

**CANADIAN PHOENIX RESOURCES CORP.**  
**(formerly Arapahoe Energy Corporation)**

Financial Statements

For the years ended December 31, 2007 and 2006

# CANADIAN PHOENIX RESOURCES CORP.

## Balance Sheets

See accompanying notes to financial statements

	Dec 31 2007 \$	Dec 31 2006 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash	1,285,235	8,238
Cash held in trust (note 4)	17,775,000	—
Accounts receivable and accruals	661,834	2,559,906
Advance receivable - Serrano (note 5)	900,000	—
Prepaid expenses	158,400	367,752
	<u>20,780,469</u>	<u>2,935,896</u>
<b>Property, plant and equipment</b> (note 6)	<u>32,643,473</u>	<u>36,294,996</u>
	<u>53,423,942</u>	<u>39,230,892</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	3,514,400	8,731,639
Notes payable	—	525,000
Operating loan payable (note 8)	1,980,000	4,905,000
Current tax payable	90,000	120,000
	<u>5,584,400</u>	<u>14,281,639</u>
Long term debt – debentures (note 9)	9,019,153	—
Future income tax liability (note 10)	1,947,086	3,645,749
Asset retirement obligation (note 7)	565,906	556,300
	<u>17,116,545</u>	<u>18,483,688</u>
<b>Shareholders' Equity</b>		
Share capital (note 11)	40,496,130	21,892,645
Warrants (note 11)	2,445,731	—
Deficit	(8,795,550)	(2,846,860)
Contributed surplus (note 11)	2,161,086	1,701,419
	<u>36,307,397</u>	<u>20,747,204</u>
	<u>53,423,942</u>	<u>39,230,892</u>
<b>Commitments &amp; contingencies</b> (note 13)		
<b>Going concern</b> (note 1)		
<b>Subsequent events</b> (note 16)		

Approved by the Board of Directors

Robert Chenery

Robert Chenery, Director

Barry Lee

Barry Lee, Director

**CANADIAN PHOENIX RESOURCES CORP.**  
**Statements of Operations, Comprehensive Loss, and Deficit**

See accompanying notes to financial statements

	Year ended December 31	
	2007	2006
	\$	\$
<b>Revenue</b>		
Oil and gas	5,446,928	5,451,865
Royalties	(1,311,176)	(1,273,172)
	<b>4,135,752</b>	<b>4,178,693</b>
<b>Expenses</b>		
Operating costs	1,521,503	1,447,909
Depletion, depreciation and accretion	3,473,770	1,816,940
Stock based compensation	459,668	443,868
General and administrative	5,121,184	1,549,347
Interest accretion – debentures (note 9)	3,085,917	—
Interest expense	380,149	283,185
Loss on disposal of subsidiary	—	87,067
	<b>14,042,191</b>	<b>5,628,316</b>
<b>Other income</b>		
Other income (note 9)	1,241,991	29,935
<b>Net loss for the year before taxes</b>	(8,664,448)	(1,419,688)
<b>Current income tax (expense)recovery</b>	30,000	(120,000)
<b>Future income tax recovery</b>	2,685,758	1,165,181
<b>Net loss and comprehensive loss for the year</b>	<b>(5,948,690)</b>	<b>(374,507)</b>
<b>Deficit, beginning of year</b>	(2,846,860)	(2,472,353)
<b>Deficit, end of year</b>	<b>(8,795,550)</b>	<b>(2,846,860)</b>
<b>Net loss per share</b>		
<b>Basic and Diluted (note 11)</b>	<b>(0.104)</b>	<b>(0.01)</b>
<b>Going concern (note 1)</b>		

# CANADIAN PHOENIX RESOURCES CORP.

## Statements of Cash Flows

See accompanying notes to financial statements

	Year ended December 31	
	2007	2006
<b>Cash provided by (used in)</b>	\$	\$
<b>Operating activities</b>		
Net loss for the year	(5,948,690)	(374,507)
Items not affecting cash		
Depletion, depreciation & accretion	3,473,770	1,816,940
Stock-based compensation	459,668	443,868
Payable settled with debentures	—	—
Payable settled with shares	—	—
Interest accretion on debentures	3,085,917	—
Loss on disposal of subsidiary	—	87,067
Current tax recovery	(30,000)	—
Future tax recovery	(2,685,758)	(1,165,181)
Funds from operations	(1,645,093)	808,187
Change in non-cash working capital	(4,367,922)	241,820
	<b>(6,013,015)</b>	<b>1,050,007</b>
<b>Financing activities</b>		
(Decrease)/increase in bank loan	(2,925,000)	4,905,000
Issuance of common shares for cash, net of costs	22,036,312	4,222,421
Long term debenture issue	5,933,235	—
Net change in non-cash financing activities working capital	—	(63,883)
	<b>25,044,547</b>	<b>9,063,538</b>
<b>Investing activities</b>		
Acquisition of petroleum and natural gas properties	(793,688)	(18,286,417)
Proceeds from disposal of petroleum and natural gas properties	981,046	4,010,734
Restricted cash	(17,775,000)	—
Net change in non-cash investing activities	(166,893)	3,101,355
	<b>(17,754,535)</b>	<b>(11,174,328)</b>
<b>Increase (decrease) in Cash</b>	1,276,997	(1,060,783)
<b>Cash, beginning of year</b>	8,238	1,069,021
<b>Cash, end of year</b>	<b>1,285,235</b>	<b>8,238</b>
<b>Taxes paid</b>	—	—
<b>Interest paid</b>	380,149	283,185

## 1. BASIS OF PRESENTATION AND GOING CONCERN

Canadian Phoenix Resources Corp. (the "Corporation") is engaged in the exploration, development and production of oil and natural gas in Canada. Effective January 3, 2008 pursuant to Section 173(3) of the Business Corporations Act (Alberta), the corporation changed its name from Arapahoe Energy Corp. to Canadian Phoenix Resources Corp.

