing wells. The purchase, site preparation, and construction of the pipeline interconnect have been completed. On January 14, 2005, the Company was considered to have re-entered the development stage. On August 29, 2005, Canary changed its name to Canary Operating Corporation.

On May 25, 2006, the Company subscribed to 100% of the common stock of Canary Pipeline, Inc. ("Canary Pipeline"); RLC Drilling, Inc. ("RLC"); and Willis Well Services, Inc. ("Willis") which are all Kansas corporations. Canary Pipeline is a gas gathering company providing services to Canary and third parties. RLC is a coal-bed methane drilling company which drills wells for Canary and third parties. On September 7, 2006, RLC changed its name to Canary Drilling, Inc. ("Canary Drilling"). Willis is a well servicing company that provides services to Canary and third parties.

### **2. Development Stage Activities and Going Concern**

The accompanying condensed 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.

## **CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

### **2. Development Stage Activities and Going Concern (cont'd)**

The Company is in the development stage and has realized minimal revenues from its planned operations. The Company has sustained losses of \$(2,769,158) and \$(3,207,109) for the twelve month periods ended December 31, 2007 and 2006, respectively. As of December 31, 2007, the Company had working capital deficit of \$(1,168,593) and an accumulated deficit of \$(7,272,258). The Company has funded operations primarily 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). On December 28, 2006, the Company obtained \$1,000,000 through debt financing (see note 8). On May 8, 2007, the Company entered into an unincorporated joint venture agreement with KC Clean Energy, LLC which is participating on a turnkey cost basis. KC Clean Energy, LLC will have a 50% working interest in 20 of Canary's wells. On December 28, 2007, the Company entered into a second unincorporated joint venture agreement with KC Clean Energy, LLC which is participating on a turnkey cost basis. KC Clean Energy, LLC will have a 50% working interest in 10 of Canary's wells. As of December 31, 2007, the Company had received gross proceeds of \$660,000 in a private equity placement (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 oil and 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 condensed 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.

### **3. Restatement of 2005 Consolidated Financial Statements**

On July 31, 2006, management concluded that the Company's consolidated financial statements for the 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 ("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 requires that Event Payments 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's closing date. Event Payments incur interest of 1.5% per month until paid in full beginning ten days after demand. Demand was made on April 28, 2006. The Company's total potential liability was \$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 December 31, 2005 and March 31, 2006 was a decrease to paid-in capital and an increase in liabilities of \$1,646,453. In May 2007, an agreement was reached with the purchasers to waive all defaults and breaches under the Securities Purchase Agreement in exchange for payment, the majority of which was in the form of shares (see note 10).

## **CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

### **4. Summary of Significant Accounting Policies**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

#### Recent Accounting Pronouncement

In February 2007, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115”. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is expected to expand the use of fair value measurement, which is consistent with the Board’s long-term measurement objectives for accounting for financial instruments. This statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This statement does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. This statement does not establish requirements for recognizing and measuring dividend income, interest income, or interest expense. This statement does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in FASB Statements No. 157, “Fair Value Measurements”, and No. 107, “Disclosures about Fair Value of Financial Instruments.” This statement is effective as of the beginning of the entity’s first fiscal year that begins after November 15, 2007. The Company is currently reviewing the effect, if any, the proposed guidance will have on its financial statements.

In May 2007, the FASB issued a FASB Staff Position on FIN 46(R)-7, "Application of FASB Interpretation No. 46(R) to Investment Companies" ("FSP FIN 46 (R)-7"). FSP FIN 46(R)-7 addresses the application of FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities", by an entity that accounts for its investments in accordance with the specialized accounting guidance in the American Institute of Certified Public Accountants (“AICPA”) Audit and Accounting Guide, "Investment Companies" (the “Guide”). The adoption of FSP FIN 46(R)-7 did not have a material impact on the Company's results of operations and financial condition.

## **CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

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

In June 2007, the AICPA issued Statement of Position ("SOP") No. 07-1, "Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies ("SOP No. 07-1"). SOP No. 07-1 clarifies when an entity may apply the provisions of the Guide. Investment companies that are within the scope of the Guide report investments at fair value; consolidation or use of the equity method for investments is generally not appropriate. SOP No. 07-1 also addresses the retention of specialized investment company accounting by a parent company in consolidation or by an equity method investor. SOP No. 07-1 is effective for fiscal years beginning on or after December 15, 2007 with early adoption encouraged. The Company is currently evaluating the impact, if any, of SOP No. 07-1 on the Company's consolidated financial statements.

