

**Financial Statements of
Canadian Spirit Resources Inc.**

December 31, 2006

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Canadian Spirit Resources Inc.

REPORT OF MANAGEMENT

The accompanying Financial Statements of Canadian Spirit Resources Inc. are the responsibility of Management.

Management has prepared the Financial Statements in accordance with accounting principles generally accepted in Canada. If alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgements. Management has ensured that the Financial Statements are presented fairly in all material respects.

Canadian Spirit Resources Inc. maintains internal accounting and administrative controls designed to provide reasonable assurance that the financial information is relevant, reliable and accurate and that assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for reviewing and approving the Financial Statements and Management's Discussion and Analysis and, primarily through its Audit Committee, ensures that management fulfills its responsibilities for financial reporting.

The Audit Committee is appointed by the Board and is entirely composed of Directors who are independent of the Company. The Audit Committee meets regularly with management, and periodically with the external auditors, to discuss internal controls and reporting issues and to satisfy itself that each party is properly discharging its responsibilities. It reviews the Financial Statements and the external auditors' report. The Audit Committee also considers, for review by the Board and approval by the shareholders, the engagement or reappointment of the external auditors.

PricewaterhouseCoopers LLP, the external auditors, have audited the Financial Statements in accordance with auditing standards generally accepted in Canada on behalf of the shareholders. PricewaterhouseCoopers LLP have full and free access to the Audit Committee.

(signed) "Phillip D.C. Geiger"

Phillip D.C. Geiger,
President & Chief Operating Officer

(signed) "Donald R. Gardner"

Donald R. Gardner,
Chief Financial Officer & Secretary

Canadian Spirit Resources Inc.

AUDITORS' REPORT

April 19, 2007

To the Shareholders of Canadian Spirit Resources Inc.

We have audited the balance sheets of Canadian Spirit Resources Inc. as at December 31, 2006 and 2005 and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

"PricewaterhouseCoopers LLP"

Chartered Accountants

Calgary, Alberta

Canadian Spirit Resources Inc.

BALANCE SHEETS

| As at December 31 | 2006 | 2005 |
|--|----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,212,878 | \$ 10,688,123 |
| Accounts receivable | 202,176 | 1,039,211 |
| Prepaid expenses and other | 39,989 | 36,921 |
| | <u>3,455,043</u> | <u>11,764,255</u> |
| Property, plant and equipment (note 3) | <u>32,793,986</u> | <u>22,247,043</u> |
| | <u>\$ 36,249,029</u> | <u>\$ 34,011,298</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued trade liabilities | \$ 857,202 | \$ 3,722,768 |
| Accrued liability for share appreciation rights (note 5) | 534,000 | 1,176,000 |
| Asset retirement obligation (note 4) | 158,650 | 84,395 |
| | <u>1,549,852</u> | <u>4,983,163</u> |
| Shareholders' equity | | |
| Equity instruments (note 5) | 46,991,811 | 40,879,476 |
| Contributed surplus (note 5) | 3,250,910 | 2,616,988 |
| Deficit | (15,543,544) | (14,468,329) |
| | <u>34,699,177</u> | <u>29,028,135</u> |
| | <u>\$ 36,249,029</u> | <u>\$ 34,011,298</u> |

Nature of operations and going concern (note 1)
Commitments (note 8)

ON BEHALF OF THE BOARD:

(signed) "Philip H. Grubbe"

Director

(signed) "J.R. Richard Couillard"

Director

Canadian Spirit Resources Inc.

STATEMENTS OF OPERATIONS AND DEFICIT

| For the year ended December 31 | 2006 | 2005 |
|---|------------------------|------------------------|
| Revenue | | |
| Interest and other income | \$ 277,305 | \$ 499,089 |
| Expenses | | |
| Consulting fees | 222,563 | 157,841 |
| Salaries and benefits | 416,731 | 339,541 |
| Other general administration | 593,098 | 468,770 |
| Stock-based compensation (note 5) | 4,782 | 2,175,851 |
| Accretion expense | 15,391 | 3,069 |
| Impairment of conventional natural gas costs (note 3) | 51,744 | 1,121,164 |
| Amortization | 48,211 | 39,269 |
| | <u>1,352,520</u> | <u>4,305,505</u> |
| Net Loss | (1,075,215) | (3,806,416) |
| Deficit, beginning of period | <u>(14,468,329)</u> | <u>(10,661,913)</u> |
| Deficit, end of period | <u>\$ (15,543,544)</u> | <u>\$ (14,468,329)</u> |
| Loss per share (Basic & Diluted) | <u>\$ (0.04)</u> | <u>\$ (0.16)</u> |

Nature of operations and going concern (note 1)

Canadian Spirit Resources Inc.

