



## **Primary Petroleum Corporation**

### **Consolidated Financial Statements**

**May 31, 2007**

### **Auditors' Report**

To: The Shareholders of  
**Primary Petroleum Corporation**

We have audited the consolidated balance sheets of **Primary Petroleum Corporation** as at May 31, 2007 and 2006 and the consolidated statements of loss and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Kenway Mack Slusarchuk Stewart LLP*

September 7, 2007 (except Note 14 which  
is dated September 12, 2007)

Chartered Accountants

# Primary Petroleum Corporation

## CONSOLIDATED BALANCE SHEETS

As at May 31,	2007	2006
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 1,319,341	\$ 5,232,500
Accounts receivable	481,158	255,757
Inventory	30,593	30,593
Prepaid expenses and deposits	283,030	25,256
Loan receivable (note 3)	181,379	-
	<u>2,295,501</u>	<u>5,544,106</u>
Loan receivable (note 3)	-	167,021
Property and equipment (note 4)	<u>5,989,788</u>	<u>1,073,166</u>
	<u>\$ 8,285,289</u>	<u>\$ 6,784,293</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 1,347,429	\$ 1,195,341
Convertible notes (note 5)	2,133,659	-
Asset retirement obligation (note 6)	<u>389,573</u>	<u>210,783</u>
	<u>3,870,661</u>	<u>1,406,124</u>
Shareholders' equity		
Common shares (note 7)	10,162,656	3,124,168
Convertible notes equity component (note 5)	336,524	-
Subscription receipts (note 7)	-	4,515,454
Special warrants (note 7)	-	761,434
Contributed surplus (note 7)	200,843	62,038
Deficit	<u>(6,285,395)</u>	<u>(3,084,925)</u>
	<u>4,414,628</u>	<u>5,378,169</u>
	<u>\$ 8,285,289</u>	<u>\$ 6,784,293</u>
<b>Commitments and contingencies</b> (note 13)		

The accompanying notes form an integral part of these consolidated financial statements.

Approved by the Board of Directors

(signed)  
*"Mike Marrantino", Director*

(signed)  
*"Russell Zaharko", Director*

# Primary Petroleum Corporation

## CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT

Years ended May 31,	2007	2006
<b>Revenue</b>		
Oil and natural gas	\$ 479,891	\$ 2,612
Royalties	(123,820)	(382)
	<u>356,071</u>	<u>2,230</u>
Interest	151,837	47,066
	<u>507,908</u>	<u>49,296</u>
<b>Expenses</b>		
Operating	131,269	11,943
General and administrative	1,112,479	370,941
Stock-based compensation	275,902	-
Interest	752	16,161
Interest and accretion on convertible notes	304,943	-
Depletion, depreciation and accretion (note 4)	2,331,123	3,209,609
	<u>4,156,468</u>	<u>3,608,654</u>
<b>Loss before income taxes</b>	(3,648,560)	(3,559,358)
Future income taxes reduction (note 8)	(448,090)	(558,398)
	<u>(3,200,470)</u>	<u>(3,000,960)</u>
<b>Net loss</b>	(3,200,470)	(3,000,960)
<b>Deficit, beginning of year</b>	(3,084,925)	(83,965)
	<u>(6,285,395)</u>	<u>(3,084,925)</u>
<b>Deficit, end of year</b>	\$ (6,285,395)	\$ (3,084,925)
<b>Net loss per share</b>		
Basic and diluted (note 7)	\$ (0.13)	\$ (0.24)

The accompanying notes form an integral part of these consolidated financial statements.

# Primary Petroleum Corporation

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended May 31,	2007	2006
<b>Operating</b>		
Net loss	\$ (3,200,470)	\$ (3,000,960)
Non-cash items		
Stock-based compensation	275,902	-
Accretion on convertible notes	232,683	-
Depletion, depreciation and accretion	2,331,123	3,209,609
Future income taxes	(448,090)	(558,398)
	<u>(808,852)</u>	<u>(349,749)</u>
General and administrative expenses settled in shares	19,898	63,000
Increase in loan receivable	(14,358)	-
Asset retirement costs incurred	(61,473)	-
Change in non-cash working capital (note 9)	45,944	96,402
	<u>(818,841)</u>	<u>(190,347)</u>
<b>Financing</b>		
Issue of share capital, net of issue costs	1,517,695	2,758,410
Exercise of stock options	85,000	-
Issue of subscription receipts, net of issue costs	-	4,368,407
Issue of special warrants, net of issue costs	-	1,038,188
Convertible notes issued, net of issue costs	2,237,500	-
Change in non-cash working capital (note 9)	45,867	(5,000)
	<u>3,886,062</u>	<u>8,160,005</u>
<b>Investing</b>		
Expenditures on property and equipment	(6,557,482)	(3,540,134)
Loan receivable	-	(167,021)
Change in non-cash working capital (note 9)	(422,898)	607,135
	<u>(6,980,380)</u>	<u>(3,100,020)</u>
<b>Increase (Decrease) in cash</b>	<b>(3,913,159)</b>	<b>4,869,638</b>
<b>Cash and cash equivalents, beginning of year</b>	<b>5,232,500</b>	<b>362,862</b>
<b>Cash and cash equivalents, end of year</b>	<b>\$ 1,319,341</b>	<b>\$ 5,232,500</b>
<b>Supplemental information</b>		
Interest received	\$ 130,593	\$ 45,362
Interest paid	\$ 15,409	\$ -

