



Yangarra Resources Ltd.
2010 Annual Report

President's Letter

Dear fellow shareholders:

2010 was a year of transition for Yangarra in which, the focus shifted to oil and liquids-rich gas targets in Central Alberta. The Company drilled its first horizontal well in the area in March 2010 and followed this well with five additional wells in the area. Acquisitions of a 15% gross overriding royalty and the Willesden Green/Ferrier asset purchase were both very accretive transactions for shareholders and demonstrate our philosophy to grow while keeping interest of shareholders in mind. In AJM's latest evaluation of our reserves, we increased our proven plus probable reserve base by 78%, and increased the NPV10 value by 113%. The NPV10 of the reserves and our undeveloped land valuation give the company a net asset value per share of \$1.00. This represents a solid base to build our upside from during 2011. Financially, we remain strong with a credit facility in place and a recently completed equity financing. The Company is committed to keep the balance sheet strong, 2011 growth will be funded with the resources in place and cash flow from operations.

We continue to believe that Central Alberta is one of the most exciting plays in North America. Horizontal drilling and multi-stage fracturing technology has unlocked multiple geological zones with significant returns and manageable geological risk. The most significant risk in the area is operational and the Company has been structured to handle that risk, combining significant operational experience and strategic control of infrastructure in our operating areas. The Company has focused on the Glauconite and the Cardium, but will drill horizontal wells into other zones during 2011.

2011 will be an exciting year for the Company; we have announced a \$50 million capital spending program. This program includes the drilling of 31 gross (14 net) wells focused in Central Alberta. The Company currently has 123 gross (70 net) drilling locations which will provide us a four to five year drilling inventory, however it is our intention to continue to grow the drilling inventory through drilling and land acquisitions.

The Company continues to increase operating netbacks as we continue our strategy of controlling infrastructure and reducing operating costs by maintaining a field and office staff with operating experience. The Company still holds various gas-weighted assets in the Medicine Hat and Jaslan area and intends to continue to hold these assets to provide an option on the price of gas go forward.

I would like to thank my colleagues at Yangarra for their ongoing dedication to the development of the company. They have delivered seamless, reliable operations and demonstrated the ability to quickly interpret, react and adapt to the technical results of our pioneering efforts. I also wish to take this opportunity to thank my fellow directors for their support and leadership.

James Evaskevich
President, CEO and Director
April 19, 2011

Yangarra Resources Ltd.
Management's discussion and analysis
December 31, 2010



YANGARRA RESOURCES LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS
For the year ended December 31, 2010

Management's discussion and analysis ("MD&A") of the financial condition and the results of operations should be read in conjunction with the December 31, 2010 audited consolidated financial statements of Yangarra Resources Ltd. (the "Yangarra" or "Company"), together with the accompanying notes.

Additional information about Yangarra filed with Canadian securities commissions is available on-line at www.sedar.com.

*The MD&A has been prepared using information that is current to **April 19, 2011**.*

The financial information presented herein has been prepared on the basis of Canadian generally accepted accounting principles ("GAAP"). Throughout this discussion, percentage changes are calculated using numbers rounded to the decimal to which they appear. All references to dollar amounts are in Canadian dollars.

The comparative results included herein for the three months and year ended December 31, 2010 are those of Yangarra only.

On December 31, 2009, the Company acquired all of the issued and outstanding shares of Athabaska Energy Ltd. ("Athabaska"), a non-arm's length private corporation, in exchange for 10,000,001 common shares of the Company. On May 1, 2010, the Company and Athabaska were amalgamated and continue to carry on business under the name Yangarra Resources Ltd. At this time, the Company consolidated its common shares on a five old for one new (5:1) basis. All common share, warrant and stock option figures disclosed herein are presented on a consolidated basis.

BOE Presentation – *Production information is commonly reported in units of barrel of oil equivalent ("boe"). For purposes of computing such units, natural gas is converted to equivalent barrels of oil using a conversion factor of six thousand cubic feet to one barrel of oil. This conversion ratio of 6:1 is based on an energy equivalent wellhead value for the individual products. Such disclosure of boe may be misleading, particularly if used in isolation. Readers should be aware that historical results are not necessarily indicative of future performance.*

Special Note Regarding Non-GAAP Measures – *This MD&A includes references to financial measures commonly used in the oil and gas industry. The terms "net petroleum and natural gas revenue" (petroleum and natural gas sales less royalties, production expenses and transportation costs) and "funds flow from operations" (net loss for the period adjusted for non-cash items in the statement of operations) are not GAAP measures and do not have standardized meanings prescribed by GAAP.*

Forward-looking Statements – *Certain information regarding the Company set forth in this report, including management's assessment of the Company's future plans and operations, contain forward-looking statements that involve substantial known and unknown risks and uncertainties. These risks and uncertainties, many of which are beyond the Company's control, include the impact of general economic conditions and specific industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, the lack of available qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. The Company's actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements, and accordingly, no assurance can be given that any events anticipated by the forward-looking statements will transpire or occur, or if any of them do, what benefits the Company will derive from such events.*

YANGARRA RESOURCES LTD.
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Company Description and Outlook

Yangarra is a junior oil and gas company engaged in the exploration, development and production of natural gas and oil with operations in Western Canada, with a main focus on Central Alberta, where the Company has extensive infrastructure and land holdings.

Yangarra is dedicated to creating value for its shareholders through its commitment to a clear business strategy and performance objectives. The Company's strategy is to increase the value of its corporate assets through the drill bit and by assembling a large focused land base in Alberta that features high-quality, long-life light oil and liquids-rich gas reserves. The Company has assembled a significant future drilling inventory and will strive to grow this inventory through drilling, geology and strategic acquisitions.

During the year ended December 31, 2010 the Company completed the following significant milestones:

- Purchased a 15% gross sliding scale over-ride on 11 sections in the Willesden Green area.
- Completed equity raises in March, May, June and October for total proceeds of \$23 million, with each equity raise priced at a premium to the previous financing.
- Secured a drilling rig for the balance of 2010, through to spring breakup 2011 and exercised an option to retain the drilling rig through spring breakup 2012.
- Completed an asset acquisition in the Willesden Green/Ferrier area of Alberta for \$4.0 million.
 - The asset included 31 sections of land (12.3 net), 10 gross producing wells (4.25 net) and 9 gross standing wells (4.8 net) with 50 boe/d, 90% weighted to oil, of production.
- Entered into a credit facility agreement with Alberta Treasury Branches in November 2010 and increased the facility to \$12,000,000 in December 2010.
 - Credit facility increased to \$14.5 million in first quarter of 2011

Subsequent to the year ended December 31, 2010 the Company completed the following :

- Established a capital budget for 2011 of \$50 million which includes the drilling of 31 gross (13.7 net wells)
- Significantly increased the Company's future drilling locations to 123 gross (70.2 net) locations in the Glauconite, Cardium and multiple other zones

The following is a list of the initial 30 day production rates ("IP 30") of the horizontal wells that were drilled during 2010:

Location	Horizontal Length	Fracturing	Working Interest (w.i.)	IP	Production
06-03-41-7W5 Glauconite (operated)	710 m	8 stages 200 tonne	100% w.i.	IP 30	602 boe/d
09-20-41-7W5 Cardium (non-operated)	699 m	5 stages 150 tonne	68.15% w.i. plus 15% override	IP 30	85 boe/d
07-20-41-7W5 Cardium (operated)	725 m	8 stages 200 tonne	68.15% w.i. plus 15% override	IP 30	324 boe/d
13-02-41-7W5 Glauconite (operated)	1106 m	12 stages 300 tonne	68.15% w.i. plus 15% override	IP 30	760 boe/d
14-36-37-8W5 Cardium (operated)	550 m	6 stages 300 tonne	100% w.i.	IP 30	50 boe/d (on restricted production)
1-20-41-7W5 Cardium (operated)	1,067 m	6 stages 300 tonne	68.15% w.i. plus 15% override	IP 30	285 boe/d

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Summary Financial Information

	For the Years ended December 31		
	2010	2009	2008
Statement of Operations and Deficit			
Petroleum & natural gas sales	\$ 6,534,377	\$ 3,579,738	\$ 8,642,336
Net (loss) income for the period	\$ (4,047,125)	\$ (7,268,020)	\$ (1,825,080)
Net (loss) income per share - basic	\$ (0.07)	\$ (0.46)	\$ (0.15)
Weighted average number of shares - basic	57,581,832	15,662,664	13,499,997
Statement of Cash Flows			
Funds flow from operations	\$ 2,959,286	\$ 106,856	\$ 3,820,278
Balance Sheet			
Property and equipment	\$ 61,475,178	\$ 38,830,516	\$ 41,922,138
Total assets	\$ 65,945,647	\$ 39,641,449	\$ 44,081,309
Preferred shares	\$ 1,000,000	\$ 1,000,000	\$ -

Business Environment

	For the Years ended December 31	
	2010	2009
West Texas Intermediate ("WTI") (US\$/bbl)	\$ 78.48	\$ 61.80
AECO gas (Cdn\$/GJ)	\$ 4.08	\$ 3.75
Foreign Exchange (Cdn\$/US\$)	\$ 1.030	\$ 1.142

Crude oil prices strengthened in 2010, with West Texas Intermediate ("WTI") reference price averaging US\$78.48 per barrel compared to US\$61.80 per barrel in 2009. Demand for crude oil is generally tied to global economic growth, but is also influenced by factors such as political instability, market uncertainty, weather conditions and government regulations. The WTI forward strip price for the remainder of 2011 is over US\$100.

Oil prices in Canada are also affected by the Canada/US dollar exchange rate since the WTI reference price of oil is in US dollars. During 2010, the Canadian dollar strengthened against the US dollar, averaging Cdn\$1.030 to US\$1 compared with Cdn\$1.142 to US\$1 in 2009. The strengthening dollar partially offsets the increased WTI benchmark pricing experienced during 2010.

AECO natural gas prices for 2010 increased to \$4.08 per GJ from \$3.75 per GJ in 2009. Demand from the price sensitive power and industrial sectors and hot weather patterns in the Northeast part of the United States temporarily offset the strong incremental production from shale gas plays. Although natural gas prices have recovered compared to a weak 2009 price environment, strong US natural gas production is limiting the upside to natural gas price recovery.

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Results of Operations

Net petroleum and natural production, pricing and revenue

	Three months ended		Years ended	
	December 31		December 31	
	2010	2009	2010	2009
Daily production volumes				
Natural Gas (mcf/d)	2,564	1,362	2,151	1,583
Oil (bbl/d)	260	11	116	12
NGL's (bbl/d)	54	12	28	15
Royalty income (boe/d)	19	-	6	-
Combined (boe/d 6:1)	761	249	509	291
Product pricing				
Oil (\$/bbl)	\$ 80.54	\$ 69.07	\$ 74.70	\$ 65.56
NGL (\$/bbl)	\$ 62.30	\$ 50.37	\$ 56.04	\$ 38.03
Gas (\$/mcf)	\$ 3.93	\$ 3.69	\$ 3.92	\$ 3.88
Combined (\$/boe)	\$ 40.94	\$ 32.91	\$ 35.55	\$ 33.74
Revenue				
Petroleum & natural gas sales - Gross	\$ 2,864,802	\$ 754,728	\$ 6,534,377	\$ 3,579,738
Royalty income	\$ 93,882	\$ -	\$ 123,106	\$ -
Royalty expense	\$ (128,984)	\$ (87,683)	\$ (165,309)	\$ (195,223)
Royalty recovery		\$ 114,092		\$ 289,728
Petroleum & natural gas sales - Net	\$ 2,829,700	\$ 781,137	\$ 6,492,174	\$ 3,674,243

	Three months ended		Years ended	
	December 31		December 31	
	2010	2009	2010	2009
Production by Area (boe/d)				
Willesden Green/Ferrier	546	72	244	73
Willesden Green/Ferrier - royalty income	19	-	6	-
Medicine Hat	87	90	93	102
Jaslan	98	80	153	109
Other	11	7	13	7
Total	761	249	509	291

The increased production in 2010 can be attributed to the drilling program in Central Alberta. The initial 100% owned Glauconite horizontal well in the area was drilled in May which resulted in additional flush oil production in May. This well along with a second horizontal Cardium well were placed on full production in early August. Four additional horizontal wells were drilled over the remainder of the year, three Cardium and one Glauconite. Two of these wells were put on production in the fourth quarter, while the last two were not on production until the first quarter of 2011. These wells have significantly higher rates than the Company's traditional gas wells in the Jaslan and Medicine Hat area and have resulted in significant production increases from 2009. The overall average price earned by the Company was higher when compared to 2009 due to increased oil and natural gas liquids production (29% compared to 5% in 2009).

