

**CANARY RESOURCES INC. AND SUBSIDIARIES**  
**(A DEVELOPMENT STAGE COMPANY)**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
**SIX MONTH PERIODS ENDED JUNE 30, 2006 , AND 2005**  
**(UNAUDITED)**

**CONTENTS**

Consolidated Balance Sheets	<b>1</b>
Consolidated Statements of Operations	<b>2</b>
Consolidated Statements of Stockholders' Equity	<b>3</b>
Consolidated Statements of Cash Flows	<b>4</b>
Notes to Consolidated Financial Statements	<b>5 - 22</b>

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

Consolidated Balance Sheets

June 30, 2006

(Unaudited)

**ASSETS**

**Current**

Cash and cash equivalents	\$ 2,140,862
Prepaid expenses and sundry	83,205
Deposits	60,436
Inventories	<u>120,018</u>

**Total Current Assets** 2,404,521

**Gas Properties** (note 5) 1,250,503

**Property, Plant and Equipment, net** (note 6) 1,670,841

**Total Assets** \$ 5,325,865

**LIABILITIES**

**Current**

Accounts payable and accrued liabilities	\$ 1,167,595
Advances from stockholders (note 7)	144,359
Current portion of long-term debt (note 8)	<u>35,263</u>

**Total Current Liabilities** 1,347,217

**Long-Term Debt, Less Current Portion** (note 8) 358,735

**Contingent Liability** (note 9) 921,453

**Total Liabilities** 2,627,405

**Commitments and Contingencies** (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 issued and  
outstanding 18,125

Common stock, \$0.001 par value, 100,000,000 shares authorized,  
30,892,700 issued and outstanding 30,893

**Additional Paid in Capital** 5,553,593

**Accumulated Deficit and Deficit Accumulated During the  
Development Stage** (2,904,151)

**Total Stockholders' Equity** 2,698,460

**Total Liabilities and Stockholders' Equity** \$ 5,325,865

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

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

Consolidated Statements of Operations

Three Months and Six Months Ended June 30, 2006, and 2005, and the  
 Period from Re-entering the Development Stage through to June 30, 2006  
 (Unaudited)

	<b>Three Months Ended 2006</b>	<b>Three Months Ended 2005</b>	<b>Six Months Ended 2006</b>	<b>Six Months Ended 2005</b>	<b>Period from Re-entering the Development Stage through to Ended June 30, 2006 (note 1)</b>
<b>Revenues</b>	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Expenses:</b>					
Professional fees	247,594	9,225	553,529	44,349	715,236
Salaries and wages	232,423	-	403,592	-	598,711
General and administrative	140,812	74,700	244,608	148,657	448,507
Management fees (note 13)	146,286	105,000	212,952	210,000	782,952
Field expenses	72,953	-	72,953	-	72,953
Stock compensation cost (note 12)	30,379	-	50,632	-	50,632
Rent paid to related parties (note 13)	16,050	-	32,100	-	96,300
Allowances paid to related parties (note 13)	14,800	-	30,200	-	92,600
Interest	22,645	-	27,178	-	27,178
Exploratory expenditures	-	65,569	-	65,569	100,175
Depreciation	44,575	-	56,172	-	74,774
<b>Total Expenses</b>	<b>968,517</b>	<b>254,494</b>	<b>1,683,916</b>	<b>468,575</b>	<b>3,060,018</b>
<b>Loss from Operations</b>	<b>(968,517)</b>	<b>(254,494)</b>	<b>(1,683,916)</b>	<b>(468,575)</b>	<b>(3,060,018)</b>
<b>Other Income:</b>					
Interest	31,153	-	75,752	-	164,317
<b>Loss Before Income Taxes</b>	<b>(937,364)</b>	<b>(254,494)</b>	<b>(1,608,164)</b>	<b>(468,575)</b>	<b>(2,895,701)</b>
Income taxes (note 15)	-	-	-	-	-
<b>Net Loss</b>	<b>\$ (937,364)</b>	<b>\$ (254,494)</b>	<b>\$ (1,608,164)</b>	<b>\$ (468,575)</b>	<b>\$ (2,895,701)</b>
<b>Loss per share:</b>					
Basic	\$ (0.03)	\$ (0.01)	\$ (0.05)	\$ (0.02)	
<b>Basic weighted average number of shares outstanding during the periods</b>	<b>30,892,700</b>	<b>30,725,118</b>	<b>30,892,700</b>	<b>30,437,175</b>	
<b>Diluted weighted average number of shares outstanding during the periods</b>	<b>60,755,200</b>	<b>30,725,118</b>	<b>60,371,867</b>	<b>30,437,175</b>	