The accompanying notes form an integral part of these consolidated financial statements.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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## 1. Nature of operations and basis of presentation

Primary Petroleum Corporation (the “Company”) was incorporated under the laws of the Province of British Columbia on May 20, 2004, and is engaged in the exploration and development of petroleum and natural gas reserves in the Province of Alberta and the State of Montana.

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada and include its wholly owned subsidiary and the company’s proportionate share of the assets, liabilities, revenues, expenses and cash flows of its joint ventures.

## 2. Significant accounting policies

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of periodic financial statements necessarily involves the use of estimates and approximations. Accordingly, actual results could differ from those estimates. The financial statements have, in management’s opinion, been properly prepared using careful judgement within reasonable limits of materiality and within the framework of the significant accounting policies summarized below:

### (a) Cash and cash equivalents

The Company considers all highly liquid investments with maturity of three months or less at the time of purchase to be cash equivalents. These cash equivalents primarily consist of funds on deposit under various terms.

### (b) Property and equipment

The Company follows the full cost method of accounting for its petroleum and natural gas operations whereby all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized in cost centers by country. Costs include lease acquisition costs, geological and geophysical expenses and costs of drilling both productive and non-productive wells and equipment costs. Proceeds from the sale of properties are applied against capitalized costs and gains or losses are not recognized unless such sale would alter the depletion rate by more than 20%.

Depletion of capitalized costs, excluding unproved properties and estimated salvage value is provided by the unit-of-production method based upon estimated proved petroleum and natural gas reserves, before royalties, as determined by independent engineers. A new cost center in the preproduction stage is excluded from depletion until proved reserves are attributable to the properties or impairment occurs. For depletion and depreciation purposes, equivalent volumes of petroleum and natural gas production and reserves are converted based on the relative energy content of six thousand cubic feet of natural gas to one barrel of crude oil.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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## 2. Significant accounting policies, continued

### (b) Property and equipment, continued

The costs of acquiring and evaluating unproved property with no assigned proved reserves are initially excluded from depletion. These properties are assessed periodically for impairments. When proved reserves are assigned to the property or the property is considered to be impaired, the cost of the property and the amount of impairment are transferred to costs subject to depletion.

The Company performs a ceiling test to determine whether the carrying value of its petroleum and natural gas properties is recoverable and does not exceed the fair value of the properties. The carrying value is considered to be recoverable and not impaired when the undiscounted cash flows expected, using estimated future product prices and costs from the production of proved reserves and the lower of cost or market of unproved properties exceeds the net book value of the properties. When permanent impairment is recognized, a write-down is recorded to the extent that the carrying value of the petroleum and natural gas properties and future development costs exceed the estimated net present value of future cash flows from proved and probable reserves using future product prices and costs, discounted at a risk free interest rate. The amount of write-down is included as additional depletion and amortization expense in the statement of operations.

Office equipment is amortized on a declining balance basis over its estimated useful life at rates varying from 20% to 50%.

### (c) Asset retirement obligation

The Company recognizes the fair value of a liability for an asset retirement obligation in the period in which it is incurred and records a corresponding increase in the carrying value of petroleum and natural gas properties. The fair value is determined through a review of engineering studies, industry guidelines, and management's estimate on a site-by-site basis. The liability is subsequently adjusted for the passage of time, and is recognized as an accretion expense in the statement of operations. The liability is also adjusted due to revisions in either the timing or the amount of the original estimated cash flows associated with the liability. The increase in the carrying value of the asset is depleted using the unit of production method based on estimated gross proved reserves as determined by independent engineers. Actual costs incurred upon settlement of the asset retirement obligations are charged against the asset retirement obligation to the extent of the liability recorded.