STATEMENTS OF CASH FLOWS

| For the year ended December 31 | 2006 | 2005 |
|--|---------------------|----------------------|
| Operating Activities: | | |
| Net loss | \$ (1,075,215) | \$ (3,806,416) |
| Add items not affecting cash | | |
| Amortization | 48,211 | 39,269 |
| Accretion expense | 15,391 | 3,069 |
| Impairment of conventional natural gas costs | 51,744 | 1,121,164 |
| Stock-based compensation | 4,782 | 2,175,851 |
| | <u>(955,087)</u> | <u>(467,063)</u> |
| Changes in non-cash working capital items | <u>(29,341)</u> | <u>104,842</u> |
| | <u>(984,428)</u> | <u>(362,221)</u> |
| Financing Activities: | | |
| Equity instruments issued for cash | 6,576,000 | 12,460,168 |
| Equity instruments issue costs | (472,633) | (260,676) |
| | <u>6,103,367</u> | <u>12,199,492</u> |
| Investing Activities: | | |
| Furniture and office equipment | (15,058) | (68,378) |
| Exploration expenditures | (10,528,347) | (7,004,057) |
| Acquisition/retention of natural gas rights | (44,629) | (2,209,791) |
| | <u>(10,588,034)</u> | <u>(9,282,226)</u> |
| Changes in non-cash working capital items | <u>(2,006,150)</u> | <u>2,161,748</u> |
| | <u>(12,594,184)</u> | <u>(7,120,478)</u> |
| Change in cash | (7,475,245) | 4,716,793 |
| Cash position, beginning of period | <u>10,688,123</u> | <u>5,971,330</u> |
| Cash position, end of period | <u>\$ 3,212,878</u> | <u>\$ 10,688,123</u> |
| Cash taxes paid | <u>\$ -</u> | <u>\$ -</u> |
| Interest paid | <u>\$ -</u> | <u>\$ -</u> |

See the accompanying notes to the financial statements

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

1. NATURE OF OPERATIONS AND GOING CONCERN

Canadian Spirit Resources Inc. (the “Company”) incorporated in British Columbia, is a public company listed on the TSX Venture Exchange (the “Exchange”). Effective June 15, 2004, the Company changed its name from Spirit Energy Corp. to Canadian Spirit Resources Inc.

Since May 2002, the Company has been evaluating the resource potential of certain natural gas from coal exploration properties and is considered to be in its development stage of operations. The recoverability of amounts shown for natural gas properties is dependent upon the determination of economically recoverable reserves. The Company’s ability to continue its operations and to realize assets at their carrying values is dependent upon the continued support of its shareholders, obtaining additional financing and generating revenues sufficient to cover its operating costs.

The Company has incurred losses since inception totaling \$15,543,544, which includes a net loss of \$1,075,215 for the year ended December 31, 2006 (2005: loss of \$3,806,416). The financial statements have been prepared using Canadian generally accepted accounting principles applicable to a going concern which may or may not be appropriate. The financial statements do not give effect to any adjustments which would be necessary should the Company be unable to continue as a going concern and therefore be required to realize its assets and discharge its liabilities at amounts different from those reflected in these financial statements; such adjustments could be material.

2. SIGNIFICANT ACCOUNTING POLICIES

Measurement Uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The amounts recorded for amortization, asset retirement obligation, impairment of unproved properties, stock based compensation and future income taxes are based upon estimates. Actual results could differ from those estimates.

Joint Interests

Exploration, development and production activities may be conducted jointly with external parties and, accordingly, the Company only reflects its proportionate interest in such activities.

Cash and Cash Equivalents

Cash and short term deposits include investments with an original maturity of three months or less.

Financial Instruments

The Company’s financial instruments consist of cash, accounts receivable, accounts payable and accrued expenses. It is management’s opinion that the Company is not exposed to significant interest, currency or credit risk arising from its financial instruments and that their fair values approximate their carrying values due to their short term nature, unless otherwise noted.

