

PROPHECY RESOURCE CORP.

FINANCIAL STATEMENTS

SEPTEMBER 30, 2007

AUDITORS' REPORT

To the Shareholders of
Prophecy Resource Corp.

We have audited the balance sheets of Prophecy Resource Corp. as at September 30, 2007 and 2006 and the statements of operations and deficit and cash flows for the year ended September 30, 2007 and 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 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 September 30, 2007 and 2006 and the results of its operations and its cash flows for the year ended September 30, 2007 and for the period from February 9, 2006 (inception) to September 30, 2006 in accordance with Canadian generally accepted accounting principles.

“DMCL”

Vancouver, Canada
January 8, 2008

DALE MATHESON CARR-HILTON LABONTE LLP
Chartered Accountants

PROPHECY RESOURCE CORP.
BALANCE SHEETS
AS AT SEPTEMBER 30

	2007	2006
ASSETS		
Current		
Cash	\$ 28,005	\$ 157,944
Short-term investments (Note 3)	175,000	-
Receivables	24,646	4,430
Prepays	44,950	-
	272,601	162,374
Mineral property (Note 4)	69,000	22,000
Deferred exploration costs (Note 5)	498,315	102,232
Deferred finance fees (Note 7)	-	17,000
Reclamation bond (Note 4)	6,500	6,500
	\$ 846,416	\$ 310,106
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	\$ 13,158	\$ 13,000
Due to related parties (Note 6)	9,735	10,292
	22,893	23,292
SHAREHOLDERS' EQUITY		
Share capital (Note 7)	906,557	308,650
Contributed surplus (Note 7)	178,767	76,850
Deficit	(261,801)	(98,686)
	823,523	286,814
	\$ 846,416	\$ 310,106

Nature and continuance of operations (Note 1)

Commitments (Notes 4 and 10)

Subsequent events (Note 11)

Approved on behalf of the Board:

 "STUART ROGERS" Director
 Stuart Rogers

 "DONALD SHARP" Director
 Donald Sharp

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

PROPHECY RESOURCE CORP.
STATEMENTS OF OPERATIONS AND DEFICIT

	For the year ended September 30, 2007	February 9, 2006 (inception) to September 30, 2006
EXPENSES		
Consulting	\$ 480	\$ -
Office, rent and miscellaneous (Note 6)	19,953	8,354
Management fees (Note 6)	12,000	-
Management fees – stock based compensation (Notes 7 and 8)	81,696	76,850
Professional fees	26,756	13,483
Shareholder communications	27,570	-
Transfer agent and filing fees	38,345	1,727
Travel	2,474	-
LOSS BEFORE OTHER ITEM	(209,274)	(100,414)
OTHER ITEM		
Interest income	11,479	1,728
NET LOSS BEFORE INCOME TAXES	(197,795)	(98,686)
Future income tax recovery (Notes 7 and 10)	34,680	-
NET LOSS AND COMPREHENSIVE LOSS DEFICIT, BEGINNING	(163,115) (98,686)	- -
DEFICIT, ENDING	\$ (261,801)	\$ (98,686)
BASIC AND DILUTED LOSS PER COMMON SHARE		
	\$ (0.02)	\$ (0.03)
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING – BASIC AND DILUTED		
	6,947,877	3,122,008