### (d) Joint operations

Many of the exploration and production activities of the Company are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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## 2. Significant accounting policies, continued

### (e) Flow-through shares

A portion of the Company's exploration activities is financed through proceeds received from the issue of flow-through shares. Under the terms of the flow-through share issues, the tax attributes of the related expenditures are renounced to the share subscribers. To recognize the foregone tax benefits to the Company the carrying value of the shares issued is reduced by the tax effect of the benefits renounced to subscribers. The tax effect of the renouncement is recorded when the renouncement documents are filed with the tax authorities.

### (f) Future income taxes

The Company follows the liability method of accounting for income taxes. Under this method future tax assets and liabilities are determined based on differences between financial reporting and income tax bases of assets and liabilities, and are measured using substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future tax assets and liabilities of a change in tax rates is recognized in net income in the period in which the change is substantively enacted. A valuation allowance is recorded against a future income tax asset if it is more likely than not that the asset will not be realized.

### (g) Convertible notes

The Company's convertible financial instruments with an embedded conversion feature are partitioned into a liability and an equity component based on their relative fair market value. The initial issuance costs are deducted from the relative liability and equity component when incurred. The liability component will be accreted up to the principal balance by the effective interest method over the terms of the instruments and expensed accordingly. Upon conversion, a corresponding portion of the liability and equity components are transferred into the Company's common share account.

### (h) Stock-based compensation

The Company uses the fair value method using the Black-Scholes option pricing model to account for stock options and warrants granted. As such, compensation expense is calculated based on the fair value of the option or warrant on the date of grant. As a private company, the Company uses the minimum value method which uses zero volatility in the calculation of fair value for stock options and warrants. For options granted in respect of future services, compensation expense is recorded over the vesting period. Upon the exercise of options, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital. The Company has not incorporated an estimated forfeiture rate, rather the Company accounts for actual forfeitures as they occur.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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## 2. Significant accounting policies, continued

### (h) Stock-based compensation, continued

The Company has entered into arrangements with certain officers and consultants whereby the officers and consultants can receive part of their compensation in shares of the Company at amounts per share negotiated from time to time based upon the most recent financing prior to the services being rendered. The Company has the option to modify the arrangements upon 30 days notice should the fair value of the Company's shares exceed the negotiated subscription price per share. Amounts owing to officers and consultants under this arrangement for which shares have not yet been issued are recorded as an expense with a corresponding increase to contributed surplus. Upon the issuance of the shares the amount previously recognized in contributed surplus is recorded as an increase to share capital.

### (i) Foreign currency translation

Monetary assets and liabilities of integrated foreign operations that are denominated in foreign currencies are translated into Canadian dollars at the rate of exchange in effect at the balance sheet date. Non-monetary assets and liabilities are translated into Canadian dollars at historical rates and items affecting earnings are translated at the average rate in effect during the year, except depletion and amortization. Depletion and amortization are translated at the same rate as the related assets. Gains or losses arising from these foreign currency transactions are included in the determination of income.

### (j) Revenue recognition

Revenues from the sale of petroleum and natural gas are recorded when title passes to an external party. Interest revenue is recognized on a monthly basis as earned.

### (k) Use of estimates

The amounts recorded for depletion of property and equipment and the ceiling test are based on estimates of gross proved reserves, production rates, petroleum and natural gas prices, future costs and other relevant assumptions. Inherent in the fair value calculation of asset retirement obligations are numerous assumptions and judgments including the ultimate settlement amounts, inflation factors, credit adjusted discount rates, timing of settlement, and changes in the legal and regulatory environments. By their nature, these estimates are subject to measurement uncertainty and the impact on the financial statements of changes in such estimates in future periods could be material.

## 3. Loan receivable

The loan receivable consists of a US\$150,000 promissory note due no later than May 1, 2008, secured by a charge over all of the present and after acquired property of the borrower and includes certain oil and gas leases located in the State of Montana. The loan bears interest at the simple rate of twelve percent (12%) per annum, payable upon repayment of the principal.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

## 4. Property and equipment

	<b>2007</b>		
	<b>Cost</b>	<b>Accumulated depletion and amortization</b>	<b>Net</b>
Petroleum and natural gas properties	\$ 11,422,602	\$ (5,501,863)	\$ 5,920,739
Office equipment	86,318	(17,269)	69,049
	<b>\$ 11,508,920</b>	<b>\$ (5,477,213)</b>	<b>\$ 5,989,788</b>

  

	<b>2006</b>		
	<b>Cost</b>	<b>Accumulated depletion and amortization</b>	<b>Net</b>
Petroleum and natural gas properties	\$ 4,263,642	\$ (3,201,158)	\$ 1,062,484
Office equipment	13,593	(2,911)	10,682
	<b>\$ 4,277,235</b>	<b>\$ (3,204,069)</b>	<b>\$ 1,073,166</b>

At May 31, 2007, property and equipment included \$454,384 (2006 – \$259,827) of undeveloped land, \$4,902,195 (2006 – \$768,972) of preproduction exploration costs have been excluded from depletion.