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

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

Consolidated Statements of Stockholders' Equity  
Six Months Ended June 30, 2006 and 2005, and the Period from Re-entering  
the Development Stage through to June 30, 2006  
(Unaudited)

	<u>Preferred Stock</u>		<u>Common Stock</u>		Additional Paid-in Capital	Accumulated Deficit and Deficit Accumulated During the Development Stage	Total' Shareholders' 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	-	-	150,000	150	(150)	-	-
Preferred shares issued for cash	18,125,000	18,125	-	-	6,880,277	-	6,898,402
Shelf Registration Event Payment (note 3 and 9)	-	-	-	-	(1,646,453)	-	(1,646,453)
Net loss for the period	-	-	-	-	-	(1,287,537)	(1,287,537)
<b>Balance, December 31, 2005 (note 3)</b>	<b>18,125,000</b>	<b>18,125</b>	<b>30,892,700</b>	<b>30,893</b>	<b>5,502,961</b>	<b>(1,295,987)</b>	<b>4,255,992</b>
Net loss for the period	-	-	-	-	-	(670,800)	(670,800)
Stock option expense recognized	-	-	-	-	20,253	-	20,253
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
Net loss for the period	-	-	-	-	-	(937,364)	(937,364)
Stock option expense recognized	-	-	-	-	30,379	-	30,379
<b>Balance, June 30, 2006</b>	<b>18,125,000</b>	<b>\$ 18,125</b>	<b>30,892,700</b>	<b>\$ 30,893</b>	<b>\$ 5,553,593</b>	<b>\$ (2,904,151)</b>	<b>\$ 2,698,460</b>

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

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

Consolidated Statements of Cash Flows

Six Months Ended June 30, 2006, and 2005, and the Period from Re-entering  
the Development Stage through to June 30, 2006

(Unaudited)

	Six Months Ended 2006	Six Months Ended 2005	Period from Re-entering the Development Stage through to June 30, 2006
<b>Cash Flows from Operating Activities</b>			
Net loss	\$ (1,608,164)	\$ (468,575)	\$ (2,895,701)
Adjustment for:			
Depreciation	56,172	-	74,774
Stock option expense	50,632	-	50,632
	<u>(1,501,360)</u>	(468,575)	<u>(2,770,295)</u>
Changes in non-cash working capital			
Prepaid expenses and sundry	(27,551)	(3,000)	(83,205)
Deposits	(59,286)	-	(60,436)
Inventories	(64,445)	-	(120,018)
Accounts payable and accrued liabilities	354,103	191,800	1,230,995
Advances from stockholders	(27,461)	100,000	72,539
Contingent liability	(435,000)	-	921,493
	<u>(1,761,000)</u>	(179,775)	<u>(808,927)</u>
<b>Net Cash Flows Used in Operating Activities</b>			
<b>Cash Flows from Investing Activities</b>			
Acquisition of gas properties	(725,046)	-	(1,250,503)
Acquisition of property, plant and equipment	(1,297,165)	-	(1,745,615)
	<u>(2,022,211)</u>	-	<u>(2,996,118)</u>
<b>Net Cash Flows Used in Investing Activities</b>			
<b>Cash Flows from Financing Activities</b>			
Issuance of preferred shares	-	-	5,251,909
Issuance of common shares	-	300,000	300,000
Long-term debt	172,748	-	393,998
	<u>172,748</u>	300,000	<u>5,945,907</u>
<b>Net Cash Flows Provided by Financing Activities</b>			
	<u>172,748</u>	300,000	<u>5,945,907</u>
<b>Net Change in Cash and Cash Equivalents</b>	<u>(3,610,463)</u>	120,225	<u>2,140,862</u>
<b>Cash and Cash Equivalents</b>			
- beginning of year	<u>5,751,325</u>	-	-
<b>Cash and Cash Equivalents</b>			
- end of year	<u>\$ 2,140,862</u>	\$ 120,225	<u>\$ 2,140,862</u>
<b>Supplemental Cash Flow Information</b>			
Interest paid	<u>\$ 11,010</u>	\$ -	\$ -
Income taxes paid	<u>\$ -</u>	\$ -	\$ -

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

# **CANARY RESOURCES INC. AND SUBSIDIARIES**

## **(A DEVELOPMENT STAGE COMPANY)**

Notes to Consolidated Financial Statements

June 30, 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.

