

**PROPHECY RESOURCE CORP.**

**FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2008**

## AUDITORS' REPORT

To the Shareholders of  
Prophecy Resource Corp.

We have audited the balance sheets of Prophecy Resource Corp. as at September 30, 2008 and 2007 and the statements of operations, comprehensive loss and deficit and cash flows for the years ended September 30, 2008 and 2007. 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, 2008 and 2007 and the results of its operations and its cash flows for the years ended September 30, 2008 and 2007 in accordance with Canadian generally accepted accounting principles.

*DMCL*

Vancouver, Canada  
November 24, 2008

**DALE MATHESON CARR-HILTON LABONTE LLP**  
Chartered Accountants



**PROPHECY RESOURCE CORP.**  
**STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT**

	For the year ended September 30, 2008	For the year ended September 30, 2007
<b>EXPENSES</b>		
Consulting	\$ -	\$ 480
Investor relations – stock-based compensation (Note 10)	13,133	-
Office, rent and miscellaneous (Note 8)	20,990	19,953
Management fees (Note 8)	17,000	12,000
Management fees – stock based compensation (Note 10)	-	81,696
Professional fees	41,440	26,756
Shareholder communications	79,055	27,570
Transfer agent and filing fees	19,460	38,345
Travel	96	2,474
<b>LOSS BEFORE OTHER ITEM</b>	(191,174)	(209,274)
<b>OTHER ITEM</b>		
Interest income	11,148	11,479
<b>LOSS BEFORE INCOME TAXES</b>	(180,026)	(197,795)
Future income tax recovery (Notes 9 and 12)	104,700	34,680
<b>NET LOSS AND COMPREHENSIVE LOSS</b>	(75,326)	(163,115)
<b>DEFICIT, BEGINNING</b>	(261,801)	(98,686)
<b>DEFICIT, ENDING</b>	\$ (337,127)	\$ (261,801)
<b>BASIC AND DILUTED LOSS PER COMMON SHARE</b>	\$ (0.01)	\$ (0.02)
<b>WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING – BASIC AND DILUTED</b>	10,677,036	6,947,877

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

**PROPHECY RESOURCE CORP.**  
**STATEMENTS OF CASH FLOWS**

	For the year ended September 30, 2008	For the year ended September 30, 2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss	\$ (75,326)	\$ (163,115)
Items not involving cash:		
Future income tax recovery	(104,700)	(34,680)
Investor relations – stock-based compensation	13,133	81,696
Changes in non-cash working capital items:		
Decrease (increase) in receivables	21,802	(20,216)
Decrease (increase) in prepaids	40,000	(44,950)
Increase in accounts payable and accrued liabilities	838	158
Decrease in due to related parties	(9,735)	(557)
Net cash used in operating activities	(113,988)	(181,664)
<b>CASH FLOWS USED IN INVESTING ACTIVITIES</b>		
Short-term investments	5,000	(175,000)
Acquisition of mineral property	(20,000)	(37,000)
Deferred exploration costs	(560,930)	(396,083)
Net cash used in investing activities	(575,930)	(608,083)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Shares issued, net of share issuance costs	679,700	659,808
Net cash provided by financing activities	679,700	659,808
<b>Decrease in cash</b>	(10,218)	(129,939)
<b>Cash, beginning</b>	28,005	157,944
<b>Cash, ending</b>	\$ 17,787	\$ 28,005

**Supplemental disclosures with respect to cash flows** (Note 11)

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 and trades publicly on the TSX Venture Exchange ("TSX-V").

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.

### **Government Grants**

Government assistance is recorded as either a reduction of the cost of the applicable assets or credited in the statement of operations as determined by the terms and conditions of the agreement under which the assistance is provided to the Company. Claims for tax credits are accrued upon the Company attaining reasonable assurance of collection from the Canadian tax authorities.

### **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.

**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, 2008 and 2007, management has determined that there are no material asset retirement obligations to the Company.

**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 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 year.

**Financial instruments**

On October 1, 2007, the Company adopted CICA Handbook Sections 3855 and 3861, financial instruments and Section 3856, hedges. Sections 3855 and 3861 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

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

**Financial instruments (cont'd...)**

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 Company's financial instruments consist of cash, short-term investments, receivables, accounts payable and due to related parties. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest, currency risks, or credit risks arising from these financial instruments. The Company has made the following classifications for the financial instruments:

- (i) Cash and short-term investments – held-for-trading; measured at fair value;
- (ii) Receivables recorded at amortized cost; and
- (iii) Accounts payable and due to related parties – other financial liabilities; recorded at amortized cost.

Fair Value estimates are made at the balance sheet date, based on relevant market information and other information about financial instruments.

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 Handbook Section 3870, "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.

