KENARTHA OIL AND GAS COMPANY LIMITED

FINANCIAL STATEMENTS

MARCH 31, 2006 AND 2005

Hilborn Ellis Grant LLP
Chartered Accountants
Toronto, Ontario

Hilborn Ellis Grant LLP
Chartered Accountants

Auditors' Report

To the Shareholders of
Kenartha Oil and Gas Company Limited

We have audited the balance sheets of **Kenartha Oil and Gas Company Limited** as at March 31, 2006 and 2005 and the statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

Hilborn Ellis Grant LLP

Toronto, Ontario
July 14, 2006

Chartered Accountants

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KENARTHA OIL AND GAS COMPANY LIMITED

Balance Sheets

March 31	2006 $	2005 $
ASSETS		
Current assets		
Cash and short term investments (note 5)	**1,295,867**	16,785
Accounts receivable	**3,000**	15,701
Deposits and advances (notes 10(e) and (f))	**31,782**	58,150
Prepaid expenses	**3,645**	4,645
	1,334,294	95,281
Investment in flow-through shares (note 3)	**127,760**	-
Equipment (note 4)	**43,777**	62,482
Natural gas properties, exploration and development (note 5)	**367,605**	-
	1,873,436	157,763
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities	**97,843**	125,489
Notes payable (note 6)	**178,500**	140,500
	276,343	265,989
Future income taxes (note 7)	**424,944**	-
	701,287	265,989
SHAREHOLDERS' EQUITY (DEFICIENCY IN ASSETS)		
Capital stock (note 9)	**3,556,240**	2,427,000
Deficit	**(2,384,091)**	(2,535,226)
	1,172,149	(108,226)
	1,873,436	157,763

Approved on behalf of the Board:

"Ernest W. Harrison", Director

"Marty Martinello", Director

KENARTHA OIL AND GAS COMPANY LIMITED

Statements of Income

Years ended March 31	2006 $	2005 $
Revenue		
Sales of natural gas	**201,313**	204,126
Interest income	**4,726**	-
	206,039	204,126
Expenses		
Amortization	**18,704**	21,580
Interest (note 6)	**14,612**	6,476
Management fees (note 8(b))	**24,288**	25,168
General and administrative	**15,930**	17,764
Professional fees	**11,500**	7,950
Rent	**14,953**	14,546
Field supplies and maintenance (note 8(b))	**45,090**	40,127
Production royalties (note 8a))	**51,156**	50,728
	196,233	184,339
Income before income taxes	**9,806**	19,787
Income taxes (recovery)		
Current	**-**	11,369
Future (note 7)	**(141,329)**	-
Recovery due to prior years losses	**-**	(11,369)
	(141,329)	-
Net income for year	**151,135**	19,787
Basic income per share	**0.0210**	0.0025
Weighted average number of shares outstanding	**7,981,790**	7,895,790

Statements of Retained Earnings

Years ended March 31	2006 $	2005 $
Deficit, beginning of year	**(2,535,226)**	(2,555,013)
Net income for year	**151,135**	19,787
Deficit, end of year	**(2,384,091)**	(2,535,226)

Statements of Cash Flows

Years ended March 31	2006 $	2005 $
Cash flows from operating activities		
Net income for year	**151,135**	19,787
Item not affecting cash		
Amortization	**18,704**	21,580
	169,839	41,367
Changes in non-cash working capital items		
Decrease in accounts receivable	**12,701**	8,061
Increase in deposits and advances	**26,368**	(47,000)
Decrease in prepaid expenses	**1,000**	-
Increase (decrease) in accounts payable and accrued liabilities	**(27,645)**	17,094
Increase in future income taxes	**424,944**	-
	607,207	19,522
Cash flows from investing activities		
Purchase of investment in flow-through shares, net	**(127,760)**	-
Purchase of equipment	-	(12,000)
Increase in natural gas properties exploration and development	**(367,605)**	-
	(495,365)	(12,000)
Cash flows from financing activities		
Increase in notes payable	**38,000**	-
Proceeds on issuance of common shares, net (note 9)	**1,129,240**	-
	1,167,240	-
Increase in cash and short term investments	**1,279,082**	7,522
Cash and short term investments, beginning of year	**16,785**	9,263
Cash and short term investments, end of year	**1,295,867**	16,785