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") all of which are 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. Willis is a well servicing company that provides services to Canary and third parties.

### **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 \$937,364 for the three month period ended June 30, 2006. At June 30, 2006, the Company had working capital of \$1,057,304 and an Accumulated Deficit of \$2,904,151. The Company has funded operations through the issuance of capital stock. On July 22, 2005, the Company closed a private placement for gross proceeds of \$7,250,000 (see Note 11). Management's plan is to continue raising additional funds through future equity or debt financing until it achieves profitable operations from its gas drilling activities. 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.

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

**2. Going Concern (cont'd)**

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.

**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 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 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 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 December 31, 2005 and March 31, 2006 was a decrease to paid-in-capital and an increase in liabilities of \$1,646,453.

**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. There have been no significant changes of accounting policy since December 31, 2005. 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 for the fiscal year ended December 31, 2005.

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

Notes to Consolidated Financial Statements  
June 30, 2006, and 2005  
(Unaudited)

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

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 subsidiaries, Canary, Canary Pipeline, RLC, and Willis, under the accrual method of accounting. On consolidation, all material intercompany transactions and balances have been eliminated.

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.

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

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

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 5.

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 5 of Notes to Consolidated Financial Statements.

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

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

f) Gas Properties (cont'd)

Exploration

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

g) Property, Plant and Equipment

Property, plant and equipment are stated at cost. 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
Field equipment	7 years	straight line
Vehicles	3 years	straight line, 20% salvage
Heavy trucks and trailers	7 years	straight line, 20% salvage
Drilling equipment	7 years	straight line

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

Notes to Consolidated Financial Statements  
June 30, 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 June 30, 2006, 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, collectibility is reasonably assured and title has transferred.

Interest revenue is recorded on an accrual basis, when collection is reasonably assured.

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

Notes to Consolidated Financial Statements

June 30, 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 12.

n) Concentration of Credit Risk

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

Notes to Consolidated Financial Statements  
June 30, 2006, and 2005  
(Unaudited)

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

p) Recent Accounting Pronouncements

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.

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 June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes". This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, application of the provision of FIN 48 is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this Interpretation is adopted. The Company is currently reviewing the effect, if any, the proposed guidance will have on its financial statements. FASB has not established an effective date for the Interpretation.



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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

**7. Advances From Stockholders**

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

**8. Long-Term Debt**

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, 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%.

During the quarter ended June 30, 2006, the Company purchased five vehicles for operations that were financed for a total of \$149,605 amortized over 5-year basis with an average fixed interest rate of 6.15%. Assets with a net carrying value of \$152,160 at June 30, 2006 were used as security for these loans.

	<b>2006</b>
Long-term debt	\$ 393,998
Less: current portion	<u>35,263</u>
Long-term portion	<u>\$ 358,735</u>

Future minimum payments required are as follows:

2006	\$ 17,350
2007	36,407
2008	38,824
2009	41,422
2010	44,215
2011	18,730
Thereafter	<u>197,050</u>
	<u>\$ 393,998</u>

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

**9. Contingent Liability**

The Company failed to file an Initial Registration Statement by September 30, 2005 in accordance with Section 6.1 of the Securities Purchase Agreement dated July 22, 2005. This event 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 is \$1,656,453 excluding interest. At June 30, 2006, the Company also recorded interest of \$16,168 that began accruing May 8, 2006. 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 June 30, 2006, \$921,453 was a contingent liability and \$725,000 was an accrued liability. The Company is negotiating with the purchasers to cure the event and expects to make payment in shares to satisfy the majority of the liability.

**10. Commitments and Contingencies**

Lease Obligations

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

2006	\$	18,102
2007		36,204
2008		36,204
2009		<u>29,304</u>
	\$	<u>119,814</u>

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 June 30, 2006, the Company is not obligated to make any royalty payments.