### Going concern

These financial statements have been prepared in accordance with GAAP on a going concern basis, which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. Should the Corporation be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due.

The Corporation reported a loss of \$5,948,690 and a net operating cash outflow of \$1,645,093 for year ended December 31, 2007. However, the company had a positive working capital of \$15,196,069 at December 31, 2007.

The Corporation has a number of significant transactions which will impact the future results of its operations and its ability to continue to report under the going concern basis:

1. On February 1, 2008, the Corporation executed a term sheet with Serrano Energy Ltd. ("Serrano"), an oil and natural gas company, replacing the transaction contemplated in the purchase agreement dated August 15, 2007 (Note 16).
2. On February 21, 2008, the Corporation entered into a non-binding letter of intent with Marble Point Energy Ltd. ("Marble Point"), which was further amended on April 16, 2008, whereby the Corporation would acquire not less than 60% of Marble Point through a series of transactions (Note 16).
3. On March 17, 2008, the Corporation issued 202,398,000 units at a price of \$0.125 per unit for gross proceeds of \$25.3 million (Note 16).
4. As at April 3rd, 2008, the Corporation issued 100,425,408 common shares in conversion of \$8,368,784 of secured convertible debentures (Note 16).

There can be no assurance that the Corporation will be sufficiently funded after these initiatives are executed. These circumstances create uncertainty as to the ability of the Corporation to meet its obligations as they come due and accordingly, there is doubt as to the appropriateness of the use of accounting principles applicable to a going concern. The accompanying 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 Corporation be unable to continue in existence. Such adjustments could be material.

## **2. ACCOUNTING POLICIES**

The financial statements of the Corporation are stated in Canadian dollars and have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amount of revenues and expenses during the year. Actual results could differ from these estimates.

### **a) Property, plant and equipment**

#### **(i) Petroleum and natural gas properties**

The Corporation follows the full cost method of accounting for petroleum and natural gas properties, whereby all costs of exploring for and developing petroleum and natural gas reserves are capitalized. Costs include land acquisition costs, geological and geophysical costs, carrying charges on non-productive properties, costs of drilling both productive and non-productive wells.

The capitalized costs, less undeveloped land costs, are depleted using the unit-of-production method based upon estimated proved petroleum and natural gas reserves before royalties as determined by independent engineers. Production and reserves of natural gas are converted to equivalent barrels of crude oil on the basis of six thousand cubic feet of gas to one barrel of oil.

At least annually, the Corporation’s net capitalized costs of property, plant and equipment (PP&E) is subject to an impairment test. Impairment is recognized if the carrying amount of the net PP&E exceeds the sum of the undiscounted future net cash flows expected to result from proved reserves (ceiling test). Cash flows are calculated based on an estimate of future prices and costs. In circumstances of impairment, the impairment would be calculated as the amount by which carrying amounts of the PP&E exceed the estimated net present value of future cash flows from proved plus risked probable reserves. In circumstances of impairment, the calculated impairment would be charged to current operations as additional depletion. The cost of unproved properties and major development projects are excluded from the ceiling test calculation and subject to a separate impairment test.

#### **(ii) Asset retirement obligations**

The Corporation recognizes the fair value of the liability for asset retirement obligations in the period it is incurred with a corresponding increase to the carrying amount of the related asset. The fair value of the obligation is calculated as the present value of the expected future costs of the abandonment and reclamation. The liability is increased each reporting period through the accretion of interest up to the future amount of the liability. The charge for accretion is recorded as an expense. The addition to the carrying amount of the asset is amortized on the same basis as PP&E. Actual costs incurred upon settlement of the retirement obligation are charged against the liability.

### **b) Revenue recognition**

Revenues from the sale of crude oil, natural gas and natural gas liquids are recorded when title passes to a third party.

**c) Joint venture**

A significant portion of the Corporation's activities are conducted within unincorporated joint ventures. The accounts reflect the Corporation's proportionate interest in such activities.

**d) Cash and cash equivalents**

Cash and cash equivalents include cash, and money market instruments that carry terms less than 91 days at the date of investment.

**e) Flow-through shares**

Tax deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. Share capital is reduced, with a corresponding increase to the future tax liability, by the estimated cost of the tax deductions when applicable documentation has been filed.

**f) Future income taxes**

Income taxes are calculated using the liability method of tax accounting. Temporary differences arising from the difference between the tax basis of an asset or liability and its carrying amount on the balance sheet are used to calculate future income tax assets and liabilities. Future income tax assets and liabilities are calculated using tax rates anticipated to apply in the years that the temporary differences are expected to reverse.