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For the year ended December 31, 2010, the Company's production was more heavily weighted to oil (24% oil, 5% NGL and 71% natural gas) than the 2009 comparative period (4% oil, 5% NGL and 91% gas), this caused the overall average 2010 price to be higher as the realized price for oil and liquids in the 2010 period improved.

Included in petroleum and natural gas revenue for the three and twelve months ended December 31, 2010 is nil and \$31,131, respectively, of realized gains on the fulfilled portion of commodity contracts from January 1 to March 31, 2010. Including the realized gains, the average gas price earned by the Company for the twelve month 2010 period increased to \$4.29 per mcf from \$4.25 per mcf.

Included in petroleum and natural gas revenue for the three and twelve months ended December 31, 2009 is \$232,261 and \$920,429, respectively, of realized gains on the fulfilled portion of commodity contracts from April 1 to December 31, 2009. Including the realized gains, the average gas price earned by the Company for the three and twelve months ended December 31, 2009 was \$5.06 per mcf and \$5.37 per mcf, respectively.

Royalty Income

	Three months ended December 31		Years ended December 31	
	2010	2009	2010	2009
Royalty income	\$ 93,882	\$ -	\$ 123,106	\$ -

The majority of the royalty income is a result of the 15% sliding scale royalty purchased in the Willesden Green area in March 2010.

Royalty Expense

	Three months ended December 31		Years ended December 31	
	2010	2009	2010	2009
Royalty expense	\$ 128,984	\$ 87,683	\$ 165,309	\$ 195,223
Per boe	\$ 1.84	\$ 3.82	\$ 0.90	\$ 1.84
As a % of sales	5%	12%	3%	5%
Royalty recovery	\$ -	\$ 114,092	\$ -	\$ 289,728

During the three and twelve months ended December 31, 2010, the Company received \$15,270 and \$263,451, respectively, of capital cost allowance, custom processing and operating deductions which are included in royalty expense. The capital cost allowance, custom processing and operating deductions in the three month period ended September 30, 2010 was \$124,018 which caused the increase in royalty in the fourth quarter of 2010. The crown royalty rate on the new horizontal wells in Willesden Green is 5% for the earlier of 2 years or 60,000 boe of production.

During 2009, the Company recognized a recovery in the amount of \$289,728 related to freehold and gross overriding royalties calculated and paid in previous years.

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Production and Transportation Costs

	Three months ended December 31		Years ended December 31	
	2010	2009	2010	2009
Production costs	\$ 738,831	\$ 954,655	\$ 1,820,683	\$ 1,994,861
Per boe	\$ 10.56	\$ 41.63	\$ 9.91	\$ 18.80
Transportation costs	\$ 72,990	\$ 54,810	\$ 237,893	\$ 137,692
Per boe	\$ 1.04	\$ 2.39	\$ 1.29	\$ 1.30

	Three months ended December 31		Years ended December 31	
	2010	2009	2010	2009
Operating costs for core areas				
Willesden Green/Ferrier	\$ 8.91	\$ 8.93	\$ 9.25	\$ 31.83
Medicine Hat	\$ 21.88	\$ 24.13	\$ 23.49	\$ 23.55
Jaslan	\$ 8.31	\$ 5.31	\$ 12.81	\$ 7.30

Production and transportation costs per boe have dropped in 2010 due to increased production in areas with facilities in place and where the majority of the costs are fixed. Operating and transportation costs per boe in the Willesden Green area are expected to continue to decline as more production is brought on stream and fixed costs are shared over higher volumes. Lower volumes in Medicine Hat will likely increase operating costs during 2011 in that area.

Operating Netback

\$/boe	Three months ended December 31		Years ended December 31	
	2010	2009	2010	2009
Revenues	\$ 40.94	\$ 32.91	\$ 35.55	\$ 33.74
Royalty income	1.34	-	0.67	-
Royalty expense	(1.84)	(3.82)	(0.90)	(1.84)
Production costs	(10.56)	(41.63)	(9.91)	(18.80)
Transportation costs	(1.04)	(2.39)	(1.29)	(1.30)
Netback	\$ 28.83	\$ (14.93)	\$ 24.12	\$ 11.80

Netbacks were stronger due to higher oil and liquid sales and therefore higher relative prices to natural gas. The higher oil and liquid sales were a result of the Company's focus on Glauconite and Cardium wells in Willesden Green versus the gas-weighted Medicine Hat and Jaslan areas in 2009. The Company has also lowered operating costs as economies of scale are being realized in the Willesden Green/Ferrier due to increasing volumes.

As the Company continues to focus drilling in Central Alberta it expects netbacks to continue to rise as a result of both the increased proportion of oil and liquids and the continued decrease in operation costs.

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Depletion, depreciation and accretion

	Three months ended		Years ended	
	December 31		December 31	
	2010	2009	2010	2009
Depletion and depreciation	\$ 2,532,404	\$ 816,289	\$ 6,066,568	\$ 8,064,412
Per boe	\$ 36.19	\$ 35.60	\$ 33.01	\$ 76.00
Accretion	\$ 46,478	\$ 37,077	\$ 173,703	\$ 146,621

Depletion and depreciation per boe decreased in 2010 compared to 2009 due to: (1) an increase in the Company's proved reserves from that stated in the December 31, 2009 external reserve report; (2) the reclassification of reserves from the probable to proved category in the current period as a result of drilling activity; and (3) the addition of proved reserves related to a gross overriding royalty acquired in March 2010.

The 2009 depletion rates include the effect of a ceiling test impairment in the amount of \$4,300,000. The continued lower commodity prices combined with a decline in some of the Company's probable reserves resulted in the Company's net book value of its assets at September 30, 2009 being greater than the value as determined by the ceiling test.

Accretion expense increased in 2010 due to an increase in the undiscounted cash flows associated with the retirement of the Company's assets resulting from the increase in the number of properties and changes to certain reserve life and cost estimates.

Other expenses

	Three months ended		Years ended	
	December 31		December 31	
	2010	2009	2010	2009
General and administrative expenses	\$ 380,831	\$ 333,256	\$ 1,161,575	\$ 898,084
Interest and financing fees	\$ 94,780	\$ 493,200	\$ 265,251	\$ 1,295,660
Dividends on preferred shares	\$ 12,603	\$ -	\$ 50,000	\$ -
Stock-based compensation	\$ 961,984	\$ 206,091	\$ 1,746,939	\$ 206,091

General and administrative expenses were higher in the 2010 periods due to an increase in professional fees related to the yearend audit, salaries/consulting fees related to new employees/consultants commensurate with the increase in the Company's exploration and development activities and legal fees related to a dispute with a joint venture partner.

Interest and financing fees for the three and twelve months ended December 31, 2010 is for interest on the revolving operating demand loan for which the average amount drawn in 2010 was \$6,200,000 at an effective interest rate of 4.0%.

Interest and financing fees for the three and twelve months ended December 31, 2009 were significantly higher on a comparative basis as they included:

- \$91,142 and \$394,644, respectively, on the revolving operating demand loan for which the average amount drawn during the 2009 period was \$8,175,000 at an effective interest rate of 4.8% plus other fees; and
- \$250,205 and \$732,534, respectively, of interest and financing fees on the subordinated credit facility (settled in December 2009) based on the effective interest method.

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Dividends on preferred shares for the three and twelve months ended December 31, 2010 are at a rate of 5% payable semi-annually in cash or common shares of the Company on \$1,000,000 of preferred shares issued in December 2009 in conjunction with the settlement of the subordinated credit facility.

During the year ended December 31, 2010, the Company granted a total of 4,570,000 stock options which vested immediately. The total fair value of the options was estimated at \$2,817,600 of which \$1,746,939 was recognized as stock-based compensation expense ("SBC") and \$1,070,661 was capitalized to property and equipment. The Company did not grant any options in the 2009 comparative period.

Commodity price risk contracts

	Three months ended December 31		Years ended December 31	
	2010	2009	2010	2009
Commodity contract settlement	\$ (32,766)	\$ -	\$ 40,734	\$ -
Change in fair value of commodity contracts	(6,270)	6,983	113,361	(113,361)
	<u>\$ (39,036)</u>	<u>\$ 6,983</u>	<u>\$ 154,095</u>	<u>\$ (113,361)</u>

As at January 1, 2010, the Company was committed to the following commodity price risk contracts for the sale of natural gas:

- 1,000 GJ per day from January 1 to January 31, 2010 at a fixed price of \$5.51 per GJ;
- 1,000 GJ per day from February 1 to February 28, 2010 at a fixed price of \$5.53 per GJ; and
- 500 GJ per day from January 1 to December 31, 2010 at a fixed price of \$5.68 per GJ.

In addition the Company sold calls which provided a ceiling for the price it received for natural gas as follows:

- 500 GJ per day from January 1 to December 31, 2010 at the ceiling price of \$6.25 per GJ;
- 500 GJ per day from March 1 to December 31, 2010 at the ceiling price of \$6.50 per GJ; and
- 500 GJ per day from March 1 to December 31, 2010 at the ceiling price of \$6.70 per GJ.

In March 2010, the Company settled all outstanding commodity price risk contracts for proceeds of \$73,500 and reported an unrealized gain of \$113,361 related to the reversal of the mark-to-market liability recognized at December 31, 2009.

In September 2010, the Company was committed to a commodity price risk "basis" contract for the sale of 1,000 MMBTU of natural gas per day from November 1, 2010 to March 31, 2011, the terms of which were related to the difference in price between AECO and NYMEX fixed at \$0.45 per MMBTU. The Company terminated the contract in November 2010 at a cost of \$32,766.

Included in petroleum and natural gas revenue for the year ended December 31, 2010 are \$172,345 of realized gains (December 31, 2009 – \$920,429) on the fulfilled portion of commodity contracts.

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Future income tax reduction

During the year ended December 31, 2010, the Company recognized a \$464,897 future tax benefit in share capital for share issue costs incurred in the period and a \$356,887 future tax liability in property and equipment and SBC capitalized in the period. During the three and twelve months ended December 31, 2010, the Company recorded a reduction of future income taxes of \$255,152 and \$1,825,498.

During the three and twelve months ended December 31, 2009, the Company recorded a reduction of future income taxes of \$255,152 and \$1,825,498 respectively, related to the reversal of temporary differences between the carrying value and tax basis of the Company's property and equipment. Of this temporary timing difference, \$1,000,000 related to the effect of the \$4.3 million ceiling test impairment that was recorded during the third quarter 2009.

Liquidity and Capital Resources

During the year ended December 31, 2010, the Company generated \$2,959,286 of funds flow from operations compared to \$106,856 in the 2009 comparative period. Funds flow from operations was higher for the 2010 period due primarily to the increase in petroleum and natural gas revenue and the reduction in interest and financing fees.

As at December 31, 2010, the maximum amount available under the revolving operating demand loan was \$12,000,000 (December 31, 2009 – \$8,300,000) at an interest rate of bank prime plus 1% per annum, payable monthly, and increased to bank prime plus 1.5% if the Company's net debt to trailing cash flow ratio is equal to or greater than 1 to 1.

