

PROPHECY RESOURCE CORP.

FINANCIAL STATEMENTS

SEPTEMBER 30, 2006

AUDITORS' REPORT

BALANCE SHEET

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STATEMENT OF CASH FLOWS

NOTES TO FINANCIAL STATEMENTS

AUDITORS' REPORT

To the Directors of Prophecy Resource Corp.

We have audited the balance sheet of Prophecy Resource Corp. as at September 30, 2006 and the statements of operations and deficit and cash flows for the period from February 9, 2006 (inception) to September 30, 2006. 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 audit.

We conducted our audit 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 September 30, 2006 and the results of its operations and its cash flows for the period from February 9, 2006 (inception) to September 30, 2006 in accordance with Canadian generally accepted accounting principles.

“DMCL”

DALE MATHESON CARR-HILTON LABONTE LLP
CHARTERED ACCOUNTANTS

Vancouver, Canada
December 29, 2006

A MEMBER OF  MGI INTERNATIONAL, A WORLDWIDE NETWORK OF INDEPENDENT ACCOUNTANTS AND BUSINESS ADVISORS

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PROPHECY RESOURCE CORP.
BALANCE SHEET
AS AT SEPTEMBER 30, 2006

ASSETS	
Current	
Cash	\$ 157,944
Other receivables	4,430
	<u>162,374</u>
Mineral properties (Note 3)	22,000
Deferred exploration costs (Note 4)	102,232
Deferred finance fees (Note 5)	17,000
Reclamation bond	<u>6,500</u>
	<u>\$ 310,106</u>
LIABILITIES	
Current	
Accounts payable and accrued liabilities	\$ 13,000
Due to related parties (Note 6)	10,292
	<u>23,292</u>
SHAREHOLDERS' EQUITY	
Share capital (Note 7)	308,650
Contributed surplus (Note 9)	76,850
Deficit	<u>(98,686)</u>
	<u>286,814</u>
	<u>\$ 310,106</u>

Nature and continuance of operations (Note 1)
Commitments (Note 3 and 7)
Subsequent events (Note 11)

Approved on behalf of the Board:

<u>“Stuart Rogers”</u> Stuart Rogers	Director	<u>“Donald Sharp”</u> Donald Sharp	Director
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The accompanying notes are an integral part of these financial statements.

PROPHECY RESOURCE CORP.
STATEMENT OF OPERATIONS AND DEFICIT

	February 9, 2006 (inception) to September 30, 2006
EXPENSES	
Filing fees	\$ 1,727
Office, rent and miscellaneous	8,354
Management fees – stock based compensation (Note 7)	76,850
Professional fees	13,483
LOSS FROM OPERATIONS	(100,414)
OTHER ITEM	
Interest income	1,728
NET LOSS	(98,686)
DEFICIT, BEGINNING	-
DEFICIT, ENDING	\$ (98,686)
BASIC AND DILUTED LOSS PER COMMON SHARE	\$ (0.03)
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING	3,122,008

The accompanying notes are an integral part of these financial statements.

PROPHECY RESOURCE CORP.
STATEMENT OF CASH FLOWS

	February 9, 2006 (inception) to September 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES	
Net loss	\$ (98,686)
Non-cash operating items:	
Stock based compensation	76,850
Changes in non-cash working capital items:	
Increase in other receivables	(4,430)
Increase in accounts payable and accrued liabilities	13,000
Net cash used in operating activities	<u>(13,266)</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Acquisition of mineral properties	(22,000)
Deferred exploration costs	(102,232)
Reclamation bond	(6,500)
Net cash used in investing activities	<u>(130,732)</u>
CASH FLOWS FROM FINANCING ACTIVITIES	
Issuance of common shares for cash	308,650
Deferred finance fees	(17,000)
Amounts due to related parties	10,292
Net cash provided by financing activities	<u>301,942</u>
Increase in cash during the period	157,944
Cash, beginning	<u>-</u>
Cash, ending	\$ 157,944

Supplemental disclosures with respect to cash flows:

Cash paid during the period for interest	\$ -
Cash paid during the period for income taxes	\$ -

The accompanying notes are an integral part of these financial statements.

1. NATURE AND CONTINUANCE OF OPERATIONS

The Company was incorporated under the Business Corporations Act (British Columbia) on February 9, 2006 and is primarily in the exploration stage with respect to its mineral properties. Based on the information available to date, the Company has not yet determined whether its mineral properties contain economically recoverable reserves. The recoverability of the amounts shown for mineral properties and deferred exploration costs is dependent upon the confirmation of economically recoverable reserves, the ability of the Company to obtain necessary financing to successfully complete their development and upon future profitable production. The Company is in the process of filing an Initial Public Offering prospectus with the British Columbia Securities Commission to raise up to \$550,000 by issuing up to 2,200,000 shares at a price of \$0.25 per share, subject to regulatory approval.