**g) Stock-based compensation plans**

Stock options granted to directors, officers, employees and consultants are accounted for using the fair value method under which compensation expense is recorded based on the estimated fair value of the options at the grant date using the Black-Scholes option pricing model. Compensation cost is expensed over the vesting period with a corresponding increase in contributed surplus. When stock options are exercised, the cash proceeds along with the amount previously recorded as contributed surplus are recorded as share capital.

**h) Per share amounts**

Net loss per share is calculated using the weighted average number of shares outstanding during the year. Diluted net loss per share is calculated using the treasury stock method to determine the dilutive effect of stock options and warrants. The treasury stock method assumes that the proceeds received from the exercise of "in-the-money" stock options and warrants are used to purchase common shares at the market price at the end of the year.

**i) Use of estimates and measurement uncertainty**

The preparation of the financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts and presentation of assets, liabilities, revenues, expenses and disclosures of contingencies and commitments. Such estimates primarily relate to unsettled transactions and events at the balance sheet date which are based on information available to management at each financial statement date. Actual results could differ from those estimated.

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The amounts recorded for depletion and depreciation of property, plant and equipment, the provision for asset retirement obligations, and the amounts used for the impairment test calculations are based on estimates of reserves and future costs. The Corporation's reserve estimates are reviewed annually by an independent engineering firm. The estimate related to asset retirement obligations requires estimates of the amount and timing of future abandonment liabilities, inflation, and interest rates. The recognition of amounts in relation to stock-based compensation requires estimates related to volatility of the Corporation's share price, expected lives of options and other relevant assumptions at the time of issuance. Future taxes require estimates as to the realization of future tax assets and the timing of reversal of tax assets and liabilities.

By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the financial statements for current and future periods could be significant.

**j) New standards**

On January 1, 2007, the Corporation adopted the Canadian Institute of Chartered Accountants (CICA) handbook section 1530 "Comprehensive Income," section 3251 "Equity," section 3855 "Financial Instruments – Recognition and Measurement" and section 3865 "Hedges." These standards result in changes in the accounting for financial instruments and hedges as well as introduce comprehensive income as a separate component of shareholders' equity. As required, these standards have been adopted prospectively and comparative amounts for the prior periods have not been restated.

**k) Future accounting changes**

The CICA issued three new accounting standards, section 1535 "Capital Disclosures", section 3862 "Financial Instruments – Disclosures", and section 3863 "Financial Instruments – Presentation". These standards become effective for Canadian Phoenix in the first quarter of 2008. Section 1535 requires the disclosure of the company's objectives, policies and processes for managing capital. This includes qualitative information regarding the corporation's objectives, policies and processes for managing capital and quantitative data about what the company manages as capital. These disclosures are based on information that is provided internally to the corporation's key management. Sections 3862 and 3863 replace section 3861 "Financial Instruments – Disclosure and Presentation" which revises and enhances financial instruments disclosure requirements and leaves 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 Canadian Phoenix manages those risks.

**3. CHANGE IN ACCOUNTING POLICIES**

Effective January 1, 2007, the Corporation adopted the new CICA accounting standards as set out in Handbook section 1530 "Comprehensive Income," section 3251 "Equity," section 3855 "Financial Instruments – Recognition and Measurement" and section 3865 "Hedges." The Corporation has adopted these standards prospectively and as such the comparative financial statements have not been restated.

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The adoption of these standards had no effect on the Corporation's net income or cashflows or on opening retained earnings or accumulated other comprehensive income.

a) Financial instruments - recognition and measurement:

The new standard prescribes when a financial asset, financial liability or non-financial derivative is to be recognized on the balance sheet and at what amount, requiring fair value or cost-based measures under different circumstances. Financial instruments must be classified into one of the following 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 and non-financial derivatives are measured in the balance sheet at fair value except for loans and receivables, and other financial liabilities which are measured at amortized cost determined using the effective interest rate method. Subsequent measurement and changes in fair value will depend on their initial classification, as follows: held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net earnings; available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the investment is derecognized or impaired at which time the amounts are recorded in net earnings.

Under adoption of these standards, the Corporation classified its cash as held-for-trading, which is measured at fair value. Accounts receivable are classified as loans and receivables, which are measured at amortized cost. Accounts payable and long term debt are classified as other financial liabilities, which are measured at amortized cost.

b) Derivatives:

All derivative instruments, including embedded derivatives, are recorded on the balance sheet at fair value unless exempted from derivative treatment as a normal purchase and sale. All changes in the fair value of derivative instruments are recorded in earnings unless cash flow hedge accounting is used, in which case changes in fair value are recorded in other comprehensive income.

c) Other comprehensive income

The new standards require a new statement of comprehensive income, which is comprised of net earnings and other comprehensive income. The Corporation has combined this new statement with the statement of operations.

d) Effective interest rate method

Transaction costs attributable to financial instruments classified as other than held-for-trading are included in the recognized amount of the related financial instrument and recognized over the life of the resulting financial instrument.