As at December 31, 2010, the \$5,559,208 (December 31, 2009 – \$8,195,069) reported amount of bank debt was comprised of \$4,600,000 (December 31, 2009 – \$7,800,000) drawn on the revolving operating demand loan and \$959,208 (December 31, 2009 – \$395,069) of bank overdraft

The Company is compliant with all debt covenants as at December 31, 2010.

As at December 31, 2010, the Company had a working capital deficit of \$11,472,461 compared to a deficit of \$7,963,051 at December 31, 2009. The change in the Company's working capital position occurred primarily in the fourth quarter as the Company ramped up the drilling program utilizing the proceeds from the October equity financing and the increased credit facility. Production from the wells was not fully online until the first quarter of 2011.

The audited consolidated financial statements have been prepared on a going concern basis which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. Subsequent to December 31, 2010 the Company completed a \$17 million equity financing, with completion of the financing the Company's 2010 capital budget is fully funded. Any adverse changes to market conditions can be accommodated by revising the size and timing of the capital program through-out the year

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Capital Spending

Capital spending is summarized as follows:

	Three months ended December 31		Years ended December 31	
	2010	2009	2010	2009
Land and lease rentals	\$ 3,827,343	\$ 102,562	\$ 5,449,298	\$ 237,407
Drilling and completion	10,593,594	262,256	16,777,716	854,518
Geological and geophysical	190,640	42,801	505,583	74,615
Equipment	2,148,426	251,496	4,272,875	448,421
	\$ 16,760,003	\$ 659,115	\$27,005,472	\$ 1,614,961

2010 Drilling Activity:

	Three months ended December 30, 2010		Years ended December 31, 2010	
	Gross	Net	Gross	Net
Natural gas	–	–	–	–
Oil	3.0	2.36	6.0	4.0
	3.0	2.36	6.0	4.0

Asset Retirement Obligation

As at December 31, 2010, the undiscounted fair value of the asset retirement obligation associated with the Company's existing properties was estimated to be \$4,815,382 for which \$2,620,549 has been recorded using a discount rate of 7% - 10%, an inflation rate of 2% and an estimated weighted average timing of cash flows of 10 years.

Off Balance Sheet Arrangements

There were no off balance sheet arrangements, other than the office, field equipment and truck lease commitments which are accounted for as operating leases.

Related Party Transactions

During the three and twelve months ended December 31, 2010 and 2009, the Company was charged or invoiced the following amounts by certain of its officers and directors and by companies controlled by certain of the Company's officers and directors:

	Three months ended December 31		Years ended December 31	
	2010	2009	2010	2009
Administration and consulting fees	\$ 35,055	\$ 121,348	\$ 168,270	\$ 159,174
Production and capital expenditures	\$ 87,698	\$ 28,571	\$ 614,055	\$ 119,865

These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

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Share Capital

Details of changes in the number of outstanding equity instruments are detailed in the following table:

	Common Shares	Preferred Shares	Warrants	Stock Options
Balance - December 31, 2009	37,388,006	1,000,000	2,000,000	3,542,255
Private placement March 2010	16,000,000	-	8,000,000	-
Private placement May 2010 (Flow-through)	3,745,454	-	-	-
Private placement June 2010 (Flow-through)	1,650,000	-	-	-
Private placement June 2010	1,650,000	-	-	-
Special Warrant Financing October 2010 (Flow-through)	8,666,667	-	-	-
Special Warrant Financing October 2010	10,000,000	-	-	-
Grant of Options	-	-	-	4,570,000
Exercise of Options	70,000	-	-	(70,000)
Expiry of Options	-	-	-	(223,455)
Forfeiture of Options	-	-	-	(35,000)
Exercise of Warrants	548,000	-	(548,000)	-
Balance - December 31, 2010	79,718,127	1,000,000	9,452,000	7,783,800
Financing March 2011	23,632,500	-	-	-
Grant of Options	-	-	-	2,620,000
Exercise of Options	260,000	-	-	(260,000)
Expiry of Options	-	-	-	(15,000)
Exercise of Warrants	184,000	-	(184,000)	-
Redemption of Preferred Shares	-	(1,000,000)	-	-
Balance - Date of MD&A	103,794,627	-	9,268,000	10,128,800

Subsequent Events

On March 8, 2011, the Company, closed a "bought deal" financing, completed by way of a short form prospectus, for the sale of 23,632,500 common shares of the Company at a price of \$0.73 per share for gross proceeds of \$17,251,725.

On March 8, 2011, the Company granted options to purchase 2,570,000 common shares at a price of \$0.74 per share, pursuant to its stock option plan. The options vested immediately and will expire March 8, 2016. Officers were granted options on 1,250,000 shares, directors were granted options on 200,000 shares, and the balance of the options were issued to employees and consultants.

Contingency

In December 2009, the Company terminated the Standstill Agreement that it had with an industry partner regarding a joint producing property and served that industry partner with a Statement of Claim issued from The Court of Queen's Bench of Alberta, by which the Company claims breach of the agreements between the parties, gross negligence and default of operator. The Company seeks judgment for specified and such further damages to be determined by the Court, as well as appointment as operator. The industry partner has filed a Statement of Defence and Counterclaim. The potential outcome of the lawsuit and claims are undetermined however they may be material. As the likely outcome of this litigation cannot be determined at this time, no provision has been made in the consolidated financial statements.

YANGARRA RESOURCES LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS
For the year ended December 31, 2010

Commitments

As at December 31, 2010, the Company has until December 31, 2011 to incur \$9,690,000 of qualifying flow-through expenditures related to the private placement of flow-through shares issued in May, June and October 2010, of which approximately \$3,600,000 has been incurred.

The Company has entered into lease agreements for office premises, field equipment and Company vehicles with estimated minimum annual payments as follows:

2011	\$	185,571
2012	\$	185,571
2013	\$	109,695

Financial instruments and financial risk management

The Company's financial instruments include cash, accounts receivable, accounts payable and accrued liabilities, bank debt, credit facility and preferred shares. The carrying values of accounts receivable, accounts payable and accrued liabilities, bank debt and credit facility approximate their fair values due to their relatively short periods to maturity.

The Company is required to classify fair value measurements using a hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy is as follows:

- Level 1 - quoted prices in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The Company has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments. This note presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with the risk management policies as set out herein:

Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable are with natural gas and liquids marketers and joint venture partners in the oil and gas industry and are subject to normal industry credit risks. Purchasers of the Company's natural gas and liquids are subject to credit review to minimize the risk of non-payment. As at December 31, 2010, the maximum credit exposure is the carrying amount of the accounts receivable and accruals of \$3,752,477 (December 31, 2009 – \$658,080). As at December 31, 2010, the Company's receivables consisted of \$2,611,471 from joint venture partners and other trade receivables and \$1,141,005 of revenue receivable from petroleum and natural gas marketers.

Receivables from petroleum and natural gas marketers are typically collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any

YANGARRA RESOURCES LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS
For the year ended December 31, 2010

significant collection issues with its petroleum and natural gas marketers. All of the revenue accruals and receivables from petroleum and natural gas marketers were received in January and February 2011.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company mitigates the risk from joint venture receivables by obtaining partner approval of capital expenditures prior to starting a project. However, the receivables are from participants in the petroleum and natural gas sector, and collection is dependent on typical industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. Further risk exists with joint venture partners as disagreements occasionally arise which increases the potential for non-collection. For properties that are operated by the Company, production can be withheld from joint venture partners who are in default of amounts owing. In addition, the Company often has offsetting amounts payable to joint venture partners from which it can net receivable balances.

The Company did not provide for any doubtful accounts nor was it required to write-off any receivables during the year ended December 31, 2010. The Company would only choose to write-off a receivable balance (as opposed to providing an allowance) after all reasonable avenues of collection had been exhausted.

As at December 31, 2010, the Company considers its receivables to be aged as follows:

Not past due	\$	2,048,397
Past due by less than 90 days		1,117,588
Past due by more than 90 days		474,910
Related to contingency		111,582
	\$	<u>3,752,477</u>

Liquidity risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company uses authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures.

To facilitate the capital expenditure program, the Company has a revolving reserve-based bank facility which is regularly reviewed by the lender. The Company monitors its total debt position monthly. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month. The Company anticipates it will have adequate liquidity to fund its financial liabilities through its future cash flows. The Company's financial liabilities are comprised of accounts payable and accrued liabilities, bank debt and the credit facility, which have expected maturities of less than one year resulting in their current classification on the balance sheet.

Market risk

Market risk consists of interest rate risk, currency risk and commodity price risk. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may use both financial derivatives and physical delivery sales contracts to manage market risks. All such transactions are conducted in accordance with a risk management policy as set out herein:

- i) Interest rate risk

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MANAGEMENT'S DISCUSSION AND ANALYSIS
For the year ended December 31, 2010

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank debt which bears interest at a floating rate. For the year ended December 31, 2010, if interest rates had been 1% lower with all other variables held constant, earnings for the period would have been \$62,000 (December 31, 2009 – \$79,750) higher, respectively, due to lower interest expense. An equal and opposite impact would have occurred had interest rates been higher by the same amounts. The Company had no interest rate swap or financial contracts in place at December 31, 2010.

ii) Currency risk

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. All of the Company's petroleum and natural gas sales are denominated in Canadian dollars, however, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. The Company had no outstanding forward exchange rate contracts in place at December 31, 2010.

iii) Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand as well as the relationship between the Canadian and United States dollar, as outlined above. The Company's commodity price risk contracts are disclosed in note 11 of the audited financial statements.

Capital management

The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute its capital expenditure program, which includes expenditures in oil and gas activities which may or may not be successful. Therefore, the Company monitors the level of risk incurred in its capital expenditures to balance the proportion of debt and equity in its capital structure.

The Company considers its capital structure to include:

	<i>December 31</i>	<i>December 31</i>
	<i>2010</i>	<i>2009</i>
Shareholders' equity	\$ 47,382,168	\$ 26,848,381

The Company monitors capital based on annual funds from operations and capital expenditure budgets, which are updated as necessary and are reviewed and periodically approved by the Company's Board of Directors.

The Company manages its capital structure and makes adjustments by continually monitoring its business conditions including the current economic conditions, the risk characteristics of the Company's petroleum and natural gas assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other facts that influence commodity prices and funds from operations such as quality and basis differentials, royalties, operating costs and transportation costs.

In order to maintain or adjust the capital structure, the Company considers its forecasted funds from operations while attempting to finance an acceptable capital expenditure program including acquisition opportunities, the current level of bank credit available from the Company's lender, the level of bank credit that may be attainable from its lender as a result of petroleum and natural gas reserve growth, the availability of other sources of debt with different characteristics than existing debt, the sale of assets, limiting the size of the capital expenditure program and the issue of new equity if available on favorable terms. At December 31, 2010, the Company's capital structure was not subject to external restrictions. The Company's bank facility is determined by the senior lender and based on the lender's borrowing base model and the Company's petroleum and natural gas reserves.

YANGARRA RESOURCES LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS
For the year ended December 31, 2010

Selected Historical Financial Information

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2010				
Petroleum and natural gas sales	\$ 1,009,188	\$ 839,054	\$ 1,821,333	\$ 2,864,802
Net petroleum and natural gas revenue	\$ 646,831	\$ 439,729	\$ 1,299,935	\$ 2,017,879
Net loss	\$ (570,592)	\$ (1,637,373)	\$ (672,494)	\$ (1,195,890)
Net loss per share	\$ (0.00)	\$ (0.03)	\$ (0.01)	\$ (0.02)
Funds flow from operations	\$ 410,168	\$ 59,390	\$921,972	\$1,567,756
Net capital expenditures	\$ 3,799,846	\$ 3,756,574	\$ 2,689,049	\$ 16,760,003
2009				
Petroleum and natural gas sales	\$ 1,025,969	\$ 909,592	\$ 889,449	\$ 754,728
Net petroleum and natural gas revenue	\$ 629,971	\$ 533,449	\$ 430,962	\$ (228,328)
Net loss	\$ (405,050)	\$ (757,791)	\$ (4,308,038)	\$ (1,797,141)
Net loss per share	\$ (0.05)	\$ (0.05)	\$ (0.25)	\$ (0.10)
Funds flow from (used in) operations	\$ 432,673	\$ 180,863	\$ 133,901	\$ (640,581)
Net capital expenditures	\$ 298,013	\$ 132,898	\$ 524,935	\$659,115

Business Risks and Uncertainties

The Company is exposed to several operational risks inherent in exploring, developing, producing and marketing crude oil and natural gas. These inherent risks include: economic risk of finding and producing reserves at a reasonable cost; financial risk of marketing reserves at an acceptable price given current market conditions; cost of capital risk associated with securing the needed capital to carry out the Company's operations; risk of environment impact; and credit risk of non-payment for sales contracts and joint venture partners.