**Comprehensive income**

The Company adopted CICA Handbook Section 1530, "Comprehensive Income". Section 1530 establishes standards for the reporting and presenting of comprehensive income which is defined as the change in equity from transaction and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income that are excluded from net income (loss). At September 30, 2008 and 2007 the Company had no significant items that caused other comprehensive loss to be different than net loss.

**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.

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

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

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.

**Change in accounting policies**

On December 1, 2006, the Canadian Institute of Chartered Accountants (“CICA”) issued three new accounting standards: Capital Disclosures (Handbook Section 1535), Financial Instruments – Disclosures (Handbook Section 3862), and Financial Instruments – Presentation (Handbook Section 3863). These new standards became effective for the Company on October 1, 2007.

*Capital Disclosures*

Handbook Section 1535 specifies the disclosure of (i) an entity’s objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has not complied with any capital requirements; and (iv) if it has not complied, the consequences of such noncompliance. The Company has included disclosures recommended by the new Handbook section in Note 4 to these financial statements.

*Financial Instruments*

Handbook Sections 3862 and 3863 replace Handbook Section 3861, Financial Instruments – Disclosure and Presentation, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. The Company has included disclosures recommended by the new Handbook sections in Note 5 to these financial statements.

**Recent accounting pronouncements**

The CICA accounting standards board amended Handbook Section 1400, “General standards of financial statement presentations”, to include requirements for management to assess and disclose an entity’s ability to continue as a going concern. This section applies to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2008. The Company does not expect the adoption of this amendment to have a significant impact on its financial statements.

In 2006, the Canadian Accounting Standards Board (“AcSB”) published a strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian generally accepted accounting principles with International Financial Reporting Standards (“IFRS”) over an expected five year transitional period. In February 2008, the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canada’s own generally accepted accounting principles. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The transition date of January 1, 2011 will require the restatement for comparative purposes of amounts reported by the Company for the year ended September 30, 2010. The Company continues to monitor and assess the impact of Canadian GAAP and IFRS.

**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, 2008, the instruments were yielding an annual interest rate of 2.80 % (2007 – 3.80%).

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

#### **4. CAPITAL MANAGEMENT**

The Company manages its capital structure and makes adjustments to it, based on the funds available to the Company, in order to support the acquisition, exploration and development of mineral properties. The Board of Directors does not establish quantitative return on capital criteria for management, but rather relies on the expertise of the Company's management to sustain future development of the business.

The property in which the Company currently has an interest is in the exploration stage; as such the Company is dependent on external financing to fund its activities. In order to carry out the planned exploration and pay for administrative costs, the Company will spend its existing working capital and raise additional amounts as needed. The Company will continue to assess new properties and seek to acquire an interest in additional properties if it feels there is sufficient geologic or economic potential and if it has adequate financial resources to do so.

Management reviews its capital management approach on an ongoing basis and believes that this approach, given the relative size of the Company, is reasonable.

There were no changes in the Company's approach to capital management during the year ended September 30, 2008. The Company is not subject to externally imposed capital requirements.

#### **5. FINANCIAL INSTRUMENTS**

##### **Financial Risk Management**

The Company is exposed in varying degrees to a variety of financial instrument related risks.

##### *Credit Risk*

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss. The Company's primary exposure to credit risk is on its bank accounts and short-term investments, whose balance at September 30, 2008 were \$17,787 and \$170,000 respectively. Bank accounts are held with a major bank in Canada. As all of the Company's cash is held by a Canadian bank and all the short-term investments are also held by the same Canadian bank, there is a concentration of credit risk with one bank in Canada. This risk is managed by using a major bank that is a high credit quality financial institution as determined by rating agencies. The Company's secondary exposure to credit risk is on its receivables. This risk is minimal as receivables consist primarily of refundable government sales taxes.

##### *Currency Risk*

The Company operates in Canada and is therefore not exposed to foreign exchange risk arising from transactions denominated in a foreign currency.

##### *Interest Rate Risk*

The Company is exposed to interest rate risk as bank accounts and short-term investments earn interest income at variable rates. The fair value of its portfolio is relatively unaffected by changes in short term interest rates. The income earned on these bank accounts is subject to the movements in interest rates. A +/- 1% change in interest rates would have an effect on the loss before taxes for the year ended September 30, 2008 of approximately +/- \$1,900.

##### *Liquidity Risk*

Liquidity risk arises through the excess of financial obligations over available financial assets due at any point in time. The Company's objective in managing liquidity risk is to maintain sufficient readily available reserves in order to meet its liquidity requirements at any point in time. The Company achieves this by maintaining sufficient cash and short-term investments. As at September 30, 2008, the Company was holding cash of \$17,787 and short-term investments of \$170,000.