#### **4. CASH HELD IN TRUST**

On December 31, 2007, the Corporation closed the issuance of 102,200,000 flow-through common shares for total proceeds of \$12,775,001 and the issuance of 40,000,000 warrant units of the Corporation for total proceeds of \$5,000,000. Due to the late closing of the transactions, the funds were held in trust by the Corporation's legal counsel until the first banking day in January 2008.

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**5. ADVANCE RECEIVABLE**

During the year ended December 31, 2007, the Corporation advanced to Serrano Energy Ltd. a total of \$900,000 to be treated as a contribution against the cumulative net operating revenue from the property. Upon closing, net operating revenue between June 1, 2007 and the closing date will be calculated to determine the adjusted purchase price.

**6. PROPERTY, PLANT AND EQUIPMENT**

	<b>Cost</b>	<b>Accumulated Depreciation Depletion Accretion</b>	<b>Dec 31, 2007 Net Book Value</b>	<b>Dec 31, 2006 Net Book Value</b>
<b>P&amp;NG Properties</b>	<b>\$ 37,811,904</b>	<b>\$ 5,334,553</b>	<b>\$ 32,477,351</b>	<b>\$ 36,049,462</b>
<b>Field vehicle</b>	<b>25,000</b>	<b>14,587</b>	<b>10,413</b>	<b>14,875</b>
<b>Office assets</b>	<b>281,337</b>	<b>125,627</b>	<b>155,710</b>	<b>230,659</b>
<b>TOTAL</b>	<b>\$ 38,118,241</b>	<b>\$ 5,474,767</b>	<b>\$ 32,643,474</b>	<b>\$ 36,294,996</b>

The depletion calculation excluded major development projects of \$7,176,493 (December 31, 2006 - \$18,653,361). The Corporation has not capitalized any general and administrative expenses for the years ended December 31, 2007 or 2006.

The company based its estimates on the future price quotas for U.S. gas at Nymex, adjusted for heat content and basis differential and for Canadian gas at the AECO price to the end of 2012 and held constant thereafter. Oil prices used were WTI for U.S. properties and Edmonton Light for Canadian properties, both adjusted for quality differentials

**Price Estimates Used for Ceiling Test**

	<b>Nymex (\$U.S./Mcf)</b>	<b>AECO (\$Cdn/Mcf)</b>	<b>Edmonton Light (\$Cdn/Bbl)</b>	<b>Hardistry Heavy (\$Cdn/Bbl)</b>	<b>WTI (\$U.S./Bbl)</b>
2008	7.75	6.69	89.50	54.30	90.00
2009	8.35	7.29	86.01	52.31	86.52
2010	8.25	7.18	84.34	52.13	84.87
2011	8.20	7.13	82.78	51.28	83.32
2012	8.30	7.19	82.23	50.88	82.78

The application of the impairment test to unproved properties at December 31, 2007 resulted in an impairment of \$6,744,214. The amount of impairment has been included in the costs subject to depletion.

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**7. ASSET RETIREMENT OBLIGATION**

The future asset retirement obligations were estimated by management based on the Corporation's working interest in its wells, estimated costs to remediate, reclaim and abandon the wells and estimated timing of the costs to be incurred in future periods. The Corporation has estimated the net present value of its total asset retirement obligation to be \$565,906 at December 31, 2007 (December 31, 2006 - \$556,300). These costs are expected to be incurred over the next three to thirty-four years. The Corporation's risk-free interest rate of 9.85% and an inflation rate of 2.2% were used to calculate the net present value of asset retirement obligation.

The following table provides a reconciliation of the carrying amount of the obligation associated with the retirement of oil and gas properties:

	<b>Dec 31 2007</b>	<b>Dec 31 2006</b>
Asset retirement obligation, beginning of year	\$ 556,300	\$ 359,384
Liabilities incurred/acquired (disposed) during year	(74,922)	141,286
Adjustments to estimates	35,597	-
Accretion expense	48,931	55,630
<b>Asset retirement obligation, end of year</b>	<b>\$ 565,906</b>	<b>\$ 556,300</b>

**8. BANK LOAN**

The Corporation has a revolving line of credit with the National Bank of Canada. The facility reduced by \$250,000 per month, which commenced on April 30, 2007. At December 31, 2007 the Corporation had an available amount of \$3,050,000. At December 31, 2007 the Corporation has drawn \$1,980,000. The full facility bears interest at the lenders' prime rate plus 1% and is secured with a general security agreement over the property and assets of the Corporation. During the year ended December 31, 2007, the Corporation incurred interest on this facility totaling \$380,148.