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

Property, Plant and Equipment

(a) Natural Gas Interests:

The Company follows the full cost method of accounting for exploration and development expenditures whereby all costs relating to the acquisition of, exploration for and development of natural gas reserves are capitalized. Such costs include lease acquisitions, geological and geophysical, lease rentals on undeveloped properties, drilling both productive and non-productive wells, production equipment, and overhead charges directly related to acquisition, exploration and development activities. Proceeds received from disposals of properties and equipment are credited against capitalized costs unless the disposal would alter the rate of depletion and amortization by more than 20 percent, in which case a gain or loss on disposal is recorded.

Upon commencement of commercial production all costs of acquisition, exploration and development of natural gas reserves, associated tangible plant and equipment costs, asset retirement obligations and estimated costs of future development of proved undeveloped reserves are depleted and/or amortized by the unit of production method based on estimated gross proved reserves before royalties as determined by independent evaluators. Natural gas reserves are converted to equivalent units using their relative energy content of six thousand cubic feet of natural gas to one barrel of oil.

The costs of acquiring and evaluating unproved properties are excluded from costs subject to depletion calculations. These properties are assessed annually to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to the costs subject to depletion.

Natural gas assets are evaluated annually to determine that the costs are recoverable and do not exceed the fair value of the properties. The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves plus the lower of cost and market of unproved properties exceed the carrying value of the petroleum and natural gas assets. If the carrying value of the petroleum and natural gas assets is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties. The cash flows are estimated using future product prices and costs and are discounted using the risk-free interest rate.

(b) Mineral Property:

Expenditures incurred on properties identified as having development potential are recorded at cost and are deferred on a project basis until the viability of the project is determined. If a project is successful, the project costs are amortized using the unit of production method based on recoverable mineral reserves. If a project is abandoned or it is determined that the mineral property is uneconomic to produce, the accumulated project costs are charged to earnings in the period in which the determination is made.

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

(c) Office Equipment:

Computer and office equipment are recorded at cost and amortized on a straight line basis over their estimated useful life of three years. Furniture and fixtures are recorded at cost and amortized on a straight line basis over their estimated useful life of five years.

Asset Retirement Obligation

The Company follows the accounting methodology outlined in Section 3110 of the Canadian Institute of Chartered Accountants (“CICA”) handbook with respect to asset retirement obligations. The Company records the present value of legal obligations associated with the retirement of long-lived tangible assets, such as producing well sites and natural gas processing plants, in the period in which they are incurred with a corresponding increase in the carrying amount of the related long-lived asset. The liability accretes until the Company settles the retirement obligation. The carrying amounts of the long-lived assets are depleted using the unit of production method. Actual costs to retire tangible assets are deducted from the liability as incurred.

Revenue Recognition

Revenues from the sale of natural gas are recorded when title passes to an external party.

Stock-based Compensation

Stock options granted on or after January 1, 2003 have been accounted for based on the fair value method. The fair value is measured at the grant date and charged to earnings on a pro-rata basis over the vesting period with a corresponding increase in contributed surplus. Consideration paid to the Company on exercise of all options is credited to share capital.

Compensation cost attributable to awards to employees that call for settlement in cash is measured at intrinsic value and charged to stock-based compensation expense on a straight-line basis over the vesting period with a corresponding increase in accrued liabilities. Changes in intrinsic value between the grant date and each measurement date result in a change in the measure of compensation cost.

Earnings per Share

Basic earnings per common share are calculated on the net earnings using the weighted average number of shares outstanding during the fiscal period. Diluted earnings per share information is calculated using the treasury stock method which assumes that proceeds obtained upon exercise of options and warrants would be used to purchase common shares at the average market price for the period. No adjustment to diluted earnings per share is made if the result of this calculation is anti-dilutive.

Flow-Through Shares

The Company has financed a portion of its exploration and development activities through the issue of flow-through shares. Under the terms of these share issues, the related resource expenditure deductions for income tax purposes are renounced to investors. Accordingly, when the expenditures are renounced and upon filing of documents with the taxation authorities, share capital is reduced and future income tax liabilities are increased by the estimated value of the renounced tax deductions.

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

Income Taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax liabilities and assets are recognized for the estimated tax consequences attributable to differences between the amounts reported in the financial statements and their respective tax bases, using substantively enacted income tax rates. The effect of a change in income tax rates on future income tax liabilities and assets is recognized in income in the period the change occurs. A valuation allowance is recorded against any future income tax asset if it is more likely than not that the asset will not be realized.

