Yangarra Resources Ltd.
Consolidated Financial Statements
December 31, 2012 and 2011

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 International Financial Reporting Standards as issued by the International Accounting Standards Board 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.

KPMG 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.

March 27, 2013

"James G. Evaskevich" (signed)	*"James A. Glessing" (signed)*
James G. Evaskevich	James A. Glessing
Chief Executive Officer	Chief Financial Officer

KPMG LLP
205 – 5th Avenue SW
Suite 2700, Bow Valley Square 2
Calgary AB T2P 4B9

Telephone (403) 691-8000
Fax (403) 691-8008
www.kpmg.ca

INDEPENDENT AUDITORS' REPORT

To the Shareholders of Yangarra Resources Ltd.

We have audited the accompanying consolidated financial statements of Yangarra Resources Ltd., which comprise the consolidated statement of financial position as at December 31, 2012, the consolidated statement of income (loss) and comprehensive income (loss), changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated 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 audit. We conducted our audit 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 from 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 our 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, we consider internal control 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 that the audit evidence we have 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 consolidated financial position of Yangarra Resources Ltd. as at December 31, 2012, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards.

Other Matters

The consolidated financial statements of Yangarra Resources Ltd. as at and for the year ended December 31, 2011 were audited by another auditor who expressed an unmodified opinion on those consolidated financial statements on April 4, 2012.

KPMG LLP

Chartered Accountants
March 27, 2013
Calgary, Canada

Yangarra Resources Ltd.
Consolidated Statements of Financial Position
As at:

		December 31, 2012		December 31, 2011
Assets				
Current				
Accounts receivable *(note 14)*	$	**8,398,042**	$	16,109,194
Prepaid expenses and deposits		**1,766,655**		1,318,702
Assets held for sale *(note 3)*		**463,100**		463,100
Commodity contract *(note 14c iii)*		**2,059,853**		–
Total current assets		**12,687,650**		17,890,996
Non-current				
Property and equipment *(note 3)*		**121,842,378**		119,374,219
Exploration and evaluation assets *(note 4)*		**4,025,828**		4,025,828
Commodity contract *(note 14c iii)*		**338,258**		–
Total assets	$	**138,894,114**	$	141,291,043
Liabilities				
Current				
Bank debt *(note 5)*	$	**32,138,763**	$	26,245,533
Accounts payable and accrued liabilities		**14,790,876**		25,673,625
Commodity contract *(note 14c iii)*		–		1,491,875
Total current liabilities		**46,929,639**		53,411,033
Non-current				
Other long-term liabilities		**794,114**		410,000
Decommissioning liability *(note 6)*		**5,297,166**		4,898,222
Flow-through share premium liability		–		1,500,000
Deferred tax liability		**6,183,430**		4,444,544
Total liabilities		**59,204,349**		64,663,799
Shareholders' Equity				
Share capital *(note 7)*		**94,717,629**		90,895,319
Warrants *(note 9)*		**241,826**		2,116,564
Contributed surplus		**9,593,670**		8,261,009
Deficit		**(24,863,360)**		(24,645,648)
Total shareholders' equity		**79,689,765**		76,627,244
Total liabilities and shareholders' equity	$	**138,894,114**	$	141,291,043

Contingency (note 16), Commitments (note 17)

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 consolidated financial statements

Yangarra Resources Ltd.

Consolidated Statements of Income (Loss) and Comprehensive Income (Loss)

For the year ended December 31:

		2012		2011
Revenue				
Petroleum and natural gas sales	$	**21,327,157**	$	20,742,259
Royalty income		**2,024,819**		613,139
Royalty expense		**(1,057,597)**		(972,706)
		22,294,379		20,382,692
Commodity price risk contracts *(note 14c iii)*				
Commodity contract settlement		**907,863**		1,269,687
Change in fair value of commodity contracts		**3,889,986**		(1,491,875
		27,092,228		20,160,504
Expenses				
Production		**4,771,074**		3,248,011
Transportation		**585,176**		348,431
General and administrative		**1,766,537**		1,374,170
Finance		**1,583,661**		330,107
Gain on sale of Property and Equipment		**(648,520)**		–
Share-based compensation *(note 8)*		**499,724**		1,682,583
Depletion, depreciation and impairment *(note 3)*		**18,513,402**		8,304,505
		27,071,054		15,287,807
Income before tax		**21,174**		4,872,697
Deferred income tax expense *(note 12)*		**238,886**		3,486,999
Net income (loss) and total comprehensive income (loss)	$	**(217,712)**	$	1,385,698
Income (loss) per share *(note 10)*				
Basic & Diluted	$	**0.00**	$	0.01
Weighted average number of shares *(note 10)*				
Basic		**120,663,095**		105,960,324
Diluted		**120,663,095**		113,781,122

	2012	2011
Share Capital		
Balance, beginning of year	$ **90,895,319**	$ 65,909,948
Issued	–	25,751,725
Share issue costs (net of tax)	–	(1,438,625)
Exercise of warrants	**3,822,310**	348,227
Exercise of options	–	324,044
Balance, end of year	**94,717,629**	90,895,319
Warrants		
Balance, beginning of year	**2,116,564**	2,216,541
Exercised	**(1,269,977)**	–
Expired	**(604,761)**	(99,977)
Balance, end of year	**241,826**	2,116,564
Contributed Surplus		
Balance, beginning of year	**8,261,009**	5,740,753
Share-based compensation related to:		
Options granted in current year	**727,900**	2,714,300
Exercised options	–	(194,044)
Expired warrants	**604,761**	–
Balance, end of year	**9,593,670**	8,261,009
Deficit		
Balance, beginning of year	**(24,645,648)**	(26,031,346)
Net income (loss)	**(217,712)**	1,385,698
Balance, end of year	**(24,863,360)**	(24,645,648)
Total Equity	$ **79,689,765**	$ 76,627,244