**9. DEBENTURE FINANCING**

On April 11, 2007, the Corporation entered into a Trust Indenture for the issuance of convertible secured subordinated debentures. The Corporation issued the following debentures during the year ended December 31, 2007:

	April tranche	Debt Settlement	June tranche	Total
Total debentures issued for cash	8,650,000	923,734	1,550,000	11,123,734
Cash commission	(645,676)	—	(108,500)	(754,176)
Bank charges	—	—		

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			(10)	(10)
Net proceeds (cash/debt settlement)	8,004,324	923,734	1,441,490	10,369,548

In total, 11,123,734 debenture units were issued (“Initial Debenture Units”) at the per unit price of \$1.00 per unit. The gross proceeds of the debenture issue were \$11,123,734 with net cash proceeds of \$9,445,814 and a reduction of trade payables of \$923,734 after issuance costs. Each Initial Debenture Unit entitles the holder to a repayment amount of \$1.50/unit and four Warrants. The repayment amount is due and payable to the unit holders on April 11, 2009. Each whole Warrant entitles the holder to purchase one common share of the Corporation for \$0.125 with an expiry date of April 11, 2009, subject to other terms and conditions of the Trust Indenture. The Initial Debenture Units accrue interest at a rate of 20% per annum from April 11, 2008 (subsequently revised to May 1, 2008) until maturity on April 11, 2009 or the date of conversion, whichever is earlier.

A gain on settlement, shown as other income on the statement of operations, arose from the negotiations with trade payables which included an option of accepting a cash reduction on amounts outstanding or a combination of debenture units and cash.

On March 5, 2008, the debenture holders approved the transaction involving Serrano Energy Ltd. (as described in note 13) constituting a Business Combination Transaction as defined in the trust indenture and thereby obliging the conversion of each \$1.00 invested in the debenture into 12 common shares of the Corporation concurrent with the completion of the transaction with Serrano Energy Ltd.

Upon conversion, brokers of the issue will be entitled to an equivalent amount of broker warrants at 10% of the total debentures converted to common shares with an exercise price of \$0.0833 per share.

The Corporation’s Initial Debenture Unit’s are classified as debt with a portion of the proceeds allocated to equity representing the value of the detachable warrants and conversion rights. If the Initial Debenture Units are granted the conversion option, and these convertible debentures are converted to equity, the debt component will be transferred to share equity. Prior to conversion, the debt component accretes over time to the amount owing at maturity with such increases appearing as interest accretion on the statement of operations.

The following table summarizes financial reporting of the Initial Debenture Units:

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**Debentures**

	<u>Equity Component</u>		Debt Component
	Warrants	Conversion Rights	
Opening carrying value, April 11, 2007	755,933	3,628,613	6,739,188
Placement costs	(51,251)	(246,016)	(456,909)
Broker warrants	(37,974)	(182,284)	(338,545)
Adjusted opening carrying value, April 11, 2007	666,708	3,200,313	5,943,734
April 11 to December 31, 2007 interest accretion			3,075,418
Carrying value, December 31, 2007	666,708	3,200,313	9,019,151
Carrying value, April 11, 2009 (assumes no conversion to equity)	666,708	3,200,313	18,910,348

**10. FUTURE INCOME TAXES**

Under the terms of a flow-through share issue in December 2007, the Corporation is obligated to incur Canadian Exploration Expenditures in the amount of \$12,775,001 prior to December 31, 2008. The full amount of \$12,775,001 has been renounced to the subscribers at December 31, 2007.

Under the terms of a flow-through share issued in 2006, the Corporation was obligated to incur Canadian Exploration Expenditures in the amount of \$4,150,510. As at December 31, 2007, the Corporation considers it has fulfilled all expenditure obligations related to this issue. All renouncements to subscribers was completed at December 31, 2006, however the future income tax liability of \$1,079,132 was recorded in 2007 when the regulatory filings were mailed.

The future income tax liability is made up of the excess of the accounting amounts over the related tax bases of the Corporation's property, plant and equipment and share capital.

The provision for future income taxes is different from the amount computed by applying the combined statutory Canadian federal and provincial tax rates to the pre-tax income for the year. The differences are as follows:

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	<b>2007</b>	<b>2006</b>
Statutory combined federal and provincial income tax rates	33.47%	37.06%
Expected income taxes	\$ (2,864,312)	\$ (526,136)
Add (deduct) the income tax effect of:		
Non-deductible expenses	32,458	–
Resource allowance	–	(54,435)
Stock-based compensation	153,850	164,497
Rate adjustments	(15,509)	(745,113)
Other	7,755	(3,994)
<b>Future income taxes recovery</b>	<b>\$ (2,685,758)</b>	<b>\$ (1,165,181)</b>

The significant components of the future income tax liability as at December 31 are as follows:

	<b>2007</b>	<b>2006</b>
Future income tax assets:		
Asset retirement obligation	\$ 137,880	\$ 172,515
Share issue costs	374,958	420,676
Non-capital losses carried forward	2,415,315	1,548,013
	<u>2,928,153</u>	<u>2,141,204</u>
Future income tax liabilities:		
Property, plant and equipment	4,875,238	5,786,953
	<b>\$ 1,947,085</b>	<b>\$ 1,890,546</b>

The measurement of the Corporation's income tax liability and tax asset pools requires interpretation of complex laws and regulations. All tax filings and compliance with tax regulations are subject to audit and reassessment, potentially several years after the initial filing. Accordingly, actual income tax assets and liabilities may differ significantly from the amounts initially estimated.