3. PROPERTY, PLANT AND EQUIPMENT

| | <u>2006</u> | <u>2005</u> |
|--|----------------------|----------------------|
| Natural gas properties | \$ 33,905,396 | \$ 23,273,556 |
| Mineral property | 1 | 1 |
| Office furniture and equipment | 161,387 | 146,329 |
| | <u>34,066,784</u> | <u>23,419,886</u> |
| Less: Accumulated depletion, amortization & impairment | <u>(1,272,798)</u> | <u>(1,172,843)</u> |
| Total property, plant and equipment | <u>\$ 32,793,986</u> | <u>\$ 22,247,043</u> |

As the Company had no production or proved reserves at December 31, 2006, there was no depletion charge for the period. At December 31, 2006, natural gas properties included \$13,354,015 (2005: \$13,309,386) relating to undeveloped properties. There has been no impairment of undeveloped properties and all costs incurred on the development of natural gas from coals and shales charged to natural gas properties are considered to be on unproven properties. During 2006, the Company capitalized \$604,174 (2005: \$628,217) of overhead directly related to exploration activities.

During 2006, the Company expended a further \$51,744 towards the completion and production testing of two test wells at West Farrell for conventional gas in the Bluesky formation that had commenced in 2005. Although these wells continue to be prospective for both shale gas in the Gates and Moosebar formations and natural gas from coal in the Gething formation, it was determined that the Bluesky formation does not contain commercially recoverable quantities of hydrocarbons. As a result, the Company has made an impairment provision of \$51,744 for 2006 (2005: \$1,121,164) relating to the Bluesky completion costs.

The Company's mineral property is the Isk Wollastonite project where the Company holds a 100 percent undivided interest, subject to a 10 percent net profits interest, in ten mineral claims covering 1,425 hectares in the Iskut River area of the Liard Mining Division, British Columbia. In prior years, the book value of the mineral property was written down to \$1 to reflect its present economic value. The Company was party to an option agreement which granted an unrelated party the sole and exclusive right and option to acquire a 50 percent undivided interest, subject to a 3 percent Net Smelter Return, in the Isk Wollastonite property. This option agreement expired on December 31, 2005 and was not renewed.

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

4. ASSET RETIREMENT OBLIGATION

| | 2006 | 2005 |
|--|-------------------|------------------|
| Balance, beginning of year | \$ 84,395 | \$ 26,236 |
| Liabilities incurred | 20,466 | 55,090 |
| Revisions in estimated future obligation | 38,398 | - |
| Accretion expense | 15,391 | 3,069 |
| Less: liabilities settled | - | - |
| Balance, end of year | <u>\$ 158,650</u> | <u>\$ 84,395</u> |

The total future asset retirement obligation including costs to reclaim and abandon wells and facilities plus the year in which such costs are expected to be incurred is estimated by management. At December 31, 2006 the estimated total future liability of \$863,447 has a present value of \$158,650 assuming the liability is settled in approximately 25 years, using an estimated credit-adjusted risk-free interest rate of 7.0 percent, and an inflation rate of 2.0 percent.

5. EQUITY INSTRUMENTS

The Company has authorized share capital of an unlimited number of common shares of no par value. The Company has closed the following private placements during the past two years:

On August 11, 2006, the Company issued 3,200,000 Units at \$2.05 per Unit. Each Unit consisted of one common share and one share purchase warrant. Each warrant entitles the holder to purchase one share for one year at an exercise price of \$2.50 per share. The fair value of the warrants was estimated at the date of closing using the Black-Scholes pricing model, under which the Company has assigned a value of \$0.64 per warrant or \$1,358,782 of the proceeds to the warrants, with the remaining \$5,201,218 of the proceeds assigned to the common shares.

On March 11, 2005, the Company issued 1,341,696 Units at \$6.75 per Unit. Each Unit consists of one common share and one-half share purchase warrant. Each whole warrant entitles the holder to purchase one share for one year at an exercise price of \$8.00 per share. The Company has not assigned any portion of the proceeds to the warrants. During January 2006, the Company extended the expiry date of these warrants to July 11, 2006, at which time all 670,848 warrants expired.