Supplementary Disclosure of Cash Flow Information

	2006 $	2005 $
Interest paid	**14,612**	6,476
Income taxes paid	-	-

March 31, 2006 and 2005

1. **Basis of presentation**

These financial statements have been prepared on a going concern basis, which contemplates that the company will be able to discharge its liabilities in the normal course of operations.

In order to continue in operation, the company requires extended payment terms on the amount due to a corporation, which is a member of the controlling group and the amount due under the note payable.

2. **Significant accounting policies**

(a) **Capitalized costs**

The company follows the full cost method of accounting whereby all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized in a Canadian cost centre and charged against income as discussed below. Such costs include lease acquisition costs, geological and geophysical expenditures, lease rentals on non-productive properties, cost of drilling both productive and non-productive wells, equipment costs and general and administrative expenses applicable to these activities.

Gains or losses on sales of properties are recognized only when crediting the proceeds to costs would result in a change of 20 percent or more in the depletion and amortization rate.

(b) **Flow through shares**

The company has issued flow-through shares to finance its exploration expenditure program. Pursuant to the terms of the flow-through share agreements, the tax deductions associated with the expenditures have been renounced to the subscribers. Accordingly, share capital is reduced and a future income tax liability is recorded equal to the estimated amount of future income taxes payable by the company as a result of the renunciations.

(c) **Per share information**

Per share information is calculated on the basis of the weighted average number of shares outstanding during the period.

(d) **Investments**

The company follows the cost method of accounting for its investments, written down for any impairment in value that is considered other than temporary.

2. **Significant accounting policies (continued)**

(e) **Equipment**

Equipment are recorded at cost. The company provides for amortization using the declining balance method at rates designed to amortize the cost of the equipment over their estimated useful lives. The annual amortization rates are as follows:

Equipment	20 %
Pipeline	20 %
Compressor	30 %

(f) **Future income taxes**

Income taxes are calculated using the liability method of tax allocation accounting. Temporary differences arising from the difference between the tax basis of an asset or liability and its carrying value on the balance sheet are used to calculate future income tax liabilities or assets. Future income tax liabilities or assets are calculated using tax rates anticipated to apply in the periods that the temporary differences are expected to reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that substantive enactment occurs. To the extent that the company does not consider it to be more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

(g) **Financial instruments**

The carrying amount of the company's financial instruments, consisting of cash and short term investments, accounts receivable, deposits and advances, investment in flow-through shares, accounts payable and accrued liabilities and notes payable, approximate their fair value unless otherwise noted.

It is management's opinion that, unless otherwise noted, the company is not exposed to significant interest rate, currency or credit risks arising from these financial instruments.

(h) **Management estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

3. Investment in flow-through shares

The company's investment in 2,000,000 flow-through common shares of Millstream Mines Ltd. is recorded at cost less the income tax value of the share incentive. The company holds 2,000,000 warrants, expiring November 14, 2007, to purchase an additional 2,000,000 common shares, at $0.10 per share.

Millstream Mines Ltd. and Kenartha Oil and Gas Company Limited have common officers and some common board members.

Millstream Mines Ltd. is a public company operating under the TSX Venture Exchange and its principal objective is to enhance and develop known mineral properties to production potential.

As a flow-through share investment, the tax cost of the shares is $nil. The fair value of the investment is impracticable to determine as the value is subject to the future financing and development results of the Millstream properties and the share price for a large block of shares.