As at December 31, 2007, the Corporation has approximately \$9,289,670 million of non-capital losses available for deduction against future taxable income, as indicated below

<u>Year of Expiry</u>	<u>Amount</u>
2008	\$439,747
2009	\$409,508
2010	\$826,785
2011	\$1,141,791
2015	\$1,270,066
2027	\$5,201,773

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**11. SHARE CAPITAL**

**a) Authorized**

Unlimited number of common voting shares of no par value

Unlimited number of preferred shares of no par value

**b) Issued and outstanding**

	<u># Shares</u>	<u>\$ Value</u>
<b>Balance – December 31, 2005</b>	<b>47,787,710</b>	<b>20,661,024</b>
Exercise of warrants	1,132,322	452,929
Flow Through shares issued for cash	5,615,400	3,650,010
Flow Through shares issued for cash	770,000	500,500
Share issue costs	—	(381,019)
Share issue costs – tax effect	—	118,299
Stock-based compensation – Warrants	—	(9,700)
Tax effect flow through renoucement	—	(3,099,398)
<b>Balance – December 31, 2006</b>	<b>55,305,432</b>	<b>21,892,645</b>
Shares issued for debt settlement	1,500,000	189,475
Value of equity component – brokers warrants, April 14, 17/2007 - June 14/2007	—	558,803
Value of equity component – debenture warrants April 14, 17/2007- June 14/2007	—	666,708
Value of equity component – debenture conversion rights April 14, 14/2007- June 14/2007	—	3,200,313
Flow-through common shares issued (i)	102,200,000	12,775,001
Common share units issued in private placement (ii)	40,000,000	3,779,779
Value of equity component-common share warrants	—	1,220,221
Share issue costs (2007 Flow Through)	—	(353,988)
Share issue costs (2006 Flow Through)	—	92,036
Tax effect flow through renoucement (2006)	—	(1,079,132)
<b>Balance – December 31, 2007</b>	<b>199,005,432</b>	<b>42,941,861</b>

- (i) On December 28, 2007, 102,200,000 flow-through common shares were issued at a price of \$0.125 per share for total proceeds of \$12,775,001, before fees and expenses. The terms of this issue require the Corporation to renounce to subscribers Canadian Exploration Expenditures in the amount of \$12,775,001 to be incurred before December 31, 2008.
- (ii) On December 28, 2007, 40,000,000 units of the Corporation were issued at a price of \$0.125 per unit for total proceeds of \$5,000,000. Each unit consists of one common share and one common share purchase warrant. Each warrant entitles the holder to purchase one common share during the period expiring on December 31, 2008 at an exercise price of \$0.20 per share.

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**c) Stock Option Plan**

The Corporation has a stock option plan, under which the Corporation may grant options to its employees, directors and consultants for up to 20% of the total shares of common stock issued and outstanding at time of option grant. The number of options and the exercise price thereof is set by the Board of Directors at the time of grant, provided that the exercise price shall not be less than the market price of the common shares on the stock exchange on which such shares are then traded. The options granted may be exercisable for a period and may vest at such times as the Board of Directors may determine at the time of grant.

A summary of the status of the Corporation's stock option plan as at December 31, 2007 and changes during the year ended December 31, 2007:

		<b>2007</b>
	<b># Shares</b>	<b>Weighted average exercise price \$</b>
Outstanding – beginning of year	4,503,181	0.12
Granted during year	5,281,000	0.125
Expired during year	(895,834)	(.02)
Cancelled during year	(1,069,166)	(0.53)
<b>Outstanding – end of year</b>	<b>7,819,181</b>	<b>0.08</b>

The following table summarizes information about stock options outstanding at December 31, 2007:

<b>Exercise price</b>	<b>Options outstanding # Outstanding Dec. 31, 2007</b>	<b>Options outstanding Weighted average remaining contractual life in years</b>	<b>Options outstanding Weighted average exercise price at Dec. 31, 2007</b>	<b>Options exercisable Number exercisable</b>	<b>Options exercisable Weighted average exercise price</b>
\$0.125 - \$0.76	7,819,181	4.06	\$0.26	3,781,764	\$0.40
	<b>7,819,181</b>			<b>3,781,764</b>	

Compensation cost of \$459,668 has been recognized in 2007 for stock options granted. These costs have been recorded as stock based compensation expense with the offsetting amount being credited to contributed surplus. The fair value for options granted to employees and directors was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following assumptions:

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Volatility factor of expected market price	107.45%
Weighted average risk-free interest rate	4.01%
Weighted average expected life in years	5.0
Weighted average expected annual dividends per share	Nil

**d) Warrants**

A summary of the status of the Corporation's warrants as at December 31, 2007 and changes during the year ended December 31, 2007:

	# Warrants	2007 Weighted average exercise price \$
Outstanding – beginning of year	638,540	0.65
Issued	44,494,936	0.125
Issued	40,000,000	0.20
Expired	—	-
<b>Outstanding – end of year</b>	<b>85,133,476</b>	<b>0.164</b>

The following table summarizes information about warrants outstanding at December 31, 2007:

Exercise price	Warrants outstanding # Outstanding Dec. 31, 2007	Warrants outstanding Weighted average remaining contractual life in years	Warrants outstanding Weighted average exercise price at Dec. 31, 2007	Warrants exercisable Number exercisable	Warrants exercisable Weighted average exercise price
\$0.65	638,540	.35	\$0.65	638,540	\$0.65
\$0.125	44,494,936	1.15	\$0.125	44,494,936	\$0.125
\$0.20	40,000,000	1.0	\$0.20	40,000,000	\$0.20
	<b>85,133,476</b>			<b>85,133,476</b>	

There were 44,494,936 warrants issued during the year ended December 31, 2007 as part of the debenture issue (note 11). There were also 40,000,000 warrants issued on December 31, 2007.