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

PROPHECY RESOURCE CORP.
STATEMENTS OF CASH FLOWS

	For the year ended September 30, 2007	February 9, 2006 (inception) to September 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (163,115)	\$ (98,686)
Items not involving cash:		
Future income tax recovery	(34,680)	-
Management fees - stock based compensation	81,696	76,850
Changes in non-cash working capital items:		
Increase in receivables	(20,216)	(4,430)
Increase in prepaids	(44,950)	-
Increase in accounts payable and accrued liabilities	158	13,000
Net cash used in operating activities	<u>(181,107)</u>	<u>(13,266)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Short-term investments	(175,000)	-
Acquisition of mineral property	(37,000)	(10,000)
Deferred exploration costs	(396,083)	(102,232)
Reclamation bond	-	(6,500)
Net cash used in investing activities	<u>(608,083)</u>	<u>(118,732)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Deferred finance fees	-	(17,000)
Related party advances (repayments)	(557)	10,292
Shares issued, net of share issuance costs	659,808	296,650
Net cash provided by financing activities	<u>659,251</u>	<u>289,942</u>
Change in cash	(129,939)	157,944
Cash, beginning	<u>157,944</u>	<u>-</u>
Cash, ending	<u>\$ 28,005</u>	<u>\$ 157,944</u>

Supplemental disclosures with respect to cash flows (Note 9)

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

1. NATURE AND CONTINUANCE OF OPERATIONS

Prophecy Resource Corp. (the "Company") was incorporated under the Business Corporations Act (British Columbia) on February 9, 2006. The Company's Initial Public Offering (the "Offering") prospectus was filed with the British Columbia Securities Commission and became effective December 29, 2006. Pursuant to the Offering, the Company raised \$550,000 by issuing 2,200,000 shares at a price of \$0.25 per share on February 9, 2007 (Note 7) and commenced trading on the TSX Venture Exchange ("TSX-V") on February 14, 2007.

The Company is a mineral property exploration company and has not yet determined whether its mineral properties contain economically recoverable reserves. The recoverability of the amounts shown for mineral properties 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.

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.

These financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

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, expected tax rates for future income tax recoveries, the fair values of financial instruments and determining the fair value of stock based payments. Where estimates have been used financial results as determined by actual events could differ from those estimates.

Short-term investments

Short-term investments consist of highly liquid Canadian dollar denominated guaranteed investment certificates with terms to maturity greater than ninety days, but not more than one year, that are readily convertible to contracted amounts of cash. Short-term investments are classified as held-for-trading and recorded at fair value with realized and unrealized gains and losses reported in the statement of operations.

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.

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

Mineral properties (cont'd...)

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 the carrying value of 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 capitalized costs are impaired. 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.

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.

Values

The amounts shown for mineral properties and deferred exploration costs represent costs incurred to date, and do not necessarily represent present or future values which are entirely dependent upon the economic recovery from production or from disposal.

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. As at September 30, 2007 and 2006, the Company does not foresee the necessity to make any material expenditures in this area.

Asset retirement obligations

The Company has adopted the Canadian Institute of Chartered Accountants ("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.

Mineral property related retirement obligations are capitalized as part of deferred exploration and development costs and amortized over the estimated useful lives of the corresponding mineral properties.

At September 30, 2007 and 2006, management has determined that there are no material asset retirement obligations to the Company.

Deferred finance fees

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

Impairment of long-lived assets

The Company follows the recommendations of the CICA Handbook section 3063, "Impairment of Long-Lived Assets". Section 3063 establishes standards for recognizing, measuring and disclosing impairment of long-lived assets held for use. The Company conducts its impairment test on long-lived assets when events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment is recognized when the

Impairment of long-lived assets (cont'd...)

carrying amount of an asset to be held and used exceeds the undiscounted future net cash flows expected from its use and disposal. If there is an impairment, the impairment amount is measured as the amount by which the carrying amount of the asset exceeds its fair value, calculated using discounted cash flows when quoted market prices are not available.

Foreign currency translation

The financial statements are presented in Canadian dollars. 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 results of operations for the period.

Financial instruments

Effective October 1, 2006, the Company adopted CICA Handbook Sections 3855, financial instruments; Section 1530, comprehensive income and Section 3856, hedges. Section 3855 prescribes when a financial instrument is to be recognized on the balance sheet and at what amount. Under Section 3855, financial instruments must be classified into one of five categories: held-for-trading, held-to-maturity, loans and receivables, available-for-sale financial assets, or other financial liabilities. All financial instruments, including derivatives, are measured at the balance sheet date at fair value except for loans and receivables, held-to-maturity investments, and other financial liabilities which are measured at amortized cost. The adoption of these policies has not had a significant impact on the financial statement presentation or disclosures.