These financial statements have been prepared on a going concern basis which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The continuing operations of the Company are dependent upon its ability to raise adequate financing to develop its mineral properties, and to commence profitable operations in the future. To date the Company has not generated any significant revenues and is considered to be in the exploration stage.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and are presented in Canadian dollars.

Use of estimates

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the period. Actual results could differ from these estimates. Significant areas requiring the use of management estimates relate to the determination of impairment of mineral property interests and future tax rates used to determine future income taxes. Where estimates have been used financial results as determined by actual events could differ from those estimates.

Mineral properties

The Company records its interests in mineral properties and areas of geological interest at cost. All direct and indirect costs relating to the acquisition of these interests are capitalized on the basis of specific claim blocks or areas of geological interest until the properties to which they relate are placed into production, sold or management has determined there to be an impairment. These costs will be amortized on the basis of units produced in relation to the proven reserves available on the related property following commencement of production. Mineral properties which are sold before that property reaches the production stage will have all revenues from the sale of the property credited against the cost of the property. Properties which have reached the production stage will have a gain or loss calculated based on the portion of that property sold.

The recorded cost of mineral exploration interests is based on cash paid, the value of share considerations and exploration and development costs incurred. The recorded amount may not reflect recoverable value as this will be dependent on the development program, the nature of the mineral deposit, commodity prices, adequate funding and the ability of the Company to bring its projects into production.

Management evaluates each mineral interest on a reporting period basis or as changes in events and circumstances warrant, and makes a determination based on exploration activity and results, estimated future cash flows and availability of funding as to whether costs are capitalized or charged to operations. Mineral property interests, where future cash flows are not reasonably determinable, are evaluated for impairment based on management's intentions and determination of the extent to which future exploration programs are warranted and likely to be funded.

2. SIGNIFICANT ACCOUNTING POLICIES (cont'd...)

Deferred finance fees

The Company capitalizes fees incurred in connection with proposed equity financings. These finance fees will be offset against the proceeds of the financing or charged to operations if the financing is not completed.

Deferred exploration costs

The Company defers all exploration costs relating to mineral properties and areas of geological interest until the properties to which they relate are placed into production, sold, abandoned or management has determined there to be an impairment. These costs will be amortized on the basis of units produced in relation to the estimated reserves available on the related property following commencement of production or written-off to operations in the period related properties are abandoned.

Environmental protection and reclamation costs

The Company's policy relating to environmental protection and land reclamation programmes is to charge to income during the period any costs incurred in environmental protection and land reclamation.

Foreign currency translation

The Company's monetary assets and liabilities that are denominated in foreign currencies are translated at the rate of exchange at the balance sheet date. Non-monetary assets and liabilities are translated at exchange rates prevailing at the transaction date. Income and expenses are translated at rates which approximate those in effect on transaction dates. Gains and losses arising on translation are included in earnings.

Financial instruments

The Company's financial instruments consist of cash, other receivables, accounts payable and accrued liabilities, and amounts due to related parties. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair value of these financial instruments approximates their carrying values, unless otherwise noted.

Future income taxes

Future income taxes are recorded using the asset and liability method whereby future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using the enacted or substantively enacted tax rates expected to apply when the asset is realized or the liability settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that substantive enactment or enactment occurs. To the extent that the Company does not consider it more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

Stock-based compensation

The Company has adopted the accounting standards issued by the Canadian Institute of Chartered Accountants ("CICA") Handbook Section, *Stock-based compensation and other stock-based payments*, which recommends the fair-value based method for measuring compensation costs. The Company determines the fair value of the stock-based compensation using the Black-Scholes option pricing model.

Loss per share

The Company uses the treasury stock method to compute the dilutive effect of options, warrants and similar instruments. Under this method the dilutive effect on loss per share is recognized on the use of the proceeds that could be obtained upon exercise of options, warrants and similar instruments. It assumes that the proceeds would be used to purchase common shares at the average market price during the period. Basic and diluted loss per common share are calculated using the weighted-average number of common shares outstanding during the period.

2. SIGNIFICANT ACCOUNTING POLICIES (cont'd...)

Flow-through shares

The Company provides certain share subscribers with a flow-through component for tax incentives available on qualifying Canadian exploration expenditures. The Company renounces the qualifying expenditures upon the issuance of the respective flow-through common shares and accordingly is not entitled to the related taxable income deductions from such expenditures.