The Company attempts to control operating risks by maintaining a disciplined approach to implementation of its exploration and development programs. Exploration risks are managed by hiring experienced technical professionals and by concentrating the exploration activity on specific core regions that have multi-zone potential where the Company has experience and expertise. The Company also generates internal prospects and participates in projects where ownership interest is considered sufficient to minimize risk. Operational control allows the Company to manage costs, timing and sales of production and to ensure new production is brought on-stream in a timely manner.

The Company maintains a comprehensive insurance program to reduce risk to an acceptable level and to protect it against significant losses.

Disclosure Controls and Procedures

The Company's certifying officers will file a Venture Issuer Basic Certificate with respect to the information contained in its audited financial statements and the accompanying Management's Discussion and Analysis. The Venture Issuer Basic Certification includes a 'Notice to Reader' stating that the certifying officers do not make any representations relating to the establishment and maintenance of disclosure controls and procedures and internal control over financial reporting, as defined in National Instrument 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings.

Critical Accounting Estimates

The Company's financial statements are prepared in accordance with Canadian generally accepted accounting principles. A comprehensive discussion of the Company's significant accounting policies is contained in Note 2 to the audited consolidated financial statements for the year ended December 31, 2010. The Company's significant accounting policies are subject to estimates and key judgments about future events, many of which are beyond management's control.

The Company believes the following are the most critical accounting estimates used in the determination of its financial results:

Petroleum and natural gas properties – depletion and ceiling test

The Company follows the full cost method of accounting by initially capitalizing all costs related to the acquisition, development and exploration of petroleum and natural gas reserves. Costs capitalized include land acquisition costs, geological and geophysical expenditures, rentals on undeveloped properties, costs of drilling productive and non-productive wells, together with overhead directly related to exploration and development activities and lease and well equipment. Costs capitalized are depleted using the unit-of-production method based on gross proved petroleum and natural gas reserves as determined by independent qualified reserve evaluators. Production and reserves of petroleum and natural gas are converted to common units of measure based on their relative energy content where one barrel of oil is equivalent to six thousand cubic feet of natural gas. The depletion base excludes the cost of significant unproved properties until it is determined whether proved reserves are attributable to the properties or impairment has occurred.

The Company performs a ceiling test where the carrying amount of property and equipment is compared to the sum of the undiscounted cash flows expected to result from the future production of proved and probable reserves and the cost, less any impairment of unproved properties. Estimated cash flows are discounted at the Company's risk-free rate of interest using forecast prices and costs. The carrying amount of undeveloped properties and seismic excluded from the ceiling test are compared to independent evaluations of fair value. Any impairment is recorded as additional depletion expense.

Estimates are the basis for amounts recorded as depletion and the ceiling test. These estimates include proved and probable reserves, production rates, future petroleum and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates could be material in future periods.

Asset retirement obligation

The Company recognizes the liability for the asset retirement obligation associated with the abandonment of petroleum and natural gas wells, related facilities, compressors and plants and the removal of equipment from leased acreage and returning such land to its original condition. The fair value the Company's asset retirement obligation is recorded in the period a well or related asset is drilled, constructed or acquired. Fair value is estimated using the present value of the estimated future cash outflows to abandon the assets at the Company's credit-adjusted risk-free interest rate based on the expected timing of such cash outflows. Future costs and their expected timing are estimates that are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates could be material in future periods.

Income taxes

The Company records future tax assets and liabilities to account for the expected future tax consequences of events that have been recorded in its consolidated financial statements and its tax returns. These amounts are estimates and the actual tax consequences may differ from the estimates due to changing tax rates and regimes, as well as changing estimates of cash flows and capital expenditures in current and future periods. A valuation allowance is recorded to the extent that there is uncertainty regarding utilization of future tax assets.

YANGARRA RESOURCES LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS
For the year ended December 31, 2010

The determination of the Company's income and other tax liabilities requires interpretation of complex laws and regulations, often involving multiple jurisdictions. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability and expense may differ from that estimated and recorded.

Stock-based compensation

Stock-based compensation expense is recorded in the statement of loss and deficit for all options granted based on the estimated fair value at the time of the grant and recognized as expense over the vesting period of the option. The fair value of options is estimated using the Black-Scholes pricing model based on estimates and assumptions for expected life of the options, expected volatility, risk-free interest rate and dividend yield. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates could be material in future periods.

International Financial Reporting Standards ("IFRS")

The Canadian Accounting Standards Board (AcSB) published a new strategic plan that outlines the convergence of Canadian generally accepted accounting principles with IFRS over an expected five year transitional period. The changeover date for publicly-listed companies to use IFRS, replacing Canada's own generally accepted accounting principles is interim and annual financial statements for fiscal years beginning on or after January 1, 2011 with the restatement for comparative purposes of amounts reported by the Company for the year ended December 31, 2010.

The Company has completed a high-level review and preliminary assessment of the differences between Canadian GAAP and IFRS and the potential effects of IFRS to accounting and reporting processes, information systems, business processes and external disclosures. This assessment has provided insight into what are anticipated to be the most significant areas of difference applicable to the Company. The next step is to perform an in-depth review of the significant areas of difference and select ongoing IFRS policies. Key areas addressed will also be reviewed to determine any information technology issues, the impact on internal controls over financial reporting and the impact on business activities including the effect, if any, on covenants and compensation arrangements.

The Company will also continue to monitor standards development as issued by the IASB and the AcSB as well as regulatory developments as issued by the Canadian Securities Administrators, which may affect the timing, nature or disclosure of its adoption of IFRS.

The following IFRS standards are considered most relevant to the Company's conversion process:

IFRS 1 - First-time Adoption of IFRS which generally requires that an entity apply all IFRS standards retrospectively, with specific mandatory exemptions, and a limited number of optional exemptions. A preliminary assessment of the available exemptions has been completed.

Elections made upon transition to IFRS can have a significant impact on the level of time and effort needed for the conversion to IFRS. The following optional exemptions appear to be the most applicable to the Company:

- a) fair value as deemed cost - this exemption provides the Company with the option to elect specific fair values as the deemed cost of any qualifying item of property, plant and equipment;
- b) deemed cost of full cost oil and gas assets - this exemption provides the Company with the option of measuring exploration and evaluation assets and assets in the D&P phases at the amount determined for the cost centre under Canadian GAAP; the cost of the D&P assets are allocated to the underlying assets on a pro rata basis using reserve volumes or reserve values as of the transition date;
- c) business combinations - this exemption provides the Company with the option of not applying IFRS 3 Business Combinations to business combinations that took place before the date of transition;
- d) share-based payments - this exemption provides the Company with the option of not applying IFRS 2 to

YANGARRA RESOURCES LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS
For the year ended December 31, 2010

equity-settled share-based payment transactions issued after November 7, 2002 and which have vested before the date of transition; and

- e) decommissioning liabilities - if the exemption discussed under b) is utilized, the Company may then measure decommissioning, restoration and similar liabilities at the transition date in accordance with IAS 37 and recognize, directly in retained earnings, any difference between that amount and the Canadian GAAP carrying amount of the liabilities at the transition date.

In addition to these exemptions, IFRS 1 provides other exemptions that are available on transition to IFRS. These exemptions may become useful for the Company to consider in the future.

IFRS 2 – Share-based Payments requires the use of a forfeiture rate based on an estimate of the number of options expected to vest and requires that each tranche of options be treated as a separate arrangement as graded vesting is utilized.

IFRS 6 – Exploration and Evaluation of Mineral Resources (“E&E”) requires that costs associated to the exploration for and evaluation of resources be recorded separately from the costs associated to the development of resources. Assets within this category are not depreciated and are tested for impairment when events suggest that the carrying amount may exceed the recoverable amount.

IAS 16 – Property, Plant and Equipment requires that assets be assigned to a cash generating unit and be depreciated over the useful life of each significant component. This requires a useful life assessment at a potentially lower level than under current Canadian GAAP and potential amendments to the accounting system to enable the tracking of costs at both a component and cash generating unit level.

IAS 36 – Impairment of Assets involves an impairment test at the cash generating unit level using either proven or proven and probable reserves whereby the recoverable amount, defined as the higher of the fair value less costs to sell or value in use, is compared to the carrying value of the assets. Impairments are likely to be triggered at an earlier date under IFRS as this test involves a one step approach utilizing discounted cashflows at a potentially lower asset group than currently required under Canadian GAAP.

IAS 37 - Provisions, Contingent Liabilities, and Contingent Assets will impact the calculation and presentation of the asset retirement obligation. This calculation will now include both legal and constructive obligations based on managements estimate and will be discounted based on the risk specific to the asset to be retired which is likely to be a lower discount rate.

There is also a potential Canadian GAAP – IFRS difference with respect to the treatment of flow-through shares which may impact the Company’s financial statements with respect to future flow-through share issuances. As the International Accounting Standards Board is not expected to issue specific guidance on the accounting treatment of flow-through shares, the Company will be required to develop an appropriate accounting policy which may or may not be significantly different from current Canadian GAAP.

Based on the preliminary assessment of IFRS, the Company anticipates the conversion to IFRS will primarily impact the reported amount for property and equipment and asset retirement obligation. Financial statement disclosures will be greatly expanded.

The Company has received a formal diagnostic of Canadian GAAP and IFRS differences. The Company has commenced a more detailed analysis of each of the specific areas identified in the diagnostic (i.e. preparing position papers, drafting consolidated financial statements, identifying the impact on systems and processes, etc) to conclude on the accounting and systems implications. Subsequent phases will propose detailed solutions for accounting policies and quantify the expected impact. The Company plans to have a draft opening balance sheet and related IFRS disclosures completed in the first quarter.

Yangarra Resources Ltd.
Consolidated Financial Statements
December 31, 2010 and 2009

Management's Responsibility

To the Shareholders of Yangarra Resources Ltd.:

Management is responsible for the preparation and presentation of the accompanying consolidated financial statements, including responsibility for significant accounting judgments and estimates in accordance with Canadian generally accepted accounting principles and ensuring that all information in the annual report is consistent with the statements. This responsibility includes selecting appropriate accounting principles and methods, and making decisions affecting the measurement of transactions in which objective judgment is required.

In discharging its responsibilities for the integrity and fairness of the financial statements, management designs and maintains the necessary accounting systems and related internal controls to provide reasonable assurance that transactions are authorized, assets are safeguarded and financial records are properly maintained to provide reliable information for the preparation of financial statements.

The Board of Directors exercises its responsibilities for financial controls through an Audit Committee. The Audit Committee is responsible for overseeing management in the performance of its financial reporting responsibilities, and for approving the financial information included in the annual report. The Committee has the responsibility of meeting with management and external auditors to discuss the internal controls over the financial reporting process, auditing matters and financial reporting issues. The Committee is also responsible for recommending the appointment of the Company's external auditors.

Meyers Norris Penny LLP, an independent firm of Chartered Accountants, is appointed by the shareholders to audit the financial statements and report directly to them; their report follows. The external auditors have full and free access to, and meet periodically and separately with, both the Audit Committee and management to discuss their audit findings.