These standards have been applied prospectively. The adoption of these standards has not resulted in any adjustments to the carrying amounts of financial assets and financial liabilities at October 1, 2006.

The Company's financial instruments consist of cash, short-term investments, 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.

The Company has determined that it does not have derivatives or embedded derivatives.

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 CICA, "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. Any consideration paid on the exercise of stock options is credited to share capital.

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

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. For the periods presented, dilutive loss per share is equal to basic loss per share.

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.

Comparative figures

Certain comparative figures have been re-classified to conform with the current year’s presentation.

3. SHORT-TERM INVESTMENTS

Short-term investments consists of highly liquid Canadian dollar denominated guaranteed investment certificates with term to maturity of greater than ninety days but not more than one year. The counter-parties are financial institutions. At September 30, 2007, the instruments were yielding an annual interest rate of 3.80 % (2006 – 0.00%).

The fair market value of the Company’s short-term investment approximates its carrying value at the balance sheet dates.

4. MINERAL PROPERTY

	September 30, 2007	September 30, 2006
Okeover Property, British Columbia, Canada	\$ 69,000	\$ 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 property and, to the best of its knowledge, title to its property is in good standing.

On March 8, 2006 the Company acquired Goldrush Resources Ltd.’s (“Goldrush”) option with Eastfield Resources Ltd.. (“Eastfield”) whereby Goldrush had the right to earn an interest in mineral exploration claims located north of Powell River in British Columbia (the “Okeover Property”) (formerly the “OK Property”) from Eastfield.

Subject to an underlying agreement, the Company paid \$5,000 and issued 100,000 shares with a fair value of \$12,000 to Goldrush to acquire the option during the year ended September 30, 2006. Pursuant to the underlying

PROPHECY RESOURCE CORP.
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2007

4. MINERAL PROPERTY (cont'd...)

agreement, the Company paid the final \$10,000 due to Goldrush during the year ended September 30, 2007. The Company also paid \$27,000 to Eastfield for property payments.

The Company can earn a 60% interest, subject to a 2.5% net smelter royalty, in the Okeover Property from Eastfield in exchange for cash and common shares as follows:

- \$5,000 cash to be paid upon the acquisition of the option (paid during the year ended September 30, 2006, and
- \$100,000 in exploration expenditures by September 30, 2006 (completed).

The Company also has the following optional commitments:

- \$10,000 in cash or issuance of common shares by March 8, 2007 (issued common shares),
- An additional \$200,000 in exploration expenditures by September 30, 2007 (completed),
- \$20,000 in cash or issuance of common shares by March 8, 2008,
- An additional \$250,000 in exploration expenditures by September 30, 2008,
- \$25,000 in cash or issuance of common shares by March 8, 2009,
- An additional \$300,000 in exploration expenditures by September 30, 2009,
- \$50,000 in cash or issuance of common shares by March 8, 2010; and
- Have completed \$1,000,000 in cumulative exploration expenditures by March 8, 2010.

At September 30, 2007, the Ministry of Energy, Mines and Petroleum Resources of British Columbia holds a \$6,500 (2006 - \$6,500) reclamation bond from the Company to guarantee reclamation of the environment on the Okeover Property.

5. DEFERRED EXPLORATION COSTS

The following exploration expenses were incurred on the Okeover Property to September 30, 2007:

	February 9, 2006 (inception) to September 30, 2006	For the year ended September 30, 2007	Total
Assays and drilling	\$ 8,794	\$ 255,592	\$ 264,386
Consulting	36,254	68,374	104,628
Field expenses	43,681	69,424	113,105
Road building	13,503	-	13,503
Property maintenance	-	2,693	2,693
Total	\$ 102,232	\$ 396,083	\$ 498,315

6. RELATED PARTY TRANSACTIONS

The Company entered into the following transactions with related parties:

- a) Paid office rent of \$18,000 (2006 - \$7,500) to a company controlled by a director and officer of the Company;
- b) Paid management fees of \$12,000 (2006 - \$Nil) to a director and officer of the Company; and
- c) Paid \$145,774 (2006 - \$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 \$8,080 (2006 - \$2,700) which were paid to this same director.