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

The equity instruments are as follows:

| | 2006 | | 2005 | |
|-------------------------------------|------------------|-------------------------------|------------------|-------------------------------|
| | Number of shares | Amount of shares and warrants | Number of shares | Amount of shares and warrants |
| Balance - beginning of year | 25,593,082 | \$ 40,879,476 | 22,337,348 | \$ 28,613,668 |
| Equity instruments issued for cash: | | | | |
| Stock options | 40,000 | 16,000 | 125,000 | 105,000 |
| Private placements | 3,200,000 | 6,560,000 | 1,341,696 | 9,056,448 |
| Warrants exercised | - | - | 1,789,038 | 3,298,720 |
| Equity instruments issue costs | - | (472,633) | - | (260,676) |
| Credit from contributed surplus | - | 8,968 | - | 66,316 |
| Balance - end of year | 28,833,082 | \$ 46,991,811 | 25,593,082 | \$ 40,879,476 |

Share Purchase Warrants

In conjunction with previous financings, the Company issued warrants with terms of one to two years to acquire common shares at specific exercise prices. Warrants outstanding at year-end are:

| Exercise Price of Warrants | Outstanding at Dec. 31, 2005 | Issued | Expired | Outstanding at Dec. 31, 2006 | Expiry Date |
|----------------------------|------------------------------|-----------|-----------|------------------------------|--------------------------------|
| \$3.75 | 750,000 | - | 750,000 | - | ¹⁾ January 15, 2006 |
| \$8.00 | 670,848 | - | 670,848 | - | ²⁾ July 11, 2006 |
| \$2.50 | - | 3,200,000 | - | 3,200,000 | August 11, 2007 |
| Total | 1,420,848 | 3,200,000 | 1,420,848 | 3,200,000 | |

Notes:

- 1) The expiry date of these warrants was extended from September 15, 2005 to January 15, 2006 at which time all 750,000 warrants expired.
- 2) The expiry date of these warrants was extended from March 11, 2006 to July 11, 2006 at which time all 670,848 warrants expired.

Stock Options

The Company has stock option plans for directors, officers, employees and consultants which provides for the granting of options to acquire common shares. Under the terms of each plan, options vest over periods as determined by the Company and expire after a maximum of five years. At December 31, 2006, there were 2,700,000 common shares reserved for issuance under the plans of which options to acquire 2,426,000 common shares were outstanding (1,850,000 vested and 576,000 unvested).

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

| Exercise Price of Option | Out-standing at Dec. 31, 2005 | Granted | Exercised or Cancelled | Out-standing at Dec. 31, 2006 | Vested at Dec. 31, 2006 | Year of Expiry |
|--------------------------|-------------------------------|-----------------------|--|-------------------------------|-------------------------|----------------|
| \$0.40 to \$0.41 | 505,000 | - | 40,000 | 465,000 | 465,000 | 2008 |
| \$1.50 to \$1.72 | 680,000 | - | - | 680,000 | 567,500 | 2009 |
| \$2.05 | - | ³⁾ 195,000 | - | 195,000 | - | 2009/10 |
| \$2.05 | - | 41,000 | - | 41,000 | - | 2011 |
| \$2.15 | - | 100,000 | - | 100,000 | - | 2011 |
| \$2.50 | - | 50,000 | - | 50,000 | 12,500 | 2008 |
| \$3.15 | - | 25,000 | ²⁾ 25,000 | - | - | 2008 |
| \$3.30 | 75,000 | - | - | 75,000 | 75,000 | 2009 |
| \$3.65 | 450,000 | - | - | 450,000 | ¹⁾ 450,000 | 2008 |
| \$4.50 | 300,000 | - | ²⁾ 150,000 ³⁾ 100,000 | 50,000 | 50,000 | 2009 |
| \$4.60 | 50,000 | - | ²⁾ 50,000 | - | - | 2010 |
| \$4.15 | 165,000 | - | ³⁾ 25,000 | 140,000 | 140,000 | 2010 |
| \$7.15 | 250,000 | - | ³⁾ 70,000 | 180,000 | 90,000 | 2010 |
| Total | 2,475,000 | 411,000 | 460,000 | 2,426,000 | 1,850,000 | |

Notes:

- 1) The exercise of these vested stock options are subject to the Company achieving certain minimum production or profit thresholds.
- 2) These stock options were forfeited and cancelled during 2006.
- 3) These stock options were re-priced on September 19, 2006 with no change to the original expiry date.