**PROPHECY RESOURCE CORP.**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008**

**6. MINERAL PROPERTY**

	September 30, 2008	September 30, 2007
Okeover Property, British Columbia, Canada	\$ 89,000	\$ 69,000

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") 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 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),
- \$20,000 in cash or issuance of common shares by March 8, 2008 (paid),
- \$25,000 in cash or issuance of common shares by March 8, 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 (completed).

At September 30, 2008, the Ministry of Energy, Mines and Petroleum Resources of British Columbia holds a \$6,500 (2007 - \$6,500) reclamation bond from the Company to guarantee reclamation of the environment on the Okeover Property.

**7. DEFERRED EXPLORATION COSTS**

The following exploration costs were incurred on the Okeover Property to September 30, 2008:

	Assays and drilling	Consulting	Field expenses	Road building	Property maintenance	Other	Total
September 30, 2006	\$ 8,794	\$ 36,254	\$ 43,681	\$ 13,503	\$ -	\$ -	\$ 102,232
Additions	255,592	68,374	69,424	-	2,693	-	396,083
September 30, 2007	264,386	104,628	113,105	13,503	2,693	-	498,315
Additions	323,793	95,577	131,697	12,213	2,957	-	566,237
Government grants	-	-	-	-	-	(45,965)	(45,965)
September 30, 2008	\$ 588,179	\$ 200,205	\$244,802	\$ 25,716	\$ 5,650	\$ (45,965)	\$ 1,018,587

**PROPHECY RESOURCE CORP.**  
NOTES TO THE FINANCIAL STATEMENTS  
SEPTEMBER 30, 2008

**8. RELATED PARTY TRANSACTIONS**

The Company entered into the following transactions with related parties:

- a) Paid office rent of \$19,000 (2007 - \$18,000) to a company controlled by a director and officer of the Company;
- b) Paid management fees of \$17,000 (2007 – \$12,000) to a director and officer of the Company; and
- c) Paid \$226,660 (2007 - \$145,774) to a private company in which a director is a 50% partner for exploration work incurred on the Company’s property.

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, 2008 \$5,307 (2007 - \$9,735) was 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.

**9. SHARE CAPITAL**

	Number of Shares	Amount	Contributed Surplus	Total
Authorized				
Unlimited common shares without par value				
Issued				
Balance 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 at September 30, 2007	8,250,000	906,557	178,767	1,085,324
Shares issued at \$0.35 per share	1,450,000	507,500	-	507,500
Finder’s warrants	-	(7,005)	7,005	-
Share issuance costs	-	(37,800)	-	(37,800)
Shares issued on exercise of warrants at \$0.15	1,400,000	210,000	-	210,000
Stock-based compensation	-	-	13,133	13,133
Renounced flow-through share expenditures	-	(190,450)	-	(190,450)
Balance as at September 30, 2008	11,100,000	\$ 1,388,802	\$ 198,905	\$ 1,587,707

As at September 30, 2008, 1,372,500 (2007 – 2,287,500) common shares included in share capital were held in escrow subject to a three year escrow agreement pursuant to TSX-V policies.

**9. SHARE CAPITAL (cont'd...)**

**2008**

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 consisted 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 granting of these 108,000 finder's warrants resulted in stock-based compensation expense, calculated using the Black-Scholes option pricing model, of \$7,005 which has been charged to share issuance costs. The Company has included the fair value of the warrants in share capital.

During the year ended September 30, 2008 at total of 1,400,000 warrants were exercised for proceeds of \$210,000.

**2007**

On February 9, 2007, the Company completed its Initial Public Offering (the "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 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 year ended September 30, 2007, 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 6).

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 Company has included the fair value of the warrants in share capital.

**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.

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.

**10. 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.

**PROPHECY RESOURCE CORP.**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008**

**10. STOCK OPTIONS AND WARRANTS (cont'd...)**

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, 2008, the Company granted 200,000 (2007 - 450,000) incentive stock options to consultants, directors and officers. These options may be exercised within 2-5 years at a price of \$0.25 per share. The fair value of the 200,000 stock options granted during the year ended September 30, 2008 was estimated at \$15,759 (2007 - \$81,696) and had a vesting provision which allocates the amount of compensation to be recorded over a twelve month service period. During the year ended September 30, 2008, the Company recognized \$13,133 (2007 - \$81,696) in compensation expense related to these options. The weighted average fair value of the stock options granted was \$0.08 (2007 - \$0.18).