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

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

Legal Proceedings

In December 2005, a civil lawsuit was filed in the District Court of Miami County, Kansas by Osborn Energy, LLC, the company with which Canary entered into certain joint venture agreements in December 2004, for the exploration and development of coal-bed methane in Johnson and Miami Counties in Kansas, and Cass and Bates Counties in Missouri. The lawsuit names the Company, Canary, and several of the Company's employees and directors as defendants, and makes multiple allegations of contract and tort claims. The Company denies these allegations, believes it has numerous meritorious defences, and intends to defend the case vigorously. As it is not possible to estimate the ultimate cost or outcome, if any, relative to the lawsuit, no loss accruals have been recorded for this matter at June 30, 2006. 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 SUBSIDIARIES**  
**(A DEVELOPMENT STAGE COMPANY)**

Notes to Consolidated Financial Statements  
June 30, 2006, and 2005  
(Unaudited)

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

In March 2006, the Company filed a lis pendens notice on property located in Cass County, Missouri, on which the mineral rights are subject to the joint venture agreements with Osborn Energy, LLC. The Company filed the lis pendens notice to alert potential buyers of the property to the lawsuit pending in Miami County, Kansas, which concerns mineral rights on the property. In June 2006, a civil lawsuit was filed in the 17th Judicial Circuit Court of Cass County, Missouri by Osborn Properties, LLC, a company managed by James L. Osborn, Jr. The lawsuit names the Company as defendant and alleges that the lis pendens notices were improper and that the Company interfered with the sale of the property. The Company denies any wrong-doing regarding the lis pendens notices and will vigorously defend against the allegations. Management believes that the ultimate resolution of the lawsuit will not have a material adverse affect 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 presently be determined.

**11. Capital Stock**

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

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

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

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

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

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

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

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 \$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 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.

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.

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(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 shares reserved for issuance under the 2005 Stock Option Plan is 7,500,000.

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 for the six month period ended June 30, 2006 was \$50,632.

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 June 30, 2006 is 2,300,000. The weighted average exercise price was \$0.50. The weighted average life in years was 9.59. The weighted average grant-date fair value was \$0.16.

**13. Related Party Transactions**

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

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

**14. Segmented Information**

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

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

Canary Operating Corporation ("Canary") – a subsidiary

Canary Pipeline, Inc. ("Canary Pipeline") – a subsidiary

RLC Drilling, Inc. ("RLC") – a subsidiary

Willis Well Services, Inc. ("Willis") – a subsidiary

	2006	2005
Other Income by Segment:		
Corporate	\$ 72,846	\$ -
Canary	2,906	-
Canary Pipeline	-	-
RLC	-	-
Willis	-	-
	<hr/>	<hr/>
Consolidated revenues	\$ 75,752	\$ -
	<hr/>	<hr/>
Operating (Loss) by Segment:		
Corporate	\$ (718,626)	\$ (179,081)
Canary	(760,859)	(35,000)
Canary Pipeline	(6,071)	-
RLC	(54,709)	-
Willis	(67,899)	-
	<hr/>	<hr/>
Consolidated operating loss	\$ (1,608,164)	\$ (214,081)
	<hr/>	<hr/>
Total Assets by Segment:		
Corporate	\$ 497,718	\$ 140,319
Canary	3,559,285	-
Canary Pipeline	192,000	-
RLC	793,742	-
Willis	283,080	-
	<hr/>	<hr/>
Consolidated total assets	\$ 5,325,825	\$ 140,319
	<hr/>	<hr/>

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

Notes to Consolidated Financial Statements

June 30, 2006, and 2005

(Unaudited)

**15. Income Taxes**

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

The Company's current income taxes are as follows:

	2006	2005
Expected income tax recovery at the statutory rates of 40% (2005 - 34%)	\$ (643,265)	\$ (159,316)
Valuation allowance	<u>643,265</u>	<u>159,316</u>
Provision for income taxes	<u>\$ -</u>	<u>\$ -</u>

The Company has deferred income tax assets as follows:

	2006
Net operating loss carryforward	\$ 1,271,339
Net book value and tax value differences	(187,439)
Valuation allowance for deferred income tax assets	<u>(1,083,900)</u>
	<u>\$ -</u>

As of June 30, 2006 the Company had approximately \$3,448,775 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>1,645,933</u>
	<u>\$ 3,448,775</u>

**CANARY RESOURCES INC. AND SUBSIDIARIES**  
**(A DEVELOPMENT STAGE COMPANY)**  
Notes to Consolidated Financial Statements  
June 30, 2006, and 2005  
(Unaudited)

**16. Comparative Figures**

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

## CERTIFICATION

I, Charles E. Hancock, certify that:

I have reviewed this quarterly 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.

/s/ Charles E. Hancock

---

Charles E. Hancock  
Chief Financial Officer

July 31, 2006