	2012	2011
Operating		
Net income (loss) for the year	$ **(217,712)**	$ 1,385,698
Add back non-cash items:		
Change in fair value of commodity contracts	**(3,889,986)**	1,491,875
Share-based compensation *(note 8)*	**499,724**	1,682,583
Depletion, depreciation and impairment *(note 3)*	**18,513,402**	8,304,505
Accretion expense *(note 6)*	**92,611**	107,281
Deferred income tax expense *(note 12)*	**238,886**	3,486,999
Gain on sale of property and equipment	**(648,520)**	–
Abandonment expenditures	–	(117,761)
	14,588,405	16,341,180
Change in non-cash working capital *(note 11)*	**2,428,026**	(9,676,331)
Net cash from operating activities	**17,016,431**	6,664,849
Financing		
Issue of equity instruments, net of costs	**2,552,332**	25,711,807
Redemption of preferred shares *(note 7)*	–	(1,000,000)
Bank debt advance *(note 5)*	**5,893,230**	20,686,325
Other long-term liabilities advance	**384,114**	410,000
Change in non-cash working capital *(note 11)*	–	–
Net cash from financing activities	**8,829,676**	45,808,132
Investing		
Expenditures property and equipment	**(24,448,531)**	(61,632,752)
Sale of property and equipment	**4,650,000**	
Expenditures on exploration and evaluation assets	–	(3,385,936)
Change in non-cash working capital *(note 11)*	**(6,047,576)**	12,534,029
Net cash used in investing activities	**(25,846,107)**	(52,484,659)
Change in cash and cash equivalents	–	(11,678)
Cash, beginning of the year	–	11,678
Cash, end of the year	$ –	$ –
Supplemental cash flow information		
Interest paid	$ **1,363,326**	$ 213,866
Dividends paid	$ –	$ 8,960

1. Basis of preparation, adoption of IFRS and statement of compliance

Yangarra Resources Ltd. (the "Company") is a publicly traded company involved in the production, exploration and development of resource properties in Western Canada. The address of the registered office is 1530, 715 – 5 Avenue SW, Calgary Alberta, T2P 2X6.

These 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.

Statement of compliance and authorization

These consolidated financial statements, including comparatives, have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("ASB")

These financial statements are presented in Canadian dollars, which is the functional currency of the Company and its subsidiary.

The consolidated financial statements were authorized for issue by the Company's Board of Directors on March 27, 2013.

2. Summary of significant accounting policies

a) Basis of measurement

The consolidated financial statements have been prepared under the historical cost method, except for the revaluation of derivative instruments.

b) Cash and cash equivalents

Cash consists of bank balances.

c) Property and equipment and exploration and evaluation assets

(i) Exploration and evaluation assets

Exploration and evaluation ("E&E") costs, including the costs of acquiring licenses and directly attributable general and administrative costs, initially are capitalized as either tangible or intangible E&E assets according to the nature of the assets acquired. The costs are accumulated in cost centers by well, field or exploration area, pending determination of technical feasibility and commercial viability.

The Company assesses the recoverability of the E&E assets, before and at the moment of reclassification, to property and equipment. E&E assets are assessed for impairment if (a) sufficient data exists to determine technical feasibility and commercial viability and (b) facts and circumstances suggest that the carrying amount exceeds the recoverable amount. The impairment of E&E assets, and eventual reversal thereof, is recognized in the statement of loss.

The technical feasibility and commercial viability of extracting a mineral resource is considered to be determinable when proved or probable reserves are determined to exist. A review of each license or field is carried out, at least annually, to ascertain whether proved or probable reserves have been discovered. Upon determination of proved or probable reserves, intangible E&E assets attributable to these reserves are first tested for impairment and then reclassified from E&E assets to property and equipment. The costs of undeveloped land that expires is recognized in income.

2. Summary of significant accounting policies (continued)

c) Property and equipment and exploration and evaluation assets

(ii) Property and equipment

Property and equipment ("P&E") is carried at cost, less accumulated depletion, depreciation and accumulated impairment losses. The cost of an item of P&E consists of the purchase price, any costs directly attributable to bringing the asset into the location and condition necessary for its intended use, a discounted current estimate of the decommissioning costs and borrowing costs for qualifying assets.

Oil and gas capitalized costs are depleted using the unit-of-production method. Depletion is calculated using the ratio of production in the year to the remaining total proved and probable reserves before royalties, taking into account future development costs prior to inflation necessary to bring those reserves into production. These estimates are evaluated and reported on by independent reserve engineers annually. Proven and probable reserves are estimated using independent reserve engineer reports. There is a 50 percent estimated statistical probability that the actual quantity of recoverable reserves will be more than the amount estimated as proven and probable. The statistical probability for proven reserves is 90 percent.

Where an item of P&E comprises major components with different useful lives, the components are accounted for as separate items of P&E. The expected useful lives of P&E, residual values and methods of depreciation are reviewed at each reporting period and, if necessary, changes are accounted for prospectively.

Changes in estimates such as quantities of proved and probable reserves that affect unit-of-production calculations are applied on a prospective basis.

An item of P&E is derecognized upon disposal or is impaired when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss on disposal of the asset, determined as the difference between the net proceeds and the carrying amount of the asset, is recognized in the statement of comprehensive income (loss) in the period incurred.

Corporate assets are recorded at cost less accumulated amortization, which is calculated using the declining balance method at rates of 20 percent to 30 percent per annum.

(iii) Impairment of non-financial assets

At each financial reporting date, the carrying amounts of P&E are reviewed to determine whether there is any indication that those assets are impaired. If such indication exists, an estimate of the recoverable amount of the asset is calculated.

Individual assets are grouped together for impairment assessment purposes into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (the cash generating unit or CGU). The carrying amount of P&E assets within a CGU are compared to the recoverable amount of the CGU. Goodwill is allocated to CGUs that are expected to benefit from synergies of the combination. E&E assets are allocated to CGUs when they are assessed for impairment if indicators of impairment exist as well as upon their reclassification into P&E.

2. Summary of significant accounting policies (continued)

c) Property and equipment and exploration and evaluation assets (continued)

(iii) Impairment of non-financial assets (continued)

A CGU's recoverable amount is the higher of its fair value less costs to sell and its value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money to the Company and the risks specific to the asset. Fair value less cost to sell is derived by estimating the discounted after-tax future net cash flows. Discounted future net cash flows are based on forecasted commodity prices and costs over the expected economic life of the reserves and discounted market-based rates to reflect a market participants view of the risks associated with the assets.

Where the carrying amount of a CGU exceeds its recoverable amount, the CGU is considered impaired and is written down to its recoverable amount. The impairment loss is charged to the statement of income (loss) and comprehensive income (loss). A previously recognized impairment loss is reversed or partially reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognized. If that is the case, the carrying amount of the asset is increased to its recoverable amount. The new carrying amount cannot exceed the carrying amount that would have been determined, net of depletion and depreciation, had no impairment loss been recognized for the asset in prior periods.