April 19, 2011

"James G. Evaskevich" (signed)

James G. Evaskevich
Chief Executive Officer

"James A. Glessing" (signed)

James A. Glessing
Chief Financial Officer

To the Shareholders of Yangarra Resources Ltd.:

We have audited the consolidated financial statements of Yangarra Resources Ltd. and its subsidiary which comprise the consolidated balance sheets as at December 31, 2010 and December 31, 2009, the consolidated statements of operations, comprehensive loss and deficit, and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian Generally Accepted Accounting Principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Yangarra Resources Ltd. and its subsidiary as at December 31, 2010 and December 31, 2009, and their results of operations and their cash flows for the years then ended in accordance with Canadian Generally Accepted Accounting Principles.



Chartered Accountants

Calgary, Canada
April 19, 2011

Yangarra Resources Ltd.
Consolidated Balance Sheets
(audited)

	December 31 2010	December 31 2009
Assets		
Current		
Cash and cash equivalents	\$ 11,678	\$ –
Accounts receivable	3,752,477	658,080
Prepaid expenses and deposits	243,214	152,853
Assets held for sale <i>(note 5)</i>	463,100	–
	4,470,469	810,933
Property and equipment <i>(note 5)</i>	61,475,178	38,830,516
	\$ 65,945,647	\$ 39,641,449
Liabilities		
Current		
Bank debt <i>(note 6)</i>	\$ 5,559,208	\$ 8,195,069
Accounts payable and accrued liabilities	9,383,722	465,554
Commodity price risk contracts <i>(note 11)</i>	–	113,361
Preferred shares <i>(note 8(c))</i>	1,000,000	–
	15,942,930	8,773,984
Asset retirement obligation <i>(note 7)</i>	2,620,549	2,181,727
Preferred shares <i>(note 8(c))</i>	–	1,000,000
Future income tax liability <i>(note 13)</i>	–	837,357
	18,563,479	12,793,068
Shareholders' Equity		
Share capital <i>(note 8)</i>	62,955,605	43,019,290
Warrants <i>(note 9)</i>	2,216,541	340,600
Contributed surplus <i>(note 10)</i>	5,740,753	2,972,097
Deficit	(23,530,731)	(19,483,606)
	47,382,168	26,848,381
	\$ 65,945,647	\$ 39,641,449

Nature of operations and basis of presentation *(note 1)*
Subsequent events *(note 20)*

Approved on behalf of the Board of Directors

"James G. Evaskevich" (signed)
James G. Evaskevich

"Gordon A. Bowerman" (signed)
Gordon A. Bowerman

The accompanying notes are an integral part of these audited consolidated financial statements

Yangarra Resources Ltd.
Consolidated Statements of Operations, Comprehensive Loss and Deficit
For the years ended December 31
(audited)

	2010	2009
Revenue		
Petroleum and natural gas sales	\$ 6,534,377	\$ 3,579,738
Royalty income	123,106	–
Royalties	(165,309)	(195,223)
Royalty recoveries (note 12)	–	289,728
	6,492,174	3,674,243
Interest	–	10,855
Commodity price risk contracts (note 11)	154,095	(113,361)
	6,646,269	3,571,737
Expenses		
Production	1,820,683	1,994,861
Transportation	237,893	137,692
General and administrative	1,161,575	898,084
Interest and financing fees	265,251	1,295,660
Dividends (note 8(d))	50,000	–
Stock-based compensation (note 8(d))	1,746,939	206,091
Depletion and depreciation	6,066,568	8,064,412
Accretion	173,703	146,621
Other (income) expenses	25,129	(78,166)
	11,547,741	12,665,255
Loss before income taxes	(4,901,472)	(9,093,518)
Future income tax reduction (note 13)	854,347	1,825,498
Net loss and comprehensive loss for the year	(4,047,125)	(7,268,020)
Deficit, beginning of year	(19,483,606)	(12,215,586)
Deficit, end of year	\$ (23,530,731)	\$ (19,483,606)
Net loss per share		
Basic and diluted	\$ (0.07)	\$ (0.46)
Weighted average number of shares		
Basic and diluted	57,581,832	15,662,664

The accompanying notes are an integral part of these audited consolidated financial statements

Yangarra Resources Ltd.
Consolidated Statements of Cash Flows
For the years ended December 31
(audited)

	2010	2009
Operating		
Net loss for the year	\$ (4,047,125)	\$ (7,268,020)
Add back non-cash items:		
Unrealized (gain) loss on commodity price risk contracts	(113,361)	113,361
Interest and financing fees	–	705,000
Shares issued for services	–	84,000
Stock-based compensation	1,746,939	206,091
Depletion and depreciation	6,066,568	8,064,412
Accretion	173,703	146,621
Gain on sale of investment	–	(23,201)
Future income tax reduction	(854,347)	(1,825,498)
Abandonment expenditures (note 7)	(13,091)	(95,910)
	2,959,286	106,856
Change in non-cash working capital (note 14)	(2,863,908)	1,023,649
	95,378	1,130,505
Financing		
Issue of equity instruments, net of costs	21,423,415	416,335
Bank debt repayment, net	(2,635,861)	(658,921)
Financing fees	–	(270,000)
Related party advance	–	70,913
Change in non-cash working capital (note 14)	190,988	–
	18,978,542	(441,673)
Investing		
Expenditures on property and equipment	(27,005,472)	(1,614,961)
Business combination (note 3)	–	92,063
Proceeds on sale of investment	–	33,669
Change in non-cash working capital (note 14)	7,943,230	800,397
	(19,062,242)	(688,832)
Change in cash	11,678	–
Cash, beginning of year	–	–
Cash, end of year	\$ 11,678	\$ –
Supplemental cash flow information		
Interest paid	\$ 265,251	\$ 594,496
Dividends paid	\$ 25,000	\$ –

The accompanying notes are an integral part of these audited consolidated financial statements

Yangarra Resources Ltd.
Notes to the Consolidated Financial Statements
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(audited)

1. Nature of operations and basis of presentation

Yangarra Resources Ltd. (the “Company”) is a publicly traded company involved in the production, exploration and development of resource properties in Western Canada.

On May 1, 2010, the Company and its wholly owned subsidiary Athabaska Energy Ltd. (“Athabaska”) were amalgamated and continue to carry on business under the name Yangarra Resources Ltd. At this time, the Company consolidated its common shares on a five old for one new (5:1) basis. All common share, warrant and stock option figures disclosed herein are presented on a consolidated basis.

These audited consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Yangarra Resources Corp. (“YRC”), after the elimination of intercompany transactions and balances.

These audited consolidated financial statements have been prepared on a going concern basis which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. As at December 31, 2010, the Company had a working capital deficiency of \$11,472,461 (December 31, 2009 – \$7,963,051). Subsequent to December 31, 2010 the Company completed a \$17 million equity financing, with completion of the financing the company’s 2011 capital budget is fully funded. Any adverse changes to market conditions can be accommodated by revising the size and timing of the capital program through-out the year.

On October 22, 2009, the Company held a meeting to present a formal proposal to restructure under the Bankruptcy and Insolvency Act (the “Proposal”) to its creditors at which time all affected creditors had the opportunity to vote on the Proposal as presented by the Company. Of the votes cast, 85% supported the Proposal which represented approximately 96% of the corresponding monetary value. The Company received court approval of the Proposal on November 10, 2009 and received final approval from the TSX Venture Exchange on December 31, 2009 upon completion of all aspects of the Proposal.

The purpose of the Proposal was to restructure the financial affairs of the Company in order to continue business. Pursuant to the terms of the Proposal:

- a) The Company continued to make payments to its senior lender in accordance with the terms of its than arrangements with that senior lender. The senior lender had a first secured charge on the property, assets and undertakings of the Company.
- b) A second secured creditor that was owed \$4,950,000 including accrued interest and fees had its debts satisfied as disclosed in note 6.
- c) Ordinary unsecured creditors who were owed \$2,018,065 had their debts settled as follows:
 - i) the first \$558 of each such ordinary unsecured creditor’s claim was paid in cash resulting in a total cash payment of \$55,000; and
 - ii) the balance was satisfied via the issuance of common shares of the Company at a deemed price of \$0.85 per share resulting in the issuance of 2,320,000 common shares (note 8(b)(vi)).
- d) The Company acquired Athabaska on December 31, 2009 as disclosed in note 4.
- e) The Company completed a private placement on December 31, 2009 for total proceeds of \$500,000 as disclosed in note 8(b)(vii).

2. Significant accounting policies

The consolidated financial statements have been prepared by management in accordance with generally accepted accounting principles in Canada. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts recorded in the financial statements and accompanying notes. Actual results could differ from these estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment within the reasonable limits of materiality and the framework of the significant accounting policies summarized below:

a) *Cash*

Cash consists of bank balances and overdrafts.

b) *Investments*

Investments are classified as held-for-trading financial assets and are measured at fair value with changes in fair value recognized in earnings.

c) *Property and equipment*

The Company follows the full cost method of accounting for its petroleum and natural gas operations. Under this method all costs related to the acquisition of, exploration for, and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses, stock-based compensation directly related to field personnel, asset retirement costs, costs of drilling both productive and non-productive wells and overhead costs directly related to exploration and development activities which have been charged in accordance with standard industry operating agreements. Proceeds from the sale of resource properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would alter the rate of depletion by greater than 20%.

Depletion of resource properties and related equipment, net of estimated salvage or residual value, is provided using the unit of production method based upon estimated proven resource reserves before royalties, as determined by independent engineers. The costs of significant unevaluated properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment occurs.

For depletion purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

Other property and equipment, such as computer and office equipment and leasehold improvements ("office equipment"), are initially recorded at cost.

Depreciation is provided using methods and rates intended to depreciate the cost of office equipment over estimated useful lives.

	Method	Rate
Computer equipment	declining balance	30 %
Leasehold improvements	straight-line	5 years
Office equipment	declining balance	20 %

2. Significant accounting policies (continued)

d) *Long-lived assets*

Long-lived assets consist of property and equipment, including resource properties. Long-lived assets held for use are measured, depleted or depreciated as described in the applicable accounting policy.

The Company performs impairment testing on long-lived assets held for use whenever events or changes in circumstances indicate that the carrying value of property and equipment or resource properties may not be recoverable. Under the full cost method of accounting, a “ceiling test” is performed to recognize and measure impairment, if any, of the carrying amount of petroleum and natural gas properties. Impairment is recognized if the carrying amount of the petroleum and natural gas properties, less the cost of undeveloped properties, net of impairment, exceeds the estimated undiscounted future cash flows from the Company’s proved reserves. The future cash flows are based on a forecast of prices and costs, as provided by an independent third party. The magnitude of the impairment, if any, is then measured by comparing the carrying amount of petroleum and natural gas properties less the cost of undeveloped properties, net of impairment, to the estimated discounted future cash flows from the Company’s proved and probable reserves. The future cash flows are discounted at the Company’s risk-free interest rate, using forecasted prices and costs.

Any impairment recognized is recorded as additional depletion and depreciation expense.

e) *Asset retirement obligation*

Asset retirement costs and liabilities associated with site restoration and abandonment of property and equipment are initially measured at a fair value which approximates the cost a third party would incur in performing the tasks necessary to retire such assets. Such costs are capitalized as part of the cost of property and equipment and amortized to expense through depletion over the life of the asset. The change in the liability due to the passage of time is measured by applying an interest method of allocation to the opening liability and is recognized as an increase in the carrying value of the liability and an expense. The expense is recorded as accretion expense in the statement of operations. A change in the liability resulting from revisions to either the timing or the amount of the original estimate of undiscounted cash flows is recognized as an increase or decrease in the carrying amount of the liability, with an offsetting increase or decrease in the carrying amount of the associated asset.

f) *Joint venture operations*

A portion of the Company's petroleum and natural gas exploration and production activities are conducted jointly with others, and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

g) *Bank debt and credit facility*

The Company classifies borrowings as a current liability where the lender has a right to demand payment within twelve months, or where the lender may not re-finance the borrowing for a further lending period longer than twelve months.

h) *Future income taxes*

The Company follows the asset and liability method of accounting for future income taxes. Under this method, future income tax assets and liabilities are recorded based on temporary differences between the carrying amount of balance sheet items and their corresponding tax bases. In addition, the future benefits of income tax assets, including unused tax losses, are recognized, subject to a valuation allowance, to the extent that it is more likely than not that such future benefits will ultimately be realized. Future income tax assets and liabilities are measured using substantively enacted tax rates and laws expected to apply when the tax liabilities or assets are to be either settled or realized.