4. Equipment

	Cost $	Accumulated Amortization $	2006 Net $	2005 Net $
Equipment	4,807	4,785	22	30
Pipeline	76,045	74,863	1,182	1,479
Compressor	195,445	152,872	42,573	60,973
	276,297	232,520	43,777	62,482

5. Natural gas properties, exploration and development

The company under an agreement as described in note 10(f) is undertaking the drilling and exploration of gas wells. The company will present the results of testing on the first six wells and the holders of warrants will have 40 days from the release of the report to exercise their rights under the warrants. If all outstanding warrants are exercised the company will have an additional $1,000,000 of working capital. The current cash balance of the company will be utilized primarily to complete the exploration and development commitment of the flow-through share financing.

The fair value of the properties under development cannot be ascertained at this time due to the early stage of progress of the project.

6. Notes payable

The notes payable are due to a related corporation as described in note 8(a), are due on demand and bear interest at the Bank of Nova Scotia's prime lending rate and 6 per cent respectively, compounded monthly. During the year the company paid interest of $14,612 (2005-$6,476).

	2006 $	2005 $
	120,500	140,500
	58,000	-
	178,500	140,500

7. Income taxes

a) The significant components of the future income tax liability are as follows:

	2006 $	2005 $
Future income tax liability		
Temporary differences on renunciation of qualified exploration and development costs	722,400	-
Share issuance costs	(67,110)	-
Temporary differences due to equipment and resource deductions previously unrecognized	(117,682)	-
Non-capital loss carry-forwards previously unrecognized	(40,424)	-
Temporary difference due to acquisition of flow-through share investment	(72,240)	-
	424,944	-

7. **Income taxes (continued)**

b) Income taxes expense differs from that which would be expected from applying the combined Canadian federal and provincial income tax rate of 36.12% (2005 - 36.12%) to the income for before income taxes. The difference results from the following:

	2006 $	2005 $
Income for the year before income taxes	9,806	19,787
Tax on accounting income	3,542	7,147
Tax effect of the following:		
Application of non-capital loss carry-forwards	-	(12,232)
Temporary difference on equipment not recognized	-	7,795
Reduced tax rates for resource allowance	-	(2,710)
Recognition of non-capital loss carry-forwards previously unrecognized	(40,424)	-
Recognition of prior year temporary differences on equipment and resource deductions previously unrecognized	(131,124)	-
Share issue costs	16,777	-
Other	9,900	-
Provision for income taxes	(141,329)	-

The company has accumulated non-capital losses for income tax purposes of $111,917, which can be carried forward to be applied against taxable income. The right to apply these losses expires in 2008 ($42,086) and 2015 (69,831) respectively.

In addition, the company has approximately $518,000, (2005 - $363,000) in amounts that have been deducted for accounting purposes that have not, as yet, been deducted for income tax purposes, relating to its equipment and resource deductions.

The future income tax benefit of the non-capital losses and available tax deductions have been recognized in the accounts for 2006.

The company has net capital losses of $250,607, which can be carried forward indefinitely to be applied against future taxable capital gains.

March 31, 2006 and 2005

8. Related party transactions

(a) Production royalty expense includes $25,152 (2005 - $25,513) charged by a corporation for which a director of the company is an officer. The corporation has been assigned a 12½% royalty on natural gas sales as an inducement with respect to financial assistance the corporation provided to Kenartha Oil and Gas Company Limited as detailed in note 6.

(b) A corporation, which is a member of the controlling group, provides management services to the company and makes certain payments on its behalf. Management fees of $24,288 (2005 - $25,168) and field expenses of $nil (2005 - $8,729) have been charged in this respect. Included in accounts payable are amounts due to the corporation totaling $26,809 (2005 - $24,203). This corporation also charged the company $47,715 (2005 - $nil) for services provided in connection with the funding and administration of the Norfolk exploration and development project.