(iv) Decommissioning liability

The Company recognizes a decommissioning liability in the period it arose with a corresponding increase to the carrying amount of the related asset. Measurement occurs when a legal or constructive obligation arises. Provisions are measured at the present value of the expenditures expected to be required to settle the obligation discounted using the pre-tax risk-free rate, updated at each reporting date. The increase in the provision due to the passage of time (accretion) is recognized as a finance expense whereas increases or decreases due to changes in the estimated cost to decommission the asset are capitalized as P&E. Actual costs incurred upon settlement of the decommissioning liability reduce the liability to the extent the provision was established. The related decommissioning asset is depreciated or depleted on the same basis as the P&E to which it relates.

d) Leases

Leases that transfer substantively all the benefits, risks and rewards of ownership to the Company are recorded as finance leases. Finance leases are capitalized at the lease's commencement at the lower of the fair value of the leased asset and the present value of the minimum lease payments with a corresponding increase to obligations under finance leases. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the obligation outstanding. The finance charge is included in the statement of comprehensive income (loss) over the lease period.

Leases that do not transfer the risks and rewards of ownership to the Company are classified as operating leases under which leasing costs are expensed in the period incurred.

2. Summary of significant accounting policies (continued)

e) Joint operations

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

f) Revenue recognition

Revenue is recognized from petroleum sales when the petroleum is delivered to the buyer and from gas sales when the gas passes through the pipeline at the delivery point. Petroleum and natural gas royalty income is recognized as it accrues in accordance with the terms of the overriding royalty agreements.

g) Income taxes

Income tax expense represents the sum of current tax expense and deferred tax expense. Current tax expense is based on the taxable profits for the year. Income tax expense is recognized in the statement of comprehensive income (loss) except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax expense is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax assets and liabilities are recognized based on differences in the financial statement carrying amount for assets and liabilities and the associated tax balance. Deferred tax liabilities are generally recognized for all taxable temporary differences. Deferred tax assets are generally recognized for all deductible temporary differences, unused tax credits carried forward and unused tax losses to the extent that it is probable that there will be taxable profits against which deductible temporary differences can be utilized. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination. In addition, deferred tax is not recognized for taxable difference arising in the initial recognition of goodwill.

Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the tax benefit will be realized.

Deferred taxes are measured based on enacted or substantively enacted tax rates for the period in which the temporary differences are expected to be realized or settled, and are presented as non-current.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities, when they relate to income taxes levied by the same taxation authority and when the Company intends to settle its current tax assets and liabilities on a net basis.

h) 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 proceeds from issuance are allocated between the offering of shares and the sale of tax benefits. The allocation is made based on the difference between the quoted price of the existing shares and the amount the investor pays for the shares. A flow through share premium liability is recognized for this difference. The liability is reversed when tax benefits are incurred and a deferred tax liability is recognized at that time. Income tax expense is the difference between the amount of the deferred tax liability and the liability recognized on issuance.

2. Summary of significant accounting policies (continued)

i) Share-based compensation plans

Stock options granted to directors, officers, employees and consultants are accounted for using the fair value method under which compensation expense is recorded based on the estimated fair value of the options at the grant date using the Black-Scholes option pricing model. Each tranche in an award is considered a separate award with its own vesting period and grant date fair value. Compensation cost is either expensed or capitalized depending upon whether or not the individual to which the award relates is directly related to the development of its oil and gas projects, over the vesting period with a corresponding increase in contributed surplus. When stock options are exercised, the cash proceeds along with the amount previously recorded as contributed surplus are recorded as share capital. The number of awards expected to vest is reviewed annually. The Company does not incorporate forfeitures into the Black-Scholes option pricing model as all options granted vest immediately.

j) Earnings per share

Basic earnings per share ("EPS") is calculated by dividing the net income (loss) for the period attributable to equity owners of the Company by the weighted average number of common shares outstanding during the period. Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The Company's potentially dilutive instruments are comprised of stock options granted and warrants granted.

k) Financial instruments

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantively all the risks and rewards of ownership.

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded contract are not closely related, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and the combined instrument is not measure at fair value through profit or loss. Changes in the fair value of separate embedded derivatives are recognized immediately in the statement of income (loss) and comprehensive income (loss).

The Company accounts for forward physical delivery contracts, which are 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. As such these contracts are not considered to be derivatives financial instruments and are not recorded at fair value on the statement of financial position. Settlements on physical sales contracts are recognized in oil and natural gas revenues.

2. Summary of significant accounting policies (continued)

k) Financial instruments (continued)

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instrument were acquired.

(i) Fair value through profit or loss

A financial asset can be classified as fair value asset through profit or loss only if it is designated at fair value through profit or loss or held-for-trading. Held-for-trading assets are comprised of derivatives or assets acquired or incurred principally for the purpose of selling or repurchasing in the near term. The Company's commodity contracts are derivatives and are recorded at fair value with changes in fair value included in the statement of income (loss) and comprehensive income (loss). The Company does not apply hedge accounting to its derivative instruments.

(ii) Held-to-maturity

These assets are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Company has the positive intention and ability to hold until maturity. These assets are measured at amortized cost using the effective interest method. If there is objective evidence that the investment is impaired, impairment losses are included in the statement of income (loss) and comprehensive income (loss).

(iii) Loans and receivables

These assets are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. These assets are measured at amortized cost using the effective interest method. Any gains or losses on the realization of receivables are included in the statement of income (loss) and comprehensive income (loss). The financial assets that are categorized as loans and receivables included cash and cash equivalents and accounts receivable.

iv) Other financial liabilities

Other financial liabilities are measured at amortized cost using the effective interest method. Any gains or losses in the realization of other financial liabilities are included in profit or loss. The financial liabilities that are categorized as other financial liabilities include bank debt, accounts payable, accrued liabilities and other long-term liabilities.

Impairment of financial assets

All financial assets except for those at fair value through profit or loss are subject to review for impairment at each reporting date. Financial assets are impaired when there is any objective evidence that a financial asset or a group of financial assets are impaired. Impairment losses on financial assets carried at amortized cost are reversed in subsequent periods if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized.