In May 2007 the FASB issued FASB Interpretation FIN No. 48-1, "Definition of Settlement in FASB Interpretation 48" ("FIN 48-1"). FIN 48-1 amends FIN 48, "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109", to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FIN 48-1 is effective retroactively to January 1, 2007. The adoption of FIN 48-1 did not have a material effect on the Company's consolidated condensed financial statements.

In September 2007, the FASB published Proposed FASB Staff Position ("FSP") No. APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion." The proposed FSP applies to convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative under SFAS No. 133. Convertible debt instruments within the scope of the proposed FSP are not addressed by APB 14. Therefore, the liability and equity components of convertible debt instruments within the scope of the proposed FSP shall be separately accounted for in a manner that will reflect the entity's nonconvertible debt borrowing rate. This will require an allocation of the convertible debt proceeds between the liability component and the embedded conversion option (i.e., the equity component). The difference between the principal amount of the debt and the amount of the proceeds allocated to the liability component would be reported as a debt discount and subsequently amortized to earnings over the instrument's expected life using the effective interest method. The proposed FSP is expected to be effective for fiscal years beginning after December 15, 2007 and will require retrospective application. The Company is currently reviewing the effect, if any, if the proposed FSP were to be adopted.

## **CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

### **5. Oil and Gas Properties**

The carrying value of the Company's oil and gas properties are attributable to unproved properties and eleven proved properties. The proved costs are not currently being depreciated, depleted or amortized as they are not material to the condensed consolidated financial statements at December 31, 2007.

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 oil and gas properties:

Unproved property acquisition costs	\$ 1,503,896
Wells-in-progress	352,947
Proved gas properties	<u>252,437</u>
	<u>\$ 2,109,280</u>

**CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

**6. Property, Plant and Equipment, net**

Property, plant and equipment are comprised as follows:

	<u>Cost</u>	<u>Accumulated Depreciation</u>
Land	\$ 25,000	\$ -
Land improvements	14,736	8,234
Building	286,068	14,245
Leasehold improvements	2,339	1,170
Office and furniture	22,501	6,831
Computer equipment	59,990	47,078
Software	1,195	199
Vehicles	202,441	104,964
Drilling equipment	371,960	72,846
Field equipment	331,737	80,910
Heavy trucks and trailers	390,280	73,702
Pipeline	855,020	9,861
	<u>\$ 2,563,267</u>	<u>\$ 420,040</u>
Net carrying amount		<u>\$ 2,143,227</u>

**7. Advances from Stockholders**

The advances from stockholders include non-interest bearing expense reimbursements as well as a \$100,000, 8% per annum interest bearing note with no fixed terms of repayment. The advances are unsecured with no fixed terms of repayment.

**8. Long-term Debt**

a. Promissory Note	\$ 1,000,000
b. Mortgage	214,166
c. Loans	<u>135,340</u>
	1,349,506
Less: Current portion	<u>(1,047,065)</u>
Long-term portion	<u>\$ 302,441</u>

## CANARY RESOURCES INC. AND SUBSIDIARIES

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

### 8. Long-term Debt (cont'd)

- a) On December 28, 2006, the Company obtained a bridge loan in the amount of \$1,000,000 bearing interest at the rate of 10% per annum payable monthly, secured by a promissory note that matured December, 2007. As of December 31, 2007, the loan has been extended via verbal agreement. The note also provides for an additional \$1,000,000 advance, by agreement of the parties. The loan provides funding for completion of the Company's pipeline tap and for development of the Company's coal-bed methane gas properties.
- b) 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 and closing costs. This facility is near the initial drilling field, which is located in the southwest corner of Cass County, Missouri, and the warehouse 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% per annum, and is repayable in blended monthly payments of \$1,789.
- c) As of December 31, 2007, the Company had purchased six vehicles for operations that were financed by loans for a total of \$199,347, amortized over 5-year basis with an average fixed interest rate of 6.95% per annum and repayable in blended monthly payments of \$4,270. The loans have various maturity dates ranging from January 2009 to May 2011. Vehicles (note 6) with a net carrying value of \$97,477 at December 31, 2007 were used as security for these loans.