The Company has adopted the recommendation by the Emerging Issues Committee (“EIC”) of the CICA relating to the recording of flow-through shares. EIC 146 stipulates that future income tax liabilities resulting from the renunciation of qualified resource expenditures by the Company from the issuance of flow-through shares are recorded as a reduction of share capital. Any corresponding realization of future income tax benefits resulting in the utilization of prior year losses available to the Company not previously recorded, whereby the Company did not previously meet the criteria for recognition, are reflected as part of the Company’s operating results in the period the Company files the appropriate tax documents with the Canadian tax authorities.

Asset retirement obligations

The Company has adopted the CICA Handbook section 3110, *Asset retirement obligations*. This standard focuses on the recognition and measurement of liabilities related to obligations associated with the retirement of property, plant and equipment. Under this standard, these obligations are initially measured at fair value and subsequently adjusted for any changes resulting from the passage of time and revisions to either the timing or the amount of the original estimate of undiscounted cash flows. The asset retirement cost is to be capitalized to the related asset and amortized into earnings over time. This section became effective on January 1, 2004. Mineral property related retirement obligations are capitalized as part of deferred exploration and development costs.

3. MINERAL PROPERTIES

	September 30, 2006
OK Property, British Columbia, Canada	\$ 22,000

Title to mining properties involves certain inherent risks due to the difficulties of determining the validity of certain claims as well as the potential for problems arising from the frequently ambiguous conveyancing history characteristic of many mining properties. The Company has investigated title to all of its mineral properties and, to the best of its knowledge, title to all of its properties are in good standing.

On March 8, 2006 the Company acquired Goldrush Resource Corp.’s (“Goldrush”) option with Eastfield Resource Corp. (“Eastfield”) whereby Goldrush had the right to earn an interest in mineral exploration claims located north of Powell River in British Columbia (the “OK Property”) from Eastfield. The Company can earn a 60% interest in the OK Property from Eastfield by spending up to \$1,000,000 in exploration costs on the OK Property within four years of the date of the agreement and by making cash payments totalling \$110,000 (paid \$10,000). To acquire the option from Goldrush, the Company agreed to issue to Goldrush 100,000 shares of the Company (issued) at a value of \$12,000 and make a payment of \$10,000 on completion of its proposed Initial Public Offering.

4. DEFERRED EXPLORATION COSTS

The following exploration expenses were incurred on the OK Property during the period:

Balance, February 9, 2006	\$ -
Assays	8,794
Consulting	36,254
Field expenses	43,681
Road building	<u>13,503</u>
Balance, September 30, 2006	<u>\$ 102,232</u>

5. DEFERRED FINANCE FEES

On October 24, 2006 the Company entered into an agreement with Bolder Investment Partners, Ltd. (“Bolder”) whereby Bolder has agreed, subject to regulatory approval and certain conditions, to act as the agent to sell up to \$550,000 of the Company’s securities in an Initial Public Offering (the “Offering”). The Offering will consist of 2,200,000 shares of the Company at \$0.25 per share for gross proceeds of \$550,000. As compensation, Bolder is to receive a work fee of \$10,000 (of which \$5,000 has been paid), a corporate finance fee of 75,000 shares, a commission of 8% of the gross proceeds of the Offering, and be issued Broker’s Warrants equivalent to 10% of the number of Shares sold under the Offering, with each Broker Warrant exercisable to purchase a share at the Offering price for a period of one year from the date of the Offering.

To date the Company has incurred \$17,000 in direct costs consisting of legal and agent fees in connection with this proposed financing.

6. RELATED PARTY TRANSACTIONS

The Company entered into the following transactions with related parties:

- a) Accrued office rent of \$7,500 to a company controlled by a director of the Company.
- b) Paid \$99,232 to a private company in which a director is a 50% partner for exploration work done on the Company’s property. Included in this amount are geological consulting fees of \$2,700 which were paid to this same director.
- c) See Note 7

These transactions were in the normal course of operations and were measured at the exchange amount, which was the amount of consideration established and agreed to by the related parties.

At September 30, 2006 \$10,292 is owing to related parties. Amounts due to related parties are non-interest bearing, unsecured and have no fixed terms of repayment.

PROPHECY RESOURCE CORP.
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2006

7. SHARE CAPITAL

	Number of Shares	Amount
Authorized		
Unlimited number of common shares without par value		
Issued		
Balance at February 9, 2006	-	\$ -
Shares issued for cash at \$0.001 per share	2,650,000	2,650
Shares issued for mineral property at \$0.12 per share	100,000	12,000
Shares issued for cash at \$0.12 per share	2,450,000	294,000
Balance as at September 30, 2006	5,200,000	\$ 308,650

As at September 30, 2006, 3,050,000 common shares included in capital stock are held in escrow. The shares subject to escrow will be released as follows: 10% upon the issuance of notice of listing of the common shares for trading by the TSX-V, and the remainder in six equal tranches of 15% every six months thereafter for a period of 36 months.