Borrowing costs

Borrowing costs that are directly related to the issuance of new debt are recorded net of the associated debt and recognized into income using the effective interest rate method over the life of the debt.

2. Summary of significant accounting policies (continued)

k) Financial instruments (continued)

Discounts or transaction costs on issuance of new debt

Discounts, where proceeds received are less than the par value of the debt or transaction costs related to the issuance of debt, are recorded as a reduction to long-term debt. These discounts would be amortized using the effective interest method and included in finance expense.

Share capital

Common shares are classified as equity on the statement of financial position. Transaction costs directly attributable to the issue of common shares and share options are recognized as a deduction from equity, net of any tax effects.

l) Provisions

Provisions and liabilities for legal and other contingent matters are recognized in the period when it becomes probable a future cash outflow resulting from past operations or events will occur and the amount of the cash outflow can be reasonably estimated. The timing of recognition and measurement of the provision requires the application of judgment to existing facts and circumstances, which can be subject to change, and the carrying amounts of provisions and liabilities are reviewed regularly and adjusted accordingly. The Company is required to both determine whether a loss is probable based on judgment and interpretation of laws and regulations, and determine that the loss can be reasonably estimated. When a loss is recognized, it is charged to the statement of income (loss) and comprehensive income (loss). The Company continually monitors known and potential contingent matters and makes appropriate provisions when warranted by the circumstances present.

m) Assets held for sale

Non-current assets are classified as assets held for sale if it is highly probable that they will be recovered primarily through sale rather than through continuing use. The assets are measure at the lower of the carrying amount and the fair value less costs to sell. Once classified as held for sale, P&E is no longer amortized or depreciated.

n) Significant accounting estimates judgments and estimates

The preparation of the consolidated financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect reported amounts and presentation of assets, liabilities, revenues, expenses and disclosures of contingencies and commitments. Such estimates primarily relate to unsettled transactions and events at the statement of financial position date which are based on information available to management at each financial statement date. Actual results could differ from those estimated. Judgments, estimates and assumptions are continuously evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

<u>Critical judgments in applying accounting policies</u>

CGU Determination

The Company's assets are aggregated into cash-generating-units (CGUs) based on their ability to generate largely independent cash flows and are used for impairment testing. CGUs are determined by similar geological structure, shared infrastructure and geographical proximity.

2. Summary of significant accounting policies (continued)

n) Significant accounting judgments and estimates (continued)

Impairment indicator assessment

The Company assesses its P&E and E&E assets for possible impairment if there are events or changes in circumstances that indicate the carrying values of the assets may not be recoverable. Such indicators include changes in the Company's business plans, changes in commodity prices, evidence of physical damage and significant downward revisions to estimated recoverable volumes or increases in estimated future development expenditures.

Contingencies

By their nature, contingencies will only be resolved when one or more of the future events occur or fail to occur. The recognition of contingencies inherently involves the estimates of the outcome of future events.

Key sources of estimation uncertainty

Reserves

Reserves are used in the unit of production calculation for depletion and depreciation as well as impairment analysis. The quantity of reserves is subject to a number of estimates and projections including assessment of engineering data, projected future rates of production, commodity prices, regulatory changes, operating costs and sustaining capital expenditures. These estimates and projections are uncertain as the Company does not have a long commercial production history to assist in the development of these forward-looking estimates. However, all reserve and associated financial information is evaluated and reported on by a firm of qualified independent reserve evaluators in accordance with the standards prescribed by applicable securities regulators. The calculation of future cash flows based on these reserves is dependent on a number of estimates including: production volumes, facility performance, commodity prices, and royalties, operating costs, sustaining capital and tax rates. The price used in the Company's assessment of future cash flows is based on the Company's independent evaluator's estimate of future prices and evaluated for reasonability by the Company against other available information. The Company believes these prices are reasonable estimates for a long-term outlook.

Decommissioning liabilities

The Company measures decommissioning liabilities at each financial statement date. The estimate is based on the Company's share of costs to reclaim the assets and certain facilities. To determine the future value of the liability, estimates of the amount, timing and inflation of the associated abandonment costs are made. The present value of the cost is recorded as the decommissioning liability using a risk-free discount rate. Due to the long-term nature of current and future project developments, abandonment costs will be incurred many years in the future. As a result of these factors, different estimates could be used for such abandonment costs and the associated timing. Assumptions of higher future abandonment costs, regulatory changes, higher inflation, lower risk-free rates or an assumption of earlier or specified timing of abandonment would cause the decommissioning liability of the corresponding asset to increase. These changes would also cause future accretion expenses to increase and future income to decrease.

Impairment Estimate

The assessment for impairment for P&E and E&E assets involves comparing the carrying value of the CGU with the higher of value in use calculations and fair value less costs to sell. Determination as to whether and how much an asset is impaired involves management estimates on highly uncertain matters such as future commodity prices, the effects of inflation on operating expenses, discount rates, production profiles and the outlook for regional supply-and-demand conditions for crude oil, natural gas and liquids. Impairment is recognized in the statement of income (loss) and comprehensive income (loss) in the period in which carrying amount exceeded the recoverable amount.

2. Summary of significant accounting policies (continued)

n) Significant accounting judgments and estimates (continued)

Key sources of estimation uncertainty (continued)

Deferred taxes

Deferred income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. An estimate is required for both the timing and corresponding tax rate for this reversal. Should these estimates change, it may impact the measurement of the Company's assets or liabilities as well as deferred tax recovery or expense recognized to earnings. Where unfavorable evidence exists, additional considerations and evidence for recognition of deferred tax assets is required. The Company has applied management's judgment and evaluated applicable factors necessary in making this determination and has concluded that the positive evidence in consideration of the estimated future cash flows based on reserve reports from the Company's independent engineers, does not sufficiently outweigh negative factors. The Company only recognizes deferred tax assets arising from unused tax losses to the extent that the Company has sufficient taxable temporary differences or it is probable that sufficient taxable profit will be available against which the unused tax losses can be utilized.