Future minimum long-term debt payments required are as follows:

2008	\$ 1,047,065
2009	42,136
2010	44,190
2011	18,145
Thereafter	<u>197,970</u>
	<u>\$ 1,349,506</u>

### 9. Drilling Advances

In May 2007, Canary entered into a joint operating agreement for an unincorporated joint venture drilling program with KC Clean Energy, LLC which is participating on a turnkey costs basis (see Note 2). The first phase of the drilling program involved a commitment for Canary to drill 16 new wells in which KC Clean Energy, LLC has acquired a 50% working interest. Canary will operate the 16 new wells and will retain a 50% working interest in them. The drilling advances from KC Clean Energy, LLC offset the costs of drilling the wells as they were incurred. As of December 31, 2007, all 16 wells under this agreement were complete.

## **CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

### **9. Drilling Advances (cont'd)**

In December 2007, Canary entered into a second joint operating agreement for an unincorporated joint venture drilling program with KC Clean Energy, LLC which is participating on a turnkey basis (see Note 2). The first phase of the drilling program involves a commitment for Canary to drill 10 new wells in which KC Clean Energy, LLC has acquired a 50% working interest. Canary will operate the 10 new wells and will retain a 50% working interest in them. The drilling advances from KC Clean Energy, LLC will offset the costs of drilling the wells as they are incurred. The Company accounts for the activities of these unincorporated joint ventures using the proportionate method of accounting.

### **10. Commitments and Contingencies**

#### 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 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 until paid in full beginning ten days after demand. Demand was made on April 28, 2006. The Company's total potential liability was \$1,646,453 excluding interest. At December 31, 2007 the Company had recorded interest of \$237,605 that began accruing May 8, 2006.

In May 2007, agreement was reached with the purchasers to waive all defaults and breaches under the Securities Purchase Agreement and to amend the Securities Purchase Agreement in exchange for payment, the majority of which was in the form of shares. Based upon an agreed value of \$0.40 per share, the Company issued 4,559,225 shares of common stock to the purchasers in order to discharge Event Payment liabilities of \$1,823,690 and paid \$17,562 cash in order to discharge Event Payment liabilities of \$17,562.

The Company is required under the amended Securities Purchase Agreement to file a registration statement to list shares on a trading market as soon as practicable, but in any event no later than December 31, 2007. The Company and the purchasers may, by mutual agreement, extend such date if deemed practicable by the parties. If the Company fails to file a registration statement and list its common shares on a trading market by December 31, 2007, and if the Company and the purchasers do not agree to extend such date, the Company will be liable for payments of \$2,500 per month for up to 24 months from December 31, 2007, with unpaid penalties bearing interest at 1.5% per month. As of December 31, 2007, the Company had not filed a registration statement or listed its shares on a trading market, and no agreement to extend the date had been reached.

## CANARY RESOURCES INC. AND SUBSIDIARIES

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

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

#### Lease Obligations

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

2008	\$	26,900
2009		18,900
2010		<u>12,000</u>
	\$	57,800

#### Contingent Royalties Payable

The Company has entered into various contractual land lease agreements with the owners of the gas properties which require 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. As of December 31, 2007, the Company is obligated to make royalty payments. This liability has been recorded.

### 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 condensed consolidated financial statements and the calculation of loss per share.

In March and April 2005, three investors purchased for cash 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 was the price per share to be increased.

On July 22, 2005, the Company closed a private placement of its class "A" convertible preferred stock for gross proceeds of \$7,250,000. Expenses associated with the private placement were approximately \$351,598 and a contingent liability of \$1,646,453 was set up for contingent Event Payments as described in note 10. 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.

## CANARY RESOURCES INC. AND SUBSIDIARIES

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

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

The private placement was comprised of one convertible preferred stock 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 stock carries no dividend and is 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. 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.

The value of each warrant using the Black-Scholes pricing model was \$nil 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%

On October 31, 2007, the Company reached agreement with a majority of the holders of the warrants issued under the July 22, 2005 private placement for an exercise price reduction to \$0.20 per common share and immediate exercise of warrants. The Company received \$1,750,000 from the exercise of 8,750,000 Securities Purchase Agreement warrants into 8,750,000 common shares.