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

	2008	2007
Risk-free interest rate	3.55%	4.09%
Expected life	1.5 – 2 years	1-5 years
Annualized volatility	52%	92%
Dividend yield	0%	0%

The following options were outstanding at September 30, 2008:

Number of Shares	Exercise Price	Expiry Date
450,000	\$0.25	February 14, 2012
200,000	\$0.25	December 4, 2009

Stock option transactions are summarized as follows:

	Number of Options Outstanding	Number of Options Exercisable	Weighted Average Exercise Price
Balance, September 30, 2006	-	-	\$ -
Options granted	450,000	450,000	0.25
Balance, September 30, 2007	450,000	450,000	0.25
Options granted	200,000	166,667	0.25
Balance, September 30, 2008	650,000	616,667	0.25

The weighted average life remaining of the stock options outstanding and exercisable at September 30, 2008 are 2.70 and 2.78 years, respectively.

**Warrants**

The following warrants were outstanding at September 30, 2008:

Number	Exercise Price	Expiry Date
750,000	\$0.40	May 11, 2009
725,000	\$0.45	April 30, 2009
108,000	\$0.35	April 30, 2009

**PROPHECY RESOURCE CORP.**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008**

**10. STOCK OPTIONS AND WARRANTS (cont'd...)**

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, September 30, 2006	1,600,000	\$ 0.09	0.15
Issued	<u>970,000</u>	0.14	-
Balance, September 30, 2007	2,570,000	0.23	0.65
Issued	833,000	0.44	-
Exercised	(1,400,000)	0.15	-
Expired	<u>(420,000)</u>	0.20	-
Balance, September 30, 2008	<u>1,583,000</u>	<u>\$ 0.42</u>	<u>0.59</u>

**11. SUPPLEMENTAL DISCLOSURE WITH RESPECT TO CASH FLOWS**

	2008	2007
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, 2008 included:

- a) Recording finder's warrants as share issuance costs at a fair value of \$7,005 (Note 9).
- b) Recording in due to related parties \$5,307 for deferred exploration expenditures.
- c) Recording a mining tax refund of \$45,965.

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 6).
- c) Recording agent's warrants as share issuance costs at a fair value of \$20,221 (Note 9).
- d) Issuing 75,000 shares with a fair value of \$18,750 to Bolder (Note 9).

**PROPHECY RESOURCE CORP.**  
NOTES TO THE FINANCIAL STATEMENTS  
SEPTEMBER 30, 2008

**12. INCOME TAXES**

	2008	2007
Net loss before income taxes	\$ (180,026)	\$ (197,795)
Expected income tax recovery at 31.80% (2007 – 34.12%)	\$ (57,248)	\$ (67,448)
Non-deductible items	(7,829)	27,858
Share issuance costs	36,525	-
Tax credits earned	(34,933)	-
Tax rate change	19,672	-
Change in valuation allowance	<u>(60,887)</u>	<u>4,910</u>
Future income tax expense (recovery)	\$ (104,700)	\$ (34,680)

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

	2008	2007
Canadian exploration expenses	\$ (205,000)	\$ (35,000)
Investment tax credits	23,000	-
Non-capital losses	96,250	54,000
Share issuance costs	<u>-</u>	<u>41,000</u>
	(85,750)	60,000
Valuation allowance	<u>-</u>	<u>(60,000)</u>
Net future tax liability	\$ (85,750)	\$ -

The Company has non-capital losses of approximately \$370,000 which may be available to offset future income for income tax purposes which commence expiring in 2026. 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, 2008, the Company issued 1,450,000 flow-through units at a price of \$0.35 per share for proceeds of \$507,500 pursuant to a private placement (Note 9). The flow-through subscription agreements required the Company to renounce certain tax deductions for Canadian exploration expenditures incurred on the Company's mineral property to the flow-through participants. The Company filed the renunciation documentation for \$507,500 of expenditures to the subscribers during 2008 which was effective December 31, 2007. Accordingly, \$190,450, being the taxable benefit renounced, has been charged as a reduction to share capital (Note 9). Concurrent with the renunciation, the Company realized a future tax benefit. The realized tax benefit was recorded as a future income tax recovery during the year ended September 30, 2008, 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 9). 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 \$225,000 of expenditures to the subscribers during 2007 which was effective December 31, 2006. Accordingly, \$34,680, being the taxable benefit renounced, has been charged as a reduction to share capital (Note 9). Concurrent with the renunciation, the Company realized a future tax benefit. The realized tax benefit was recorded as a future income tax recovery during the year ended September 30, 2007, in accordance with CICA emerging issue pronouncement EIC-146.

**PROPHECY RESOURCE CORP.**  
NOTES TO THE FINANCIAL STATEMENTS  
SEPTEMBER 30, 2008

---

**12. INCOME TAXES** (cont'd...)

As at September 30, 2008, the Company has satisfied its flow-through commitments and has fulfilled its commitment to expend the funds on qualifying exploration in accordance with the provisions of the Canadian Income Tax Act.

During the year ended September 30, 2008, the Company has applied for a mining tax refund from the Government of British Columbia of \$45,965 for exploration work incurred on the Okeover property.