Options granted after January 1, 2003 are accounted for using the fair value method. The compensation cost charged in 2006 against earnings for stock options granted was \$646,782 (2005: \$1,845,184).

The fair value of each option grant or re-pricing in 2006 was estimated on the date of grant using the Black-Scholes pricing model with the following weighted average assumptions:

| | 2006 | 2005 |
|---------------------------------|-----------|-----------|
| Risk free interest rate | 4.02% | 3.17% |
| Expected dividend yield | 0% | 0% |
| Expected stock price volatility | 63.81% | 83.51% |
| Expected life of options | 2.6 years | 3.0 years |

| | | |
|--|--------|--------|
| Weighted average fair value of options granted during the year | \$0.71 | \$2.92 |
|--|--------|--------|

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

CONTRIBUTED SURPLUS

| | 2006 | 2005 |
|---|---------------------|---------------------|
| Balance, beginning of year | \$ 2,616,988 | \$ 838,120 |
| Value of options granted | 642,890 | 1,845,184 |
| Options exercised and transferred to equity instruments | <u>(8,968)</u> | <u>(66,316)</u> |
| Balance, end of year | <u>\$ 3,250,910</u> | <u>\$ 2,616,988</u> |

Performance Units

On September 19, 2006, the Company implemented a full value performance unit incentive plan for senior officers and directors of the Company. Three senior officers of the Company were granted a total of 39,000 performance units with vesting in equal amounts at the end of performance periods ending on the 1st of January 2007, 2008, and 2009. The four independent directors of the Company were granted a total of 16,000 performance units with vesting on January 1, 2009. A performance factor ranging from zero to three will be determined for each performance period based on the average closing price of the Company's shares over the last ten trading days of each calendar year relative to a share price scale established at the date of grant. Awards under this plan are paid in cash within 60 days of the end of each performance period. Payments for vested units are determined by multiplying the number of units vested by the performance factor achieved during that performance period and multiplying the product by the 10 day average closing price of the Company's shares at the end of the performance period. For the purpose of calculating the performance factor associated with the 2006 grant, minimum and maximum 10 day average closing share prices were set at \$2.50 and \$5.00 per share for all performance periods. The total compensation expense for Performance Units for 2006 was therefore \$Nil as the 10 day average closing share price on the Exchange as at December 31, 2006 was \$1.43 per share.

| Grant Date | Outstanding at Dec. 31, 2005 | Granted, (Expired) or (Cancelled) | Exercised and Paid | Outstanding at Dec. 31, 2006 | Expiry Date |
|----------------|------------------------------|-----------------------------------|--------------------|------------------------------|---------------|
| Sept. 19, 2006 | - | 55,000 | - | 55,000 | March 2, 2009 |

Share Appreciation Rights

On August 28, 2003, three senior employees were granted share appreciation rights ("SARs") entitling them to cash payments equal to the excess of the then current price of the common shares (to a maximum of \$3.65, as amended) over the exercise price of the right. Terms of the SARs are similar to the provisions of the stock option plans however, the exercise of vested SARs is subject to achieving certain minimum production or profit thresholds.

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

| Exercise Price | Out-standing at Dec. 31, 2005 | Granted or (Cancelled) | Exercised or Expired | Out-standing at Dec. 31, 2006 | Vested at Dec. 31, 2006 | Expiry Date |
|----------------|-------------------------------|------------------------|----------------------|-------------------------------|-------------------------|---------------|
| \$0.48 | 600,000 | - | - | 600,000 | 600,000 | Aug. 28, 2008 |

Total compensation recovery for share appreciation rights for 2006 was \$642,000 (2005: expense of \$330,667) based on a closing price of \$1.37 per share on the Exchange at December 29, 2006. The Company has accrued a long term liability of \$534,000 at December 31, 2006 (2005: \$1,176,000) relating to share appreciation rights.

Per Share Amounts

The weighted average number of shares outstanding during 2006 was Basic 26,854,671 (2005: 24,513,950) and Diluted 30,731,209 (2005: 25,682,701).

For the year ended December 31, 2006, the existence of stock options and warrants affects the calculation of loss per share on a diluted basis. As the effect of this dilution is to reduce the reported loss per share, diluted loss per share equals basic loss per share.