PROPHECY RESOURCE CORP.
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2007

6. RELATED PARTY TRANSACTIONS (cont'd...)

d) 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, 2007 \$9,735 (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. The fair value of amounts due to related parties is not determinable as they have no specified repayment terms.

7. SHARE CAPITAL

	Number of Shares	Amount	Contributed Surplus	Total
Authorized				
Unlimited common shares without par value				
Issued				
Balance at February 9, 2006	-	\$ -	\$ -	\$ -
Shares issued at \$0.001 per share	2,650,000	2,650	-	2,650
Shares issued for mineral property	100,000	12,000	-	12,000
Shares issued at \$0.12 per share	2,450,000	294,000	-	294,000
Stock-based compensation	-	-	76,850	76,850
Balance as at September 30, 2006	5,200,000	308,650	76,850	385,500
Shares issued at \$0.25 per share	2,200,000	550,000	-	550,000
Shares issued for finance fee	75,000	-	-	-
Broker's warrants	-	(20,221)	20,221	-
Shares issued for mineral property	25,000	10,000	-	10,000
Shares issued at \$0.30 per share	750,000	225,000	-	225,000
Share issuance costs	-	(132,192)	-	(132,192)
Stock-based compensation	-	-	81,696	81,696
Renounced flow-through share expenditures	-	(34,680)	-	(34,680)
Balance as at September 30, 2007	8,250,000	\$ 906,557	\$ 178,767	\$ 1,085,324

During the period ended September 30, 2006, 3,050,000 common shares included in capital stock were held in escrow subject to a three year escrow agreement pursuant with TSX-V policies. During the year ended September 30, 2007, 762,500 shares were released from escrow leaving a balance of 2,287,500 in escrow pursuant to the agreement at September 30, 2007.

2007

On February 9, 2007, the Company completed its Offering and issued 2,200,000 common shares at \$0.25 per share for gross proceeds of \$550,000. The Company had entered into an agreement with Bolder Investment Partners, Ltd. ("Bolder") whereby Bolder agreed, subject to regulatory approval and certain conditions, to act as the agent for the Offering. As compensation, Bolder received a work fee of \$10,000, a corporate finance fee of 75,000 shares at a fair value of \$18,750, a commission of 8% of the gross proceeds of the Offering, and was issued warrants (the "broker's warrants") equivalent to 10% of the number of shares sold under the Offering (220,000), 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. The broker's warrants have been recorded as share issuance costs at a fair value of \$20,221. As at September 30, 2006

7. SHARE CAPITAL (cont'd...)

2007 (cont'd...)

the Company had incurred \$17,000 in direct costs consisting of legal and agent fees in connection with this proposed financing. On completion of the Offering, these deferred finance charges were charged to share issuance costs. During the current year, the Company incurred additional share issuance costs in the amount of \$61,192.

On March 8, 2007 the Company issued 25,000 shares at a fair value of \$10,000 with respect to an option payment on the Okeover property (Note 4).

On May 11, 2007 the Company issued 750,000 flow-through units at a price of \$0.30 per share for proceeds of \$225,000 pursuant to a private placement. Each unit consisted of one flow-through common share and one share purchase warrant. Each warrant is exercisable into an additional non-flow-through common share at a price of \$0.40 until May 11, 2009. The fair value of the warrants was estimated to be \$22,500 (10% of the proceeds received from the private placement), this estimate has not been recorded as a separate component of shareholders' equity.

2006

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 (Note 4).