2. Significant accounting policies (continued)

i) *Flow-through shares*

Expenditure deductions for income tax purposes related to exploratory activities funded by flow-through equity instruments are renounced to investors in accordance with income tax legislation. The Company provides for the future effect on income taxes related to flow-through equity instruments as a reduction of share capital and an increase in future income tax liabilities when the renouncement documents are filed with taxation authorities.

j) *Stock-based compensation*

Stock-based compensation is based on the estimated fair value of options granted at the time of the grant. The fair value is recognized as stock-based compensation with a corresponding increase to contributed surplus over the vesting period of the options. Upon the exercise of the stock options, consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase in share capital. In the event that vested options expire, previously recognized compensation expense associated with such stock options is not reversed. In the event that unvested options are forfeited, previously recognized compensation expense associated with such stock options is reversed.

k) *Per share amounts*

Basic earnings per share is calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share is calculated based on the treasury stock method which assumes that any proceeds obtained on the exercise of options and warrants would be used to purchase common shares at the average price during the period. The effect of anti-dilutive options and warrants is not included in the calculation of diluted earnings per share.

l) *Revenue recognition*

Revenue is recognized from oil sales when the oil is delivered to the buyer and from gas sales when the gas passes through the pipeline at the delivery point.

m) *Use of 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 disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period.

Accounts receivable are stated after evaluation as to their collectibility and an appropriate allowance for doubtful accounts is provided where considered necessary. Amounts recorded for depletion of resource properties, amortization of property and equipment, asset retirement obligations and impairment calculations are based on estimates of natural gas and crude oil reserves and future costs required to develop those reserves. Amounts related to the fair value of stock options and warrants are based on estimates of share price volatility, risk-free interest rate and expected lives of options and warrants. Future income tax assets and liabilities are reported based on estimates of future income tax rates. Amounts reported for the fair value of commodity price risk contracts are based on the counterparties' estimates of future commodity prices.

By their nature, these estimates and related future cash flows are subject to measurement uncertainty, and the impact on the consolidated financial statements of future periods could be material. These assumptions are reviewed periodically and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

2. Significant accounting policies (continued)

n) *Financial instruments*

All financial instruments, including derivatives, are to be recognized on the balance sheet initially at fair value. Subsequent measurement of all financial assets and liabilities except those held-for-trading and available for sale are measured at amortized cost determined using the effective interest rate method. Held-for-trading financial assets are measured at fair value with changes in fair value recognized in earnings. Available-for-sale financial assets are measured at fair value with changes in fair value recognized in comprehensive income and reclassified to earnings when derecognized or impaired.

The Company has classified its financial assets and liabilities as follows:

<u>Held-for-trading</u>	<u>Loans and receivables</u>	<u>Other liabilities</u>
Investment	Accounts receivable	Bank debt
Commodity price risk contracts		Credit facility
Cash		Accounts payable and accrued liabilities
		Preferred shares

At each balance sheet date, the Company will assess financial assets for impairment with any impairment recorded in the consolidated statement of operations.

o) *Commodity price risk contracts*

The Company may use various types of derivative financial instruments to manage risks associated with crude oil and natural gas price fluctuations. These instruments are not used for trading or speculative purposes. Proceeds and costs realized from holding the related contracts are recognized in petroleum and natural gas revenues at the time that each transaction under a contract is settled. For the unrealized portion of such contracts, the Company utilizes the fair value method of accounting. The fair value is based on an estimate of the amounts that would have been paid to or received from counterparties to settle these instruments given future market prices and other relevant factors. The method requires the fair value of the derivative financial instruments to be recorded at each balance sheet date with the unrealized gains or losses on these contracts recorded through the consolidated statement of operations.

The Company has elected to account for its physical delivery sales contracts, which were entered into and continue to be held for the purpose of receipt or delivery of non-financial items in accordance with its expected purchase, sale or usage requirements as executory contracts on an accrual basis rather than as non-financial derivatives.

p) *Transaction costs*

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 using the effective interest rate method.

q) *Comprehensive income*

Comprehensive income (loss) is the change in shareholders' equity during a period from transactions and other events and circumstances from non-owner sources and includes unrealized gains and losses on financial assets classified as available-for-sale. The Company has reported a consolidated statement of comprehensive loss combined with the consolidated statement of operations. When related amounts are recorded in accordance with this new standard, a new category for accumulated other comprehensive income will be presented in the shareholders' equity section of the consolidated balance sheet.

3. Recent Accounting Pronouncements (IFRS)

The CICA Accounting Standards Board (AcSB) has confirmed that the use of International Financial Reporting Standards (IFRS) will be required for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011 for publicly accountable profit-oriented enterprises. Companies will be required to provide comparative IFRS information for 2010. The Company is assessing the potential impacts of this changeover and has developed a plan for the conversion. The Company has completed an initial impact assessment and is currently performing a detailed evaluation of the impact of IFRS on its financial statements, data systems and internal controls.

4. Business combination

On December 31, 2009, the Company acquired all of the issued and outstanding shares of Athabaska Energy Ltd. ("Athabaska"), a non-arm's length private corporation, in exchange for 10,000,001 common shares of the Company.

Although the Company and Athabaska are related by virtue of common shareholders, officers and directors, the acquisition resulted in a substantive change of ownership of Athabaska. Consequently, the acquisition has been recognized at the \$2,524,326 exchange amount of consideration paid, with a third-party reserve evaluation of Athabaska's petroleum and natural gas assets representing independent evidence of fair value.

The consideration paid for the acquisition of Athabaska has been allocated to the fair value of the net assets of Athabaska as follows:

Net assets acquired:	
Cash	\$ 92,063
Other working capital	72,443
Petroleum and natural gas properties	3,114,312
Asset retirement obligation	(49,402)
Future income tax liability	(705,090)
	<u>\$ 2,524,326</u>
Consideration paid:	
10,000,001 common shares of the Company (<i>note 8(b)</i>)	<u>\$ 2,524,326</u>

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5. Property and equipment

<i>December 31, 2010</i>	<i>Cost</i>	<i>Accumulated depletion and depreciation</i>	<i>Net book value</i>
Petroleum and natural gas properties	\$ 98,786,663	\$ 37,424,591	\$ 61,362,072
Office equipment	338,589	\$ 225,483	\$ 113,106
	<u>\$ 99,125,252</u>	<u>\$ 37,650,074</u>	<u>\$ 61,475,178</u>

<i>December 31, 2009</i>	<i>Cost</i>	<i>Accumulated depletion and depreciation</i>	<i>Net book value</i>
Petroleum and natural gas properties	\$ 70,134,763	\$ 31,380,391	\$ 38,754,372
Office equipment	279,281	203,137	76,144
	<u>\$ 70,414,044</u>	<u>\$ 31,583,528</u>	<u>\$ 38,830,516</u>

At December 31, 2010, the Company excluded \$639,892 (2009 – \$1,206,467) of resource properties relating to unproved properties from the depletion calculation. Unproved properties have been separately evaluated by management for impairment. In addition, \$30,320,000 (December 31, 2009 – \$11,055,300) of future development costs were included in the depletion calculation.

During the year ended December 31, 2010, the Company capitalized \$278,210 (2009 – \$13,517) related to the asset retirement obligation of property and equipment and \$1,427,548 (2009 – \$286,145) comprised of stock-based compensation of \$1,070,661 and \$356,887 of related future income taxes for options granted to field consultants. The Company also capitalized \$76,565 (2009 – \$86,765) of general and administrative costs as well as related costs of the Company's working interest in operated capital expenditure programs on which operator's fees have been charged in accordance with standard industry operating agreements.

Property and equipment totalling \$463,100 (2009 – nil) was classified as a current asset held for sale as the Company intends to recover the carrying amount principally through a sale transaction rather than through continuing use in the next twelve months. The current asset classified as held for sale was measured at the lower of its carrying amount and fair value less costs to sell.

The Company applied the ceiling test to its petroleum and natural gas properties in 2009 and determined that there was an impairment of \$4,300,000, which has been included in depletion and depreciation for the year ended December 31, 2009. The December 31, 2010 ceiling test determined that there was no additional impairment. For purposes of this impairment test, the following future commodity prices were used:

	<i>WTI US\$/bbl</i>	<i>WTI Cdn \$/bbl</i>	<i>Alberta AECO Average Cdn \$/mcf</i>
2011	85.00	85.00	4.10
2012	87.50	85.75	4.50
2013	88.00	83.60	5.00
2014	90.00	85.50	5.20
2015	95.00	90.25	5.30
Escalation rate thereafter	2%	2%	2%

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6. Bank debt

As at December 31, 2010, the \$5,559,208 (2009 – \$8,195,069) reported amount of bank debt was comprised of \$4,600,000 (2009 – \$7,800,000) drawn on the revolving operating demand loan and \$959,208 (2009 – \$395,069) of bank overdraft. The Company is subject to a financial covenant with respect to working capital, with which the Company was in compliance with at December 31, 2010. The facility is secured by a general security agreement.

In November 2010, the Company signed a credit facility agreement with a new lender for a revolving operating loan with a maximum availability of \$8,500,000. The credit facility bears interest at bank prime plus 1% per annum, increased to bank prime plus 1.5% if the Company's net debt to trailing cash flow ratio is equal to or greater than 1 to 1.

In December 2010, the facility was increased to \$12 million (2009 - \$8.3 million) and planned monthly increases based on production levels will move the facility to \$14.5 million by March 2011. The terms of the facility remained unchanged.

On October 22, 2009, a subordinated lender accepted the Proposal to its creditors (note 1) pursuant to which the credit facility was settled as follows:

- a) \$450,000 of accrued interest and fees satisfied through the issuance of 1,800,000 common shares of the Company at a deemed price of \$0.25 per share (note 8(b)(iv));
- b) \$3,500,000 satisfied through the issuance of 4,666,667 common shares of the Company at a deemed price of \$0.75 per share (note 8(b)(v)); and
- c) \$1,000,000 satisfied through the issuance of preferred shares of the Company, such preferred shares having a 5% annual dividend payable in common shares of the Company, redeemable at any time by the Company and redeemable by the subordinated lender on June 30, 2011 (note 8(c)).