Contingencies

When recognized, management makes its best estimate with respect to future cash outflow

Other areas of estimates

The recognition of amounts in relation to stock-based compensation requires estimates related to valuation of stock options at the time of issuance including share price, risk free rate, volatility, expected life and dividend yield. The fair value of commodity contracts is calculated using valuation models that require estimates as to future market prices expected interest rates and expected volatility in these variables. By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the financial statements for current and future periods could be significant.

o) Accounting standards issued but not yet applied

Certain new standards, interpretations, amendments and improvements to existing standards were issued by the IASB or International Financial Reporting Interpretations Committee ("IFRIC") that are mandatory for accounting periods beginning after January 1, 2013 or later periods. The standards impacted that are applicable to the Company are as follows:

IFRS 9, 'Financial Instruments' was issued in November 2009 as the first step in its project to replace IAS 39 'Financial Instruments: Recognition and Measurement'. IFRS 9 introduces new requirements for classifying and measuring financial assets that must be applied starting January 1, 2015, with early adoption permitted. The IASB intends to expand IFRS 9 during the intervening period to add new requirements for classifying and measuring financial liabilities, de-recognition of financial instruments, impairment and hedge accounting. The Company is currently assessing the impact of this standard.

IFRS 10, 'Consolidated Financial Statements' was issued in May 2011 and will supersede the consolidation requirements in SIC-12 'Consolidation – Special Purpose Entities' and IAS 27 'Consolidated and Separate Financial Statements' effective for annual periods beginning on or after January 1, 2013, with early application permitted. IFRS 10 builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company. The standard also provides additional guidance to assist in the determination of control where this is difficult to assess. The Company is currently assessing the impact of this standard.

2. Summary of significant accounting policies (continued)

n) Accounting standards issued but not yet applied (continued)

IFRS 11, 'Joint Arrangements' was issued in May 2011 and will supersede existing IAS 31, 'Joint Ventures' effective for annual period beginning on or after January 1, 2013, with early application permitted. IFRS 11 provides for the accounting of joint arrangements by focusing on the rights and obligations of the arrangement, rather than its legal form (as is currently the case). The standard also eliminates the option to account for jointly controlled entities using the proportionate consolidation method. The Company is currently assessing the impact of this standard.

IFRS 12, 'Disclosure of Interests in Other Entities' was issued in May 2011 and is a new and comprehensive standard on disclosure requirements for all forms of interests in other entities, including subsidiaries, joint arrangements, associates and unconsolidated structured entities. IFRS 12 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. The Company is currently assessing the impact of this standard.

IFRS 13, 'Fair Value Measurement' was issued in May 2011 and sets out in a single IFRS a framework for measuring fair value. IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This definition of fair value emphasizes that fair value is a market-based measurement, not an entity-specific measurement. In addition, IFRS 13 also requires specific disclosures about fair value measurement. IFRS 13 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. The Company is currently assessing the impact of this standard.

IAS 28, 'Investments in Associates and Joint Ventures' – The IASB issued amendments to IAS 28 Investments in Associates and Joint Ventures to coincide with the changes made in IFRS 10 and IFRS 11.

3. Property and equipment

	Oil and Natural Gas Interests	*Well and plant equipment*	*Other Assets*	*Total*
Cost or Deemed Cost				
Balance at December 31, 2010	53,617,892	15,704,399	135,452	69,457,743
Additions	53,935,149	9,487,625	992,498	64,415,272
Balance at December 31, 2011	107,553,041	25,192,024	1,127,950	133,873,015
Cash Additions	**21,464,682**	**2,812,328**	**171,521**	**24,448,531**
Dispositions	**(4,001,480)**	–	–	**(4,001,480)**
Capitalized stock based compensation and decommissioning liability	**534,510**	–	–	**534,510**
Balance at December 31, 2012	**$ 125,550,753**	**$ 28,004,352**	**$ 1,299,471**	**$ 154,854,576**
Depletion, depreciation and impairment				
Balance at December 31, 2010	5,634,445	537,500	22,346	6,194,291
Depletion and depreciation	7,256,900	938,000	109,605	8,304,505
Balance at December 31, 2011	12,891,345	1,475,500	131,951	14,498,796
Depletion and depreciation	**12,506,000**	**1,722,900**	**249,076**	**14,477,976**
Impairment loss	**4,035,426**	–	–	**4,035,426**
Balance at December 31, 2012	**$ 29,432,771**	**3,198,400**	**381,027**	**33,012,198**
Net Book Amount				
At December 31, 2011	$ 94,661,696	$ 23,716,524	$ 995,999	$ 119,374,219
At December 31, 2012	**$ 96,117,982**	**$ 24,805,952**	**$ 918,444**	**$ 121,842,378**

3. Property and equipment (continued)

The depletion, depreciation and impairment of property and equipment, and any eventual reversal thereof, are recognized in depletion and depreciation in the statement of income and comprehensive income. Future development costs of 90,935,330 (2011 – 62,410,000) are included in the depletion calculation. At December 31, 2012 all of the Company's properties are pledged as security for the bank loans.

During the year ended December 31, 2012, the Company capitalized $306,333 (2011 – $1,406,896) related to the decommissioning liability of property and equipment and $228,176 (2011 – $1,375,622) of share-based compensation. The Company also capitalized $463,894 (2011 – $718,809) of general and administrative costs as well as $717,536 (2011 - $755,658) of recoveries related to the Company's working interest in operated capital expenditure programs on which overhead has been charged in accordance with standard industry operating agreements.

In December 2012, the Company divested an asset in the Central Alberta area for net cash proceeds of $4,650,000. As a result of the disposition Yangarra recorded a gain of $648,520 in 2012.

As at December 31, 2012 and 2011, property and equipment totaling $463,100 (2011 – $463,100) 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.

During the year ended December 31, 2012 the Company recognized an impairment of $4,035,426 (December 31, 2011 - $nil) on its Jaslan and Medicine Hat cash generating unit ("CGU") as the carrying amount exceeded fair value less costs to sell, due to the decrease in natural gas prices. Fair value was determined using the net present value of proved plus probable reserves discounted at 10% in the reserve report and using the following commodity price estimates:

	Average Price Forecast		
Year	***WTI Cushing*** **40° API**	***Alberta AECO-C Spot***	***Exchange Rate***
2013	$90.00	$3.20	1.000
2014	$89.75	$3.75	1.000
2015	$91.55	$4.05	1.000
2016	$93.40	$4.35	1.000
2017	$92.00	$4.65	1.000
2018	$93.85	$5.10	1.000
2019	$95.70	$5.40	1.000
2020	$97.65	$5.75	1.000
2021	$99.60	$6.10	1.000
2022	$101.60	$6.45	1.000
	Escalation rate of 2.0% thereafter		

The benchmark prices listed above are adjusted for quality differentials, heat content, distance to market and other factors in performing the ceiling test. Percentage change represents the change in each year after 2022 to the end of the reserve life.