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The associated costs of these warrants have been included within interest expense being accreted over the 24 month life of the debentures.

The debenture warrants have been capitalized within share capital bearing a value of \$666,708. The warrants issued on December 31, 2007 have been capitalized within share capital bearing a value of \$1,824,721. The treatment of the warrants as an equity component reduced the carrying value of the debt component of the debentures. The carrying value of the debenture warrants was calculated using a Black-Scholes Option Pricing Model with the following assumptions:

Volatility factor of expected market price	107.45%
Weighted average risk-free interest rate	4.00%
Weighted average expected life in years	0
Weighted average expected annual dividends per share	Nil

**e) Contributed surplus**

	<b>Year ended Dec. 31, 2007</b>
Balance December 31, 2006	1,701,419
Options granted	459,668
Warrants granted	-
<b>Balance Dec. 31, 2007</b>	<b>2,161,086</b>

**f) Per share amounts**

For the year ended December 31, 2007 the weighted average number of shares were 56,049,268 (2006- 52,238,294). Diluted earnings per share reflect the exercise of options and warrants as if issued at the later of the date of grant or the beginning of the year. This calculation takes into account only the options and warrants that are considered in-the-money at December 31, 2007. Given the share price at December 31, 2007, no options or warrants were considered to be dilutive and therefore were not factored into the weighted average number of shares. The diluted weighted average number of shares for the year ended December 31, 2007 was 252,997,339 (2006 – 52,238,294).

**12. RISK MANAGEMENT ACTIVITIES**

Substantially all of the Corporation's accounts receivable are due from companies in the oil and gas industry and are subject to the normal industry credit risks. The carrying value of accounts receivable reflects management assessment of the associated risks.

### **13. COMMITMENTS & CONTINGENCIES**

- a) At December 31, 2007, there was an outstanding legal proceeding filed against the Corporation. An industry partner filed a claim in the amount of approximately \$1.3 million and the Corporation filed a counterclaim in the amount of \$200,000. The ultimate settlement of the dispute and amounts owed is dependent upon the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time. The adjustment, if any, on resolution of this matter will be accounted for in the period of determination.
- b) At December 31, 2007, the Corporation had an obligation to incur \$12,775,001 of qualifying exploration expenditures by December 31, 2008 in relation to a flow-through share issuance. At December 31, 2007, \$nil had been incurred with respect to this commitment.

### **14. RELATED PARTY TRANSACTIONS**

Effective December 31, 2007, the lease agreement with Kinghorn Resources Ltd. was terminated and the deposit in the amount of \$204,000 was surrendered. During the year ended December 31, 2007, the Corporation paid \$234,276 to Kinghorn in relation to the lease agreement (2006 - \$236,928).

### **15. FINANCIAL INSTRUMENTS**

The Company's financial instruments that are included in the balance sheet are comprised of cash, accounts receivable and all current liabilities.

#### *Fair Values of Financial Assets and Liabilities*

The fair values of financial instruments that are included in the balance sheet approximate their carrying amount due to the short-term maturity of those instruments.

#### *Credit Risk*

A substantial portion of the Company's accounts receivable are with customers in the oil and gas industry and are subject to normal industry credit risks.

#### *Interest Rate Risk*

The Company is exposed to risks from interest rate fluctuation on its bank loan.

## 16. SUBSEQUENT EVENTS

- a) On February 1, 2008, the Corporation executed a term sheet with Serrano Energy Ltd. (“Serrano”), an oil and natural gas company, replacing the transaction contemplated in the purchase agreement dated August 15, 2007. Pursuant to the term sheet:
- i. the Corporation will sell a certain producing heavy oil property to Serrano, with an effective date of June 1, 2007, in exchange for 7.0 million shares of Serrano at a deemed price of \$5.00 per share (the “Sale Transaction”);
  - ii. the Corporation will subscribe for 2.0 million shares of Serrano at a price of \$5.00 per share (the “Subscription Transaction”); and
  - iii. the Corporation will farm-in on certain qualifying Canadian exploration expenditures on Serrano properties of up to \$5.0 million and receive 2.0 million Serrano shares. The Company will have the right and obligation to subscribe for and purchase from treasury on September 30, 2008, that number of Serrano common shares equal to the \$5.0 million not spent under the farm-ins at September 30, 2008 divided by \$5. On or before September 30, 2013, Serrano has the right to exercise on the purchase of the working interests earned on by the Corporation for \$1 (the “Farm-in Transaction”).