The July 22, 2005 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.

## CANARY RESOURCES INC. AND SUBSIDIARIES

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

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

In December 2006, the Company received 100,000 shares of restricted common stock from James Osborn as one of the conditions for settlement of the lawsuits. The stock was placed in the treasury thereby reducing the number of outstanding shares of common stock. No monetary consideration was given for the return of the shares placed in the treasury. The treasury stock was valued at \$65,000 represented by the value of the shares at the date the treasury stock was received. The treasury stock was recorded as a reduction to legal costs.

In May 2007, the Company issued 4,559,225 shares of common stock to purchasers under the Securities Purchase Agreement in order to discharge Event Payment liabilities of \$1,823,690 based upon a value of \$0.40 per share (see note 10).

The Company entered into a private placement in May 2007. Under that placement, the Company issued 1,475,000 units in the second quarter of 2007, 150,000 units in the third quarter of 2007 and 25,000 units in the fourth quarter of 2007 at a price of \$0.40 per unit for total consideration of \$660,000. Each unit comprised one share of common stock of the Company plus one half of an A-Warrant, plus one half of a B-Warrant. Each whole A-Warrant entitles the holder to purchase one share of common stock of the Company for \$1.00 if exercised within four years. Each whole B-Warrant entitles the holder to purchase one share of common stock of the Company for \$1.50 if exercised within four years. The value of the A-Warrant and B-Warrant using the Black-Scholes pricing model was \$0.06 and \$0.04, respectively, based upon the following assumptions:

	<b>A-Warrant</b>	<b>B-Warrant</b>
Risk-free interest rate	4.792%	4.792%
Expected life in years	4.0	4.0
Exercise price	\$1.00	\$1.50
Stock price	\$0.30	\$0.30
Volatility	59%	59%
Expected dividend yield	0%	0%
Fair value per option granted	\$0.06	\$0.04

In the fourth quarter of 2007, the Company received \$52,500 from the exercise of 262,500 A-Warrants from the May 2007 private placement into 262,500 common shares at a price of \$0.20 per share.

In November 2007, the Company issued 60,000 shares of common stock to Arkoma Power and Energy to purchase an option to lease certain lands in Missouri.

As of December 31, 2007, the Company had 46,074,425 common shares, 18,125,000 Class "A" Convertible Preferred Stock, 2,075,000 warrants issued and outstanding, and 3,885,000 stock options issued. After conversion of all of the Class "A" Convertible Preferred Stock and excluding exercise of any Warrants and Options, the Company would have 64,199,425 common shares outstanding.

## CANARY RESOURCES INC. AND SUBSIDIARIES

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

### 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 common shares reserved for issuance under the 2005 Stock Option Plan is 7,500,000 of which 3,615,000 options are available.

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.

On November 16, 2006, the Board of Directors granted options to purchase 185,000 common shares at a price of \$0.60 per share until November 15, 2016.

On February 22, 2007, the Board of Directors granted options to purchase 1,250,000 common shares at a price of \$0.55 per share until February 21, 2017.

On June 26, 2007, the Board of Directors granted options to a non-employee to purchase 150,000 common shares at a price of \$0.50 per share until June 26, 2011.

The compensation cost that has been charged against income for this plan for the twelve month period ended December 31, 2007 was \$243,218. No shares had been exercised or forfeited as of December 31, 2007.

The estimated fair value of the options was determined using the Black-Scholes option pricing model using the following assumptions:

	<u>1/31/2006</u>	<u>11/16/2006</u>	<u>2/22/2007</u>	<u>6/26/2007</u>
	Grant	Grant	Grant	Grant
Risk-free interest rate	4.66%	4.77%	4.73%	4.96%
Expected life in years	6.0	6.0	6.0	3.5
Exercise price	\$0.50	\$0.60	\$0.55	0.50
Stock price	\$0.45	\$0.60	\$0.50	0.30
Volatility	30%	48%	59%	59%
Expected dividend yield	0%	0%	0%	0%
Fair value per option granted	\$0.16	\$0.27	\$0.29	\$0.10

## CANARY RESOURCES INC. AND SUBSIDIARIES

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

### 12. Stock-Based Compensation (cont'd)

Stock options outstanding during the period ended December 31, 2007 are 3,885,000 common shares (2006: 2,485,000). The weighted average exercise price was \$0.52 (2006: \$0.51). The weighted average life in years was 8.58 (2006: 9.15). The weighted average grant-date fair value was \$0.20 (2006: \$0.17). The total proceeds that would be generated upon exercising of all issued and outstanding options are approximately \$2,023,500 (2006: \$1,261,000).