9. Capital stock

a) Authorized

2,000,000 voting, redeemable (at 1/10th of 1 cent each) non-participating preference shares
Unlimited common shares

b) Issued

	2006		2005	
	Number	**Amount $**	**Number**	**Amount $**
Common shares				
Balance March 31, 2005	7,895,790	2,426,500	7,895,790	2,426,500
Flow-through shares issued (note 9c)	400,000	2,000,000	-	-
Reduction due to income tax deductions renounced to subscribers (note 9c)	-	(722,400)	-	-
Share issuance costs (net of income taxes of $83,888)	-	(148,360)	-	-
	8,295,790	3,555,740	7,895,790	2,426,500
Preference shares				
	500,000	500	500,000	500
	8,795,790	3,556,240	8,395,790	2,427,000

c) Flow-through shares

During the year the company issued through a private placement offering, as described in note 10(f), 2,000,000 flow-through common shares at a price of $5.00 per share (2005 - $nil). Income tax exploration deductions in the amount of $722,400 were renounced to subscribers effective December 31, 2005. Qualifying expenditures in the amount of $352,135 were incurred to March 31, 2006 and $1,647,865 must be incurred by December 31, 2006.

d) Stock option plan

The company has a designated stock option plan ("DSOP") permitting the granting of options to officers, employees and consultants. The limit for the DSOP is 10% of the issued common shares and for a single participant, 5% of the issued common shares. No options have been allocated and granted under the DSOP.

March 31, 2006 and 2005

10. **Commitments and contingencies**

a) In common with other corporations in the gas industry, the company self-insures for any costs related to environmental matters. No events have occurred which might give rise to liability for site cleanup costs and no estimate can be made of future costs, if any, related to environmental matters.

b) The company has asset retirement obligations associated with long-lived assets, which include abandonment of natural gas, related facilities, compressors, and removal of equipment from leased acreage and returning such land to its original condition. Management has determined that the deposits held by government authorities are sufficient to cover such costs at this time.

c) The company is committed to make lease payments of $1,000 annually until 2006 for its revenue producing property. As at the financial statement reporting date, the company was in the process of negotiating a renewal of this lease.

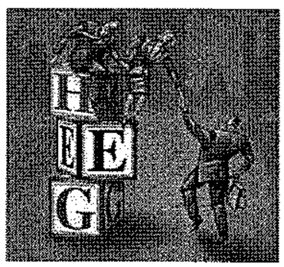
d) On June 1, 2005, the company entered into a three-year premises lease requiring monthly payments of $1,168.

e) Deposits in the amount of $11,500 (2005 - $11,150) are held by the Ontario Ministry of Natural Resources for the company's three operating gas well leases. Under current legislation, an increase in deposits, to a maximum of $22,000, will be phased in over the next several years.

f) The company has entered into an agreement with Norfolk Oil & Gas Limited to earn a 49% working interest in certain gas wells to be drilled. To obtain the working interest the company is required to finance the drilling costs of each individual well. The number of wells in which the company acquires an interest is dependent on the amount of financing raised by the company.

To finance the company's participation in the project described above, the company issued a private placement offering memorandum dated March 17, 2005, which offered 400 units in the share capital of the company at $5,000 per unit; each unit consisting of 1,000 flow through common shares to be issued from the treasury of the company and one full warrant. The offering was fully subscribed for in the current year.

The company has renounced its claim for Canadian Exploration Expenses to the holders of the flow-through common shares effective December 31, 2005. The warrants are exercisable at $2,500 each and provide the holders, on exercise, the right to repayment of their initial investment from net profits of the project, and thereafter to retain a pro-rata net profit interest royalty of up to 24% in each of the above drilled wells that are purchased by capital raised under the offering memorandum. The company's net profit interest will accordingly be reduced from 49% pro-rata on the exercise of the warrants. Included in deposits, is $20,632 (2005-$47,000) advanced in excess of drillings costs incurred to date. No warrants have been exercised for this project to the date of the Auditors' Report.



We give your business a hand to succeed.

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Since 1930

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