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, 2007, \$102,000 was expended as qualifying exploration expenditures. This amount was sufficient to meet the Company's commitment on qualifying exploration expenditures to be renounced to investors. For income tax purposes, the subscription funds relating to the flow-through shares have been applied towards carrying out qualifying Canadian exploration activities in accordance with the Canadian Income Tax Act. The tax deductions and credits available for the expenditures are renounced in favour of the subscribers.

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 until December 23, 2007. The fair value of the warrants was estimated to be \$16,800 (10% of the proceeds received from the private placement), this estimate has not been recorded as a separate component of shareholders' equity.

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 until December 29, 2007. The fair value of the warrants was estimated to be \$2,400 (10% of the proceeds received from the private placement), this estimate has not been recorded as a separate component of shareholders' equity.

Flow-through shares

In accordance with accounting recommendations relating to the issuance of flow-through shares (Note 2), the Company reduced from flow-through share proceeds assigned to share capital and recognized as a future tax liability, the estimated tax effect of the timing difference resulting from renouncing exploration expenditures using currently enacted tax rates and laws.

7. SHARE CAPITAL (cont'd...)

Flow-through shares (cont'd...)

Concurrently the Company recognized a future income tax recovery from the utilization of available tax losses of prior periods to offset the future tax liability recognized. The Company has not previously recognized tax benefits relating to losses of prior periods as the criteria for recognition had not been met.

8. STOCK OPTIONS AND WARRANTS

Stock options

The Company follows 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 expenses the fair value of all stock-based compensation awards as determined using the Black-Scholes option pricing model. During the year ended September 30, 2007, the Company granted 450,000 incentive stock options to officers and directors. These options may be exercised within 5 years at a price of \$0.25 per share. The granting of these 450,000 incentive stock options resulted in stock-based compensation expense, calculated using the Black-Scholes option pricing model, of \$81,696 which has been recorded as compensation expense on the statement of operations.

The following assumptions were used for the Black-Scholes valuation of stock options and agents' warrants granted during the year:

	2007	2006
Risk-free interest rate	4.09%	-
Expected life	1 - 5 years	-
Annualized volatility	92%	-
Dividend yield	0%	-

The following options were outstanding at September 30, 2007:

Number of Shares	Exercise Price	Expiry Date
450,000	\$0.25	February 14, 2012

Stock option transactions are summarized as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Life Remaining (in years)
Balance, February 9, 2006 and September 30, 2006	-	\$ -	-
Options granted	450,000	0.25	-
Balance, September 30, 2007	450,000	0.25	4.62
Number of options exercisable at September 30, 2007	450,000	\$ 0.25	4.62

PROPHECY RESOURCE CORP.
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2007

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

Warrants

The following warrants were outstanding at September 30, 2007:

Number	Exercise Price	Expiry Date
1,400,000	\$0.15	December 23, 2007 (Note 11(b))
200,000	\$0.15	December 29, 2007 (Note 11(c))
220,000	\$0.25	February 9, 2008
750,000	\$0.40	May 11, 2009

The weighted average remaining life of the warrants is 0.65 years and the weighted average exercise price is \$0.23.

Warrant transactions and the number of warrants are summarized as follows:

	Number of Warrants	Weighted Average Exercise Price	Weighted Average Life Remaining (in years)
Balance, February 9, 2006	-	\$ -	-
Issued	1,600,000	0.09	-
Balance, September 30, 2006	1,600,000	0.09	0.15
Issued	970,000	0.14	-
Balance, September 30, 2007	2,570,000	0.23	0.65

9. SUPPLEMENTAL DISCLOSURE WITH RESPECT TO CASH FLOWS

	2007	2006
Cash paid during the year for interest	\$ -	\$ -
Cash paid during the year for income taxes	\$ -	\$ -

The significant non-cash transactions during the year ended September 30, 2007 included:

- a) Reallocating \$17,000 from deferred finance fees to share capital as share issuance costs.
- b) Issuing 25,000 shares with a fair value of \$10,000 with respect to an option payment on the Okeover Property (Note 4).
- c) Recording broker's warrants as share issuance costs at a fair value of \$20,221 (Note 7).
- d) Issuing 75,000 shares with a fair value of \$18,750 to Bolder (Note 7).