Included in the current year's depletion and amortization expense is a ceiling test write-down of \$1,741,587 (2006 – \$3,169,799).

The Company did not capitalize any general and administrative costs during 2007 and 2006.

For the purposes of the May 31, 2007 ceiling test, the following benchmark prices were used:

	Gas reference price \$/mcf
2007	7.50
2008	7.50
2009	7.75
2010	7.75
2011	7.75
Thereafter (inflation %)	+ 2.5%

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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## 5. Convertible notes

The 5% unsecured convertible notes with interest payable at maturity are convertible at the option of the holders into units of the Company at the conversion price of \$1.00 per unit of the principal amount or any part thereof plus accrued and unpaid interest. Each unit consists of one common share and one non-transferable share purchase warrant. Each warrant entitles the holder to purchase one common share at a price of \$1.25 per share for a period of one year from the date of issue. The Company has valued the equity component of these notes using the residual value of equity component method, whereby the liability component is valued first using management's best estimate of the current market rate for comparable instruments, at the time of issuance. The difference between the notes issued and the fair value of the liability is assigned to the equity component.

The details of the convertible notes including fair values assigned and issuance costs are as follow:

Interest Rate	Issue Date	Maturity Date	Liability Component	Equity Component	Issuance Costs	Net Proceeds
5%	September 27, 2006 to October 23, 2006	September 27, 2007 to October 23, 2007	\$ 1,911,596	\$ 338,404	\$ 12,500	\$ 2,237,500

The outstanding balance and changes in the liability component during the year ended May 31, 2007 are as follows:

	Opening Balance	Addition	Accretion	Ending Balance
\$2,250,000 5% convertible notes	\$ 0	\$ 1,900,976	\$ 232,683	\$ 2,133,659

On May 8, 2007, the Company entered into extension agreements with respect to the Convertible Notes extending the maturity of the Convertible Notes to dates ranging from June 27, 2008 to July 23, 2008.

## 6. Asset retirement obligation

The asset retirement obligation results from the Company's net ownership interests in petroleum and natural gas assets including well sites and gathering systems. The Company estimates the net present value of its asset retirement obligation based on total undiscounted future liabilities measured as at May 31, 2007 of \$496,752 (2006 – \$216,300), using a credit adjusted risk free interest rate of 8% and an inflation rate of 2% over a period of one to three years.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

## 6. Asset retirement obligation, continue

The following table reconciles the changes in the asset retirement obligation account.

	<u>2007</u>	<u>2006</u>
Asset retirement obligation, beginning of year	\$ 210,783	\$ -
Additions and revisions	224,203	205,243
Accretion	16,060	5,540
Costs incurred	(61,473)	-
<b>Asset retirement obligation, end of year</b>	<b>\$ 389,573</b>	<b>\$ 210,783</b>

## 7. Share capital

### (a) Authorized

Unlimited number of common shares

### (b) Issued

<b>Common shares</b>	<b>Number of shares</b>	<b>Amount</b>
Balance, May 31, 2005	8,125,000	\$ 751,250
Private placement of units for cash (i)	1,332,100	770,000
Shares issued for debt (ii)	126,000	63,000
Private placement for cash (iii)	2,010,000	2,005,000
Share issues costs net of tax effect	-	(10,700)
Tax effect of flow-through share renunciation	-	(454,382)
Balance, May 31, 2006	11,593,100	3,124,168
Private placement of flow-through shares for cash (iv)	609,832	731,798
Private placement of units for cash (iv)	275,000	275,000
Special warrants converted (v)	1,888,700	761,434
Private placement of flow-through shares for cash (vi)	714,667	857,600
Shares issued for finders' fee (vii)	450,000	450,000
Subscription receipts converted (Note 7(c))	11,128,320	4,515,454
Shares issued for debt (viii)	98,698	62,135
Stock options exercised for cash	160,000	85,000
Contributed surplus on exercise of stock options	-	94,860
Share issues costs net of tax effect	-	(230,557)
Tax effect of flow-through share renunciation	-	(564,236)
<b>Balance, May 31, 2007</b>	<b>26,918,317</b>	<b>\$ 10,162,656</b>

# Primary Petroleum Corporation

## Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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### 7. Share capital, continue