7. Asset retirement obligation

The following table presents the reconciliation of the carrying amount of the obligation associated with the retirement of the Company's property and equipment:

	<i>2010</i>	<i>2009</i>
Asset retirement obligation, beginning of year	\$ 2,181,727	\$ 2,124,242
Liabilities incurred	221,964	13,517
Liabilities acquired (<i>note 4</i>)	–	49,402
Liabilities settled	(13,091)	(95,910)
Effect of change in estimates	56,246	(56,145)
Accretion	173,703	146,621
Asset retirement obligation, end of year	<u>\$ 2,620,549</u>	<u>\$ 2,181,727</u>

The following significant assumptions were used to estimate the asset retirement obligation:

	<i>2010</i>	<i>2009</i>
Undiscounted cash flows	\$ 4,815,382	\$ 4,263,142
Discount rate	7% - 10%	7% - 10%
Inflation rate	2%	2%
Weighted average expected timing of cash flows	10.2 years	10.3 years

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8. Share capital

a) Authorized

Unlimited number of common shares, without nominal or par value

Unlimited number of preferred shares, without nominal or par value

On May 1, 2010, the Company consolidated its common shares on a five old for one new (5:1) basis. All common share, warrant and stock option figures disclosed herein are presented on a consolidated basis.

b) Common shares issued

	<i>Number of shares</i>	<i>Amount</i>
Balance, December 31, 2008	15,112,382	\$ 34,116,201
Settlement of accounts payable (i)	936,156	280,847
Salary compensation (ii)	352,800	88,200
Senior lender fees (iii)	200,000	150,000
Subordinated lender interest and fees (iv)	1,800,000	450,000
Subordinated lender credit facility (v)	4,666,667	3,500,000
Unsecured creditor settlement (vi)	2,320,000	1,963,065
Flow-through unit private placement (vii)	2,000,000	159,400
Business combination (note 4)	10,000,001	2,524,326
Share issue costs, net of \$20,916 of future income tax	–	(62,749)
Tax effect of 2008 flow-through shares (viii)	–	(150,000)
Balance, December 31, 2009	37,388,006	\$ 43,019,290
Unit private placement (ix)	16,000,000	4,009,700
Exercise of warrants (x)	548,000	388,359
Flow-through share private placement (xi)	3,745,454	2,060,000
Private placement (xii)	3,300,000	1,914,000
Special warrant equity financing (xiii)	18,666,667	13,000,000
Exercise of stock options (xiv)	70,000	83,944
Tax effect of flow-through shares	–	(125,000)
Share issue costs, net of \$464,897 of future income tax	–	(1,394,688)
Balance, December 31, 2010	79,718,127	\$ 62,955,605

- i) In August 2009, the Company issued 936,156 common shares at a value of \$0.30 per share for the settlement of \$280,847 of accounts payable.
- ii) Between August 18 and December 31, 2009, the Company issued 352,800 common shares at a value of \$0.25 per share to the President and CEO for \$84,000 of compensation and \$4,200 of related Goods and Services Tax for the period May 1 to November 30, 2009.
- iii) On December 31, 2009, the Company issued 200,000 common shares at a value of \$0.75 per share to the Company's senior lender as payment of a \$150,000 fee.
- iv) Between August 18 and December 31, 2009, the Company issued 1,800,000 common shares at a value of \$0.25 per share to the Company's subordinated lender as payment for \$450,000 of interest expense and fees (note 6).
- v) On December 31, 2009, the Company issued 4,666,667 common shares at a value of \$0.75 per share to the Company's subordinated lender as settlement of \$3,500,000 of credit facility indebtedness (note 6).

8. Share capital (continued)

b) Common shares issued (continued)

- vi) On December 31, 2009, the Company issued 2,320,000 common shares at a value of \$0.85 per share to unsecured creditors as settlement of \$1,963,065 of accounts payable.
- vii) On December 31, 2009, the Company completed a private placement of 2,000,000 units on a flow-through basis at \$0.25 per unit for total proceeds of \$500,000. Each unit was comprised of one flow-through common share and one flow-through common share purchase warrant exercisable at \$0.50 per flow-through common share until December 31, 2014. Officers and directors subscribed for 100% of the units.

At the time of the private placement, \$340,600 was ascribed to the warrants using the Black-Scholes fair value pricing model based on a risk-free rate of 2.8%, expected volatility of 146% and an expected life of 5 years. \$159,400 was ascribed to common shares.

- viii) The related tax benefits of the flow-through share proceeds will be renounced to investors with an effective date of December 31, 2010. The Company has until December 31, 2011 to incur the qualifying flow-through expenditures.
- ix) On March 17, 2010, the Company completed a private placement of 16,000,000 units at \$0.375 per Unit for gross proceeds of \$6,000,000. Each unit was comprised of one common share of the Company and one half of one common share purchase warrant, with each full warrant exercisable anytime up to March 15, 2012, at a price of \$0.50 per share, subject to certain earlier termination provisions. Management and directors subscribed for 2,671,334 units for gross proceeds of \$1,001,750 or 16% of the financing. Finder's fees of \$364,480 were paid in conjunction with the financing.

At the time of issuance, the fair value of the warrants was estimated to be \$1,990,300 (\$0.25 per warrant) based on the Black-Scholes fair value pricing model (note 8(e)) and \$4,009,700 was ascribed to common shares.

- x) In March 2010, the Company issued 280,000 flow-through common shares on the exercise of 280,000 warrants at \$0.50 per share for cash proceeds of \$140,000 plus a pro-rata allocation of the warrants' fair value in the amount of \$47,684.

From October 2010 to December 2010, the Company issued 268,000 common shares on the exercise of 268,000 warrants at \$0.50 per share for cash proceeds of \$134,000 plus a pro-rata allocation of the warrants' fair value in the amount of \$66,675.

- xi) On May 21, 2010, the Company completed a private placement of 3,745,454 flow-through common shares at \$0.55 per share for gross proceeds of \$2,060,000. An 8% cash commission was paid on the proceeds raised.
- xii) On June 26, 2010, the Company completed a private placement of 1,650,000 common shares at \$0.56 per share and 1,650,000 flow-through common shares at \$0.60 per share for total gross proceeds of \$1,914,000. A 6% cash commission was paid on the proceeds raised.
- xiii) On October 25 and 28, 2010, the Company completed a special warrant financing for total gross proceeds of \$13,000,000. The financing consisted of 8,666,667 flow-through special warrants priced at \$0.75 each, issued on a flow-through basis and 10,000,000 common share special warrants priced at \$0.65 each. Each special warrant was exercisable into common shares of the Company, and all unexercised warrants were deemed to be exercised the 5th day after receiving receipts from the various securities regulatory authorities for a final prospectus, which receipts were obtained on November 22, 2010.

8. Share capital (continued)

b) Common shares issued (continued)

xiv) In November 2010, the Company issued 70,000 common shares on the exercise of 70,000 options at \$0.50 per share for cash proceeds of \$35,000 plus a pro-rata allocation of the options' fair value in the amount of \$48,944.

c) Preferred shares issued

As at December 31, 2010, the Company had 1,000,000 preferred shares issued and outstanding with an annual dividend rate of 5% payable semi-annually in cash or common shares of the Company. The preferred shares have an eighteen month term, at which time they are redeemable for \$1,000,000 cash. Dividends of 50,000 were expensed during the year ended December 31, 2010.

As the terms of the preferred shares provide for a mandatory redemption at a fixed amount, they are classified as a financial liability. The December 31, 2010 estimated fair value of preferred shares approximates their carrying value and redemption value.

d) Stock options

The Company has a stock option plan under which the Board of Directors may grant options to directors, officers, other employees and key consultants. The purpose of the plan is to advance the interests of the Company by encouraging these individuals to acquire shares in the Company and thereby remain associated with, and seek to maximize the value of, the Company.

Under the plan, the number of shares reserved for issuance pursuant to the exercise of all options under the plan may not exceed 10% of the issued and outstanding common shares on a non-diluted basis at any time. The options expire not more than five years from the date of grant, or earlier if the individual ceases to be associated with the Company, and vest over terms determined at the time of grant.

On January 7, 2010, the Company granted 100,000 stock options to a director. The options are exercisable at \$0.50 per share, vest immediately and expire five years from the date of grant. The fair value of the options was estimated at \$21,700 (\$0.22 per option) using the Black-Scholes pricing model (note 8(e)), all of which was recognized as stock-based compensation expense on the date of grant.

On April 26, 2010, the Company granted 200,000 stock options to field consultants. The options are exercisable at \$0.50 per share, vest immediately and expire five years from the date of grant. The fair value of the options was estimated at \$129,400 (\$0.65 per option) using the Black-Scholes pricing model (note 8(e)), all of which was capitalized to property and equipment (note 5) on the date of grant.

On June 29, 2010, the Company granted 1,600,000 stock options to directors, officers and consultants. The options are exercisable at \$0.60 per share, vest immediately and expire five years from the date of grant. The fair value of the options was estimated at \$746,600 (\$0.47 per option) using the Black-Scholes pricing model (note 8(e)). \$641,610 was recognized as stock-based compensation expense and \$104,990 was capitalized to property and equipment (note 5) on the date of grant.

On July 30, 2010, the Company granted 715,000 stock options to an employee and consultants. The options are exercisable at \$0.55 per share, vest immediately and expire five years from the date of grant. The fair value of the options was estimated at \$362,400 (\$0.51 per option) using the Black-Scholes pricing model (note 8(e)). \$121,645 was recognized as stock-based compensation expense and \$240,755 was capitalized to property and equipment (note 5) on the date of grant.

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8. Share capital (continued)

d) Stock options

On November 24, 2010, the Company granted 1,955,000 stock options to officers, directors and employees and consultants. The options are exercisable at \$0.86 per share, vest immediately and expire five years from the date of grant. The fair value of the options was estimated at \$1,557,500 (\$0.80 per option) using the Black-Scholes pricing model (note 8(e)). \$961,984 was recognized as stock-based compensation expense and \$595,516 was capitalized to property and equipment (note 5) on the date of grant.

The following tables summarize information about stock options outstanding as at:

	<i>December 31, 2010</i>		<i>December 31, 2009</i>	
	<i>Options</i>	<i>Weighted – average exercise price</i>	<i>Options</i>	<i>Weighted – average exercise price</i>
Opening	3,542,255	\$0.75	1,253,405	\$ 1.55
Granted	4,570,000	0.69	2,470,000	0.50
Exercised	(70,000)	0.50	–	–
Cancelled	(35,000)	(1.39)	(102,350)	(3.00)
Expired	(223,455)	(2.84)	(78,800)	(1.55)
Closing	7,783,800	0.67	3,542,255	\$ 0.75

<i>Range of exercise price</i>	<i>Number outstanding</i>	<i>Weighted-average remaining contractual life (years)</i>	<i>Weighted-average exercise price</i>	<i>Number exercisable</i>
\$ 0.50 – \$ 1.00	7,658,800	4.22	\$ 0.65	7,658,800
\$ 1.50 – \$ 1.70	110,000	1.01	1.59	110,000
\$ 3.55	15,000	0.59	3.55	15,000
	7,783,800	4.16	\$ 0.67	7,783,800

e) Black-Scholes pricing model

The Black-Scholes pricing model was used to estimate the fair value of options granted and warrants issued based on the following significant assumptions:

	<i>2010</i>	<i>2009</i>
Weighted average fair value per option	\$0.62	\$ 0.15
Risk-free interest rate	1.59% to 3.09%	2.8%
Expected volatility	146% to 164%	146%
Expected life	5 years	5 years

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9. Warrants

The following table summarizes information about warrants outstanding as at:

	<i>December 31, 2010</i>			<i>December 31, 2009</i>		
	<i>Number of warrants</i>	<i>Exercise price</i>	<i>Fair value ascribed</i>	<i>Number of warrants</i>	<i>Exercise price</i>	<i>Fair value ascribed</i>
Opening	2,000,000	\$0.50	\$340,600	–	\$ –	\$ –
Issued	8,000,000	0.50	\$1,990,300	2,000,000	0.50	340,600
Exercised	(548,000)	(0.50)	(114,359)	–	–	–
Closing	9,452,000	\$0.50	2,216,541	2,000,000	\$ 0.50	\$ 340,600

As at December 31, 2010, warrants had a weighted average remaining life of 1.9 years.

10. Contributed surplus

	<i>2010</i>	<i>2009</i>
Balance, beginning of year	\$ 2,972,097	\$ 2,551,397
Stock-based compensation related to:		
Options granted in current year	2,817,600	420,700
Exercised options (<i>note 8(b)(xiv)</i>)	(48,944)	–
Balance, end of year	\$ 5,740,753	\$ 2,972,097

11. Commodity price risk contracts

As at January 1, 2010, the Company was committed to the following commodity price risk contracts for the sale of natural gas:

- 1,000 GJ per day from January 1 to January 31, 2010 at a fixed price of \$5.51 per GJ;
- 1,000 GJ per day from February 1 to February 28, 2010 at a fixed price of \$5.53 per GJ; and
- 500 GJ per day from January 1 to December 31, 2010 at a fixed price of \$5.68 per GJ.