The significant non-cash transaction during the period ended September 30, 2006 included the Company issuing 100,000 shares at a fair value of \$12,000 with respect to the Okeover Property (Note 4).

PROPHECY RESOURCE CORP.
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2007

10. INCOME TAXES

	2007	2006
Net loss	\$ (197,795)	\$ (98,686)
Expected income tax recovery at 34.12% (2006 – 34.90%)	\$ (67,448)	\$ (34,441)
Non-deductible items	27,858	7,620
Unrecognized benefit of non-capital losses	<u>4,910</u>	<u>26,821</u>
Future income tax recovery	\$ 34,680	\$ -

The significant components of the Company's future income tax assets and liabilities are as follows:

	2007	2006
Canadian exploration and development expenses	\$ (35,000)	\$ -
Non-capital losses	54,000	34,000
Share issuance costs	<u>41,000</u>	<u>-</u>
	60,000	34,000
Valuation allowance	<u>(60,000)</u>	<u>(34,000)</u>
Net future tax assets	\$ -	\$ -

The Company has non-capital losses of approximately \$159,000 which may be available to offset future income for income tax purposes which commence expiring in 2027. Due to the uncertainty of realization of these loss carry-forwards, 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 carry-forwards.

During the year ended September 30, 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. The flow-through subscription agreements required the Company to renounce certain tax deductions for Canadian exploration expenditures incurred on the Company's mineral properties to the flow-through participants. The Company filed the renunciation documentation for \$102,000 of expenditures to the subscribers during 2006 which was effective December 31, 2006. Accordingly, \$34,680, being the taxable benefit renounced, has been charged as a reduction to share capital (Note 7). Concurrent with the renunciation, the Company realized a future tax benefit equal to the amount renounced. The realized tax benefit is recorded as a future income tax recovery during the year ended September 30, 2007, in accordance with CICA emerging issue pronouncement EIC-146.

During the year ended September 30, 2007, the Company issued 750,000 flow-through units at a price of \$0.30 per share for proceeds of \$225,000 pursuant to a private placement (Note 7). The Company is committed to expending the funds on qualifying exploration in accordance with the provisions of the Canadian Income Tax Act. As at September 30, 2007, the Company has \$Nil of cash on hand relating to its unexpended 2007 flow-through commitments.

11. SUBSEQUENT EVENTS

PROPHECY RESOURCE CORP.
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2007

The following events occurred subsequent to September 30, 2007:

- a) On November 2, 2007 the Company completed a non-brokered private placement of 1,450,000 flow-through units at a price of \$0.35 per unit for gross proceeds of \$507,500. Each unit consists of one common share of the Company and one half share purchase warrant, with each full warrant exercisable into one additional common share of the Company for a period of eighteen months from closing at an exercise price of \$0.45 per share. Finder's fees of \$37,800 were paid on a portion of this placement along with the issuance of 108,000 finder's warrants, exercisable at \$0.35 per share until April 30, 2009. The fair value of the warrants was estimated to be \$50,750 (10% of the proceeds received from the private placement).
- b) Of the 1,400,000 warrants outstanding at September 30, 2007, 1,200,000 warrants were exercised for proceeds of \$180,000 and 200,000 warrants expired unexercised.
- c) 200,000 warrants outstanding at September 30, 2007 were exercised for proceeds of \$30,000.
- d) The Company entered into an investor relations service agreement for a minimum three month term at \$8,000 per month, plus reimbursement of approved expenses. The Company has also agreed to grant 200,000 incentive stock options exercisable at a price of \$0.25 for a period of two years. The agreement is subject to acceptance for filing by the TSX-V.