A 5% increase in the assumed discount rate would have resulted in an additional impairment of $878,700 for the year ended December 31, 2012 while a 5% decrease in the forward commodity price estimate would result in an additional impairment of approximately $465,000.

4. Exploration and evaluation assets

Cost or Deemed Cost		
Balance at December 31, 2010		5,005,176
Additions		**3,385,939**
Balance at December 31, 2011		8,391,115
Additions		–
Balance at December 31, 2012	**$**	**8,391,115**
Depletion, depreciation and impairment losses		
Balance at January 1, 2010	$	3,798,712
Amortization		566,575
Balance at December 31, 2011		4,365,287
Amortization		–
Balance at December 31, 2012	**$**	**4,365,287**
Net book value		
At December 31, 2011	**$**	**4,025,828**
At December 31, 2012	**$**	**4,025,828**

Exploration and evaluation ("E&E") assets consist of the Company's undeveloped land which are pending the determination of proven or probable reserves. Additions represent the Company's share of costs incurred on E&E assets during the period.

5. Bank debt

As at December 31, 2012, the $32,138,763 (2011 – $26,245,533) reported amount of bank debt with a Canadian chartered bank was comprised of $21,950,000 (2011 – $24,450,000) drawn on the revolving operating demand loan, $9,992,093 (December 31, 2011 – $nil) of guaranteed notes and $196,658 (2011 – $1,795,533) of bank overdraft. The Company is subject to a financial covenant requiring a working capital ratio of 1 : 1, which the Company was in compliance with at December 31, 2012.

The facility is secured by a fixed and floating charge on the assets of the Company and is secured by a general security agreement.

As at December 31, 2012, the maximum amount available under the revolving operating demand loan was $42,000,000 (December 31, 2011 – $40,000,000) at an interest rate of bank prime plus 1.5% per annum on the operating demand load, payable monthly, and a credit spread of 2.5% on the guaranteed notes. The next scheduled review is May 31, 2013.

During the year, the weighted average effective interest rate for the bank debt was approximately 4.5% (2011 - 3.25 %).

6. Decommissioning liability

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

	December 31, 2012	*December 31, 2011*
Balance, beginning of year	**$ 4,898,222**	$ 3,501,805
Liabilities incurred	**283,823**	652,382
Liabilities settled	–	(117,761)
Effect of change in discount rate	**77,816**	502,585
Accretion	**92,611**	107,281
Change in assumptions	**(55,305)**	251,929
Balance, end of year	**$ 5,297,166**	$ 4,898,222

The following significant assumptions were used to estimate the decommissioning liability:

	December 31, 2012	*December 31, 2011*
Undiscounted cash flows	**$ 6,905,036**	$ 6,120,528
Discount rate	**1.51% - 3.35%**	1.51% - 3.35%
Inflation rate	**2%**	2%
Weighted average expected timing of cash flows	**8.7 years**	8.7 years

7. Share capital

a. Authorized

Unlimited number of common shares, without nominal or par value
Unlimited number of preferred shares, without nominal or par value

b. Common shares issued

	Number of shares	*Amount*
Balance December 31, 2010	79,718,127	$ 65,909,948
Transfer agent correction	(70)	–
Equity financing *(i)*	23,632,500	17,251,725
Flow-through equity financing *(ii)*	12,500,000	8,500,000
Exercise of stock options *(iii)*	260,000	324,044
Exercise of warrants *(iv)*	496,500	348,227
Share issue costs, net of $479,248 of deferred income tax	–	(1,438,625)
Balance December 31, 2011	116,607,057	$ 90,895,319
Exercise of warrants *(v)*	**5,104,666**	**3,822,310**
Balance, December 31, 2012	**121,711,723**	**$ 94,717,629**

7. Share capital (continued)

i) 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.

ii) On June 23, 2011 the Company, closed a "bought deal" financing, completed by way of private placement, for the sale of 12,500,000 flow-through shares of the Company at a price of $0.80 per share for gross proceeds of $10,000,000. $1.5 million was classified as a flow through premium liability until the tax effect is renounced.

iii) The Company issued 260,000 common shares on the exercise of options at $0.50 per share for cash proceeds of $130,000 plus a pro-rata allocation of the options' fair value in the amount of $194,044.

iv) The Company issued 496,500 common shares on the exercise of warrants at $0.50 per share for cash proceeds of $248,250 plus a pro-rata allocation of the warrants' fair value in the amount of $99,977.

v) The Company issued 5,104,666 common shares on the exercise of warrants at $0.50 per share for cash proceeds of $2,552,332 plus a pro-rata allocation of the warrants' fair value in the amount of $1,269,978.

8. Share-based payments

The Company has an equity settled 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.

During the year ended December 31, 2012, the Company granted options to purchase 3,155,000 common shares, with the options vesting immediately. The fair value of the options was estimated at $727,900 ($0.23 per option) using the Black-Scholes pricing model.

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

	December 31, 2012		*December 31, 2011*	
	Options	***Weighted – average exercise price***	*Options*	*Weighted – average exercise price*
Opening	**11,353,800**	**$0.65**	7,808,800	$0.67
Granted	**3,155,000**	**0.42**	4,175,000	0.69
Exercised	–	–	(260,000)	0.50
Forfeited	**(2,500,800)**	**0.65**	(255,000)	0.72
Expired	**(168,000)**	**1.00**	(115,000)	1.83
Closing	**11,840,000**	**$0.59**	11,353,800	$0.65

8. Share-based payments (continued)

The following provides a summary of the stock option plan as at December 31, 2012:

Range of exercise price	*Number outstanding*	*Weighted-average remaining contractual life (years)*	*Weighted-average exercise price*	*Number exercisable*
$ 0.25 – $ 0.50	5,100,000	3.20	$ 0.45	5,100,000
$ 0.51 – $ 0.75	5,455,000	2.98	0.66	5,455,000
$ 0.76 – $ 1.00	1,285,000	2.90	0.86	1,285,000
	11,840,000	3.06	$ 0.59	11,840,000