6. RELATED PARTY TRANSACTIONS

During 2006 and 2005, the Company had transactions with directors and a former officer of the Company, persons related to them or companies controlled by them in the normal course of business as follows:

| | 2006 | 2005 |
|-----------------------|------------|------------|
| Consulting fees | \$ 97,650 | \$ 79,450 |
| Salaries and benefits | \$ 111,640 | \$ 104,572 |

Consulting fees in 2006 included \$90,450 (2005: \$79,450) paid or payable to a director and senior officer of the Company, and \$7,200 (2005: \$Nil) to a former officer of the Company. Accounts payable includes \$14,157 (2005: \$11,848) due to a director and senior officer of the Company, and \$5,350 (2005: \$Nil) due to a former officer of the Company for consulting fees earned during 2006.

Salaries and benefits of \$111,640 (2005: \$104,572) was the compensation paid or payable to a director and senior officer of the Company during 2006.

Transactions with related parties are recorded at exchange amounts for services provided. In addition during 2006, certain directors, relatives of directors, or companies controlled by directors subscribed for Nil (2005: 14,354) shares or units in private placement offerings of the Company under the same terms as other investors.

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

7. FUTURE INCOME TAXES

The provision for future income taxes differs from the amount computed by applying the combined statutory Canadian Federal and Provincial tax rates to earnings before taxes. The reasons for these differences are as follows:

| | 2006 | 2005 |
|--|----------------|----------------|
| Loss before income taxes | \$ (1,075,215) | \$ (3,806,416) |
| Rate | 34.50% | 37.62% |
| Computed / expected income tax expense | \$ (370,895) | \$ (1,431,974) |
| Increase in taxes resulting from: | | |
| Stock-based compensation | 223,107 | 694,158 |
| Non-deductible expenses | 8,212 | 8,812 |
| Effect of change in tax rate | 6,795 | 70,390 |
| Resource allowance loss | 40,885 | 66,987 |
| Unrecognized future tax benefit | 91,896 | 591,627 |
| Income tax expense | \$ - | \$ - |

At December 31, 2006, the Company had estimated tax assets of \$2,865,567 (2005: \$2,800,864) against which a valuation allowance has been applied and therefore no tax recovery has been recognized as follows:

| | 2006 | 2005 |
|--------------------------------|--------------|--------------|
| Property, plant and equipment | \$ 1,235,023 | \$ 1,295,347 |
| Asset retirement obligation | 50,958 | 28,374 |
| Stock-based compensation | 171,521 | 395,371 |
| Equity instruments issue costs | 258,140 | 215,063 |
| Tax loss carryforwards | 1,149,925 | 866,709 |
| | 2,865,567 | 2,800,864 |
| Less: Valuation allowance | (2,865,567) | (2,800,864) |
| Future income tax asset | \$ - | \$ - |

Canadian Spirit Resources Inc.

NOTES TO FINANCIAL STATEMENTS

Years ended December 31, 2006 and 2005

The following estimated tax deductions are available to reduce future taxable income:

| | |
|---|----------------------|
| Non-capital losses | \$ 3,550,966 |
| Capital losses | 25,932 |
| Canadian exploration expense | 3,691,301 |
| Canadian development expense | 19,108,617 |
| Canadian oil and gas property expense | 13,189,542 |
| Foreign exploration and development expense | 120,908 |
| Undepreciated capital cost | 528,648 |
| Cumulative eligible capital | 3,194 |
| Equity instruments issue expense | 803,675 |
| | <u>\$ 41,022,783</u> |

The non-capital losses available at December 31, 2006 to reduce future taxable income expire as follows:

| | |
|------|---------------------|
| 2007 | \$ 65,797 |
| 2008 | 127,522 |
| 2009 | 599,379 |
| 2010 | 455,973 |
| 2014 | 592,574 |
| 2015 | 543,450 |
| 2026 | 1,166,271 |
| | <u>\$ 3,550,966</u> |

8. COMMITMENTS

The Company has entered into an office sub-lease agreement which expires on May 30, 2011. Under the terms of the sub-lease agreement, the Company is obligated to pay base annual rent of \$12.75 per square foot on 6,793 square feet until December 31, 2007 and \$28.00 per square foot thereafter. The Company is also obligated to pay for its share of the operating costs on this office space. The Company has an option, upon six months notice, at both December 31, 2007 and December 31, 2008 to terminate the sub-lease agreement without penalty.