### 13. Related Party Transactions

Allowances of \$43,200 (2006: \$51,800) were paid to a director and companies controlled by directors of the Company. During the twelve month period ended December 31, 2007, management fees of \$235,607 (2006: \$276,606) were paid to 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 related parties.

### 14. Segmented Information

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

#### Revenues by Segment:

Company	\$ -
Canary	45,102
Canary Pipeline	18,520
Canary Drilling	232,494
Willis	477,936
Total consolidated revenues	<u>\$ 774,052</u>

#### Net Operating Loss by Segment:

Company	\$ (1,272,296)
Canary	(419,699)
Canary Pipeline	(236,854)
Canary Drilling	(359,667)
Willis	(257,942)
Total consolidated net operating loss	<u>\$ (2,546,458)</u>

#### Total Assets by Segment:

Company	\$ 591,109
Canary	443,060
Canary Pipeline	62,734
Canary Drilling	-
Willis	63,602
Total consolidated assets	<u>\$ 1,160,505</u>

**CANARY RESOURCES INC. AND SUBSIDIARIES**

(A DEVELOPMENT STAGE COMPANY)

Notes to Condensed Consolidated Financial Statements

December 31, 2007 and 2006

Unaudited

**15. Income Taxes**

The Company has net losses for tax purposes 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:

Expected income tax recovery at the statutory rates of 40% (2006 - 40%)	\$ (1,107,663)
Stock compensation	<u>97,287</u>
	(1,010,376)
Valuation allowance	<u>1,010,376</u>
Provision for income taxes	<u>\$ -</u>

The Company has deferred income tax assets as follows:

Net operating loss carryforward	\$ 3,103,820
Net book value and tax value differences	(318,061)
Valuation allowance for deferred income tax assets	<u>(2,785,759)</u>
	<u>\$ -</u>

As of December 31, 2007 the Company had approximately \$8,029,976 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	1,794,392
2021	3,293,699
2022	<u>2,933,435</u>
	<u>\$ 8,029,976</u>

**CANARY RESOURCES INC. AND SUBSIDIARIES**  
(A DEVELOPMENT STAGE COMPANY)  
Notes to Condensed Consolidated Financial Statements  
December 31, 2007 and 2006  
Unaudited

**16. Supplemental Cash Flow Information**

	2007	(Restated, Note 3) 2006	Period from Re-entering the Development Stage through to Dec. 31, 2007
Interest paid	<u>\$ 285,235</u>	<u>\$ 141,102</u>	<u>\$ 426,337</u>
Income taxes paid	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

**17. Comparative Figures**

Certain of the prior period balances have been reclassified to conform with the current period's financial statement presentations.

**18. Subsequent Event**

On February 20, 2008, the Board of Directors granted options to purchase 1,440,000 common shares at a price of \$0.40 per share until February 19, 2018.

The Company entered into a private placement in May 2007 that included the issuance of 825,000 A-Warrants and 825,000 B-Warrants (see Note 11). In the first quarter of 2008, the Company received \$93,750 from the exercise of 468,750 A-Warrants into 468,750 common shares at a price of \$0.20 per share.

## **CERTIFICATION**

I, William Chandler, certify that:

I have reviewed this annual report of Canary Resources, Inc. and that, based on my knowledge, such statements and the notes thereto present fairly, in all material respects, the financial position of the issuer and the results of its operations and cash flows for the periods presented, in conformity with accounting principles generally accepted in the United States, consistently applied.

“William Chandler”

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William Chandler  
Acting as Chief Financial Officer

March 31, 2008

## **CERTIFICATION**

I, William Chandler, certify that:

I have reviewed this annual report of Canary Resources, Inc. and that, based on my knowledge, such statements and the notes thereto present fairly, in all material respects, the financial position of the issuer and the results of its operations and cash flows for the periods presented, in conformity with accounting principles generally accepted in the United States, consistently applied.

“William Chandler”

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William Chandler  
Chief Executive Officer

March 31, 2008