- (i) On June 17, 2005, the Company completed a private placement of 770 units, representing 1,332,100 shares, at a price of \$1,000 per unit for gross proceeds of \$770,000. Each unit consists of 380 non flow-through common shares and 1,350 flow-through common shares. At May 31, 2006 all qualifying flow-through expenditures had been incurred.
- (ii) On May 8, 2006, the Company issued 126,000 units, each unit consisting of one common share at \$0.50 per share and one share purchase warrant, in payment of consulting services provided by an officer and director of the Company. Each whole warrant entitles the holder to purchase one additional common share at a price of \$0.75 per share expiring on the date which is the earlier of the following:
  - (i) 24 months from the date the Company obtains a receipt for its final IPO prospectus approved by a Canadian Securities Commission.
  - (ii) 24 months from the date the Company's shares are listed for trading through the facilities of the TSX Venture Exchange.
  - (iii) May 8, 2010.
- (iii) On May 11, 2006, the Company closed private placements of 2,000,000 units at \$1.00 per share and issued 10,000 common shares to a consultant at \$0.50 per share, for gross proceeds of \$2,005,000. Each unit consists of one common share and one share purchase warrant. Each whole warrant entitles the holder to purchase one additional common share at a price of \$1.15 per share expiring on December 31, 2007.
- (iv) On October 26, 2006, the Company closed private placements of 609,832 flow-through common shares at \$1.20 per share for gross proceeds of \$731,798, and 275,000 units at \$1.00 per unit for gross proceeds of \$275,000. Each unit comprises one common share and one share purchase warrant. Each whole warrant entitles the holder to purchase one additional common share at \$1.25 per share for a period of one year after closing. At May 31, 2007 all qualifying flow-through expenditures had been incurred.
- (v) On November 17, 2006 – 473,400 (November 30 – 690,300), (December 31 – 725,000) special warrants were deemed converted to common shares.
- (vi) On December 31, 2006, the Company closed a private placement of 714,667 flow-through common shares at \$1.20 per share for gross proceeds of \$857,000. At May 31, 2007 all qualifying flow-through expenditures had been incurred.
- (vii) On February 19, 2007, the Company issued 450,000 common shares pursuant to agreements with certain consultants and an officer and director of the Company for three initial drillable targets (industry definition) in each of the Pondera/Teton and the Tiber prospects in Montana.
- (viii) On February 28, 2007, the Company issued 98,698 common shares in lieu of cash payments for services provided by consultants.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

## 7. Share capital, continue

### (c) Subscription receipts

	<b>Number of subscription receipts</b>	<b>Amount</b>
Balance May 31, 2006	9,676,800	\$ 4,515,454
Conversion to common shares	(9,676,800)	(4,515,454)
<b>Balance May 31, 2007</b>	<b>-</b>	<b>\$ -</b>

On March 15, 2006, the Company closed a private placement of 9,000,000 subscription receipts \$0.50 each for gross proceeds of \$4,500,000. An additional 40,000 subscription receipts at \$0.50 each closed on April 17, 2006. 636,800 subscription receipts valued at \$0.50 each were paid to brokers as a commission. Each subscription receipt was initially exchangeable for one common share and two-thirds of one share purchase warrant at no additional cost. Each whole warrant entitles the holder to purchase one additional common share at a price of \$0.75 per share expiring on the date which is the earliest of two years after the Company files a prospectus or the effective date of the listing of the shares of the Company on a stock exchange in Canada or March 15, 2010. Under certain circumstances the Company may give 30 days notice of earlier expiration.

As the Company did not file a prospectus or become listed on a Canadian stock exchange within seven months of the closing of the subscription receipts, each subscription receipt is entitled to an additional 0.10 common share and 0.074 of a warrant, plus an additional 0.01 common share and 0.007 of a warrant for each month subsequent to the seven month period referred to above that the Company does not file a prospectus or become listed on a stock exchange in Canada for a maximum of 0.15 additional common share and 0.11 additional warrant.

On March 16, 2007, the 9,676,800 issued and outstanding subscription receipts were converted into 11,128,320 units. The 11,128,320 units are comprised of 11,128,320 common shares and 7,499,520 share purchase warrants. Each whole warrant entitles the holder to purchase one additional common share at \$0.75 per share for a period of two years from the date of receipt for a final prospectus

### (d) Special warrants

	<b>Number of special warrants</b>	<b>Amount</b>
Balance May 31, 2006	1,888,700	\$ 761,434
Conversion to common shares (note 7(b) (v))	(1,888,700)	(761,434)
<b>Balance May 31, 2007</b>	<b>-</b>	<b>\$ -</b>

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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## 7. Share capital, continued

On November 17, November 30, and December 31, 2005, the Company issued a total of 1,888,700 special warrants exchangeable into 517,200 non flow-through common shares and 1,371,500 flow-through common shares for gross proceeds of \$1,081,500. At May 31, 2006, all qualifying flow-through expenditures had been incurred. Any special warrants not exchanged by the holder will be deemed to have been exchanged without any action on the part of the holder, on the earlier of twelve months from the date of issue, or the fifth business day after which a receipt is issued by the British Columbia Securities Commission for a final prospectus.