On March 31, 2006 the Company issued 2,650,000 founders' shares at \$0.001 per share for proceeds of \$2,650. Management determined that the fair value of the 2,650,000 escrowed shares issued to the founders of the Company to be \$79,500, or \$0.03 per share. As a result, an amount of \$76,850 was expensed in the period to management fees.

On April 30, 2006 the Company issued 100,000 shares to Goldrush at an agreed price of \$0.12 per share. Refer to Note 3.

On June 20, 2006 the Company issued 850,000 flow-through shares at a price of \$0.12 per share for proceeds of \$102,000 pursuant to a private placement.

As at September 30, 2006, \$101,194 was expended as qualifying exploration expenditures. The Company is committed to spending a total of \$102,000 on qualifying exploration expenditures to be renounced to investors. If this is not done, certain amounts become payable to investors and the Canada Revenue Agency. The Company intends on meeting its commitment on a timely basis.

On June 23, 2006 the Company issued 1,400,000 units at a price of \$0.12 per unit for proceeds of \$168,000 pursuant to a private placement. Each unit consisted of one common share and one share purchase warrant. Each warrant is exercisable into an additional common share at a price of \$0.15 for a period of the earlier of December 23, 2007 or twelve months from the date the British Columbia Securities Commission accepts the Company's IPO prospectus. The Company has not recorded a separate value to the warrants.

On August 30, 2006 the Company issued 200,000 units at a price of \$0.12 per unit for proceeds of \$24,000 pursuant to a private placement. Each unit consisted of one common share and one share purchase warrant. Each warrant is exercisable into an additional common share at a price of \$0.15 for a period of the earlier of February 28, 2008 or twelve months from the date the British Columbia Securities Commission accepts the Company's IPO prospectus. The Company has not recorded a separate value to the warrants.

8. STOCK OPTIONS AND WARRANTS

Stock options

The Company intends to follow the policies of the TSX-V under which it would be authorized to grant options to executive officers and directors, employees and consultants enabling them to acquire up to 10% of the issued and outstanding common stock of the Company. Under the policies, the exercise price of each option equals the market price or a discounted price of the Company's stock as calculated on the date of grant. The options can be granted for a maximum term of five years. The Company has not yet granted any stock options or recorded any stock-based compensation.

8. STOCK OPTIONS AND WARRANTS (cont'd...)

Warrants

The following warrants were outstanding at September 30, 2006:

Number	Exercise Price	Expiry Date
1,400,000	\$0.15	The earlier of December 23, 2007 or twelve months from the effective date of the Company's IPO
200,000	\$0.15	The earlier of February 28, 2008 or twelve months from the effective date of the Company's IPO

The weighted average remaining life of the warrants is 1.23 years and the weighted average exercise price is \$0.15.

9. CONTRIBUTED SURPLUS

Balance, February 9, 2006	\$ -
Stock-based compensation expense (Note 7)	<u>76,850</u>
Balance, August 31, 2006	<u>\$ 76,850</u>

10. FUTURE INCOME TAXES

The actual income tax provisions differ from the expected amounts calculated by applying the Canadian combined federal and provincial corporate income tax rates to the Company's loss before income taxes. The components of these differences are as follows:

	<u>2006</u>
Loss before income taxes	\$ 98,686
Corporate tax rate	<u>34.9%</u>
	34,441
Non-capital loss carryforward	(7,620)
Non-deductible item	<u>(26,821)</u>
Future income tax provision	<u>\$ -</u>

The Company has non-capital losses of approximately \$21,000 which may be available to offset future income for income tax purposes which expire over the next ten years. In addition, there are resource-related expenditures of approximately \$101,000 which maybe be used to offset future taxable resource income indefinitely, subject to annual rates prescribed by the Canadian Income Tax Act. However, upon the renunciation of qualified resource expenditures by the Company from the issuance of flow-through shares, the resource-related expenditures will be reduced by the renounced amounts. Due to the uncertainty of realization of these loss carryforwards, the benefit is not reflected in the financial statements as the Company has provided a full valuation allowance for the potential future tax assets resulting from these loss carryforwards.

11. SUBSEQUENT EVENTS

The Company is in the process of filing an Initial Public Offering prospectus with the British Columbia Securities Commission to raise up to \$550,000, subject to regulatory approval.

On November 15, 2006 the Company granted 450,000 options to acquire 450,000 common shares of the Company at a price of \$0.25 per share. The options will expire five years from the date of listing of the Company's common shares on the TSX-V.