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

	2012	*2011*
Weighted average fair value per option	**$0.23**	$0.65
Risk-free interest rate	**1.49% to 1.64%**	1.51% to 2.81%
Expected volatility	**65%**	163% to 164%
Expected life	**5 years**	5 years
Forfeiture rate	**0%**	0%

9. Warrants

The following table summarizes information about warrants outstanding as at:

	December 31, 2012			*December 31, 2011*		
	Number of warrants	***Exercise price***	***Fair value ascribed***	*Number of warrants*	*Exercise price*	*Fair value ascribed*
Opening	**8,955,500**	**$0.50**	**$2,116,564**	9,452,000	$0.50	$2,216,541
Exercised	**(5,104,666)**	**(0.50)**	**(1,269,977)**	(496,500)	(0.50)	(99,977)
Expired	**(2,430,834)**	**(0.50)**	**(604,761)**	–	–	–
Closing	**1,420,000**	**$0.50**	**$241,826**	8,955,500	$0.50	$2,116,564

As at December 31, 2012, warrants had a weighted average remaining life of 2.00 years (2011 – 0.9 years).

10. Net (loss) income per common share

Basic earnings per share was calculated as follows:

	2012	2011
Net (loss) income for the period	$ **(217,712)**	$ 1,385,698
Weighted average number of shares (basic)		
Issued common shares at beginning of period	**116,607,057**	79,718,127
Stock options exercised	–	215,836
Transfer agent correction	–	(70)
Warrants exercised	**4,056,038**	190,856
Effect of shares issued	–	25,835,575
Weighted average number of common shares - basic	**120,663,095**	105,960,324

Diluted earnings per share was calculated as follows:

	2012	2011
Weighted average number of shares (basic)	**120,663,095**	105,960,324
Effect of outstanding options	–	1,110,721
Effect of outstanding warrants	–	6,710,099
Weighted average number of common shares - diluted	**120,663,095**	113,781,144

The average market value of the Company's shares for purposes of calculating the dilutive effect of share options was based on quoted market prices for the period that the options were outstanding. Excluded from diluted earnings per share is the effect of 11,840,000 options (2011 – 3,543,605 options) and 1,420,000 warrants (2011 – nil) as they are out of the money.

11. Change in non-cash working capital

	2012	2011
Accounts receivable	$ **7,711,152**	$ (12,356,717)
Prepaid expenses	**(447,953)**	(1,075,488)
Accounts payable and accrued liabilities	**(10,882,749)**	16,289,903
	$ **(3,619,550)**	$ 2,857,698

The changes in non-cash working capital has been allocated to the following activities:		
Operating	$ **2,428,026**	$ (9,676,331)
Financing	–	–
Investing	**(6,047,576)**	12,534,029
	$ **(3,619,550)**	$ 2,857,698

12. Income taxes

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

	2012	*2011*
Income before income taxes	$ **21,174**	$ 4,872,697
Combined federal and provincial statutory income tax rate	**25.0%**	26.5%
Expected income tax expense (reduction)	$ **5,294**	$ 1,291,265
Stock-based compensation	**124,931**	445,884
Rate adjustments	–	(101,290)
Flow through share obligation	**1,000,000**	1,329,613
Other	**(891,339)**	521,527
	$ **238,886**	$ 3,486,999

The 2012 corporate tax rate decreased to 25.0% from 26.5% in 2011 due to scheduled federal tax rate adjustments.

The components of the net deferred income tax asset (liability) are:

	Balance December 31, 2011	*Recognized in Income*	*Flow Through Share Premium*	*Recognized in Equity*	*Balance December 31, 2012*
Decommissioning liability	1,224,556	99,736	–	–	**1,324,292**
Non-capital and capital loss carry-forwards	–	257,639	–	–	**257,639**
Share issue costs	671,516	(194,635)	–	–	**476,881**
Commodity price risk contracts	372,969	(972,497)	–	–	**(599,528)**
Property and equipment	(6,713,585)	570,871	(1,500,000)	–	**(7,642,714)**
	(4,444,544)	(238,886)	(1,500,000)	–	**(6,183,430)**

	Balance December 31, 2010	*Recognized in Income*	*Flow Through Share Premium*	*Recognized in Equity*	*Balance December 31, 2011*
Decommissioning liability	875,451	349,105	–	–	1,224,556
Non-capital and capital loss carry-forwards	242,761	(242,761)	–	–	–
Share issue costs	386,904	(194,635)	–	479,247	671,516
Commodity price risk contracts	–	372,969	–	–	372,969
Property and equipment	(1,449,428)	(3,827,365)	(1,436,792)	–	(6,713,585)
Deferred tax asset not recognized	(55,688)	55,688	–	–	
	–	(3,486,999)	(1,436,792)	479,247	(4,444,544)

As at December 31, 2012, the Company has approximately $97 million of tax pools available for deduction against future taxable income.

13. Related party disclosure

The consolidated financial statements include the financial statements of Yangarra Resources Ltd. and the subsidiary listed below:

Name	Country of Incorporation	% equity interest 2012	2011
Yangarra Resources Corp.	Canada	100%	100%

Balances between Yangarra Resources Ltd. and its subsidiary have been eliminated on consolidation and are not disclosed in this note. Details of transactions between the Company and other related parties are disclosed below. During the years ended December 31, 2012 and 2011, 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:

	2012	2011
Administration and consulting fees	$ **194,960**	$ 237,694
Production and capital expenditures	**137,846**	339,896
	$ **332,806**	$ 577,590

Included in accounts payable and accrued liabilities at December 31, 2012 is $11,221 (December 31, 2011 – $117,020) 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.

Other long-term liabilities includes a mortgage for $361,411 (December 31, 2011 - $410,000) held in the name of an officer of the Company. The property against which the mortgage is secured is owned by the Company through a trust agreement and is used as a field office. All mortgage payments are made by the Company.

Compensation of key management personal (Directors, Officers and Vice Presidents):

	2012	2011
Compensation	$ **1,197,000**	$ 731,250
Share-based payments	**427,080**	1,385,279
	$ **1,624,080**	$ 2,116,529

14. Financial instruments and financial risk management

The Company's financial instruments include accounts receivable, bank debt, accounts payable and accrued liabilities, other long term liabilities and commodity contracts. The carrying values of accounts receivable, accounts payable and accrued liabilities and bank debt 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.