### (e) Contributed surplus

	<u>2007</u>	<u>2006</u>
Balance, beginning of year	\$ 62,038	\$ -
Value of broker's option issued	-	19,801
Contribution by consultants in advance of share issue	19,898	42,237
Transfer to common shares on issuance for debt	(62,135)	
Stock-based compensation	275,902	-
Transfer to common shares on exercise of stock options	(94,860)	-
<b>Balance, end of year</b>	<b>\$ 200,843</b>	<b>\$ 62,038</b>

### (f) Stock options

On December 1, 2006, the Company granted a director 100,000 options to purchase 100,000 common shares of the Company at a price of \$0.25 per share and on December 12, 2006, the Company granted an individual 60,000 options to purchase 60,000 common shares of the Company at a price of \$1.00 per share. These options vested immediately and have a maximum term of five years. The fair value of these options granted was \$98,860 on the date of grant, calculated using the Black-Scholes option pricing model with the following assumptions: average risk free interest rate of 3.74%, average expected life of 5 years, expected volatility of 20% and no expected dividends.

On February 19, 2007, the Company's directors approved a stock option plan to assist the Company in attracting, retaining and motivating directors, officers, employees and consultants whereby the Company may grant options to purchase common shares up to a maximum of 10% of the number of issued and outstanding common shares of the Company. The options vest over a three year period and have a maximum terms of five years. The Company granted 2,912,500 options under the plan to directors, officers and consultants with an exercise price equal to the price of the shares to be offered through the Company's initial public offering, expiring February 19, 2012. Further on March 27, 2007 100,000 options under the plan were granted to an officer of the Company. The fair value of the options granted was \$2,003,813 on the date of grant, calculated using the Black-Scholes option pricing model with the following assumptions: assumed initial public offering price of \$1.00 per share, risk free interest rate of 4.02%, average expected life of 5 years, expected volatility of 80%, and no expected dividends.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

## 7. Share capital, continue

### (f) Stock options

The following table summarizes changes in the number of stock options outstanding for the year ended May 31.

	2006	
	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of year	-	\$ -
Granted	3,172,500	0.98
Exercise	(160,000)	0.53
<b>Outstanding, end of year</b>	<b>3,012,500</b>	<b>\$ 1.00</b>
<b>Exercisable, end of year</b>	<b>-</b>	<b>\$ -</b>

The following table summarizes information about the stock options outstanding at May 31, 2007.

Exercise Price	Outstanding			Exercisable	
	Number of options	Weighted average exercise price	Weighted average remaining contractual life (years)	Number of options	Weighted average exercise price
\$1.00	3,012,500	\$ 1.00	4.7	-	\$ -
	<b>3,012,500</b>	<b>\$ 1.00</b>	<b>4.7</b>	<b>-</b>	<b>\$ -</b>

### (g) Broker's options and warrants

On March 16, 2007, the 900,000 issued and outstanding broker options were converted into 1,035,000 broker warrants on the same basis as the subscription receipts described in note 7(c). Each broker warrant is exchangeable at a price of \$0.50 per warrant for one common share of the Company and 0.674 of one additional warrant (aggregate of 697,500 additional warrants). Each additional warrant entitles the holder to purchase one additional common share at a price of \$0.75 per share for a period of two years from the date of a receipt for a final prospectus.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

## 7. Share capital, continue

### (h) Share warrants and broker warrants outstanding at May 31, 2007

	Outstanding			Exercisable	
	Number of warrants and options	Weighted average exercise price	Weighted average remaining contractual life (years)	Number of warrants and options	Weighted average remaining contractual life (years)
Share purchase warrants	7,625,520	\$ 0.75	2.2	7,625,520	2.2
Share purchase warrants	2,000,000	1.10	0.6	2,000,000	0.6
Share purchase warrants	275,000	1.25	1.4	275,000	1.4
Share purchase warrants	2,250,000	1.25	2.2	2,250,000	2.2
Broker warrants	1,035,000	0.50	2.2	1,035,000	2.2
Broker warrants	697,500	0.75	2.2	697,500	2.2
	<b>13,883,020</b>	<b>\$ 0.87</b>	<b>2.0</b>	<b>13,883,020</b>	<b>2.0</b>

### (i) Per share amounts

Basic per share calculations are based on the weighted average number of common shares outstanding and the weighted average of subscription receipts and special warrants outstanding as follows:

	2007	2006
Common shares	15,851,165	9,505,044
Subscription receipts	7,635,393	2,037,791
Special warrants	986,477	885,316
<b>Total weighted average shares outstanding – basic</b>	<b>24,473,035</b>	<b>12,428,151</b>

The options and warrants to purchase common shares and the shares that would have been converted under the convertible notes outstanding at May 31, 2007 and 2006 were not included in the computation of diluted earnings per share because they were anti-dilutive .