In addition the Company sold calls which provided a ceiling for the price it received for natural gas as follows:

- 500 GJ per day from January 1 to December 31, 2010 at the ceiling price of \$6.25 per GJ;
- 500 GJ per day from March 1 to December 31, 2010 at the ceiling price of \$6.50 per GJ; and
- 500 GJ per day from March 1 to December 31, 2010 at the ceiling price of \$6.70 per GJ.

In March 2010, the Company settled all outstanding commodity price risk contracts for proceeds of \$73,500 and reported an unrealized gain of \$113,361 related to the reversal of the mark-to-market liability recognized at December 31, 2009.

In September 2010, the Company was committed to a commodity price risk “basis” contract for the sale of 1,000 MMBTU of natural gas per day from November 1, 2010 to March 31, 2011, the terms of which were related to the difference in price between AECO and NYMEX fixed at \$0.45 per MMBTU. The Company terminated the contract in November 2010 at a cost of \$32,766.

Included in petroleum and natural gas revenue for the year ended December 31, 2010 are \$172,345 of realized gains (December 31, 2009 – \$920,429) on the fulfilled portion of commodity contracts.

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12. Royalty recoveries

During the year ended December 31, 2009, the Company recognized a recovery in the amount of \$289,728 of freehold and gross overriding royalties calculated and paid in previous years.

13. 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:

	2010	2009
Loss before income taxes	\$ (4,901,472)	\$ (9,093,518)
Combined federal and provincial statutory income tax rate	28.0%	29.0%
Expected income tax reduction	\$ (1,372,412)	\$ (2,637,120)
Stock-based compensation and other non-deductible charges	495,877	61,641
Effect of tax provision and filing position differences	-	23,098
Rate adjustments	37,315	376,850
Other	96,438	(12,090)
Change in valuation allowance	(171,566)	362,123
	<u>\$ (854,347)</u>	<u>\$ (1,825,498)</u>

The components of the net future income asset (liability) at December 31 are:

	2010	2009
Asset retirement obligation	\$ 655,137	\$ 545,432
Non-capital and capital loss carry-forwards	242,761	308,750
Share issue costs	386,904	21,632
Commodity price risk contracts	-	31,741
Property and equipment	(1,094,245)	(1,382,789)
Valuation allowance	(190,557)	(362,123)
	<u>\$ -</u>	<u>\$ (837,357)</u>

As at December 31, 2010, the Company has approximately \$60 million of tax pools available for deduction against future taxable income. The Company also has non-capital tax losses of approximately \$766,600 available for deduction against future taxable income that expire in 2029.

14. Change in non-cash working capital

	2010	2009
Accounts receivable	\$ (3,094,397)	\$ 1,058,430
Prepaid expenses, assets held for sale and deposits	(553,461)	285,070
Accounts payable and accrued liabilities	8,918,168	480,546
	<u>\$ 5,270,310</u>	<u>\$ 1,824,046</u>

The change in non-cash working capital has been allocated to the following activities:

	2010	2009
Operating	\$ (2,863,908)	\$ 1,023,649
Financing	190,988	-
Investing	7,943,230	800,397
	<u>\$ 5,270,310</u>	<u>\$ 1,824,046</u>

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15. Related party transactions

In addition to those disclosed elsewhere in these financial statements, the Company had the following related party transactions:

During the year ended December 31, 2010 and 2009, the Company was charged or invoiced the following amounts by certain of its officers and directors and by companies controlled by certain of the Company's officers and directors:

	<i>2010</i>	<i>2009</i>
Administration and consulting fees	\$ 168,990	\$ 159,174
Production and capital expenditures	\$ 614,055	\$ 119,865

Included in accounts payable and accrued liabilities at December 31, 2010 is \$29,698 (December 31, 2009 – \$12,000) relating to the above transactions. These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

16. Financial instruments and financial risk management

The Company's financial instruments include cash, accounts receivable, accounts payable and accrued liabilities, bank debt, credit facility and preferred shares (note 8(c)). The carrying values of accounts receivable, accounts payable and accrued liabilities, bank debt, credit facility and preferred shares approximate their fair values due to their relatively short periods to maturity.

The Company is required to classify fair value measurements using a hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy is as follows:

- Level 1 - quoted prices in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

The fair value of cash and bank debt is considered Level 1 as it is determined by amounts held at/lent by financial institutions.

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities. The Company has exposure to credit risk, liquidity risk and market risk as a result of its use of financial instruments. This note presents information about the Company's exposure to each of the above risks and the Company's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with the risk management policies as set out herein:

16. Financial instruments and financial risk management (continued)

a. Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. A substantial portion of the Company's accounts receivable are with natural gas and liquids marketers and joint venture partners in the oil and gas industry and are subject to normal industry credit risks. Purchasers of the Company's natural gas and liquids are subject to credit review to minimize the risk of non-payment. As at December 31, 2010, the maximum credit exposure is the carrying amount of the accounts receivable and accruals of \$3,752,477 (December 31, 2009 – \$658,080). As at December 31, 2010, the Company's receivables consisted of \$2,611,471 from joint venture partners and other trade receivables and \$1,141,005 of revenue receivable from petroleum and natural gas marketers.

Receivables from petroleum and natural gas marketers are typically collected on the 25th day of the month following production. The Company's policy to mitigate credit risk associated with these balances is to establish marketing relationships with large purchasers. The Company historically has not experienced any significant collection issues with its petroleum and natural gas marketers. All of the revenue accruals and receivables from petroleum and natural gas marketers were received in January and February 2011.

Joint venture receivables are typically collected within one to three months of the joint venture bill being issued to the partner. The Company mitigates the risk from joint venture receivables by obtaining partner approval of capital expenditures prior to starting a project. However, the receivables are from participants in the petroleum and natural gas sector, and collection is dependent on typical industry factors such as commodity price fluctuations, escalating costs and the risk of unsuccessful drilling. Further risk exists with joint venture partners as disagreements occasionally arise which increases the potential for non-collection. For properties that are operated by the Company, production can be withheld from joint venture partners who are in default of amounts owing. In addition, the Company often has offsetting amounts payable to joint venture partners from which it can net receivable balances.

The Company did not provide for any doubtful accounts nor was it required to write-off any receivables during the year ended December 31, 2010. The Company would only choose to write-off a receivable balance (as opposed to providing an allowance) after all reasonable avenues of collection had been exhausted.

As at December 31, 2010, the Company considers its receivables to be aged as follows:

Not past due	\$	2,048,397
Past due by less than 90 days		1,117,588
Past due by more than 90 days		474,910
Related to contingency (note 18)		111,582
		111,582
	\$	3,752,477

b. Liquidity risk

Liquidity risk is the risk that the Company will incur difficulties meeting its financial obligations as they are due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions without incurring unacceptable losses or risking harm to the Company's reputation.

16. Financial instruments and financial risk management (continued)

b. Liquidity risk (continued)

The Company prepares annual capital expenditure budgets, which are regularly monitored and updated as considered necessary. The Company uses authorizations for expenditures on both operated and non-operated projects to further manage capital expenditures.

To facilitate the capital expenditure program, the Company has a credit facility agreement, as disclosed in note 6, which is regularly reviewed by the lender. The Company monitors its total debt position monthly. The Company also attempts to match its payment cycle with collection of petroleum and natural gas revenues on the 25th of each month. The Company anticipates it will have adequate liquidity to fund its financial liabilities through its future cash flows. The Company's financial liabilities are comprised of accounts payable and accrued liabilities, bank debt and the credit facility, which have expected maturities of less than one year resulting in their current classification on the balance sheet.

c. Market risk

Market risk consists of interest rate risk, currency risk and commodity price risk. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximizing returns. The Company may use both financial derivatives and physical delivery sales contracts to manage market risks. All such transactions are conducted in accordance with a risk management policy as set out herein:

i) Interest rate risk

Interest rate risk is the risk that future cash flows will fluctuate as a result of changes in market interest rates. The Company is exposed to interest rate fluctuations on its bank debt which bears interest at a floating rate. For the year ended December 31, 2010, if interest rates had been 1% lower with all other variables held constant, earnings for the period would have been \$62,000 (December 31, 2009 – \$79,750) higher, respectively, due to lower interest expense. An equal and opposite impact would have occurred had interest rates been higher by the same amounts. The Company had no interest rate swap or financial contracts in place at December 31, 2010.

ii) Currency risk

Foreign currency exchange rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in foreign exchange rates. All of the Company's petroleum and natural gas sales are denominated in Canadian dollars, however, the underlying market prices in Canada for petroleum and natural gas are impacted by changes in the exchange rate between the Canadian and United States dollar. The Company had no outstanding forward exchange rate contracts in place at December 31, 2010.

iii) Commodity price risk

Commodity price risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in commodity prices. Commodity prices for petroleum and natural gas are impacted by world economic events that dictate the levels of supply and demand as well as the relationship between the Canadian and United States dollar, as outlined above. The Company's commodity price risk contracts are disclosed in note 11.

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17. Capital management

The Company's objective when managing capital is to maintain a flexible capital structure which will allow it to execute its capital expenditure program, which includes expenditures in oil and gas activities which may or may not be successful. Therefore, the Company monitors the level of risk incurred in its capital expenditures to balance the proportion of debt and equity in its capital structure.

The Company considers its capital structure to include shareholders' equity:

	2010	2009
Shareholders' equity	\$ 47,382,168	\$ 26,848,381

The Company monitors capital based on annual funds from operations and capital expenditure budgets, which are updated as necessary and are reviewed and periodically approved by the Company's Board of Directors.

The Company manages its capital structure and makes adjustments by continually monitoring its business conditions including the current economic conditions, the risk characteristics of the Company's petroleum and natural gas assets, the depth of its investment opportunities, current and forecasted net debt levels, current and forecasted commodity prices and other facts that influence commodity prices and funds from operations such as quality and basis differentials, royalties, operating costs and transportation costs.

In order to maintain or adjust the capital structure, the Company considers its forecasted funds from operations while attempting to finance an acceptable capital expenditure program including acquisition opportunities, the current level of bank credit available from the Company's lender, the level of bank credit that may be attainable from its lender as a result of petroleum and natural gas reserve growth, the availability of other sources of debt with different characteristics than existing debt, the sale of assets, limiting the size of the capital expenditure program and the issue of new equity if available on favorable terms. At December 31, 2010, the Company's capital structure was not subject to external restrictions.

18. Contingency

In December 2009, the Company terminated the Standstill Agreement that it had with an industry partner regarding a joint producing property and served that industry partner with a Statement of Claim issued from The Court of Queen's Bench of Alberta, by which the Company claims breach of the agreements between the parties, gross negligence and default of operator. The Company seeks judgment for specified and such further damages to be determined by the Court, as well as appointment as operator. The industry partner filed a Statement of Defence and Counterclaim. The potential outcome of the lawsuit and claims are undetermined however they may be material. As the likely outcome of this litigation cannot be determined at this time, no provision has been made in these consolidated financial statements.

19. Commitments

As at December 31 2010, the Company has until December 31, 2011 to incur \$9,690,000 of qualifying flow-through expenditures related to flow-through shares issued in March, May, June and October 2010 as disclosed in note 8(b), of which approximately \$3,600,000 has been incurred.

The Company has entered into lease agreements for office premises, field equipment and Company vehicles with estimated minimum annual payments as follows

2011	\$	185,571
2012	\$	185,571
2013	\$	109,695

20. Subsequent events

a) Equity financing

On March 8, 2011, the Company closed a "bought deal" financing, completed by way of a short form prospectus, for the sale of 23,632,500 common shares of the Company at a price of \$0.73 per share for gross proceeds of \$17,251,725.

b) Stock Option Grant

On March 8, 2011, the Company granted options to purchase 2,570,000 common shares at a price of \$0.74 per share, pursuant to its stock option plan. The options vested immediately and will expire March 8, 2016. Officers were granted options on 1,250,000 shares, directors were granted options on 200,000 shares, and the balance of the options were issued to employees and consultants