The Corporation and Serrano entered into agreements dated April 28, 2008 in respect of the sale of the Sale Transaction and the Subscription Transaction. As at April 29<sup>th</sup>, 2008, the Corporation has advanced \$3.4 million to Serrano for consideration against the purchase and sale adjustments due on closing of the Sale Transaction which includes a secured deposit of \$1 million. The Corporation has also entered into participation agreements with Serrano in respect of the Farm-in Transaction and has incurred expenditures in the aggregate amount \$2.9 Million. It is anticipated that the Sale Transaction and the Subscription Transaction will be completed following a meeting of the shareholders in the second or third quarter of 2008. After closing the Sale Transaction, the Subscription Transaction and the Farm-in Transaction, the Corporation will own 11 million shares of Serrano or approximately 50.1% of the then issued and outstanding shares of Serrano. The completion of the transactions with Serrano is subject to a number of conditions, including but not limited to, TSX Venture Exchange acceptance and, if required pursuant to TSX Venture Exchange requirements and shareholder approval.

- b) On February 8, 2008, the Corporation granted certain officers and directors stock options to purchase 3,180,000 common shares. All options have an exercise price of \$0.125, vest 25% immediately and 25% on each of the 6, 12 and 18 month anniversaries of the grant and expire on February 6, 2013.
- c) On February 21, 2008, the Corporation entered into a non-binding letter of intent with Marble Point Energy Ltd. (“Marble Point”), which was further amended on April 16, 2008, whereby the Corporation would acquire not less than 60% of Marble Point through a series of transactions:

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- i. Marble Point proposes to conduct a private placement of up to 100 million preferred shares at a price of \$0.65 per share, concurrent with a financing proposed by the Corporation, each preferred share redeemable by Marble Point in certain events by the issue of a promissory note in the amount of \$0.65.
  - ii. The Corporation would issue up to 433 million units to the subscribers of the Marble Point preferred shares in consideration of the promissory notes received by such subscribers upon redemption of the preferred shares. Each unit will be issued at a deemed price of \$0.15 per unit and will be comprised of one common share of the Corporation and one purchase warrant. Each warrant will entitle the holder to purchase one additional common share of the Corporation at a price of \$0.20 per share on or before the earlier of the date that is two years from the completion of a private placement and 30 days after the Corporation has given notice of early termination.
  - iii. The Corporation would subscribe for 90 Million common shares of Marble Point at the price of \$0.65, representing a total subscription amount of \$58.5 Million or approximately 60% of the outstanding shares.
  - iv. The Corporation has provided a guarantee to Ionic Capital Corp. with respect to Marble Point's obligations under a \$35 million secured credit facility with Ionic Capital Corp. Marble Point borrowed an initial \$7.25 million under this facility and the Corporation has issued 4,381,753 common shares to Ionic Capital Corp. at a deemed price of \$0.14895 in partial consideration of the fees associated with the initial advance. The shares will be held in escrow and released upon successful completion of the transaction with Marble Point.
  - v. The Corporation and Marble Point entered a corporate governance agreement pursuant to which the Corporation's nominees shall join Marble Point's board of directors and the pre-emptive right to participate and purchase up to its pro-rata share in any equity securities distributions by Marble Point. The corporate governance agreement also sets out Marble Point's reporting obligations, which includes providing the Corporation with monthly performance reports, financial statements and MD&A. The corporate governance agreement also includes covenants of Marble Point to not carry out certain types of actions without the consent of the Corporation, including amending its articles or by-laws, debt or equity financings and material asset sale and dispositions. In addition, Marble Point has the right under the corporate governance agreement to nominate one person to the board of directors of the Corporation and the Corporation is provided a pre-emptive right to participate in any future equity issuances of Marble Point to avoid dilution of its ownership position.
- d) It is anticipated that the transaction with Marble Point will be completed following a meeting of the shareholders in the second or third quarter of 2008. The completion of the transactions with Marble Point is subject to a number of conditions, including but not limited to, TSX Venture Exchange acceptance and, if required pursuant to TSX Venture Exchange requirements and shareholder approval.

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- e) On March 17, 2008, the Corporation issued 202,398,000 units at a price of \$0.125 per unit for gross proceeds of \$25.3 million. Each unit consists of one common share of the Corporation and one common share purchase warrant entitling the warrant holder to purchase one common share of the Corporation at an exercise price of \$0.15 per common share, expiring on March 17, 2010. If the closing price of the Corporation's shares on the TSX Venture Exchange is at least \$0.25 for a minimum period of 30 trading days, the Corporation may reduce the exercise period to that date which is 30 days following the date on which the warrant holders receive notice of the shortened exercise period.
- f) On March 14, 2008, the Corporation settled a dispute with a former executive of the Corporation and issued 1,000,000 common shares as part of the settlement.
- g) As at April 22, 2008, the Corporation issued 107,083,128 common shares in conversion of \$8,923,594 of secured convertible debentures. The Corporation is entitled to convert the balance of the debentures that remain outstanding, which will result in the issue of an additional 26,401,680 common shares.
- h) A statement of claim has been filed against the Corporation by a working interest holder in lands which the Corporation operates and has oil and gas working interests. At this time there can be no assurance or quantification of the outcome of this action against the Corporation. No accrual has been made within these financial statements
- i) During the first quarter of 2008, the Corporation advanced \$350,000 to First West Petroleum Inc. by way of a series of promissory notes, which are secured by general security arrangements in favour of the Corporation over the assets of First West..