14. Financial instruments and financial risk management (continued)

The fair value of commodity contracts is measured at level 2.

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:

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, 2012, the maximum credit exposure is the carrying amount of the accounts receivable of $8,398,042 (2011 – $16,109,194).

The maximum exposure to credit risk for receivables at the reporting date by type of customer was:

Oil and natural gas marketers	$	2,367,306
Joint venture partners		4,873,316
Other		1,157,420
	$	8,398,042

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. To mitigate the risk associated with of dealing with a smaller marketer the Company has entered into an arrangement with Computershare to allow them to retain ownership of the product. All of the revenue accruals and receivables from petroleum and natural gas marketers were received in January and February 2013.

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.

14. Financial instruments and financial risk management (continued)

The Company did not provide for any doubtful accounts nor was it required to write-off any accounts receivable during the year ended December 31, 2012. The Company would only choose to write-off a receivable balance after all reasonable avenues of collection had been exhausted.

As at December 31, 2012, the Company considers its receivables to be aged as follows:

Not past due	$	5,194,920
Past due by less than 90 days		1,805,871
Past due by more than 90 days		1,397,251
	$	8,398,042

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. 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 5, 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 other long-term liabilities, which have expected maturities of less than one year resulting in their current classification on the statement of financial position.

As at December 31, 2012	Carrying Amount	Contractual Cash Flows	Less than 1 year	1-2 Years	2-5 Years	More than 5 years
A/P and accrued liabilities	14,790,876	14,790,876	14,790,876	–	–	–
Bank Debt (1)	32,138,763	32,138,763	32,138,763	–	–	–
Other long-term liabilities	794,114	794,114	–	541,888	126,939	125,287
Estimated Interest Payments	–	1,446,244	1,446,244	–	–	–
	47,723,753	49,169,997	48,375,883	541,888	126,939	125,287

(1) Assumes the credit facilities are not renewed May 2013

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:

14. Financial instruments and financial risk management (continued)

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, 2012, if interest rates had been 1% lower with all other variables held constant, income for the period would have been $287,000 (2011 - $260,000) higher, due to lower interest expense. An equal and opposite impact would have occurred had interest rates been higher by the same amount. The Company had no interest rate swap or financial contracts in place at December 31, 2012.

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, 2012.

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.

As at December 31, 2012, the Company was committed to the following commodity price risk contracts for the sale of oil:

<u>2013 Contracts:</u>

- 200 bbl/d from January 1 to December 31, 2013 at a fixed price of $98.00 CAD/bbl;
- 100 bbl/d from January 1 to December 31, 2013 at a fixed price of $97.50 CAD/bbl;
- 200 bbl/d from January 1 to December 31, 2013 at a fixed price of $98.30 USD/bbl;
- 100 bbl/d from January 1 to December 31, 2013 at a fixed price of $98.00 USD/bbl;
- 100 bbl/d from January 1 to December 31, 2013 at a fixed price of $104.80 CAD/bbl and;
- Sold calls on 200 bbl/d d from January 1 to December 31, 2013 at $110 USD/bbl.

<u>2014 Contracts:</u>

- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $98.30 CAD/bbl;
- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $100.00 CAD/bbl;
- 100 bbl/d from January 1 to December 31, 2014 at a fixed price of $101.05 CAD/bbl; and
- Sold Swaption on 200 bbl/d @ $100.00 WTI/USD for January – December 2014.

14. Financial instruments and financial risk management (continued)

As at December 31, 2012, the Company was committed to the following commodity price risk contracts on the AECO basis:

- 2,000 GJ/d at $3.51/GJ for January – December 2013;
- 1,000 GJ/d at $3.35/GJ for January – December 2013; and
- 500 GJ/d at $3.42/GJ for January – December 2013.

The following table summarizes the fair value and the change in fair value for year ended December 31, 2012:

	2012	2011
Commodity contract (liability) asset, beginning of year	**$ (1,491,875)**	$ -
Unrealized change in fair value	**3,889,986**	(1,491,875)
Commodity contract (liability) asset, end of year	**2,398,111**	$ (1,491,875)

The following table summarizes the sensitivity of the fair value of the Company's derivative positions as at December 31, 2012 to fluctuations in commodity prices, with all other variables held constant. When assessing the potential impact of these commodity price changes, the Company believes 10 percent volatility is a reasonable measure. Fluctuations in commodity prices potentially could have resulted in unrealized gains (losses) impacting income before tax as follows:

	Impact on Income Before Tax	
	Increase 10%	Decrease 10%
Crude oil	**(3,439,213)**	3,439,213
Natural Gas	**(383,250)**	383,250

15. Capital disclosures

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 and debt:

	December 31, 2012	*December 31, 2011*
Shareholders' equity	$ 79,689,765	$ 76,627,244

The Company monitors capital based on annual cash from operations before changes in non-cash working capital and capital expenditure budgets, which are updated as necessary and are reviewed and periodically approved by the 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.

15. Capital disclosures (continued)

In order to maintain or adjust the capital structure, the Company considers its forecasted cash from operations before changes in non-cash working capital 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, 2012, the Company's capital structure was not subject to external restrictions. No changes have been made to the capital policy since 2011

16. 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 Company increased the statement of claim based on the information provided by the defendant. The potential outcome of the lawsuit and claims are undetermined, however, they may be material.

In the normal conduct of operations, there are other pending claims by and against the Company. Litigation is subject to many uncertainties, and the outcome of individual matters is not predictable with assurance. In the opinion of management, based on the advice and information provided by its legal counsel, the final determination of these other litigations will not materially affect the Company's financial position or results of operations.

17. Commitments

The Company had until December 31, 2012 to incur $10,000,000 of qualifying flow-through expenditures related to flow-through shares issued in June 2011. The flow-through commitment was fully spent as at December 31, 2012.

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

2013	$	244,745
2014	$	241,277
2015	$	241,277

18. Supplemental Disclosure

Yangarra's statement of comprehensive income is prepared primarily by nature of expense, with the exception of employee compensation cost which is included in both operating and general and administrative expenses.

The following table details the amount of total employee compensation costs included in operating and general administration expense.

	2012	2011
Production	**$ 230,200**	$ 36,182
General and Administration	**641,657**	361,440
Total employee compensation costs	**$ 871,857**	$ 397,622