# Primary Petroleum Corporation

## Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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### 8. Income taxes

The provision for future income taxes differs from the amount computed by applying the combined federal and provincial tax rates to the loss before taxes. The difference results from the following:

	<b>2007</b>	<b>2006</b>
Loss before income taxes	\$ (3,648,560)	\$ (3,559,358)
Canadian basic statutory tax rate	33.5%	35.5%
Expected income tax provision	(1,222,268)	(1,263,572)
Foreign tax rate difference	6,335	629
Non-allowable deduction	2,159	4,840
Resource allowance	11,168	11,918
Stock-based compensation	92,427	-
Accretion on convertible notes	77,949	-
Lower effective rate due to decreasing rates in the future	18,337	45,473
Increase in valuation allowance	565,803	642,314
<b>Income tax provision</b>	<b>\$ (448,090)</b>	<b>\$ (558,398)</b>

Significant components of the company's future tax assets and liabilities as of May 31, 2007 and 2006 are as follows:

	<b>2007</b>	<b>2006</b>
Property and equipment	\$ 451,478	\$ 292,942
Non-capital losses	456,717	140,900
Share issue costs	196,722	137,773
Asset retirement obligation	144,199	66,113
Valuation allowance	(1,249,116)	(637,728)
<b>Future income tax assets (liabilities)</b>	<b>\$ -</b>	<b>\$ -</b>

As at May 31, 2007, the Company has approximately \$7,976,000 of tax pools and \$1,418,000 of non-capital loss carry-forwards available for deduction against future taxable income. Non-capital losses begin to expire in 2015.

# Primary Petroleum Corporation

## Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

### 9. Change in non-cash working capital

	2007	2006
Accounts receivable	\$ (225,401)	\$ (250,093)
Inventory	-	(30,593)
Prepaid expenses and deposits	(257,774)	(25,256)
Accounts payable and accrued liabilities	152,088	1,004,479
Net change	\$ (331,087)	\$ 698,537
Net change by activities		
Operating	\$ 45,944	\$ 96,402
Financing	45,867	(5,000)
Investing	(422,898)	607,135
<b>Net change</b>	<b>\$ (331,087)</b>	<b>\$ 698,537</b>

### 10. Segmented information

The company operates in one reportable operating segment, being the exploration and development of resource property interests. Segmented information relative to this activity on a geographic basis is as follows:

	2007		
	Canada	USA	Total
Oil and gas sales	\$ 479,891	\$ -	\$ 479,891
Interest income	151,837	-	151,837
Interest and accretion expense	305,695	-	305,695
Depletion, depreciation and accretion	2,331,123	-	2,331,123
Future income taxes reduction	(448,090)	-	(448,090)
Net Loss	(3,125,937)	(74,533)	(3,200,470)
Capital expenditures	3,395,137	3,836,548	7,231,685
Property and equipment	\$ 1,384,268	\$ 4,605,520	\$ 5,989,788

# Primary Petroleum Corporation

## Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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### 10. Segmented information, continued

			2006
	Canada	USA	Total
Oil and gas sales	\$ 2,612	\$ -	\$ 2,612
Interest income	47,066	-	47,066
Interest and accretion expense	16,161	-	16,161
Depletion, depreciation and accretion	3,209,609	-	3,209,609
Future income taxes reduction	(558,398)	-	(558,398)
Net loss	(2,994,966)	(5,994)	(3,000,960)
Capital expenditures	3,018,642	768,972	3,787,614
Property and equipment	\$ 304,194	\$ 768,972	\$ 1,073,166

### 11. Financial instruments

#### (a) Fair values of financial assets and liabilities

The Company's carrying value of cash, accounts receivable and accounts payable and accrued liabilities approximates their fair values due to the immediate or short-term maturity of these instruments. The Company has not entered into any hedging contracts.

The carrying value of the loan receivable approximates the fair value.

The carrying value of the convertible loan approximates the fair value.

#### (b) Credit risk

The majority of the accounts receivable is in respect of oil and natural gas operations. The Company generally extends unsecured credit to these customers, and therefore, the collection of accounts receivable may be affected by changes in economic or other conditions and may accordingly impact the Company's overall credit risk. Management believes the risk is mitigated by the size and reputation of the companies to which they extend credit. The Company has not experienced any material credit loss in the collection of receivables in the past.

#### (c) Foreign currency risk

The Company is exposed to fluctuations in the exchange rate on US currency.

# Primary Petroleum Corporation

## Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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### 12. Related party transactions

The Company had the following related party transactions occurring in the normal course of operations and were recorded at the exchange amount, which is the amount of consideration established and agreed to by the related parties:

- (a) Management and consulting fees totalling \$205,500 (2006 – \$102,000) were charged to the Company by companies controlled by directors and officers of the Company. At May 31, 2007, \$10,600 (2006 - \$9,095) is payable in relation to these services and is included in accounts payable and accrued liabilities.
- (b) Legal fees of \$9,432 (2006 – \$15,169) were charged to the Company by a legal firm of which a director of the Company is a member. At May 31, 2007, \$4,160 (2006 – \$4,804) is payable in relation to these services and is included in accounts payable and accrued liabilities.

### 13. Commitments and contingencies

- (a) The Company has a five year lease agreement expiring on March 1, 2012 with a minimum rent of \$123,172 per annum excluding operating costs.
- (b) Pursuant to an agreement dated July 26, 2006, the Company has committed to purchase a minimum of 100,000 and up to 300,000 net mineral acres in Montana, with a net revenue interest of not less than 85% to the Company, at a cost of US \$12.50 per acre plus the issue of one-half of a common share of the Company for each acre acquired. 35,000 acres were acquired as of May 31, 2007. As at May 31, 2007, the Company has accrued a liability of \$17,500 with respect to the issuance of the shares, but has not yet issued the shares.
- (c) Pursuant to an agreement dated August 31, 2006, finder's fees are payable by the Company upon the completion of certain Powder River prospect land acquisitions in Montana. The amount of final obligation is not determinable at this time. The fees are payable on the basis of the issuance of one common share of the Company for each acre acquired. 35,000 acres were acquired as of May 31, 2007. As at May 31, 2007, the Company has accrued a liability of \$35,000 with respect to the issuance of the shares, but has not yet issued the shares.
- (d) In December, 2004 and May, 2005, the Company issued 2,625,000 common shares in private placements to certain subscribers for the subscription price of \$0.25 per common share. The common shares were issued pursuant to subscription agreements for the issuance of flow – through shares. Each agreement contained covenants by the Company to incur Canadian exploration expenses and Canadian development expenses and to renounce them to the subscribers in the manner and within the time limits prescribed by the Tax Act for flow – through shares. The Company incurred the expenses and renounced them pursuant to the terms of the agreements and made the required filings with the Canada Revenue Agency.

# Primary Petroleum Corporation

Notes to Consolidated Financial Statements

For the years ended May 31, 2007 and 2006

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## 13. Commitments and contingencies, continue

- (d) The Company was advised in January, 2007 that certain language included in the subscription agreements could, under certain circumstances, result in the subscribers being denied certain tax benefits related to the subscription agreements. In the event of this occurring, and a claim being made by some or all of the subscribers, the Company could be liable to such subscribers for damages. The Company has estimated the amount of its potential liability in the event of claims for damages being made by all the subscribers to be approximately \$325,000.

The Company applied to the Supreme Court of British Columbia for an order rectifying the subscription agreements by deleting certain language from the subscription agreements to eliminate the potential that the subscribers' tax benefits would be denied and the corresponding risk of liability for the Company in damages. All of the subscribers delivered acknowledgements of service confirming that they did not oppose the application, and the Court pronounced an order rectifying the agreements in the manner requested by the Company on August 17, 2007.

## 14. Subsequent events

- (a) On August 9, 2007, the Company entered into an agency agreement to complete an initial public offering (the "Offering"), on a best effort basis of, 8,500,000 units at the price of \$1.00 per unit for gross proceeds of \$8,500,000, excluding 1,275,000 over-allotment units granted to the agent. Each unit consists of one common shares and one-half of a share purchase warrant. Each warrant is exercisable at a price of \$1.35 per share for two years from the date closing. As compensation for its services, the agent will receive the followings:
- i. A cash commission equals to 8% of the gross proceeds of the Offering.
  - ii. Warrants equal to 8% of the number of units (including over-allotment units) sold under the Offering. Each warrant is exercisable at a price of \$1.35 per share for a period of two years from the date of closing.
  - iii. A corporate finance fee of 100,000 units, each unit consisting of one common share and one-half of a share purchase warrant. Each warrant is exercisable at a price of \$1.35 per share for a period of two years from the date of closing.
- (b) The final prospectus for the Offering was receipted on August 21, 2007. The Offering was completed on September 12, 2007 of 8,500,000 units for gross proceeds of \$8,500,000.